LFA
Legislative Fiscal Analyst

Utah Legislature **June 2014**

Revenue Update

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Part A: Tax Collections

We anticipate combined General and Education funds collections will end FY 2014 $25 million to $150 million above the May 2014 target. We believe the Transportation Fund will end FY 2014 $5 million below to $10 million above target.

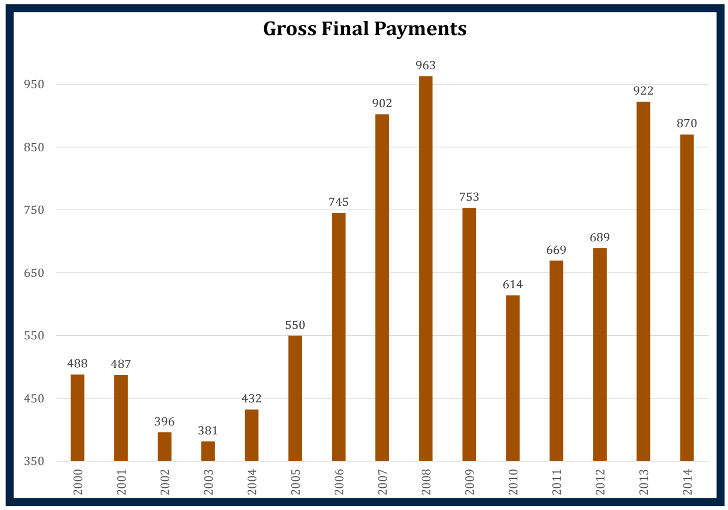
The largest portion of the potential GF/EF surplus is due to above target growth in the income tax. Within the income tax, the strength is largely the result of higher-than-anticipated gross final payments, coming in at around $870 million, or a decline of around 6 percent over FY 2013 final payments. We had anticipated a decline of approximately 17 percent.

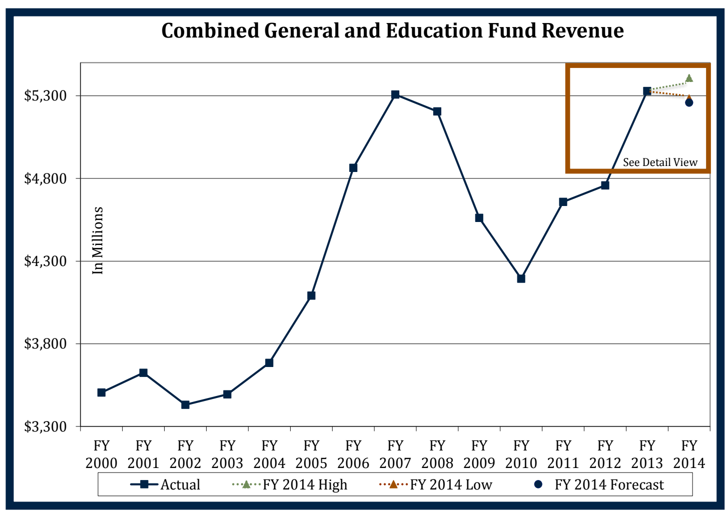
Behind the realized decline in gross final payments is tax-induced shifting and continued strong performance of financial asset prices. Instead of a steady increase in final payments across the economic recovery, final payments jumped in FY 2013 and then gave up some of that increase in FY 2014. The major tax changes inflicting the tax shifting were increases in the top marginal tax rate, small business input changes, and investment income taxes.

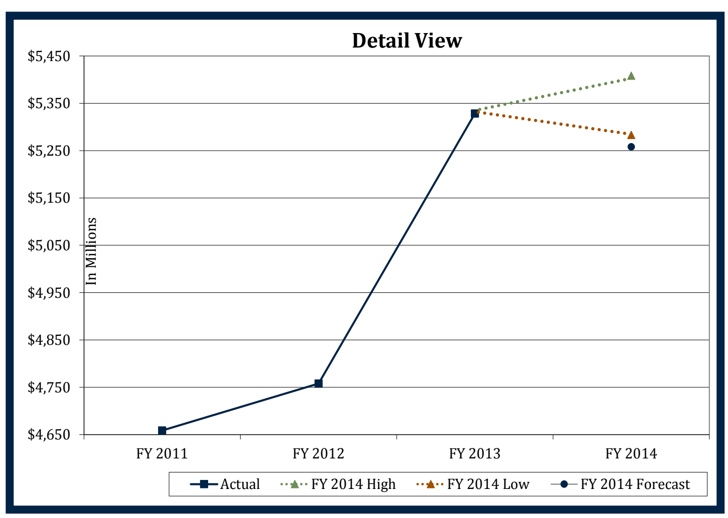
Overall the economic outlook for Utah remains strong. Employment in the western states is doing particularly well: Arizona, Colorado, Oregon, Idaho and Utah are five of the 10 states forecasters expect to have the highest growth rates through 2014. Utah is also ranked number one for economic outlook in the report *Rich States, Poor States, 2014* (American Legislative Exchange Council, 2014). The methodology used indicates that the state is poised for growth and prosperity going forward. The state has received this ranking for the past seven years. In the same report Utah is ranked second for economic performance. The diverse economy of the state has allowed it to weather some of the potential uncertainty and continue the trend of economic growth. Steady home construction, robust investment in high tech and the aerospace industry, and trade with Asia are a few of the reasons why businesses in Utah are doing comparatively so well.

Housing will continue to contribute to the growth in the economy through 2014 and 2015, as evidenced by construction employment and housing permits. Construction employment is expected to grow by about 12,000 from 2013 to 2015, or about 16 percent. Additionally, the residential permit values and the number of dwelling permits are expected to grow by $158.9 million and 15,000 respectively for 2014.

The baseline strong growth scenario comes with some downside risks include a slowdown in growth in China, higher gasoline prices, geopolitical risks between Russia and Ukraine, continued growth in some unprofitable student debt, and potential effects from finicky financial markets.







