

ARIZONA
MONTHLY FISCAL HIGHLIGHTS
May 2005

Summary

May General Fund revenue collections were \$663.5 million, which was an increase of 30.7% above May 2004. May collections are \$99.5 million above the forecast for the month from the recently enacted state budget. Combined with the April variance, we are now a total of \$252.1 million above the forecast.

Most of this gain was again due to increased individual income tax collections in May compared to a year ago. While May is not as large a collection month as April, May individual income tax collections were almost 70% above last year. As we saw last month, final payments associated with the 2004 tax year filing remained especially strong.

Along with real estate and stock market capital gains, increased small business profitability is thought to be a driving factor in this recent growth. The greater role of small businesses in individual income tax collections is discussed in more detail on page 7 of this issue. If small businesses are experiencing the same growth as corporations, they could account for 48% of the increase in final payments over the last 2 months.

The 2 other largest revenue categories, corporate income tax and sales tax, also grew significantly. As with individual taxes, May is a smaller month for corporate collections. Nonetheless, the \$68 million in May receipts was 79% higher than last year. Sales tax collections grew by 13.8% in May. The contracting sector of sales tax was once again particularly strong, and was up 22.5% over last year.

While General Fund revenues are running substantially ahead of forecast, this does not mean necessarily that there will be surplus revenues from the perspective of future budgets. As enacted, the FY 2006 budget had only a small surplus. With the recent April/May revenue surge, those extra monies will carry over into the next fiscal year and could result in a FY 2006 ending balance of \$250 million. Revenue collections during the course of FY2006 could also exceed the forecast, but those monies are already statutorily dedicated to the Budget Stabilization Fund.

In developing a FY 2007 General Fund budget, the State will first need to replace \$345 million in one-time monies used to balance the FY 2006 budget. As a result, any FY 2006 "surplus" will first go for this purpose. As FY 2006 progresses, we will need to monitor revenue collections and possible supplementals so as to refine our FY 2007 estimates further.

The May Monthly Fiscal Highlights also includes a summary of recent reports submitted to the JLBC and a summary of the June 28th JLBC meeting. The recent reports included:

- An update on a corrective action plan at the Arizona State Hospital to address deficiencies uncovered by a federal audit. Through the end of May, DHS has expended 60% of their supplemental appropriation.
- The Department of Revenue's report on their Revenue Generating Program, which is running \$20 million behind projections through March.
- The Arizona Department of Education's projected surplus estimate of \$35 million for FY 2005, which has already been factored into the budget.

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JLBC

MAY REVENUES

Sales Tax revenue increased by 13.8% on a year-over-year basis in May and was \$12.3 million above the forecast for the month. Year-to-date collections are 10.6% over last fiscal year. The following is based on year-to-date collections through May:

- Retail sales tax receipts have increased by 9.0%.
- Contracting continues to exhibit the large increases begun last year, with a year-to-date increase of 19.8%.
- Restaurants and bars collections are up 9.8%.
- Use tax receipts (all of which are retained by the state) are up 12.7%.

Individual Income Tax collections for May were 69.4% above last year, due largely to growth in final payments from the April 15th tax filings. The May results were comparable to April's 57.4% growth over the prior year. This strong showing may be a combination of real estate capital gains, stock market profits, and increased small business profitability. The role of small business in individual income tax actions is discussed in more detail at the end of this report.

It is also believed that the large surge in tax payments can be partially attributed to other factors, such as the state's decoupling of the federal bonus depreciation provision that expired last year, increases in year-end bonuses by employers, and Microsoft's \$32 billion one-time dividend distribution in December 2004.

In other individual categories, withholding tax was up 12.7% and refunds were (7.1)% less than May of last year. Overall, May collections were \$59.0 million above forecast.

In terms of total liability (withholding, payments, refunds), individual income tax collections are up 30.2% for the fiscal year to date.

Corporate Income Tax revenue of \$68.0 million was 79.1% over May 2004 collections. While May is not a large collection month, this increase was \$26.4 million over the forecast for the month. Year-to-date corporate collections are 49.8% over the previous year.

The General Fund portion of **Luxury Tax** collections for May was 9.7% greater than last May, increasing the year-to-date total to 2.9% over the first 11 months of last year. The liquor categories of the luxury tax increased by 11.9% compared to May of last year. The tobacco tax component was up by 8.1% for the month. Year-to-date, tobacco tax collections are up 3.7% over the prior year.

