STATE OF WISCONSIN

Notice of **Material Information** #2003-09
Dated January 28, 2003

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Type of Information: Revised Expenditure and Revenue Estimates – January 23, 2003

Attached is a report, dated January 23, 2003, from the Director of the Legislative Fiscal Bureau to the Joint Committee on Finance. This report provides revised general-fund expenditure and revenue estimates and projected general fund closing balance for the 2002-03 fiscal year.

Type of Filing: Filed in both electronic and paper form with each Nationally Recognized Municipal Securities Information Repository. This notice is also available on the State of Wisconsin Capital Finance web site at:

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The undersigned represents that he is the Capital Finance Director, State of Wisconsin Capital Finance Office, which is the office of the State of Wisconsin responsible for providing Annual Reports and giving notice of Listed Material Events when notice is required by the State's Master Agreement on Continuing Disclosure.

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State of Wisconsin

January 23, 2003

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

Dear Senator Darling and Representative Kaufert:

Annually, this office prepares general fund expenditure and revenue projections for the Legislature as it begins to consider the state's budget and other legislation.

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. The purpose of this report is to present the conclusions of our analysis.

Comparison with the Administration's November 20, 2002, Report

On November 20, 2002, the Departments of Administration and Revenue submitted a report to the Governor and Legislature that identified revenue projections for the 2002-03 fiscal year and the 2003-05 biennium. Our analysis indicates that for that three-year period, the state's general fund will have $656 million less than is reflected in the November 20 report.

The $656 million is the net result of: (1) a projected decrease in tax collections of $646 million for the three-year period; (2) a decline in departmental revenues of $49 million for 2002-03; and (3) reduced expenditures of $39 million for 2002-03.

Prior to addressing the reasons for this difference, it is important to note the nature of the November 20 document. The DOA/DOR report is required, by statute, to be submitted at that time to inform the Governor, Governor-Elect, and Legislature of the magnitude of agency budget requests and present a projection of tax collections. Given the report's timing in the 2002-03 fiscal year, sufficient data is not available to reestimate certain revenues and expenditures for the current fiscal year. Thus, as indicated in their report, departmental revenues and expenditures were not reestimated by DOA. This is consistent with previous November 20 reports.

2002-03 General Fund Condition Statement

Our analysis indicates that, unless addressed by the Governor and Legislature prior to the end of the current fiscal year, the gross balance of the general fund on June 30, 2003, will be -$373 million. This is shown in Table 1.

TABLE 1

Estimated 2002-03 General Fund Condition Statement

	2002-03
Revenues	
Opening Balance, July 1	$53,782,000
Taxes	10,223,500,000
Departmental Revenues	
Tobacco Settlement	149,081,600
Other	216,673,800
Total Available	$10,643,037,400
Appropriations	
Gross Appropriations	$11,121,564,300
Compensation Reserves	79,815,500
Transfer to Tobacco Control Board	15,345,100
Less: Lapses and Sum Sufficient Reestimates	-200,490,700
Net Appropriations	$11,016,234,200
Balance	
Gross Balance	-$373,196,800

The administration's November 20 report contained a 2002-03 general fund condition statement that showed a gross balance of -$185 million. Thus, the projected gross balance of this report (-$373 million) is $188 million less than that shown in the November 20 report.

The $188 million consists of a decrease in estimated tax collections of $178 million, a decrease in departmental revenues of $49 million, and decreased expenditures of $39 million. The reduction in departmental revenues is primarily due to a projected reduction of $27 million in interest earnings, and an $8.5 million decline in tobacco settlement monies because of a reduction in the volume of cigarettes shipped in, or to, the United States. The primary item of the expenditure reduction is a projected lapse of $24.3 million from the appropriation for SeniorCare (prescription drug program for the elderly). When the SeniorCare program was enacted in the 2001-03 biennial budget, it was not anticipated that federal funds would be available to support the program. That changed in July, 2002, when the U.S. Department of Health and Human Services waived a federal law and allowed the state to claim medical assistance (MA) matching funds for a portion of Wisconsin's eligible, elderly population. In addition, enrollments in the program are below budgeted estimates.

In reviewing the 2002-03 condition statement, the following points should be noted. First, it is currently estimated that MA and BadgerCare benefit costs will exceed amounts budgeted for these programs in 2002-03 by $64 million GPR. If this shortfall were to be addressed in 2002-03, the gross balance of -$373 million would instead be -$437 million. Second, it is uncertain at this time if the 2001-03 collective bargaining agreements and proposed amendments to the state compensation plan will be approved by the Legislature and Governor. If they do not take effect in 2002-03, the deficit figure shown above would improve by an estimated $33 million. Finally, the -$373 million is a gross balance figure and does not include a statutory reserve amount. If the Governor and Legislature were to address the gross deficit and maintain a statutory balance ($134 million), the total amount needed in 2002-03 would be $507 million.

