FINANCE ADVISORY COMMITTEE

December 17, 2002

Highlights

- *The JLBC Staff asked the FAC panel to opine on 2 alternative forecast scenarios for FY 2004: a "no growth" and a "slow growth" scenario.*
- *While the FAC panelists' forecast assessments varied, a majority of them generally supported a revenue forecast in the no to slow growth range.*
- *While most FAC members expected some recovery in the next year, no existing signs of an upturn were identified.*

The JLBC Staff convened the third and final Finance Advisory Committee (FAC) meeting for this year on December 17. The FAC is an 18-member panel of Arizona's leading economists from government, business, and academia. The panelists provide expert advice to the JLBC Staff regarding the U.S. and Arizona economy and General Fund revenues. Although the outlook for the economy and state revenues varied among the panelists, the general mood was one of considerable caution. While the FAC members generally expected some economic recovery, they also acknowledged a greater degree of uncertainty than just a few months ago. The possibility of a war with Iraq and further terrorist attacks on American soil were some of the reasons for an increased risk assessment.

Staff Presentation

Richard Stavneak, JLBC Staff Director, began the staff presentation by asking the panel to identify any existing signs of an economic recovery, if any, and what these indicators may suggest regarding the strength of the recovery. Mr. Stavneak explained that the JLBC Staff had developed 2 forecast scenarios for FY 2004: (1) a "no growth" scenario with baseline revenues growing by 0.2% and (2) a "slow growth" scenario with a 2.5% growth rate. Mr. Stavneak also noted an apparent disconnect between the economy and revenues in the sense that state revenues are faring worse than general economic indicators would suggest. The Staff economists then described the status of each of the major tax categories.

<u>Sales Tax</u>

- Brian Schmitz noted that sales tax collections, year to date, were up by 0.8%. He attributed the flat growth rate to the following: (1) consumers are spending less on big-ticket items, (2) retail sales this holiday season are concentrated at discount stores rather than department stores, and (3) a hoped-for rebound from last year's weak post-September 11th sales has not materialized. The JLBC Staff expects a continued slow growth in FY 2003 of 0.7%. For FY 2004, the "no growth" scenario calls for a forecast of 0.7%, whereas the "slow growth" scenario calls for a forecast of 2.5%.

<u>Individual Income Tax</u>

- Hans Olofsson informed the panel that although individual income tax collections are declining at a slower rate than last year, revenues are still down by 4%, year to date. It was noted that it would be difficult for revenues to return to their pre-recession levels until manufacturing employment rebounds. The JLBC Staff projects that tax revenues will decline by (3.7)% in FY 2003. For FY 2004, under the "no growth" scenario, revenues are expected to decline by (1.1)%, and under the "slow growth" scenario to grow by 2.6%.

<u>Corporate Income Tax</u>

- Tom Mikesell cautioned that a more than 20% decline in September electronic corporate income tax transfers in the last 2 years was a cause for concern. Under Arizona law only companies with a tax liability in excess of $20,000 have to make their estimated payments by electronic fund transfers. The fact that tax payments by large filers are falling so rapidly may not bode well for the future. Another concern is the large credit carry forward, which in tax year 2000 reached a record-high amount of $350 million. However, it was also pointed out that it is unlikely that the entire amount will be claimed in future years since most tax credits are non-refundable. The JLBC Staff forecasts that corporate income tax revenues will decline by (19.8)% in FY 2003. For FY 2004, the "no growth" scenario calls for a decline of (2.3)%, while the "slow growth" scenario calls for a 2.0% growth.

National Outlook

The outlook for the U.S. economy was given by Elliott Pollack, of Elliott D. Pollack & Company. Mr. Pollack's assessment of the economy had not changed markedly since the last FAC meeting in September. In the absence of any pent-up consumer demand, he argued that a modest recovery is all that we can expect in the near term for the national economy. A combination of record low interest rates and consumer borrowing has kept the auto and housing sectors largely insulated from the recession. These two sectors of the economy are typically the first ones to lead in a recovery. The prospect of rising interest rates may also moderate the recovery. He also speculated that only a shock, such as a protracted war in Iraq, could throw the economy back into a recession. Mr. Pollack concurred with the FY 2003 JLBC Staff forecast but noted that for FY 2004 he was slightly more optimistic than the "slow growth" scenario.

State Outlook

Tracy Clark, of the Arizona State University, presented the outlook for the Arizona economy. Mr. Clark noted that despite job losses, the state's population was still growing at a healthy rate. Population growth typically lags employment growth. He also noted that the actual loss of manufacturing jobs is understated due to the increased use of outsourcing. Jobs, such as business and computer consulting, which were previously listed under manufacturing employment are now classified as business services.

According to Mr. Clark, the only bright spot on the horizon currently is a slight increase in the sales of servers and laptop computers to businesses. He speculated that this may indicate that companies are now starting to replace existing equipment in an effort to enhance their productivity.

Mr. Clark attributed the large decline in individual income tax collections last year to a 26% decrease in the numbers of tax filers with an income of $1,000,000 or more. Since these individuals pay a disproportionately large share of the state's total tax liability, the impact on the General Fund is significant. For the individual and corporate income tax forecasts, Mr. Clark recommended the "no growth" scenario, whereas for the sales tax forecast he favored the "slow growth" scenario.

Marshall Vest, of the University of Arizona, analyzed the state's employment picture. Mr. Vest had a more optimistic outlook on the economy than the two previous panelists. For example, he noted that the unemployment rate was much lower this time than in the 1990-91 recession. Mr. Vest believes that the national recession ended in December 2001 and that it is only the current anemic growth rate that causes us to feel as though we are still in a recession. He speculated that now would be a good time for companies to hire people with skills as labor shortages could become a problem in a year from now. Mr. Vest considered the JLBC Staff forecasts too pessimistic. However, he also added that while his economic outlook was more optimistic, he would still advise policymakers to use a cautious approach when adopting the FY 2004 budget revenue forecast.

Hank Reardon, of H.C. Reardon Economics, opined that the economic conditions are now in place for a national recovery, of which Arizona would be a part. Specifically, Mr. Reardon pointed out that personal income only declined in the fourth quarter of 2001 but has been growing ever since. Mr. Reardon's revenue outlook was slightly more optimistic than the "slow growth" scenario.

Brian Cary, of Pinnacle West Energy Corporation, commented that there are currently few tangible signs of a recovery. He expressed some concerns that a war with Iraq could push up long-term interest rates as a result of rising oil prices.

Georganna Meyer, of the Department of Revenue, pointed out that while a federal tax cut may stimulate the economy, it could potentially end up hurting state income tax collections. The impact on state revenues depends on which tax provisions are adopted. For example, if the Congress were to eliminate the double-taxation of dividends and double the maximum amount that can be claimed for capital losses, as proposed, the federal adjusted gross income would decline, which in turn would lower state income tax liability. (Under state law, Arizona adjusted gross income is based on federal adjusted gross income.) For revenue forecasting purposes, Ms. Meyer would give more weight to the no growth scenario.

Attendance at this meeting of the FAC numbered 40.

Prepared by Hans Olofsson, Senior Economist.