

Legislative Fiscal Bureau

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State of Wisconsin

May 11, 2011

Senator Alberta Darling, Senate Chair
Representative Robin Vos, Assembly Chair
Joint Committee on Finance
State Capitol
Madison, WI 53702

Dear Senator Darling and Representative Vos:

Last January, this office released estimates of general fund tax revenues for 2010-11 and the two years of the 2011-13 biennium. Those figures, which included the effects of tax legislation enacted during the January, 2011 Special Session (Act 1, relating to health savings accounts; Act 3, creating a tax deduction/credit for businesses that relocate to Wisconsin; and Act 5, creating a tax deduction for businesses that add employees in Wisconsin), were incorporated into the Governor's 2011-13 biennial budget bill.

Recently, tax collections data for April became available and IHS Global Insight, Inc. (Global Insight) released its May, 2011, forecast of the U.S. economy. The collections data shows considerable strength in the individual income tax, but lower than expected revenues from the sales tax and the corporate income and franchise tax. However, the strength in income tax collections significantly exceeds the weakness in the other two major taxes.

The May economic forecast shows some improvement over the January forecast for a number of economic indicators, including nominal (current dollar) gross domestic product (GDP), personal consumption, personal income, home sales, and corporate profits. But total employment, light vehicle sales, housing starts, and real (inflation-adjusted) GDP are expected to be somewhat lower in 2011 through 2013 than was projected in January. Also, Global Insight assigns a higher probability to its pessimistic alternative in the new forecast (20% in April versus 15% in January). Compared to the January forecast, the U.S. unemployment rate is expected to be about 0.5% lower in 2011 and 2012; however, this is due to reduced labor force participation rather than an increase in employment. Consumer prices are expected to be somewhat higher relative to the January forecast, primarily due to increased inflation in 2011. Crude oil prices are expected to be 10% to 15% higher than forecast in January. Although there are a number of differences between the two forecasts, in terms of magnitude, most of the major economic indicators in the current forecast do

not vary significantly from the January figures. Both forecasts project a continued slow recovery over the next several years, with nominal GDP growth of 4% to 5% each year and 1% to 2% annual employment growth.

Based on our review of the collections data and the new economic forecast, we now believe that general fund tax revenues will be higher than the previous estimates by \$233 million in 2010-11, \$204 million in 2011-12, and \$199 million in 2012-13. The three-year increase is \$636 million, or 1.6%. Over the three-year period, the income tax estimates have been increased by \$910 million, and the sales tax and corporate tax projections have been reduced by \$240 million and \$68 million, respectively. Smaller revisions have been made to the estimates for other taxes.

As noted, the primary factor in the revised estimates is unanticipated strength in individual income tax collections since the January figures were released. When those estimates were prepared, total income tax collections through December, 2010, were 3.7% above the year-to-date collections for the prior year. Quarterly estimated payments of income taxes on business, investment, and retirement income were relatively strong (10.3% growth), but withholding payments showed only 2.8% year-to-date growth. Based on Global Insight's January forecast of taxable components of personal income, it was estimated that the second half of the fiscal year would see slightly better growth rates, and that total income tax revenues in 2010-11 would be 4.3% higher than the 2009-10 amount.

In the months since the January estimates were released, total income tax collections have increased by approximately 28% over the same four-month period last year, and year-to-date growth through April has improved to 12.3%. The main source of strength has been in amounts collected with income tax returns filed this spring for the 2010 tax year. In the last four months, payments remitted with returns have increased by almost 35% compared to last year, and refunds are 7.3% lower. Together, this has resulted in additional revenues of \$228 million over the amount collected during the same period last year. The most likely reasons for this strength are the large gains in the stock market since early 2009 and improved business profits of pass-through entities (partnerships, limited liability companies, and subchapter S corporations) that are taxed under the individual income tax.

In addition, withholding taxes have increased substantially in recent months. Monthly growth in April was 13.3%, and year-to-date growth has improved to 5.5%. Growth in estimated taxes has tapered off somewhat, but is still at 7.6% year-to-date through April. Many other states have also reported strong personal income tax collections this spring.

An offsetting factor that could affect future income tax collections involves the changes to local government employee retirement contributions included in 2009 Act 10. When Act 10 was passed by the Legislature, it was understood that the increased retirement contributions by state and local employees would be made from the employee's after-tax income, and that the employee's liability for federal payroll (FICA) taxes and federal and state income taxes would not be impacted. This office has recently learned that it will be possible for local governing bodies to implement the retirement contributions in a way that allows them to be made from the employee's pre-tax income for federal and state income tax purposes. Structuring the contributions this way would result in the local employees paying lower federal and state income taxes, but would not affect federal payroll

taxes. If this option were used by all local units of government in Wisconsin, state income taxes would be reduced by an estimated \$40 million annually beginning in 2011-12. A similar payment structure could be implemented for retirement contributions by state employees, but additional legislative action would be needed.

