

Toledo Income Tax Revenue: Forecast 2005



December 16, 2004

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Table of Contents

| | |
|-----------------------------|----|
| Table of Contents..... | 1 |
| Executive Summary..... | 2 |
| A. Economic Conditions..... | 3 |
| B. Forecast 2004..... | 7 |
| C. Forecast 2005..... | 10 |
| Risks to the Forecast..... | 12 |

Executive Summary

National economic conditions continued to improve this year: increased production and sales, low inflation and low interest rates. Employment grew little, however. While local business conditions improved during the second-half of 2004 as forecast last year, those improvements have not translated into job growth yet.

Our forecast a year ago was too optimistic and the predicted rise in withholding revenue did not materialize. Based on data through the third quarter, the City can expect withholding revenue to be about \$134.4 million in 2004; that is 1.3% below the amount collected in 2003. The \$1.7 million decline in withholding revenue is attributable to a downside risk we cited in last year's forecast: **Continued weak labor market conditions that limit jobs and income growth nationwide and in the Toledo area.**

A jobless recovery from the 2001 recession accounts for the drop in the City's income tax revenue this year. Lack of job growth had a severe negative impact on the amount of withholding, City's major source of income tax revenue. Although our forecast shows a gain in tax revenue from business income during 2004, the City's total income tax revenue will be down nearly \$700,000 this year. Unfortunately, this lower amount of income tax revenue sets the stage for the City going forward into 2005.

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 | 133,577,209 | 0.7 | 14,156,273 | 7.0 | 6,231,758 | 24.8 | 153,965,240 | 2.0 |
| 2003 | 136,189,345 | 2.0 | 13,315,649 | -5.9 | 5,607,526 | -10.0 | 155,112,520 | 0.7 |
| 2004 | 134,445,002 | -1.3 | 14,374,286 | 8.0 | 5,605,873 | 0.0 | 154,425,161 | -0.4 |
| 2005 | 135,779,126 | 1.0 | 14,508,173 | 0.9 | 5,732,995 | 2.3 | 156,020,294 | 1.0 |

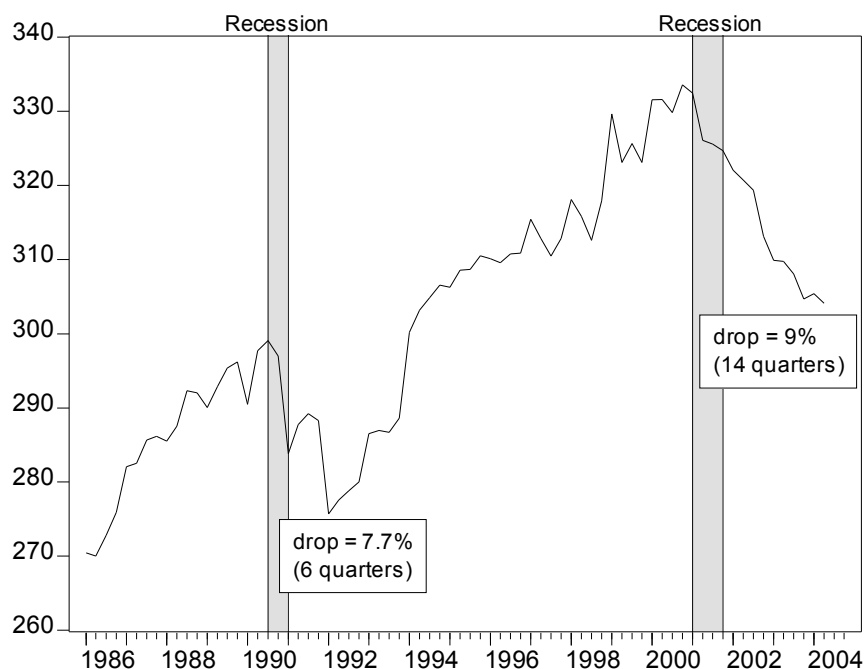
Slow job growth will limit increases in income tax revenue next year. Our forecast shows total income tax revenue rising 1.0% in 2005 to \$156 million. The \$1.6 million increase comes from a rebound in withholding revenue. Our forecasts for gains in all sources of income tax are small, however. Recovery is expected to continue next year, but our forecast puts income tax revenue only 1.4% above its pre-recession level in 2000. That is a \$2.2 million increase over the last five years. The lack of growth in income tax revenue represents a problem for the City going into 2005.

