

Legislative Fiscal Bureau

Robert Wm. Lang, Director

One East Main, Suite 301 • Madison, WI 53703
Email: Fiscal.Bureau@legis.wisconsin.gov
Telephone: (608) 266-3847 • Fax: (608) 267-6873



State of Wisconsin

January 24, 2013

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

Dear Senator Darling and Representative Nygren:

Annually, this office prepares general fund revenue and expenditure projections for the Legislature prior to commencement of legislative deliberations on the state's budget.

In the odd-numbered years, our report includes estimated revenues and expenditures for the current fiscal year and tax collection projections for each year of the next biennium. This report presents the conclusions of our analysis.

Comparison with the Administration's November 20, 2012, Report

On November 20, 2012, the Departments of Administration and Revenue submitted a report to the Governor and Legislature that identified revenue projections for the 2012-13 fiscal year and the 2013-15 biennium. That report, required by statute, identifies the magnitude of state agency biennial budget requests and presents a projection of general fund tax collections.

Compared to the November 20 report, our analysis indicates that for the three-year period, aggregate general fund tax collections will be \$259.1 million less than those reflected in the report (\$37.1 million higher in 2012-13, \$152.7 million lower in 2013-14, and \$143.5 million lower in 2014-15).

The primary reason for the \$259.1 million reduction is due to the enactment of the American Taxpayer Relief Act of 2012. At the time of the November 20 report, under state and federal law, Wisconsin's estate tax would have been restored for deaths occurring in 2013 and after. It was estimated that this restoration would have increased tax collections for the state by \$219.0 million (\$94.0 million in 2013-14 and \$125.0 million in 2014-15). The \$219.0 million was included in the November report. However, Congress modified federal law so that this will not occur.

Based upon the November report, the administration's general fund condition statement for 2012-13 reflects a gross ending balance (June 30, 2013) of \$348.1 million and a net balance (after consideration of the \$65.0 million required statutory balance) of \$283.1 million.

Our analysis indicates a general fund gross balance of \$484.7 million and a net balance of \$419.7 million. This is \$136.6 million above that of the administration's report. The 2012-13 general fund condition statement is shown in Table 1.

TABLE 1

Estimated 2012-13 General Fund Condition Statement

| | <u>2012-13</u> |
|-----------------------------------|---------------------|
| Revenues | |
| Opening Balance, July 1 | \$342,088,000 |
| Taxes | 13,799,100,000 |
| Departmental Revenues | |
| Tribal Gaming | 24,077,000 |
| Other | <u>616,710,400</u> |
| Total Available | \$14,781,975,400 |
| Appropriations | |
| Gross Appropriations | \$14,755,176,400 |
| Transfers to: | |
| Transportation Fund | 137,627,000 |
| Budget Stabilization Fund | 9,953,500 |
| Compensation Reserves | 61,910,000 |
| Biennial Appropriation Adjustment | -10,548,300 |
| Sum Sufficient Reestimates | -72,722,200 |
| Less Lapses | <u>-584,153,100</u> |
| Net Appropriations | \$14,297,243,300 |
| Balances | |
| Gross Balance | \$484,732,100 |
| Less Required Statutory Balance | <u>-65,000,000</u> |
| Net Balance, June 30 | \$419,732,100 |

The factors that cause the \$136.6 million difference between the administration's report and our analysis are described below. In reviewing the difference, it is important to note that the November 20 report focuses on tax collections for the three-year period and the sum of state agency budget requests for 2013-15. The report does not examine departmental revenues (non-tax receipts deposited in the general fund) or projected expenditures for the current fiscal year. Those items were reviewed in our analysis and comprise a large portion of the \$136.6 million.

First, the estimated tax collections of this memorandum are \$37.1 million above the

administration's projections.

Second, net departmental revenues are projected to be \$35.0 million above the amounts shown in the November 20 report.

Third, it is estimated that net appropriations will be \$64.5 million below the amount reflected in the administration's report. Among the reasons for the difference are a reduction in estimated debt service payments (\$25.5 million), a projected lapse in the SeniorCare program (\$18.0 million), and an estimated reduction in the cost of various refundable tax credits (\$19.0 million).

General Fund Tax Revenues

The following sections present information related to general fund tax revenues for 2012-13 and the 2013-15 biennium. The information provided includes a review of the U.S. economy in 2012, a summary of the national economic forecast for 2013 through 2015, and detailed general fund tax revenue estimates for the current fiscal year and the next biennium.

Review of the National Economy in 2012

In February, 2012, this office prepared updated revenue estimates for the 2011-13 biennium based on Global Insight, Inc.'s February, 2012, forecast for the U.S. economy. That forecast called for moderate growth in 2012 and 2013, following an improvement in U.S. economic activity in the second half of 2011. Real (inflation-adjusted) gross domestic product (GDP) growth was estimated at 2.1% in 2012 and 2.3% in 2013. Risks to the forecast included weakened economic conditions among international trading partners (Europe and China) and severe tightening of domestic fiscal policy at the beginning of 2013.

