

Toledo Income Tax Revenue: Forecast 2003



December 12, 2002

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Prepared for Toledo City Council
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Executive Summary

The nation is recovering slowly from the recession of 2001, but recovery in the Toledo area has been weak this year. The local labor market reflected the weak recovery; initial claims for unemployment insurance have not fallen. With a high degree of uncertainty surrounding national economic conditions, it seems likely that the City's tax revenue will grow slowly next year. That is positive in the sense that a decline in total income tax revenue, similar to the drop in 2001, seems unlikely in 2003.

For 2002, we expect the City's income tax revenue to be close to its pre-recession level of \$153.8 million recorded in 2000, and our forecast shows total income tax revenue for 2003 up about 2.2% from that level. It is important to note, however, that for nine years ending in 2000 the City's total income tax revenue grew at an average rate of 4.4% per year. **If growth of the 1990s had continued, the City's revenue would be nearly \$18 million more than we project for 2003.** The recession, therefore, not only pulled down the absolute level of revenue, but also left the City short of its long-run trend in revenue. It will take years for the City to recovery from the slump in tax revenue.

Based on information from the City's Finance Department, our dynamic quarterly forecast model (DQF) predicts revenue to be up 1.5% this year, as tax withholdings rise 1.3%. The continued terrorist threat contributed to the weak recovery this year, and uncertainty about future prospects did hold down business and consumer confidence. The biggest drag on growth of revenue is from business tax collections, which we forecast to be down again this year.

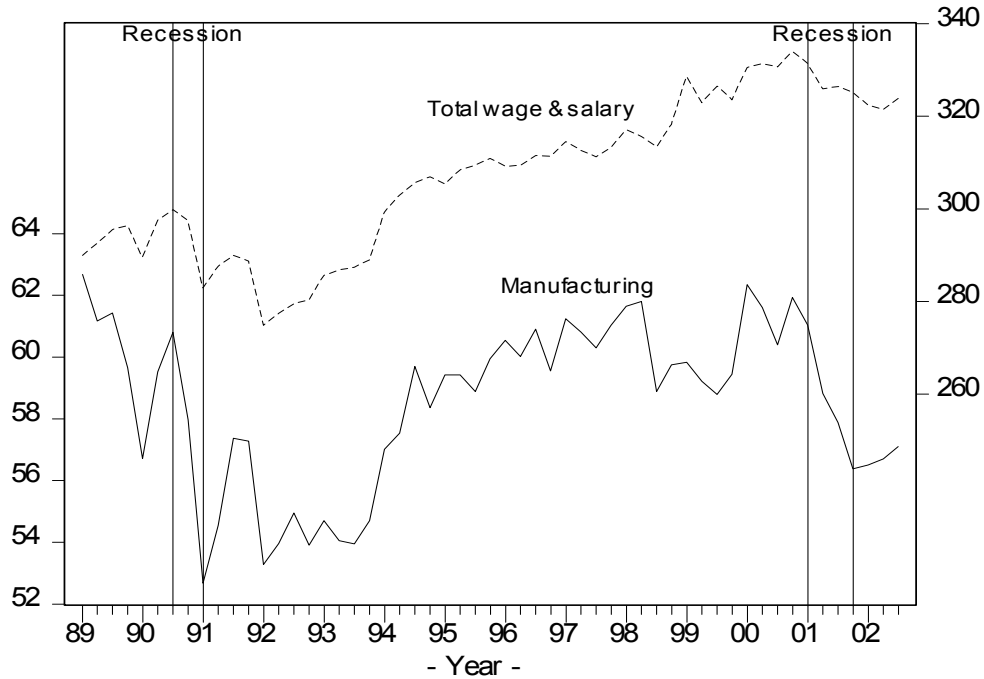
The figures below show Toledo's income tax revenue since 1998, including our forecast for 2002 and 2003. Note the drop of 1.9% during the slump of 2001. Improved national economic conditions are setting the stage for a possible second consecutive year of recovery in the City's income tax revenue, and our forecast shows growth of 2.6% next year. Nevertheless, downside risks do exist, and they impose negative threats to the City's revenue growth for 2003.

