GENERAL FUND REVENUE UPDATE FISCAL 2010

A Report Prepared for the

Revenue and Transportation Interim Committee
Legislative Finance Committee

By

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INTRODUCTION

The purpose of this report is to provide the committees with general fund revenue collection data through September FY 2009 compared to September FY 2010. This and future updates are intended to provide the most recent information on general fund revenue collections as we proceed through the 2011 biennium. These reports, most of the time, will only highlight the significant revenue sources with a brief explanation of what trends may be developing.

As a reminder, during the regular legislative session, our office recommended to the 61st Legislature that the general fund revenue estimates be decreased by $292.6 million for fiscal 2009, 2010, and 2011. The House Taxation Committee adopted these recommendations and included the assumptions in HJ 2, the revenue estimating resolution. The reduced revenue was anticipated from major sources such as individual and corporation income taxes and oil and gas production taxes. The revenue estimates used by the legislature for the 2011 biennium have been incorporated into this report.

GENERAL FUND REVENUE UPDATE

FISCAL 2010 REVENUE COLLECTIONS

Based on information recorded on the Statewide Accounting, Budgeting, and Human Resource System (SABHRS), total general fund receipts through September for FY 2010 were $300.3 million as shown in Figure 1. This compares to $376.2 million collected through September for FY 2009. This is a decline in collections from FY 2009 of $75.8 million or a 20.2 percent decrease. To be on target with the estimates used by the 61st Legislature, collections should have been down by only 1.9 percent or $7.3 million after the first three months of the fiscal year.

Total general fund collections as estimated by the legislature were expected to be $35.1 million (1.9 percent) below the FY 2009 actual collections. These estimates were used by the 61st Legislature and contained in the adjusted HJ 2 (revenue estimate resolution plus impacts of enacted legislation). Most of this reduction was expected from corporate income tax, oil and gas production tax, and TCA (treasury cash account) investment earnings. Corporation income tax collections were expected to decline because of the impacts of the economic recession on corporate profits. Oil and gas production collections were expected to decline because of significantly reduced commodity prices and reduced production levels. TCA investments earnings were expected to decline because of the historical low level for short-term interest rates. Individual income tax, the largest general fund revenue source, was expected to increase as the effects of the economic recession were expected to subside by the end of FY 2010.

Figure 1 shows revenue collection and estimate data by major revenue category. The last three columns in the figure compare collections from the revenue source to the estimate contained in HJ 2. For example, corporation income tax (10th line) shows a negative $28.0 million in the "Difference" column. This means collections through September of this year are $28.0 million less than the amount received through September of FY 2009 for a negative 61.4 percent difference shown in the "% Change" column. The legislature assumed collections would be down by 30.5 percent shown in the last column. This means collections are lagging the legislative estimate and will need to accelerate in subsequent months to be on track with the HJ 2 estimate.