A1 General Fund

We expect General Fund revenue to end FY 2014 $25 million below to $25 million above the May FY 2014 target.

Of the GF revenue sources, oil and gas severance tax is in the strongest condition, currently up 50 percent over the prior year. The strength in this severance tax type is largely the result of a recovery in the price of natural gas. Since bottoming in 2012 at $2.82 per thousand cubic feet, the price of natural gas has increased to around $4.35 today.

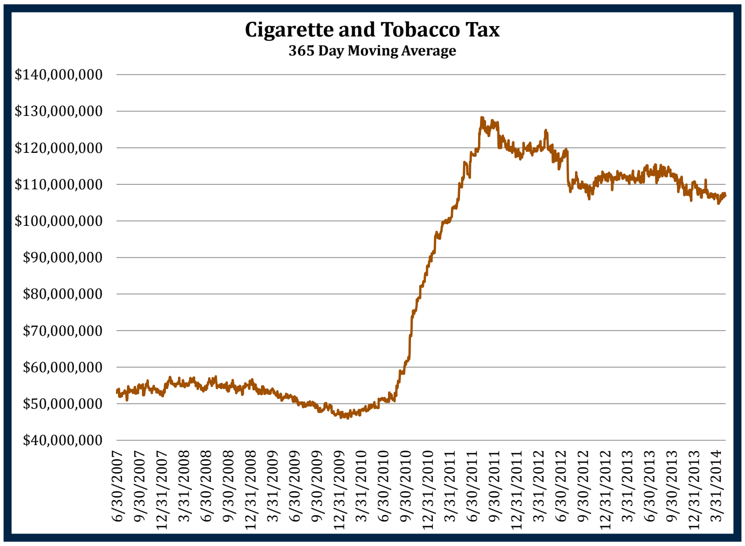
Cigarette and tobacco taxes are in the weakest condition. Since jumping to almost $130 million following the tax increase, cigarette and tobacco taxes have consistently declined, down $25 million on a 365 day moving average basis.

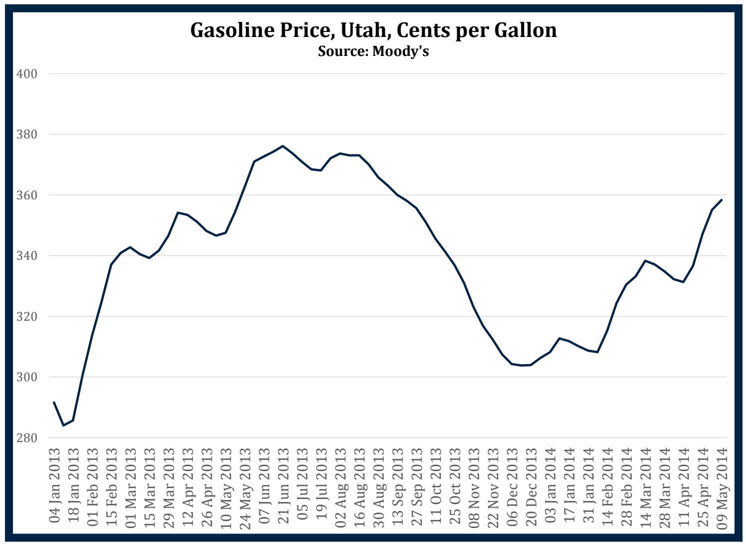
A2 Transportation Fund

We anticipate the Transportation Fund will end FY 2014 between $5 million below and $10 million above target.

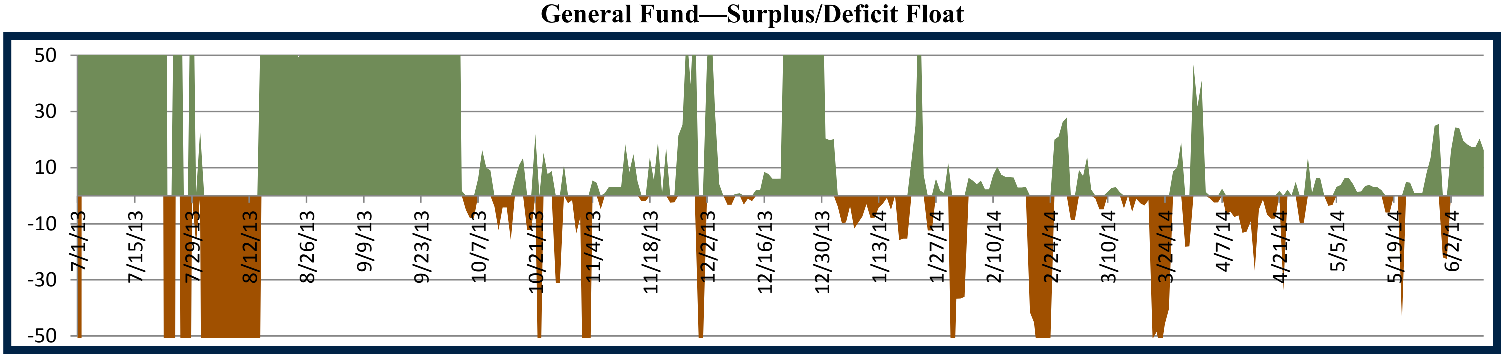
In terms of the float throughout the year, revenue to the Transportation Fund started the year off in deficit territory until about March, only briefly floating in surplus territory for November. Since March, collections have generally floated in a surplus position.

The switch since March is partially the result of reduced gas prices during the winter months. The price of gasoline peaked in June 2013 at $3.76 per gallon and bottomed at around $3.04 per gallon for the week of December 13, 2013. The lower gasoline prices for the first quarter of CY 2014 appears to have induced more travel. On outlook, the recent increase in gas prices may put downward pressure on consumption.