2003-05 Projected Imbalance

In addition to projecting the $185 million deficit for 2002-03, the administration's November 20 report indicated a potential general fund imbalance for the 2003-05 biennium. In preparing the estimate, the November 20 report assumed the following: (1) a 2003-04 opening balance of -$185 million; (2) the general fund revenue estimates for each year of the next biennium as contained in the November 20 report; (3) general fund appropriation amounts requested by state agencies for 2003-05; and (4) the current statutory balance requirements of 1.6% of appropriations in 2003-04 and 1.8% in 2004-05. Using those assumptions, the November 20 report showed an imbalance in 2003-04 of $1,597 million and an additional imbalance of $972 million in 2004-05. Thus, for the 2003-05 biennium, the November 20 report showed an imbalance of $2,569 million ($1,597 million plus $972 million).

If the 2003-04 opening balance of -$373 million and the 2003-05 tax collections of this report were used along with the other assumptions of the November 20 document, the projected imbalance would be $1,999 million in 2003-04 and an additional $1,226 million in 2004-05 for a biennial total of $3,225 million. This is $656 million more than the $2,569 million imbalance figure of the November 20 report for the next biennium.

The imbalance figure above is shown for comparative purposes only. At this time, the level of appropriations, departmental revenues, compensation reserves, and other items of the Governor's budget recommendations and those of the Legislature for 2003-05 are unknown. Also, the Constitution requires that the Legislature adopt a balanced budget. Thus, any imbalance projections for 2003-05 will be addressed by the Governor and Legislature in upcoming budget recommendations and deliberations.

General Fund Tax Revenues

The following sections provide information related to general fund tax revenues for 2002-03 and the 2003-05 biennium. The information provided includes a review of the economy in 2002, a discussion of the national economic forecast for 2003 through 2005, and detailed general fund tax revenue projections for the current fiscal year and the next biennium.

Review of the Economy in 2002

Last January, this office prepared general fund revenue estimates for the 2001-03 biennium based on the January, 2002, forecast of the economy prepared by DRI-WEFA (a subsidiary of Global Insight, Inc. that was formed by integrating DRI and Wharton Econometric Forecasting Associates). Global Insight, Inc. now prepares the forecast. The forecast reflected the effects on the national economy of the recession that was declared to have started in March, 2001, by the National Bureau of Economic Research. The recession was projected to bottom out in the first quarter of 2002, followed by gradually accelerating growth during the rest of the year. Relatively strong growth was forecast for 2003. The forecast indicated that the federal tax cuts approved before the September 11, 2001, terrorist attacks, increased federal spending on education, security, defense, and intelligence, and monetary policy that enhanced liquidity and produced low interest rates would all contribute to an economic turn-around. The forecast also assumed a reversal of a build-up of inventories beginning in the first quarter of 2002, and increased expenditures for travel and leisure activities as the impact of September 11 began to fade.

Nominal gross domestic product (GDP) was projected to increase 1.9% in 2002 and 6.0% in 2003, while real GDP was forecast to increase by 0.6% in 2002 and 3.7% in 2003. Inflation would remain relatively low, with the consumer price index at 1.9% in 2002 and 2.6% in 2003. The economic slowdown would cause unemployment to increase to 6.2% in 2002 and then decrease slightly to 5.9% in 2003, as the economy rebounded. Reflecting increased unemployment and the sluggish economy, the growth in personal income was projected to slow in 2002, then pick up in 2003. Growth in personal income was anticipated to be 2.2% in 2002 and increase to 5.2% in 2003, as employment began to grow again. Consumer spending was expected to drop in early 2002 then increase and help spur economic recovery beginning in the spring of 2002. The January, 2002, forecast assumed growth in personal consumption expenditures of 2.3% in 2002 and 6.1% in 2003.

Based on estimated growth in real GDP, it appears that the recession ended in the fourth quarter of 2001, and positive growth occurred in each quarter of 2002. However, when the final numbers are computed for 2002, the economy's quarterly growth rates will exhibit an erratic pattern, with peaks of 5% and 4% of real growth in the first and third quarters and lower growth rates of 1.3% and 1.0% in the second and fourth quarters, respectively. Consumer spending was the primary force behind economic growth during the year, although spending patterns were somewhat inconsistent. Consumer spending increased by 4.5% last year, with growth rates ranging from 3.9% in the first quarter to 5.4% in the third quarter. Both total personal income and disposable personal income increased to support spending. In 2002, personal income increased 3.0%, while disposable income increased 5.9%. Low prices, product innovations, low interest rates, and the return of zero-percent financing for automobiles led to additional purchases. In addition, falling mortgage rates and increasing home values allowed consumers to tap into the equity in their homes for additional funds for consumer purchases. Although consumers generally kept spending through the year, their mood mirrored the erratic pattern of the economy. Consumer confidence improved over most of the first half of 2002, declined for five months, rebounded in November, and then dropped back at year-end. The Conference Board's index of consumer confidence was 80.3 for December, down from 84.9 in November. The University of Michigan's index of consumer sentiment increased in December to 86.7 from 84.2 in November. Overall, the confidence indices taken together made no strong gains through the end of the year. Consumers were concerned about the stagnant job market, falling stock market, and the possibility of war in the Middle East.