At the time Global Insight issued its February, 2012, forecast, evidence of a virtuous cycle in which employment, incomes, and consumer spending would increase together began to mount. However, the forecast cautioned that the mild 2011-12 winter might overstate employment, construction, and auto sales, since seasonal adjustment procedures might overstate growth when compared to winter months in prior years. In addition, seasonal adjustment procedures following the economy's severe downturn in late 2008 and early 2009 could have also been affecting the measurement for seasonally adjusted growth. Tightening of federal fiscal policy following the expiration of stimulus spending in 2012 was expected to hinder growth. As noted, real GDP growth was estimated at 2.1% for 2012.

The economy grew inconsistently in 2012, with relatively strong growth in the first and third quarters offset by weaker growth in the second and fourth quarters. In the first quarter, Global Insight's recession risk dropped from a probability of 30% to 20% as strong employment gains and pent-up consumer demand for durable goods, particularly light automobiles, drove first quarter personal consumption to an annualized growth rate of 5.0%. Global Insight anticipated that consumer spending could not maintain this pace, noting that high debt burdens, low housing prices, increases in consumer prices outpacing wage growth, and a lack of confidence in government policy would cause spending growth to moderate over the remainder of the year. In the second quarter, rather than GDP growth accelerating to reflect strong job growth,

employment slowed to meet GDP growth. The economy experienced a mid-year slump in 2012, similar to the one that occurred in 2011. In the third quarter, an expected increase in federal defense spending, in conjunction with strong growth in residential fixed investment and purchases of durable goods, helped lift annualized real GDP growth to 3.1%, as compared to 1.3% in the second quarter. Conversely during the fourth quarter, a corresponding drop in federal defense spending occurred, which helped reduce the annualized fourth quarter growth rate to 1.0%. Hurricane Sandy, which caused major destruction and economic disruption in the northeast, was estimated to reduce fourth quarter growth by 0.3%.

Energy prices faced downward pressure in 2012. The unseasonably warm winter at the beginning of the year drove down demand for natural gas, increased inventories, and helped bring 2012 gas prices down to levels that had not been seen in over a decade. Domestic oil production surged by 935,000 barrels per day from October, 2011, to October, 2012. Two states, Texas and North Dakota, accounted for 80% of this growth. Production increased over that period by 30.5% in Texas and 52.4% in North Dakota. Increased foreign oil production in Canada, Iraq, Brazil, and Kazakhstan, coupled with global growth remaining sluggish during 2012, also added downward pressure to prices. In spite of these factors, oil prices increased briefly in the first quarter of 2012 after tensions between the United States and Iran heightened over political and economic sanctions on Iran. The potential for trade route disruptions did provide some upward pressure on oil prices throughout the year, but the average annual price for oil was \$8 (7.1%) per barrel lower in 2012 than Global Insight had projected in its February forecast.

Possibly the biggest cause of uncertainty for business investment and growth in 2012 was anticipating how Congress would deal with the looming "fiscal cliff", a combination of across-the-board tax increases and steep spending cuts that were scheduled to take effect on January 1, 2013. According to Global Insight, if this combination of tax increases and spending cuts would have taken effect as scheduled, estimated real GDP growth in 2013 would have been reduced by 2.4%. The forecast assumed that the cuts to defense spending, nondefense spending, and tax increases in 2013 would not occur, and instead would be replaced with a combination of tax increases and cuts to Medicare, Medicaid, Social Security, and nondefense spending that would phase in over several years, beginning in 2014. There is evidence that uncertainty over future tax rates and spending cuts had an effect on economic activity in 2012. In anticipation of the scheduled expiration of cuts to the tax rates on capital gains and dividends, corporations made special dividend payments in the fourth quarter of 2012. Global Insight estimates that an additional \$10 billion of dividend payments were made in the fourth quarter that otherwise would not have occurred.

There was an additional element of uncertainty during 2012 with regards to economic growth among the United States' major international trading partners. Worries that the European recession could become more severe, due to either a tightening of credit markets in southern countries or a Greek exit from the European Union, created concern that the recession could spread across the Atlantic. China, a destination for approximately 7% of U.S. exports, began to show slower growth during 2012. Concern that China might face a steep slowdown also served to undermine business confidence. Global Insight expected a rebound to growth in Japan following the Fukushima earthquake, but that rebound failed to materialize in 2012. In addition,

the threat of military conflict with Iran was a concern, which could have disrupted trade and created an oil price spike (as noted, oil futures did increase temporarily when tensions began to rise between the U.S. and Iran). While these concerns did not materialize to as severe a magnitude as feared during 2012, reduced confidence from uncertainty in international trade may have been a drag on business investment and overall growth. Among major trading partners, real GDP growth was 1.2%, slightly higher than the February 2012 forecast of 1.0%. Growth in international trade, however, was slower in 2012 than anticipated, with growth in exports of 4.5% and imports of 3.2% as compared to the February forecast's estimate of 4.8% for export growth and 5.8% for import growth.

