

Toledo Income Tax Revenue: Forecast 2006



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Executive Summary

National economic conditions improved again this year: production, sales, and employment increased and the unemployment rate declined. Corporate profits rose considerably and they are expected to rise again next year. The result was a good economic environment for the City in 2005 that is expected to continue through 2006.

After four years of sub-par performance, the City's income tax revenue finally turned around this year. A year ago the forecast cited some upside risks: **a bottoming out of employment losses in 2004 and a rebound in 2005; growth in profits that generates more income tax revenue.** The City can expect withholding revenue to be about \$139.6 million in 2005, a strong 3.7% gain over the amount collected in 2004. Revenue from business income is expected to be up about \$1.5 million this year.

These upside risks materialized resulting in greater gains than forecast in all income tax categories last year. That's positive; it will bring \$6.5 million more to the City based on a final forecast for total income tax revenue of \$161.7 million this year. The 4.2% gain in total income tax revenue is the largest annual percent change since 1996. From 2001 to 2004, annual percent changes averaged only 0.2%. The current forecast highlights a long-awaited rebound in the City's income tax revenue.

The forecast for 2006 is optimistic. It is based on continued growth in the national economy along with improved business conditions in the Toledo area. The economic signals are pointing to a turnaround in employment conditions here. The 3.1% gain forecast for next year's income tax revenue is based on favorable movements in the national and local economies. The outlook for income tax revenue next year is strongly positive, and it follows a solid increase that is now forecast for this year.

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	134,704,005	-1.1	14,355,695	7.8	6,183,237	10.3	155,242,937	0.1
2005	139,643,569	3.7	15,893,349	10.7	6,199,158	0.3	161,736,076	4.2
2006	144,310,574	3.3	16,048,078	1.0	6,353,368	2.5	166,712,020	3.1

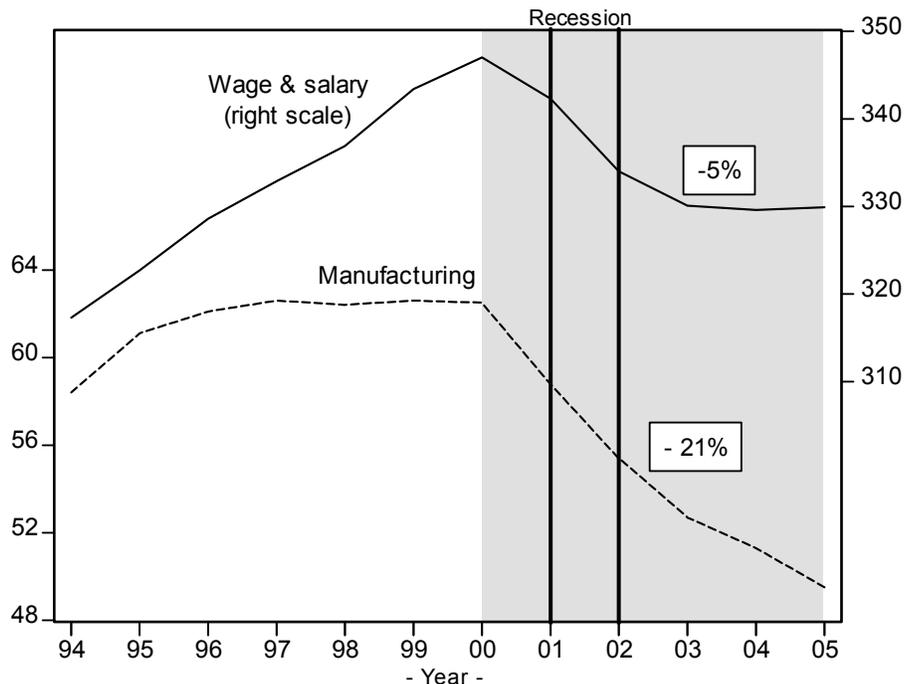
Revenue should rise again next year, but slow job growth in the Toledo area remains a constraint. The dark cloud over the City is the continued loss of manufacturing jobs. Nevertheless, the forecast indicates that the City can expect a good year in 2006. Although weaknesses still exist, the base going forward is stronger than a year ago.