The continuing boom in the housing market made a significant contribution to economic growth during the year. Primarily as a result of low interest rates, sales of both new and existing homes posted their best year ever. Sales of new houses increased 7.6% over 2001 while existing home sales increased from about 5.3 million to 5.6 million, or 5.6% for the year. The increased demand for housing stimulated construction as housing starts were up 5.5% in 2002. The growing demand also bid up home prices as the average price for new homes increased from $210,100 in 2001 to $223,300 in 2002. Similarly, the average price of existing homes went from $184,200 in 2001 to $200,000 in 2002. Assisted by the expansionary monetary policy followed by the Federal Reserve, mortgage interest rates fell to historic lows. In November, the Federal Open Market Committee cut the target federal funds rate 50 basis points to 1.25%. This was the first decrease in 2002, but the twelfth rate cut in two years. The annual average conventional 30-year fixed mortgage rate dropped from 7.0% in 2001 to 6.5% in 2002. The combination of low interest rates and rising home values spurred homeowners to refinance. According to the Mortgage Bankers Association of America, an estimated $1.24 trillion in mortgages were refinanced in 2002, and a study by an economist at Goldman, Sachs & Co. found that refinancing provided an amount equal to 2% of disposable income during the first half of 2002.

The year-end employment picture was not good. Payroll contracted by 101,000 in December and there were downward revisions in reported employment for October and November. However, the monthly unemployment rate remained unchanged at 6.0%. For the year, the unemployment rate was 5.8%, up from 4.8% for 2001. The unemployment rate reflects weak labor force growth. Businesses have been reluctant to add employees. In addition, firms are uncertain about the potential economic impact of a war with Iraq, the standoff with North Korea, and any future terrorist attacks. This uncertainty has also contributed to a lack of business investment. Firms are not sure that demand will remain strong enough to justify an increase in capital budgets and to start new capital projects. In addition, operating rates at many companies are quite low. The average factory operating rate was 70% for 2002. Finally, strong productivity growth allows businesses to increase output without adding new machinery. Real nonresidential fixed investment decreased 5.7% for the year, while purchases of equipment and software declined 1.8%.

In 2002, productivity gains were the best in decades. Nonfarm output per hour increased 4.7%, while manufacturing output per hour increased 5.2%. In 2001, the rate of growth of those factors was 1.1% and 0.9% respectively. At the same time, compensation per hour increased 2.9% and unit labor costs actually declined 1.8%. As a result, businesses were able to increase employee pay and improve profitability. As noted, personal income increased 3.0% in 2002. After declining in 2001, after-tax corporate profits turned around and started increasing throughout the year. The bonus depreciation provisions enacted in the federal Job Creation and Worker Assistance Act of 2002 also increased business cash flow.

Inflation remained contained in 2002, with consumer prices increasing 1.6% for the year. Producer prices for finished goods declined by 1.3% for the year. However, energy prices jumped 9.0% in the last quarter, as a result of the strike against the Venezuela national oil company and concern over war with Iraq. Core CPI inflation was a stable 2.0% for the same quarter.

Although the value of the dollar began declining against most currencies of industrialized counties in 2002, it did not drop far enough to have a positive effect on international trade. As a result, trade was a drag on the U. S. economy for the year. The strong dollar makes imports relatively cheap, while U.S. exporting firms have difficulty selling products and services overseas. The annualized current account balance deficit was almost $500 billion. America is importing more than it exports, while the income it gets from foreign investments is less than the amount paid to foreigners for investments in the U. S. The combination of a relatively strong dollar and tough competition from countries with low production costs has led to elimination of two million jobs in the manufacturing sector of the economy since 2000.

A series of corporate governance scandals, major bankruptcies, and revelations of accounting fraud that began in late 2001 shook the financial markets in 2002. These events severely undermined confidence in the financial markets. Combined with sluggish economic growth and corporate earnings, rising unemployment, and apprehension about war and terrorism, the market declined in 2002. The market did rally some late in the year, climbing two straight months in the fourth quarter, the first time since March, 1998. However, this was not enough to offset the annual decline. By the end of 2002, the market value of household equity holdings had fallen by an estimated $3.2 trillion, bringing the three-year decrease to $7.0 trillion, or 22%. Similarly, for 2002, the Dow index was down 17%, the S&P 500 was down 24%, and the Nasdaq was down 33%. The last time the market saw a three-year run in losses was 1939 to 1941.

National Economic Forecast

The revenue estimates included in this report are based on the January, 2003, forecast of the economy by Global Insight, Inc.

As 2003 began, the United States faced a world filled with uncertainties that could have significant consequences beyond the effects on the economy. The possibility of war with Iraq looms, the North Korean government has revived a program for enriching uranium and threatened aggression if certain conditions are not met, and terrorist groups remain at large and dangerous. The events surrounding potential war in Iraq, the outcome of the confrontation with North Korea, and possible terrorist activities could have substantial impacts on the U. S. economy.

Many economists believe that apprehension by consumers and businesses regarding potential war in Iraq helped contribute to a slowdown in the economy at the end of 2002. The final quarter of 2002 is expected to have a real annual rate of GDP growth of 1.0%. Final demand, reflecting depressed consumer confidence, only increased at an annual rate of 0.3%. Industrial production dropped and the unemployment rate increased. However, according to Global Insight, Inc., the slowdown in growth and increase in unemployment in the fourth quarter of 2002 gives a misleading picture of the health of the economy. Personal income grew at an annual rate of 3.8% and consumer spending for nondurables and services increased more than in the third quarter. After-tax corporate profits were strong and real nonresidential fixed investment changed from a negative annual rate of growth to a positive increase of 3.3%. Government purchases also contributed to economic growth. Inflation remained constrained and interest rates were low.