It also believed that the large surge in tax payments can be attributed to other factors, such as the state's decoupling of the federal bonus depreciation provision that expired last year, increases in year-end bonuses by employers, and Microsoft's \$32 billion one-time dividend distribution in December 2004.

Table 1

General Fund Revenues
Compared to Adopted Forecast and FY 2004 Collections
(\$ in Millions)

	<u>FY 2005 Collections</u>	<u>Difference From May 2004 Forecast</u> ^{1/}	<u>Difference From May 2005 Forecast</u> ^{2/}	<u>Difference From FY 2004</u>
April	\$ 1,015.9	\$ 189.5	\$ 160.8	\$ 255.1
Year-to Date	\$ 6,336.0	\$ 602.5	\$ 160.8	\$ 1,004.9 ^{3/}

1/ Originally enacted FY 2005 budget (May 2004).

2/ May 2005 Enacted Budget.

3/ Including the receipt of \$87.2 million federal cash assistance grant in October, 2003.

State of Arizona

General Fund Revenue: Change from Previous Year and May Forecast

May 2005

	Current Month					FY 2005 YTD (Eleven Months)				
	Actual May 2005	Change From				Actual May 2005	Change from			
		May 2004		Revised Forecast			May 2004		Revised Forecast	
		Amount	Percent	Amount	Percent		Amount	Percent	Amount	Percent
<u>Taxes</u>										
Sales and Use	\$315,664,510	\$38,295,266	13.8 %	\$12,304,983	4.1 %	\$3,329,166,186	\$320,406,251	10.6 %	\$17,430,683	0.5 %
Income - Individual	229,122,033	93,843,969	69.4	58,955,367	34.6	2,691,036,902	624,344,577	30.2	225,006,268	9.1
- Corporate	68,048,720	30,050,203	79.1	26,372,601	63.3	604,455,760	200,981,199	49.8	17,411,198	3.0
Property	5,286,836	(916,386)	(14.8)	1,136,506	27.4	22,029,510	(8,054,770)	(26.8)	1,288,085	6.2
Luxury	5,846,293	518,055	9.7	12,872	0.2	57,894,764	1,627,572	2.9	(1,076,953)	(1.8)
Insurance Premium	31,506,259	4,865,466	18.3	0	0.0	293,731,183	44,838,393	18.0	(1)	(0.0)
Estate	1,626,355	(2,887,501)	(64.0)	(398,645)	(19.7)	29,933,699	(6,753,090)	(18.4)	(1,099,406)	(3.5)
Other Taxes	48,154	282	0.6	(51,846)	(51.8)	2,532,078	(202,927)	(7.4)	(51,959)	(2.0)
Sub-Total Taxes	\$657,149,160	\$163,769,354	33.2 %	\$98,331,838	17.6 %	\$7,030,780,082	\$1,177,187,205	20.1 %	\$258,907,915	3.8 %
<u>Other Revenue</u>										
Lottery	3,140,400	3,140,400	--	40,400	1.3	27,411,600	(3,588,400)	(11.6)	(1,116,800)	(3.9)
License, Fees and Permits	2,381,686	684,403	40.3	(18,230)	(0.8)	26,193,918	3,208,208	14.0	(356,736)	(1.3)
Interest	3,046,735	1,702,919	126.7	2,818,559	--	22,485,198	(913,286)	(3.9)	5,329,391	31.1
Sales and Services	3,464,094	(5,041)	(0.1)	(2,020,101)	(36.8)	39,580,858	(3,604,313)	(8.3)	(3,404,482)	(7.9)
Other Miscellaneous	3,145,233	(2,759,871)	(46.7)	259,079	9.0	20,015,696	(19,267,689)	(49.0)	(3,360,399)	(14.4)
Disproportionate Share	0	0	--	0	--	0	(5,625,187)	(100.0)	0	--
Transfers and Reimbursements	1,188,862	1,030,270	649.6	112,662	10.5	37,230,847	(64,449,162)	(63.4)	(3,871,656)	(9.4)
Sub-Total Other Revenue	16,367,010	3,793,080	30.2 %	1,192,369	7.9 %	172,918,117	(94,239,829)	(35.3) %	(6,780,682)	(3.8) %
TOTAL BASE REVENUE	\$673,516,170	\$167,562,434	33.1 %	\$99,524,207	17.3 %	\$7,203,698,199	\$1,082,947,376	17.7 %	\$252,127,233	3.6 %
<u>One-Time Revenue</u>										
Urban Revenue Sharing	(31,089,382)	(667,285)	2.2	0	0.0	(341,983,197)	(7,340,130)	2.2	0	0.0
Budget Balancing Transfers	15,493,300	15,493,300	--	0	0.0	15,493,300	15,493,300	--	0	0.0
VLT Transfer	5,500,888	5,500,888	--	0	0.0	117,825,282	117,825,282	--	0	0.0
Tax Amnesty	0	(32,043,121)	(100.0)	0	--	0	(47,123,527)	(100.0)	0	--
Judicial Enhancement	87,000	87,000	--	0	0.0	2,496,600	(2,892,700)	(53.7)	0	0.0
Sub-Total Transfers In	(10,008,194)	(11,629,218)	-- %	0	0.0 %	(206,168,015)	75,962,225	(26.9) %	0	0.0 %
TOTAL REVENUE	\$663,507,976	\$155,933,216	30.7 %	\$99,524,207	17.6 %	\$6,997,530,184	\$1,158,909,601	19.8 %	\$252,127,233	3.7 %

