LBO Testimony on Revenue Forecasts

Before The Committee of Conference

On The FY 2000 - 2001 Biennial Budget

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Summary

Mr. Chairman, members of the Conference Committee, I am here today to present somewhat more detailed testimony about the economic outlook and the LBO revenue forecasts. As you know, the Senate-passed budget was based on OBM's March 1999 revenue forecast for FY 1999, and LBO's March 1999 revenue forecasts for FY 2000-2001. LBO's updated forecasts of state GRF revenues (excluding federal grants) exceed those original forecasts by $273 million in FY 2000 and $198 million in FY 2001. This provides an additional $471 million in GRF revenues for the biennium. However, we also believe that lottery profits will fall $84 million short of the Senate appropriation levels (based on the Ohio Lottery Commission forecasts) for the biennium. The net gain to the GRF and the LPEF combined is thus $387 million for the biennium. (Taking into account the higher human services GRF cost lowers the net amount available to $347.8 million). At the back of my testimony are two tables that show:

(i) the current LBO forecasts, baseline and adjusted for tax law changes. The tax law changes shown are for the Senate-passed budget. A number of changes now in HB 282 or HB 283 do not appear because their first impact is outside the FY 2000-2001 biennium;

(ii) the difference between the current (Jun-99) LBO forecast and the prior (Mar-99) LBO forecast;

Table 1, below, summarizes the forecast changes from the Senate-passed budget.

Table 1 - Comparison of LBO Jun-99 GRF and LPEF Forecasts and Senate-passed budget forecasts, FY 1999 - 2001

	FY 1999	FY 2000	FY 2001
LBO GRF Jun-99			
Tax Revenue	$14,646.2	$16,507.1	$16,176.7
Non-Tax Income	$302.0	$291.6	$288.6
Transfers	$677.6	$91.0	$92.0
Total State GRF Revenue	$16,625.8	$16,889.7	$16,554.3
Federal Revenue	$3,376.0	$3,752.8	$3,959.1
Senate Budget GRF			
Tax Revenue	$14,338.1	$16,229.8	$15,978.9
Non-Tax Income	$293.6	$296.6	$288.6
Transfers	$763.7	$90.0	$91.0
Total State GRF Revenue	$16,395.4	$16,616.4	$16,356.5
Federal Revenue	$3,476.0	$3,721.0	$3,955.6
LBO Jun-99 GRF Forecast minus Senate Budget, State $	$230.4	$273.3	$197.8
LBO Jun-99 minus Senate Budget, Federal $	($100.0)	$31.8	$3.5
Lottery Profits			
LBO Jun-99	$692.0	$661.1	$631.2
Senate Budget (OLC Forecast)	$693.0	$686.0	$690.2
LBO Jun-99 minus Senate Budget	($1.0)	($24.9)	($59.0)
Grand Total, GRF + LPEF	$229.4	$248.4	$138.8

amounts in millions of $

Most of the difference between our earlier forecast and our current forecast is in the personal income tax. Aside from the income tax, our projections have gone up only slightly from those used in the Senate budget. We have adjusted the estate tax forecast upward, and the cigarette tax forecast downward. We have made very minor forecast revisions in other revenue sources. Finally, in our detail spreadsheets we show the new natural gas tax separately, rather than together with the public utility excise tax.

This morning, we were still changing our calculations of the year-end surplus amount that will be in excess of the $415.7 million committed to public school buildings and SchoolNet Plus. Based on some Controlling Board requests to transfer appropriation authority or encumber money, we adjusted our estimate of the year-end tax cut down to about $220 million. This number is still quite fluid and OBM is probably a better source for the estimate, since they are in minute-to-minute contact with the agencies requesting the transfers or encumbrances.

LBO's forecast of the income tax in FY 1999 is $6,453.0 million, $302 million higher than the July, 1998 forecast of $6,150.6 million. As of the end of May, income tax collections were $304.9 million above the July, 1998 estimate. Our income tax forecasts for FY 2000 and FY 2001 are $261 million and $191 million above the original figures, respectively.

