

# Toledo Income Tax Revenue: Forecast 2004



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By The University of Toledo Urban Affairs Center

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## Executive Summary

Economic fundamentals improved this year, but labor market conditions remained weak. Employment, especially in manufacturing, has not rebounded strongly even though the national economy recorded solid gains in the second half of 2003. For the local economy, 2003 hardly seemed like a second year of recovery. Nevertheless, local signs of recovery exist and we expect improvement in 2004 as the pace of picks up.

We cited weak labor market conditions as a downside risk a year ago and that caused recovery in the City's income tax revenue to stall this year. For 2003 our forecast now shows a 1.4% gain in tax withholdings but declines in collections from businesses and individuals. We do not expect the \$1.8 million gain in tax withholding this year to offset the decreases in business and individual collections. A year ago we cited growth of revenue from business tax collections as the biggest potential drag on the City's income tax revenue for 2003. That turned out to be the case. Our dynamic quarterly forecast procedures (DQF) show a slight drop (0.6%) in total income tax revenue this year, which translates into a loss of nearly \$1 million for the City. Overall, we were too optimistic in our forecast a year ago.

Our forecast for 2004 shows a 3.4% gain in the City's total income tax revenue to \$158.2 million. That's up about \$5 million from 2003. Most of the gain next year comes from tax withholding, \$4.3 million, but collections from businesses and individuals also contribute positively. Expected improvements in national and local economic conditions contribute to predicted increases in income tax revenue. Improving local labor market conditions translate directly to gains in the City's income tax revenue next year.

The figures below show Toledo's income tax revenue since 1998, including our forecast for 2003 and 2004. Our forecast shows a solid gain for 2004. If the City's total income tax revenue was close to its long-run trend, revenue next year would be about \$164 million instead of the \$158.3 that we are forecasting. The cumulative losses from the recession and weak recovery on the City's income tax revenue are large, and the City's revenue pattern is similar to the one observed during the early-1990s. Our forecast shows a move upward in all categories for 2004; in that sense it is optimistic but guarded. Downside risks exist, including weak gains in local employment during 2004.

### Toledo Income Taxes - Forecasts are bold.

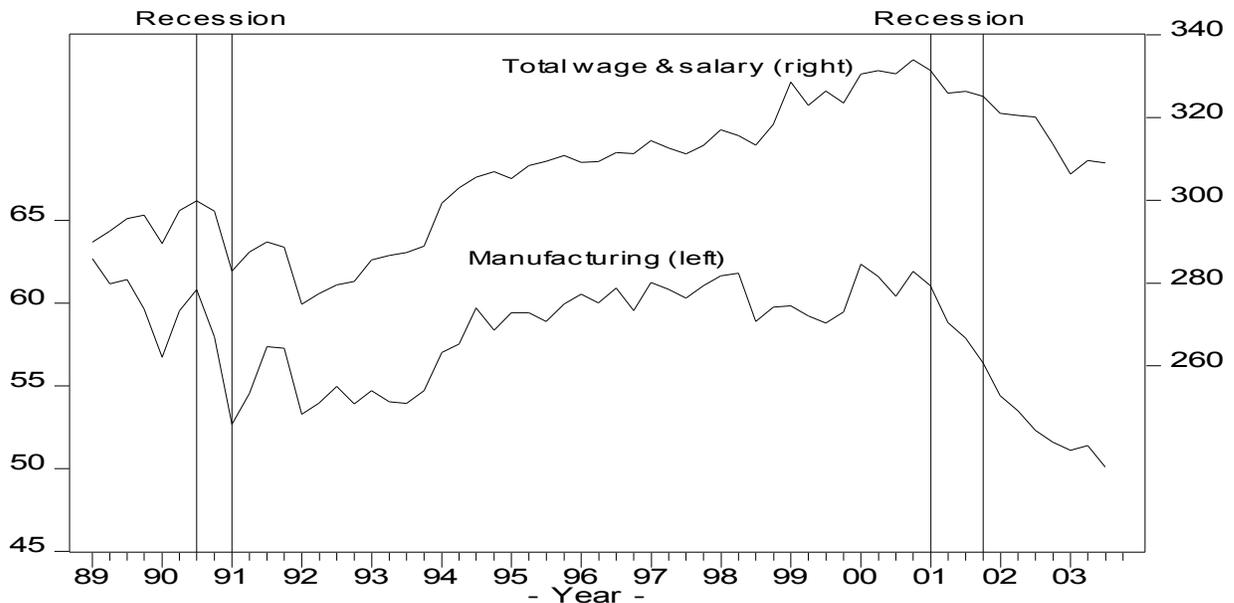
	Withholding	Percent change	Business	Percent change	Individual	Percent change	Total	Percent change
1998	125,178,347	1.3	15,904,590	0.3	3,421,660	4.2	144,504,597	1.3
1999	130,843,903	4.5	15,645,820	-1.6	3,680,593	7.6	150,170,316	3.9
2000	134,806,279	3.0	15,287,726	-2.3	3,736,243	1.5	153,830,248	2.4
2001	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
<b>2003</b>	<b>135,423,108</b>	<b>1.4</b>	<b>12,168,239</b>	<b>-14.0</b>	<b>5,507,945</b>	<b>-11.6</b>	<b>153,099,292</b>	<b>-0.6</b>
<b>2004</b>	<b>139,719,496</b>	<b>3.2</b>	<b>12,818,812</b>	<b>5.3</b>	<b>5,750,295</b>	<b>4.4</b>	<b>158,288,603</b>	<b>3.4</b>