VP% = Percent change from comparable period in prior year

VF% = Variance from forecast

F% = Forecast percent change for the fiscal year.

R% = Average percent change from comparable period in prior year which must be attained over remaining months to realize the forecast for year.

RECENT ECONOMIC INDICATORS

The nation's economic indicators produced mixed results in May. The **U.S. Index of Leading Economic Indicators** decreased (0.5)% from the prior month. Although the stock prices component made a positive contribution, the remaining indicators were negative. However, consumer sentiment rebounded in May. The Conference Board's **Consumer Confidence Index** jumped 4.8% from April's reading, bolstered by an improving job market and better expectations for the economy's short-term outlook.

The Semiconductor Industry Association's latest forecast, which was released in early June, predicted worldwide sales would grow by 6% in 2005 and by a compound annual growth rate of 9.8% through 2008. The previous forecast from November 2004 expected sales to be flat this year. While the forecast is positive for all regional markets, Asia is anticipated to have the fastest growth. Domestically, **U.S. semiconductor billings** (three-month moving average) dipped (0.7)% in April but remained 1.1% above the level from a year ago.

The **U.S. Consumer Price Index (CPI)** declined (0.1)% in May as gasoline prices eased from record levels. The index's three-month moving average increased 0.4% and stood 3.2% higher than a year ago. Excluding food and energy prices, the core CPI increased 0.1% in May.

Arizona's job market showed steady improvement. Statewide **non-farm employment** advanced 3.9% during the last 12 months, a net gain of 92,300 jobs, with the goods-producing sectors – manufacturing, mining and construction – all reporting increases. The unemployment rate dropped (0.2)% to 4.8% in May.

Arizona personal income reflected the strength in the regional economy, with a year-over-year increase of 8.5% posted in 2005's first quarter. The state's 1.4% growth from the previous quarter ranked 7th in the nation.

The **Arizona Business Conditions Index**, derived from a statewide survey of supply-chain managers, declined (5.8)% in May. However, the latest reading of 62.8 remained well above the level (50) associated with a growing economy.

The number of TANF recipients decreased to 99,430 in April, a (1.6)% decline from March and a (15.0)% drop from April 2004. The **AHCCCS caseload** increased in April. Enrollment was 0.6%, or 4,485 more than March and stood 11.8% above the level from one year ago.

The **Department of Corrections' inmate population** increased by an average of 85 inmates per month from March through May. The total population increased by 791 inmates from a year ago.