Partly in response to uncertainty in domestic fiscal policy and concerns over foreign economic conditions, the Federal Reserve maintained an accommodative monetary policy in 2012. The Fed held the federal funds rate between 0.00% and 0.25% and continued "Operation Twist" throughout the year. Operation Twist was a program that began in 2011 and consisted of purchasing approximately \$45 billion in longer-term Treasury securities per month, while selling shorter-term Treasury securities, in an attempt to put downward pressure on long-term interest rates. In addition to these maturity extensions, the Fed launched another round of quantitative easing (QE3) at the September 12-13 Federal Open Markets Committee (FOMC) meeting. Under QE3, the Fed pledged to purchase \$40 billion in mortgage-backed securities each month, with no end date or purchasing limit stated, until the labor market outlook improves sufficiently. With regards to the federal funds rate target, the Fed began the year providing an estimate of when a rate increase would first occur. At the beginning of the year, the Fed projected its first rate increase would occur in late 2014, but that date was later pushed back to mid-2015. At the December 11-12 FOMC meeting, the Fed eliminated its date-based guidance for when the first increase in the federal funds rate might occur and, instead, provided more clarity to markets by describing what economic thresholds would need to be met before the Fed would consider increasing the federal funds rate.

National Economic Forecast

Global Insight's January, 2013, forecast calls for slower economic growth in 2013, followed by increases in 2014 and 2015. While fundamental parts of the economy, such as housing, are improving, weak growth in the fourth quarter of 2012 coupled with impediments from federal fiscal policy are expected to slow growth in 2013 compared to 2012. The American Taxpayer Relief Act of 2012 (the "fiscal cliff" legislation) averted most of the scheduled higher tax rates and spending reductions, but expiration of the 2% payroll tax cut and increased taxes on high-income earners are expected to hamper growth. The fiscal cliff legislation: (a) delayed discretionary defense and nondefense sequestration cuts for two months; (b) extended emergency unemployment insurance benefits through 2013; (c) prevented a severe cut in reimbursement rates to Medicare providers; (d) permanently indexed the alternative minimum tax; (e) permanently extended the Bush-era marginal income tax rates for individuals earning less than \$400,000 and married couples earning less than \$450,000; (f) permanently set the maximum capital gains and dividend tax rate at 15% for individuals earning less than \$400,000, but raised the top rate on capital gains and dividends from 15% to 20% for higher-income taxpayers; (g) reinstated the personal exemption phase-out and the phase-out of itemized deductions for individuals earning more than \$250,000 (or married couples over \$300,000); (h) raised the top

estate tax rate to 40% with a \$5 million exemption; (i) extended certain tax credits for five years; and (j) extended the 50% "bonus" depreciation allowance provision, as well as other business incentives, for one year. Global Insight had not previously expected that the 2% payroll tax cut would expire in 2013, and now estimates that the loss of this provision alone will reduce real consumer spending by 0.6% and real GDP by 0.4% in 2013.

While the fiscal cliff legislation provided some clarity on federal tax rates, the bill did not deal with the major budgetary challenges facing the United States. The current statutory debt limit will need to be raised during the first quarter of 2013. If the debt limit is not raised, the federal government could be forced to reduce its expenditures, cut its services, and implement personnel reductions and emergency furloughs. In addition, even if the federal debt limit is raised, steep spending cuts to discretionary defense and nondefense spending through sequestration are scheduled to take effect in March, which would also slow the recovery. After these two budgetary challenges are dealt with, Congress will have to address funding the federal government through the second half of federal fiscal year 2013. Global Insight expects that Congress will increase the debt ceiling, but only at the last minute, and that the sequestration cuts will not occur in 2013. The forecast also anticipates that the sequestration cuts will be replaced with a combination of increases in income taxes (mostly on upper income individuals through restrictions in deductions) and with cuts in Medicare, Medicaid, Social Security, and nondefense discretionary spending, most of which will begin in January of 2014. Global Insight anticipates that the emergency unemployment insurance benefits will be phased out over several years, starting in 2014, and the 50% bonus depreciation incentive will not be extended beyond 2013.

In addition to the assumptions on fiscal policy, Global Insight's latest forecast is also based on what it terms the following key assumptions. First, household formation is increasing demand for owner-occupied homes as compared to rental units. While housing starts are expected to show strong growth in 2013 and 2014, declining inventories over the forecast period are expected to result in rising home prices. Second, business spending on equipment and software is expected to remain an important driver of GDP growth. Third, oil prices will soften over the medium term as increased supplies in the United States, Canada, Iraq, Brazil, and Kazakhstan exceed domestic and global demand. Fourth, the Federal Reserve will continue its policy of quantitative easing through 2014 and will keep the federal funds target rate between 0.00% and 0.25% through the fourth quarter of 2015 (when the unemployment rate is expected to fall below 6.5%). Fifth, the euro will weaken against the U.S. dollar to a low of \$1.18 per euro in May, 2014 (coinciding with Greece exiting the Eurozone), whereas the value of the U.S. dollar will remain constant against China's renminbi in 2013. Sixth, global growth among the United States' major-currency trading partners will further weaken to 1.0% in 2013, with the expectation that Japan will show no growth over the next year.

GDP. It is estimated that real GDP grew by 2.3% in 2012. Global Insight expects reduced real GDP growth of 1.7% in 2013, primarily slowed by tightening of federal fiscal policy from the expiration of the 2% payroll tax cut, as well as increased tax rates on high-income earners. As noted, expiration of the payroll tax cut reduced Global Insight's real GDP growth forecast by 0.4% in 2013. Real GDP is expected to grow at a rate of 2.7% in 2014 and 3.4% in 2015. Nominal (current-dollar) GDP is expected to track a similar course, decelerating from estimated growth of 4.1% in 2012 to growth of 3.3% in 2013, followed by accelerated growth of 4.4% in

2014 and 5.0% in 2015.