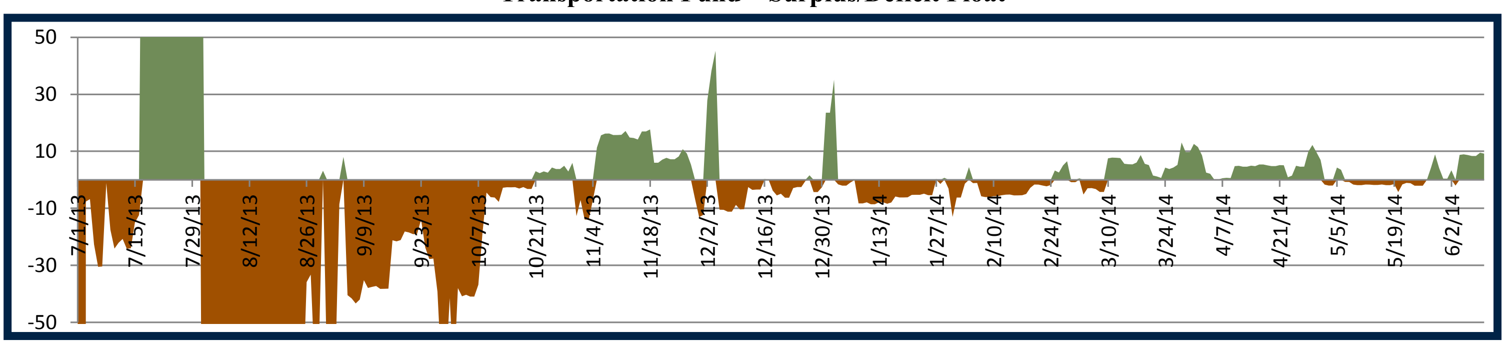




General Fund—Surplus/Deficit Float



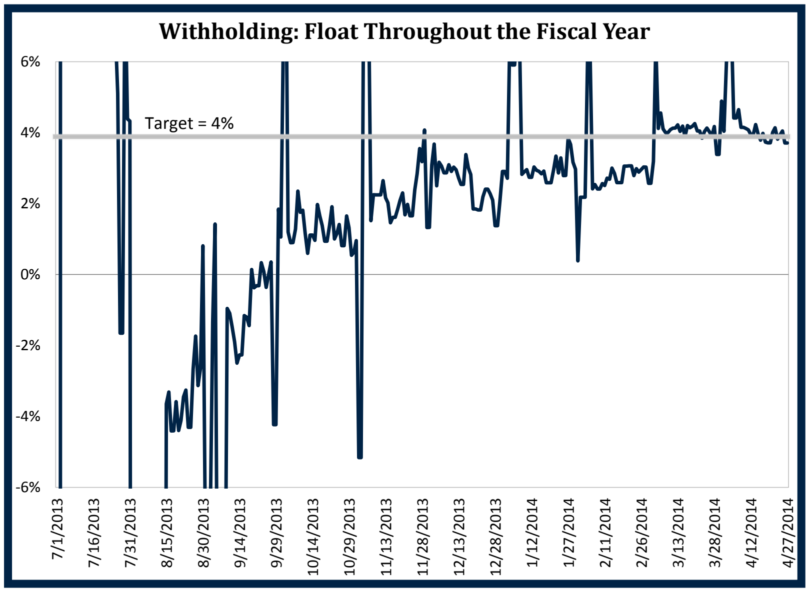
Transportation Fund—Surplus/Deficit Float



Education Fund

We believe the Education Fund will end FY 2014 $50 million to $125 million above the May target, most of which is due to net final payments coming in above expectations. The largest revenue component of the Education Fund is withholding, which continues to float slightly below the 4 percent target.

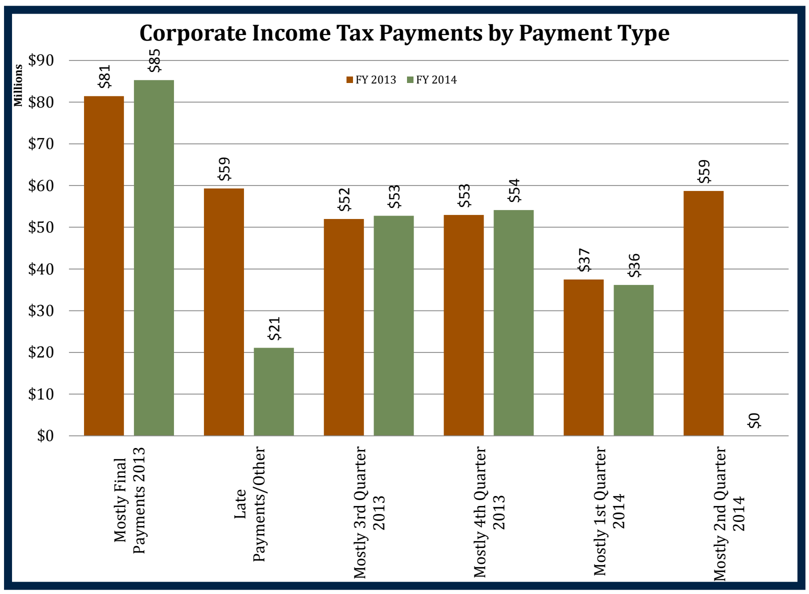
Outside of the income tax, corporate income tax is the second largest revenue source to the Education Fund. Overall, corporate tax revenue is down about 10 percent over FY 2013, largely due to payments that are classified as "Late/ Other" payments. When looking at the normal quarterly and annual revenue payment time frames, revenue in FY 2014 is close to FY 2013 revenue by filing period.



The Education Fund is largely made up of taxes on income earned by individuals at work. A couple major shifts in the employment arena affecting the makeup of Education Fund revenue include the shift to contract/online work, new hires earning less money, and many college graduates earning less than expected.

