

## State of Wisconsin

Notice of **Material Information** #2008-05  
Dated February 13, 2008

### Information Cover Sheet

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**Legislative Fiscal Bureau memorandum of February 13, 2008** that contains projections of General Fund tax collections, re-estimates of departmental revenues and expenditures, and projected General Fund condition statement for the 2007-09 biennium.

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) and is authorized to distribute this information publicly.



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# Legislative Fiscal Bureau

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February 13, 2008

Senator Mark Miller, Senate Chair  
Representative Kitty Rhoades, Assembly Chair  
Joint Committee on Finance  
State Capitol  
Madison, WI 53702

Dear Senator Miller and Representative Rhoades:

On January 24, 2008, I sent a letter to you that discussed preliminary information regarding general fund tax revenue estimates for the remainder of the 2007-09 biennium. In that letter, I noted that the December, 2007, tax collection report was considerably weaker than in previous months and thought that it would be prudent to wait until February before issuing our analysis of the condition of the general fund. This would allow us to examine sales taxes paid on purchases during the Christmas shopping season and determine if the weak December report was an anomaly or a trend in collections. It would also provide the opportunity to review the February economic forecast and more recent data on a variety of factors, including the potential effect of interest rate decisions by the Federal Reserve Board and the federal economic stimulus plan.

We have now completed our review. Unfortunately, the January, 2008, collections report and the February forecast both point to further weakness in general fund tax collections.

Based upon our analysis, we project the closing net general fund balance at the end of the biennium to be -\$652.3 million. This is prior to decisions made by the Department of Administration (DOA) on February 12, 2008 (described below). The -\$652.3 million is \$655.0 million below the \$2.7 million ending balance that was indicated upon enactment of the state's 2007-09 biennial budget (2007 Act 20).

The \$655.0 million is the net result of a decrease in estimated tax collections of \$586.5 million, a decrease in departmental revenues of \$34.9 million (primarily due to lower interest earnings), and an increase in net expenditures (laws enacted after Act 20, sum sufficient appropriation reestimates, and lapse reestimates) of \$33.6 million.

Yesterday, DOA announced two administrative actions aimed at reducing the magnitude of the potential deficit.

In a memorandum to state agency heads dated February 12, 2008, the Secretary of DOA indicated that the Department is taking two actions relating to state agency spending. First, the previously announced allocation of lapses to meet the required \$200 million lapse provision under Act 20 will be modified by DOA, so that the entire \$200 million will accrue from segregated funds or program revenue accounts. Second, acting under s.16.50 of the statutes, DOA will require GPR-funded agencies to lapse the \$106 million previously identified as part of the \$200 million lapse under Act 20, as well as an additional \$5 million in 2008-09. The effect of these actions will be to improve the general fund's balance by \$53 million in 2007-08 and \$58 million in 2008-09 compared to the estimates used under Act 20.

The administration also indicates that it will use its existing authority to roll over short-term general obligation borrowing that otherwise would have been paid off in 2007-08 and 2008-09. This action will reduce GPR debt service expenditures by an estimated \$63.6 million in 2007-08 and \$61.8 million in 2008-09 compared to estimated GPR debt service under Act 20.

These two decisions of the administration are projected to reduce the \$652.3 million deficit by a biennial total of \$236.4 million to \$415.9 million.

The following table reflects the estimated 2007-09 general fund condition statement, which incorporates the revenue and expenditure estimates of this letter and the February 12 actions of the administration.

**TABLE 1**  
**2007-09 General Fund Condition Statement**

|                                    | <u>2007-08</u>      | <u>2008-09</u>      |
|------------------------------------|---------------------|---------------------|
| <b>Revenues</b>                    |                     |                     |
| Opening Balance, July 1            | \$66,288,000*       | -\$76,860,200       |
| Estimated Taxes                    | 12,868,300,000      | 13,271,500,000      |
| Departmental Revenues              |                     |                     |
| Tribal Gaming Revenues             | 96,731,600          | 46,250,700          |
| Other                              | <u>467,103,700</u>  | <u>472,175,900</u>  |
| Total Available                    | \$13,498,423,300    | \$13,713,066,400    |
| <b>Appropriations and Reserves</b> |                     |                     |
| Gross Appropriations               | \$13,780,810,400    | \$14,171,612,500    |
| Compensation Reserves              | 62,759,600          | 156,617,900         |
| Less Lapses                        | <u>-268,286,500</u> | <u>-264,286,400</u> |
| Net Appropriations                 | \$13,575,283,500    | \$14,063,944,000    |
| <b>Balances</b>                    |                     |                     |
| Gross Balance                      | -\$76,860,200       | -\$350,877,600      |
| Less Required Statutory Balance    | <u>-65,000,000</u>  | <u>-65,000,000</u>  |
| Net Balance, June 30               | -\$141,860,200      | -\$415,877,600      |

\*In addition, \$55.6 million of the 2006-07 ending balance has been transferred to the budget stabilization fund pursuant to s. 16.518 of the statutes.

There are three items that deserve mention which could impact the figures shown in Table 1. Those items are discussed below.