However, the Dane County Circuit Court has issued a temporary restraining order prohibiting implementation of Act 10 until litigation regarding passage of the bill has been resolved. Also, it has been reported that some local units of government have entered into contracts that do not require employees to make the retirement contributions specified in Act 10. In addition, if the Act 10 provisions take effect, it is unclear how many other local government units would implement the retirement contributions in a way that allows them to be made from the employee's pre-tax income. Because of this uncertainty, the revised income tax estimates do not include an adjustment to reflect this factor. However, the estimates may have to be reduced in the future if the Act 10 provisions take effect and local governments elect to structure the retirement contributions as described above.

Table 1 shows the revised general fund tax estimates and Table 2 outlines the May, 2011, economic forecast by Global Insight. The tax revenue estimates in Table 1 reflect all legislation passed to date, but do not include any of the tax law changes recommended by the Governor in the biennial budget bill. The sections following the tables present additional information about the new revenue estimates.

TABLE 1
Projected General Fund Tax Collections
Current Law Through 2011 Act 15
(\$ in Millions)

	<u>2009-11 Biennium</u>		<u>2011-13 Biennium</u>	
	<u>2009-10</u> <u>Actual</u>	<u>2010-11</u> <u>Estimated</u>	<u>2011-12</u> <u>Estimated</u>	<u>2012-13</u> <u>Estimated</u>
Individual Income	\$6,089.2	\$6,690.0	\$6,930.0	\$7,290.0
General Sales and Use	3,944.2	4,090.0	4,270.0	4,385.0
Corporate Income and Franchise	834.5	880.0	890.0	920.0
Public Utility	319.4	339.5	344.6	352.6
Excise				
Cigarette	644.3	620.0	615.0	610.0
Tobacco Products	59.9	61.6	63.6	65.7
Liquor and Wine	44.2	46.0	47.1	48.2
Beer	9.6	9.5	9.5	9.5
Insurance Company	130.7	139.5	147.0	150.0
Miscellaneous taxes	<u>55.8</u>	<u>48.6</u>	<u>51.6</u>	<u>57.0</u>
Total	\$12,131.7	\$12,924.7	\$13,368.4	\$13,888.0
Change from Prior Year		\$793.0	\$443.7	\$519.6
Percent Change		6.5%	3.4%	3.9%

TABLE 2

Summary of National Economic Indicators
IHS Global Insight, Inc., May, 2011
(\$ in Billions)

	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>
Nominal Gross Domestic Product	\$14,660.4	\$15,315.7	\$15,994.1	\$16,709.0
% Change	3.8%	4.5%	4.4%	4.5%
Real Gross Domestic Product	\$13,248.2	\$13,605.7	\$14,002.9	\$14,388.8
% Change	2.9%	2.7%	2.9%	2.8%
Consumer Prices (Percent Change)	1.6%	3.0%	1.8%	2.0%
Personal Income	\$12,546.7	\$13,207.6	\$13,693.4	\$14,318.9
% Change	3.1%	5.3%	3.7%	4.6%
Personal Consumption Expenditures	\$10,349.0	\$10,879.9	\$11,326.3	\$11,740.5
% Change	3.5%	5.1%	4.1%	3.7%
Economic Profits	\$1,624.8	\$1,708.7	\$1,734.7	\$1,776.2
% Change	29.2%	5.2%	1.5%	2.4%
Unemployment rate	9.6%	8.8%	8.3%	7.8%
Total Nonfarm Payrolls (millions)	129.8	131.4	133.7	136.2
% Change	-0.7%	1.2%	1.8%	1.8%
Light Vehicle Sales (millions)	11.5	12.7	14.6	15.8
% Change	11.0%	10.1%	14.6%	8.4%
Housing Starts (millions)	0.585	0.630	1.021	1.418
% Change	5.6%	7.6%	62.0%	38.9%

Individual Income Tax. Individual income tax receipts are estimated at \$6,690 million in 2010-11, \$6,930 in 2011-12, and \$7,290 million in 2012-13. The revised figures represent increases relative to the previous projections of \$340 million in 2010-11, \$280 million in 2011-12, and \$290 million in 2012-13. These increases total \$910 million.

In January, income tax collections for 2010-11 were estimated to increase by 4.3% compared to collections in 2009-10, based on the economic forecast and collections data at the time. The reestimate is based on year-to-date tax collections that are 12.3% above the collections total for the same period last year. The estimates for the 2011-13 biennium have also been increased to reflect the estimated increase in base year collections.