Consumer Prices. Inflation was relatively low in 2012, as the consumer price index (CPI) increased by 2.1%. Global Insight expects even lower levels of inflation throughout the near-term forecast period, with CPI increasing by 1.4% in 2013, 1.7% in 2014, and 1.6% in 2015. Global Insight expects inflation to remain low due to the global slowdown reducing demand for commodities, reduced oil prices as global demand grows at a slower rate than supplies, and relatively high levels of domestic unemployment tempering price increases. Food costs are expected to provide upward pressure on prices, as the effects of last summer's drought will continue to influence food prices over the next year. Core CPI, which excludes the more volatile food and energy costs, rose by 2.1% in 2012. Core CPI is expected to slightly outpace overall CPI, with projected annual increases of 1.9% in 2013, 2.0% in 2014, and 1.9% in 2015.

Monetary Policy. The Federal Reserve has elected to maintain a very accommodative monetary policy. As noted, at the FOMC meeting on December 11-12, 2012, the Fed chose to replace the \$45 billion per month in maturity extension of its Treasury holdings (which would have expired at the end of 2012) with \$45 billion per month in outright longer-term Treasury purchases. In addition, the Fed will maintain the current pace of mortgage-backed security purchases at \$40 billion per month. In total, the Fed is expected to expand its balance sheet by \$85 billion per month in long-term securities in an attempt to keep downward pressure on interest rates, support the housing market, support the broader recovery, and support financial markets. Global Insight expects that asset purchases will continue into 2014, perhaps tapering off in the second quarter when the unemployment rate is projected to decrease to 7.3%.

At the December FOMC meeting, the Fed committed to continuing a near zero federal funds rate (between 0.00% and 0.25%) and provided quantitative measures as to when the Fed might increase interest rates in the future. Following that meeting, the Fed committed to keep the federal funds rate at its current level "at least as long as the unemployment rate remains above 6.5%, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2% longer-run goal, and longer-term inflation expectations continue to be well anchored." It should be noted that the Fed has committed to keep interest rates low until these conditions are met, not to increasing the federal funds rate once these conditions are met. Based on this new information from the Federal Reserve, Global Insight does not expect a federal funds rate increase until the end of 2015.

Among benchmark interest rates in 2012, the yield on the 10-year U.S. Treasury averaged 1.80%, and the rate for a 30-year conventional fixed mortgage averaged 3.66%. Global Insight expects average annual yields on 10-year U.S. Treasury notes to increase slowly over the forecast period to 2.01% in 2013, 2.60% in 2014, and 3.02% in 2015. The average annual interest rate on 30-year conventional fixed mortgages is expected to drop further in 2013 to 3.38%, before increasing in 2014 and 2015 to 3.89% and 4.63%, respectively.

Personal Consumption Expenditures. Nominal personal consumption expenditures rose by an estimated 3.6% in 2012. Sales of items that are generally subject to the sales tax (most durable goods, clothing, restaurant meals and accommodations, and other taxable nondurable goods and services) grew by 5.2% in 2012, while sales of nontaxable items (food for home

consumption, gasoline, certain medical equipment and products, and most services) grew 2.9%. Spending on consumer durables was strong in 2012, with growth of 6.2%. Consumer durables were driven by sales of light vehicles, which grew 14.4%.

In 2013, total consumer spending is projected to slow, increasing by just 2.9%. The expiration of the two percentage point reduction in payroll taxes reduced Global Insight's estimated growth for first quarter consumer spending in 2013 from 2.6% to 1.4%. Growth in consumer spending is expected to accelerate in 2014 and 2015, increasing by 4.0% and 4.2%, respectively, driven primarily by growth in motor vehicle sales and recreational services.

Personal Income. Personal income grew by an estimated 3.3% in 2012, showing slower growth from 2011's rate of 5.1%. Global Insight expects continued deceleration of personal income growth in 2013 to 2.8%, followed by increases of 5.0% in 2014 and 2015, primarily due to private sector growth in wages and salaries. Government wage and disbursements are expected to show slight positive growth, but at much lower rates than the private sector.

Employment. The average unemployment rate for 2012 improved to 8.1% from a 9.0% rate in 2011, however total nonfarm payrolls in the fourth quarter of 2012 were still more than 4.1 million below their pre-recession levels. The private sector began adding jobs in the second quarter of 2010, and is expected to continue this trend through the forecast period. Following an increase of 2.0 million jobs in 2012, private sector payrolls are projected to increase by 1.9 million in 2013, 2.3 million in 2014, and 2.7 million in 2015.

Public sector employee cutbacks are expected to slow in 2013, and state and local government employers are expected to begin slowly adding positions in 2014 and 2015. Public sector payrolls fell 132,000 in 2012, and are expected to fall by 52,000 in 2013, offsetting some of the gains in private sector payroll growth. Global Insight forecasts a reversal of this trend, with growth in public sector payrolls of 37,000 in 2014 and 144,000 in 2015, due to hiring by state and local governments. Federal employee payrolls are expected to continue to fall by 2% or more, annually, throughout the forecast period, offsetting some of the employment gains in state and local government.