## A. Economic Conditions

The National Bureau of Economic Research (NBER) declared that the national recession ended in November 2001. The recession was short and mild overall. Until recently, however, the national recovery was relatively weak, especially in the labor market. Moreover, considerable uncertainty about terrorism and the consequences of war in Iraq adversely affected business and consumer confidence about future economic prospects. Although the economic fundamentals improved this year, labor market conditions remained weak; and employment, especially in manufacturing, has not rebounded strongly. Economic recovery is likely to be stronger in 2004 as consumer spending and business investment increase. The national economy recorded solid gains during the second half of 2003, but job gains continued to lag. Those conditions had a direct negative effect on the City's income tax revenue.

For the local economy, 2003 hardly seemed like a second year of recovery. In our forecast a year ago, we cited "Weak job gains that limit income growth nationwide and in the Toledo area" as a significant downside risk to our forecast for a small increase in the City's income tax revenue (*Toledo Income Tax Revenue: Forecast 2003*, December 12, 2002, page 9). That is exactly what happened this year, and local weakness limited the growth of income tax revenue. Nevertheless, local signs of recovery exist and we expect improvement in 2004 as the pace of economic recovery picks up. The last three years have been tough on jobs in the Toledo area, and tough on the City's income tax revenue.

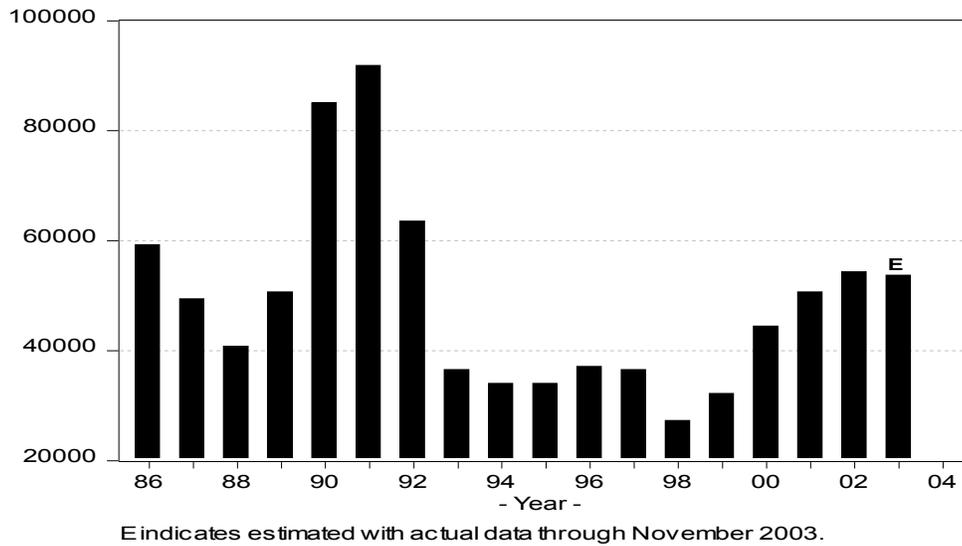
**Figure 1: Toledo Metro Employment (thousands, seasonally adjusted)**