Figure 1

General Fund Revenue Monitoring Report							
Revenue Source	Actual Fiscal 2009	HJ2 Estimate Fiscal 2010	Through 9/30/08	Through 9/30/09	Difference	% Change	HJ2 Estimate % Change
GF0100 Drivers License Fee	3,478,285	3,920,000	811,621.57	902,034.86	90,413.29	**11.14%**	12.70%
GF0200 Insurance Tax	50,038,468	58,762,000	(55,557.21)	11,960,282.69	12,015,839.90	**-21627.87%**	17.43%
GF0300 Investment Licenses	6,461,446	6,210,000	91,944.06	501,451.71	409,507.65	445.39%	-3.89%
GF0400 Vehicle License Fee	89,334,878	92,247,000	16,547,467.81	4,515,863.93	(12,031,603.88)	**-72.71%**	3.26%
GF0500 Vehicle Registration Fee	15,344,744	17,970,000	3,555,931.32	766,956.82	(2,788,974.50)	**-78.43%**	17.11%
GF0600 Nursing Facilities Fee	5,468,766	5,213,000	1,242,497.66	1,213,764.31	(28,733.35)	-2.31%	-4.68%
GF0700 Beer Tax	3,114,729	3,218,000	970,222.34	944,971.49	(25,250.85)	**-2.60%**	3.32%
GF0800 Cigarette Tax	34,320,412	32,007,000	10,157,390.28	8,178,989.33	(1,978,400.95)	**-19.48%**	-6.74%
GF0900 Coal Severance Tax	13,028,228	10,846,000	2,801,674.77	2,731,709.02	(69,965.75)	-2.50%	-16.75%
GF1000 Corporation Tax	166,354,514	115,638,000	45,647,183.47	17,634,595.03	(28,012,588.44)	**-61.37%**	-30.49%
GF1100 Electrical Energy Tax	4,824,659	4,717,000	1,100,960.12	932,276.66	(168,683.46)	**-15.32%**	-2.23%
GF1150 Wholesale Energy Trans Tax	3,864,771	3,931,000	888,006.18	782,222.28	(105,783.90)	**-11.91%**	1.71%
GF1200 Railroad Car Tax	2,099,454	2,295,000	101.52	74.41	(27.11)	**-26.70%**	9.31%
GF1300 Individual Income Tax	815,138,193	840,263,000	216,764,628.79	185,450,871.97	(31,313,756.82)	**-14.45%**	3.08%
GF1400 Inheritance Tax	217,097	29,000	22,301.01	29,120.70	6,819.69	30.58%	-86.64%
GF1500 Metal Mines Tax	5,992,923	3,248,000	6,246,930.55	2,721,420.13	(3,525,510.42)	**-56.44%**	-45.80%
GF1700 Oil Severance Tax	100,490,971	66,930,000	-	-	-		-33.40%
GF1800 Public Contractor's Tax	5,929,999	4,322,000	1,552,260.57	1,626,791.39	74,530.82	4.80%	-27.12%
GF1850 Rental Car Sales Tax	2,904,340	3,182,000	707,316.87	607,144.53	(100,172.34)	**-14.16%**	9.56%
GFxxxx Property Tax	217,042,057	228,853,000	14,600,790.69	14,138,850.82	(461,939.87)	**-3.16%**	5.44%
GF2150 Lodging Facilities Sales Tax	12,477,461	13,376,000	3,269,353.96	3,052,374.26	(216,979.70)	**-6.64%**	7.20%
GF2200 Telephone Tax	-	-	-	-	-		
GF2250 Retail Telecom Excise Tax	22,250,383	21,672,000	5,536,014.55	5,367,581.27	(168,433.28)	**-3.04%**	-2.60%
GF2300 Tobacco Tax	4,990,497	4,738,000	1,394,024.54	1,517,742.37	123,717.83	8.87%	-5.06%
GF2400 Video Gaming Tax	62,458,106	69,003,000	16,046,971.09	15,418,135.71	(628,835.38)	**-3.92%**	10.48%
GF2500 Wine Tax	1,936,052	2,043,000	515,315.65	530,712.24	15,396.59	**2.99%**	5.52%
GF2600 Institution Reimbursements	14,100,804	16,047,000	-	-	-		13.80%
GF2650 Highway Patrol Fines	4,179,882	4,055,000	940,137.56	966,172.69	26,035.13	2.77%	-2.99%
GF2700 TCA Interest Earnings	15,506,889	7,967,000	3,618,690.11	527,014.75	(3,091,675.36)	**-85.44%**	-48.62%
GF2900 Liquor Excise Tax	12,650,902	16,581,000	2,832,361.40	-	(2,832,361.40)	**-100.00%**	31.07%
GF3000 Liquor Profits	7,250,000	7,039,000	-	-	-		-2.91%
GF3100 Coal Trust Interest Earnings	26,958,378	28,574,000	2,535,790.68	2,452,524.20	(83,266.48)	**-3.28%**	5.99%
GF3300 Lottery Profits	10,136,213	10,969,000	-	-	-		8.22%
GF3450 Tobacco Settlement	4,127,609	4,007,000	-	-	-		-2.92%
GF3500 U.S. Mineral Leasing	31,573,364	27,796,000	9,693,028.53	11,006,977.34	1,313,948.81	13.56%	-11.96%
GF3600 All Other Revenue	31,922,159	35,247,000	6,145,808.28	3,870,784.12	(2,275,024.16)	**-37.02%**	10.42%
Grand Total	1,807,967,633	1,772,915,000	376,181,168.72	300,349,411.03	(75,831,757.69)	**-20.16%**	-1.94%

