MINUTES OF THE MEETING
REVENUE ESTIMATING TAXATION SUBCOMMITTEE
50TH LEGISLATIVE SESSION
HOUSE OF REPRESENTATIVES

January 13, 1987

The meeting of the Revenue Estimating Subcommittee was called to order by Chairman Harp on January 13, 1987, at 5 p.m. in Room 317 of the State Capitol.

ROLL CALL: All members were present with the exception of Rep. Ellison, who was excused, and Rep. Sands, who was absent. Also present was Dave Bohyer, Researcher, Legislative Council.

Chairman Harp introduced staff from the Office of Budget and Program Planning (OBPP), Dave Hunter and Terry Johnson, and from the office of the Legislative Fiscal Analyst, Judy Curtis, Curt Nichols, and Madalyn Quinlan.

REVENUE ESTIMATES: Dave Hunter, OBPP, stated that in 1983 Rep. Ramirez introduced a revenue resolution, which was not heavily used, and then in 1985, Rep. Waldron introduced another, (HR #91), using the governor's estimates as the basis. He advised committee members that Chairman Harp chaired the Revenue Estimating Subcommittee in 1985, whose purpose was to adopt both assumptions and resolutions used to balance the budget in March, 1986. He said the Legislative Finance Committee requested joint OBPP and LFA revenue estimates.

Mr. Hunter stated that former State Senator Bill Mathers chaired the first bi-partisan revenue estimating subcommittee to adopt assumptions. He advised subcommittee members the OBPP has submitted revenue resolutions consistent with those assumptions on page 25 of the Governor's Executive Budget.

MEETING AGENDA: Dave Bohyer provided subcommittee members with a meeting agenda from January 14 through February 16, 1987. He said House Taxation Committee Chairman Jack Ramirez advised the Subcommittee he introduced a bill to make the Subcommittee a standing committee. Mr. Bohyer added that the Subcommittee would attempt to balance the budget, based on all assumptions.

Chairman Harp advised that the Subcommittee would not meet for more than one and one-half hours and would convene at 5 p.m., whenever possible. He said three reports have been requested, one for the 40th legislative day, one when the appropriations bill comes out of committee, and one on the 85th day, to see where revenue is prior to adjustments in matching revenue with expenditures.

Senator Hirsch told subcommittee members he offered an amendment to have the final report come out on the 57th day instead of the 70th day, to allow time for changes.

Chairman Harp advised the Subcommittee that February 14 is the 35th legislative day, which would give the Subcommittee ten days prior to the appropriations bill coming out of that committee.

Dave Bohyer commented that when the Subcommittee reports its bill out, it will have to go through the usual mechanical process, which takes several days.

Chairman Harp told members of the Subcommittee that during the 1985 session, they had a spread sheet containing OBPP and LFA figures, on which subcommittee members added their own projections. He stated he would prefer the Subcommittee pay more attention to what is driving the figures instead of tying into presented figures. He suggested the Subcommittee may want to spend more time on industry, and other issues, rather than the raw figures themselves.

Chairman Harp further commented that last legislative session, the OBPP and LFA rotated making first presentations on issues before the Subcommittee. He stated he would request realistic assumptions without worrying about what each department is doing.

Rep. Williams asked how the OBPP and LFA would like to make their presentations. Dave Hunter replied that Dave Bohyer could format a subcommittee worksheet on a source-by-source basis, as a preventive measure.

Curt Nichols, LFA agreed that a worksheet would help, and said that, in the end of the OBPP and LFA are each asked why their projections differ. He agreed to make an effort to help make the situation better.

Rep. Williams stated he felt confident that the methods used last session would be appropriate for the Subcommittee, and that it would be best to follow the suggestions made by Mr. Hunter and Mr. Nichols.

Dave Bohyer commented that industry works on a CY and not a FY basis, and that the Subcommittee will need to address this.

Curt Nichols advised it might be better to estimate coal, gas, and other revenues on a FY basis. He said the LFA could make some conversions up front from CY to FY, and that his office would work with industry in this area, either directly, or through the Subcommittee.

Terry Johnson, OBPP, stated he took the opposite view, as it would be easier for the OBPP and the LFA to make the necessary conversions for the Subcommittee. As an example, he said oil revenue net proceeds are driven on a CY basis, then converted to a FY basis to project the severance tax. He added that such conversions are not a difficult process.

