BULLETIN

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1997 Annual FTA Revenue Estimation and Tax Research Conference
(Summary of Proceedings)

To State Tax Administrators:

Summary
The 52nd Annual FTA Revenue Estimating and Tax Research Conference was held September 7-10, 1997 in Dearborn, Michigan. Presiding over the conference was Philip Spilberg, California Franchise Tax Board and Chair of the FTA Research Section. This bulletin summarizes the proceedings and lists the various papers available from FTA.

The 52nd Annual FTA Revenue Estimating and Tax Research Conference was held September 7-10, 1997 in Dearborn, Michigan. Presiding over the conference was Philip Spilberg, California Franchise Tax Board and Chair of the FTA Research Section. Welcoming the participants were Conference Host, Mark Haas, with the Michigan Department of Treasury, and B. D. Copping, Michigan's Commissioner 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 recent trends in federal tax collections, deregulation of the electric utility industry and estate tax reform efforts. The entire day Tuesday was dedicated to various concurrent sessions covering issues of interest to state economists. Some of the topics included telecommunications taxation, taxation of electronic commerce, taxation of deregulated industries, capital gains forecasting, using federal databases, welfare reform, managing a research section, and new developments in modeling techniques.

On Wednesday morning, the participants heard several presentations on topics of broad interest to state economists. Presentations were made on the impact of federal legislation on state revenues and the effectiveness of state tax incentives and enterprise zones. Updates were given on the IRS implementation of the North American Industrial Classification System and several multistate tax programs under way.

Economic Forecasts

The conference included several presentations by major forecasting companies on the overall macro economic outlook, regional economic outlook, and international issues affecting the economic outlook.

Cynthia Latta, a senior financial economist with DRI/McGraw-Hill, described the current state of the U.S. economy as the "best in a generation." She noted that every sector is doing well. Consumer sentiment is at the highest since the 1960s, business profits are up, government

revenues at all levels are increasing and deficits decreasing, and low interest rates and inflation are making the Federal Reserve look good.

Through the remainder of 1997, Ms. Latta expects the economy (GDP) to grow by just over 3.0 percent. She forecasts the growth rate to fall to an average of 2.5 percent in 1998. Inflation (CPI) is expected to remain steady over the next 18-months at 2.5 percent, increasing to around 3 percent after 2000. Under two alternative scenarios, the DRI economist forecasts a sharper decrease in the GDP growth rate. A pessimistic outlook has the growth rate falling to near zero in 1998, while a boom-bust scenario (where the federal reserve is late reacting to growing inflation) has the economy entering a recession in 2000.

Peter Jaquette, vice president of World Services with WEFA Group, discussed international issues affecting the economic outlook. He noted how international trade has become an increasingly important sector of the U.S. economy and will see further improvement in 1997 and 1998. This is attributed to the increased competition and the low level of inflation throughout the world economy.

Mr. Jaquette expects the strong growth rate in Latin America and western Europe, and the recovery in the former Soviet Union, to outweigh the slowdown in Pacific and Japanese economies. Japan's growth will slow this year due to fiscal tightening by that government; however, current growth has been stronger than most analysts expected, and economic growth should improve in 1998. The rest of eastern Asia is expected to see a slow recovery. Meanwhile, Latin American countries are expected to see strong growth, with current growth rates of nearly 8 percent expected to continue in some of these countries. Western Europe will see a gradual pick-up in growth. However, the phase-in requirements for the European Monetary Union (EMU) are expected to limit growth and keep unemployment high.

Mark Zandi, chief economist for Regional Financial Associates, pointed out how the U.S. economy has been doing well. The unemployment rate is at a generational low, home ownership at record highs, and medium household income will reach a record high. Indeed, this good economic news is shared by almost everyone with all sectors and all regions seeing strong growth. The only problem areas are the District of Columbia, Hawaii and the areas around Rhode Island. Mr. Zandi then turned his discussion to answering questions on why this phenomena has developed and if it will continue.

