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## **1998 Annual FTA Revenue Estimation and Tax Research Conference** *Summary of Proceedings*

### **To State Tax Administrators:**

#### **Summary**

The 53rd Annual FTA Revenue Estimating and Tax Research Conference was held September 13-16, 1998 in Whitefish, Montana. Presiding over the conference was Mark Muchow of the West Virginia Dept. of Tax and Revenue and Chair of the FTA Research Section. This bulletin summarizes the proceedings and lists the various papers available from FTA.

The 53rd Annual FTA Revenue Estimating and Tax Research Conference was held September 13-16, 1998, in Whitefish, Montana. Presiding over the conference was Mark Muchow of the West Virginia Dept. of Tax and Revenue and Chair of the FTA Research Section. Welcoming the participants was the Conference Host, Mary Bryson, Director of the Montana Dept. of Revenue.

The program included presentations by the major forecasting firms and industry representatives on their economic forecasts for the next 18 months. Presentations were also made on deregulation of the electric utility industry, fiscal outlook for the states, compliance research, and managing a research section. The entire day Tuesday was dedicated to various concurrent sessions covering issues of interest to state economists such as telecommunications taxation, modeling and data development issues, natural resources taxation, taxation under utility deregulation, tax incentives, state tax issues under education finance reform and income tax forecasting.

On Wednesday morning, the participants heard several presentations on topics of broad interest to state economists. These presentations included local option taxes, creating state composite economic indicators, and an update on federal legislative activities. Also, FTA gave a presentation on the New TaxExchange—an electronic service available to member agencies.

### **Economic Forecasts**

The conference included several presentations by the major forecasting companies on the overall macro economic outlook, regional economic outlook, and international issues affecting the economic outlook. Cynthia Latta, DRI McGraw Hill, gave the overall macro economic forecast. She expects the real growth rate for Gross Domestic Product (GDP) to fluctuate between 2 and 4 percent, during the next 18 months. Also, with consumer confidence at very high levels, she noted that many people are currently making major purchases leading to strong growth in auto and new home sales. She cited several factors responsible for this strong economic outlook. The federal budget surplus, a low inflation rate, and a net inflow of foreign money (seeking refuge in the U.S.) have pushed interest rates very low. This, along with an improved wealth effect from

the recent growth in the stock market, has stimulated the growth in consumer spending. Still, there is a possibility for a downturn in the economy.

Ms. Latta pointed out several factors which could adversely affect the economic outlook. The Asian crises could spread to other countries, adversely affecting export sales from the U.S. While the decrease in exports to Asian countries has not significantly affected the U.S. economy, there is a chance that Asian financial problems could spread to Latin American countries. Also, consumer debt loads are at record levels, which could adversely affect the level of consumer spending. However, interest rates are currently at record low levels, which greatly decrease the cost to consumers of servicing this debt. Finally, a strong correction in the stock market could affect consumer confidence. Still, the DRI forecast only puts a 30 percent probability of a small recession in 1999.

Genio Staranczak, Director of long-term forecasting for the WEFA Group, discussed the world economic outlook and its implications for the U.S. He began by discussing the economic conditions and outlook for the various world markets, followed by a discussion of the implications for the U.S. Finally, Genio examined various risks to his forecast. Still, WEFA expects the world economy (excluding the U.S.) to grow by 1.7 percent in 1998, and show an improved growth rate of 2.4 percent in 1999.

Asia and other Pacific Basin countries are still suffering from the currency debacle of 1997 and the drop in intra-Asian trade. Japan has failed to step-in and pickup the slack from this drop in trade and has also been trying to deal with various internal structural problems of its own. Still, WEFA forecasts a 1999 real growth rate of 1.4 percent in Japan, and 1.2 percent in other Pacific Basin countries. Western Europe is dealing with several internal problems in the individual countries and must also deal with unification issues. Yet, the 1999 real growth rate is forecasted to be 2.8 percent. Canada is expected to continue to do well, with the real growth rate expected to fall slightly from 3.4 percent in 1998 to 2.9 percent in 1999. Genio also briefly discussed other regions of the world, including Mexico and Latin America, the Middle East, the former Soviet Union, Africa and Eastern Europe.

Mr. Staranczak expects that a rebound in world economic growth will stimulate sales from the U.S. World export growth is forecasted to accelerate from 1.1 percent in 1997 to 4.5 percent in 1999. Meanwhile a lower dollar will lead to lower import growth for the U.S, improving the trade balance. On a net basis, U.S. growth is projected to increase by 0.3 percent in 1999, due to a recovery abroad. Still, there are several factors that could adversely affect world growth. Stimulation policies in Japan could fail, IMF policies in Asia and the former Soviet Union may not work, Europe could turn more inward as unification proceeds, or the Federal Reserve could increase U.S. interest rates. Still, WEFA does not place a high probability on these events happening.