The 2005 forecast is restrained by a low probability of significant improvements in local employment conditions next year. The jobless recovery experienced here has taken a toll on the City's income tax revenue. Our forecast for a 1% rise in total income tax revenue forecast for next year is positive but cautious.

A. Economic Conditions

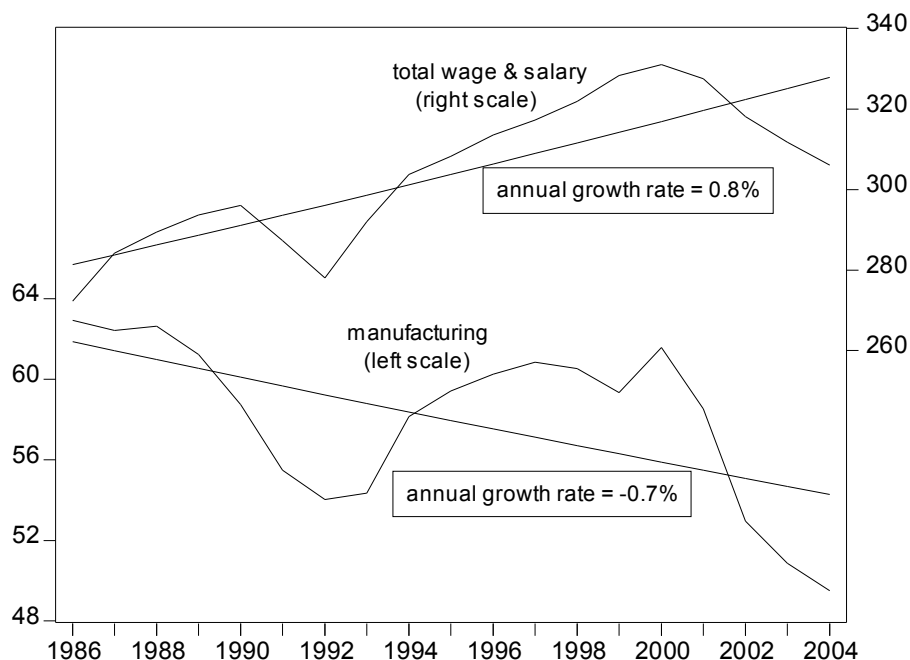
Last year's forecast cited: "Continued weak labor market conditions that limit jobs and income growth nationwide and in the Toledo area," as a major downside risk for Toledo's economy in 2004. That is exactly what occurred and the result was a loss of income tax revenue for the city. Although the short and mild national recession ended in November 2001, a strong recovery has not occurred in Toledo. In fact, the distinguishing characteristic of the recent recession in Toledo has been its length, especially with respect to jobs which have not rebounded. While fundamental economic conditions improved during 2004, especially in terms of national production, employment conditions remained weak here. This had a direct negative impact on the City's income tax revenue, especially for withholdings on wages and salaries that account for 88% of total income tax revenue.

Figure 1: Toledo Metro Wage & Salary Employment (SA, thousands)



Source: Ohio Bureau of Labor Market Information and Paul Kozlowski, University of Toledo.

Figure 1 illustrates the current slump in employment. In the Toledo metro area it has fallen for 14 quarters, or three and one-half years, compared to only 6 quarters in 1990-91. The failure of employment to rebound from the 2001 recession is the major factor accounting for the falloff in the City's income tax revenue this year. While there was a slight gain in the third quarter of 2004, the anticipated recovery in local employment simply did not occur this year. Even at the pace recorded after the 1990-91 recession, the Toledo area will not regain jobs lost since 2001 for at least two more years. So far, however, there are few signals that local jobs will grow at that pace.