<u>The Economy</u>

Since we spoke to the House Finance Committee in March, economic forecasts for CY 1999 have improved dramatically. Real GDP growth is now expected to be about 3.9%, rather than the roughly 2.5% that forecasting firms were predicting as recently as January. DRI has reduced its forecasted growth for CY 2000 slightly, but WEFA has increased its projections for both CY 2000 and CY 2001 (see Table 2). DRI has reduced its forecast probability of a near-term recession to 15%, and WEFA has reduced its near-term recession probability to 20%.

Table 2 - Revisions to GDP Growth Forecasts, CY 1999-2001

	1995	1996	1997	1998	1999	2000	2001
Real GDP	2.3%	3.4%	3.9%	3.9%			
DRI Jan99					2.7%	2.0%	2.0%
DRI Jun99					3.9%	1.7%	2.0%
WEFA Jan99					2.4%	1.7%	2.2%
WEFA Jun99					3.9%	2.0%	2.9%
GEAC Jan99					2.4%	2.5%	2.5%

Up until very recently, the inflation news had also been very good. This led the forecasting firms to believe that even if there was a near-term recession, continued low inflation would free the Federal Reserve to aggressively cut short-term interest rates and stimulate the economy. This in turn would keep any recession brief. The bad CPI report for April (increase of 0.7%) has rekindled inflation fears and led the Federal Reserve to change its "policy stance" from neutral to leaning toward raising rates. The CPI report that will be released June 16th (tomorrow) will be important for determining the Federal Reserve's action. The consensus forecast by analysts is that the May CPI inflation figure will be only 0.2%, not enough to spur immediate Fed action.

DRI clearly states in their June outlook that they believe that inflation fears are overstated. The April increase in the CPI was driven by three factors: oil price increases (seen at the gas pump); apparel price increases, where a weak dollar led to price increases after 8 straight monthly declines; and tobacco price increases. DRI actually predicts that the core CPI (excluding food and energy) will fall in CY 1999. Growth in the employment cost index (ECI) has also moderated, easing the wage pressure on inflation. Finally, increases in productivity are helping to hold down output price increases.

Increases in productivity have an important role to play in our long-term forecasts. DRI's June 1999 U.S. economic outlook states that they expect annual productivity gains to average 1.7% over the next five years, greater than the 1.5% average of the last five years, and well above the 1.0% average of the 1980s. If true, this will act to hold down unit labor costs and keep inflation in check. It will also allow for faster real growth of the economy.

CY 1996 through 1998 were exceptional growth years for the economy, as can be seen by looking at real GDP (see table 2). That GDP growth is probably above the long-term trend, but by how much? Mainstream economists have long held that trend growth in real GDP was about 2.25% to 2.5%. This figure was derived by adding labor force growth of about 1.0% to 1.25% annually to labor productivity growth of 1.0% to 1.25% annually. But DRI now expects labor productivity growth to be about 1.7% annually. If labor force growth stays at 1.0% to 1.25%, that results in trend growth of 2.75% or 3.0%. While Ohio's tax revenues are not tied to GDP, faster economic growth means faster growth in personal income and in consumption, which do drive tax revenues.

In the short run, the U.S. economy and the Ohio economy are both expected to slow down, and that slowdown is reflected in our revenue forecasts. Our baseline growth rates are lower than recent history. However, based on the latest economic and revenue news, we have adjusted upward the starting point for those growth percentages, and have adjusted the growth percentages themselves.

The major risk seems to be rising interest rates, lower investment, and a stock-market correction. LBO's income tax forecasts call for higher growth in FY 2000 than in FY 2001. This is partly because, even if there were a stock market correction, capital gains might still increase in taxable year 1999, since it appears that there is still a large stock of unrealized gains for taxpayers. Negative impacts would fall primarily in FY 2001.