| Toledo Income taxes - Forecasts are bold | | | | | | | | |
|---|--------------------|----------------|-------------------|----------------|------------------|----------------|--------------------|----------------|
| | Withholding | Percent Change | Business | Percent Change | Individual | Percent Change | Total | Percent Change |
| 1998 | 125,178,347 | 1.3 | 15,904,590 | 0.3 | 3,421,660 | 4.2 | 144,504,597 | 1.3 |
| 1999 | 130,843,903 | 4.5 | 15,645,820 | -1.6 | 3,680,593 | 7.6 | 150,170,316 | 3.9 |
| 2000 | 134,806,279 | 3.0 | 15,287,726 | -2.3 | 3,736,243 | 1.5 | 153,830,248 | 2.4 |
| 2001 | 132,688,940 | -1.6 | 13,228,732 | -13.5 | 4,993,735 | 33.7 | 150,911,407 | -1.9 |
| 2002 | 134,421,348 | 1.3 | 12,541,277 | -5.1 | 6,154,016 | 23.2 | 153,116,641 | 1.5 |
| 2003 | 137,929,825 | 2.6 | 13,055,524 | 4.1 | 6,157,842 | 0.1 | 157,143,191 | 2.6 |

A. Economic Conditions

The National Bureau of Economic Research (NBER) has not yet declared an ending date for the 10th recession that began April 2001, but Real Gross Domestic Product (GDP) has increased for the last four quarters. Recovery appears to have taken hold during 2002 as production expanded during the year. The recovery nationwide and locally has been slow, however, and employment growth has been weak. Considerable uncertainty surrounds prospects for the short-term future because of concerns about continued terrorism and possible war in Iraq. Nevertheless, the economic fundamentals point toward continued economic recovery in 2003. Domestic demand is expected to keep the economy moving upward, but the pace is likely to be moderate, and there are potential problems ahead that will constrain the local economy.

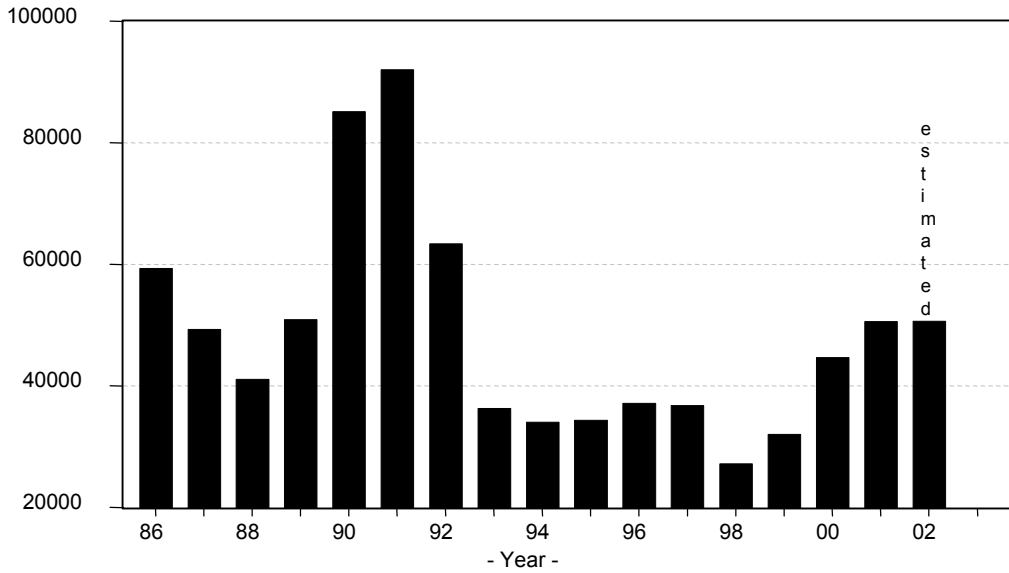
Figure 1: Toledo Metro Employment (thousands, seasonally adjusted)



Source: Ohio Bureau of Labor Market Information.

Figure 1 shows the drop in total and manufacturing employment during 2001 and 2002. Because the City's income tax withholdings are directly related to employment, the slump in 2001 was the major contributor to the 1.6% drop in withholdings in 2001. Employment began to recover in 2002 and the City can expect tax revenue from withholdings to increase as well. It is important to note, however, that recovery in local employment to levels before the recession is unlikely during 2003; this will keep the City's income tax revenue below its long-term trend.