Curt Nichols commented that Terry Johnson was saying essentially the same thing he had just told the Subcommittee.

Dave Bohyer advised there are benefits to making some assumptions as soon as possible. He commented the assumption could always be changed later on, but those made early would serve as a benefit to other decisions to be made.

ADJOURNMENT: There being no other business before the Subcommittee, the meeting was adjourned at 5:30 p.m.

Representative John Harp,
Chairman

THE IMPACT OF FEDERAL TAX REFORM ON MONTANA AND MONTANANS

An Introductory Presentation to the Committee on Taxation

Montana House of Representatives

by

Dan Bucks, Deputy Director
Montana Department of Revenue

January 8, 1987

This presentation summarizes the impact of federal tax reform on both Montana taxpayers and state revenues including:

* The estimated change in individual income and corporate tax liabilities incurred by Montana taxpayers for both state and federal taxes in 1988.

* The distribution of the change in individual income tax liabilities among taxpayers at different income levels, again for both state and federal taxes in 1988.

* The estimated change in state revenues for Fiscal Years 87, 88, and 89 as a result of federal tax reform.

I will also discuss the procedures involved in making these estimates and some of the primary changes in federal tax law that cause the changes in tax liability.

This is an introductory presentation. I am certain that you will want additional information beyond what is provided here. We want to provide that information, and I would hope that the Department could return to discuss those items at future meetings of this committee.

The information presented here is a refinement of information presented on November 14 and December 13, 1986 to the Revenue Oversight Committee. I will be presenting today a new estimate of the change in federal taxes paid by Montana residents. This new estimate incorporates assumptions about the change in capital gains earned as a consequence of the changes in federal tax law. The old estimate is also presented for comparison.

This same assumption about changes in capital gains had already been worked into the estimates of state tax liability, so those estimates are not affected by this refinement.

<u>Information Behind the Estimates</u>

Three kinds of information are used to make the estimates presented here:

1) Income Information -- how much, what kinds, and how it is distributed among different categories of taxpayers.

2) Tax Law Information -- what changes in law and when.

3) Taxpayer Responses -- what taxpayers do in response to changes in laws to minimize their taxes.

For income, the Department used a database of approximately 45,000 returns for 1984. This database includes 10% of the returns with adjusted gross incomes below $40,000 and 100% of the returns above that level. This database was reviewed for the Revenue Oversight Committee by two Montana economists, Myles Watt of MSU and Maxine Johnson of the U of M, and they certified the database as valid for estimating purposes.

In grouping taxpayers by income level, we use a broad measure of income that includes Montana adjusted gross income plus all income declared on returns that is excluded from taxation. The excluded items that are added to arrive at this income measure include: the excluded portion of capital gains, payments to retirement plans, the marriage deduction, excluded interest, exempt retirement income, and other exempt income reported on returns. We refer to this measure as "expanded income."

We use expanded income for two important reasons:

1) It is a better measure of ability to pay income taxes than other measures available to us, and

2) It does not change significantly as a result of changes in tax law. It is a constant measure against which changes in federal and state tax law can be evaluated. Thus, we avoid comparing apple and orange income.

The changes in tax law used in these estimates are primarily those changes in federal law that will be in effect during 1988. Although portions of the new federal tax law will be phased in through 1991, most provisions are effective in 1988. 1987 is a unique transition year during which fewer portions of federal tax reform will be effective than in later years. Except for the FY 88 estimate of state revenues, the tax law effective for 1987 is not used in these estimates.

Whenever I refer to the term "old law," I will be referring to existing state law and the federal law <u>before</u> tax reform. The term "current law" is used to refer to existing state law and the new federal tax law for 1988.

Taxpayers are expected to change the way they earn or spend their incomes because of the new federal law. Consumers are expected to borrow less in the future because of the phase-out of the consumer interest deduction. Investors are expected to shift from investments in stocks to investments in assets with fixed returns because of the increase in the effective tax rate on capital gains. Other investors are expected to shift out of tax shelters and into investments based on their real economic return.

Overall, these taxpayer responses are expected to be significant and must be anticipated in order to generate reasonably valid estimates.

Taxpayer responses, without exception, operate in one direction: they reduce the level of taxes that taxpayers would otherwise have paid.

For estimates of taxpayer responses, we have relied on the same people that Congress has relied on for their estimates: the Joint Committee on Taxation.