* plus impacts of enacted legislation

DISCUSSION OF SELECTED SOURCES FOR FISCAL 2010

The following section of the report addresses some of the key general fund revenue sources that were monitored closely during the regular session. These sources are individual income tax, corporation income tax, treasury cash account (TCA) interest earnings, and oil and gas production tax. These sources were chosen because of their vulnerability to the economic recession and the discussion these sources received during the past legislative session. A discussion on video gaming tax revenue was dropped from this report since no new information was available since the September report. This section of the report also includes a discussion on sources that are showing very unusual collection patterns. These sources are insurance taxes, vehicle fees/taxes, cigarette taxes, and liquor excise taxes. As discussed in the September report, US mineral leasing revenues were lagging the HJ 2 estimate because of a revenue deposit timing issue. This issue has been resolved and these revenues are currently exceeding expectations.

Individual Income Tax

Based on September accounting data, net individual income tax collections for FY 2010 (gross collections less refunds) were 14.5 percent below net collections for FY 2009 or a decrease of $31.3 million. The 61st Legislature assumed that revenues would increase by 3.1 percent from the FY 2009 amount or an increase of $25.1 million. This increase was anticipated because the effects of the economic recession were expected to subside by the end of FY 2010.

Figure 2 shows the September accounting details of individual income tax collections of FY 2010 compared to the same period for FY 2009. Since withholding tax collections are a proxy of total wage growth, the negative 3.5 percent growth from last year indicates total wages have declined from the level observed a year ago. Withholding payments for mineral royalties have declined by $4.8 million or 67.7 percent. This decline was anticipated because of the significant reduction in Montana's wellhead oil price.

Figure 2

Individual Income Tax Comparison				
Revenue Code & Description	Through 9/30/2008 Fiscal 2009	Through 9/30/2009 Fiscal 2010	Difference	Percent Change
510101 Withholding Tax	159,749,745.88	154,089,314.74	(5,660,431.14)	-3.54%
510482 Mineral Royalty WH Tax	7,045,138.64	2,274,039.92	(4,771,098.72)	-67.72%
510102 Estimated Tax	55,919,922.16	39,400,963.76	(16,518,958.40)	-29.54%
510103 Current Year I/T	3,715,100.79	(962,164.56)	(4,677,265.35)	-125.90%
510105 Income Tax - Audit Collections	7,841,771.00	12,187,561.00	4,345,790.00	55.42%
510106 Income Tax Refunds	(17,507,049.68)	(21,538,842.89)	(4,031,793.21)	23.03%
Totals	$216,764,628.79	$185,450,871.97	($31,313,756.82)	-14.45%
Percent of Actual/Estimated	25.01%	22.07%		

Estimated payments, due September 15th, were $16.5 million (29.5 percent) below last year. During the last two quarters of FY 2009, estimated payments declined by 14.5 and 33.6 percent, respectively. Review of the first quarter FY 2010 payments shows a continuation of this trend. With a substantial drop in the equity markets during late 2008 and early 2009, historical low interest rates, and reductions in corporate profitability, it is not surprising to observe a significant reduction in estimated payments. Estimated payments and current year payments are a good indicator of taxpayers' non-wage components of income are changing relative to economic conditions.

Since October 15th is the due date for tax returns that were extended beyond the April 15th due date, refunds issued between now and the end of October will be monitored closely. If refunds during this period are unusually high, this will indicate taxpayers overpaid during FY 2009 thereby inflating actual receipts for FY 2009. Conversely, if refunds are unusually low, taxpayers underpaid during FY 2009 which would mean FY 2009 receipts were understated. As of the end of September, refunds were $4.0 million or 23.0 percent above the same period for FY 2009. This trend would indicate that taxpayers may have overpaid their taxes during FY 2009 thereby overstating FY 2009 total collections. This is an unfavorable trend for FY 2010 that will require close monitoring in subsequent months especially in October.

When all of the accounting categories are added together, total individual income tax collections through September are $31.3 million below FY 2009 amounts. Since total FY 2010 collections were estimated to be $25.1 million above FY 2009 amounts, the HJ 2 individual income tax estimate for FY 2010 appears to be too optimistic. Since there is only three months of accounting information available, it is difficult to project how much the estimate could vary from the HJ 2 estimate. Using several extrapolation techniques indicates individual income tax revenues could be below the HJ 2 estimate anywhere from $37 million to $80 million for FY 2010. The low end of the range assumes an economic rebound beginning early calendar 2010 while the high end of the range assumes an economic rebound beginning mid-year 2010. Further data on withholding and estimated payments should help narrow this range.