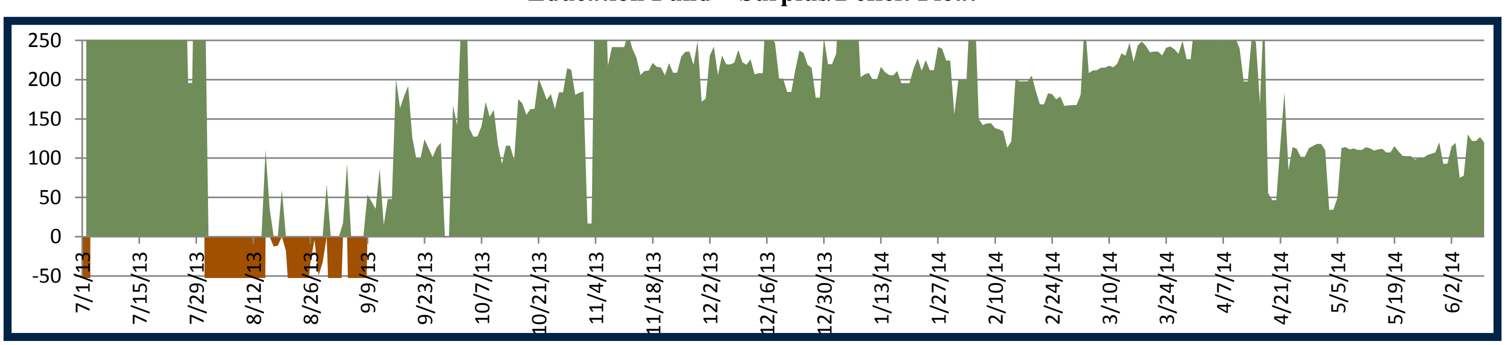
Shift to contract work: A major component of shift in the Education Fund is the shift in the labor market from employee work to online/independent contractor work. Depending on the ability of the individual, this may result in increased or decreased earnings potential.

New hires making less: The year-over growth rate in hiring during the post-recession expansion in Utah was an average of 10.7 percent per year. At the same time new-hire earnings grew 2.3 percent per year statewide. Although the number of new hires increased significantly in the state after 2009, both areas had only recovered approximately 80 percent of the quarterly new hires generated at the peak of the business cycle in 2007.



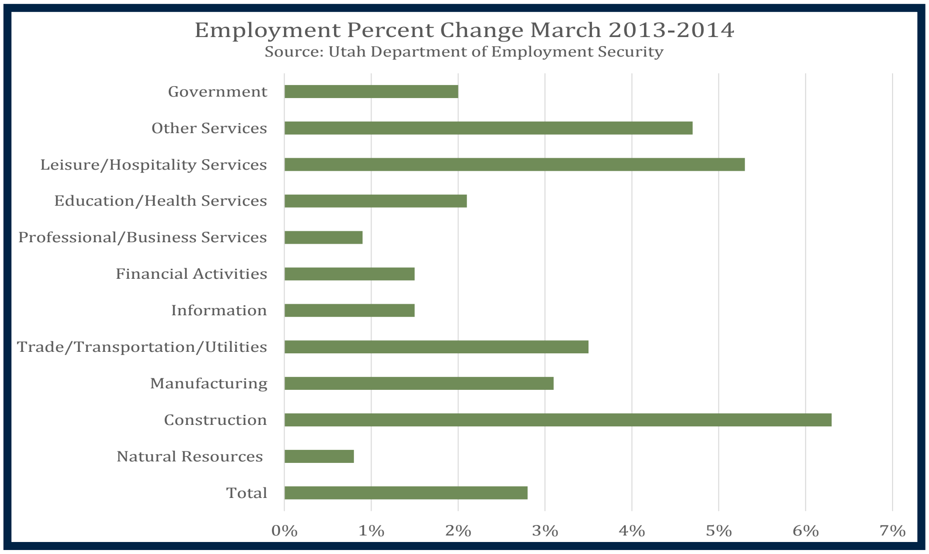
Younger college degree recipients earn less: Individuals graduating from college continue to be generally disappointed with the earnings offered from prospective employers. College graduates with mispriced earnings potential may experience a prolonged return to college. It also may result in certain college degrees turning out to be unprofitable. This matters for revenue in that a globally uncompetitive workforce generally has less tax revenue associated with the employment activity as does an individual graduating from college in say the 1980s or 1990s.