Mark Zandi with Regional Finance Associates, gave a presentation on the regional economic outlook. He noted that the U.S. economy has been experiencing strong growth during the past 3 years in all regions. Indeed, the percentage of metropolitan statistical areas with a jobless rate below 5 percent is nearly 90 percent, while over half have jobless rates below 4 percent. Zandi attributes this to strong consumer spending. However, he expects this growth rate to fall.

While the U.S. economy grew by more than 5 percent in the first quarter, real GDP growth weakened to 1.4 percent in the second quarter. Zandi expects this decline in the growth rate to continue, forecasting a 1.9 percent real growth rate for 1999. Much of this can be attributed to the Asian economic crisis, which will largely affect the states in the west (Washington, Oregon, California and Arizona). Still, consumer confidence is strong in this region. Another cause of the recent slowdown in economic growth can be attributed to the drop in the stock market. States

(mainly in the northeast) most affected by stock market activities are: New York, Pennsylvania, Maryland, Delaware, Connecticut, Massachusetts, Illinois, Colorado and California.

John Cappellari, with the Wisconsin Dept. of Revenue, discussed state taxation issues of electric utilities under deregulation. He began by examining the different issues states must address when changing their tax systems in response to a deregulated electric utility market. He then discussed recent reforms in several states and how they addressed these issues. Before deregulation, states used the monopoly status of electric utilities to levy various taxes that were higher than other industries. They typically took the form of special gross receipts taxes or higher property tax levies. However, under a deregulated environment, these taxes place in-state utilities at a competitive disadvantage. Gross receipts taxes cannot be levied on out-of-state producers of electricity without a nexus presence in the state. High property tax burdens also place a competitive burden on in-state-producers. Meanwhile, local governments would suffer a drop in revenues as competition lowers the market value of expensive power plants (stranded costs).

Cappellari noted that several states have already implemented changes to address these issues. Arizona will tax utility property the same as other industrial property, beginning in 1999. Connecticut replaced the tax on electric generation with taxes on transmission and distribution. Illinois and New Hampshire imposes all electric taxes on a consumption basis, while New Jersey subjects utilities to the general business taxes. Iowa eliminated local utility property taxes, placing a tax on generation, transmission and consumption. Louisiana has repealed its occupational tax on utilities; and Massachusetts and Pennsylvania have provisions to make up for lost revenues from electric utility deregulation.

Scott Mackey, an analyst with the National Conference of State Legislatures, gave an overview of the fiscal outlook of the states. States finances have steadily improved since 1992, with year-ending balances for the 1998 fiscal year totaling 8.6 percent—the highest rate since 1980. Most states have balances over 5 percent. Still, Mackey noted that state policymakers have been reluctant to spend these higher balances, given their experiences during the tight fiscal years in the early 90s. However, recently approved budgets have enacted tax cuts totaling 1.4 percent of revenues, with individual income taxes being the most widely cut tax. Wyoming is the only state to enact a tax increase in the 1999 budget. Overall, Mackey noted that state policymakers have enacted budgets intended to draw down year-ending balances. However, he noted that rainy-day fund balances may continue to grow, if revenues continue above forecasts. If this happens, policymakers may face increased pressure for permanent tax cuts next year.

### **Keynote Luncheon Speaker**

Prof. Joel Slemrod of the University of Michigan's Office of Tax Policy Research, discussed his views on recent tax policy developments during a luncheon talk to the conference attendees. He noted that the three big issues in tax policy are what to do with the federal/state budget surpluses, what to do about tax reform, and what is the impact of IRS reform efforts? At the federal level, the debate centers around saving the surplus to finance future social security outlays versus financing tax cuts. The choices that state policymakers are debating include cutting taxes or increasing spending on various infrastructure projects.

Professor Slemrod noted that the discussion concerning federal/state surpluses centers around one question: Is the increased revenue temporary or permanent? He cites two potential causes for the recent surge in revenues—increased capital gains realization and a shift in income distribution. The former is clearly temporary, driven in part by the strong gains in the stock market during 1996. Meanwhile, there has been a definite shift in income distribution with the share of income earned by households with incomes over \$200,000 rising from 14 percent in 1986 to 17 percent in 1997.