Overall, total nonfarm payrolls are not expected to reach their pre-recession levels until late 2014. The nation's unemployment rate is projected to average 7.6% in 2013, 7.3% in 2014, and 6.7% in 2015. Employment gains throughout the forecast period will not be high enough to bring the unemployment rate back to pre-recession levels, as new entrants joining the workforce will offset some of the employment gains.

Housing. The housing market strengthened somewhat in 2012, primarily driven by a combination of low interest rates and reduced inventories of new and existing homes. Sales of new and existing homes increased by 10.3% in 2012 to 5.1 million units, but remained 39% below the 2005 peak. At 0.8 million units, the number of housing starts increased by 26.5% in 2012, but remained 63% below the 2005 peak. Global Insight expects slow improvement in the housing market, with home inventories dropping as new home construction does not keep up with demand. Housing starts are expected to increase to 1.0 million units in 2013, 1.3 million units in 2014, and 1.6 million units in 2015. Sales of new and existing homes are expected to increase to 5.5 million units in 2013, 6.3 million units in 2014, and 6.8 million units in 2015.

Home prices began to strengthen in the second half of 2012, increasing by 2.7%. Global Insight calls for subdued growth in home prices over the near-term, increasing by 0.5% in 2013, 0.2% in 2014, and 2.3% in 2015. Prices are expected to remain below their 2006 peak throughout the forecast period.

Corporate Profits. In 2012, before-tax profits posted strong growth over the prior year of 16.3%. Global Insight projects that before-tax profits will be volatile over the forecast period, contracting by 2.3% in 2013, followed by growth of 11.6% in 2014 and a 2.0% decrease in 2015. This pattern of growth is due, in part, to the scheduled expiration of 50% bonus depreciation and more generous Section 179 expensing provisions in 2014. Economic profits, which are not affected by federal tax laws, finished 2012 with relatively strong growth of 6.2%. Economic profits are expected to show much slower, but still positive growth of 0.5%, 2.2%, and 1.9% in 2013, 2014, and 2015, respectively.

Business Investment. The two major categories of business investment showed positive growth in 2012. Investment in business equipment and software grew by 7.7%, and is anticipated to increase by 6.3%, 6.5%, and 8.0% in 2013, 2014, and 2015, respectively.

Investment in nonresidential structures showed strong growth in 2012 of 12.9%, primarily driven by a sharp spike in growth in the first half of the year. Growth began slowing in the second half of 2012, and is not expected to begin accelerating again until the third quarter of 2013. Over the forecast period, Global Insight estimates a lower growth rate of 1.9% in 2013, followed by stronger increases of 10.4% in 2014 and 11.4% 2015.

International Trade. In 2012, global demand for US goods and services began to decrease. Following strong growth in both exports and imports in 2010 and 2011, global trade began to slow in 2012. As the recession in Europe continues, combined with modest growth in China and sluggish outlooks in Japan, India, and Brazil, Global Insight forecasts lower (but positive) growth in the near-term. The dollar value growth of exported goods and services was 4.5% in 2012, and is expected to slow to 4.0% in 2013 before accelerating to 5.1% in 2014 and 6.6% in 2015. Imported goods are expected to follow a similar path, as businesses remain in a cautious mode, with growth of 1.1% in 2013, 4.1% in 2014, and 5.9% in 2015, following growth of 3.2% in 2012.

The projections outlined above, which reflect Global Insight's baseline forecast, are summarized in Table 2.

TABLE 2
Summary of National Economic Indicators
IHS Global Insight, Inc., Baseline Forecast, January, 2013
(\$ in Billions)

| | <u>2012</u> | <u>2013</u> | <u>2014</u> | <u>2015</u> |
|--------------------------------------------|-------------|-------------|-------------|-------------|
| Nominal Gross Domestic Product | \$15,688.1 | \$16,206.0 | \$16,924.9 | \$17,769.8 |
| Percent Change | 4.1% | 3.3% | 4.4% | 5.0% |
| Real Gross Domestic Product | \$13,598.6 | \$13,835.9 | \$14,209.0 | \$14,695.8 |
| Percent Change | 2.3% | 1.7% | 2.7% | 3.4% |
| Consumer Prices (Percent Change) | 2.1% | 1.4% | 1.7% | 1.6% |
| Personal Income | \$13,380.5 | \$13,758.1 | \$14,449.0 | \$15,171.5 |
| Percent Change | 3.3% | 2.8% | 5.0% | 5.0% |
| Personal Consumption Expenditures | \$11,118.8 | \$11,443.4 | \$11,905.7 | \$12,404.7 |
| Percent Change | 3.6% | 2.9% | 4.0% | 4.2% |
| Economic Profits | \$1,940.8 | \$1,950.1 | \$1,992.3 | \$2,030.9 |
| Percent Change | 6.2% | 0.5% | 2.2% | 1.9% |
| Unemployment Rate | 8.1% | 7.6% | 7.3% | 6.7% |
| Total Nonfarm Payrolls (millions) | 133.24 | 135.08 | 137.39 | 140.21 |
| Percent Change | 1.4% | 1.4% | 1.7% | 2.1% |
| Light Vehicle Sales (millions) | 14.42 | 15.01 | 15.65 | 16.21 |
| Percent Change | 13.3% | 4.1% | 4.2% | 3.6% |
| Sales of New and Existing Homes (millions) | 5.060 | 5.516 | 6.275 | 6.817 |
| Percent Change | 10.3% | 9.0% | 13.8% | 8.6% |
| Housing Starts (millions) | 0.774 | 0.970 | 1.281 | 1.612 |
| Percent Change | 26.5% | 25.3% | 32.1% | 25.8% |