Figure 2: Toledo Metro Annual Employment (thousands)

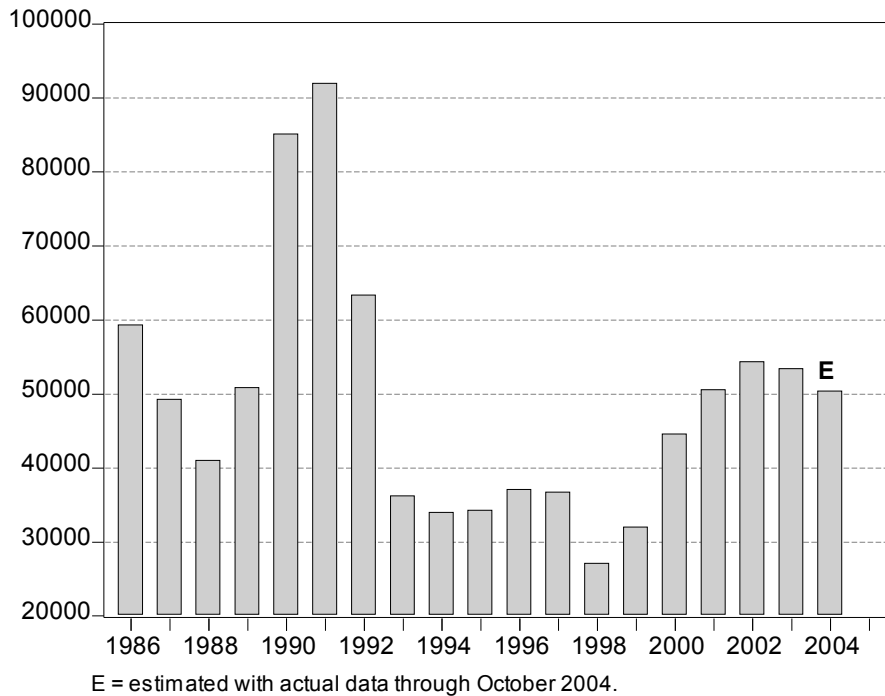
Source: Ohio Bureau of Labor Market Information and Paul Kozlowski, University of Toledo.

The long-term employment situation is captured in Figure 2. Since 1986 manufacturing employment has declined 0.7% per year. It is about 22% below its pre-recession level recorded more than four years ago. The loss is about 10,000 manufacturing jobs in the last four years. The upward trend in total wage and salary employment since 1986 is a slow 0.8% per year. The slump in local employment during the last four years has had a direct negative impact on income tax revenue.

Improved local business conditions point to job gains for 2005. National forecasts show increases in payroll employment of about 1% this year and 1.5% for 2005. Those are modest increases nationwide which translate into only slight gains for the Toledo area. The slump in employment in the Toledo area may have bottomed out during the summer of 2004, but it will take more than five years for local employment to regain its pre-recession level at the very slow upward pace observed this summer.

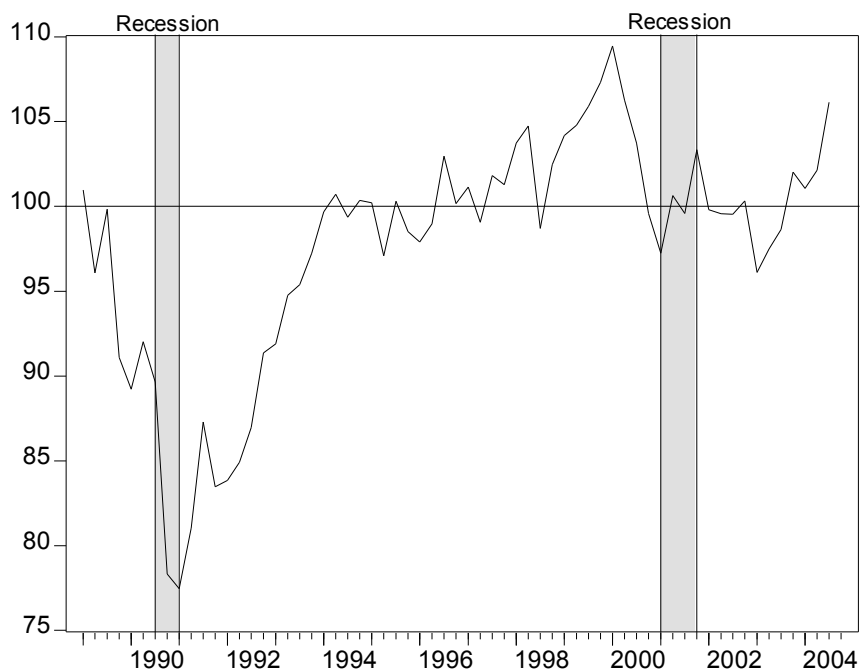
Our outlook is for modest economic improvement in 2005. Local employment remains a concern, and a return to growth of the mid-1990s is highly unlikely next year.