The Global Insight, Inc. forecast incorporates the effects of a war with Iraq, new federal income tax cuts, and the extension of unemployment benefits into its economic projections for 2003 and beyond. Concern about possible setbacks and a jump in oil prices are expected to depress consumer confidence and the stock market. Consumer spending and business investment will be constrained until a successful outcome of the war is assured.

An additional $50 billion in federal spending is projected, with most of the initial spending for activating reserves and combat pay. Federal expenditures to replace equipment and munitions used in the war will occur in late 2003 and 2004. The tax cut package finally adopted by Congress and approved by the President and the extension of unemployment benefits is assumed to amount to another $50 billion. Thus the total fiscal stimulus provided by possible war with Iraq, federal tax cuts, and extended unemployment benefits is forecast to be $100 billion over the next 18 months.

A resolution of the situation in Iraq, combined with the underlying strengths in the economy and the fiscal stimulus provided by war expenditures, the federal tax cuts, and unemployment compensation benefits, are expected to propel economic recovery beginning in the second half of 2003 and carrying on into 2004. Economic expansion will continue in 2005, but at a lower rate. For the forecast period, moderating growth in consumer spending will be offset by the jump in federal spending, the reversal of business investment in equipment from annual decreases to annual increases, and a decline in the value of the dollar that will improve trade. Global Insight, Inc. estimates that real GDP will grow at an annual rate of 5.5% the last two quarters of 2003. For the year, real GDP will increase 3.1%, compared to 2.4% for 2002. Real GDP growth will increase to 4.7% in 2004, and then moderate to 3.3% in 2005. Nominal GDP, which increased 3.6% in 2002, is projected to increase 5.2% in 2003, 7.2% in 2004, and 5.7% in 2005.

Consumer spending was the primary force behind economic growth in 2002. Purchasing power was enhanced by zero-percent financing for autos, federal tax cuts, and low mortgage interest rates that allowed individuals to borrow from the equity of their homes through refinancing or by taking out new home-equity loans. Despite the year-end drop in consumer confidence and slowdown in spending, the consumer will continue to be a key contributor to economic growth. Since the factors, such as mortgage refinancings, that spurred consumer spending are likely to be less significant, increasing income is expected to be the primary source of additional spending. Continued productivity gains and slowly increasing employment will cause incomes to grow. Increasing productivity gives employers the opportunity to increase wages for their workers and still maintain or increase profit margins. The Global Insight, Inc. forecast estimates that personal income will increase 5.0% in 2003, 6.5% in 2004, and 5.6% in 2005. Productivity (output per hour) is projected to increase 3.3% in 2003, 2.5% in 2004, then slow to 2.0% in 2005. Although consumer spending is expected to continue pushing economic growth during the next three years, the anticipated war with Iraq will weaken consumer spending in the first half of 2003. Oil prices are forecast to increase to almost $32 per barrel in the first quarter and consumer confidence will fall. However, it is projected that later in 2003 oil prices will decline and consumer confidence and the stock market will surge. Spending is forecast to jump in late 2003 and 2004, as increasing incomes and the proposed federal tax cut provide consumers with more disposable income. Increased hiring over the forecast period will also raise the willingness of consumers to spend. The forecast estimates the annual growth in personal consumption expenditures will be 4.4% for the first half of 2003, then increase to 5.2% for the second half of the year. Annually, personal consumption expenditures are expected to increase 4.8% in 2003, 6.7% in 2004, and 5.8% in 2005. The consumer sentiment index is projected to jump almost ten points from 86.9 in 2003 to 96.4 in 2004. The index will then stabilize at 95.8 in 2005.

At the start of 2003, the state of affairs in the world is reinforcing risk-averse behavior in businesses. In addition to the possibility of war with Iraq and confrontation with North Korea, the strike against the national oil company in Venezuela has created fears of an oil-price spike. Until these situations are cleared up, businesses will be reluctant to undertake substantial investment projects. A strong economic recovery depends on businesses' willingness to take risks and invest. Without investment, businesses are not making commitments to future growth and new hires. The forecast assumes that, once the situation with Iraq is resolved, business investment will be a primary contributor to economic growth from the second half of 2003 through 2005. The underlying factors for increased investment seem to be in place. Businesses have engaged in cost-cutting activities over the past two years. Jobs have been pared, major capital investment projects have been delayed, and worker productivity has increased. As a result, income from sales is generally going directly to a firm's bottom line. Federal bonus depreciation tax provisions will provide additional short-term cash flow to certain businesses as well. Improved earnings and cash flow are expected to drive a rebound in capital spending. In addition, a weakening dollar should make exports more competitive and foreign goods more expensive. This will improve the pricing power of U. S. businesses. The forecast assumes that, in the aftermath of a successful resolution of the situation in Iraq, the economy will experience a substantial increase in growth. Finally, increasing consumer demand is helping raise earnings. Reflecting increased consumer spending and continued strong productivity, pre-tax corporate profits will surge to an annual rate of growth of

15.0% in 2003 and 16.5% in 2004. Businesses will make the capital purchases and start the capital investment projects that have been postponed the past two years. With the ratio of inventories to sales below the ten-year trend, new orders for replacements are likely. This should spur additional investment to support expanded output. Under the forecast, real nonresidential fixed investment is projected to increase 4.8% in 2003, 10.7% in 2004, and 8.2% in 2005. Similarly, real investment in equipment and software is expected to grow by 7.6% in 2003, 12.1% in 2004, and 7.0% in 2005.