Education Fund—Surplus/Deficit Float

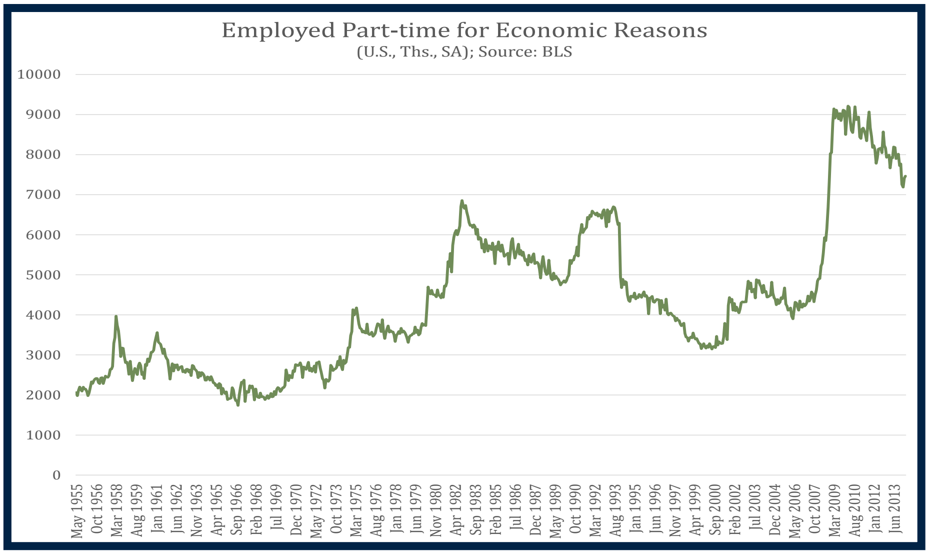


B1 EMPLOYMENT & EARNINGS

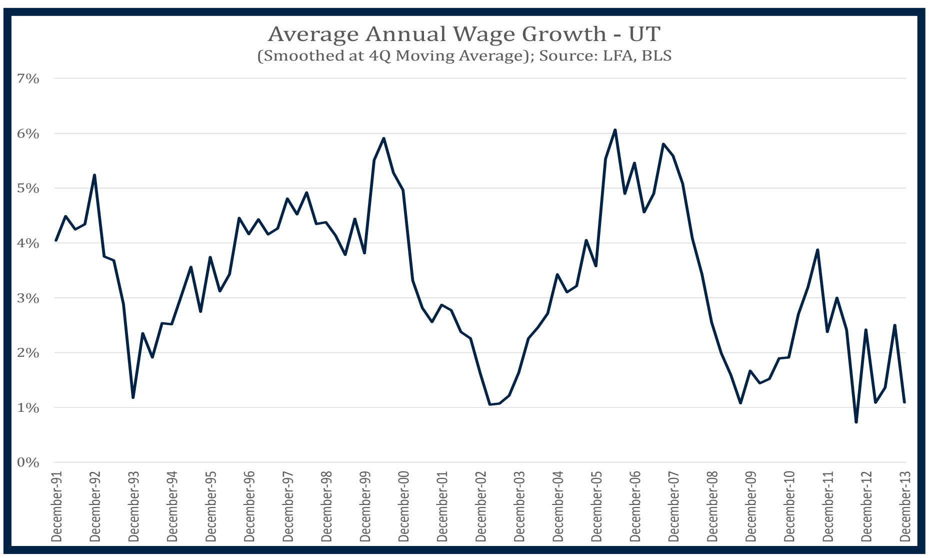
Employment Growth by Industry. Employment is expected to grow at the long run average of 3.1 percent in 2014. All private sector industries are showing growth based on the most recent labor market data. The largest overall employment increases were in Trade, Transportation and Utilities (8,400 jobs), Leisure and Hospitality (6,500 jobs), and Government (4,500 jobs). The strongest growth rates were in Construction (6.3 percent), Leisure and Hospitality (5.3 percent), and Other Services (4.7 percent).



Employment Cycle. Viewing the employment picture from the business cycle perspective shows that the current recovery is the worst since World War II. The baseline case is for continued employment growth over the next two years, akin to the long 1980s and 1990s recovery. If some of the headwinds materialize, the employment growth cycle could turn out to be more similar to the 2001 or 1974 situation, which saw employment growth weaken at around 85 months. The current growth cycle is at 75 months.



Part-time Employment. The Bureau of Labor Statistics identifies two groups of part-time workers: 1) individuals working part-time for economic reasons. They would prefer to work full time and as a result are regarded as involuntary part-time workers. 2) Voluntary part time workers are those working part-time as a preference. Nationally, individuals working part-time for economic reasons is still elevated at about 50 percent above where it stood in 2008. Overall, when viewed from the full-time employment perspective, the labor market is still weak. The national employment picture matters for businesses in Utah in that it affects external demand, competitiveness, and the ability to add value.



Average Hourly Earnings. Generally a sign of labor market tightness, average hourly earnings has been stuck at around 2 percent (Y/Y) for the past five years, only briefly jumping to above 3 percent territory in the summer and fall months of 2011 (smoothed, four quarter moving average basis). Overall, wage inflation peaked in the latter half of 2009 at around 6 percent. The lack of strong wage pressure is a factor preventing inflation from picking up.

Every occupied housing unit constitutes a household. Households can be comprised of families, single individuals, unrelated individuals, or a combination of families and unrelated individuals. Historically household formation rises consistently with age.

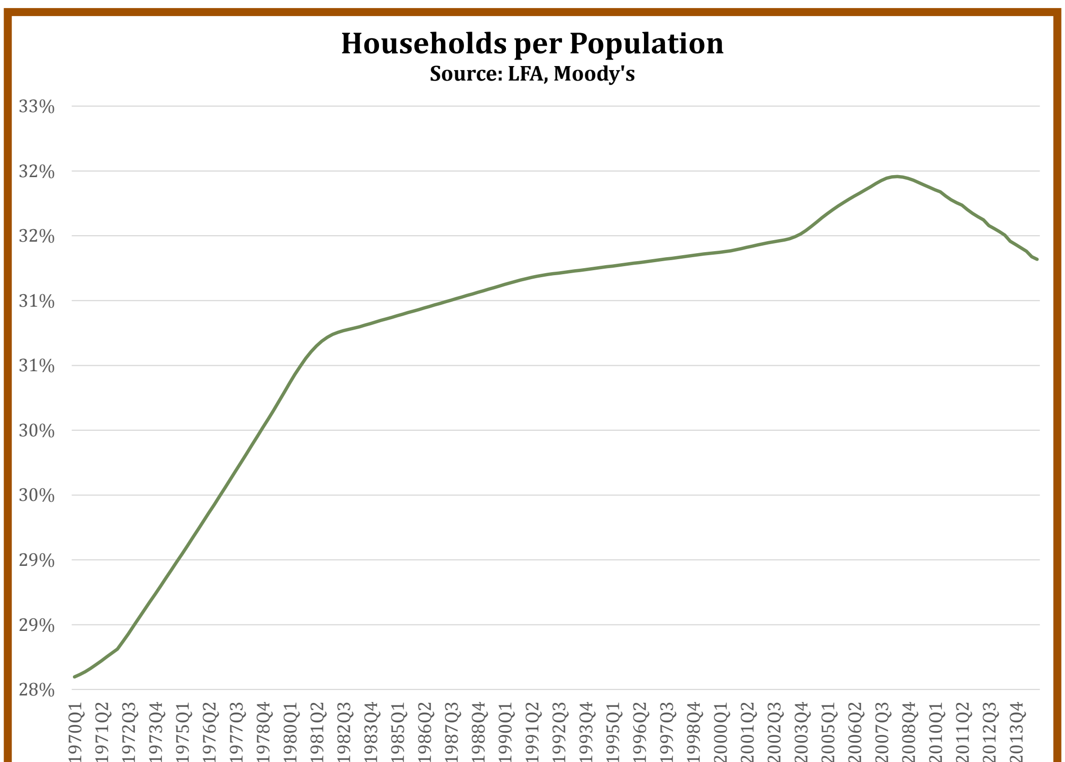
What it really takes to sustain an entire housing market is two things: household formation and births. In recent years, household formation and births are being delayed because in general young people have had a tough time in this economy. Since 2007, many young people have not been able to get the jobs they expected out of college, and many are saddled with high levels of consumer and student debt. Additionally, a large portion of these young people are living with their parents. As a result, we have seen a hindrance on the housing sector.