First, the 2007-09 tribal gaming revenues shown in Table 1 (\$96,731,600 in 2007-08 and \$46,250,700 in 2008-09) include certain state payments under the Ho-Chunk Nation's 2003 gaming compact amendments. Under the amendments, the Ho-Chunk Nation was to provide certain lump-sum payments to the state in 2003-04 and 2004-05 and payments based on a percent of net casino win in subsequent years. The general fund revenue from tribal gaming indicated in Table 1 assumes the Ho-Chunk will pay, in 2007-08, the lump-sum payment of \$30 million originally due in 2004-05, as well as percent-of-net-win payments associated with 2005-06 and 2006-07 casino earnings. In 2008-09, the general fund revenue amount assumes the Ho-Chunk will make a percent-of-net-win payment associated with its 2007-08 casino earnings. However, the timing of any Ho-Chunk payments may be affected by the outcome of litigation, currently pending in the federal court for the Western District of Wisconsin, relating to a dispute between the state and the Ho-Chunk Nation. It is unclear at this time how or when the disputed issues will be resolved.

Second, 2007 Act 20 authorized the transfer of \$71.5 million SEG in 2007-08 and \$128.5 million SEG in 2008-09 from the injured patients and families compensation fund (IPFCF) to the medical assistance trust fund (MATF), and increased SEG funding from the MATF and reduced GPR funding for MA benefits by corresponding amounts. In response to the Act 20 directive, the Department of Administration has made the 2007-08 transfer.

On October 29, 2007, the Wisconsin Medical Society filed an action in Dane County Circuit Court seeking, among other things, to permanently enjoin the transfer of monies out of the IPFCF, the immediate return to the IPFCF of all monies so transferred, along with lost earnings, and the recovery of the Medical Society's attorneys' fees and costs. The lawsuit remains pending and its ultimate impact on the state's finances, including the MATF, cannot be predicted at this time.

Finally, the tax revenue estimates shown in Table 1 do not include the potential effect of a decision issued by the Court of Appeals on January 25, 2007, in the case Wisconsin Department of Revenue v. Menasha Corporation, with respect to the taxability of computer software. Under state law, while prewritten computer software is subject to the state sales tax on tangible personal property, sales of custom computer software are exempt. In 1998, Menasha Corporation filed a refund claim with the Department of Revenue (DOR) for sales taxes paid on certain computer software that the company believed was custom software. DOR denied the refund claim, and Menasha Corporation appealed to the Tax Appeals Commission, which decided in favor of Menasha Corporation on December 1, 2003. The decision broadened the DOR interpretation of what computer software is to be considered nontaxable custom software. The case was appealed to the Circuit Court, which reversed the Tax Appeals Commission decision on October 26, 2004, and ruled that DOR was correct in collecting sales tax on the computer software in question. Menasha Corporation appealed the Circuit Court's decision to the Court of Appeals, which decided in favor of Menasha Corporation. DOR has appealed the Appeals Court decision, and the Supreme Court agreed to hear the case. Oral arguments were presented in late 2007 and a

ruling is expected this spring.

Subsequent to the Appeals Court decision, DOR had estimated the fiscal effect of a final decision in favor of Menasha Corporation as a reduction in state sales tax revenues of approximately \$28 million annually. In addition, the Department estimated related refund requests associated with years prior to 2007-08 of up to \$221 million. Assuming that the final decision will be made closer to the end of 2007-08, and based on the Department's methodology, this estimate should be updated to approximately \$265 million associated with refunds for years prior to 2008-09.

Generally, the statutes authorize claims for refunds to be filed for up to four years from the unextended due date of the claimant's income tax return for the year to which the claim relates. However, longer periods may apply under certain conditions, such as audits or protective claims for refunds. The Department's estimate of the cost of refund requests associated with Menasha Corporation is based on the assumption that refund claims will be filed for 50% of potential claims for 1999 through 2002 and 80% of potential claims for 2003 through the time of final determination of the case. Actual refund requests could be higher or lower than the Department's estimate. Assuming that a final determination of the case would be made prior to the end of 2007-08 or early in 2008-09, the Department expects that most refunds would be paid in the current biennium.

Given the uncertainty of the final determination of the case, the sales tax estimates shown above for the 2007-09 biennium do not incorporate the potential effect of the decision. However, should the Appeals Court decision represent the final determination of the case, it is projected that general fund revenues would be reduced by up to approximately \$293 million prior to the end of the 2007-09 biennium (\$265 million for refunds for fiscal years through 2007-08 and \$28 million associated with computer software sales during 2008-09). While both the precise magnitude and timing of the fiscal effect are uncertain, the \$293 million total is based on DOR's expectations for the combined effect of refunds and annual costs through the end of the biennium.

## **General Fund Taxes**

The following section provides information on general fund tax revenues for the 2007-09 biennium, including a discussion of the national economic forecast for 2008 and 2009 and general fund tax revenue projections for fiscal years 2007-08 and 2008-09.

**National Economic Forecast.** This office first prepared revenue estimates for the 2007-09 biennium in January, 2007, based on the January, 2007, forecast of the U.S. economy by Global Insight, Inc. At that time, positive economic growth was expected to continue in 2007, 2008, and 2009, although at a slower pace than that of 2006. The primary risks to the forecast were that the economy's excess production capacity was less than estimated and that foreign investors would diversify from the dollar in response to the large U.S. trade deficit, which would lead to an acceleration in inflation and interest rates and a lower level of economic growth.

In June, 2007, this office revised its fiscal year 2006-07 revenue estimates upward by \$49 million (approximately 0.4%). The revision was based primarily on actual collections through May, 2007. However, because the more recent economic forecasts were somewhat weaker than the January, 2007, forecast, the estimates for 2007-08 and 2008-09 were not increased. Actual collections for 2006-07 exceeded the June estimates by an additional \$22 million. However, individual income tax collections in 2006-07 were artificially high by approximately \$75 million due to delays in paying refunds for tax year 2006 until 2007-08.