Corporation Income Tax

Based on September accounting data, net corporation income tax collections for FY 2010 (gross collections less refunds) were 61.4 percent below net collections for FY 2009 or a decrease of $28.0 million. The 61st Legislature assumed that revenues would decrease by 30.5 percent from the FY 2009 amount or a decrease of $50.7 million. This decrease was anticipated because of the effects the economic recession on corporate profitability for both state and national corporations.

As pointed out in the September report, part of the strength in FY 2009 collections was explained by the auditing efforts of the DOR and the resulting unusual high audit collections. Total audit collections were $31.0 million in FY 2009 compared to $16.9 million in FY 2008. When audit collections are removed from FY 2008 and 2009 totals, then the trend for the remaining collections are a negative 5.7 percent, a decline rate greater than estimated in HJ 2 for FY 2009.

Estimated payments, due September 15th, were $19.9 million (53.5 percent) below last year. Further review of tax payment detail by corporation provides some additional insight to estimated payments. Similar to individual income tax, estimated payments for the last two quarters of FY 2009 declined by 34.9 and 41.3 percent, respectively. Review of the first quarter FY 2010 payments shows a continuation of this trend. With announced job layoffs, business closures and/or cutbacks, significant consumer spending reductions, and construction plummeting, it is not surprising to observe a significant reduction in estimated payments.

Figure 3

Corporation Income Tax Comparison

Revenue Code & Description	Through 9/30/2008 Fiscal 2009	Through 09/30/09 Fiscal 2010	Difference	Percent Change
510501 Corporation Tax	5,874,142.23	3,460,269.14	(2,413,873.09)	-41.09%
510505 Corporation Tax Estimated Paym	37,234,144.02	17,306,257.85	(19,927,886.17)	-53.52%
510502 Corporation Tax Refunds	(2,592,417.78)	(4,100,230.96)	(1,507,813.18)	58.16%
510503 Corporation Tax-Audit Collect.	5,131,315.00	968,299.00	(4,163,016.00)	-81.13%
Totals	$45,647,183.47	$17,634,595.03	($28,012,588.44)	-61.37%
Percent of Actual/Estimated	28.47%	15.25%		

When all of the accounting categories are added together, total corporation income tax collections through September are $28.0 million below FY 2009 amounts (61.4 percent). Since total FY 2010 collections were estimated to be $50.7 million (30.5 percent) below FY 2009 amounts, the HJ 2 corporation income tax estimate for FY 2010 appears to be too optimistic. Since there is only three months of accounting information available, it is difficult to project how much the collections could vary from the HJ 2 estimate. Using several extrapolation techniques indicates corporation income tax revenues could be below the HJ 2 estimate anywhere from $11 million to $41 million for FY 2010. Further data on estimated payments should help narrow this range. The low end of the range assumes an economic rebound beginning early calendar 2010 while the high end of the range assumes an economic rebound beginning mid-year calendar 2010.

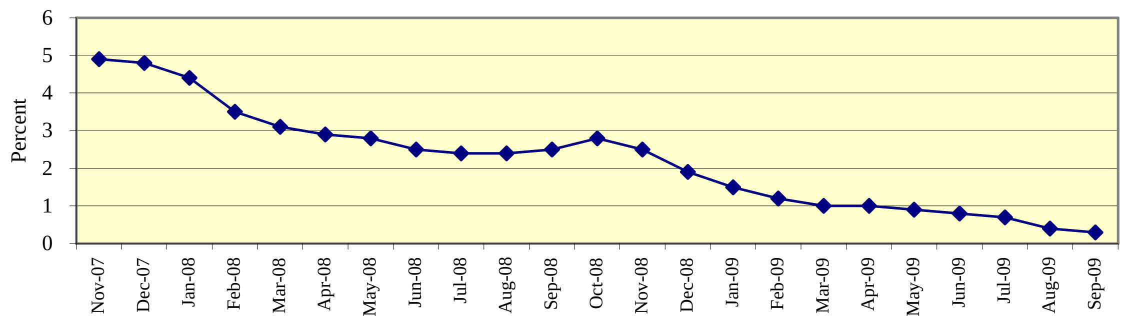
Treasury Cash Account (TCA) Interest Earnings

Based on September accounting data, TCA interest earnings for FY 2010 were 85.4 percent below collections for FY 2009 or a decrease of $3.1 million. The 61st Legislature assumed that revenues would decrease by 48.6 percent from the FY 2009 amount or a decrease of $7.5 million. This decrease was anticipated because of the reduced rate of return anticipated for short-term securities.