Figure 3: Toledo Metro Initial Claims for Unemployment Insurance



Source: Ohio Bureau of Labor Market Information.

Figure 3 shows declines in initial claims for unemployment insurance in the Toledo area for 2003 and 2004. The declines are very small, however, and claims remain at a relatively high level this year. The failure of claims to drop significantly is another indicator of weak employment conditions here. Our analysis anticipates another drop in claims for unemployment insurance during 2005, but weak local labor market conditions are likely to limit declines.

Figure 4: Toledo Metro Index of Leading Indicators (1996 = 100)

Source: Paul Kozlowski, Department of Finance & Business Economics, University of Toledo.

Signals of local economic recovery picked up strength during the third quarter of 2004. The Toledo index of leading indicators shown in Figure 4 rose 3.9% during the July-September period, its strongest gain since the end of the national recession in 2001. For the third quarter of 2004, the index equaled 106.1 (1996 = 100), its highest level in four years.

The Toledo index of leading indicators has six components: local initial claims for unemployment insurance, the average workweek in local manufacturing, local residential housing units authorized by building permit, new orders for local manufactured goods, light vehicle sales nationwide, and the University of Michigan's index of consumer sentiment. All six moved favorably during the third quarter. New orders for local manufactured goods and residential housing units authorized by building permit recorded strong gains at 17% and 16%, respectively. Initial claims for unemployment insurance in the Toledo metropolitan area dropped 12% during the summer months, while the average workweek in local manufacturing industries inched up slightly to 42.4 hours. In addition, nationwide sales of light vehicles rose 3.6% and the University of Michigan's index of consumer sentiment increased 3.4%.

Upward momentum in the Toledo index of leading indicators suggests improvement in the local economy into 2005. It is a qualified positive economic outlook because slow job growth is likely to limit gains in the City's income tax revenue next year.

B. Forecast 2004

A review of our forecast from last December shows 2003 income tax withholding predicted at \$135,423,108, a 1.4% gain from 2002. Actual 2003 withholding revenue turned out to be \$136,189,345. That was an under-prediction of only \$766,237 or 0.6% for the City's major source of income tax revenue.

Our forecasting record for 2004 was not that good, however; we were too optimistic about economic conditions and the growth of income tax revenue. A year ago, we predicted withholding tax revenue of \$139,719,496 for 2004. Based on data through the third quarter we expect the City's withholding revenue to be \$134,445,002. The difference of \$5,274,494, a 3.9% over-prediction, is the result of the downside risk cited in last year's forecast: **Continued weak labor market conditions that limit jobs and income growth nationwide and in the Toledo area** (p. 14). That is exactly what happened this year: employment failed to recover in 2004 at the pace predicted; that weakness showed up nationwide and in the Toledo area. The result for the City is a drop in withholding tax revenue this year.

The forecast for the fourth quarter of 2004 uses updated information available through November 2004. Table 1 shows the quarterly income tax revenue from withholdings generated by our DQF procedures that account for long-term trend, the business cycle, and seasonal movements in the City's revenue. The forecast for 2004 shows a 1.3% drop in withholding revenue, an actual loss of revenue of \$1.7 million this year. For the third year of a national economic recovery, not only is it highly unusual but it also sets a lower base going forward into 2005. The revenue loss in 2004 represents a severe, unexpected negative change for the City's financial condition.

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

| | | Withholding (sa) | Seasonal Index | Re- Seasonalized | Withholding (nsa) | Annual Percent Change |
|--------|---|---------------------|-------------------|---------------------|----------------------|-----------------------------|
| 2004 | 1 | | | | 34,641,916 | |
| | 2 | | | | 31,149,815 | |
| | 3 | | | | 32,744,048 | |
| | 4 | 34,221,031 | 1.049332 | 35,909,223 | 35,909,223 | |
| Annual | | | | 134,445,002 | -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.

Based on our current forecast for total income tax revenue of \$154,425,161 for 2004, last year's forecast over-predicted the City's revenue by 2.5%, or about \$3.9 million. The poor performance of withholding tax revenue accounts for that error. Table 2 shows the three income tax categories. Our updated forecast predicts a loss in total income tax revenue of \$687,359 this year. Although that represents a small 0.4% drop, it follows a slight 0.7% gain in 2003.