Despite considerable weakness in the housing market, high energy prices, and significant disruptions to credit markets, the economy continued to expand throughout 2007. After a sluggish first quarter of 0.6% real (inflation-adjusted) growth in gross domestic product (GDP), the second and third quarters showed real growth rates of 3.8% and 4.9%, respectively. However, it is believed that the economy slowed dramatically in the fourth quarter, with 0.6% real GDP growth. The slowdown in the fourth quarter reflects an accelerated decline in residential construction, slower consumption growth, and reduced growth in inventories following an unusually high accumulation in the third quarter. For the entire year, nominal (current-dollar) GDP growth is estimated at 4.9% and real growth is estimated at 2.2%. The nominal growth rate is 0.5% higher than projected last January, while the real growth rate is 0.1% lower. This discrepancy reflects a higher rate of inflation than was estimated last January, primarily due to increased prices for fuel.

The labor market was resilient in 2007. Personal income grew by an estimated 6.2% in 2007, compared to last January's estimate of 5.1%, which reflected higher than anticipated growth in both jobs and wages. The unemployment rate for 2007 is now estimated at 4.6%, compared to last January's estimate of 4.9%. The employment and income growth led to higher consumption expenditures, which increased by an estimated 5.5%, compared to last January's projection of 4.7%. As anticipated, growth in corporate profits slowed significantly from the double-digit increases seen during 2002 through 2006. Growth in pre-tax profits in 2007 is now estimated at 4.2%, which is twice the rate of growth forecast last January.

As described above, by most measures, the economy performed better in 2007 than was anticipated last January, due to strength in the second and third quarters. However, as noted, growth slowed significantly in the fourth quarter, and the current (February, 2008) forecast assumes that the economy has begun to contract. Global Insight believes that the U.S. economy has entered into a recessionary phase that will last through the first half of this year. Real GDP growth is estimated at -0.4% in the first quarter and -0.5% in the second quarter. Positive growth is expected to resume in the third quarter of 2008, in part due to the effects of interest rate cuts and the federal stimulus package. Third-quarter growth is estimated at 3.4% and fourth-quarter growth is estimated at 2.7%. Significantly slower growth (0.7%) is expected in the first quarter of 2009 as the boost to consumer spending from the federal tax rebates diminishes. Real GDP growth is estimated at approximately 3% over the remainder of 2009.

For all of 2008 and 2009, the current forecast expects reduced levels of production, employment, income, profits, and consumption expenditures compared to last year's forecast. Nominal GDP growth is now estimated at 3.6% in 2008 and 4.0% in 2009, compared to last

January's estimates of 5.2% and 5.5%, respectively. Real GDP growth is now estimated at 1.4% in 2008 and 2.2% in 2009, compared to the previous forecast of 3.2% and 3.4%. As in recent months, the main areas of concern going forward are the housing and credit markets and high energy prices. However, new information regarding consumption expenditures, profits, and employment indicates a broader downturn has begun.

After increasing rapidly for several years, housing starts peaked at 2.1 million units in 2005, and then declined by 12.6% (to 1.8 million units) in 2006 and an estimated 25.8% (to 1.3 million units) in 2007. The forecast expects another significant decline in 2008, followed by a strong rebound in 2009. Housing starts are estimated at 0.9 million units in 2008 (a decrease of 33.0% from 2007) and 1.2 million units in 2009 (an increase of 31.1%). Sales of new and existing homes are expected to exhibit a similar pattern, with decreases of 9.5% in 2006, 14.6% in 2007, and 19.5% in 2008, followed by an increase of 10.2% in 2009. The recent declines in housing activity reflect high inventory levels and prices, along with reduced availability of credit. In addition, compared to historical trends, much of the demand for housing in 2004 and 2005 was from investors who did not intend to use the home as a primary residence. These former purchasers have now become sellers of homes, which has contributed to the imbalanced housing market.

The forecast expects housing activity to bottom out in the first half of 2008 and then begin to rebound as the excess inventory is sold off, interest rates decrease, and affordability improves as housing prices decline. Nationwide, housing prices (as measured by the constant-quality price index) decreased by 0.2% in 2007 and are expected to decrease by 5.1% in 2008 and 1.7% in 2009. Beginning in 2010, modest price increases are expected to resume. Median and average prices of new and existing homes are also expected to continue declining at least through 2009. All of these measures of housing activity have been revised downward since last January. As discussed later, a key risk to the baseline forecast is that the housing market will deteriorate further.

Closely tied to the housing market are the credit markets, which experienced significant uncertainty and financial losses during 2007, primarily due to weakness in subprime mortgage loans. In recent years, relaxed lending standards by banks and other lenders have allowed more families to become homeowners and to purchase homes that previously had been beyond their means. These loans often were made with small or no down-payments, and low initial interest rates, which would later adjust upward to reflect market rates. As housing price appreciation slowed and interest rates reset, delinquencies and foreclosures began to rise dramatically, leading to large losses by lenders and by investors who had purchased mortgage-backed securities. Toward the end of 2007, there was also a significant increase in delinquencies on prime-rate mortgages, auto loans, and credit card debt. In response, lending standards have been tightened and there has been a "flight to quality" as investors increased their purchases of less risky assets such as U.S. Treasury securities.

