November 2018

NEVADA ECONOMIC FORUM

Revenue Outlook: State 2% Sales and Use Tax, Gaming Percentage Fees

Prepared by
Sarah Crane
Economist
+610.235.5160

Contact Information

Client Services

Representatives are available: 7AM to 6PM EST (12PM-11AM GMT), Mon-Fri. Email help@economy.com or contact us at a location below:

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Worldwide Offices

West Chester 121 N. Walnut St., Suite 500, West Chester PA 19380	+1.610.235.5000
United Kingdom One Canada Square, Canary Wharf, London E14 5FA	+44.20.7772.5454
Australia Level 10, 1 O'Connell Street, Sydney, NSW, 2000 Australia	+61.2.9270.8111
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Revenue Outlook: State 2% Sales and Use Tax, Gaming Percentage Fees

BY SARAH CRANE

The following revenue forecasts link Nevada's general sales and use tax revenues (NRS 372) and its gaming percentage fee revenues (NRS 463) to measures of underlying economic growth. Sales tax collections for fiscal 2018 fell short of the previous forecast in light of downward revisions to historical personal consumption expenditures data. Despite volatility, gaming percentage fee collections in fiscal 2018 grew roughly in line with expectations. Nevertheless, it will take time for gaming revenues to fully recover from a severely depressed base given changing consumer dynamics.

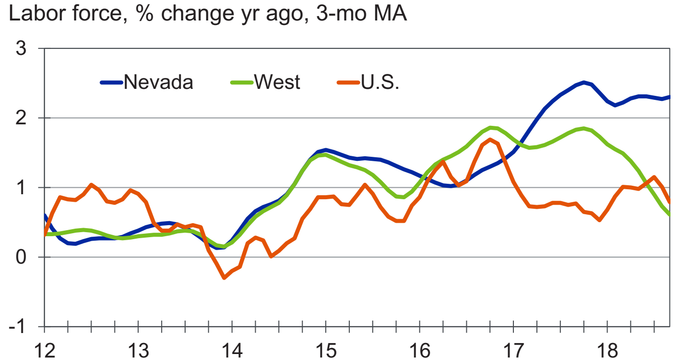
Regional economy

Nevada's economy is red-hot, with job growth clocking in at around 3% since the start of the year, double the national average. Nearly all industries are moving in the right direction, with private services providing the bulk of the gains. Hiring in retail and leisure/hospitality is gaining momentum, while professional/business services employment has also climbed since the start of the year. Manufacturing is contributing more to growth, responsible for 17% of job gains so far this year, the second highest in the West after Idaho. Even the public sector is having a greater impact. Local government payrolls have climbed sharply since the start of the year, helping total government employment hit an all-time high. The jobless rate recently ticked down to 4.5%, even as the labor force sustains growth that is more than double the national pace (see Chart 1).

Nevada tourism remains healthy, but Las Vegas visitor volume has been unable to keep up with last year's chart-topping figures (see Chart 2). The hotel occupancy rate is also below year-ago levels, with renovations at the Monte Carlo and Palms properties temporarily reducing room inventory and pushing up the average daily room rate. Developers on the Las Vegas Strip are busier than they have been in years. Six major projects, including Las Vegas Stadium and new casinos and resorts, are all slated to open in 2020.

Chart 1: Nevada Labor Force on a Tear

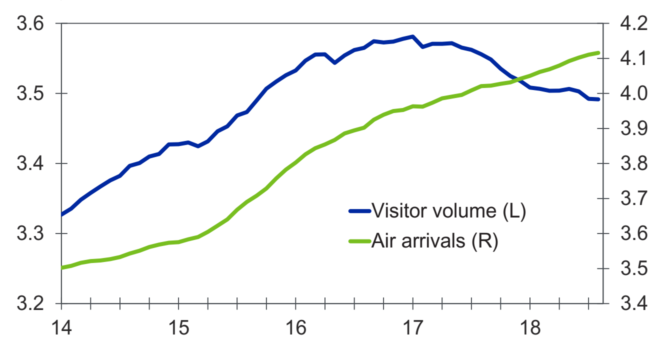
Labor force, % change yr ago, 3-mo MA



Sources: BLS, Moody's Analytics

Chart 2: Vegas Tourism Figures at Odds

mil, 12-mo MA



Sources: Las Vegas Convention & Visitors Authority, Moody's Analytics

Improvements to the Las Vegas Convention Center will also help draw more business travelers and convention-goers to the metro area. The second phase of the $1.4 billion project, which entails building a 600,000-square-foot exhibit space, will get under way soon and is also expected to be completed in 2020. With similar projects having occurred in other major convention cities such as Orlando and Chicago, the upgrades are necessary for Las Vegas to maintain its dominance of the meetings and trade-show industry.