Table 2: Toledo Quarterly Income Taxes – Forecasts are bold.

| | Withholding (nsa) | Business Income (nsa) | Individual Direct Pays (nsa) | Total (nsa) | Annual Percent Change |
|--------|----------------------|--------------------------|---------------------------------|----------------------|-----------------------------|
| 2003 | \$136,189,345 | \$13,315,649 | \$5,607,526 | \$155,112,520 | 0.7 |
| 2004 | | | | | |
| 1 | | | | 39,459,454 | |
| 2 | | | | 38,623,485 | |
| 3 | | | | 36,767,183 | |
| 4 | 35,909,223 | 2,979,183 | 686,631 | 39,575,039 | |
| Annual | 134,445,002 | 14,374,286 | 5,605,873 | \$154,425,161 | - 0.4 |

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.

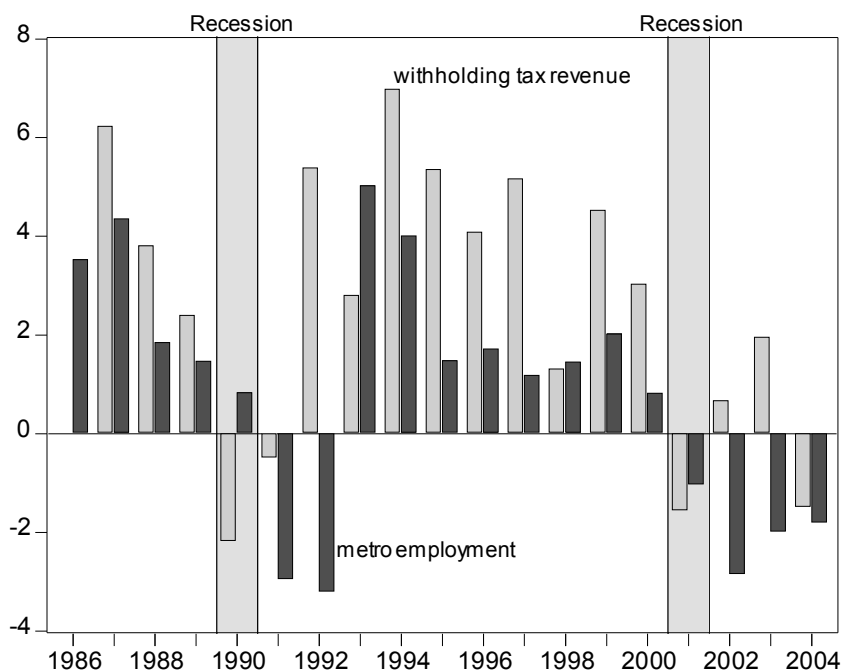
A predicted loss of \$1,744,343 in withholding tax revenue is partially offset by a gain of \$1,058,637 from the business income tax category. A year ago, we forecast a pickup in business tax revenue for this year. Based on data through the third quarter of 2004, we anticipate a rise in business income tax revenue that will exceed last year's forecast. It represents a positive financial impact for the City during 2004. Business tax revenue accounts for less than 10% of total revenue, however, and its growth is erratic. Rising business profits this year generated more revenue for the City. Financial outlooks show corporate profits rising again next year. Improved business financial conditions, however, have not translated into significant job growth yet.

The current forecast for revenue collected from individuals in 2004 is close to the prediction a year ago. At \$5,605,873 for 2004, the revenue collected from individuals is almost equal to the amount collected in 2003. Economic recovery and the City's enhanced procedures contributed to improved collections from this source. Even with weak labor market conditions here, tax collections from individuals are about \$2,000,000 above the amounts recorded during the boom years in the 1990s. It should be noted, however, that there has been no growth from this source in the last three years, and that our current forecast in Table 2 leaves individual income tax revenue about \$600,000 below the amount collected in 2002.

If the City's total income tax revenue grew at its long-term growth rate, then revenue projected for 2004 would be just over \$168 million. Our forecast for 2004 indicates that the City's income tax revenue will be about \$14 million below that amount.

Table 2 showed that the drop in withholding tax revenue accounts for the loss in total income tax revenue this year. Figure 5 illustrates the yearly changes in metro employment and in the City’s withholding tax revenue.