Table 3

RECENT ECONOMIC INDICATORS

<u>Indicator</u>	<u>Time Period</u>	<u>Current Value</u>	<u>Change From Prior Period</u>	<u>Change From Prior Year</u>
Arizona				
- Unemployment Rate	May	4.8%	(0.2)%	(0.3)%
- Jobs	May	2.47 million	0.1%	3.9%
- Contracting Tax Receipts (3-month average)	Mar-May	\$59.6 million	6.1%	23.2%
- Retail Sales Tax Receipts (3-month average)	Mar-May	\$147.5 million	(2.9)%	10.6%
- Residential Building Permits - (3-month moving average)				
Single-unit	Feb-Apr	6,574	8.6%	4.4%
Multi-unit	Feb-Apr	1,206	33.6%	31.2%
- Arizona Tourism Barometer	January	100.7	1.4%	6.4%
- Phoenix Sky Harbor Air Passengers	April	3.64 million	(4.1)%	9.0%
- Arizona Average Natural Gas Price (\$ per thousand cubic feet)	March	\$6.05	(2.1)%	13.1%
- Leading Indicators Index	April	119.7	(0.8)%	0.7%
- Business Conditions Index (>50 signifies expansion)	May	62.8	(5.8)%	(2.3)%
- Consumer Confidence Index	2 nd Quarter 2005	97.4	(6.6)%	8.1%
- Business Leaders Confidence Index	2 nd Quarter 2005	62.8	0.8%	(7.2)%
- Arizona Personal Income	1 st Quarter 2005	\$172.5 billion	1.4%	8.5%
- Arizona Population	July 1, 2004	5.74 million	3.0%	3.0%
- AHCCCS Recipients	April	816,141	0.6%	11.8%
- TANF Recipients	April	99,430	(1.6)%	(15.0)%
- DOC Inmate Growth (3-month average)	Mar-May	32,621	85 inmates	791 inmates
United States				
Gross Domestic Product	1 st Quarter 2005	\$11.1 trillion	3.5%	3.7%
- (seasonally adjusted annual growth rate)				
- Consumer Confidence Index	May	102.2	4.8%	9.8%
- Leading Indicators Index	May	114.1	(0.5)%	(1.9)%
- U.S. Semiconductor Billings -(3-month moving average)	Feb-Apr	\$3.3 billion	(0.7)%	1.1%
- Consumer Price Index - (3-month moving average)	Mar-May	194.1	0.4%	3.2%

SUMMARY OF RECENT AGENCY REPORTS

Corporation Commission - Report on Corporations Division Filings – Pursuant to Laws 2005, Chapter 4, the Corporation Commission was appropriated \$456,206 as a FY 2005 supplemental and is required to report monthly on the total number of filings received by the Corporations Division, the total number of filings processed by the Corporations Division, and the amount of time to process the filings. The commission submitted its 2nd report on June 8, 2005.

Between March 25, 2005 and May 31, 2005, a total of 18,547 filings were received by the Corporations Division, and 22,853 were processed. Over the same time period, the amount of time required to process the filings fell from an average of 63 days to 31 days for expedited filings and an average of 164 days to 142 days for regular filings.

The commission submitted a plan to resolve the filings backlog along with its 1st report on May 6, 2005. The plan consists of:

- Using the supplemental funds for overtime and temporary staff rather than new staff, until they had clear direction from the Legislature for hiring new staff in FY 2006. The Legislature subsequently approved this FY 2006 funding.
- The implementation of the Initial Processing System (IPS) – IPS involves bar coding and scanning every LLC filing so that an electronic copy of the file is made. This creates efficiencies both during the processing of the document and for inquiries made after the document has been processed.
- Re-deploying staff who worked on the name availability phone line to examine filings instead.
- Beginning development of E-government for services such as filing LLC articles of organization online.

Economic Estimates Commission - Report on the Budget Stabilization Fund – Pursuant to A.R.S. § 35-144(F), the Economic Estimates Commission (EEC) is annually required to calculate the amount of monies that may be deposited to or withdrawn from the Budget Stabilization Fund (BSF). The EEC estimate is calculated using a formula based on historical Arizona personal income growth and the Gross Domestic Product (GDP) deflator. On May 20, 2005, the EEC reported that the formula would have called for a \$56.8 million deposit into the BSF in FY 2005. Statute does not automatically appropriate this amount to the BSF but rather allows the Legislature to include the amount in that year's General Appropriation Act.