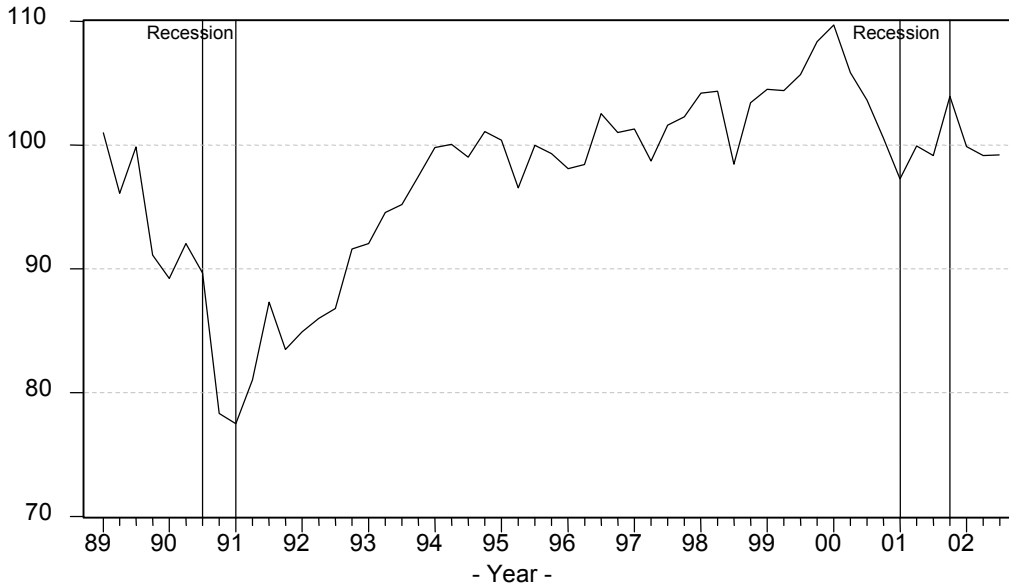
Figure 2: Toledo Metro Initial Claims for Unemployment Insurance



Source: Ohio Bureau of Employment Information

Figure 2 shows that initial claims for unemployment insurance did not fall during 2002. The weak labor market conditions held back the growth of the City’s tax revenue this year. Although the run up in claims for unemployment insurance was not as large as that of the early-1990s, initial claims filed rose in the Toledo area for four years. The Toledo index of leading indicators summarizes the near-term economic prospects. Figure 3 shows improvement in the local economy as the recession abates. Note, however, that the overall gain in the index has been moderate so far, pointing to slow recovery into 2003.

Figure 3: Toledo Index of Leading Indicators (1996=100)



Source: Paul Kozlowski, UT Dept. of Finance & Business Economics

B. Forecast 2002

In our forecast to City Council in March, we predicted a 2.1% increase in total income tax revenue for this year. That increase was expected to result from a 1.5% gain in tax withholdings, as well as a gain in collections from business. That forecast was a little too optimistic, however. Based on information available through the third quarter of 2002, it appears that total income tax revenue will increase by about 1.5% this year. Our dynamic quarterly forecast procedures (DQF) predict a gain of 1.3% in tax withholdings and a drop in collections from business, which is offset by a rise in collections from individuals. **For 2002, the DQF shows an increase in total income tax revenue of \$2,205,000**, for a total of \$153,116,641. If tax revenue had grown at the average compound rate experienced in the nine-year period ending in 2000, then the City's total income tax revenue would have amounted to \$167,665,125. Despite the gain predicted for this year, the City will find itself about \$14.5 million short of its long-run trend. The mild recession of 2001, therefore, had a significant negative impact on tax revenue that will continue into 2003.

Our forecast for the fourth quarter of 2002 uses updates based on the recent data available through November 2001. Table 1 shows the quarterly income tax revenue from withholdings generated by the DQF procedures that account for long-term trend, business cycle, and seasonal movements in the City's revenue data. The results in Table 1 suggest that the City can expect a slight recovery in revenue from withholdings, which we estimate at approximately \$1.7 million. Although that is positive, it is important to note that in 1992, the first year of recovery from the recession of 1990-91, the City's tax withholdings rose more than 5%.