Since last September, the Federal Reserve Board has cut the federal funds rate five times by a total of 225 basis points (from 5.25% to 3.0%). The most recent rate cuts occurred on January 22nd (75 basis points) and January 30th (50 basis points). The January 22nd reduction

followed an international stock sell-off based, in part, on fears of a U.S. recession. However, market rates on corporate bonds, mortgage loans, and other types of private-sector debt have not fallen by the same amounts due to increased risk-aversion by lenders. The forecast anticipates that the Federal Reserve will continue to cut rates in order to prevent or mitigate a recession. Specifically, it is expected that the federal funds rate will be reduced by an additional 100 basis points (to 2.0%) by the end of April, 2008, where it will remain through the rest of the year. It is expected that rates will be increased slightly beginning in the first quarter of 2009. Other interest rates are expected to fall by approximately 40 to 70 basis points over the next seven months and then begin rising slowly in the fourth quarter of 2008.

On February 7th, Congress approved a \$168 billion economic stimulus package, which included tax rebates for individuals and tax reductions for businesses. As of this writing, the President has not signed the bill, but it is expected that he will do so this week. The plan will provide rebate checks of up to \$600 for individuals and up to \$1,200 for married couples, with an additional payment of \$300 per child and a minimum payment of \$300 for individuals who pay less than that amount in federal income taxes. The rebates will be phased out for higher-income taxpayers (individuals with incomes of at least \$75,000 and married couples with incomes of at least \$150,000). It is anticipated that the Treasury Department will begin distributing the checks in early May after federal income tax returns have been processed. The plan will also allow businesses to depreciate equipment purchases more quickly and increase the amount of capital expenses that small businesses can immediately deduct for tax purposes. The legislation will also increase the loan limits for Fannie Mae, Freddie Mac, and the Federal Housing Administration.

The stimulus package is very similar to, but somewhat larger than, what was assumed by Global Insight in the February forecast (a total package of approximately \$150 billion). As noted, it is anticipated that the rebate checks will result in increased consumer spending in the second half of 2008 (6.5% growth in the third quarter and 3.9% growth in the fourth quarter compared to rates of 3.0% and 1.2% in the first and second quarters, respectively). Lower growth rates are expected in the first part of 2009 as the impact of the rebates fades. Global Insight believes that the business tax provisions will affect the timing of certain investments but not have a significant impact on overall economic growth.

After falling in the last quarter of 2006 and first quarter of 2007, oil prices again increased significantly during the remainder of 2007 and early 2008. Crude oil prices had receded to an average of \$58 per barrel during the first quarter of 2007, but then rose to approximately \$100 per barrel early this year (close to the inflation-adjusted record price of \$102.81 per barrel in April, 1980). Prices have since receded to between \$90 and \$95 per barrel. Global Insight believes that the recent high oil prices reflect temporary geopolitical events and speculation, rather than fundamental supply and demand, and that the slowing economy will result in reduced demand for oil and lower prices in the coming months. Oil prices are expected to decline to approximately \$73 per barrel by the fourth quarter of 2008, and then remain between \$70 and \$75 per barrel throughout the rest of that year and 2009.

As with crude oil, gasoline prices also rose significantly in 2007, from a national average price of \$2.43 per gallon in the first quarter to \$3.01 per gallon in the fourth quarter. Prices are expected to remain at approximately \$3.00 per gallon in the first half of this year and then begin falling in the third quarter. The U.S. average price is expected to be between \$2.60 and \$2.80 per gallon in the fourth quarter of 2008 and in 2009. However, even with the anticipated decreases later this year, oil and gasoline prices are expected to be significantly higher than in last January's forecast. Natural gas prices are expected to increase by approximately 11.1% during 2008 and 10.2% in 2009. A significant risk to the baseline forecast is that the recent high oil prices will be sustained because they are more reflective of ongoing supply difficulties than speculative buying.

The overall consumer price index (CPI) increased by 2.9% in 2007, primarily due to rising prices for oil and other energy commodities. The CPI for energy commodities rose by 8.2%. Lower levels of inflation are forecast for 2008 and 2009 as the economy slows and oil prices fall. The overall CPI is now estimated at 2.5% in 2008 and 1.6% in 2009. The 2007 figure exceeded last January's forecast by 1.1%; the estimates for 2008 and 2009 are very close to last year's projections. Food prices also rose faster than overall inflation in 2007, with an increase of 4.0%. Food price inflation is estimated at 4.1% in 2008 and 2.1% in 2009. Inflation would be significantly higher (2.9% in 2008 and 3.1% in 2009) if oil prices do not fall as assumed in the baseline forecast.

As noted, personal income growth is estimated at 6.2% in 2007, which is 1.1% above last January's forecast of 5.1%. The higher rate of growth reflects a higher level of both jobs and wages. Other major sources of personal income (farm income, dividends, interest, and transfer payments) also exceeded expectations in 2007. Non-farm proprietors' income was lower than forecast. Personal income growth is now projected to be 4.1% in 2008 and 4.4% in 2009. These growth rates are lower than last January's forecast by 1.4% and 1.8%, respectively. Reduced rates of growth are expected for most components of personal income as overall economic growth slows.

Employment growth is estimated at 1.1% in 2007, which is slightly higher than the 1.0% growth projected last January. However, the projections for 2008 and 2009 have been reduced since last January's forecast. The current forecast anticipates employment growth of 0.3% in 2008 and 0.7% in 2009, compared to the previous estimates of 1.3% and 1.6%. Relative to last January, lower employment growth is expected for nearly all sectors of the economy, with particular weakness in construction jobs. Consistent with the jobs numbers, the unemployment rate is now projected to be higher than estimated last January. The current forecast is for an unemployment rate of 5.3% in 2008 and 5.6% in 2009, compared with last January's projection of 4.9% and 4.6%, respectively.