The most important assumption concerning taxpayer responses is the one involving capital gains. The capital gains assumption is critical for two reasons:

1) The repeal of the 60% exclusion of capital gains is one of the largest single changes in taxable income in the new federal law, and

2) The taxpayer response is expected to be among the strongest for the first few years that federal tax reform is effective.

The Joint Committee on Taxation's capital gains assumption is as follows:

> For 1986, capital gains will be 30% higher than in 1985 because of the early sale of assets that would otherwise have been sold in 1987 or later years. For 1987, capital gains income will be 15% lower than in 1985. For 1988 through 1991, capital gains income will be on a recovery growth path that will bring total capital gains to a level in 1991 equal to what they would have been without any federal tax changes.

In summary, for the estimates presented we have used 1984 income data as a base. For "old tax law" estimates we use existing state law and the old federal tax law before reform. For "current law" estimates we use existing state law and the new federal law for 1988. Finally, we use the Joint Committee on Taxation's assumptions of taxpayer responses to the new federal law.

Statistics on Total Impact

On November 14, 1986, the Department presented to the Revenue Oversight Committee the following estimates of the effect of federal tax reform on Montana taxpayers:

IMPACT OF FEDERAL REFORM ON MONTANA TAXPAYERS
CY 1988 Tax Liabilities (Millions of Dollars)

	STATE	FEDERAL	TOTAL
Individuals	$ 37.48	$ (89.12)	$ (51.64)
Corporations	6.09	37.69	43.78
Total	$ 43.57	$ (51.43)	$ (7.86)

In these estimates, overall tax liabilities decline by almost $8 million. Individuals see their combined taxes fall by nearly $52 million, while combined corporate taxes increase by $44 million.

We have recently revised the estimate for federal tax liabilities to incorporate the assumption about the response of taxpayers to the change in capital gains taxation -- the dominant taxpayer response anticipated in the next few years. That assumption was already incorporated in the state tax figure, so that estimate is not changed. The revised estimates are as follows:

REVISED IMPACT OF FEDERAL REFORM ON MONTANA TAXPAYERS
CY 1988 Tax Liabilities (Millions of Dollars)

	STATE	FEDERAL	TOTAL
Individuals	$ 37.48	$(110.31)	$ (72.83)
Corporations	6.09	37.69	43.78
Total	$ 43.57	$ (72.62)	$ (29.05)

With this change in the analysis, the total reduction in state and federal taxes is estimated at $29 million. Combined corporate taxes are still estimated to increase by $44 million, but combined state and federal taxes for Montana residents are expected to decline by $73 million.

Some national experts believe that the taxpayer response to the new federal law will result in even lower levels of capital gains than assumed by the Joint Committee on Taxation. If assumptions advocated by other experts were used, the estimated state and federal taxes would be even lower than indicated above, meaning that the combined taxes for individuals would decrease more than the nearly $73 million listed above. The total decrease for all taxpayers would also be more than $29 million.

The Department's estimates of increased state revenue because of federal tax reform are as follows:

IMPACT OF FEDERAL REFORM ON STATE REVENUES
(Millions of Dollars)

Fiscal Year	Individuals	Corporations	Total
1987	$ 4.40	$ 1.07	$ 5.47
1988	22.58	4.72	27.30
1989	39.83	6.21	46.04
Total	$ 66.81	$ 12.00	$ 78.81
89 Biennium Only	$ 62.41	$ 10.93	$ 73.34

These are the estimates presented to the Revenue Oversight Committee on November 14, 1986. The Revenue Estimating Advisory Council reduced these estimates by 10% in its forecasts of future revenue.

Reasons for the Changes

Federal tax reform generally broadened the base of the corporation and individual income taxes by eliminating or reducing various credits, deductions, and exclusions. In exchange, both corporate and individual income tax rates were reduced. In addition, personal exemptions and standard deductions were increased significantly for individuals. For example, personal exemptions will double to $2,000 per person in 1989.

Although estimated to be revenue neutral at the federal level, the federal tax reform law increases state taxes. This change occurs because Montana's tax law is tied to federal law for the base of its income and corporation taxes, but it is not tied at present to the federal personal exemptions and standard deductions. Nor is Montana tied to the federal rate structure. Because the income base expands, state taxes increase.

The opposite occurred, of course, in 1981 when changes in federal tax law reduced the base of the federal tax as well as Montana's tax base.