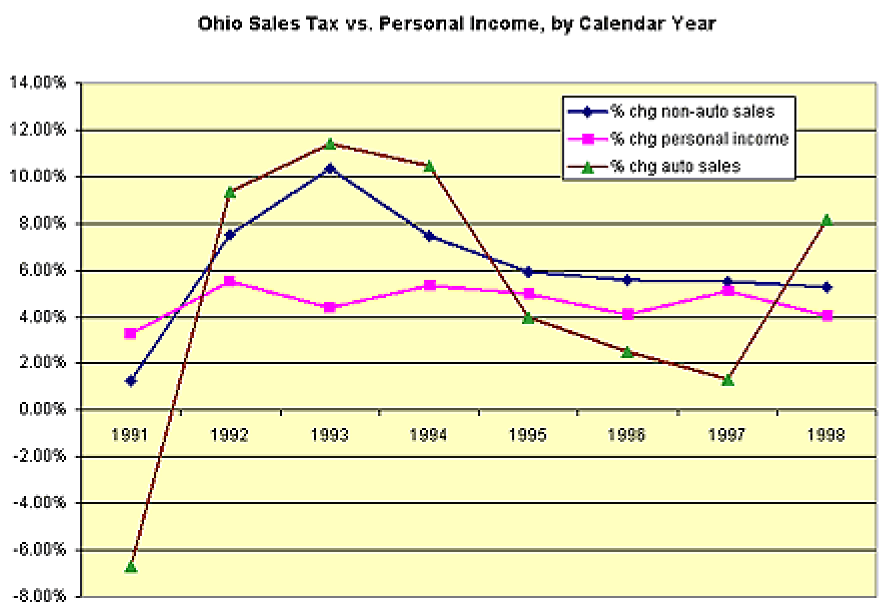
<u>Sales Tax</u>

It is somewhat surprising that, in light of the good economic news, Ohio revenues outside the income tax are not doing better in FY 1999. In July of 1998, OBM revised upward the FY 1999 forecasts of the auto sales tax, non-auto sales tax, and public utility excise tax. Of these, only the auto sales tax will exceed the revised estimate. The non-auto sales tax looks like it will end up around the original estimate. It has grown by 5.0% from last year. This is reasonable growth, but less than the 5.8% figure from FY 1998.

This slowdown has come in spite of strong income growth, and strong national growth in real consumer spending and in retail sales. Of course, low inflation, while good for the economy, does not necessarily lead to high growth in nominal retail sales or in sales tax revenue.

LBO projects that sales tax growth will be slightly slower than personal income growth over the FY 2000-2001 biennium. As the figure below illustrates, this has not been the case for the past few years (at least in non-auto sales). Consumers have been spending out of their additional real-estate and stock market wealth, refinancing their mortgages and spending the savings, and borrowing against their higher wealth. If the major forecasters are right that company earnings growth will decelerate and stock prices will grow more slowly, then this spending out of wealth should also slow down. We expect personal savings rates to resume being positive, and taxable retail sales to trail personal income.

LBO has also been thinking hard about the impact of Internet commerce on sales tax collections, trying to separate hype from reasonable estimates. LBO recently estimated that Ohio lost about $22 million in sales tax in CY 1998 from Internet sales, although the amount could have been as much as $45 million (and other state analysts apparently have even bigger numbers). The estimated GRF loss was about $18 million. If Internet sales triple again in CY 1999, the GRF tax loss increases to $54 million, or an additional $36 million. This would be enough to shave about 0.7% of growth from the non-auto sales tax. Interestingly, some Merrill Lynch analysts recently projected that store-based retail sales growth over the next few years will be reduced from 4% annually to 3.5% annually by the substitution of Internet sales for store sales. While these Internet estimates are speculative at this point, they provide a good reason for caution about future growth of the sales and use tax.



Personal Income Tax

The upward revision in the income tax is large. A skeptic might state that this is a big change for one additional quarter of data. The fact is that LBO would not make such a revision on the basis of nothing more than an additional quarter. We now have almost a complete picture of the 1999 filing season results, whereas before the filing season results were still largely speculation. We have also had the opportunity to talk to economists and/or forecasters at the CBO, Federal Reserve banks, other states, and the WEFA Group. Last week, we received data from the IRS about Ohio income, including capital gains realizations, for taxable year 1997. We have also seen the first quarterly estimated payment for taxable year 1999, as well as an uptick in withholding growth. In short, what we have is more like an additional year of data, rather than an additional quarter, plus a better feel for what is happening to income tax revenues in other states and at the federal level.