A. Economic Conditions

Fundamental economic conditions improved considerably during 2005. Real GDP is likely to grow about 3.6% this year, accompanied by gains in employment and profits. Moreover, the national unemployment rate was 5% in November, down from 5.4% a year ago. It has declined steadily since mid-2003 as employment rose about 4.5 million. Corporate profits after tax will probably rise about 30% this year; profits are expected to increase again in 2006. These positive conditions contributed to a stronger environment for the Toledo economy in 2005; that is expected to continue in 2006.

There are some clouds hanging over the local economy, however. No gain in manufacturing employment occurred nationwide in 2005; it remained steady at about 14.3 million. That is down from about 17.5 million in 1998. Nevertheless, production in manufacturing rose about 11% from mid-1998 to mid-2005. The result is more output with fewer workers. That has both positive and negative implications for the local economy. Going forward in 2006, positive impacts should more than offset negative impacts on local economic conditions and the City's income tax revenue. The forecast for 2006 is optimistic and reflects the improved economic environment for the City.

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

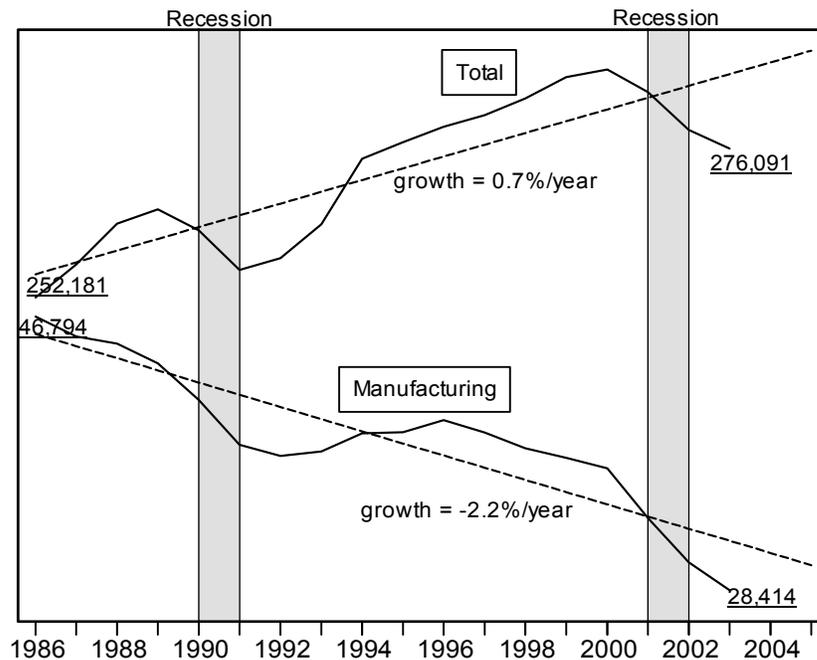


*Toledo Metro includes Fulton, Lucas, Ottawa and Wood counties.
Source: Ohio Bureau of Labor Market Information.

Figure 1 illustrates weak but slightly improved local employment conditions in 2005. Manufacturing employment declined 21% over the last five years in the Toledo metro

area. Total wage and salary employment fell 5% from 2000 to 2004. This year, however, employment is expected to rise 0.1%. That is not much of a gain, but it seems to be the start of a long-awaited recovery in local employment conditions. The turnaround in local employment will not be strong this year, but more growth is expected in 2006. Although employment is unlikely to regain its pre-recession high next year, the outlook for jobs here has improved. The dark side is manufacturing employment, which shows no signs of improving after five years of declines. A recovery in manufacturing employment next year is unlikely to be of sufficient strength to give a big boost to Toledo's economy. In short, local labor market conditions did improve during 2005.

