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FINANCE ADVISORY COMMITTEE  
SEPTEMBER 26, 2002

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**Highlights**

- FY 2002 was Arizona's worst revenue year in over 10 years, with each of the Big 3 tax categories (sales, individual income, and corporate income) experiencing near historic declines.
- The JLBC Staff asked the committee for its input on an FY 2003 forecast that shows a slight decline in revenues and an FY 2004 forecast of slow growth.
- FAC panelists expect the state's economy to stage a slow and protracted recovery. The majority thought that the Staff forecast was appropriately cautious, but a few panel members thought the recovery could be faster than expected.

Reeling from the worst revenue year in decades, and bracing for still deeper budget cuts in FY 2003, the attention of Arizona state government is now focused on the budget. Dismal revenue growth over the past year has resulted in several downward revisions to state spending. With this backdrop, the JLBC Staff convened a meeting of the Finance Advisory Committee (FAC) on September 26th. The FAC is an 18-member panel of Arizona's leading economists from government, business, and academic settings that meets several times a year to provide expert advice on economic conditions and the revenue forecast. While panelists expressed mixed opinions on when an economic recovery will begin, the majority of FAC members expect the recovery to be slow and protracted. They generally concurred with the JLBC Staff forecast due to various uncertainties in the economy.

**Staff Presentation**

The JLBC Staff opened the meeting with a presentation on the state revenue outlook ([see attachment](#)). Richard Stavneak explained the probability associated with the preliminary Staff revenue forecast. These initial estimates were built around the concept of being 80% certain that revenues will meet or exceed the forecast. The Staff economists then described the status of each of the major tax categories.

- Brian Schmitz highlighted the steep decline in sales tax collection growth rates over the past 2 years. After peaking at 9.8% in FY 2000, sales tax growth slowed to 5.5% in FY 2001 before slumping to just 0.6% in FY 2002. In fact, last year's growth of 0.6% would have been a decline of (0.3)% were it not for technical reasons. Sales tax collections have been hit particularly hard by slowdowns in tourism and in sales of general merchandise. On the other hand, retail sales activity has been buoyed by low interest rates, which have made big-ticket items such as houses and vehicles more affordable. The JLBC Staff forecast calls for continued slow growth in FY 2003 of 0.8%, with a modest rebound to 3.0% growth in FY 2004.
- Hans Olofsson described last year's record decline in individual income tax receipts, which dropped by (9.3)%. Much of this decrease is attributable to an estimated (40)% fall in Arizona capital gains. In addition, withholding tax payments have declined faster than employment due to higher than average declines in high-paying

manufacturing jobs. The JLBC Staff projects a (2.0)% decline in FY 2003 and a small uptick to 4.0% in FY 2004.

- Tom Mikesell highlighted the plunging corporate income tax, which fell by (36.0)% in FY 2002, the largest percent drop in over 10 years. Part of this decline may be due to the recent corporate accounting scandals, which may have caused firms to report lower corporate profits. General economic weakness has also taken a toll on Arizona businesses. The JLBC Staff forecast for corporate income taxes expects a decrease of (1.8)% in FY 2003 followed by an increase of 5.9% in FY 2004.
- Tim Everill wrapped up the Staff presentation with a graph depicting baseline and adjusted revenue growth rates since the last recession in FY 1991. Last year's decrease in baseline revenues of (6.1)%, prior to nearly \$500 million in one-time fund transfers, was easily Arizona's worst revenue year in a decade.

**National Outlook**

The outlook for the U.S. economy was given by Elliott Pollack, of Elliott D. Pollack & Company. Asserting that the national recession is probably already over but that recovery is proceeding at a crawl, he suggested that slow growth is the most likely scenario for the near future. There are some economic indicators that bode favorably for future growth, but other indicators suggest continued economic sluggishness. The good news is that mortgage rates are at historic lows, making home ownership affordable, motor vehicle sales remain healthy and the federal government has carried out fiscal policy in textbook fashion by increasing spending and cutting taxes during the recession. The bad news is that unemployment is rising, the stock market continues to languish, and consumer confidence is waning. Moreover, the current high levels of housing and auto sales mean that there is not much pent-up demand left to fuel a recovery. Pollack concluded his presentation by opining that the JLBC Staff forecast is justifiably conservative.

## State Outlook

Brian Cary, of Pinnacle West Energy Corporation, presented the outlook for the Arizona economy. Drawing parallels between the current recession and previous recessions, he forecasts that the state economy will begin to show signs of a slow recovery by the end of 2002. However, the job market in Arizona is the worst in 20 years, and over the next 12-18 months this could result in migrations of job seekers from Arizona to southern California. Reductions in state government spending to balance the budget will also hinder the recovery. Cary thinks retail sales have bottomed out and will soon start to increase but cautioned that the resumption of growth will be modest. He predicts that several key economic indicators, including employment, personal income, and retail sales, will register relatively small increases in FY 2003, before showing higher growth in FY 2004.

Don Wehbey, of the Department of Economic Security, analyzed the state's employment picture. Cautioning that employment projections are not rosy, he pointed out that businesses are reluctant to make capital investments. Until profitability is restored, companies will not want to hire new workers. Cyclical job losses are not over, Wehbey predicted, and manufacturing job growth is expected to stay flat. The health services and retail sectors will add jobs in 2003. Some laid-off workers are finding employment as consultants.

Marshall Vest, of the University of Arizona, commented that federal government spending has propped up the economy.

Otherwise, the wobbly recovery may not have been able to stand on its own.

Tracy Clark, of Arizona State University, warned that the preponderance of risks to the forecast is on the downside rather than the upside. Specifically, a war with Iraq could hurt our economy. With the weakness in the stock market, Clark doesn't expect much recovery in the individual income tax. He generally concurred with the JLBC Staff forecast.

Debra Roubik, of VisionEcon, offered a more optimistic view of the state's economy. She reminded panelists of Arizona's favorable business climate, as the state still boasts cheap land and low wages. Being a low cost state is attractive to businesses seeking to locate here. Roubik encouraged panelists to consider Arizona's advantages in their forecasts, rather than being overwhelmed by present economic doldrums.

Hank Reardon, of H.C. Reardon Economics, also characterized his outlook as being slightly more optimistic than some other panelists.

Georganna Meyer, of the Department of Revenue, advised the FAC that numerous corporate income tax credits are being taken this year. She also pointed out the practical implications of state budget cuts, saying that her agency has not had the temporary workers who normally process tax returns.

Attendance at this meeting of the FAC numbered 50.