Table 1: Toledo Quarterly Income Taxes – DQF forecasts are **bold**.

| | Withholding (sa) | Seasonal Index | Re- Seasonalized | Withholding (nsa) | Annual Percent Change |
|--------|---------------------|-------------------|---------------------|----------------------|-----------------------------|
| 2002 | 1 | | | 33,235,204 | |
| | 2 | | | 33,516,021 | |
| | 3 | | | 31,947,961 | |
| | 4 | | | 35,722,162 | |
| | 34,121,293 | 1.046917 | 35,722,162 | 35,722,162 | |
| Annual | | | | 134,421,348 | 1.3 |

Notes: sa = seasonally adjusted; nsa = not seasonally adjusted.

Forecasts in bold were generated by the DQF procedure outlined to City Council in *City of Toledo Payroll Tax Revenue: Annual Budget Projections and Long-term Trends*, UT-Urban Affairs Center, October 2000.

The City's total income tax revenue appears in Table 2. The DQF predicts a 1.5% increase in total income tax revenue for 2002, following the 1.9% loss in 2001. That leaves total revenue just below its pre-recession level of \$153,830,248.

Table 2: Toledo Quarterly Income Taxes – DQF forecasts are **bold**.

| | | Withholding (sa) | Business Profits (nsa) | Individual Direct Pays (nsa) | Total (nsa) | Annual Percent Change |
|--------|---|---------------------|---------------------------|------------------------------------|--------------------|-----------------------------|
| 2001 | | 132,688,940 | | | | -1.9 |
| 2002 | 1 | | | | | |
| | 2 | | | | | |
| | 3 | | | | | |
| | 4 | 35,722,162 | 1,266,593 | 721,255 | 37,710,010 | |
| Annual | | 134,421,348 | 12,541,277 | 6,154,016 | 153,116,641 | 1.5 |

Notes: sa = seasonally adjusted; nsa = not seasonally adjusted.

Forecasts in bold were generated by the DQF procedure outlined to City Council in *City of Toledo Payroll Tax Revenue: Annual Budget Projections and Long-term Trends*, UT-Urban Affairs Center, October 2000.

The increase in individual direct payments results from special factors in the collection process, which offset the impact of the recession. The decline in revenue from business profits is consistent with the slow recovery here. Weak economic conditions in 2001 and 2002 compounded a problem of no growth from the business source of City revenue since the mid-1990s.

Revenue from tax withholding and business profits is sensitive to conditions in the local economy; the DQF procedures account for that through initial claims for unemployment insurance. UI claims are almost the same this year compared to 2001, and that contributes to a positive, but very modest, gain in withholdings this year. In short, labor market conditions did not get worse and appear to be improving slightly as 2002 ends. Collections from businesses should be poised for a rebound, but that source of tax revenue continues to be very erratic with little evidence of any significant upward trend.

C. Forecast 2003

Table 3 shows the City's actual tax revenue from 1989 to 2001 and our forecasts for 2002 and 2003. The forecast procedures (DQF-dynamic quarterly forecast and LIM-leading indicator model), outlined in the *City of Toledo Payroll Tax Revenue: Annual Budget Projections and Long-term Trends*, UT-Urban Affairs Center, October 2000, predict continued recovery with another year of positive growth in income tax revenue during 2003, albeit at a slow pace. We expect total income tax revenue to grow about 2.6% in 2003 and to reach \$157.1 million. Despite this forecast for 2003, the table reveals that growth rates for income tax revenue in 2002 and 2003 are well below those that occurred during the economic expansion of the 1990s.