Figure 2: Employment Trends in Lucas County



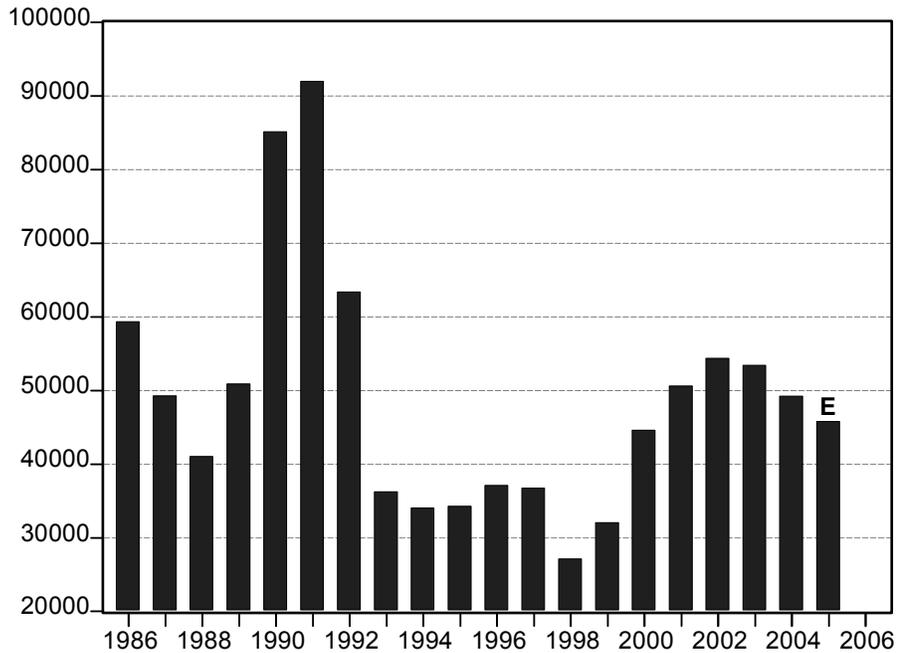
Source: U.S. Department of Commerce, Bureau of Economic Analysis, Regional Economic Information System (REIS), CA25, April 2005 and Paul Kozlowski, University of Toledo.

Figure 2 captures the long-term employment situation in Lucas county. Based on comprehensive data released by BEA's Regional Economic Information System, manufacturing employment declined 2.2% per year from 1986 to 2003. In 2003, the latest data available for Lucas county, manufacturing accounted for just 10% of total employment compared to 19% in 1986. The trend in total employment is positive but slow. The drag, of course, has been the downtrend in manufacturing employment.

Since 2000 local employment conditions had a direct negative impact on income tax revenue. Improving business conditions point to job gains for 2006. National forecasts show increases in employment of about 1.6% for 2006. Modest increases nationwide translate into only slight gains for the Toledo area. Nevertheless, the outlook is positive

but cautious. At this time, a mild recovery in local total employment seems likely and this will contribute to gains in income tax withholding next year.