Zandi's explanation as to why the current expansion is so widespread is that there is a decrease in the different types of industries across regions. Indeed, an index of business diversity (variability of state job growth during expansions) is at its lowest in four decades. He attributes much of this to new technology, which enables businesses to locate in regions where they never would have gone before. Meanwhile, deregulation and globalization have improved the competitiveness of U.S. businesses. This suggests that regional variation in the costs to businesses will become more important in growth patterns. Thus, the high cost for businesses in California and the northeastern states will lead to below-average job growth, while the low cost in the mountain states will continue to see above-average employment growth. Still, Mr. Zandi reminded the participants that business costs depend on many factors and can change over time.

Other General Session Speakers

Jim Wetzler, with Deloitte and Touche, talked about the tax issues facing state and local policymakers from the deregulation of the electric utility industry. Deregulation will create a dramatic change in the industry with the unbundling of products, as separate companies may provide the generation and the distribution of electricity. Retail choice (wheeling) will become a normal part of buying electricity, similar to what happened in the telephone industry following deregulation. These changes present new challenges to the state policymakers as they try to maintain an equal playing field for the different types of companies without losing revenues.

Mr. Wetzler listed several key issues that will affect state taxation. As competition and industry restructuring improve the efficiency of electric utilities, the resulting price decrease would lead to a decrease in revenues for states with gross receipts based taxes. In addition, the value of the property owned by electric utilities is expected to decline decreasing the amount of property tax revenues collected. States must also address nexus issues since some new producers/sellers of electricity may not have traditional nexus with the state.

He described the efforts of five states—California, New Hampshire, New Jersey, Pennsylvania and Rhode Island—that have studied their electric utility statutes and made various changes to address these issues. California has concluded that no change in the utility tax was needed. New Jersey and New Hampshire have changed from a tax on the utility (seller) to one levied on the consumer of electric services. Pennsylvania has maintained its current tax on the producers of electricity. It will require out-of-state producers to register and pay the state tax, and will adjust the tax rate administratively to maintain revenues. Rhode Island is still studying its tax structure.

Larry Ozanne, an analyst with the Congressional Budget Office (CBO), described his office's analysis of the recent trends in federal revenues. He illustrated how, except for two periods, the growth rates for federal revenues have closely tracked the rates for GDP. The first period of divergence was during the 1970's, when inflation caused revenues to grow faster than the overall economy. The second period was from 1994 through the current year. The first two years can be explained by tax law changes. However, the higher than expected revenue growth in 1996 and 1997 was unexpected.

Mr. Ozanne pointed out that one-third of the error in the CBO revenue forecast can be attributed to a higher-than-expected rate of growth in GDP. He attributes the remaining error to several factors: The rapid growth in the stock market during the past several years has led to an increase in capital gains tax revenues, as individuals cash in on their gains; the National Income Product Accounts may understate economic growth; and finally, there has been an increase in pay to higher income taxpayers, much of it in the form of bonuses and stock options. However, Mr. Ozanne pointed out that CBO does not believe these trends will continue and forecasts a decrease in federal revenue growth to a more normal rate of 3.6 percent in FY 1998.

Keynote Luncheon Speaker

Eugene Steuerle, Urban Institute, gave the luncheon talk to the conference participants. His talk, titled *Financing the American State at the Turn of the Century*, examined the current and historical trends in how governments are financed. He described the current situation as a transition from "growth based financing" to "financing based on reallocation." This new era can be characterized as a "fiscal straitjacket," where funding sources are limited and the estimator has considerable power over the programs enacted.

The 20th century was the most expansive for government growth, with expenditures increasing from only 8 percent of GDP in 1902 to over 40 percent during the 1990s. The greatest expansion in government came in the post WWII period, as the federal government transferred from defense spending to domestic spending. In the '60s, expansion of social security taxes provided much of the growth in government. During the 1970s, inflation provided a steady source of new funding through bracket creep. However, this last source did not last, as a series of tax revolts led to tax cuts and finally indexation of the income tax.

During the 1990s, the primary source of funding for new government programs is other programs. Legislators came under increased pressure to reduce various programs to finance new programs or cut taxes. Indeed, the Tax Reform Act of 1997 was the first to actually reduce tax expenditures. However, this is becoming increasingly difficult as a growing portion of the budget

consists of entitlement programs with built-in growth (cost-of-living increases). Mr. Steuerle believes that the federal government will continue to remain in this fiscal straitjacket, as long as policymakers continue to approve programs with built-in growth.