Source: Ohio Bureau of Labor Market Information.

Figure 1 illustrates the weakness in employment in the Toledo area. Note that local manufacturing employment recorded its pre-recession high in early-2000 and continued to drop through two years of economic recovery. Total wage and salary employment also did not recover much this year. Weak job growth here is a key factor restricting City's growth in income tax revenue this year.

**Figure 2: Toledo Metro Initial Claims for Unemployment Insurance**



Source: Ohio Bureau of Labor Market Information.

Figure 2 shows increases in initial claims for unemployment insurance from 1999 to 2002. They dropped as the economy rebounded from the 1990-91 recession. That has not happened so far in this recovery. In fact, initial claims this year are about the same as last year.

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



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

The Toledo index of leading indicators in Figure 3 is a composite of six indicators: 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. Although the index rose in the second and third quarters of 2003, the local economy has not exhibited consistent upward momentum. After two years of recovery, the index is up slightly compared to sizable gains after the recession of the early-1990s.

## B. Forecast 2003

Our original forecast for 2003 was a too optimistic. Based on information available through the third quarter of 2003, our dynamic quarterly forecast procedures (DQF) show a slight drop (0.6%) in total income tax revenue for this year. Even under a very optimistic scenario for the fourth quarter, the City can only expect total income tax revenue to be about equal to the total for 2002. A year ago we forecast a gain for total income tax revenue. What happened?

The downside risk of weak labor market conditions, which we cited a year ago, actually occurred this year. For 2003 our forecast shows a 1.4% gain in tax withholdings but declines of 14% and 11.6% in collections from businesses and individuals. The 1.4% gain in tax withholdings is positive for the City, but it is less than the 2.6% we predicted a year ago. We do not expect the gains in tax withholdings to offset the decreases in business and individual collections.

Our forecast for the fourth quarter of 2003 uses updates based on the recent data available through November 2003. Table 1 shows the quarterly income tax revenue from withholdings generated by the DQF procedures that account for long-term trend, the business cycle, and seasonal movements in the City's revenue. The results in Table 1 suggest that the City can count on continued recovery in revenue from withholdings. That is positive but it is weak. 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%.

The City's tax withholdings rose only 2% over the last two years: 0.7% in 2002, and a predicted 1.4% in 2003. On the positive side, it is important to note that revenue from tax withholding did increase as our forecast predicted. The gain was smaller than predicted, however. The result is that tax withholdings will generate about \$1.8 million in added revenue this year; that is less than the nearly \$4.4 million forecast a year ago. Nevertheless, the predicted revenue generated by tax withholding for 2003, \$135.4 million, moves that source above its pre-recession level of \$134.8 million. As the largest source of City's income tax revenue, that represents improvement, although it did take three years for revenue from tax withholding to recover lost ground.

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

		Withholding (sa)	Seasonal Index	Re- Seasonalized	Withholding (nsa)	Annual Percent Change
2003	1				34,132,572	
	2				33,142,410	
	3				32,028,009	
	4	34,564,606	1.045003	<b>36,120,117</b>	<b>36,120,117</b>	
Annual				<b>135,423,108</b>	<b>1.4</b>	

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.