The forecast for personal consumption expenditures shows a similar pattern, with higher than anticipated growth in 2007, but a less optimistic forecast for 2008 and 2009. Consumption expenditures increased by an estimated 5.5% in 2007, compared to last year's estimate of 4.7%. As in recent years, areas of strength were concentrated in items that are generally not subject to the state sales tax, such as food (6.1% growth), gasoline (6.1%), heating fuel (16.6%), and

services (6.0%). Purchases of items that are generally taxable grew more slowly. Sales of motor vehicles and parts increased by 1.6% and sales of other durable goods increased by 3.8%. Sales of nondurable goods, excluding food and fuel, increased by 4.1%.

Overall consumption growth is expected to slow to 4.1% in 2008 and 3.8% in 2009 due to lower personal income growth, tighter credit, and continued weakness in the housing market. The growth rate in 2008 would be even lower if the federal stimulus package had not been approved. As in 2007, higher rates of growth are forecast for food and services. However, due to falling prices, sales of gasoline are expected to show only a modest increase in 2008 and a small decrease in 2009. Sales of motor vehicles and parts are expected to be especially weak in 2008, with a decrease of 4.9%. However, a 4.9% increase is estimated for 2009 as employment and overall economic growth improve. Sales of other durable goods are forecast to rise by 0.5% in 2008 and fall by 0.4% in 2009, while sales of nondurable goods (excluding food and fuel) are expected to increase by 2.9% in 2008 and 3.7% in 2009.

Exports have been an area of strength for the U.S. economy in recent years and are expected to continue showing considerable growth in 2008 and 2009. Without the assumption of strong export growth, the baseline forecast would anticipate a longer and deeper recession. Exports increased by double-digit growth rates in each year from 2004 through 2007. An important factor in this growth has been the reduced value of the dollar relative to the currencies of the nation's major trading partners (more than 30% since early 2002), which makes U.S. products more affordable in foreign markets. In addition, the economies of Asian nations and other trading partners have experienced relatively robust growth. Export growth is estimated at 11.6% in 2008 and 8.6% in 2009, as the dollar continues to weaken throughout the first three quarters of this year before rising in the fourth quarter and stabilizing in 2009. Despite strong export growth, the U.S. trade deficit rose each year between 2002 and 2006. This occurred primarily due to increased imports of consumer goods and oil. As oil prices moderate and U.S. exports of other goods and services continue to show strong growth, it is expected that the trade deficit will decrease in 2008 and 2009.

After double-digit increases in 2005 and 2006, growth in business investment spending moderated to 6.1% in 2007, but was still an area of relative strength for the economy. Spending on nonresidential structures was particularly strong in 2007, with growth of 16.8%. However, investment in software and equipment was much weaker, with 1.7% growth. The forecast anticipates a significant slowdown in business investment as credit markets tighten and overall demand slows. Total business investment is expected to increase by 1.9% in 2008 and decrease by 0.2% in 2009. Investment in structures is expected to grow by 2.9% in 2008 and decrease by 9.5% in 2009, while investment in equipment and software is expected to increase by 1.4% and 4.3%, respectively.

The federal stimulus package will allow a first-year "bonus depreciation" deduction equal to 50% of the adjusted basis of qualified property placed into service during 2008 (the applicable time period is extended through 2009 for certain types of property). In addition, the stimulus package will increase the amount of investment that may be immediately expensed by small businesses (section 179 property) from \$128,000 to \$250,000, beginning in tax year 2008.

Under current law, the \$128,000 amount is reduced by the amount by which the cost of the qualifying property exceeds \$510,000. The new federal provisions will increase the \$510,000 threshold to \$800,000.

Global Insight does not expect the federal bonus depreciation and expensing provisions to have a significant impact on business investment. In effect, the bonus depreciation amounts to an interest-free loan from the government because the beneficial cash-flow impact is reversed in later years. The forecast assumes that business spending will be more influenced by weakening demand than by the federal tax changes, although it is believed that some investments will be moved forward from early 2009 to 2008 before the new provisions expire. As discussed below, the new provisions will result in a significant decrease in before-tax book profits in 2008 and an offsetting increase in 2009.

Following several very strong years, growth in corporate profits slowed to 4.2% in 2007. Pre-tax book profits are expected to fall by 14.8% in 2008 and increase by 20.9% in 2009. However, these growth rates are distorted by the expensing and depreciation provisions of the federal stimulus package. Economic profits, which are not affected by federal tax law changes, grew by 3.1% in 2007 and are estimated to increase by 0.2% in 2008 and 3.4% in 2009. The double-digit growth rates of recent years were driven in large part by productivity gains, which slowed considerably in 2007. The lower levels of profits also reflect continued weakness in housing-related businesses, large losses in the financial sector, high oil prices, and a general reduction in demand for goods and services as the economy slows.

Global Insight has also prepared two alternative forecasts, one more optimistic and one more pessimistic than the baseline forecast. In the optimistic scenario, productivity growth, business investment, and foreign economic growth are all stronger than under the baseline forecast, and energy prices are lower. These factors lead to lower inflation and to increased domestic production, investment, and housing starts. The federal budget deficit is also lower than under the baseline forecast due to stronger revenue growth and reduced expenditures for transfer payments. Under this alternative forecast, which is assigned a probability of 25%, there is no recession in 2008 and, compared to the baseline forecast, real GDP growth is higher by 0.8% in that year and in 2009.