Although construction and tourism drive growth in Las Vegas, other industries are playing a greater role in northern Nevada as the state makes healthy strides diversifying its economy. Proximity to Tesla's Gigafactory is causing companies to compete for space at Tahoe-Reno Industrial Park. The industrial segment, in turn, is the most valuable player of Reno's commercial real estate sector. As one of the more affordable industrial markets in the West, new distribution centers and warehouses are coming on line, supporting payrolls in transportation and warehousing.

Manufacturing from California is also spilling over into northern Nevada because of its lower cost of doing business and the tech hub forming in and around Reno. Reno manufacturers will thrive in the coming quarters as battery production for Tesla's Model 3 increases at the Gigafactory. Hiring at the plant should increase at a faster pace in the next few months now that battery production is on track and new Model 3 orders are being filled. With the facility expected to employ 10,000 workers once operating at full capacity in 2020, Nevada's manufacturers will add positions faster than the West and U.S. averages over the next several years.

With one of the most vibrant job markets in the nation, it is no surprise that workers and their families are moving to the state in droves. Nevada's population grew at the second fastest pace in the nation in 2017, behind Idaho's, owing largely to strong net migration. Among metro areas with more than 1 million residents, Las Vegas boasted the strongest population gains in the West while Carson City and Reno also posted above-average gains. A pipeline of major business investment and the resulting job opportunities will keep in-migration robust.

The increase in residents is substantially lifting demand for housing. However, a shortage of skilled construction workers is keeping a lid on the pace of homebuilding (see Chart 3). In fact, the size of Nevada's construction workforce is still further below its prerecession peak than in any other state, while permitting is below year-ago levels in Reno and Las Vegas. There is a slightly different story in Carson City, however, since the state capital has recovered a greater share of construction workers than Nevada's larger metro areas. With construction employment nearing it prerecession peak, builders in the metro area have been able to increase single-family housing starts since the start of the year.

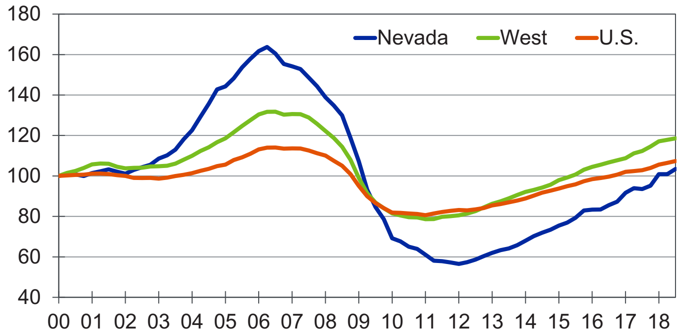
Still, housing demand continues to outstrip supply in Carson City and across Nevada, with statewide price appreciation double what it was at this time last year (see Chart 4). Builders are gradually working through labor constraints to increase inventory, and a pickup in housing starts over the next several months will cause statewide house price appreciation to cool and trend closer to the U.S. average. However, even with the cooling, homes in all of Nevada's metro areas are modestly overvalued and that is unlikely to change anytime soon.

Nevada's status as a major tourism destination makes it particularly sensitive to national economic conditions, and a transition is on the expansion's horizon. The U.S. economy is in great shape, and prospects through the remainder of the decade are bright. Sturdy domestic demand, supported by rising incomes and corporate profits, deficit-financed tax cuts, and increased government spending, will underpin the enduring expansion. The national economy is showing signs of entering the later stages of the business cycle: GDP growth is above trend, the labor market is tightening, wage growth is gradually accelerating, and inflation is within sight of the Federal Reserve's 2% target. Unemployment rates will drop further through next summer before the sugar high of the fiscal stimulus wears off and inflation pressures mount. The expansion will draw to a close in 2020 as the Federal Reserve raises interest rates and increased uncertainty takes hold. As consumers pull back spending, Nevada's still largely tourist-dependent economy will hit a rough patch as well.