The FY 2005 budget did not include an appropriation of these monies into the BSF. However, as part of the 2004 General Appropriation Act, the Legislature adopted certain conditional FY 2005 appropriations (otherwise known as "triggers") that would be enacted if revenues exceeded the budgeted forecast for FY 2004 and the first 6 months of FY 2005. These triggers resulted in a total deposit of \$156.5 million to the BSF in FY 2005.

Arizona Department of Education - Update on Projected Surplus for FY 2005 – Pursuant to A.R.S. § 35-131(D), the Arizona Department of Education (ADE) recently submitted an updated estimate of its projected FY 2005 surplus. As of June 14, 2005, ADE projects that it will have a \$35,084,900 surplus for FY 2005. This amount is \$(6,849,600) less than its most recent prior estimate dated March 15, 2005.

ADE's FY 2006 appropriation includes a \$(41,851,700) base adjustment for a projected FY 2005 surplus. This amount is \$(6,766,800) more than ADE's current surplus estimate. ADE's June and March estimates, however, both reflect a \$(10,000,000) transfer of surplus FY 2005 monies from the Homeowner's Rebate program to Achievement Testing for expanded AIMS tutoring for FY 2005. Most of those transferred monies now are expected to revert, however, which could increase the final surplus to an amount higher than the assumed \$(41,851,700) FY 2006 base adjustment.

ADE's current FY 2005 surplus estimate includes a \$29,583,800 surplus for Basic State Aid, a \$6,851,700 surplus for the Homeowner's Rebate (not including the \$10,000,000 in transferred AIMS tutoring monies), and a \$(1,823,100) shortfall for Achievement Testing (again not including transferred monies). The remaining surplus of \$472,500 is for other miscellaneous programs. The department's June 14th report does not indicate how it plans to address the projected \$(1,832,100) shortfall for Achievement Testing for FY 2005.

Department of Health Services - Report on Arizona State Hospital Corrective Action Plan – Pursuant to Laws 2005, Chapter 5, the Department of Health Services (DHS) has submitted a report on the status of the State Hospital's Corrective Action Plan. The State Hospital's Corrective Action Plan was instituted in order to address deficiencies cited by the federal government in the Hospital's operation. Supplemental funding was added in order to assist hiring and retaining nurses and other staff, to pay for increased drug costs as well as to make improvements to the facility.

According to the report, the department has expended \$771,200, or 60% of the FY 2005 supplemental funding amount of \$1,281,400, as of May 31. The Hospital has hired 5 Registered Nurses and expects to hire 3 additional Registered Nurses that will start in June. Additionally, the Hospital has hired one Social Worker that will start on May 31 and is in the process of interviewing for additional Social Workers. Three Recreational Therapists have been hired and will begin work in June and the process of interviewing for a fourth Recreational Therapist and a Psychologist II position. Maintenance contracts for housekeeping and other facility maintenance are in effect and the Hospital has recently awarded the contract to repair the mall concrete surface. *Table 4* below updates the progress of the State Hospital's Corrective Action Plan.

Table 4

**Arizona State Hospital
Status of FY 2005 Corrective Action Plan
As of May 31, 2005**

<u>Action Plan Initiative</u>	<u>FY 2005 Plan</u>	<u>Current Expenditures</u>	<u>Funding Yet to be Expended</u>
Fill Vacant RN Positions	\$487,400	\$181,000	\$306,400
Critical Positions to be Funded	55,900	--	55,900
Fund 4 Social Workers	37,600	--	37,600
Restore Maintenance Contracts	209,200	148,700	60,500
Repair Mall Concrete Surface	49,800	--	49,800
Increased Drug Costs	<u>441,500</u>	<u>41,500</u>	<u>--</u>
Total	\$1,281,400	\$771,200	\$510,200

Department of Revenue - Report on Revenue Generating Program – A footnote in the General Appropriation Act requires the Department of Revenue (DOR) to report quarterly to the Committee on the effectiveness of the revenue generating program and the department's overall enforcement and collections program, including a comparison of projected and actual revenue enforcement collections for FY 2005. The revenue generating program was expected to produce \$75.1 million of gross additional enforcement revenue, including a net increase of \$53.2 million to the State General Fund.