The pessimistic alternative (also 25% probability) assumes a deeper contraction in the housing market and higher oil prices than under the baseline forecast. Housing starts and prices are significantly lower, which leads to reduced consumption expenditures. In turn, the lower consumer demand leads to reduced production and investment by businesses. Under this scenario, employment drops for five consecutive quarters and industrial production falls for seven quarters. Real GDP declines in the first two quarters of 2008, then rebounds slightly in the second half (less than 1% growth), before decreasing again in the first quarter of 2009. Real GDP growth is estimated at -0.1% in 2008 and 0.4% in 2009, compared to the baseline estimates of 1.4% and 2.2%, respectively. The pessimistic scenario in last January's forecast, which had a probability of 20%, called for a lower level of economic growth but no recession in 2007 through 2009.

Table 2 shows a summary of national economic indicators drawn from the February, 2008, forecast by Global Insight.

**TABLE 2**  
**Summary of National Economic Indicators**  
**Global Insight, Inc., February, 2008**  
**(\$ in Billions)**

|                                | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> |
|--------------------------------|-------------|-------------|-------------|-------------|
| Nominal Gross Domestic Product | \$13,194.7  | \$13,843.0  | \$14,335.2  | \$14,902.5  |
| Percent Change                 | 6.1%        | 4.9%        | 3.6%        | 4.0%        |
| Real Gross Domestic Product    | 11,319.4    | 11,567.3    | 11,724.3    | 11,978.4    |
| Percent Change                 | 2.9%        | 2.2%        | 1.4%        | 2.2%        |
| Consumer Price Index           | 3.2%        | 2.9%        | 2.5%        | 1.6%        |
| Personal Income                | 10,983.4    | 11,667.3    | 12,144.7    | 12,676.3    |
| Percent Change                 | 6.6%        | 6.2%        | 4.1%        | 4.4%        |
| Personal Consumption           | 9,224.5     | 9,732.0     | 10,128.0    | 10,511.3    |
| Percent Change                 | 5.9%        | 5.5%        | 4.1%        | 3.8%        |
| Economic Profits               | 1,553.7     | 1,601.9     | 1,604.8     | 1,659.7     |
| Percent Change                 | 13.2%       | 3.1%        | 0.2%        | 3.4%        |
| Unemployment Rate              | 4.6%        | 4.6%        | 5.3%        | 5.6%        |

**General Fund Tax Projections.** Table 3 shows our revised general fund tax revenue estimates for the 2007-09 biennium. The estimates are based on the February, 2008, forecast of the U.S. economy by Global Insight, and incorporate all of the tax law changes included in Act 20.

**TABLE 3****Projected General Fund Tax Collections  
(\$ Millions)**

| <u>Source</u>                | <u>2006-07<br/>Actual</u> | <u>Budget Estimates<br/>(Act 20)</u> |                | <u>Revised Estimates<br/>February 2008</u> |                |
|------------------------------|---------------------------|--------------------------------------|----------------|--|----------------|
|                              |                           | <u>2007-08</u>                       | <u>2008-09</u> | <u>2007-08</u>                             | <u>2008-09</u> |
| Individual Income            | \$6,573.8                 | \$6,758.8                            | \$7,105.5      | \$6,660.0                                  | \$6,965.0      |
| General Sales and Use        | 4,158.6                   | 4,310.0                              | 4,479.4        | 4,210.0                                    | 4,295.0        |
| Corporate Income & Franchise | 890.1                     | 887.8                                | 860.3          | 810.0                                      | 815.0          |
| Public Utility               | 284.9                     | 297.2                                | 314.4          | 295.6                                      | 316.2          |
| Excise                       |                           |                                      |                |  |                |
| Cigarette                    | 296.1                     | 456.5                                | 531.0          | 448.9                                      | 523.7          |
| Liquor and Wine              | 42.7                      | 42.5                                 | 43.0           | 42.5                                       | 43.0           |
| Tobacco Products             | 17.5                      | 28.9                                 | 41.2           | 28.9                                       | 41.2           |
| Beer                         | 9.5                       | 9.4                                  | 9.4            | 9.4  | 9.4            |
| Insurance Company            | 141.4                     | 141.0                                | 144.0          | 150.0                                      | 160.0          |
| Estate                       | 121.1                     | 95.0                                 | 25.0           | 140.0                                      | 30.0           |
| Miscellaneous Taxes          | <u>82.2</u>               | <u>73.0</u>                          | <u>73.0</u>    | <u>73.0</u>                                | <u>73.0</u>    |
| Total                        | \$12,617.9                | \$13,100.1                           | \$13,626.2     | \$12,868.3                                 | \$13,271.5     |
| Change from Prior Year       |                           |                                      |                |  |                |
| Amount                       |                           | \$482.2                              | \$526.1        | \$250.4                                    | \$403.2        |
| Percent Change               |                           | 3.8%                                 | 4.0%           | 2.0%                                       | 3.1%           |

As shown in Table 3, general fund tax revenues are estimated to total \$12,868.3 million in 2007-08 and \$13,271.5 million in 2008-09. These amounts are lower than the Act 20 estimates by \$231.8 million in the first year and \$354.7 million in the second year, for a total decrease of \$586.5 million. The estimates for the three major taxes (individual income, general sales and use, and corporate income and franchise) have all been revised downward significantly. The cigarette tax estimates have also been decreased, while the estimates for the estate tax and insurance company taxes have been increased.