There are domestic and foreign headwinds that bear close watch. Global econom-

Chart 3: Construction Labor Can't Keep Up

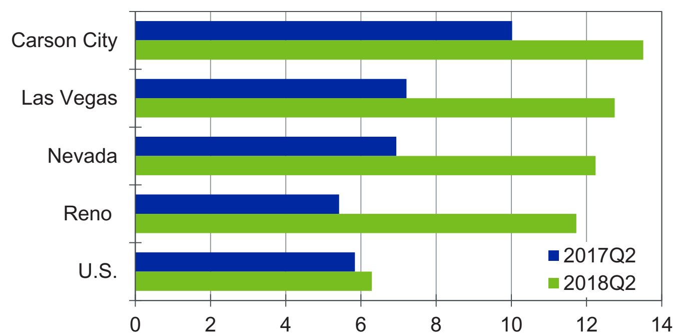
Construction employment, 2000Q1=100



Sources: BLS, Moody's Analytics

Chart 4: Surging Demand Hoists Prices

Case-Shiller® Home Price Index, % change yr ago



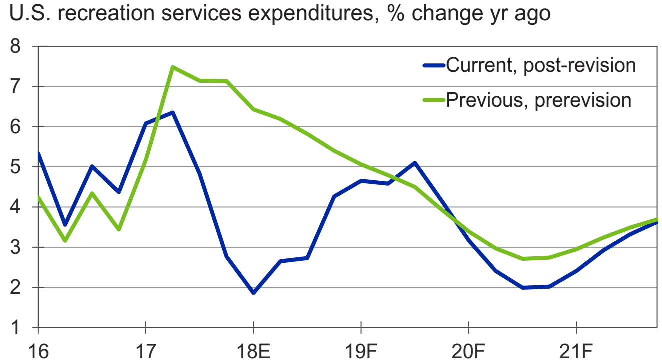
Sources: CoreLogic, Moody's Analytics

ic conditions will become less supportive for growth in international tourism to Las Vegas and Nevada in general. Although overall growth will accelerate in the near term, next year will see a synchronous deceleration in global economic activity. Despite tailwinds from a buoyant U.S. job market and rising wages, demand for high-tech goods and travel services could falter if trade tensions between the U.S. and China boil over and hasten a more significant slowdown in global growth. New manufacturing industries sprouting in Nevada incorporate electronics and other digital technologies produced in China. Even Tesla, which carries out most of its vehicle assembly in Nevada and California, relies on Chinese firms for display screens, onboard computers, and other electronic components.

The volley of tariffs proposed by the U.S. and China does not directly target service exports, but the full implementation of tariff threats would take a bite out of global growth and reduce incomes. The hit to service exports would occur through the income channel. Should growth in global incomes slow or should incomes contract outright, demand for a range of travel services would dim. This would deal an outsize blow to the Nevada economy, where travel service exports are very large relative to the state's gross product. What is more, China has the ability to make things particularly difficult for U.S. companies relying on Chinese demand as a potential retaliatory measure in a trade war. This has the potential to impact several of the state's largest gaming companies.

Chart 5: BEA Update Has a Big Impact

U.S. recreation services expenditures, % change yr ago



Sources: BEA, Moody's Analytics

Table 1: November Sales and Use Tax Forecast

	Q1	Q2	Q3	Q4	Total
Fiscal 2018, $ mil	280.74	291.20	278.23	292.63	1,142.80
% change yr ago	4.64	4.31	5.49	4.70	4.78
Fiscal 2019, $ mil	300.35	313.24	295.96	317.40	1,226.95
% change yr ago	6.99	7.57	6.37	8.47	7.36
Fiscal 2020, $ mil	316.27	327.04	306.16	324.92	1,274.39
% change yr ago	5.30	4.40	3.45	2.37	3.87
Fiscal 2021, $ mil	321.68	332.20	311.64	332.84	1,298.36
% change yr ago	1.71	1.58	1.79	2.44	1.88