DOR has reported their General Fund enforcement revenue, which includes both their baseline and revenue generating program monies. They did not separate out the enforcement monies attributed to the revenue generating program. DOR had General Fund enforcement revenues of \$214.6 million through the 3rd quarter of FY 2005, which was \$(20) million below their goal of \$234.6 million. There were shortfalls of \$(24.8) million in collections, \$(1.3) million in transaction privilege tax audit and \$(1.1) million in accounts receivable, which DOR attributes in part to the conversion of the transaction privilege tax system to the Business Re-Engineering/Integrated Tax System (BRITS) in January 2004. DOR reports that the BRITS transaction privilege tax system is

still not fully functional, and that they continue to manually review all transaction privilege tax audit bills prior to mailing. The total shortfall of \$(20) million includes results which exceeded the goals by \$278,700 in corporate tax audit, \$760,000 in individual tax audit and \$6.3 million in license compliance. *Table 5* summarizes these results.

Arizona Department of Transportation - Report on Parker MVD Field Office – Laws 2004, Chapter 276 appropriated \$500,000 from the State Highway Fund to the Arizona Department of Transportation (ADOT) to relocate the Parker Motor Vehicle Division (MVD) field office. In October 2004, ADOT estimated a total cost of \$500,000, including a contingency set aside of \$39,000. All costs were ADOT estimates, with no contracts yet in place. ADOT reported that the new office is to be located on 3 acres leased from the Colorado River Indian Tribe. At its October 14, 2004 meeting, the Joint Committee on Capital Review gave a favorable review to the Parker MVD Field Office relocation with the provision that ADOT report back to the Committee with updated expenditure estimates once construction contracts had been signed.

On May 25, 2005 ADOT reported a total cost of \$540,100, citing \$54,900 of additional unanticipated costs not included in

Table 5

DOR's General Fund Enforcement Revenue Through the 3rd Quarter of FY 2005 (Net of Duplications)

	<u>FY 2005 Through 3/31/05</u>		
	<u>Goal</u>	<u>Actual</u>	<u>Over/(Under)</u>
Corporate Tax Audit	\$40,105,700	\$ 40,384,400	\$ 278,700
Individual Tax Audit	6,187,800	6,947,800	760,000
Transaction Privilege Tax Audit	11,835,500	10,516,600	(1,318,900)
License Compliance	9,075,300	15,349,300	6,274,000
Collections	140,503,500	115,690,500	(24,813,000)
Accounts Receivable ^{1/}	26,855,600	25,712,400	(1,143,200)
Total	\$234,563,400	\$214,601,000	\$(19,962,400)

1/ Taxpayer accounts paid before they would have been moved to Collections, which allows collectors to work on other accounts.

their October 2004 estimate. The \$54,900 includes \$49,000 to stabilize loose sandy soil at the site. ADOT reports that they are paying for the \$40,100 of expenditures which exceed the appropriation from MVD's operating budget. ADOT reports that the work will be done June 17, 2005 and the Parker MVD Field Office will be relocated June 20, 2005. Table 6 shows ADOT's 2 cost estimates.

Table 6**ADOT's Expenditure Estimates**

	<u>October 2004</u>	<u>June 2005</u>
Architectural & Engineering	\$ 12,000	\$ 38,000
Site Development	75,000	237,500
Utility Connection	50,000	5,900
Modular Building	216,000	232,900
Telecommunications	54,000	7,300
Furniture	54,000	18,500
Contingency	<u>39,000</u>	<u>0</u>
Total	\$500,000	\$540,100

OTHER ISSUES

Individual Income Taxes Paid By Business – Individual income tax collections for the April/May period increased almost 75% compared to the previous year. The large surge in individual income tax collections in the current fiscal year is not a phenomenon that is unique to Arizona. Reports from many other states show revenue collections far in excess of earlier projections, although Arizona's growth was one of the nation's highest.

The current lack of detailed Arizona income tax data makes it difficult to explain the April/May revenue growth with any certainty. Based on general economic trends, the JLBC Staff speculates that the large increase in income tax revenues is spurred by capital gains from real estate investments and stock market appreciation. Higher profitability of small businesses (which often pay individual rather than corporate income taxes) is another likely factor.

There has not been significant attention paid to the role of small businesses in individual income tax collections. According to the Internal Revenue Service (IRS), the majority of businesses operating in the U.S. are subject to individual rather than corporate income taxes. A business that is subject to individual income taxes is referred to as "pass-through entity" since its income (and thus resulting income tax liability) passes or flows through the business to the individual owners or members of that business. In other words, the business itself is not a tax-paying entity. Instead, the individual owners or members of that business include their pro rata share of the business net income (or loss) on their personal tax return.