For FY 2009, collections from this source were below estimate by $1.0 million or 6.1 percent. This trend appears to be much worse in FY 2010 as collections are down 85.4 percent when Septembers' collections of FY 2009 are compared to the same period of FY 2010. Since TCA interest earnings are based on cash available for investment and the rate of return for short-term securities, reduced earnings are primarily due to reduced short-term interest rates. Figure 4 shows the average monthly rate of return received on the short-term investment pool (STIP) as published by the Board of Investments since November 2007. Short-term rates have plummeted from 4.9 percent in November 2007 to 0.3 percent in September 2009.

Figure 4

Short-Term Investment Pool Rates



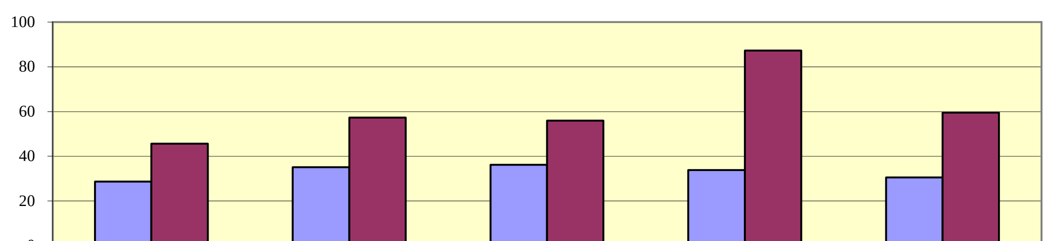
Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08	Sep-08	Oct-08	Nov-08	Dec-08	Jan-09	Feb-09	Mar-09	Apr-09	May-09	Jun-09	Jul-09	Aug-09	Sep-09
4.9	4.8	4.4	3.5	3.1	2.9	2.8	2.5	2.4	2.4	2.5	2.8	2.5	1.9	1.5	1.2	1.0	1.0	0.9	0.8	0.7	0.4	0.3

Oil and Gas Production Tax

Oil and natural gas production taxes are one of the major sources of revenue that could exceeded the HJ 2 estimate. As shown in Figure 1 (page 2), oil and gas production tax collections through September are zero for FY 2009 and 2010. This is a normal condition because tax returns are not due until 60 days after the end of the quarter and the Department of Revenue (DOR) has 60 days after receipt of the return to do the necessary processing for determining state and local revenue distribution. The most recent tax return data as filed with the DOR, however, does provide information on production and wellhead prices for FY 2009. As shown in Figure 4a, oil production in Montana was 30.6 million barrels at an average price of $59.55 per barrel for FY 2009. The estimates contained in HJ 2 were for production to be 30.1 million barrels at an average price of $54.36 per barrel. Using the production estimate contained in HJ 2 for FY 2010 (27.5 million barrels) and a price assumption of $60 per barrel (approximate current price), general fund oil production tax revenue in FY 2010 would exceed the HJ 2 estimate by approximately $30 million. General fund natural gas production tax, on the other hand, could be below the HJ 2 estimate by as much as $16 million. Natural gas production and prices are currently well below the HJ 2 assumptions for FY 2010. When combined, oil and natural gas production revenue could be $14 million above the HJ 2 estimate for FY 2010.

Figure 4a

Montana Oil Production & Price By Fiscal Year
Barrels in Millions : Price in $'s per Barrel



	2005	2006	2007	2008	2009
Barrels	28.643	35.095	36.201	33.803	30.555
Price	$45.56	$57.33	$55.84	$87.30	$59.55