Sources: Nevada Legislative Counsel Bureau, Moody's Analytics

Sales and use taxes

Forecast. Sales tax collections in fiscal 2018 fell short of the previous forecast. The Bureau of Economic Analysis' five-year comprehensive revisions to the National Income and Product Accounts included large revisions to U.S. recreation services spending. Changes to this spending category reflect new and revised source data as well as adjustments to better reflect the digital economy. The government's new estimates of historical consumer spending on recreational services in particular, a major driver of the sales tax forecast, are substantially lower than its estimates when the last forecast was developed (see Chart 5).

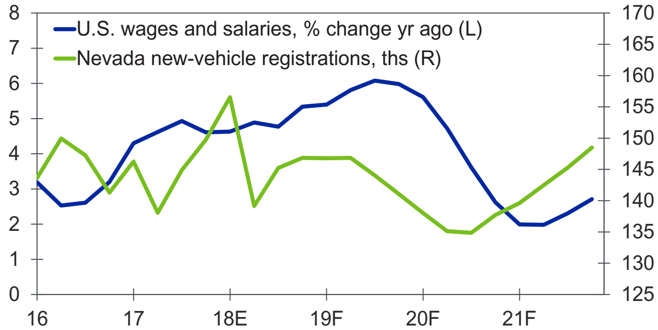
As the U.S. labor market tightens and the fiscal stimulus from the new tax law takes full effect, wages will rise, unemployment will bottom out, and consumers will respond in kind, helping to push collections higher by 7.4% in fiscal 2019. Collections then soften to 3.9% in fiscal 2020 and 1.9% in fiscal 2021 as the U.S. economy sees less stimulus from the federal government and likely confronts a major slowdown in growth if not outright recession (see Table 1).

Drivers. The main driver of sales and use tax collections is U.S. recreational spending, which serves as a proxy for Nevada tourism, particularly that of Las Vegas. Even with gaming becoming legalized in more places across the globe, Las Vegas tops most other locations from an overall entertainment perspective. As renovations and new projects are completed, Las Vegas tourism will strengthen in tune with the vibrant U.S. economy and improving consumer fundamentals. Rising wages nationwide will put extra cash into consumers' pockets to spend on recreation, further boosting visits to Las Vegas and hiring in consumer industries.

Other significant variables determining the trajectory of the sales tax forecast are U.S. wage and salary income and Nevada new-vehicle registrations (see Chart 6). Wages and salaries make up more than half of personal income and help determine consumers' ability to spend in the U.S. economy. Solid employment growth coupled with gradually building wage pressures has generated an acceleration in wage and salary growth, compelling Americans to travel more.

National wage and salary income also serves as a helpful proxy for changes in the overall U.S. business cycle. As the U.S. economy pushes beyond full employment, the dwindling pool of available workers will eventually cause the pace of job creation to slow. In the meantime the shortage of labor will put upward pressure on wages and prices. This in turn will elicit further interest rate increases from the Federal Reserve, and as the federal fiscal stimulus fades, most metrics will begin to look worse, leading to what is projected to be a broad-based slowdown in 2020.

Chart 6: Secondary Sales Tax Drivers



Sources: BEA, The Polk Co., Moody's Analytics

New-vehicle registrations help shed light on consumers' willingness to spend, not just on automobiles but also as a proxy for other large durable goods purchases. Nevada vehicle sales and registrations are on track to remain stable into 2019, but now that much of the pent-up auto demand from the Great Recession has been released, registrations are unlikely to rise much further. Coupled with higher interest rates over the next several years, consumers are due to take a bit of a pause from spending on new vehicles and other large durable goods as we get closer to 2020 and 2021.

Risks to the outlook still revolve around the potential for financial market volatility as the Federal Reserve raises interest rates and uncertainties related to weaker expansion in China and other emerging market economies. In addition, there are a number of unquantifiable risks to the forecast for sales tax collections. For example in April 2012, Amazon announced an agreement with the state to begin collecting sales tax on items purchased by Nevada residents, and just this year the Supreme Court opened the door for states to begin collecting sales taxes on online purchases. The forecast does not explicitly account for any changes in the way that Nevada collects online sales taxes.