Generally, all businesses except regular corporations are considered pass-through entities. In Arizona, a pass-through entity is either operating as a sole proprietorship, partnership, limited liability company (LLC), or a Subchapter S Corporation. These business structures differ legally most notably with respect to ownership restrictions, filing requirements, and personal liability for business debts and court judgments. For example, sole proprietors and general partners are personally liable for any debts incurred by their business, whereas members of limited liability companies and shareholders of S Corporations are not.

According to a recent report by the Council On State Taxation (COST), a national nonprofit trade association, individual income taxes paid by pass-through entities have increased significantly over the last two decades. For example, at the national level, COST estimates that the share of individual income tax liability attributable to pass-through business income has increased from 7.1% in 1980 to 13.1% in 2001.

The growing importance of pass-through business income relative to corporate net income is highlighted in COST's report. For example, in the period from 1980 to 2001, business income in the U.S. grew at an average annual rate of 8.8% for pass-through entities compared to 5.9% for regular corporations. For the nation as a whole, individual income taxes paid by pass-through entities represented about half of the amount of corporate income taxes paid by regular corporations in FY 2004.

The rapid formation of pass-through entities in Arizona is evidenced by statistics provided by the Arizona Corporation Commission (ACC). According to ACC, the number of new LLCs in the state has increased by 136% over the last 4 years. In the same period, the number of new filings of corporations decreased by 21%. LLCs comprise 43% of corporate filings currently recorded by ACC.

According to the Department of Revenue (DOR), Arizona income tax returns do not include the information that is necessary for the department to calculate the amount of state income tax attributable to pass-through entities. However, COST estimates that Arizona collected about \$200 million in income taxes in FY 2004 from the net income generated by pass-through entities. If this estimate is correct, income tax from pass-through entities represented about 9% of total individual income tax collections in FY 2004. This means that individual income taxes attributable to Arizona pass-through businesses constituted about 40% of corporate income taxes in FY 2004.

COST's estimate was based on Arizona's assumed share of the total U.S. pass-through business income as reported by the IRS. To gauge the accuracy of COST's estimate, the JLBC Staff contacted the California Franchise Tax Board (FTB), which provides its own independent estimate of California income tax attributable to pass-through entities. FTB considered COST's California estimate consistent with FTB's. This may arguably lend more credence to COST's Arizona

estimate since California tax returns (unlike Arizona tax returns) include the information that is necessary to fairly accurately calculate the amount of state income tax attributable to pass-through entities.

The growing importance of pass-through business income in Arizona can also be inferred from Arizona personal income statistics. According to the Bureau of Economic Analysis (BEA), the share of Arizona personal income attributable to proprietorships has grown from 6% in 1990 to 9% in 2004. This trend is due to the fact that while overall personal income grew at an average annual rate of 7%, proprietorship income (which is a component of personal income) grew at an even faster annual rate of 10%.

The continued growth in business income from pass-through entities is likely to further increase the volatility of the state's individual income tax collections. Generally, business income tends to be more volatile than other personal income sources. In addition, income generated by businesses (especially by limited liability companies and S Corporations) is often taxed at the top marginal tax rate. The trend of increased business income from pass-through entities is thus likely to help explain (at least in part) the increased revenue volatility observed during economic upturns and downturns.

Efforts to monitor the growing importance of pass-through entities in Arizona are hampered by a lack of state-specific data. Furthermore, national data is typically released with a lag of 2 or 3 years. For this reason, we do not expect the IRS to release tax year 2004 national income data until the fall of 2006. At this time, we expect to be in better position to account for the underlying sources of the FY 2005 revenue windfall.

In lieu of “hard” data, however, the recent growth in corporate income taxes may help to explain the simultaneous surge in individual income tax collections. Year to date, corporate income taxes have grown by 50%. If the same growth trend applies to small businesses as well, their individual income tax payments would have increased by about \$100 million. (This amount is derived by applying the 50% assumed growth rate to the FY 2004 small business individual income tax base of \$200 million reported by COST.) Since small business income is typically not subject to withholding tax payments, the increased tax liability generated by such businesses (estimated to be \$100 million) may have appeared as part of the \$208 million increase in April/May final payments.