Table 2 shows the City’s total income tax revenue for 2003. Our DQF procedures predict a slight drop in total income tax revenue this year, following a 2% gain in 2002. The result is that total income tax revenue this year is predicted to be about \$700,000 below its pre-recession peak of \$153,830,248 that occurred in 2000. The City’ tax revenue has still not fully recovered from the recession.

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

	Withholding (nsa)	Business Income (nsa)	Individual Direct Pays (nsa)	Total (nsa)	Annual Percent Change
2002	\$133,577,209	\$14,156,273	\$6,231,758	\$153,965,240	2.0
2003					
1				38,337,560	
2				40,887,823	
3				35,652,714	
4	<b>36,120,117</b>	<b>1,460,173</b>	<b>640,905</b>	<b>38,221,195</b>	
Annual	<b>135,423,108</b>	<b>12,168,239</b>	<b>5,507,945</b>	<b>153,099,292</b>	- 0.6

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.

Our forecast of \$12,168,239 for tax collections from business represents a drop of nearly \$2 million from last year. Tax revenue from business income tends to be erratic, and over the last seven years, 1997 to 2003, yearly collections dropped five times. The only increases occurred in 1998 (0.3%) and 2002 (7%). The drop in revenue from the business source for 2003 is the key factor contributing to the 0.6% decline in the City’s total income tax revenue this year.

Revenue from tax withholding and business profits is sensitive to conditions in the local economy summarized in Figures 1, 2, and 3. In short, labor market conditions improved slightly in 2003, but not enough for the predicted increase in income tax withholdings to offset the drop in tax revenue generated from business income. In last year’s forecast we stated that “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.”(page 6) That is still the case, and it applies to tax revenue collected from businesses next year.

Finally, our forecast for revenue collected from individuals is close to our prediction a year ago. At \$5,507,945 for 2003, it is off slightly from its level in 2002, but it is still above levels recorded before the recession. Economic recover combined with the City’s improved collections procedures appear to have added about \$2 million to revenue from this source. We expect slight growth through 2004.

## C. Forecast 2004

Last year we forecast the City's total income tax revenue to be \$156,947,933 for 2003, a gain of almost \$3 million. Based on information available through November, it now seems that the total is more likely to be close to \$153.1 million, a loss of about \$900,000. The error in our 2003 forecast results from smaller gains than predicted in income tax withholdings and the decline in tax revenue from businesses. We correctly predicted continued recovery in revenue from income tax withholding, although we were too optimistic a year ago. While we did forecast a drop in tax revenue from business, it now appears that the falloff will be larger than predicted.

**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
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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.