The changes in federal law that have the greatest impact on the state taxes paid by individuals are as follows:

1) Repeal of the 60% exclusion for capital gains,

2) Limitations on "passive" losses used to offset ordinary income,

3) Limitations on deductions for nonbusiness interest,

4) Repeal of the investment credit, and

5) Limitations on deductions for IRA's and Keogh retirement plans.

About one-half of the increase in state taxes for individuals is estimated to be attributable to the repeal of the capital gains exclusion alone. It is by far the most significant federal tax reform feature that will affect Montana.

The changes in federal law that have the greatest impact on the state taxes paid by corporations are as follows:

1) Capitalization of certain costs that are currently expensed,

2) Repeal of the investment credit, and

3) Recognition of gains on pledges of installment obligations.

For both individuals and corporations, state tax payments will be reduced slightly because of the liberalization of depreciation deductions for equipment.

<u>Distribution of the Impact Among Individuals</u>

Attached are tables and graphs that summarize the impact on individuals of federal tax reform.

Montana households are divided into ten income groups of nearly equal size. Approximately 28,880 households are represented in each income group.

The statistics represent averages for each group. Within each group, there are taxpayers who will experience either an increase or decrease in taxes and to varying degrees.

There are tables for both the first estimate ("Version I") the Department made of Calendar Year 1988 tax liabilities and the second estimate ("Version II") that is presented today for the first time. Graphs are attached for Version II. Graphs can also be made available for Version I if desired.

Although the statistics indicate a slight increase in taxes for the lowest income group, the majority of taxpayers at this level will actually experience a decrease. The results indicated in the table for this group are attributable, in part, to the fact that the statistics are not adjusted for tax sheltering activities. Consequently, the income of some individuals is understated, and even though their actual income is much higher, they are included. Taxes will increase for individuals investing in tax shelters, and their increases overweigh the decrease in taxes that will occur for most persons in this income group.

Except for this lowest income group, the statistics indicate that the average taxpayer at every income level will see a reduction in combined income taxes.

Version I

CHANGE IN INCOME TAXES : OLD LAW TO CURRENT LAW

		Absolute Change			Percentage Change		
		Graph IA	Graph IB	Graph IC	Graph ID	Graph IE	Graph IF
Total Number of Households	Income Group	Federal Old Law to Current Law	State Old Law to Current Law	Total Old Law to Current Law	Federal Old Law to Current Law	State Old Law to Current Law	Total Old Law to Current Law
28887	$ 3,000	3.23	2.58	5.81	40.61%	27.31%	33.39%
28956	$ 5,500	-49.07	0.45	-48.62	-76.29%	1.27%	-48.80%
28845	$ 8,500	-117.99	3.02	-114.97	-43.67%	3.72%	-32.71%
28846	$ 11,750	-183.12	8.93	-174.20	-31.48%	5.97%	-23.83%
28896	$ 15,750	-223.84	25.77	-198.07	-22.57%	10.03%	-15.86%
28843	$ 20,500	-280.11	46.41	-233.69	-18.11%	11.76%	-12.04%
28926	$ 26,250	-373.17	79.32	-293.85	-16.69%	13.60%	-10.42%
28882	$ 33,000	-475.81	124.70	-351.11	-15.24%	15.17%	-8.90%
28880	$ 43,500	-771.44	199.13	-572.31	-17.41%	17.51%	-10.28%
28877	No limit	-615.81	807.70	191.89	-5.38%	33.04%	1.38%

Estimates of state tax changes include assumptions about taxpayer responses to new federal law.

Estimates of federal tax changes do not include assumptions about taxpayer responses.