Figure 5: Annual Percent Change – Tax Revenue and Employment



Job losses over four years have taken a toll on the City’s revenue from the withholding category. As noted earlier, the duration of job declines here distinguishes the recent local slump from past episodes. Weak employment conditions represent the major factor constraining the City’s income tax revenue growth going forward. The Ohio Bureau of Labor Market Information shows employment in the Toledo metro area down about 22,000 jobs this year from the high recorded in 1999. If local employment expands at the national rate of about 1.5% forecast for 2005, then it will be up 4,500 jobs next year in the Toledo metro area. Nevertheless, even the most optimistic outlook for the Toledo area will not show a pickup of 3000-4000 higher-paying manufacturing jobs during 2005.

The last four years have been difficult on the City’s income tax revenue. Weak local employment conditions and the lack of growth in revenue this year suggest that 2005 will be another tough year for income tax revenue.

C. Forecast 2005

The City's income tax revenue has stagnated over the last two years. The average total income tax revenue for 2003 and 2004 is just under \$154.8 million, up only slightly from the \$154 million collected in 2002. Moreover, for 2004 we predict the City's total income tax revenue to be \$154.4 million, up only 0.4% from the 2000 pre-recession high of \$153.8 million. In 2004 the City finds itself with only about \$500,000 more in income tax revenue than it had four years ago. Stagnation occurred in all income tax revenue sources. Our forecast for withholding, which accounted for 88% of total income tax revenue in 2003, is \$134.4 million for 2004, leaving the City's largest source of revenue \$500,000 short of collections in 2000. A year ago our forecast for revenue from withholding was too optimistic. As noted earlier, that is due directly to weak economic recovery here with no rebound in employment.

Table 3: Toledo Income Taxes - Forecasts are bold.

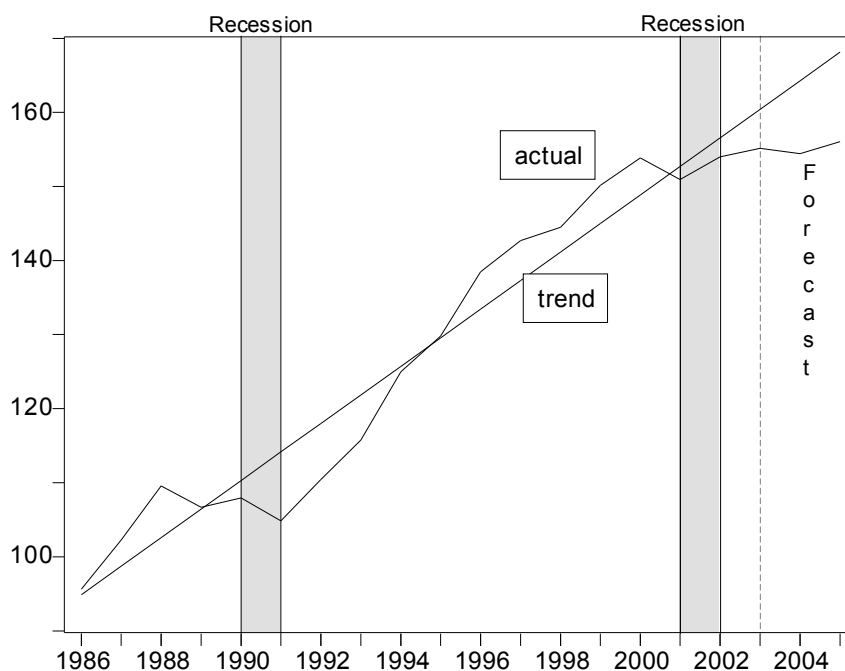
| | | % | | % | | % | | % |
|-------------|--------------------|-------------|-------------------|------------|------------------|------------|--------------------|-------------|
| | Withholding | change | Business | change | Individual | change | Total | change |
| 1989 | \$95,011,996 | 2.4 | \$9,292,927 | -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 | 133,577,209 | 0.7 | 14,156,273 | 7.0 | 6,231,758 | 24.8 | 153,965,240 | 2.0 |
| 2003 | 136,189,345 | 2.0 | 13,315,649 | -5.9 | 5,607,526 | -10.0 | 155,112,520 | 0.7 |
| 2004 | 134,445,002 | -1.3 | 14,374,286 | 8.0 | 5,605,873 | 0.0 | 154,425,161 | -0.4 |
| 2005 | 135,779,126 | 1.0 | 14,508,173 | 0.9 | 5,732,995 | 2.3 | 156,020,294 | 1.0 |

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.