The revised income tax forecasts are shown in Table 3, below.

Table 3 - GRF Income Tax History and Forecasts
amounts in millions of $

	History				Forecast		
	FY 1995	FY 1996	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001
Baseline Collections, History and Forecast	$5,457.7	$5,884.1	$6,406.5	$7,331.4	$7,920.1	$8,404.5	$8,867.2
baseline growth	7.3%	7.8%	8.9%	14.4%	8.0%	6.1%	5.5%
Adjustments							
ITRF Rate Cuts			($352.8)	($301.1)	($638.3)	($105.2)	$0.0
Exemption Increases and Indexing			($40.0)	($89.0)	($111.0)	($145.0)	($168.0)
HB 215 Withholding on Pass-Through Enities			$0.0	$0.0	$39.0	$39.0	$39.0
Total After Adjustments	$5,457.7	$5,884.1	$6,013.8	$6,941.3	$7,209.8	$8,193.3	$8,738.2
TOTAL GRF - actual	$4,880.7	$5,262.8	$5,382.3	$6,212.5	$6,452.7	$7,333.0	$7,820.7
Proposed Law Changes						($52.7)	($60.9)
Net to GRF						$7,280.3	$7,759.8

What is the source of the income tax boom that we have seen in FY 1997 through FY 1999? While employer withholding growth was very strong in FY 1998 (9.1%), the growth in quarterly estimated payments and the strength of annual return payments in spite of the rate cuts suggest that non-wage income is behind the big increases and big overages that we have seen, particularly capital gains income.

Table 4 shows IRS tabulations of capital gains income of Ohioans (excluding nonresidents, who are income taxpayers) for tax years 1989-1997, as well as an estimate for 1998 based on incomplete national data. The tax revenue estimates are based on LBO calculations. If these are correct, then by taxable year 1998 Ohio received $587 million more in annual tax revenue from capital gains than it had received four years ago (taxable year 1994). This means that much of the revenue overages that we have seen is attributable to capital gains realizations.

Table 4 - Estimates of Ohio Capital Gains Tax Revenue, 1989 - 1998

Tax Year		Capital Gains	Pct. Change		Tax Revenue	Effective Tax Rate
1989	$	3,806.3		$	248.9	6.5%
1990	$	2,646.4	-30.5%	$	170.4	6.4%
1991	$	2,862.6	8.2%	$	178.8	6.2%
1992	$	3,209.1	12.1%	$	204.1	6.4%
1993	$	4,431.6	38.1%	$	283.6	6.4%
1994	$	3,649.1	-17.7%	$	236.1	6.4%
1995	$	4,423.2	21.2%	$	288.8	6.5%
1996	$	6,701.6	51.5%	$	412.9	6.2%
1997	$	9,701.4	44.8%	$	621.2	6.4%
1998 (est.)	$	13,581.9	40.0%	$	823.2	6.1%

amounts in millions of $

While the running of the bulls has obviously benefited the federal government, Ohio, and other states, forecasters need to approach this extra revenue with some caution. As the data in table 4 shows, year-to-year capital gain behavior is quite volatile. We have said already that we expect taxable year 1999 to be another strong year, leading to good returns in FY 2000. After that, if the stimulus from the federal tax law change in 1997 begins to dissipate, and a market correction slows gains realizations, the negative impact could be significant. For example, a 20% decline in capital gains would reduce tax revenue by $150 million to $200 million.

There is also additional income tax revenue from changes in business organization. More businesses are being organized as S-corporations, partnerships, and limited liability companies (LLCs) where the business does not pay the corporate tax, but instead the owners pay the income tax on their share of profits. We cannot put a hard number to the amount of tax collected from these businesses, but we know that it is growing. In tax year 1985, when Ohio last imposed the corporate-level tax on S-corporation earnings, there were an estimated 10,000 to 15,000 S-corporations in Ohio. In 1999 there are more than 100,000 (estimated).