Figure 3: Toledo Metro Initial Claims for Unemployment Insurance

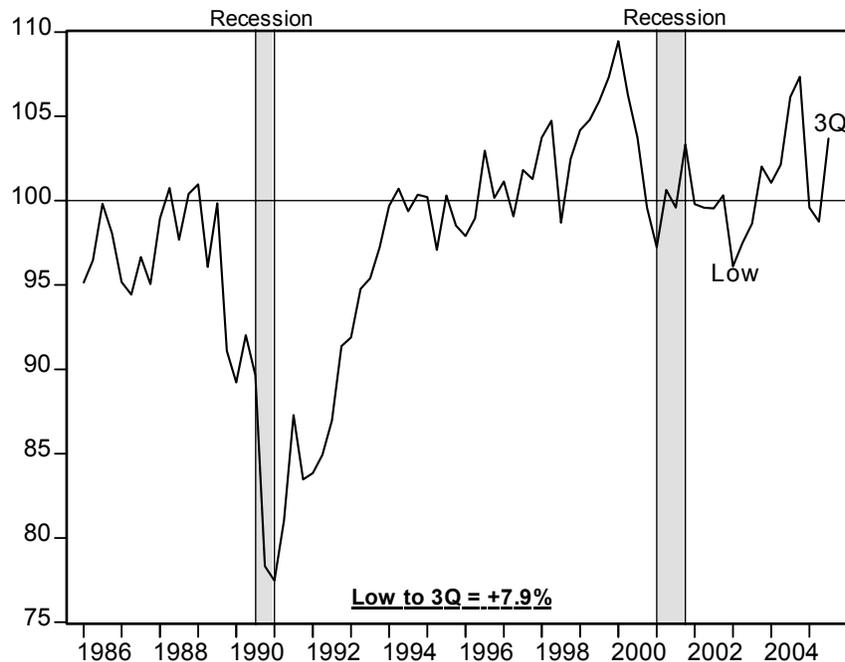


E = estimated with actual data through October 2005.
 Source: Ohio Bureau of Labor Market Information.

Figure 3 shows declines in initial claims for unemployment insurance in the Toledo area for the last three years. Note, however, that claims for unemployment insurance have not declined to levels recorded during the mid-1990's. A year ago the forecast stated:

“Our analysis anticipates another drop in claims for unemployment insurance during 2005, but weak local labor market conditions are likely to limit declines.” (page 5)

That is exactly what occurred this year. Nevertheless, the drop in claims reflects improvements in labor market conditions here. The forecast for tax revenue expects that to continue in 2006, but not at a strong pace.

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 2005 but not at an even pace. The Toledo index of leading indicators, shown in Figure 4, has increased 7.9% from its low in the first quarter of 2003 to the third quarter of 2005. Although the index retreated during the first half of 2005, the overall trend is upward for the last two years. This movement signals improvement in local business conditions into 2006.

The 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 reveal a mixed picture. The average workweek held at about 43 hours and claims for unemployment insurance were down. Although residential housing units authorized by building permit were off a little this year, they still remained at relatively high levels. Nationwide sales of light vehicles also remained at high levels throughout 2005. Unfavorable movements occurred in the University of Michigan's index of consumer sentiment, which has moved down in 2005. In addition, orders for local manufactured goods were up, but not by much.

The index behavior points to improvement in the local economy in the future. Nevertheless, the mixed signals suggest caution about the strength of improvement going forward.

B. Forecast 2005

The forecast last December showed 2004 income tax withholding at \$134,445,002, a 1.3% drop from 2003. Actual withholding revenue turned out to be \$134,704,005. The result was an under-prediction of only \$259,003 or 0.2% for the City's major source of income tax revenue.

The forecast for 2005 was too pessimistic. A year ago, the forecast for withholding tax revenue was \$135.8 million. Based on data through the third quarter the City's withholding revenue is likely to be \$139.6 million. The difference of \$3.8 million, results from an upside risk cited in last year's forecast: **On the upside is a bottoming out of employment losses this year and a rebound next year.** (p. 12). Figure 1 revealed no losses in total employment for the Toledo area this year. Gains in production resulted in more income and more income tax revenue from withholding.

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

		Withholding (sa)	Seasonal Index	Re- Seasonalized	Withholding (nsa)	Annual Percent Change
2005	1				34,051,935	
	2				33,670,229	
	3				34,619,430	
	4	35,421,820	1.053079	37,301,975	37,301,975	
Annual				139,643,569	3.7	

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

b) 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 forecast for the last quarter of 2005 uses updated information available through November. Table 1 gives quarterly income tax revenue from withholdings generated by the DQF procedures accounting for long-term trend, the business cycle, and seasonal movements in the City's revenue. For 2005, the forecast shows a 3.7% increase in withholding revenue; that represents a gain of \$4.9 million. This increase in withholding revenue is significant and reflects improved economic conditions cited in section A. It is also above the forecast made last year, which was correct in predicting a positive gain in withholding revenue but not up to the amount that now appears likely this year. The under-prediction in last year's forecast is the result of significant improvements that occurred in the second-half of the year. The forecast error for 2005 will probably be close to 2.5%, small in terms of the amount of revenue generated. Nevertheless, with revenue now forecast at \$139.6 million for this year, that error translates to an under-prediction of \$3.5 million from the City's major source of income tax revenue.