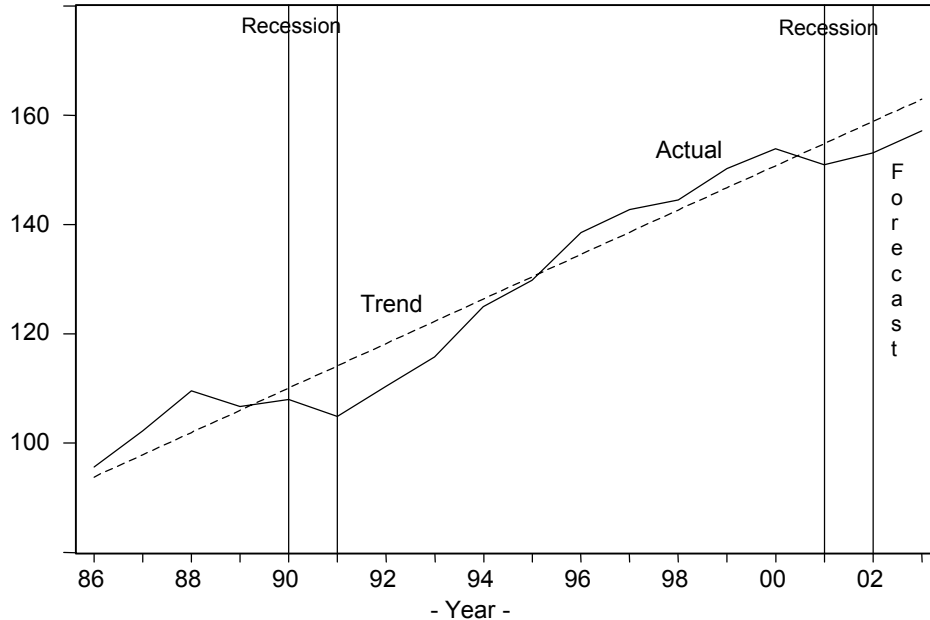
Table 3: Toledo Income Taxes - Forecasts are **bold**.

| | Withholding | % Change | Business | % Change | Individual | % Change | Total | % Change |
|------|--------------------|-------------|-------------------|-------------|------------------|-------------|--------------------|------------|
| 1989 | \$95,011,996 | 2.4 | \$9,292,927 | -35.0 | \$2,396,757 | -2.4 | \$106,701,680 | -2.6 |
| 1990 | 92,919,354 | -2.2 | 12,766,213 | 37.4 | 2,294,258 | -4.3 | 107,979,825 | 1.2 |
| 1991 | 92,452,379 | -0.5 | 9,963,000 | -22.0 | 2,454,651 | 7.0 | 104,870,030 | -2.9 |
| 1992 | 97,428,524 | 5.4 | 10,445,009 | 4.8 | 2,549,443 | 3.9 | 110,422,976 | 5.3 |
| 1993 | 100,159,047 | 2.8 | 12,805,217 | 22.6 | 2,790,750 | 9.5 | 115,755,014 | 4.8 |
| 1994 | 107,147,988 | 7.0 | 14,813,612 | 15.7 | 3,013,485 | 8.0 | 124,975,085 | 8.0 |
| 1995 | 112,883,989 | 5.4 | 13,743,551 | -7.2 | 3,161,220 | 4.9 | 129,788,760 | 3.9 |
| 1996 | 117,494,951 | 4.1 | 17,829,958 | 29.7 | 3,161,798 | 0.0 | 138,486,707 | 6.7 |
| 1997 | 123,559,489 | 5.2 | 15,856,452 | -11.1 | 3,284,787 | 3.9 | 142,700,728 | 3.0 |
| 1998 | 125,178,347 | 1.3 | 15,904,590 | 0.3 | 3,421,660 | 4.2 | 144,504,597 | 1.3 |
| 1999 | 130,843,903 | 4.5 | 15,645,820 | -1.6 | 3,680,593 | 7.6 | 150,170,316 | 3.9 |
| 2000 | 134,806,279 | 3.0 | 15,287,726 | -2.3 | 3,736,243 | 1.5 | 153,830,248 | 2.4 |
| 2001 | 132,688,940 | -1.6 | 13,228,732 | -13.5 | 4,993,735 | 33.7 | 150,911,407 | -1.9 |
| 2002 | 134,421,348 | 1.3 | 12,541,277 | -5.2 | 6,164,016 | 23.4 | 153,116,641 | 1.5 |
| 2003 | 137,929,825 | 2.6 | 13,055,524 | 4.1 | 6,157,842 | -0.1 | 157,143,191 | 2.6 |

Source: Actual revenue from City of Toledo, Finance Department/Treasury Division.
Forecasts in bold were generated by the procedures outlined to *City Council in City of Toledo Payroll Tax Revenue: Annual Budget Projections and Long-term Trends*, UT-Urban Affairs Center, October 2000.

