

FINANCE ADVISORY COMMITTEE

February 14, 2002

Highlights

- *FAC panelists agreed that the national economic recession should end within a couple months, but admonished that the recovery will be modest.*
- *The Arizona economy has been hit harder by the recession than most states, as a result of our reliance on the tourism and technology sectors.*
- *Tax revenues are expected to grow slowly over the next year.*

In the midst of an 11-month long national recession, the JLBC Staff convened a Valentine's Day meeting of the Finance Advisory Committee (FAC). The state's top economists delivered a prediction of continued slow revenue growth expected to last at least another year. The FAC is a 16-member panel of the state'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. Panelists cautioned that the recession may last a few more months and that the ensuing economic recovery is likely to be modest.

Staff Presentation

The JLBC Staff began the meeting with a presentation on the state revenue outlook (see attachment). Richard Stavneak explained that FY 2002 base revenues have been augmented by \$408 million in one-time revenues (such as the Budget Stabilization Fund and other fund transfers). The FY 2003 base revenue figure is 4.6% larger than the FY 2002 base number, yet total revenues in FY 2003 are \$(138) million less than in FY 2002 due to the one-time revenues. The Staff economists then described the status of the major tax categories.

- Brian Schmitz explained that sales tax revenue growth declined by (1.2)% in the second quarter of FY 2002. For the fiscal year-to-date, sales tax collections are (0.5)% behind last year's pace. One of the causes of this decline is the steep fall experienced in use tax collections, which have nose-dived by (25.5)% so far this fiscal year. It is speculated that the weak use tax performance

is partly attributable to low natural gas prices, which have reduced tax payments by utilities. Another area of concern is in retail sales, where pent-up consumer demand seems limited and insufficient to propel an economic recovery. Finally, in comparison to the Arizona Blue Chip "consensus" forecast and an FAC "consensus" forecast, the JLBC Staff projections for retail sales in FY 2003 and FY 2004 are lower. The consensus estimates represent the numeric average of the forecasts.

- Hans Olofsson highlighted the weak growth in wage withholding, which has only increased by 1.3% in FY 2002. This trend is expected to continue, as bonus payments and stock options are unlikely to provide much of a boost to income tax collections in the near future. Anticipating a decline in capital gains due to the faltering stock market, the revenue forecast includes a projected \$(100) million decline in FY 2002 for refunds and estimated and final payments. The Staff's personal income forecast for FY 2003 and FY 2004 is more conservative than that of the Arizona Blue Chip and the FAC consensus.
- Tom Mikesell described corporate income tax collections, which have plummeted by (45.0)% through the first half of FY 2002. The rate of decline is forecasted to slow in the second half of the fiscal year, due to a lower base in the same period of the previous fiscal year. For most of the last decade, Arizona corporate income tax receipts outpaced U.S. corporate profits. However, the relationship has reversed itself in recent

years, as corporate income tax payments have dried up to a greater extent than have profits.

National Outlook

Elliott Pollack, of Elliott D. Pollack & Company, gave the outlook for the national economy. Titled his presentation “Modest Recession, Modest Recovery,” he outlined the conditions that bode well for the U.S. economy and also those that suggest continued weakness. The good news is that mortgage rates are quite low, inflation is under control, and productivity growth is better than in a typical recession. On the other hand, consumer debt levels are high (though they have recently improved a bit), the unemployment rate has risen to 5.6%, and information technology spending has fallen to its lowest level (in terms of percent change) since 1970. Unlike in typical recessions, auto and truck sales have boomed of late, due to generous financing incentives offered by automakers. This leaves many economists wondering whether car sales are due for a slowdown. Pollack concluded by asserting that the long-term outlook for the economy remains good, despite the current recession.

State Outlook

Marshall Vest, of the University of Arizona, made the next presentation, focusing on a number of economic indicators, many of which are dismal. Unemployment has been on the rise in Arizona, the tourism industry has taken a blow, restaurant sales have declined, and bankruptcies are at the highest level in a decade. Consumers have shifted away from high-end retailers toward discount stores. The recession is not over yet, and it may persist until the second quarter of this calendar year. Vest and Pollack both agreed that the recession has hit Arizona harder than most states, due to our reliance on the tourism and technology sectors.

Tracy Clark, of Arizona State University, also analyzed the state economy. He agreed that the recession would probably end in March or April, and pointed out that job growth will trail behind the onset of the recovery by several months. Businesses will not want to hire new employees until profitability has been restored. He also called attention to the robust housing market,

explaining that individuals are increasingly choosing to invest in their home rather than in the sluggish stock market. Clark expects retail sales to remain muted for the next year or so. With respect to corporate profits, he predicts that businesses will see their bottom lines improve, but not to the same extent as in the late 1990’s.

Professor Wally Duncan, of Northern Arizona University, foresees a weak economic recovery and expects the Federal Reserve Bank to keep interest rates at their current low level. In fact, economic conditions may cause the Fed to reduce rates again.

Pete Ewen, of Arizona Public Service, whose outlook was somewhat more optimistic than that of other panelists, forecasts that the tourism industry may rebound next year. Former longtime JLBC Staff economist Hank Reardon commented that this revenue decline seems more severe than what the state experienced in previous recessions. It was suggested that this could be due to the short span of time in which the economy went from rapid growth to no growth.

Attendance at this meeting of the FAC numbered 51, including 7 state Legislators.

Prepared by: Brian Schmitz, Senior Economist

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