Table 2 shows the three income tax categories. Increases are forecast for each category in 2005. The result is total income tax revenue of \$161.7 million this year, up 4.2% from 2004. That represents a significant turnaround for the City's income tax revenue. Also, the current forecast for 2005 is a \$5.7 million above the forecast a year ago. In short, the upside was very good for the City this year.

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

	Withholding (nsa)	Business Income (nsa)	Individual Direct Pays (nsa)	Total (nsa)	Annual Percent Change
2004	\$134,704,005	\$14,365,695	\$6,183,237	\$155,242,937	+0.1
2005					
1				39,220,465	
2				42,313,086	
3				39,271,707	
4	37,301,975	2,777,903	850,941	40,930,819	
Annual	139,643,569	15,893,350	6,199,158	\$161,736,077	+4.2

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.

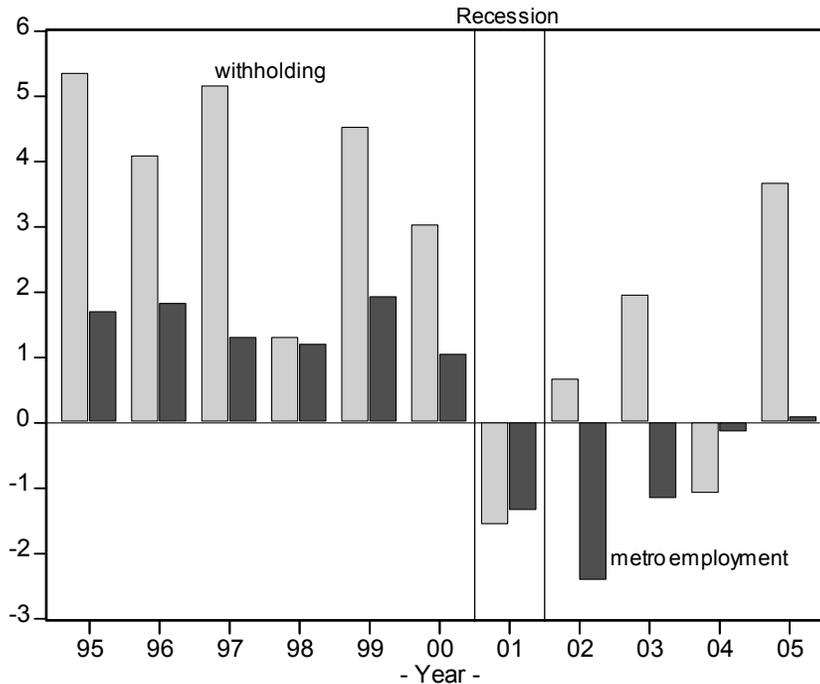
The current forecast for business income tax revenue, \$15.8 million, is a good indication of improved financial conditions for local businesses. A year ago, the forecast cited rising business profits in 2005 that would generate more revenue for the City. The forecast gain for this year exceeds last year's prediction. Moreover, financial outlooks for corporate profits remain strong for next year. Improved business financial conditions have not translated into significant local job growth yet. Nevertheless, the jump in tax revenue from business income this year is positive for the City.

The expected gain in revenue from individual collections is small for this year. The City's enhanced procedures contributed to more collections from this source. Although there is little growth in this category, collections at over \$6 million are well above the collections before the enhanced procedures became operational.

If the City's total income tax revenue grew at its long-term growth rate, then revenue projected for 2005 would about \$169 million. The forecast for the City's income tax revenue will be about \$7 million below that amount. The recovery this year seems strong, but the City has ground to make up after several years of below average growth in income tax revenue

Figure 5 illustrates annual changes in metro employment and in the City's withholding tax revenue. Employment gains from 1995 to 2000 were accompanied by growth in tax revenue. Job losses after 2000 took a toll on the City's revenue. Four years of declining employment resulted in an average gain in withholding tax revenue equal to 0.0%, no growth over four years! That has ended as Figure 5 shows. The recovery in tax revenue from withholding is now underway.