During the slump in the early-1990s, the City's income tax withholdings dropped 2.7% from \$95 million in 1989 to \$92.5 million in 1991. The decline during the recent recession was confined to one year, 2001, with a drop of 1.9%, which resulted in loss of \$2.9 million. The national economy is forecast to grow next year and local economic conditions should improve; therefore, it seems likely that the City's tax revenue will grow for a second consecutive year. Gains in tax withholdings provide the thrust for continued recovery in 2003.

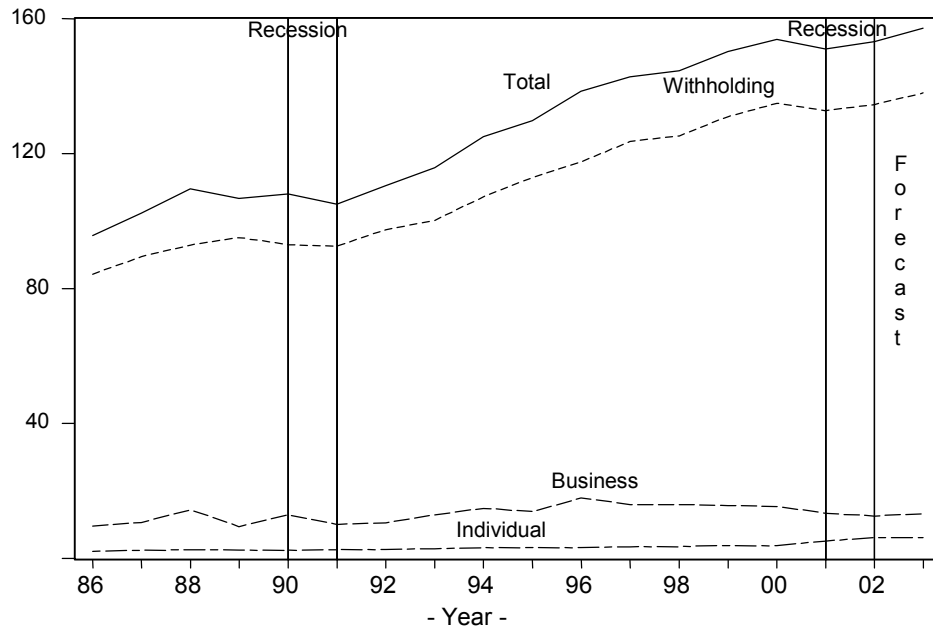
Figure 4: Annual Income Tax Revenue (millions)



Source: City of Toledo, Finance Department/Treasury Division and UT Urban Affairs Center.

Figures 4 and 5 illustrate the City’s income tax revenue performance. Our forecast puts total income tax revenue in 2002 and 2003 below its long-term trend growth, which is a characteristic of recessions in Toledo. Revenue growing below its trend is a direct consequence of the recession in the local and national economies. Our forecast puts revenue in 2002 just short of the \$153,898,984 collected in 2000 but above that pre-recession level for 2003. The City’s slump was relatively mild but it takes time for revenue to recover fully.

Figure 5: Income Tax Categories (millions).



Although the mild recession in 2001 was beyond the City's control, growth in income tax revenue was affected negatively. At the end of 2002, positive signs exist for continued recovery next year. Total employment in the Toledo metropolitan area has exhibited early signs of rebounding and local manufacturing employment may have already hit bottom. Our forecast for the City's tax revenue in 2003 is based on continued improvement in the local labor market. So far, recovery in employment nationwide and locally has been weak and we do not anticipate a strong pickup in employment next year. We expect the City's growth in tax revenue to reflect only a slow improvement in employment next year.

Downside Risks

We expect recovery to continue at a relatively slow pace during 2003 accompanied by gains in the City's revenue from income taxes. A high level of uncertainty surrounds our forecast for next year. Downside risks appear less pronounced than a year ago, however. In fact, the major upside impact is that economic fundamentals are stronger going into 2003. Nevertheless, downside risks include:

- More terror and/or war with Iraq that adversely affect consumer and business confidence;
- Weak automobile sales and further problems for automobile and parts manufacturers;
- Weak job gains that limit income growth nationwide and in the Toledo area.