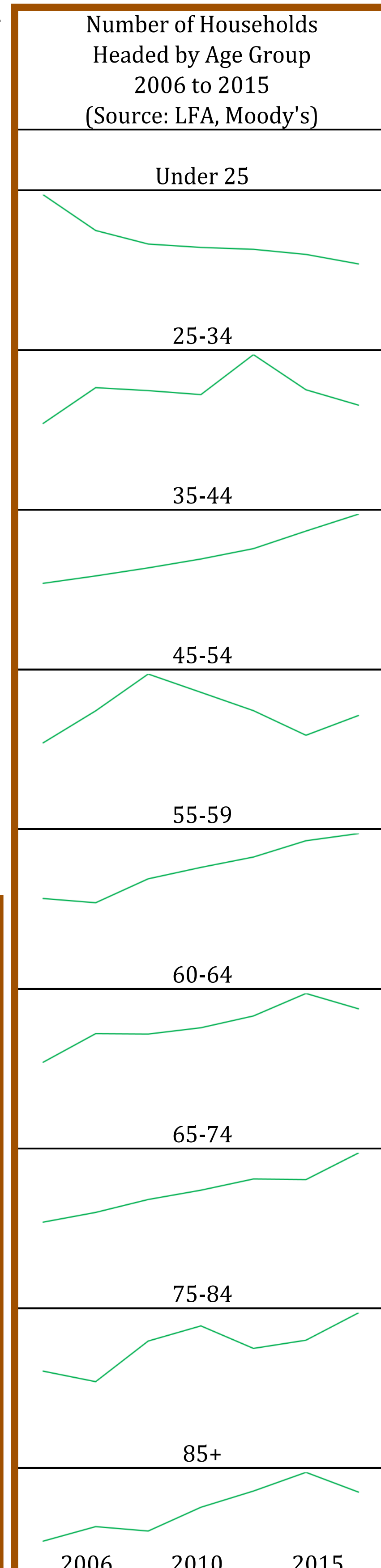
Looking at data trends from 2006 to 2015, we have seen a drop in the number of households formed by the 34 year and younger category. With weak job prospects, a slowdown and wage growth, and involuntary unemployment still elevated the younger population is still financially insecure. This population group could be delayed as much as 10 years in their home purchases.

Housing choices for many of these individuals has shifted towards renting. Because of this, as household formation improves there is still a question as to how much of the growth in the future will increase demand for single-family housing units or rental units.

In a good market, homeownership is the result of people getting married, forming a household, having kids, buying at the bottom, and accumulating wealth. Since the Great Recession we have not seen that trend the way we did in previous decades. In fact, the decline in household formations is likely the main reason the housing industry did not play its traditional role in the most recent economic recovery.

Until we see more household formation take on a very strong tone, we probably are not going to see real significant gains, preventing a return of what we generally consider a strong real estate market. Moody's Analytics estimates that each new household leads to $145,000 of economic activity as a result the decrease in household formation could have a broader impact on overall economic growth.





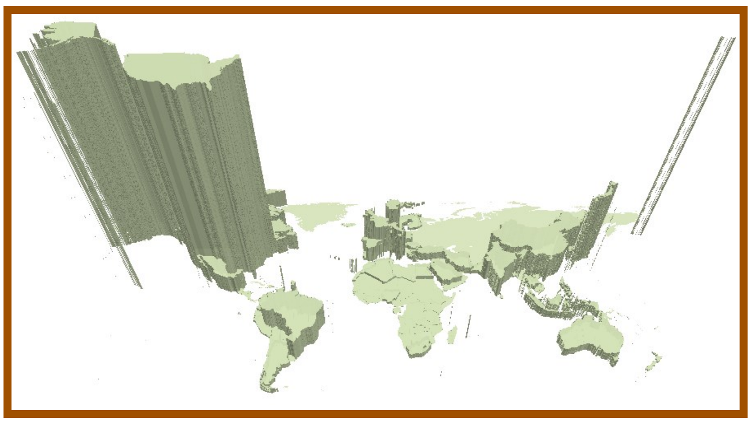
HEADWINDS

Financial world. Although lowering the federal funds target rate to near zero and attempting to induce risk-taking by purchasing long term financial assets (quantitative easing), the Federal Reserve's actions appear to have had little effect on real economic activity. Effects of Federal Reserve policy have shown up in other places, such as in the prices of stocks and other financial assets. Indications out of the Federal Reserve are that they may, within the year, completely wind down their asset purchase programs and begin to increase the federal funds target rate in 2015 (i.e. the beginning of the end of Fed "loosening"). Should a "less-loose" Federal Reserve cause financial markets to re-price risk, it may cause deterioration in asset prices, which might affect income tax payments and taxable sales.

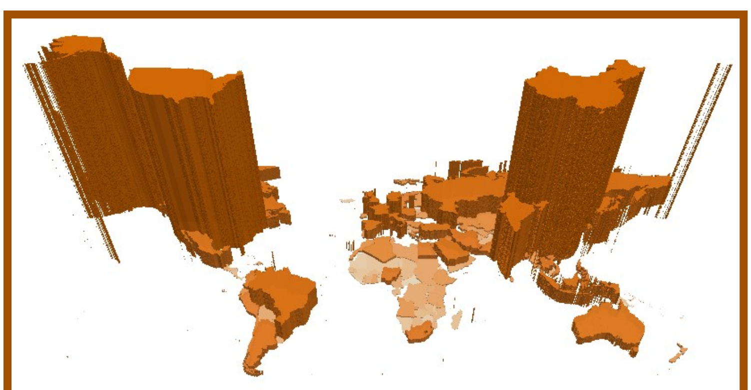
China. When measured by GDP (final demand), the economy in China is set to become the biggest in the world in 2019, surpassing the United States. This will be the first time since 1872 that another country has had a bigger economy. This matters for revenue indirectly, in that economic conditions on the eastern part of the globe matter now more than ever in revenue projections. Should business conditions in China decelerate as anticipated, U.S. conditions would slow.