The state of the labor market deteriorated in the fourth quarter of 2002, as the unemployment rate moved up to 6.0% and the economy lost jobs. Businesses have focused on reducing costs and have been reluctant to add workers. Moreover, increased productivity from the existing workforce lets businesses increase output without increasing the workforce. Employers will have to regain confidence in the stability of demand and profits before they begin hiring at a pace strong enough to significantly lower the unemployment rate. However, by historical standards, the 6.0% jobless rate is quite low at this stage of a recovery. Under the forecast, the unemployment rate is expected to edge up to 6.4% by the second quarter of 2003. Then, as the economy accelerates in the second half of the year, employment will improve gradually from the third quarter of 2003 through 2005. The annual unemployment rate is projected to be 6.2% in 2003, 5.3% in 2004, and 5.0% in 2005. After increasing only 0.7% in 2003, payroll employment will increase 2.6% in 2004 and 1.9% in 2005.

The housing market was a major contributor to economic growth in 2002. The historic low level of mortgage rates and decline of the stock market made housing a preferred investment. The low mortgage rates accelerated the transition of some households from renters to buyers, and allowed current owners to expand consumption of housing without significantly increasing their housing budgets. The Global Insight, Inc. forecast sees a reduced role for housing and construction as factors in economic growth. Early in 2003, a downswing in housing activity is anticipated once the negative impact of rising unemployment and weak wage gains outweigh the positive impact of low mortgage rates. Beginning in the second half of the year, increasing interest rates are expected to offset an improving employment outlook. The average conventional 30-year mortgage rate is projected to increase slightly from 6.5% in 2002 to 6.7% in 2003, and then jump to 8.1% in 2004, and 8.2% in 2005. Conversely, total housing starts are forecast to drop from 1.69 million units in 2002 to 1.56 million units in 2003, before rebounding somewhat to 1.64 million and 1.67 million units in 2004 and 2005, respectively. Sales of existing homes will follow a similar pattern, while sales of new homes will show annual declines. Real residential construction is projected to decrease 1.3% in 2003, and then increase 2.3% in 2004 and jump 5.4% in 2005.

The U. S. trade deficit is expected to set a record high in 2002, even though the dollar fell to a three-year low against the Euro by mid-January, 2003. Although the dollar has dropped from its peak in February, 2002, it has not fallen enough to create a competitive environment for U. S. exporters. In recessions and times of slow economic growth, trade deficits typically narrow as consumer spending weakens, and a weak economy tends to undermine the value of the dollar, and imports become more expensive and exports cheaper for foreign consumers. While U. S. economic growth has been sluggish, the economies of many of the United States' trading partners are growing more slowly, depressing overseas demand for U. S. goods, services, and financial assets. And even though the value of the dollar is falling relative to the currencies of other trading partners, many economists believe it could take up to two years for a drop in the currency to translate into noticeable export gains or declining imports. Rather than show a fairly smooth quarterly pattern of gradual expansion of the trade deficit, the forecast projects a minor improvement in trade for several quarters of 2003, as automotive manufacturers reduce North American production and imports of completed vehicles into the United States. The trade deficit is then expected to deteriorate until later in the forecast period when foreign economies improve. The trade deficit is forecast to increase from $414.9 billion in 2002 to $421.5 billion in 2003 and $431.1 billion in 2004, before dropping to $423.2 billion in 2005.

The forecast indicates that, despite recent jumps in energy prices, the inflation environment remains benign. While many broad measures of inflation have been showing modest acceleration recently, and inflation is expected to rise, Global Insight, Inc. does not consider the rise alarming. The annual rate of increase in core inflation (the Consumer Price Index, excluding food and energy) decreased through November. Part of the drop in core inflation was due to lower wage cost escalation. Lower labor cost increases may have been the single most important reason inflation has been trending down over the past few years. The annual increase in total labor costs decreased from 4.6% in 2000 to 3.7% in 2002. The annual growth in labor costs is projected to decrease to 3.3% in 2003, then to increase 4.0% in 2004 and 3.7% in 2005, as the economy rebounds. However, there is some concern about the rising cost of employee benefits, particularly health care. The producer price index (PPI) for finished goods is also seemingly under control, having declined 1.3% in 2002, partially due to decreased auto prices. The CPI and PPI are expected to increase in the first half of 2003, as a result of the strike against the Venezuelan national oil company and the possibility of war in Iraq. The PPI for energy is expected to increase 15.3% in the first quarter of 2003, while the CPI for energy will be up 17.7% for the same period. However, when these matters are resolved, energy prices are expected to drop. The drop in energy prices is expected to dampen the inflationary effects of the increased ability of producers to raise prices as the economy recovers beginning in the second half of 2003. Moreover, sluggish growth in the manufacturing sector and moderate increases in employment costs will keep prices under control. The annual change in the PPI is expected to be 1.2% in 2003 and 2004, and 1.4% in 2005. The annual increase in the CPI is projected to be 2.3% in 2003, 2.4% in 2004, and 2.6% in 2005. Finally, core inflation is forecast to grow 2.2% in 2003 and 2.7% in both 2004 and 2005.