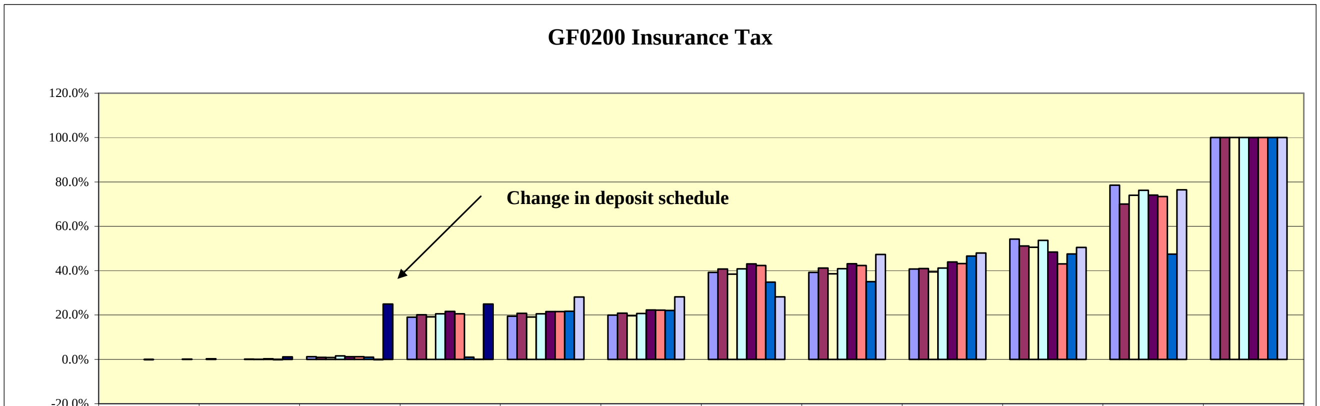
Unusual Collection Patterns

As shown in Figure 1, several sources of revenue are showing unusual collection patterns. Some of the larger sources are insurance taxes, vehicle fees/taxes, cigarette taxes, and liquor excise taxes.

Insurance Taxes

The insurance tax collection variation is due to the timing of deposits this year versus previous years. Historically, the first estimated payment for insurance taxes is deposited either in October or November. This fiscal year, the first estimated payment was deposited in September as shown in Figure 5.

Figure 5



	01 Jul.	02 Aug.	03 Sep.	04 Oct.	05 Nov.	06 Dec.	07 Jan.	08 Feb.	09 Mar.	10 Apr.	11 May	12 Jun.
Fiscal 2002	-0.0171%	0.2706%	1.2194%	18.9929%	19.3900%	19.9756%	39.1932%	39.2252%	40.6667%	54.1963%	78.5328%	100.0000%
Fiscal 2003	-0.0002%	0.0080%	0.9111%	20.0898%	20.7644%	20.8489%	40.7456%	41.1353%	40.9556%	51.0523%	70.0525%	100.0000%
Fiscal 2004	-0.0035%	-0.0094%	0.8489%	19.1308%	19.0859%	19.6606%	38.4847%	38.5334%	39.4336%	50.5804%	74.0349%	100.0000%
Fiscal 2005	-0.0010%	-0.0118%	1.4949%	20.5411%	20.5220%	20.6406%	40.8243%	40.8573%	41.1387%	53.6628%	76.2336%	100.0000%
Fiscal 2006	-0.0969%	0.1419%	1.1536%	21.5729%	21.4688%	22.3029%	43.0484%	43.1630%	43.8653%	48.4204%	74.1211%	100.0000%
Fiscal 2007	0.0000%	0.0284%	1.1851%	20.5828%	21.4859%	22.1894%	42.3377%	42.3455%	43.1804%	43.0245%	73.3843%	100.0000%
Fiscal 2008	0.0000%	0.2220%	1.0394%	1.0393%	21.6967%	22.0669%	34.8057%	34.9771%	46.5582%	47.5551%	47.4734%	100.0000%
Fiscal 2009	0.0000%	-0.1323%	-0.1110%	0.0348%	28.1124%	28.1575%	28.1987%	47.2433%	47.9933%	50.4403%	76.4067%	100.0000%
Fiscal 2010	0.1776%	1.0685%	24.9797%	24.9797%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%	0.0000%

Fiscal 2002 Fiscal 2003 Fiscal 2004 Fiscal 2005 Fiscal 2006 Fiscal 2007 Fiscal 2008 Fiscal 2009 Fiscal 2010

Vehicle Fees/Taxes

Our office has contacted the Department of Justice (DOJ) regarding vehicle fees/taxes. At the time of this report, DOJ has indicated that the interface between MERLIN (the new DOJ vehicle system) and SABHRS is not totally working correctly. DOJ personnel have assured LFD staff that by the end of October, general fund collections for motor vehicle fees/taxes will be adjusted to reflect correct collections to date. This issue will be reviewed again at the end of October.