Finally, though many of the economic effects have been built into the baseline outlook, this revenue forecast has not been add-factored to explicitly account for the direct effects of the deal between the state and Tesla. The direct impacts and their spillover are not yet fully quantifiable in terms of their impact on sales tax revenues.

Gaming percentage fees

Forecast. Fiscal 2018 gaming percentage fee collections grew at a slower pace than in the previous year, but came in slightly above expectations. Commercial casino revenue increased as strong growth in gaming machine revenue offset a slight decline in tourist visitation to Las Vegas and decreasing revenue from baccarat games favored by international high-rollers. Casinos started fiscal 2019 on the wrong foot, generating 1% less in gambling revenue in the first quarter than in the same period last year. There are a few possible explanations for casinos' disappointing showing, including a heavier calendar of events last year and changes in the scheduling of trade shows.

The forecast is generally consistent with the previous update. Increases in gaming percentage fee collections have been uneven from quarter to quarter, but collections are poised to grow by 2.2% for fiscal 2019. Nonetheless, a structural break in the relationship between visitor volume and gaming percentage fees will keep long-term growth well below the historical average, increasing just 1.9% in fiscal 2020 and 1.2% in fiscal 2021 (see Table 2).

Drivers. The cyclical drivers for Nevada's gaming percentage fees are similar to sales and use taxes but with a few exceptions. Gaming percentage fees tend to have a higher correlation with national and global economic trends, whereas sales are highly dependent on local consumer spending. National recreational services spending remains the best predictor of gaming percentage fee collections. Tourism, still the key driver in the gaming space, will perform well over the near term thanks to expanded entertainment options and the strengthened U.S. economy. Gaming revenue collections continue to be unsteady, however, as more play is concentrated across a smaller number of high-dollar games, particularly baccarat.

Toward the end of the forecast horizon, the slowdown in national economic growth will take a toll on the pace of growth in gaming percentage fees. The baseline economic forecast calls for a substantial decline in the pace of growth by late 2020 that could result in outright recession.

Outside of the economic impacts, several structural issues will also play a part in the forecast. It remains to be seen how the spread of legal sports betting, and potentially interstate wagers, will affect Nevada's gaming industry. Nevada lost its monopoly on legal sports betting when the U.S. Supreme Court struck down the Professional and Amateur Sports Protection Act in May, opening the industry to other states. The development is unlikely to be a game changer since revenue from

Table 2: November Gaming Percentage Fee Forecast

	Q1	Q2	Q3	Q4	Total
Fiscal 2018, $ mil	182.00	197.74	172.26	205.79	757.79
% change yr ago	4.22	5.92	-2.87	7.27	3.74
Fiscal 2019, $ mil	180.35	194.77	185.19	214.16	774.48
% change yr ago	-0.90	-1.50	7.50	4.07	2.20
Fiscal 2020, $ mil	183.85	200.37	188.56	216.76	789.54
% change yr ago	1.94	2.88	1.82	1.21	1.95
Fiscal 2021, $ mil	185.47	202.18	190.85	220.28	798.78
% change yr ago	0.88	0.90	1.22	1.62	1.17

Sources: Nevada Legislative Counsel Bureau, Moody's Analytics sports betting pales in comparison to that from other types of gambling, accounting for less than 2% of Nevada's total gaming revenue.

Longer term, the structural break in the historical relationship between recreational spending and gaming is becoming increasingly clear and drives a large part of the disparity in forecast growth rates for gaming compared with sales and use taxes. Increased competition from other states, international destinations such as Macau, and even online betting will further moderate Nevada's share of gaming in the years ahead. Las Vegas tourism has been relatively successful in addressing the changing gambling and entertainment landscape by diversifying beyond its traditional gaming image and branding itself more as a comprehensive vacation destination that appeals to a wider range of visitors. As a result, live entertainment and sales and use taxes will increase at the expense of gaming percentage fees.

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U.S./CANADA
+1.866.275.3266

EMEA
+44.20.7772.5454 London
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ASIA/PACIFIC
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