Slemrod briefly discussed the two leading candidates for federal tax reform, the national sales tax and the flat tax. The national sales tax option has several problems, with the main one being the rate. When combined with state and local sales taxes, the total rate needed to generate the necessary level of revenue would be over 30 percent. No one has ever tried to administer a tax with a rate this high. Meanwhile, the flat tax proposals have various transitional problems.

The recent reforms at the IRS are a step in the right direction, requiring the IRS to take into account the compliance burden on taxpayers when implementing new laws and regulations. However, he finds the provisions shifting the burden of proof to the Service in disputes troubling. With a probability of audit currently very low, shifting the burden of proof would further weaken the desire to voluntarily comply with the tax laws.

Slemrod concluded by thanking the FTA for inviting him to this conference. He noted that academics have a lot to contribute to tax policy research and proposed expanding the network of state researchers to include academics.

### **Monday Afternoon Concurrent Sessions**

Participants had the opportunity to choose between two concurrent sessions in the afternoon. One session offered the economic outlook for various sectors, including retailing, automobile sales/production and housing. The second session included presentations on managing a tax research section and compliance research issues.

### **Wednesday Morning General Session**

On Wednesday morning, participants heard presentations of general interest to state economists and policy analysts. The first speaker—Thomas Neubig, with Ernst and Young, LLP—gave an update on recent federal tax legislation. He listed four issues currently being addressed at the federal level, the budget surplus, IRS restructuring bill, miscellaneous legislation and a possible second tax bill. Congress and the President are debating what to do with the expected budget surplus, with the former wanting a tax cut while President Clinton is calling for social security reform.

Meanwhile, the IRS Restructuring and Reform Act of 1998 was essentially revenue neutral. It provides various taxpayer protections and shortens certain capital gains holding periods, while providing adequate revenue offsets. These may have some state effects from piggybacking and changes in taxpayer behavior from the federal law changes. Other legislative actions include the Internet Tax Freedom Act, bankruptcy reform and Tobacco Tax Health Bill.

Finally, Mr. Neubig addressed the possibility of a second tax bill this season. A tax reform bill was introduced in the house, granting \$80 billion in tax cuts. It would make changes to eliminate the marriage penalty, provide a self-employed health insurance deduction, and other tax relief measures. He noted that this is a prelude to the next presidential election, with additional pressure for tax reform in 1999.

Ronald Alt, Senior Research Associate with the Federation of Tax Administrators, discussed the New TaxExchange service introduced recently by FTA and MTC. This service, available only to state revenue agency employees, is an internet-based service providing member agencies quick and easy access to materials produced by each agency. It also provides various methods to facilitate communications among state officials, through various listservs. Mr. Alt noted that FTA has set up a special listserv for tax policy/economic researchers to promote communications among themselves. State employees can subscribe to the listserv by sending a blank email message with the word "subscribe" in the subject line to <research@lists.taxadmin.org>.

Employees of state revenue/tax agencies can obtain a user id/password to access TaxExchange by completing the form at: <http://www.taxexchange.org/reg/>.

Greg Harkenrider gave a presentation discussing his efforts at creating a group of composite economic indicators for the Kentucky Office of Financial Management and Economic Analysis. He used the same methodology as the Bureau of Economic Analysis when developing the national indicators. The major difference, the Kentucky indicators includes revenue variables in the reference series. This makes the indicators better suited for revenue forecasting. Harkenrider noted how these leading indicators provide a good complement to the more extensive quarterly econometric models and give state officials a short and long view of the fiscal economy. However, he also noted that the indicators must be constantly updated and reevaluated for them to continue to be useful.

Scott Mackey, an analyst with the National Conference of State Legislatures, discussed the results of his recent study on local option taxes. Recent trends in federalism, including devolution of taxing authority, tax cutting at state levels, property tax reform, and a shift to user fees, point to generating more revenues at the local level. Indeed, the trend since the 1970s has been an increase in local sales tax collections, some additional excise and other taxes, but no significant expansion of local income taxes.

Mackey, also noted how the expansion of local taxing authority has important policy implications that legislatures need to consider. While local option taxes generally improve accountability by placing taxing decisions closer to the people, it also limits state revenue options. It may also increase compliance costs, create inter-local competition, increase the fiscal disparities across the state, and affect the overall progressivity/regressivity of the state-local tax system. In granting local taxing authority, policymakers must examine how the new taxes would affect the balance in the revenue system (reliance on different taxes), how it affects the overall elasticity, and how broadly taxing authority should extend.

Stanley Chervin with the Tennessee Department of Revenue, invited everyone to attend the 1999 Revenue Estimating Conference in Nashville, Tennessee, on September 26-29.

