BULLETIN

Federation of Tax Administrators • 444 North Capitol Street, N.W., Washington, D.C. 20001 • (202) 624-5890

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48th Annual Conference on Revenue Estimation & Tax Research
(Summary of Proceedings)

To State Tax Administrators:

Summary

The 48th annual FTA Revenue Estimating and Tax Research Conference was held in Birmingham, Alabama on October 24-27, 1993. This bulletin summarizes a number of the papers presented at the conference. Since the proceedings of the conference are not published, readers are asked to contact FTA for papers in which they are interested. A listing of the papers currently available from FTA is appended.

The 48th annual FTA Revenue Estimating and Tax Research Conference was held in Birmingham, Alabama on October 24-27, 1993. Presiding over the conference was Henry Thomassen, Advisor to the Governor in Alabama. Welcoming the participants was George Mingledorff, Acting Commissioner of the Alabama Department of Revenue.

The conference examined important issues facing state revenue estimating and tax research officials today. The major forecasting firms presented their outlook for the U.S. economy as a whole, the geographic regions and various industrial sectors. Participants heard discussions on possible behavioral implications of the recent Federal tax changes and how they are incorporated into the official Federal revenue estimates. Other topics discussed at the conference included economic development incentives, data base development techniques, coping with the Davis refund issue, revenue forecast modeling, tax incidence studies, the role of research in tax compliance activities, and miscellaneous business tax issues. In addition, the attendees were given the opportunity to discuss revenue estimating and research experiences among their colleagues in smaller regional roundtable groups. The final day of the conference saw presentations on various miscellaneous topics, such as the implications of Federal health care reform, school finance reform, the current IRS restructuring plans, and an update on the joint report—*Financing State Government in the 90s.*

Economic Outlook

The conference began with presentations of the economic outlook by the major forecasting firms. Donald Walls, Senior Vice president with DRI/McGraw Hill, gave the overall Macroeconomic forecast. He was followed by Mark Zandi, Chief Economist with Regional Financial Association, who presented the local/regional forecast. The DRI forecast predicts a "half-speed expansion," in which real economic growth remains below three percent for the remainder of 1993. However, Walls expects the rate growth to increase for 1994, when it is expected to exceed three percent. Much of the impetus for this growth will come from pent-up consumer demand as the confidence indicators are slowly improving. Exports, a major factor

behind the growth during the late 1980s, will continue to lag since the rest of the world is growing at a slower rate than the U.S.

Walls warned state forecasters about recent changes in demographics and the structure of the economy, which makes many of the traditional indicators less reliable in the immediate future. He pointed to the recent trends in overall employment as an example. Improvements in manufacturing productivity have translated into growing withholding and sales tax revenues while employment growth has lagged. In addition, the patterns in employment data during the 1990 down-turn differed from previous recessions. This can be attributed to an aging population and the large portion of white collar workers laid-off recently. As a result, state forecasters must examine other sources of data to fully understand future revenue flows. Another change in the economy that he noted was the growing influence of exports. Thus, forecasters must examine international data more closely than they have in the past.

Mark Zandi also sees a modest but steady economic expansion during the next 18 months. Overall, he projects an annual rate of employment growth totaling 1.8 percent in 1994. However, he notes that growth rates in each state will vary from this average. California, Washington and many of the New England states will continue to see sluggish growth in employment. On the other hand, many of the mountain states—Idaho and Nevada—and some sunbelt states—Florida—will see above average rates of growth.

Zandi noted several characteristics of the current economic recovery, which will lead to different regional impacts. They include defense spending cutbacks, higher Federal marginal tax rates, health care reform, internationalization of U.S. markets, low inflation and interest rates, and corporate restructuring. Several states—California, Maine, Mississippi, and Virginia—with a large percentage of state product (GSP) derived from defense spending should expect some depressing economic effects from reductions in the defense industry. The recently approved federal tax bill includes an increase in the top marginal rates, which would adversely affect states with a large portion of high income taxpayers. California, Connecticut, and New York are expected to see net losses from the tax increase. The pending Federal health care changes would also have differing impacts on state economies. States with a high degree of uninsured workers—western states and California—may benefit at the expense of New England and Midwestern states. In addition, pharmaceutical companies and large hospitals are expected to be real losers under any health care reform. This would adversely affect states that have a high degree of concentration in these industries, such as New England and the Midwest.

The DRI and Regional Financial Association economists disagreed on the extent of economic problems facing California. Zandi pointed to the high cost of doing business as a major inhibitor to growth in the state, while Walls noted other factors contributing to the state's slow economy. However, both agreed that after several years of weak economy activity, California will emerge stronger in the latter part of the decade.