JLBC MEETING

At its June 28th meeting, the Joint Legislative Budget Committee considered the following issues:

Arizona Health Care Cost Containment System – Review of KidsCare Behavioral Health Capitation Rate Changes – The Committee gave a favorable review to the Arizona Health Care Cost Containment System (AHCCCS) Behavioral Health capitation rates for the KidsCare (including parents) program.

The approved rates are virtually identical to budgeted levels for FY 2006.

Department of Economic Security – Review of Transfer of Appropriations for TANF Cash Benefits and Child Care Subsidy Line Items – The Committee gave a favorable review to the Department of Economic Security's (DES) request to transfer \$12.0 million from the TANF Cash benefits line item in order to address shortfalls in the Operating budget of the Division of Benefits and Medical Eligibility (\$3.0 million) as well as in the Adoption Services (\$1.2 million) and Children Services (\$7.8 million) line items. The Committee also discussed how DES planned to address the agency's remaining \$9.4 million shortfall.

There was also concern that the transfers are replacing monies that had been made available in FY 2004 through a veto of a lump sum reduction. These monies were not replaced in the original FY 2005 budget, as the Governor had directed DES to find efficiencies. DES is now transferring TANF surplus monies to resolve this issue. TANF monies are available because of declining caseloads, resulting in the decline in TANF cash assistance payments.

The Committee also favorably reviewed a transfer of \$4 million from the Day Care Subsidy SLI to the Transitional Child Care SLI. Growth in the Transitional Day Care population has been higher than anticipated while caseloads in the Day Care Program have declined by 3.7%. In addition to the transfer, the Committee discussed the wait list that was implemented in September 2004 in light of the fact that the program is expected to have an estimated \$4 million projected surplus at the end of FY 2005.

Department of Economic Security – Review of Expenditure Plan for Discretionary Workforce Investment Act Monies – The Committee gave a favorable review of the Department of Economic Security's expenditure plan of \$184,900 in Workforce Investment Act (WIA) monies in order to provide support to the Jobs for Arizona Graduates (JAG) Program. The Committee stipulated that DES provide performance measures for the JAG Program in order to measure the program's effectiveness.

Department of Health Services – Review of Children's Rehabilitative Services Capitation Rate Changes – The Committee favorably reviewed the Department of Health Service's (DHS) capitation rate adjustments for the Children's Rehabilitative Services Program for FY 2006. The capitation rate adjustments are within the agency's FY 2006 appropriation levels for the program.

Department of Revenue – Review of Ladewig Expenditure Plan – The Committee gave a favorable review to the Department of Revenue's estimated administrative expenditure plan of \$1.4 million for the Ladewig Project for FY 2006. As part of the agency's report, DOR indicated that FY 2005 refunds included over \$6.3 million in overpayments to taxpayers. The Committee directed DOR to report back to the Committee after the taxpayer overpayment issue has been

resolved and to estimate the agency's total cost of the Ladewig project at that time.

Arizona State Retirement System – Review of FY 2006 Information Technology Expenditure Plan – The Committee gave a favorable review to the Arizona State Retirement System's (ASRS) FY 2006 Information Technology (IT) expenditure plan. The Government Information Technology Agency (GITA), in its most recent monitoring report, changed the project's status from "green" to "red," indicating a serious risk to project completion by the planned date. The Committee directed ASRS to provide an update by the end of each calendar quarter as to the progress made towards bringing the IT plan back to "green" status.

Arizona Department of Corrections – Report on Employee Overtime Pay and the On-Call Pay Settlements – The Arizona Department of Corrections submitted a report indicating that all FY 2004 compensatory time has been paid and that all but 3 on-call claims were paid as of May 2005. The report further stated that \$7.8 million was spent on FY 2004 employee compensatory time payments and \$12.3 million was expended for on-call claims.

The Committee also discussed a number of other items related to ADC, including:

- The number of vacant positions and the dollar value of vacancy savings in the department's budget;
- ADC's plan for expending its vacancy savings;
- The competitiveness of correctional officer pay;
- The resources currently in the department's budget that can be used to address compensation issues;
- Private prison contracts, particularly for a women's only facility.