**Individual Income Tax.** State individual income tax revenues were \$6,573.8 million in 2006-07 and are currently estimated at \$6,660.0 million in 2007-08 and \$6,965.0 million in 2008-09. The current estimates are lower than the Act 20 estimates by \$98.8 million in the first year and \$140.5 million in the second year. The current estimates reflect growth of 1.3% for 2007-08 and 4.6% for 2008-09. It should be noted that the growth rate for 2007-08 is affected by a delay that occurred in the payment of approximately \$75 million in individual income tax refunds for the 2006 tax year from 2006-07 to 2007-08. As a result of the delay, collections for 2006-07 were artificially high and collections in 2007-08 will be, correspondingly, artificially low. In addition, the growth rates for both years are affected by a number of law changes, primarily the implementation of the 100% income tax exclusion for social security benefits

starting in 2008. In the absence of the refund delay and the effects of the law changes, growth in individual income tax revenues would be estimated at 4.6% for 2007-08 and 4.5% for 2008-09.

Based on preliminary collections information through January, 2008, individual income tax revenues for the current fiscal year are 3.1% higher than such revenues through the same period in 2006-07. However, if the additional \$75 million in refunds for tax year 2006 had not been paid in 2007-08, then collections for this fiscal year through January would be 5.1% higher than the previous year. Based on the delay in refunds and law changes referred to above, as well as the forecast reduction in personal income growth in 2008, growth in collections is expected to slow during the remaining months of the fiscal year, resulting in the projections described above for actual growth in 2007-08 of 1.3% and adjusted growth of 4.6%.

**General Sales and Use Tax.** In 2006-07, state sales and use tax collections were \$4,158.6 million, which was a 0.8% increase over the prior year. State sales and use tax revenues are currently estimated at \$4,210.0 million in 2007-08 and \$4,295.0 million in 2008-09, which represent growth of 1.2% in the first year and 2.0% in the second year. These estimates are \$100.0 million lower in the first year and \$184.4 million lower in the second year than the Act 20 estimates of \$4,310.0 million in 2007-08 and \$4,479.4 million in 2008-09. The reductions in the estimates are based, in part, on 1.5% growth in sales and use tax collections year-to-date through January, 2008, and in part on the most recent forecast of growth in taxable personal consumption expenditures. As previously noted, the estimates do not include the impact of the Court of Appeals decision in the Menasha Corporation case.

**Corporate Income and Franchise Tax.** Corporate income and franchise taxes were \$890.1 million in 2006-07. Collections are projected to be \$810.0 million in 2007-08 and \$815.0 million in 2008-09. These amounts represent an annual decrease of 9.0% in 2007-08, and a slight increase of 0.6% in 2008-09. The new estimates are lower than the Act 20 estimates by \$77.8 million in the first year and \$45.3 million in the second year.

The new estimates reflect decreased year-to-date corporate income and franchise tax collections, which were 9.3% lower through January, 2008. The lower collections mirror the slowdown in the U. S. economy. Decreasing consumption expenditures, business investment, and industrial production are depressing corporate earnings, as the effect of the housing recession and credit restrictions spread through the economy. However, exports are projected to be a significant contributor to corporate sales and profits over the forecast period. Economic profits are forecast to increase by 0.2% in 2008, before rebounding somewhat to increase by 3.4% in 2009.

The corporate income and franchise tax estimates have been adjusted to reflect the effect of certain law changes, including the phase-in of single-sales factor apportionment, repeal of the manufacturers' sales tax credit, enactment of new tax credits, such as the dairy investment, dairy manufacturing facility, Internet equipment, Health Insurance Risk-Sharing Plan assessments, and ethanol and biodiesel fuel pump tax credits, and for the collection of back taxes from banks.

**Public Utility Taxes.** Public utility tax revenues were \$284.9 million in 2006-07, and are currently projected at \$295.6 million in 2007-08 and \$316.2 million in 2008-09. Relative to the Act 20 estimates, these figures are lower than the 2007-08 estimate by \$1.6 million but higher than the 2008-09 estimate by \$1.8 million. Utility tax collections are currently expected to increase by 3.8% in 2007-08 and by 7.0% in 2008-09, rather than by 4.3% in 2007-08 and 5.8% in 2008-09, as had been estimated under Act 20.

**Excise Tax Revenues.** General fund excise taxes are imposed on cigarettes, other tobacco products, liquor (including wine and hard cider), and beer. Total excise tax revenues were \$365.8 million in 2006-07. Under Act 20, total excise tax revenues were reestimated at \$537.3 million in 2007-08 and \$624.6 million in 2008-09, to reflect the Act 20 increases in the tax rates on cigarettes and other tobacco products as well as additional modifications to taxes on other tobacco products, which took effect January 1, 2008.

Data is not yet available to reflect the actual impact of the cigarette and other tobacco products tax law changes under Act 20. However, while the January, 2007, estimates of cigarette tax revenues under prior law had assumed a slight increase in revenues, collections through December, 2007, had decreased by 1.25% compared to the prior year. Based on the reduced collections through December, 2007, and the current forecast for slower growth in personal income and personal consumption expenditures, it is now anticipated that cigarette tax revenues will be lower than the Act 20 estimates by \$7.6 million in 2007-08 and \$7.3 million 2008-09.