Michael Niemira from Mitsubishi Bank noted that any forecast of the retail sector must take into account the changing trends in the industry. He pointed out how the industry is entering a new phase—the information phase. It is characterized by the increasing use of information to target marketing efforts and make use of different means of selling—such as home shopping and mail order. Another trend is the growth of discount retailers who will have slimmer profit margins reducing the level of corporate income tax payments. In general, most retailers are optimistic about the Christmas sales outlook. Niemira pointed out that most early indicators are projecting a strong but not outstanding season. He expects it to lag behind last year's sales, which were rebounding from a weak 1991 season.

While there has been a lot of publicity concerning the weakness in the real estate sector, Stanley Duobinis—Assistant Staff Vice President of the National Association of Homebuilders—

pointed out how the housing market had indeed led the U.S. economy out of a recession. However, he noted that there are large regional differences. The California housing market is still suffering from a weak state economy and overbuilding. Indeed, when California is removed from the total, overall home sales have exhibited a strong rate of growth since January 1991.

Duobinis noted that the current economic conditions are good for housing. Interest rates are at decade lows, housing price increases have moderated, and employment growth has returned. However, other factors must also be taken into account, which will moderate these trends. Consumers' fears about future job security (especially white collar middle managers) and recent Federal tax increases will act to limit growth in the housing market. In addition, other recent tax changes have diminished the investment incentive for housing. Still, Duobinis expects moderate growth in new housing starts. Almost all will occur in the single-family market, as multifamily and commercial building remain depressed.

Richard Lemmon, Director of North American Economics & Industry Analysis with General Motors, discussed the outlook for automobile production and sales. He presented an optimistic forecast, expecting total vehicle sales to reach 14.75 million units in 1994. This is a growth rate of more than ten percent. Supporting this view, Lemmon noted several favorable conditions. They include, continued economic expansion, low interest rates, strong used-car values, healthier consumer balance sheets, and the age of the current vehicle fleets. This must be moderated by the recent increase in Federal income and gasoline taxes, a slow-down in employment and income growth, and rising health care expenditures. In addition, Lemmon pointed to a rise in leasing activity and truck sales as a trend that is expected to continue.

Luncheon Speaker

Harley Duncan, Executive Director for the Federation of Tax Administrators, addressed the conference participants concerning how Research Divisions can better work together. He noted that legislation or issues that arise in one state soon appear later in other states. Research sections are typically asked to do reports that are also required in other states. Thus, there are potential gains by working together and sharing information. FTA can act as a coordinator or (on a limited basis) conduct specific research projects.

Duncan pointed to several tools within the FTA research section that could help facilitate a more cooperative approach. The Research Roundtable provides a forum for state officials to meet periodically in an informal setting and discuss their works, special concerns and past experiences. This forum is also useful for discussions of specific studies in more detail than is commonly found in conference settings. As a result, roundtable participants can talk about detailed methodological solutions to many complicated problems. Another tool available to state researchers is TaxExchange, FTA's electronic communications network. Through TaxExchange, states can poise questions and receive comments faster and more comprehensively than through other means. And finally, the Executive Director noted how this conference has changed over time to meet the specific needs of state research divisions. Recent years have seen more conference presentations on tax policy and specific research needs facing Revenue Departments. This trend is continuing with the planned inclusion of research training sessions in future conferences.

Monday Afternoon

Monday afternoon's session had two speakers who discussed the recent Federal tax changes and the various behavioral effects they expect. William Dow, a Senior Manager with Ernst and Young, summarized some of the key provisions in the Omnibus Budget Reconciliation Act of 1993. He then discussed some of the behavior changes from an accountant's perspective (i.e., what he is advising his clients to do.) He noted that many of the Act's provisions are effective retroactively, which limits the amount of tax planning options available. However, some shifting of income (from one tax period to another) may occur.

Dow noted that the incentives to shifting income differ depending on the status of the taxpayers. For example, the rate changes have led to a lower relative AMT tax rate. As a result, taxpayers who are expected to have an AMT liability would want to accelerate income into 1993 and slow deductions. The opposite would be true for other taxpayers. The increased individual income tax rates have increased the difference between capital gains and ordinary income. This is leading accountants to advise their clients to structure their income taking a larger share in the form of capital gains. Executives subject to the corporate income tax deduction limitation may take a larger share of their income in the form of qualified retirement plans or stock options (both excluded under the act). For corporate taxpayers, Dow noted that some may accelerate certain deductions, but the one percentage point increase in the rate should not lead to any significant behavioral changes. The new Mark-to-Market requirement will cause some change in the taxable income of security dealers. However, the increase in taxable income would be spread over a five year period.