Cigarette Taxes

Cigarette taxes are lagging FY 2009 collections through September because of a change in accounting procedures by the DOR. Historically, the DOR adjusts accrual entries during the month of October. This fiscal year, the DOR adjusted the cigarette tax accrual during August. This change created an illusion that collections were lagging the HJ 2 estimate. By the end of October, collection patterns should be comparable to historical patterns.

Liquor Excise Taxes

Liquor excise tax collections through September 2009 are not comparable to the same period of 2008. This is due to an accounting change implemented by the DOR. Our office has requested the Legislative Audit Division (LAD) to review the new accounting procedures implemented by the department to determine whether these changes conform to appropriate accounting principles. LAD has reviewed these procedures and has suggested a modification to DOR procedures. At this time, it appears DOR has not changed their internal procedures.

In aggregate, the lag in collections from these sources could account for $15 to $20 million through September. If the lag is due to accounting, timing, and computer system issues and not economic reasons, then total general fund collections would be more in line with HJ 2 expectations. Our office will continue to research each of these issues further before the next report is issued in early November.

SUMMARY

Total general fund revenue collections through September for FY 2010 are below the same period of FY 2009 by $75.8 million or 20.2 percent. The 61st Legislature assumed revenue would decline by only 1.9 percent from FY 2009 to FY 2010 or $35.1 million. This means that total future collections must improve by a net $40.7 million in subsequent months to be on track with the HJ 2 estimate for FY 2010.

The focus of this analysis was on individual income tax, corporation income tax, TCA interest earnings, oil and gas production tax, and sources with unusual collection patterns. Since individual income tax is the predominate source of revenue in the general fund account, a small percentage change in this source can have a significant impact on total general fund revenues. As detailed in the report, however, collection data for three months of the fiscal year is somewhat inadequate to draw a finite conclusion on the future collection patterns for FY 2010. Using several different extrapolation techniques indicates individual and corporation income tax revenues could be below the HJ 2 estimate anywhere from $48 to $121 million for FY 2010. As specified earlier in the report, this range is dependent on assumptions about the timing of an economic rebound. Further data on payment types (withholding, estimated, refunds) should help narrow this range. Conversely, oil and gas productions tax revenue could exceed the HJ 2 estimate by as much as $14 million if prices remain at $60 per barrel and production does not fall below the HJ 2 estimate. Close monitoring by LFD staff is imperative to ensure that the legislature remains fully informed of these revenue trends as we proceed through the biennium.

The August report indicated that collections were lagging expectations and that the lag in collections would have to be "made up" in subsequent months in order to achieve the HJ 2 estimated level. Collections through September have not improved and are considerably worse than the August totals indicated. It should be noted however, that the lag in collections from vehicle fees/taxes, cigarette taxes, and liquor excise taxes, could account for $15 to $20 million of the reduced collections. However, an accelerated deposit timeframe for insurance tax collections increased total general fund collections by almost $12 million. The net change sum (decreases plus increases) among these four sources is close to zero. Staff will continue to research each of these issues and any other issues before the next report is issued in early November. That report will highlight collections through the end of October.

Attached is a report published October 2, 2009, on the national unemployment data prepared by IHS Global Insight (GI). As you may recall, GI is the national economic forecasting firm the state contracts with to provide economic forecasts.

U.S. Economy - Perspective Article

Published: Fri 02 Oct 2009

September U.S. Employment Report Disappoints.

The September employment report brought a worse-than-expected 263,000 decline in employment. There was no silver lining, as the unemployment rate rose, hours worked fell, and earnings growth decelerated.

September payrolls fell 263,000, worse than expected and worse than Augusts' (revised) 201,000 declines. The unemployment rate rose to 9.8% from 9.7%. The report signaled a painfully slow path to stabilization in the private employment market, and sharper declines in government jobs. It also suggested that the unemployment rate is likely to hit 10% by the turn of the year. The economy has now lost 7.2 million jobs since the recession began—but the story is even worse than that. The BLS now tells us that it expects to revise down March 2009 employment by 824,000, based on a full employment count from unemployment insurance statistics. That implies that the total loss is now 8.0 million.