Figure 5: Annual Percent Change – Tax Revenue and Employment



Weak employment conditions still represent the major impediment to growth of the City's income tax revenue. The Ohio Bureau of Labor Market Information shows employment in the Toledo metro area down about 17,000 jobs this year from the high recorded in 2000. If local employment expands at a national rate forecast at 1.6% for 2006, then it will be up by 5,300 next year in the Toledo metro area. To regain all the jobs lost since 2000, employment here would have to increase 5%; that is more than three times the rate of increase predicted for the nation. Therefore, the forecast optimism about next year is constrained by employment conditions here.

This year the City's income tax revenue finally turned around after four years of sub-par performance. Going forward the outlook is good, but somewhat guarded because of weaknesses in the local economy, especially in manufacturing employment.

C. Forecast 2006

The City's income tax revenue stagnated from 2001 to 2004. In 2003 and 2004, the gains in revenue were less than 1%. Things changed in 2005. The forecast shows a 4.2% gain this year, followed by a 3.1% gain next year. Based on the current forecast, the City will have about \$6.5 million more in revenue this year resulting from increases in withholding, business and individual collections.

The forecast for 2006 shows growth in all categories as local economic conditions improve. The expected gain in withholding, which accounted for 87% of actual income tax revenue in 2004, is nearly \$5 million next year. A year ago the forecast for revenue from withholding was too pessimistic. Improved employment conditions here contribute significantly to the gain forecast for 2006.

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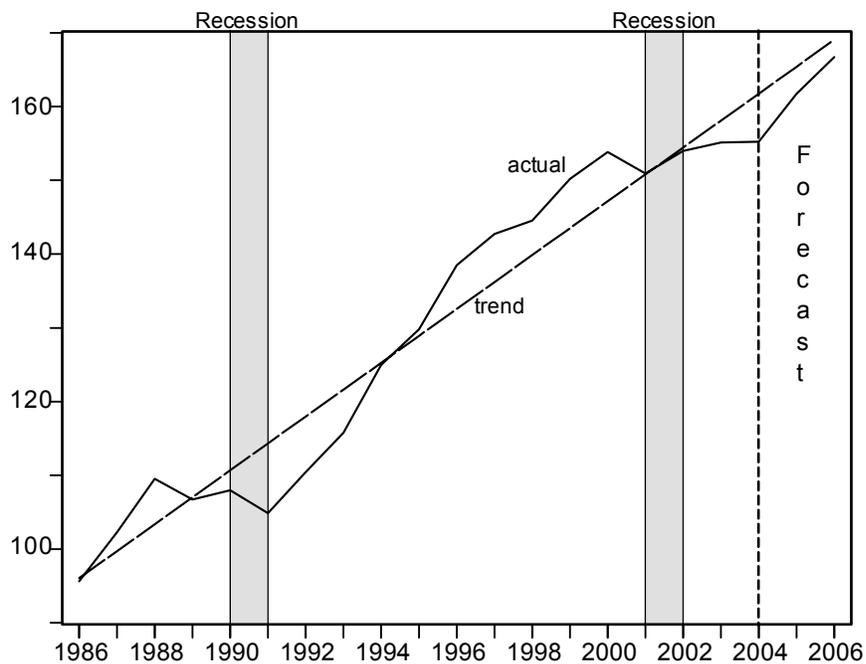
Note: Forecasts in bold were generated with procedures outlined to City Council in *City of Toledo Payroll Tax Revenue: Annual Budget Projections and Long-term Trends*, UT-Urban Affairs Center, October 2000.

Source: Actual revenue from City of Toledo, Finance Department/Treasury Division.

Economic growth is expected to continue nationwide next year. Toledo's economy should improve as well. Based on the forecast, it is highly likely the City will experience two consecutive years of growth in income tax revenue above 3%. That has not occurred here since the mid-1990s.

Figure 6 shows the City's income tax revenue performance since 1986. Although the forecast shows total income tax revenue in 2005 and 2006 below its long-run trend levels, in 2006 the City will find itself close to that long-run trend. Revenue growing below its trend is a direct consequence of the recession in the local economy followed by a very weak recovery here. It took three years for the City's revenue to get back to its long-run trend after the recession in 1990-91. This time, recovery is taking longer. By 2006, four years after the recession of 2001 ended, the City's income tax revenue will not be back to long-run trend. With recovery expected to continue, the forecast for 2006 puts income tax revenue 8.4% above the pre-recession level in 2000. That amounts to \$12.9 million, roughly \$2 million per year.