Kathleen O'Connell, staff economist with the Ways and Means Committee, discussed the current Federal revenue estimating process and how behavioral effects are included. She noted that the current Federal estimating process is dynamic (including behavioral effects) at the micro level but not the macro level. Macro level effects are changes to overall macroeconomic variables (i.e., GDP, price levels, etc.). She noted several reasons for excluding macro effects from revenue estimates. Since most tax bills contain many different changes often with conflicting macroeconomic effects, it would be impossible to accurately estimate the total impact. Indeed, O'Connell pointed out how most tax changes are too small to affect a five trillion dollar economy. Also, the complex Federal budget process requires a baseline economic estimate, which is known by all and does not change based on different provisions in the tax bill. However, O'Connell pointed out how Federal revenue estimators typically take into account micro level behavioral effects when the individual directly controls the response. Some examples include, portfolio responses, business compensation types (wages, stock options), business types (S-corp, C-corp), and consumption decisions due to excise rate changes. Indeed, she noted how the individual behavioral affects from limiting deductions for corporate executive pay substantially reduced the overall revenue estimate.

Wednesday Morning

During the final day, the conference participants heard talks on several issues of importance to state revenue estimators. With the Federal health care debate currently before the public, state officials were interested in understanding how these reforms may affect their states. With this in mind, Eric Cook from KPMG Peat Marwick discussed the state tax policy impacts of health care reform. Utilizing a microsimulation model, he discussed the impact of various funding mechanisms for Federal healthcare reform. Since the President's proposal was not released prior to Mr. Cook's talk, he ran the simulation based on five possible revenue options. They included an individual income tax surcharge, repealing social security and Medicare payroll tax cap, increasing federal excise taxes, taxing employers on excess health care expenditures, or taxing employees on excess health care expenditures. He found that repealing the payroll cap was the most progressive while excise tax increases were the most regressive.

Cook also noted how excise taxes are not a stable revenue source to link with health care expenditures. Most excise taxes have been declining due to poor sales during the previous decade. This decline would be exacerbated by higher tax rates. In addition, Federal excise tax increases have a significant negative impact on state tax collections from the same source. He also briefly discussed other commonly cited revenue sources for health care, including VAT taxes, managed competition, and health care provider taxes.

The FTA Executive Director, Harley Duncan, gave a brief update on the progress of the joint revenue report, *Financing State Government in the 90's*. This report was written jointly by the 5 major state organizations dealing with taxation—NGA, NCSL, FTA, MTC, and NASBO. The director told the participants that the report is currently going through the approval process at NGA and NCSL, and will be released in early 1994. The report documents how state officials are facing growing expenditure needs with outdated revenue systems. Most state tax structures were initially enacted several decades ago and have not been modernized to take into account changes in the economy. Some of the major changes over time that state tax systems have failed to address include the shift toward a service economy, the growth of interstate and international markets, new types of business, and the aging of the population. To give policy makers some guidance, the report also lists some policy changes states can take to solve these problems.

With school financing increasingly becoming an important issue in many states, Mark Haas from the Michigan Treasury Department discussed his state's recent attempts at reforming the current finance structure. Following a repeal of all school district property taxes, the state is currently under pressure to restructure its school financing system. In the governor's proposal, Haas pointed out how much of the funding for public K-12 education would shift to the state. The share of funding provided by state sources increase from 34 percent to 88 percent of the total. The state would also implement *charter schools*, establish standards, and create a student performance measure. The increased state funding would be financed by increasing the Single Business Tax (corporate income), a 2 percent increase in the sales tax rate, and other miscellaneous taxes changes.

Howard Ogelsby from the Internal Revenue Service discussed the latest restructuring plans being undertaken at IRS. Just as increased computerization has lead many private sector firms to restructure, TSM (Tax System Modernization) is causing the Service to rethink the way it does business. He noted that the current IRS structure was created during the 1950's and is using a computer system developed in the 60's. Reorganization is expected allow the Service to focus on improving voluntary compliance, increasing taxpayer services and implementing better enforcement programs. The latest plans call for a decentralization of certain activities, while maintaining many of the key central activities needed by state officials.

Ogelsby focused his discussion on the IRS Research and Statistics of Income (SOI) Divisions. Currently, the former is controlled by the compliance section while SOI is under the control of returns processing. The restructuring plan would combine the two under the control of the compliance section. However, SOI will remain as a stand-alone unit functioning much the way it currently does. Ogelsby believes that this arrangement would provide better support for many of SOI's activities. Applied Research, will also remain largely intact to conduct research into artificial intelligence, new systems, and tax gap studies. However, the national compliance research unit will be decentralized, with 30 new local research sites being created. It is thought that this would permit more regional and industry specific research into compliance and would make research data more readily available to tax officials. To support this decentralized approach, the Service is investing in a new data base system at the Detroit computer center to permit easier access to data.