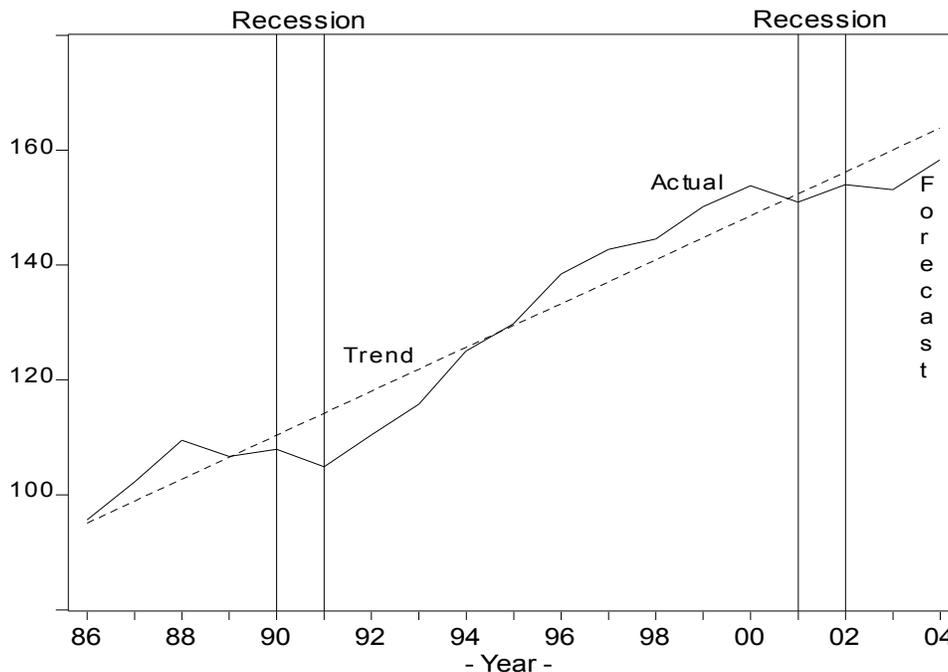
Our forecast shows a 3.4% gain in the City's total income tax revenue to \$158,288,603 for 2004. That's up about \$5 million from 2003. Table 3 shows that most of the gain comes from tax withholding, \$4.3 million. Collections from businesses and individuals also contribute positive, but small, gains to total revenue for 2004. The 3.2% predicted increase in tax withholding for next year is close to the long-run trend growth of the City's income tax withholding dating back to 1986. Next year's increase results from expected improvements in national and local economic conditions. For the Toledo area, that means improving labor market conditions, which translate directly to gains in the City's tax revenue.

Predicted revenue from businesses increases less than \$1 million next year. That is very "conservative," but that source of revenue has been very erratic over many years.

Although recovery is expected to continue through 2004, there are few economic factors that point to higher gains from that local source. Nevertheless, a strong recovery here next year may actually generate more than we are forecasting at this time.

Figure 4 illustrates the City's income tax revenue performance since 1986. Our forecast puts total income tax revenue in 2003 and 2004 below its long-run trend levels. Revenue growing below its trend is a direct consequence of the recession in the local and national economies. For the most part, that recession behavior in income tax revenue is beyond the City's control. With recovery expected to continue in 2004, our forecast puts income tax revenue for next year above the pre-recession level in 2000. Weak local economic and labor market conditions this year caused the recovery in the City's income tax revenue to stall.

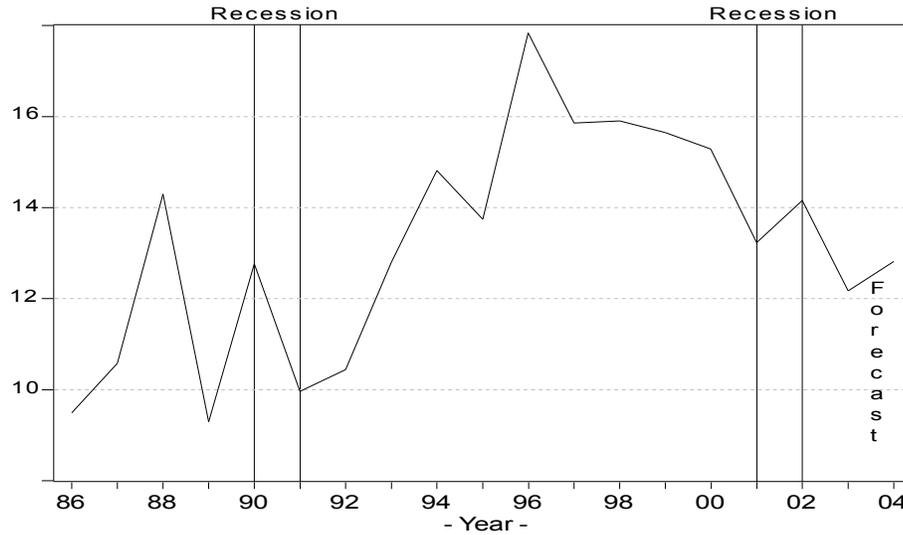
**Figure 4: Annual Income Tax Revenue (millions)**



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

The City's slump in 2001 was relatively mild, but recovery has been weak so far. Although our forecast shows a solid gain for 2004, the City's total income tax revenue is likely to remain below its long-run trend. That means lost revenue again next year compared to the City's growth potential. If the City's total income tax revenue was close to its trend, revenue next year would be about \$164 million instead of the \$158.3 that we are forecasting.