For most of the past two years, monetary policy has been the primary government tool used to manage the economy. The Federal Reserve's actions to continuously cut interest rates have thus far prevented the economy from tumbling into a major recession. The rate reductions have had the greatest effect on the automotive, housing, and mortgage markets. However, the lower rates have not had a significant effect on business investment. Global Insight, Inc. does not expect the Federal Reserve to take any actions during the first two quarters of 2003. Once the situation in Iraq is successfully resolved, economic growth will begin to surge and pressure will increase on prices. The forecast indicates that, in order to head off any inflationary pressures related to the recovery, the Federal Reserve will approve a rate hike next summer. The timing could be affected by the situation in Iraq or passage of a version of the administration's fiscal package.

In early January, President Bush proposed a fiscal stimulus package of tax cuts, extended unemployment compensation benefits, and personal re-employment accounts, with a total cost of almost $700 billion over ten years. [The extended unemployment benefits package has already been enacted into law.] As noted, the forecast includes the estimated effect of a stimulus package on the economy. In addition, the forecast assumes that Congress will pass an omnibus budget bill that is close to the administration's target. Increased federal outlays are anticipated for income security, Medicare, Medicaid, and defense. The federal deficit is expected to be $300 billion or more for the next two years. A budget surplus is not projected until 2011.

Over the past six quarters, state and local governments, in aggregate, have been running an annual operating deficit of about $50 billion, or about 4% of their operating budgets. This amounts to about 20% of non-wage, non-transfer spending. Since state and local governments must have balanced budgets, these governments have worked to fund the deficits mainly through the use of reserve funds, accounting adjustments, and short-term borrowing. These devices are generally not permanent solutions. As a result, Global Insight, Inc. anticipates that, during the next few years, state and local governments will use layoffs and spending cuts to bring their budgets back into balance. Also, some revenue increases, beyond cigarette taxes and casino gambling, are anticipated.

Table 2 shows projected values for several economic indicators that underlie the general fund revenue estimates for 2002-03 and the 2003-05 biennium.

TABLE 2

Summary of National Economic Indicators
Global Insight, Inc.
January, 2003
($ in Billions)

	2002	2003	2004	2005
Nominal Gross Domestic Product	$10,448.9	$10,987.1	$11,775.8	$12,448.7
Percent Change	3.6%	5.2%	7.2%	5.7%
Real Gross Domestic Product	$9,437.7	$9,730.0	$10,188.0	$10,524.3
Percent Change	2.4%	3.1%	4.7%	3.3%
Consumer Price Index	1.6%	2.3%	2.4%	2.6%
Personal Income	$8,947.0	$9,391.6	$10,004.3	$10,566.7
Percent Change	3.0%	5.0%	6.5%	5.6%
Personal Consumption Expenditures	$7,299.0	$7,650.6	$8,164.6	$8,640.9
Percent Change	4.5%	4.8%	6.7%	5.8%
Corporate Profits Before Tax	$659.4	$758.4	$883.4	$851.1
Percent Change	-1.6%	15.0%	16.5%	-3.7%
Unemployment Rate	5.8%	6.2%	5.3%	5.0%

The January, 2003, Global Insight, Inc. economic forecast includes a fairly extensive list of risks that could have an effect on the U. S. economy in 2003, which are described below. Most of these risks would negatively impact the economy; however, the last three risks would lead to stronger growth.

Extensive War with Iraq. Although the effects of a short war with Iraq have been built into the forecast, there is a possibility that the war could be longer and more difficult. In such a scenario, oil prices would increase more and the negative impacts on the stock market and consumer confidence would be greater. The additional uncertainty and higher oil prices could trigger recessions in the United States and other countries.

Major Terrorist Attack. A major terrorist attack in the United States or Europe would severely damage business and consumer confidence and reduce the prospects for economic recovery.

Stock Market Dive. Lackluster earnings, further corporate scandals, and geopolitical events, such as a nuclear showdown with North Korea, could cause stock prices to drop again. Though unlikely, a further large decrease in key market indexes could significantly weaken consumer spending and prevent a recovery in capital expenditures.

Housing "Bubble" Bursts. About a dozen urban housing markets in the U. S. have exhibited some symptoms of "bubble" activity, especially at the high ends of the price spectrum. Recent data indicates that these "bubbles" are slowly deflating rather than bursting. A plunge in housing prices could only occur if interest rates jumped, which is a remote possibility in 2003. However, a drop in housing wealth could reduce consumer spending.

U. S. Dollar Crashes. If the U. S. dollar were to fall precipitously, both inflation and interest rates in the U.S. could spike. A plunge in the dollar would also undermine the export-led recoveries in Europe and Asia. Global Insight, Inc. indicates that the odds of a crash in the value of the dollar are low for two reasons. First, stronger growth in the U. S. relative to most other parts of the world will support the dollar. Second, if the dollar actually started a free-fall, the Federal Reserve and central banks in other countries would likely intervene to prevent disruption of global markets.