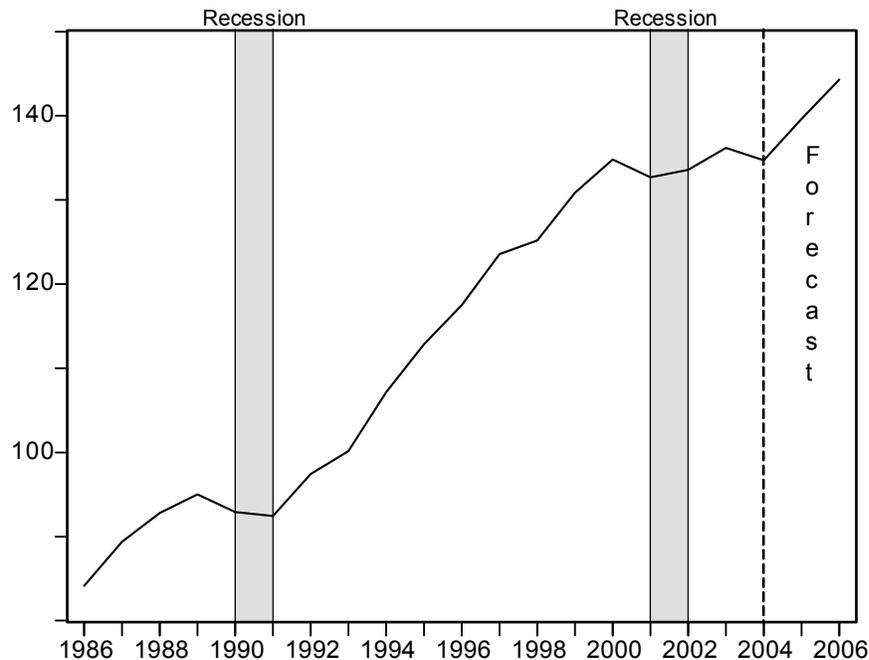
Figure 6: Annual Income Tax Revenue (millions)



Source: City of Toledo, Finance Department/Treasury Division and Paul Kozlowski, University of Toledo.

Inflation is forecast at about 3% for 2005 and 2006. The gains in the City's income tax revenue forecast for this year and next are only slightly above that. The result is that increases in tax revenue, adjusted for inflation, are smaller than the growth shown in Table 3. In inflation-adjusted terms, the City lost revenue from 2000 to 2004. The forecast for 2005 and 2006 show real increases for the first time in many years.

Figure 7 illustrates income tax withholding. The City experienced losses in revenue from its largest source in 2001 and 2004. The current forecast projects a gain for 2006 that will move withholding revenue 8.7% above its recession low in 2001. Five years after the recession in 1990-91 the City's withholding income tax revenue was up 27%. While the outlook is optimistic and growth in revenue is forecast, this certainly does not represent boom conditions. It is a start in the right direction, however.

Figure 7: Annual Income Tax Revenue - Withholding (millions)

Source: City of Toledo, Finance Department/Treasury Division and Paul Kozlowski, University of Toledo.

Risks to the Forecast

Based on continued economic expansion nationwide, our forecast shows 3.1% growth in total income tax revenue next year. This forecast is positive and it represents a turnaround in the local economy and in the City's tax revenue. Downside risks can negatively influence the growth in the City's income tax revenue next year.

Downside risks include:

- Weaker labor market conditions that limit jobs and income growth.
- Weaker automobile sales accompanied by adjustments to production.
- More terror attacks that adversely affect consumer and business confidence.
- A continued increase in interest rates that adversely affects interest-sensitive local businesses.

Upside risks reflect conditions that may result in revenue well above the forecast.

- Growth in profits for local businesses due to improved economic and financial conditions.
- Stronger employment growth resulting from stronger business conditions locally.
- Increased demand for local manufactured products resulting in a significant turnaround in local manufacturing jobs.