Other Topics

On Tuesday, participants were able to attend several concurrent breakout sessions dealing with special topics on revenue estimating, data generation, and tax policy analysis. One session dealt with state economic development incentives. The talks included a summary of the survey of economic development policy, methodologies for evaluating economic development incentives and estimating the revenue impact of enterprise zones. A session on data base development included discussions on creating a corporation data base (merging various sources) and utilizing a tax processing system for research needs. Various presentations on forecasting and tax analysis models were made in another session. Minnesota gave a presentation on their

new sales tax model, New York City discussed modeling efforts for bank tax allocation changes, and an Iowa professor examined some of the benefits to using Vector Autoregression (VAR) forecast models. Some business tax issues, such as LLC's, measuring the impact of tax incentives when courts declare them discriminatory, and alternative means of taxing corporations were discussed Several tax incidence/burden studies were discussed by Minnesota, District of Columbia, and U.S. CBO officials. A miscellaneous forecasting issues session saw presentations on analyzing the revenue effects of natural disasters, the effectiveness of state revenue forecasts, and analysis of errors in econometric models. A final session examined a new and growing role for tax research sections—compliance activities. In this session, papers were presented on the IRS market segmentation approach to compliance, the New York state sales tax compliance study, and Florida's integration of a revenue opportunity unit within the research section.

Further Information

FTA does not publish the proceedings of the Revenue Estimating and Tax Research Conference. Interested persons may obtain copies of papers presented at the conference from FTA, if a complete paper was submitted. Attached are the papers/tables that can be obtained from FTA. Please contact us if you wish further information on topics mentioned but not listed below. In these cases, we can put you in touch with the presenter.

Sincerely,

Harley T. Duncan
Executive Director

List of Papers

Donald Walls, DRI/McGraw-Hill, *Half-Speed Expansion Calls for Budgetary Caution: An Outlook for the U.S. Economy* (Tables accompanying remarks)
Mark Zandi, Regional Financial Associates, Inc., *The Regional Economic Outlook*, (Tables accompanying remarks)
Michael Niemira, Mitsubishi Bank, Ltd., *The U.S. Retail Sector Outlook: Entering a New Phase of the Cycle*, (Tables accompanying remarks)
Stanley Duobinis, National Association of Homebuilders, *Outlook for Housing and Construction Markets*, (Tables accompanying remarks)
Richard Lemmon, General Motors Corporation, *Outlook for the Automobile Market*, (Tables accompanying remarks)
Eric Cook (prepared by Michael Vlaisavljevich), *State Tax Policy Impacts of Health Care Reform*, (Outline of remarks)
Mark Haas, Michigan Department of Treasury, *School Reform and Funding in Michigan*, (Tables accompanying remarks)
Mark Haas (report from Governor John Engler's Office), *Our Kids Deserve Better—New Schools for a New Century*
Georganna Meyer, Arizona Department of Revenue, *Economic Development Policy*
Edith Brashares, U.S. Department of the Treasury, *Omnibus Budget Reconciliation Act of 1993—Empowerment Zones and Enterprise Communities*, (Outline of remarks)
Bruno Berszoner, Massachusetts Department of Revenue, *Creating Corporate Data Bases*, (Outline of remarks)
Stephen Pollock, KPMG Peat Marwick, *The Minnesota Consumption Tax Model*
Yeang-Eng Braun, Wisconsin Department of Revenue, *Corporate Tax Incentives: Measuring the Impacts When the Courts Find Them Discriminatory*
Laird Graeser, New Mexico Taxation and Revenue Department, *Business Taxes—Quo Vadamus?*
Rod Hoheisel, Minnesota Department of Revenue, *Minnesota Tax Incidence Study—Who Pays Minnesota's Household and Business Taxes*, (Outline of remarks)
Mark Gripentrog, District of Columbia Department of Finance and Revenue, *Comparing Individual Tax Burdens for Taxapayers Residing in the Largest Cities in Each State*
Frank Sammartino, U.S. Congressional Budget Office, *Trends in Federal Tax Progressivity: 1977-1994*, (Tables accompanying remarks)
Michael Lipsman, Iowa Department of Revenue and Finance, *Analyzing the Effects of Natural Disasters on State Revenues—The Floods of 1993*, (Outline of remarks)
Laird Graeser, New Mexico Taxation and Revenue Department, *Theory of Error Decomposition*, (Outline of remarks)
Bill Lefbom, Internal Revenue Service, *Overview of Market Segment Profiling*, Compliance 2000 Communique No. 4
Bill Lefbom, Internal Revenue Service, *Market Segmentation*, (Outline of remarks)
Deborah Bierbaum, New York State Department of Taxation and Finance, *Improving Sales Tax Compliance: The New York State Study*, (Summary of State Report)