Global Insight's monthly forecast also includes an optimistic scenario and a pessimistic scenario. The January, 2013, forecast assigns a 20% probability to the former. Under the optimistic scenario, the growth acceleration that is forecast for 2014 in the baseline arrives a year early with real GDP growing by 3.0% in 2013 and 4.1% in 2014. Under this scenario, consumers and businesses are relieved that the federal debt-ceiling is smoothly negotiated and equity markets react favorably to promising progress on a comprehensive, long-term fiscal plan. Policymakers will have developed a pro-growth plan to tackle sovereign-debt issues in the Eurozone under this scenario, with no country exiting the currency union, allowing U.S. growth in international trade. The optimistic scenario sees: (a) a stronger recovery in residential construction, surpassing 1.3 million housing starts by the end of 2013; (b) an improving labor

market adding an average of 330,000 jobs per month by mid-2013, resulting in the unemployment rate falling to the Fed's 6.5% threshold by the end of 2013; (c) the Fed ending the latest round of quantitative easing by mid-2013 and raising the federal funds rate for the first time in the first quarter of 2014; and (d) inflation remaining benign throughout the forecast period.

Under the pessimistic scenario (also assigned a 20% probability), the U.S. debt ceiling is only raised at the very last minute and private sector confidence and stock prices plunge due to lack of confidence in the United States government, resulting in further downgrades to the US sovereign debt rating. At the same time, policymakers cut defense and nondefense discretionary spending further than is currently scheduled to take effect in March. The European recession intensifies in this scenario after Greece is forced out of the Eurozone, ensuring that the financial struggles of Spain and Italy result in severe economic contractions and very high interest rates. Global growth is further restrained as China's growth slows. Under these domestic and global conditions in the pessimistic scenario, Global Insight forecasts a mild near-term recession in the U.S., reducing real GDP growth to 0.1% over 2013. The pessimistic scenario sees: (a) stagnant employment and weak wage gains; (b) low demand, persistent oversupply, and a high number of foreclosures dropping prices for single-family homes 7% below the baseline forecast; (c) crude oil prices dropping to \$78 per barrel in 2013, providing a cushion for incomes, and overall consumer price inflation falling to 0.8% in 2013; (d) tight production capacity and weak productivity leading to industrial production bottlenecks, which increase prices once the U.S. economy starts to recover and pent-up demand is released; and (e) the Fed expanding QE3 and not raising the federal funds rate from the currently targeted 0.00% to 0.25% range until mid-2017.

General Fund Taxes

Table 3 shows general fund tax revenue estimates for 2012-13 and each year of the 2013-15 biennium. Over the three-year period, these estimates are \$259.1 million (0.6%) lower than the figures released by the Department of Revenue (DOR) last November. By year, the new estimate for 2012-13 is higher than DOR's projection by \$37.1 million, and the new estimates for 2013-14 and 2014-15 are lower by \$152.7 million and \$143.5 million, respectively.

The total variance of \$259.1million is primarily due to the estate tax. When DOR prepared their estimates in November, federal law provided that the federal credit for state death taxes would be restored for deaths occurring in 2013. Under Wisconsin law, the state imposes an estate tax exactly equal to the federal credit for state death taxes. Therefore, if the federal credit was restored in 2013, Wisconsin would begin collecting estate tax revenues in 2013-14 (there is a nine-month grace period between the date of death and the due date for estate taxes). However, the recent federal fiscal cliff legislation permanently extended the federal deduction for state death taxes, instead of restoring the federal credit. Because the Wisconsin tax is based on the federal credit, rather than the federal deduction, no estate tax revenues will be received by the state. Based on prior federal law, DOR included estate tax revenues of \$94.0 million in 2013-14 and \$125.0 million in 2014-15 (\$219.0 million over the biennium) in their estimates. With the fiscal cliff legislation, these revenues will not be realized and are not included in the new estimates shown in Table 3.

There are a number of other differences between DOR's estimates and the new projections. Over the three years, individual income tax collections are estimated to be \$107.5 million higher and corporate income and franchise tax collections are estimated to be \$55.3 million higher. Sales tax collections are estimated to be \$103.1 million lower and revenues from excise taxes on cigarettes and other tobacco products are projected to be \$81.7 million lower. Smaller variances are estimated for the other tax sources.

All of the estimates reflect year-to-date collections data, the most recent national economic forecast, and all law changes enacted to-date.