Europe. Conditions in the old world have taken an opposite course from that in the United States.

Share of Global GDP—1990



Share of Global GDP—2019



Geopolitical risk. The situation in Ukraine poses risks to investments by Russians in the United States and by Americans in Russia. International conditions matter for state tax collections in that residents' income and wealth, to one degree or another, are connected with international economic conditions. Should individuals and businesses shift towards a risk-average view of the world economy, it would likely result in reduced tax collections.

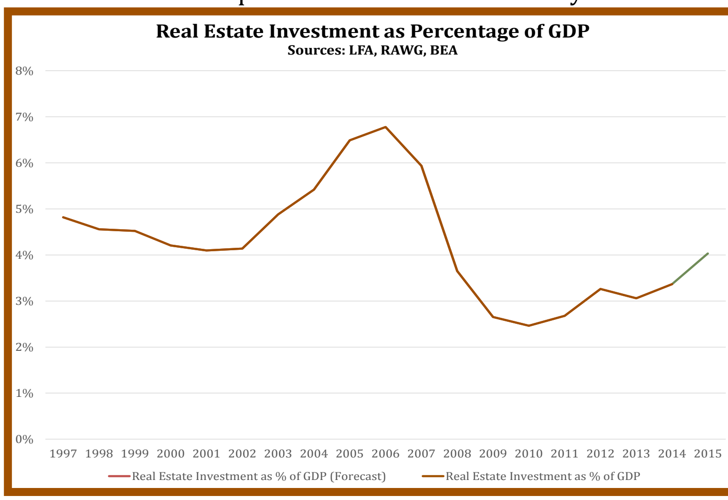
Debt. The burden of past unprofitable debt continues to dampen economic growth. Among the debt types causing shifts in behavior are student debt where the investment hasn't paid off and federal government debt.

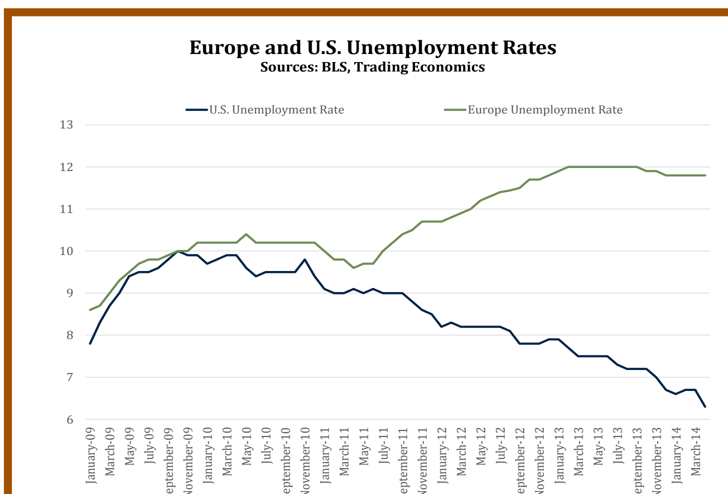
TAILWINDS

Business Investment. The driver of the recovery has been investment activity. Should investment continue to be strong, economic growth would likely accelerate.

Investable Cash. Global cash is high, with corporations and governments holding historically high balances in liquid assets. Should this cash get moved, the global economy may pick up.

Residential Investment. Bottoming in 2010, investment in the residential real estate sector has some room to go before it's back to a normal component of the overall economy.





15 Year Revenue Trend

H.B. 311 "Budgeting Amendments" directs the Office of the Legislative Fiscal Analyst and the Governor's Office of Management and Budget to include in the analysis of revenue estimates a comparison of current estimates to 15-year trends by tax type.

Of the potential models that extract out the trend and the cyclical components of the business cycle, the following presents four model results: simple linear trend, a Hodrick-Prescott trend, the Christiano-Fitzgerald trend, and the Butterworth trend.

As a note, all models assume that the methodology behind constructing the 15-year trends limits the historical information include 15 years of actual data. Only the two largest revenue sources — income tax and sales tax — are shown.

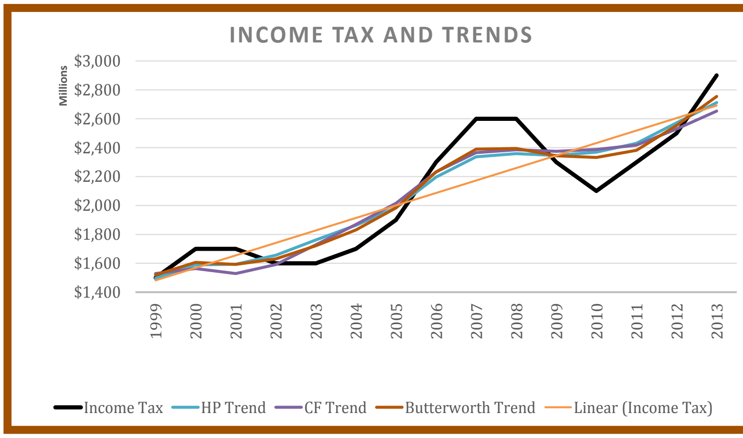
A simple linear trend estimates a best fit line between the actual figures. The next three trends divide the time series into a trend and cycle component.