Sales Tax. Through April, 2011, total year-to-date sales tax collections were 4.1% higher than in April, 2010. If the impact of the *Menasha Corporation* decision and other factors are

accounted for, the adjusted year-to-date growth rate is 2.9%. Sales tax revenue estimates have been reduced by \$60 million in 2010-11, \$80 million in 2011-12, and \$100 million in 2012-13. In January, this office estimated total year-over-year growth for 2010-11 at 5.2% based, in part, on year-over-year growth in collections of 5.1% through December. Since that time, sales tax collections have weakened as compared to forecasted growth in taxable personal consumption, and the downward revision primarily reflects this lower-than-expected growth. The revised estimates are \$4,090 million in 2010-11, \$4,270 million in 2011-12, and \$4,385 million in 2012-13.

Corporate Income and Franchise Tax. Corporate income and franchise tax revenues are now projected to be \$880 million in 2010-11, \$890 million in 2011-12, and \$920 million in 2012-13. Compared to the previous estimates, the revised estimates represent decreased corporate income and franchise tax revenues of \$55 million in 2010-11, \$10 million in 2011-12, and \$3.4 million in 2012-13.

The new estimates reflect year-to-date corporate income and franchise tax collections. The monthly rate of growth of corporate collections has slowed substantially in the past three months, and estimated payments are lower than last year. The 2010-11 estimate includes two one-time tax settlement amounts. The May, Global Insight forecast includes projections of slightly higher corporate profits than in January, so that corporate income and franchise tax collections are expected to increase each year of the 2011-13 biennium. Both sets of estimates have been adjusted to reflect the impact of corporate income/franchise tax law changes enacted during the 2009-11 biennium, including combined reporting, use of 100% of throwback sales in the apportionment formula, repeal of the domestic production activities income deduction, and enactment of a number of tax credits, such as the economic development and super research and development tax credits. The estimates also reflect tax law changes enacted in the January, 2011 Special Session, including the relocated business tax credit, and income exclusion for increased employment.

Excise Taxes. Excise tax revenues are reestimated at \$737.1 million in 2010-11, \$735.2 million in 2011-12, and \$733.4 million in 2012-13, and are lower than the previous estimates by \$1.8 million, \$2.2 million, and \$2.6 million, respectively. The reduction is primarily due to lower than expected year-to-date growth in tobacco products tax collections. The reduction in tobacco products revenue is partially offset by higher than expected liquor tax collections.

Insurance Premiums Tax. Insurance premiums taxes are projected to be \$139.5 million in 2010-11, \$147 million in 2011-12, and \$150 million in 2012-13. These projections represent increases from the previous estimates of \$7.5 million in 2010-11, \$13.7 million in 2011-12, and \$15.4 million in 2012-13. The new estimates reflect premiums tax collections, which are 6.7% higher than collections through April, 2010. Insurance premiums taxes are projected to increase in each year of the biennium, as the economy continues its gradual expansion.

Miscellaneous Taxes. Estimated revenues from miscellaneous taxes have been increased by \$2.6 million in 2010-11 and 2011-12. The projected increase in revenue is primarily due to better than anticipated real estate transfer fee collections. Although the current estimate is higher than the January projection, real estate transfer fee collections are still estimated to be 15.1% below the 2009-10 amount. As with the January estimates, growth is expected to resume in 2011-12. Total

miscellaneous tax revenues are estimated at \$48.6 million in 2010-11, \$51.6 million in 2011-12, and \$57.0 million in 2012-13.

Other Taxes. The estimates for public utility taxes, the cigarette tax and the beer tax, have not been revised.

Impact on General Fund Balance

Based upon the tax collection estimates of this analysis, the net balance in the general fund at the end of the 2010-11 fiscal year is projected to be \$214.6 million, and the net balance at the end of the 2011-13 biennium is estimated at \$659.9 million. These general fund balance projections are based upon: (1) the provisions of 2011 SB 27/AB 40, as modified, to date, by the Joint Committee on Finance; (2) bills enacted to date in the current legislative session; and (3) the current law tax collection estimates of this analysis.

It should be noted that the balance figures noted above do not include the effect of 2011 Act 10, which is pending resolution by the courts.

The balance estimates do not take into consideration any revenue or appropriation modifications that may occur over the remainder of the Finance Committee's work on SB 27/AB 40.

This office will continue to review the revenue and expenditure estimates used in SB 27/AB 40, as well as tax collections data and new economic forecasts, and notify you and your colleagues of any further adjustments that may be necessary.

Sincerely,

A handwritten signature in black ink that reads "Bob".

Robert Wm. Lang
Director

RWL/sas

cc: Members, Wisconsin Legislature