**Figure 5: Income Tax Revenue - Business (millions)**

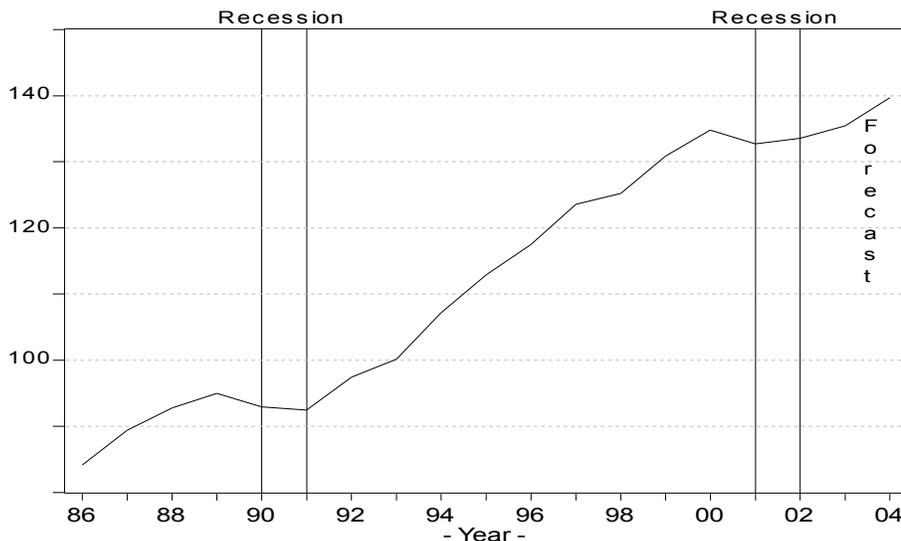


Source: City of Toledo, Finance Department/Treasury Division and Urban Affairs Center, University of Toledo.

Figure 5 shows the downtrend in tax revenue from businesses since 1997. Our forecast is for a slight gain next year, but this predicted increase still leaves the City about 28% below the high generated from this source in 1996. That translates to about \$5 million.

Figure 6 illustrates income tax withholding that accounts for about 88% of the total. The recession caused a loss of \$2.1 million from this source. Recovery occurred in 2002; our forecast predicts a gain in 2004. Unlike revenue from businesses, the City's revenue from tax withholding has recovered from the slump in 2001. The City's total income tax revenue would have recovered fully if collections from businesses had rebounded.

**Figure 6: Income Tax Revenue – Withholding (millions)**



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

## Risks to the Forecast

Our forecast for 2004 expects a continuation of economic recovery nationwide and in the local economy. Downside risks still exist, however, and they can negatively influence growth in the City's income tax revenue as happened this year.

- ✓ More terror and/or war with Iraq that adversely affect consumer and business confidence. Confidence in economic conditions improved this year, but bad news could affect both consumers and businesses adversely.
- ✓ Weak automobile sales and further problems for automobile and parts manufacturers.
- ✓ Continued weak labor market conditions that limit jobs and income growth nationwide and in the Toledo area.
- ✓ Re-location of business out of the City.

On the upside, however, is the prospect for solid economic recovery in the City next year. That may generate more income tax revenue from businesses than we forecast for 2004. Historically, the City has lagged behind the nation in recovery but, after three years of slumping employment locally, the City appears poised for solid recovery next year.

At this time, our forecast shows a gain of about \$5.1 million in the City's total income tax revenue for next year.