Version II

CHANGE IN INCOME TAXES : OLD LAW TO CURRENT LAW

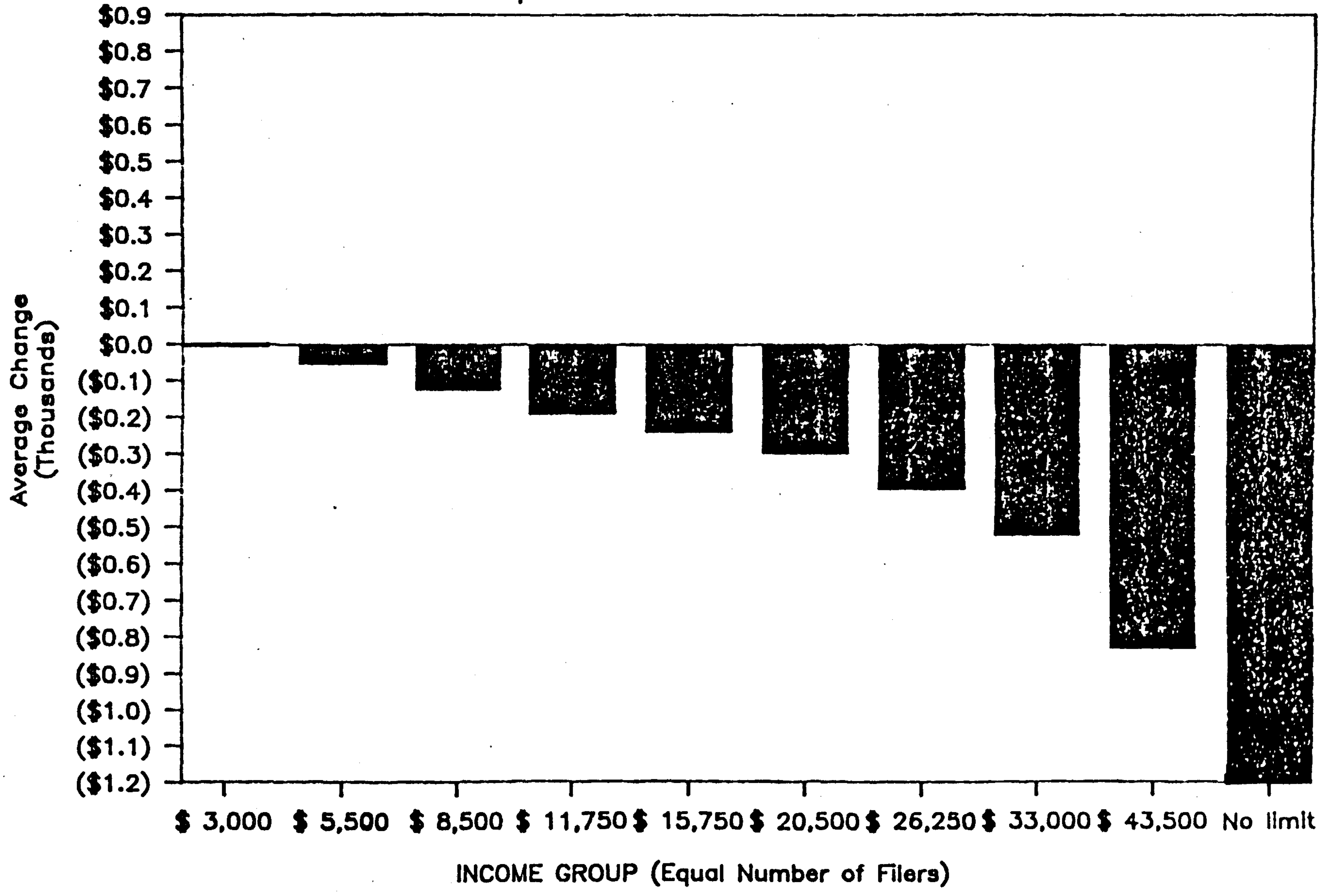
		Absolute Change			Percentage Change		
		Graph IIA	Graph IIB	Graph IIC	Graph IID	Graph IIE	Graph IIF
Total Number of Households	Income Group	Federal Old Law to Current Law	State Old Law to Current Law	Total Old Law to Current Law	Federal Old Law to Current Law	State Old Law to Current Law	Total Old Law to Current Law
28887	$ 3,000	2.77	2.58	5.35	34.83%	27.31%	30.75%
28956	$ 5,500	-49.45	0.45	-49.00	-76.88%	1.27%	-49.18%
28845	$ 8,500	-120.02	3.02	-117.00	-44.42%	3.72%	-33.29%
28846	$ 11,750	-187.15	8.93	-178.23	-32.17%	5.97%	-24.38%
28896	$ 15,750	-235.94	25.77	-210.17	-23.79%	10.03%	-16.83%
28843	$ 20,500	-295.14	46.41	-248.72	-19.08%	11.76%	-12.81%
28926	$ 26,250	-391.31	79.32	-311.99	-17.50%	13.60%	-11.06%
28882	$ 33,000	-518.04	124.70	-393.34	-16.59%	15.17%	-9.97%
28880	$ 43,500	-826.73	199.13	-627.60	-18.66%	17.51%	-11.27%
28877	No limit	-1199.73	807.70	-392.03	-10.47%	33.04%	-2.82%

Estimates of state tax changes include assumptions about taxpayer responses to changes in federal tax law.