A Financial Crisis in a Foreign Country. Many analysts worry that a world financial crisis could be set off by a default in a large, emerging market such as Brazil, or by a financial meltdown in Japan. The likelihood of this scenario is low.

Capital Spending Accelerates. Typically, spending on equipment and structures tends to rebound strongly after a recession. It is believed that worldwide weak growth and large amounts of excess capacity are discouraging companies from making capital investments. However, ratios of inventories to sales and corporate sector net investment to GDP are at historically very low levels. There is a possibility that there is a pent-up demand for capital spending that could take off after the uncertainty about the war with Iraq dissipates. This could significantly increase economic growth above the forecasted level.

Stronger Economic Growth in Europe and Japan. The forecast anticipates weak growth in Europe and Japan. The European Central Bank is showing greater willingness to promote growth. This, combined with more flexibility on fiscal policy, could mean greater growth in domestic European demand. At the same time, banking reform could occur in Japan. If accompanied by macroeconomic policies to offset any initial negative impact on growth, the net result could benefit the worldwide economy.

No War with Iraq. The forecast assumes a short war with Iraq. An alternative would be no attack on Iraq. Under this scenario, there would be less short-term fiscal stimulus from the federal government because of lower military spending. However, the economy would get a boost in 2003 from four other sources: (1) lower oil prices; (2) higher consumer sentiment, resulting in stronger consumer spending; (3) an earlier rebound in capital spending, particularly on equipment; and (4) higher economic growth in foreign trading partners, resulting in increased exports. Under this alternative, a broad recovery starts early in 2003.

General Fund Tax Collections

Table 3 shows revenue estimates for all general fund tax sources for the 2002-03 fiscal year and each year of the 2003-05 biennium. Over the three-year period, these estimates are lower than the Department of Revenue's November 20 projections by $646.1 million ($177.5 million in 2002-03, $215.1 million in 2003-04, and $253.5 million in 2004-05). In the current fiscal year, the difference is primarily due to the individual income and sales taxes, and reflects more recent collections and employment data that are less favorable than the information that was available when DOR's estimates were prepared. In the two years of the 2003-05 biennium, overall growth rates similar to DOR's are projected (5.1% in 2003-04 and 5.6% in 2004-05). However, the reduced base-year (2002-03) estimate results in lower projections in each of the two out-years. Revenues from the estate tax are also expected to be significantly lower than DOR's figures during the next two fiscal years, based on collection patterns that prevailed prior to the recent federal and state law changes in that tax (as discussed later in this report in the section on estate taxes).

TABLE 3

Projected General Fund Tax Collections
($ in Millions)

	2001-03 Biennium		2003-05 Biennium	
	2001-02 Actual	2002-03 Estimated	2003-04 Estimated	2004-05 Estimated
Individual Income	$4,979.7	$5,120.0	$5,410.0	$5,800.0
Sales and Use	3,695.8	3,760.0	3,910.0	4,100.0
Corporate Income & Franchise	503.0	490.0	540.0	555.0
Public Utility	252.2	260.4	268.0	278.0
Excise				
Cigarettes	288.8	292.0	288.4	284.7
Liquor and Wine	36.0	36.3	37.2	38.5
Tobacco Products	13.9	15.9	16.8	17.9
Beer	9.6	9.7	9.8	9.9
Insurance Company	96.1	105.0	105.0	95.0
Estate	82.6	67.0	85.0	90.0
Miscellaneous Taxes	62.5	67.2	71.3	74.7
TOTAL	$10,020.2	$10,223.5	$10,741.5	$11,343.7
Change from Prior Year		$203.3	$518.0	$602.2
Percent Change		2.0%	5.1%	5.6%

Individual Income Tax. Individual income tax receipts are estimated to total $5,120.0 million in 2002-03, which represents a 2.8% increase over collections during 2001-02. For the 2003-05 biennium, individual income tax collections are estimated to be $5,410.0 million in 2003-

04 and $5,800.0 million in 2004-05. These figures represent increases of 5.7% and 7.2%, respectively, over prior year estimates, and are based on the forecast and assumptions about taxable personal income growth in 2003 and 2004.

General Sales and Use Tax. Sales tax revenues totaled $3,695.8 million in 2001-02 and are estimated at $3,760.0 million in 2002-03, $3,910.0 million in 2003-04, and $4,100.0 million in 2004-05. These projections are based on historical experience and forecast growth in personal consumption expenditures, with adjustments for expenditures on food, gas and oil, and services to more closely reflect Wisconsin's sales tax base. The estimates represent growth rates of 1.7% in 2002-03, 4.0% in 2003-04, and 4.9% in 2004-05.

Corporate Income and Franchise Tax. Corporate income and franchise tax revenues are projected to decline from $503.0 million in 2001-02 to $490.0 million in 2002-03. Revenues are then forecast to increase to $540.0 million in 2003-04 and to $555.0 million in 2004-05.

The 2002-03 estimate reflects lower year-to-date corporate income and franchise tax collections and slow profit growth in the first quarter of 2003. Through December, 2002, monthly corporate income and franchise tax collections have declined significantly from 2001-02 monthly collections. In addition, corporate profits declined in 2002 and are not expected to rebound until the spring of 2003.