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/productions and housing. The second session included presentations on states enacting/studying estate tax reform. Presentations were made by representatives from Iowa, Massachusetts, Michigan, and Wisconsin.

Wednesday Morning General Session

In the Wednesday morning general session, participants heard several presentations of general interest to revenue estimators and tax policy analysts. Gillian Spooner, KPMG Peat Marwick, discussed the recently approved Tax Reform Act of 1997 and the implications for state finances. In general, the tax bill is not large in dollar amounts—with a net tax cut of $85 billion over five years—(the 1981 tax cut totaled $750 billion over five years). The major provisions included: $500 child credit, education incentives, a capital gains tax cut, savings incentives, and estate tax relief/reform. While the tax bill is small in dollar amounts, it makes many small changes.

Very little in the tax bill will have a direct effect on state tax revenues. Ms. Spooner cited only four key provisions that would impact states. Because the bill reduces the federal capital gains tax rate, states will not see a revenue loss. However, states will see the gain from an increased rate of realization of capital gains due to the federal tax rate reduction. The expansion of IRAs will have a direct impact on states, since it affects federal AGI. The loss is expected to grow in future years as the new Roth IRAs will exempt the withdrawals from taxation. Estate tax reform will directly feed through to state estate tax revenues, and the tobacco tax increase will cause a decrease in cigarette sales costing states excise tax revenues. In addition, Ms Spooner pointed out how the cumulative effect of the many small changes may also have an impact on states.

Alan Peters, professor at the University of Iowa, discussed tax incentives and their effectiveness. In a review of earlier literature, econometric studies comparing overall tax levels (or amounts of tax incentives) with economic growth found little or no correlation. However, professor Peters pointed out several key problems with many of these studies. Studies looking at various economic incentive programs improperly treated different types of programs in the same way. For example, he noted how these studies do not distinguish grant programs and loan guarantees. Also, some studies looked at state or local level spending/taxes only, which cannot be examined independently.

He (with professor Peter Fisher) built a broad based model of many hypothetical firms, with each making location decisions. The model uses an expert system to give various incentives, simulating the effect of investment, sales exemption, tax increment financing and loan guarantees. The model shows how tax incentives and enterprise zones have been effective at reducing the tax load and improving the rate of return of new businesses. However, the entire benefit typically does not flow through to the businesses due to substitution effects, threshold limits, and other limitations.

David Jordan, with the Internal Revenue Service—Statistics of Income Division (SOI), discussed the current plans implementing the North American Industry Classification System (NAICS). The NAICS system has been developed in cooperation with Canada and Mexico, which will allow direct comparisons between all the countries in North America. It will replace the Standard Industrial Classification (SIC) system, originally developed in the 1930s. NAICS will provide a better method of classifying types of businesses with more detail on service and other industries not well represented under the manufacturing-based SIC system.

The IRS will begin adding the new code to tax forms processed in 1999 (tax year 1998). It will replace the current industrial classification code on all corporation income tax forms, sole proprietorship and partnership returns. The NAICS is a 6-digit code (the SIC is only 4-digits) and may require some reprogramming for states using IRS data. Mr. Jordan noted that the new NAICS Classification manual will be published in several months.

Harley Duncan, Executive Director of the Federation of Tax Administrators, gave an update on two multistate tax policy projects, which state economist need to know about. The NTA—Electronic Communications Tax Project—has been formed to bring industry and tax officials together to develop a uniform and effective way to tax electronic commerce. The steering committee had their first meeting last week and will be developing alternative approaches to taxation. State economists will be asked throughout the process for suggestions and input, and will be required to analyze and estimate the revenue impact of the possible taxation approaches.

Mr. Duncan then discussed the latest results of negotiations between states and the direct marketers. In exchange for some limited level of contact in states, the direct marketers would agree to collect actual state and local taxes under a simplified collections agreement. Several provisions in the agreement could cost states revenue, such as an exemption for shipping and handling, quarterly returns/payments, and others. Revenue estimators will soon be asked to estimate the impact, balancing the potential revenue gain from the mail-order tax collections against any losses from the limited contact businesses.