Private employment fell 210,000 in September, worse than the 182,000 decline in August. It is not the first setback we've seen on the road to recovery (there was a much more severe setback in June), and the three-month moving average of private employment declines is still easing (it is now 213,000, after 273,000 in August). But the easing is gradual and we are not close to adding jobs. The leading indicators in the report were not promising. The workweek fell, and is now back at its June low. And temporary help jobs—while declining only fractionally—still have not moved into positive territory.

In the private services sector, job losses widened to 94,000 in September from 50,000 in August. The news worsened this month in retail (down 39,000 instead of down 9,000), transport and warehousing (down 15,000 instead of flat), and private education services (down 17,000 instead of up 4,000). Auto dealers lost 5,000 jobs after adding 4,000 in August, not a surprise as the surge in sales from "cash-for-clunkers" disappeared. Temporary help jobs fell 2,000, less than Augusts' 7,000 decline, but still not yet in the plus column, which would be a leading indicator of broader gains elsewhere.

Manufacturing jobs declined less sharply than in August, down 51,000 instead of down 66,000. Employment in motor vehicles and parts fell 4,000, less than the 14,000 decline in August. Recent shifts in this sector have been heavily influenced by seasonal quirks. If we exclude motor vehicles and parts, then the manufacturing job loss was 47,000 in September, just slightly better than the 52,000 loss in August.

The manufacturing workweek dropped to 39.8 hours, from 39.9 in August. Overall manufacturing hours worked fell 0.5% for the second month in a row. The ISM report says that manufacturing output is rising—but the employment report is telling us is that it is not rising fast enough for firms to need to add more hours worked. Productivity increases are covering the output gains.

Construction payrolls fell by 64,000 in September, after a 60,000 loss in August. The construction employment figures are showing a contrast between the residential and nonresidential sectors. The losses in the residential sector were just 13,000 this month, but the nonresidential sector lost 39,000 jobs. This is consistent with the story that residential construction activity is bottoming out, but that nonresidential has much further to fall. There were 12,000 jobs lost in heavy and civil engineering construction, where one might hope to see the impact from fiscal stimulus coming through—but one cannot know how many jobs would have been lost without the stimulus.

The news on government jobs is getting worse. State and local governments have now shed 160,000 jobs over the past four months as budget cuts bite. This month, they lost 47,000 jobs, of which 29,000 came in education as the school year began. The education sector as a whole lost 46,000 jobs this month, if you add in the 17,000 jobs lost in the private sector. Private universities' endowments have taken a hit, and they have cut back their hiring as a result.

The unemployment rate rose to 9.8% from 9.7%, as the household survey showed a huge decline in employment (down 785,000) and a large but not so severe drop in the labor force (down 571,000). Note that the household survey is smaller than the payroll survey, so its employment numbers are more volatile from month to month.

The most comprehensive measure of underemployment (U-6)—which includes workers who would like a job but are not currently looking, plus those working part time who would rather work full time—rose from 16.8% to 17.0%.

Total hours worked in the private sector fell 0.5% this month, after a 0.2% decline in August. The news for consumer spending power was even worse than that, because average hourly earnings rose only 0.1%, after a 0.4% gain in August. It seems that the acceleration in earnings in July and August was probably related to the hike in the minimum wage.

Hours worked fell 3.0% overall in the third quarter compared with the second, much milder than the second quarter's 7.8% drop but still heading in the wrong direction. Since we expect that GDP will grow by 3%-plus in the third quarter that implies another outsized gain in productivity after the 6.6% productivity surge in the second quarter.

This report contained nothing to support the view that the economy will be adding jobs before the end of the year. We see the economy beginning to add jobs in the second quarter of 2010—helped by government hiring for the Census—but that is dependent on the notion that the recent dramatic growth rates of productivity cannot be sustained. The unemployment rate is likely to hit 10% by the end of the year and peak above 10% in the first half of 2010. There was also nothing in the report to support the view that the consumer can sustain the spending increases that we saw in August—employment and hours worked were down, and hourly earnings only inched higher, implying that wage and salary incomes fell. A weak outlook for consumer spending remains the key reason to suppose that once we get beyond the inventory cycle, which will support growth in the second half of the year, the recovery will be a slow one.

by Nigel Gault