As the economy expands beginning in the second half of 2003, improving employment and consumer spending are expected to increase demand for business outputs and services. A surge in capital spending will also increase demand for business products. Continued productivity growth is expected to contribute to profit margins.

Public Utility Taxes. Public utility taxes are estimated to be $260.4 million in 2002-03. The estimate represents a 3.3% increase over the $252.2 million in utility taxes collected in 2001-02 and is based on year-to-date collections and assumptions about the pattern of estimated tax payments over the remainder of the fiscal year. Utility tax revenues are estimated at $268.0 million in 2003-04 and $278.0 million in 2004-05, representing year-over-year increases of 2.9% and 3.7%. These figures incorporate the reduced tax rate on wholesale electricity sales that was provided under 2001 Wisconsin Act 16 (the 2001-03 biennial budget), starting with receipts from electricity sales in 2004.

Excise Taxes. Excise taxes on cigarettes, tobacco products, and alcoholic beverages totaled $348.3 million in 2001-02. These collections are projected to be $353.9 million in 2002-03, $352.2 million in 2003-04, and $351.0 million in 2004-05. Revenues from the most significant of the excise taxes, the cigarette tax, are projected to decline during both years of the 2003-05 biennium, reflecting the continuation of a trend of gradual year-to-year consumption declines. An 18¢ increase in the cigarette excise tax (from 59¢ per pack to 77¢ per pack) was enacted in Act 16 and took effect on October 1, 2001. Because the higher rate will be in effect for the entirety of fiscal year 2002-03 but was in effect only for nine months of fiscal year 2001-02, a year-over-year increase in revenues (1.1%) is projected for 2002-03, even though year-over-year pack sales are expected to decline.

Estimates of revenues from the tobacco products tax also reflect a rate increase--from 20% of the manufacturer's list price to 25% of the price, effective October 1, 2001. In addition, sales of tobacco products are expected to grow each year during the 2003-05 biennium, trending in the opposite direction of cigarettes.

The remaining excise taxes on beer, wine, and liquor are estimated to post modest year-over-year revenue increases during all three years for which estimates have been prepared.

Insurance Premiums Taxes. Insurance premiums taxes are projected to increase from $96.1 million in 2001-02 to $105 million in 2002-03 and in 2003-04. It is estimated that insurance premiums tax revenues will then decrease to $95 million in 2004-05. The increased revenues in the first two years are due to a significant annual increase in premiums, mainly from higher prices and to a lesser extent from higher demand. Investment income is generally a significant source of income for insurers. In response to lower investment income, which reflects declining returns from equity markets, insurance companies have increased premium rates to maintain some level of profitability. Industrywide net written premiums are expected to increase 13.6% in 2002 and 12.3% in 2003. Insurance premiums tax collections to-date are significantly above last year's level. Collections are expected to moderate in 2005 as the improving economy and equity markets reduce the importance of premiums as a source of insurance company profits.

Estate Taxes. Estate tax revenues are estimated at $67.0 million in 2002-03, $85.0 million in 2003-04, and $90.0 million in 2004-05. These estimates reflect a decrease of 18.9% in 2002-03 from 2001-02 collections of $82.6 million, and increases of 26.9% and 5.9% in 2003-04 and 2004-05, respectively, over prior year estimates.

Annual estate tax collections are significantly affected by the settlement, or lack thereof, of a small number of large estates. Collections may, therefore, vary considerably from year to year. However, the variation in actual collections and estimated estate taxes from 2001-02 through 2004-05 primarily reflects the effects of the federal law changes under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and subsequent state law changes under Act 16.

Prior to Act 16, state estate taxes were coupled to federal law. Following the federal estate tax reductions under EGTRRA (which provided for the gradual elimination of the estate tax, starting with deaths in 2002, and the phase-out of the federal credit for state death taxes upon which the state estate tax was based), Act 16 decoupled state estate taxes from current federal law. Act 16 provided, instead, that state estate taxes would be linked to federal law in effect on December 31, 2000, (prior to the EGTRRA reductions) for a specified period starting October 1, 2002. The combined effect of the federal and state law changes was to temporarily reduce state estate taxes, which is reflected in the estimate of $67.0 million in estate taxes in 2002-03. Starting with fiscal year 2003-04, it is expected that state estate tax revenues will return to levels similar to those received prior to the change in the federal law. The estimates for 2003-04 and 2004-05 are based on collection patterns prior to EGTRRA.

Miscellaneous Taxes. Collections from the miscellaneous taxes--the real estate transfer fee, which comprises over 80% of miscellaneous tax revenues, and municipal and circuit court-related fees--are expected to increase by 7.4% during 2002-03, to an estimated $67.2 million, then exhibit somewhat slower growth in the two years of the 2003-05 biennium, 6.1% and 4.8%, respectively. Interest rate increases expected to occur during the economic recovery, with their dampening effects on home sales and other property transfers, are the primary factor underlying the slower growth estimates in future years.

We will continue to monitor tax collections, economic forecasts, and expenditures and keep you apprised of any modifications that may be necessary.

Sincerely,

Bob

Robert Wm. Lang
Director

RWL/sas
cc: Members, Wisconsin Legislature