TABLE 3
Projected General Fund Tax Collections
(Millions)

| | <u>2011-13 Biennium</u> | | <u>2013-15 Biennium</u> | |
|------------------------------|---------------------------------|------------------------------------|------------------------------------|------------------------------------|
| | <u>2011-12</u> <u>Actual</u> | <u>2012-13</u> <u>Estimated</u> | <u>2013-14</u> <u>Estimated</u> | <u>2014-15</u> <u>Estimated</u> |
| Individual Income | \$7,041.7 | \$7,280.0 | \$7,465.0 | \$7,855.0 |
| Sales and Use | 4,288.7 | 4,380.0 | 4,500.0 | 4,610.0 |
| Corporate Income & Franchise | 906.6 | 890.0 | 905.0 | 910.0 |
| Public Utility Excise | 365.9 | 355.6 | 358.2 | 355.8 |
| Cigarettes | 587.8 | 560.0 | 550.0 | 540.0 |
| Tobacco Products | 65.5 | 62.8 | 64.7 | 66.7 |
| Liquor and Wine | 47.0 | 49.6 | 50.5 | 51.5 |
| Beer | 9.2 | 9.1 | 9.1 | 9.0 |
| Insurance Company | 148.1 | 152.0 | 160.0 | 168.0 |
| Miscellaneous Taxes | <u>54.1</u> | <u>60.0</u> | <u>65.0</u> | <u>73.0</u> |
| Total | \$13,514.6 | \$13,799.1 | \$14,127.5 | \$14,639.0 |
| Change from Prior Year | | \$284.5 | \$328.4 | \$511.5 |
| Percent Change | | 2.1% | 2.4% | 3.6% |

Individual Income Tax. Individual income tax revenues are estimated to total \$7,280.0 million in 2012-13, which represents a 3.4% increase relative to income tax collections in 2011-12 of \$7,041.7 million. Individual income tax revenues are estimated at \$7,465.0 million in 2013-14 and \$7,855.0 million in 2014-15. These amounts represent increases of 2.5% in the first year and 5.2% in the second year.

The January, 2013, Global Insight forecast projects national personal income growth of 3.3% in 2012, 2.8% in 2013, and 5.0% in 2014 and 2015. However, personal income includes both taxable components, such as wage and salary disbursements, and nontaxable components, such as employer contributions for employee fringe benefits and government transfer payments to individuals. The taxable components of personal income are estimated to increase by 3.6% in 2012, 3.0% in 2013, 4.8% in 2014, and 5.0% in 2015. Personal income, as measured by the U.S.

Bureau of Economic Analysis, does not include income from capital gains realizations. The tax revenue estimates include a one-time upward adjustment in the amount of income tax paid on capital gains for tax year 2012. This reflects both recent increases in asset markets and the realization of gains timed to avoid the increase in the federal capital gains tax rate under the expiration of the Bush tax cuts and the enactment of the American Taxpayer Relief Act of 2012.

On a year-to-date basis, after adjustments to account for timing impacts, collections are 4.3% higher than the same period in 2011-12, but as of November, 2012, year-to-date collections exceeded the comparable amount for the prior year by only 2.8%. The increase in December collections was fueled primarily by a large increase in December withholding. However, withholding payments do not reflect two factors that help explain why the 4.3% increase is not expected to be sustained through the end of the year. First, a relatively large indexing adjustment was made to the sliding scale standard deduction and the tax brackets for tax year 2012. Second, several law changes are being implemented that will reduce collections. These include continuing the phase-in of the deduction for health insurance premiums paid by employees whose employer pays some portion of their health insurance costs and the deduction for child and dependent care expenses. In addition, the deduction authorized under 2011 Wisconsin Act 1 for health savings accounts (HSAs) was first allowed in tax year 2011. As the health insurance and child care deductions continue to be phased in and as health care costs continue to increase, amounts deducted under the three provisions are expected to increase in each of the next two years. The fiscal effects of recent law changes are estimated to lower collections by about \$60 million in 2012-13 and by over \$100 million in each year of the 2013-15 biennium.

General Sales and Use Tax. State sales and use tax revenues totaled \$4,288.7 million in 2011-12, and are estimated at \$4,380.0 million in 2012-13. The estimate represents an increase of 2.1% over the prior year. Sales tax revenues in the next biennium are estimated at \$4,500.0 million in 2013-14 and \$4,610.0 in 2014-15, reflecting growth of 2.7% and 2.4%, respectively.

Sales tax collections through December, 2012, are 1.6% higher than the same period in 2011. If the impacts of law changes and one-time refund payments are accounted for, the adjusted year-to-date growth rate is 2.8%. The projections reflect year-to-date collections, forecasts for growth in taxable personal consumption expenditures, and previously enacted law changes.

Corporate Income/Franchise Tax. Corporate income/franchise taxes are estimated to decrease from \$906.6 million in 2011-12 to \$890.0 million in 2012-13. Corporate income/franchise tax revenues are forecast to increase to \$905.0 million in 2013-14 and \$910.0 million in 2014-15. This represents a decrease in revenues of 1.8% in 2012-13, followed by increases of 1.7% in 2013-14 and 0.6% in 2014-15.

The estimate for 2012-13 is based on year-to-date corporate income/franchise collections. Through December, 2012, collections were essentially flat when compared to the same period in 2011. However, a number of tax law changes, including allowing combined group members to share pre-2009 net business losses and the phase-in of the manufacturing and agriculture tax credit, were effective for tax year 2012 or 2013, and are estimated to decrease 2012-13 corporate income/franchise tax collections.