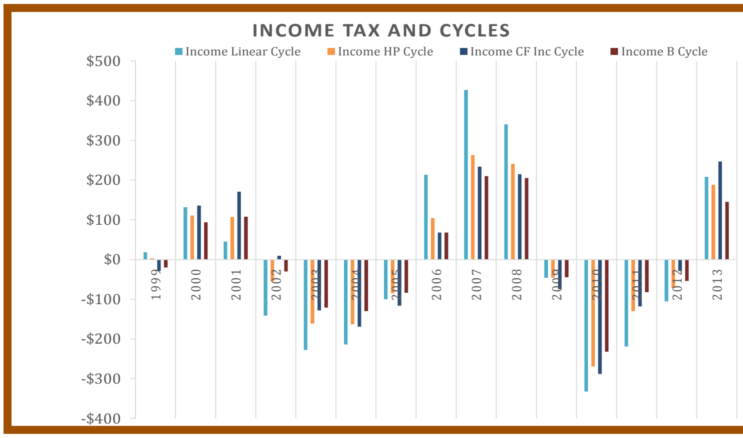
Actual Experience = Trend + Cycle.

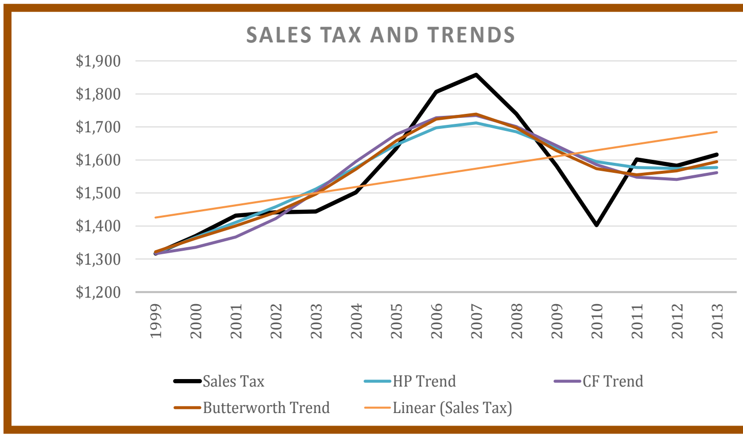
Of the models available to extract out the trend and cyclical components of a time series, three commonly used methods are the **Hodrick-Prescott trend (HP)**, the **Christiano-Fitzgerald trend (CF)**, and the **Butterworth trend (B)**. Each of these and other trend possibilities will be addressed later on this year. In terms of the difference in results, the following table presents what each model produces as the cycle for the income tax and sales tax history. Overall, the linear trend is most volatile, producing, for example, an income tax cycle peak of $427 million in 2007 and a cycle trough of $332 million in 2007.

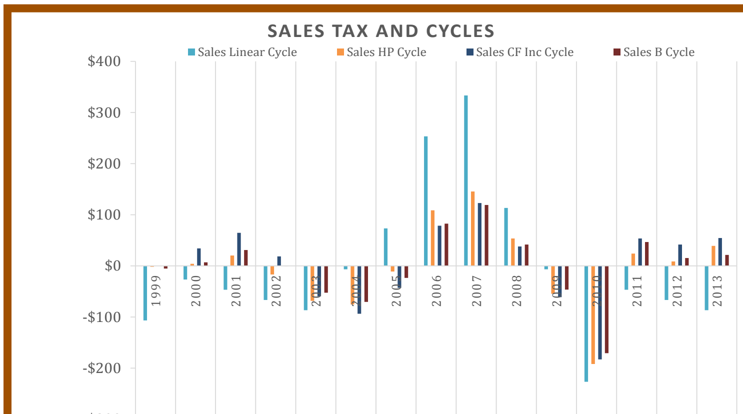
	Income Tax Cycle (millions)			
Fiscal Year	Linear	HP	CF	B
2007	$427	$263	$234	$210
2008	$340	$241	$215	$205
2009	-$46	-$46	-$74	-$44
2010	-$332	-$269	-$288	-$232
2011	-$219	-$130	-$118	-$82
2012	-$105	-$72	-$29	-$54
2013	$208	$188	$247	$145

	Sales Tax Cycle (millions)			
Fiscal Year	Linear	HP	CF	B
2007	$33	$145	$123	$119
2008	$11	$54	$38	$42
2009	-$1	-$55	-$61	-$46
2010	-$23	-$192	-$183	-$171
2011	-$5	$24	$54	$47
2012	-$7	$9	$42	$15
2013	-$9	$39	$54	$21









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Part C: Revenue Collections

Tax Revenue *(In Millions of Dollars)*	FY 2013 Final	FY 2014 Consensus	FY 2014 Consensus Growth Rate		FY 2013 Year-to-Date (6/9/2013)	FY 2014 Year-to-Date (6/9/2014)	FY 2014 Year-to-Date Growth Rate
Sales & Use Taxes	$1,616.19	$1,651.46	2.2%		$1,497.37	$1,541.38	2.9%
Individual Income Tax	2,852.02	2,781.64	-2.5%		2,651.47	2,671.58	0.8%
Corporate Franchise Tax	338.20	291.39	-13.8%		280.11	259.14	-7.5%
Beer, Cigarette & Tobacco	120.86	116.49	-3.6%		112.76	105.52	-6.4%
Insurance Premium Taxes	89.59	94.88	5.9%		89.09	90.68	1.8%
Severance Taxes	70.11	85.34	21.7%		76.06	105.08	38.2%
Other Sources	232.34	237.04	2.0%		112.82	106.98	-5.2%
Total - General & Education Funds	**$5,319.31**	**$5,258.24**	**-1.1%**		**$4,819.67**	**$4,880.36**	**1.3%**
Motor Fuel Tax	$256.87	$253.34	-1.4%		226.39	229.00	1.2%
Special Fuel Taxes	101.36	99.00	-2.3%		85.04	86.62	1.9%
Other Transportation Fund	81.18	83.99	3.5%		73.84	74.28	0.6%
Total - Transportation Fund	**$439.41**	**$436.33**	**-0.7%**		**$385.27**	**$389.90**	**1.2%**

Source: LFA, USTC, DOF