Breakout Sessions

On Tuesday, conference participants were offered several concurrent breakout sessions. Some of the topics included telecommunications taxation, taxation of electronic commerce, taxation of deregulated industries, capital gains forecasting, using federal databases, welfare reform, managing a research section, and new developments in modeling techniques.

Papers Available

General Session

"The U.S. Economic Outlook: the Best in a Generation," *Cynthia M. Latta, Ph.D*, DRI McGraw Hill (tables accompanying remarks)

"The International Economic Outlook," *Peter Jaquette,* WEFA Group (tables accompanying remarks)

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

Eugene Steuerle, Urban Institute (tables accompanying remarks)

"Tax and Spending Incentives and Enterprise Zones," *Peter S. Fisher & Alan H. Peters*, University of Iowa

"North American Industry Classification System (NAICS)," *David Jordan*, IRS (outline of remarks)

Outlook for Selected Sectors

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

"Housing Outlook," *Robert Prybolsky*, WEFA Group (tables accompanying remarks)

"Retail Outlook," *Carolyn M. Scott*, McCoy, Scott & Company (tables accompanying remarks)

Estate Tax Reform

"Michigan's Experience with Estate Tax Reform," *David Zin*, Michigan Dept. of Treasury (tables accompanying remarks)

"Estimating the Impact of Estate Tax Reform," *Kathy Harpole*, Iowa Dept. of Revenue & Finance
"Estate Tax Reform: The Massachusetts Experience," *Scott Jordan*, Massachusetts Dept. of Revenue

Telecommunications Taxation: Which State Gets the Call?
"Proposal for Uniform Sourcing for Mobile Telecommunications Transaction Taxes," *Arthur Rosen*, McDermott, Will & Emery (principal drafter)
"California Sale of Capital Assets (SOCA) Study" *Phil Spilberg,* California Franchise Tax Board (tables accompanying remarks)

Forecasting Capital Gains Tax Changes
"Forecasting Capital Gains and the Revenue Impact of Federal Proposals to Cut the Capital Gains Tax," *Larry Ozanne*, Congressional Budget Office

Taxation of Electronic Commerce
"Changing Information Technology and State Tax Revenues: A Realistic Appraisal," *Jon M. Peha & Robert P. Strauss*, Carnegie-Mellon University
"Internet Taxation: An Industry Perspective," *Dennis H. Glover*, Deloitte & Touche LLP
"International Tax Issues in Electronic Commerce," *Ned Maguire, Alan Levenson & Dennis H. Glover*, Deloitte & Touche LLP

Creative and New Uses of Federal Data
"Utilizing IRS Data to Increase Taxpayer Compliance and Enhance Tax Revenue Collection," *Yen Chen*, Florida Department of Revenue
"Return Classification Program," *Ken Hochgraf*, Internal Revenue Service

Taxation of Deregulated Industries
"Development of an Equitable, Revenue Neutral Tax Structure for Electric Power and Natural Gas Service Providers," *Mark Muchow*, West Virginia Department of Tax and Revenue
"Changing from Gross Receipts Taxation to Net Income Taxation: Can You Get There From Here?" *Patricia Cohen*, New York State Department of Taxation and Finance
"Electricity Deregulation: Focus on State and Local Taxes" *Earl Goldhammer*, American Electric Power
"Development of a Tax Structure in Response to the Deregulation of Electric and Natural Gas Public Utility Service in Pennsylvania: Giving Power to the People," *Kathleen A. Ross*, Pennsylvania Department of Revenue

Tax Policy Implications of Welfare Reform
"Tax Policy Implications of Welfare Reform in Minnesota: The Minnesota Family Investment Program (MFIP-S)," *Rod Hoheisel,* Minnesota Department of Revenue
"Implicit Tax Rates in Public Assistance Phase-out Formulas," *Thomas Clifford, PhD,* New Mexico Department of Finance and Administration

Managing a Research Section
"Managing a Research Section: Meeting the Information Dissemination Goal," *Laird Graeser*, New Mexico Taxation and Revenue Department

New Developments in Modeling Techniques
"Dynamic Revenue Estimating: Can it Work?" *John Wilkins*, Coopers & Lybrand
"New Developments in Modeling Techniques," *Robert Cline & Eric Cook*, Barents Group (outline and tables accompanying remarks)