Projected corporate income/franchise tax revenues for 2013-14 and 2014-15 reflect the forecast of consumer purchases, equipment investment, industrial production, and, as a result, corporate profits for 2013 and 2014. In general, businesses have significantly lowered their cost structures over the past few years. Companies have kept unit labor costs (compensation per unit of output) low, while increasing technological and supply chain innovation. Profit margins have expanded, and lower interest rates have allowed firms to reduce debt and generate increased cash flow. However, the savings that are generated from cost cutting are diminishing, and the expiration of the payroll tax cut is projected to dampen final demand for products and services. As a result, economic activity is projected to slow in 2013, before rebounding in 2014. It should be noted that the forecast assumes that Congress and the President will reach agreements on extending the debt ceiling and on deficit reduction.

The corporate income/franchise tax revenue estimates for the biennium have been adjusted to reflect the impact of tax law changes, including allowing members of combined unitary groups to share pre-2009 net business losses, and the phase-in of the manufacturing and agriculture tax credit. In general, the adjustments resulted in a significant decrease in estimated annual corporate income/franchise tax collections.

Public Utility Taxes. Public utility taxes are estimated to be \$355.6 million in 2012-13, \$358.2 million in 2013-14, and \$355.8 million in 2014-15. These estimates represent year-to-year changes of -2.8% in 2012-13, +0.7% in 2013-14, and -0.7% in 2014-15. The gross revenues tax group comprises about 70% of estimated collections over the three-year period, and private light, heat, and power companies are the largest taxpayer group among the gross revenues taxpayers. Utility tax collections from private light, heat, and power companies are estimated to decrease in each of the next three fiscal years. For 2012-13, a decrease of 0.1% is due primarily to low natural gas prices and a mild heating season. While natural gas revenues are projected to increase in 2013 and remain stable thereafter as greater equilibrium between supply and demand is achieved, decreasing revenues are estimated in the wholesale electricity market in the 2013-15 biennium. Recent acquisitions by investor-owned utilities of "merchant" plants owned by independent power producers and the projected shutdown of the nuclear power plant in Kewaunee are the cause for the decrease.

In addition to private light, heat, and power companies, other taxpayers in the gross revenues group include electric cooperatives, municipal light, heat, and power companies, and carline companies, and, together, collections from these taxpayers are estimated to increase by 0.3% in 2012-13 and then decrease by 0.6% in 2013-14 and 0.4% in 2014-15.

Companies subject to a state ad valorem tax comprise the other group of taxpayers covered under public utility taxes. Collections from these taxpayers are estimated to decrease by 9.3% in 2012-13, but then increase by 3.7% in 2013-14 and decrease by 1.2% in 2014-15. Adjustments to 2012 taxable values for certain telecommunications and pipeline companies will cause the decrease in 2012-13 collections. Thereafter, changes in the statewide average property tax rate are responsible for much of the change in ad valorem taxes.

Excise Taxes. General fund excise taxes are imposed on cigarettes, liquor (including wine and hard cider), tobacco products, and beer. In 2011-12, excise tax collections totaled \$709.5

million. Of this amount, \$587.8 million (approximately 83%) was from the excise tax on cigarettes. Excise tax revenues are estimated at \$681.5 million in 2012-13, which represents reduced revenue of 3.9%. The estimated reduction in excise tax revenues in 2012-13 is primarily from weak growth through December, 2012, in year-to-date cigarette tax collections, which are currently 4.8% lower than collections over the same period in 2011. Excise tax revenues over the next biennium are estimated at \$674.3 million in 2013-14 and \$667.2 million in 2014-15, which reflects reduced revenue of 1.1% in 2013-14 and 2014-15.

Insurance Premiums Taxes. Insurance premiums taxes are projected to increase from \$148.1 million in 2011-12, to \$152.0 million in 2012-13, \$160.0 million in 2013-14, and \$168.0 million in 2014-15. The 2012-13 estimate is primarily based on insurance premiums tax collections data, that have been adjusted to reflect a delay in processing late December collections. The processing change will result in decreased December premiums tax collections that will be offset by increased January collections. Estimates for 2013-14 and 2014-15 reflect industry forecasts of premiums growth in most lines of insurance. Demand for life insurance products is expected to increase, as individuals seek to offset the decline in defined benefit retirement plans with insurance products that increase lifetime income. Although the annual increase in overall health care costs appears to have slowed in recent years, health insurance premiums are expected to continue to grow, although the rate of increase is the subject of some debate. The forecast for new light vehicle sales will push automobile premium growth because both the number and value of insured cars will increase. Similarly, the expanding economy will increase both the number and value of insurable interests for property and casualty companies.

Miscellaneous Taxes. Miscellaneous taxes include the real estate transfer fee, municipal and circuit court-related fees, and a small amount from the occupational tax on coal. Miscellaneous tax revenues were \$54.1 million in 2011-12, of which 74% was generated through the real estate transfer fee. Based on the economic forecast for the housing sector, as well as collections through December, 2012, miscellaneous taxes are projected to increase to \$60.0 million in 2012-13, which represents a 10.9% increase from 2011-12 collections. Miscellaneous taxes are estimated to increase to \$65.0 million in 2013-14 and \$73.0 million in 2014-15, primarily due to an anticipated continuation of the housing recovery.

We will continue to monitor economic forecasts, tax collections, other revenues, and expenditures and keep you informed of any necessary modifications to these estimates.

Sincerely,

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

Robert Wm. Lang
Director

RWL/sas

cc: Members, Wisconsin Legislature