### **Breakout Sessions**

On Tuesday, conference participants were offered several concurrent breakout sessions. Some of the topics included telecommunications taxation, state taxation under utility deregulation, natural resources taxation issues, issues in modeling and data development, tax incentives, state tax issues under education finance reform, and new advances in income tax forecasting.

Below is a complete list of papers available from FTA. If a topic was discussed for which no paper is available, please contact us and we can put you in contact with the presenter.

Sincerely,

Harley T. Duncan  
Executive Director

## 1998 FTA Revenue Estimating Conference Papers Available

### General Session—Monday

“The U.S. Economic Outlook: Goldilocks Meets the Bears,” *Cynthia M. Latta, Ph.D*, DRI McGraw Hill (tables accompanying remarks)

“The World Economic Outlook: Growth to Rebound,” *Genio Staranczak*, WEFA Group (tables accompanying remarks)

“The Regional Economic Outlook,” *Mark Zandi*, Regional Financial Association (tables accompanying remarks)

“State Taxation of Electric Utilities Under Deregulations: An Overview,” *John Cappellari*, Wisconsin Dept. of Revenue (outline of remarks)

### General Session—Wednesday

“Update on Federal Legislation,” *Thomas Neubig*, Ernst & Young (outline of remarks)

“Kentucky Composite Economic Indicators,” *Greg Harkenrider*, Kentucky Finance and Administration Cabinet

### Concurrent Sessions

#### Outlook for Selected Sectors

“Motor Vehicle Outlook,” *Mark Haas*, Michigan Department of Treasury (tables accompanying remarks)

“The Outlook for the Economy and Housing and Mortgage Finance Markets,” *David Berson*, Fannie Mae

#### Managing a Research Section/Compliance Research

“Benefits of Field Office Automation,” *Joe Fitz*, California State Board of Equalization (outline of remarks)

“Michigan’s Cigarette Tax Experience,” *Matthew Knittel*, Michigan Department of Treasury (tables accompanying remarks)

#### Telecommunications Taxation

“Reforming Florida’s Telecommunications Tax,” *Christian Weiss*, Florida Dept. of Revenue (tables accompanying remarks)

#### Issues in Modeling and Data Development

“Merging Income Tax and Census Data to Estimate Property Tax Relief,” *Mike Sobul*, Ohio Dept. of Taxation

“Profiling Small Business in New York State,” *Patrice Cohen*, New York State Dept. of Taxation and Finance (tables accompanying remarks)

“Mining Operational Data for Revenue Analysis,” *Karen Schlain*, New York City Dept. of Finance (outline of remarks)

#### Natural Resources Taxation

“Predicting the Impact of Electric Utility Restructuring on the San Juan County Economy and on State and Local Revenues,” *Laird Graeser*, New Mexico Taxation and Revenue Dept. (paper distributed but not discussed)

**State Taxation Under Utility Deregulation**

“Survey of State Taxation of Gas and Electric Utilities,” *Arthur Friedson*, New York State Dept. of Taxation and Finance (tables accompanying remarks)

“Energy Taxation in New York: Incidence-Shifting and Local-Revenue-Shifting Implications of Reform Options,” *Michael Hyman*, New York City Dept. of Finance (tables accompanying remarks)

“Electric Power Tax Reform: The Iowa Experience,” *Steven Evans*, Mid American Energy Company (outline of remarks)

“Taxation of Electricity in West Virginia Under Deregulation,” *Tom Witt (and Patrick Mann)*, West Virginia University

“State and Local Revenue Impacts and Tax Policy Challenges of Utility Deregulation,” *Robert Cline (and Andrew Hamilton)*, Barents Group, LLC

**Tax Incentives**

“Tax Increment Financing as Economic Development Tool,” *Jason Nord*, Minnesota Dept. of Revenue

**State Tax Issues Under Education Finance Reform**

“Michigan’s Experience with School Finance Reform,” *Mark Haas*, Michigan Dept. of Treasury (tables accompanying remarks)

“Vermont Dept. of Taxes Bulletin No. 3 & No. 9,” *Robert Gross*, Vermont Dept. of Taxes (handouts accompanying remarks)

**The Income Tax: Where Do We Go From Here?**

*Thomas Marks*, New York State Dept. of Taxation and Finance (tables accompanying remarks)

*Connie Squires*, California Dept. of Finance (tables accompanying remarks)

*Frank Sammartino*, U.S. Congressional Budget Office (tables accompanying remarks)

*Richard Kaluzny*, New Jersey Dept. of Treasury (tables accompanying remarks)