For 2005, we anticipate continued economic recovery nationwide. Toledo's recovery will be considerably slower. On the positive side, however, we expect employment to rebound next year. The result is a 2005 forecast for total income tax revenue of \$156 million, up 1.0% from this year. A pickup of \$1.6 million next year comes mostly from a rebound in withholding tax revenue. While positive, the gains forecast for 2005 are small and considerably less than the long-run growth rate dating back to 1986. Figure 6 shows the City's income tax revenue performance since 1986. Our forecast puts total income tax revenue in 2004 and 2005 below its long-run trend levels.

Revenue growing below its trend is a direct consequence of the recession in the local economy followed by a very weak recovery here. Without the recession and weak recovery, growth of the City's income tax revenue at its long-term rate would have generated about \$173 million in 2005. Our forecast for 2005 is \$17 million below that level. With recovery expected to continue, the forecast for 2005 puts income tax revenue for next year 1.4% above the pre-recession level in 2000. That represents a predicted gain of only \$2 million for the five-year period 2000-2005. That is close to stagnation for income tax revenue.

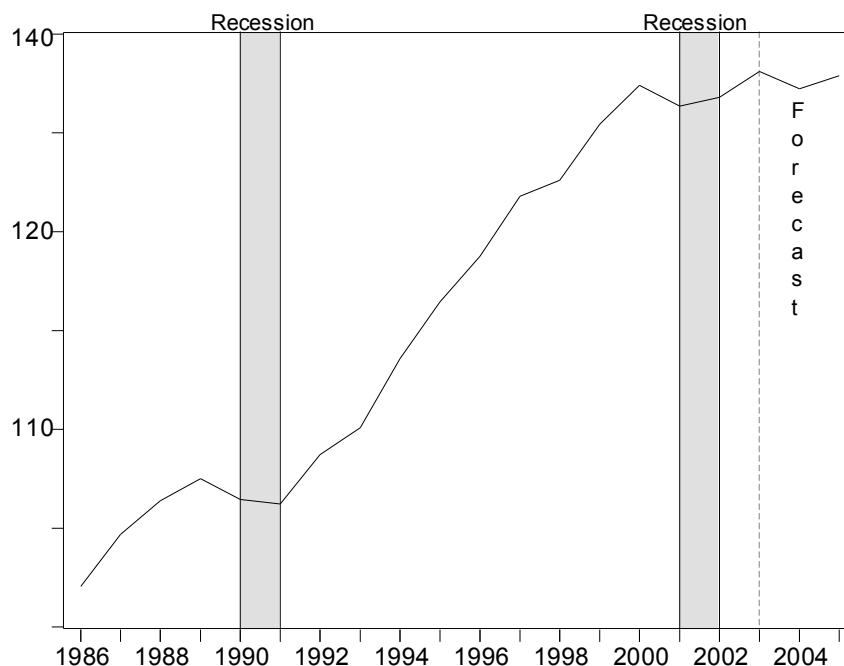
Figure 6: Annual Income Tax Revenue (millions)



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

Weak local economic and labor market conditions in 2004 caused recovery in the City's income tax revenue to stall. Although our forecast shows an increase for 2005, the City's total income tax revenue is likely to remain below its long-run trend for several years. Moreover, adjusted for inflation, the City is losing tax revenue.

Figure 7 illustrates income tax withholding. The recession caused a loss of \$2.1 million from this source and recovery as been very weak. Our forecast projects a gain for 2005; that will put withholding revenue 2.3% above its recession low in 2001. Four years after the recession in 1990-91 the City's withholding income tax revenue was up 21.5%.

Figure 7: Income Tax Revenue - Withholding (millions)

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

Risks to the Forecast

Based on continued economic recovery nationwide, our forecast shows 1.0% growth in total income tax revenue next year. This forecast is positive but cautious. We anticipate slow improvement in the local economy. Downside risks can negatively influence the growth in the City's income tax revenue next year. Those risks might include:

- Continued weak labor market conditions that limit jobs and income growth nationwide and in the Toledo area.
- Weak automobile sales with small increases in production.
- Re-location of business out of the City.
- More terror that adversely affects consumer and business confidence.

On the upside is a bottoming out of employment losses this year and a rebound next year. Growth in profits may also generate more income tax revenue from businesses than we are currently forecasting for 2005. The City has lagged behind the nation in the current recovery and income tax revenue growth has stalled. The forecast for a 1.0% increase in revenue next year is based on a low probability of significant improvements in local employment conditions.