No changes are projected from the Act 20 estimates for the remaining excise taxes. Therefore, excise tax revenues are currently estimated at \$529.7 million in 2007-08 and \$617.3 million in 2008-09.

**Insurance Premiums Taxes.** Insurance premium taxes were \$141.4 million in 2006-07. Premiums tax collections are projected to be \$150.0 million in 2007-08 and \$160.0 million in 2008-09. The projected increase in 2007-08 is primarily based on year-to-date monthly premiums tax collections, which are 4.6 % higher through January, 2008, and expected increased premiums in response to lower investment income. The estimated increase in 2008-09 reflects expected continued growth in insurance premiums. The new estimates exceed the Act 20 estimates by \$9.0 million in 2007-08 and \$16.0 million in 2008-09.

**Estate Tax.** In 2006-07, state estate tax revenues were \$121.1 million. Under Act 20, estate taxes were estimated at \$95.0 million in 2007-08 and \$25.0 million in 2008-09. However, based on collections to date in 2007-08, estate taxes are reestimated at \$140.0 million in 2007-08 and \$30.0 million in 2008-09. The revised estimates are \$45.0 million higher in 2007-08 and \$5.0 million higher in 2008-09 than the Act 20 estimates.

The significant reduction in the estimates for 2008-09 under both Act 20 and the current revision is the result of statutory provisions that effectively eliminated the state estate tax for deaths on or after January 1, 2008. Such provisions specify that, for deaths on or after January 1, 2008, the state estate tax is based on a federal credit for state death taxes paid under federal estate tax law. However, current federal law does not provide such a credit, which is the reason

that the state estate tax is eliminated. It should be noted, however, that the relevant federal provisions are scheduled to sunset on December 31, 2010. As a result, in the absence of a federal law change, Wisconsin's estate tax will again apply with respect to estates of decedents dying after December 31, 2010.

Estate taxes are typically paid nine months after the date of death. Therefore, it is expected that the state will receive estate tax revenues through September, 2008, for deaths occurring in the last nine months of 2007.

**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 \$82.2 million in 2006-07, and are estimated at \$73.0 million in both 2007-08 and in 2008-09. These estimates are unchanged from the Act 20 estimates.

Approximately 85% of miscellaneous tax revenues are from the real estate transfer fee (RETF). State RETF collections, which have fluctuated along with the strength of the housing market in recent years, reached a peak of \$80.6 million in 2005-06 before declining to \$71.7 million in 2006-07. RETF revenues are estimated to further decline to \$62.5 million in 2007-08 before stabilizing at that level in 2008-09.

## **Transportation Fund**

In addition to the discussion of the condition of the state's general fund, the following information is provided on the condition of the transportation fund.

Typically, the Department of Transportation, in cooperation with this office, prepares revised estimates of the transportation fund condition each spring. This year, the Department expects to produce this estimate in early April, utilizing February economic forecasts from Global Insight, Inc., as well as other, state-specific forecasts developed by the Department of Revenue. Of particular interest for this estimate will be the impact on transportation fund revenue collections of the economic downturn that has affected general fund revenue collections. Although it is still too early to fully evaluate the precise magnitude of the impact, based on preliminary indications, including actual collections through the first six months of the biennium, it appears that the transportation fund could have a biennium-ending deficit of as much as \$25 million to \$40 million.

The primary area of concern for transportation fund collections is vehicle registration and titling. The Act 20 revenue estimates were based on projections made in the spring of 2007, covering the three-year period from 2006-07 through 2008-09. Actual collections of vehicle registration revenue for 2006-07, however, were lower than the projections by \$16.0 million. Although these reductions were offset in that year by higher collections in other areas, including motor fuel taxes, the relative weakness of vehicle registration revenue, particularly from heavy trucks, appears to have continued into the 2007-09 biennium.

Motor fuel tax collections, which are the other major component of transportation fund revenues, appear, through the first six months of the biennium, to be close to budget projections.

The Joint Committee on Finance may have two opportunities in the coming months to address any projected transportation fund deficit. First, under current law, the Department of Transportation is required to submit a plan to the Co-Chairs to allocate additional federal highway aid among its appropriations if the amount of aid received in a given federal fiscal year is greater than the amounts estimated in the state budget by 5% or more. Last week, the Federal Highway Administration notified the Department that the state will receive \$718.3 million in federal fiscal year 2008, an amount that exceeds budget estimates by \$76.2 million, or 11.9%. In addition, the state received an additional \$23.4 million in federal fiscal year 2007 funds for expenditure in state fiscal year 2007-08, for a total of \$99.6 million in additional funds. Under the statutory provision that requires the Department to submit a plan allocating these additional funds, the plan may adjust any DOT appropriation. Consequently, the plan could be used to reduce certain SEG appropriations to eliminate a projected deficit. In considering the Department's plan, the Committee may approve or modify and approve the adjustments, including any adjustments to the Department's SEG appropriations.

In addition to being required to submit a plan to make adjustments to allocate additional federal aid, a provision of Act 20 requires the Department to develop a plan to eliminate a projected deficit by reducing SEG appropriations whenever the deficit is projected to exceed \$30 million. If the Department's spring estimate indicates that the deficit triggers this requirement, the Department will be required to submit a plan to the Committee. As with the federal funds allocation plan, the Committee may approve or modify and approve the plan.

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

Sincerely,

A handwritten signature in black ink that reads "Bob". The letters are stylized and cursive.

Robert Wm. Lang  
Director

RWL/sas

cc: Members, Wisconsin Legislature