Estimates of federal tax changes include assumptions about taxpayer responses to federal tax law changes concerning capital gains.

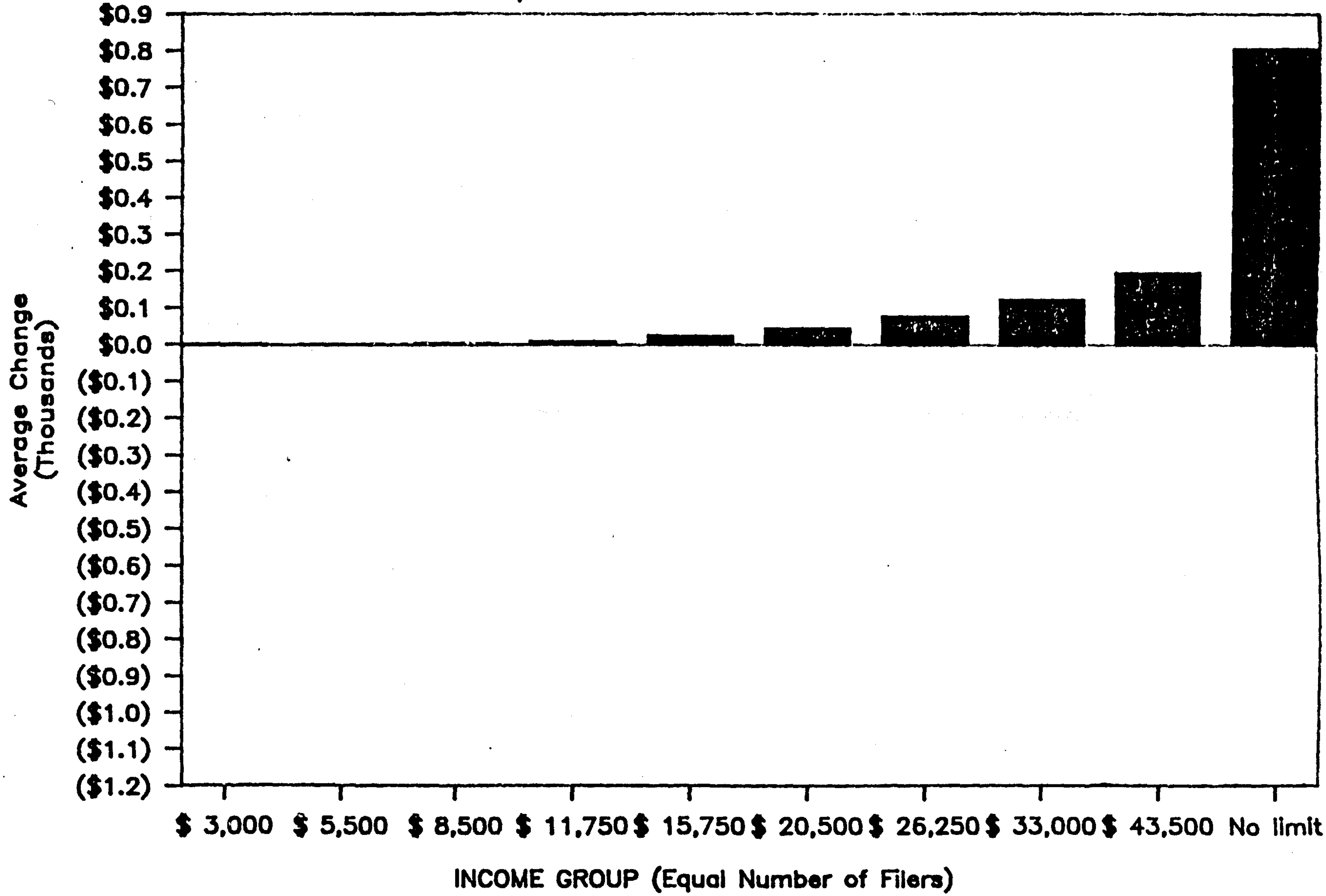
CHANGE IN FEDERAL INCOME TAXES

Graph IIA Old Law to Current Law



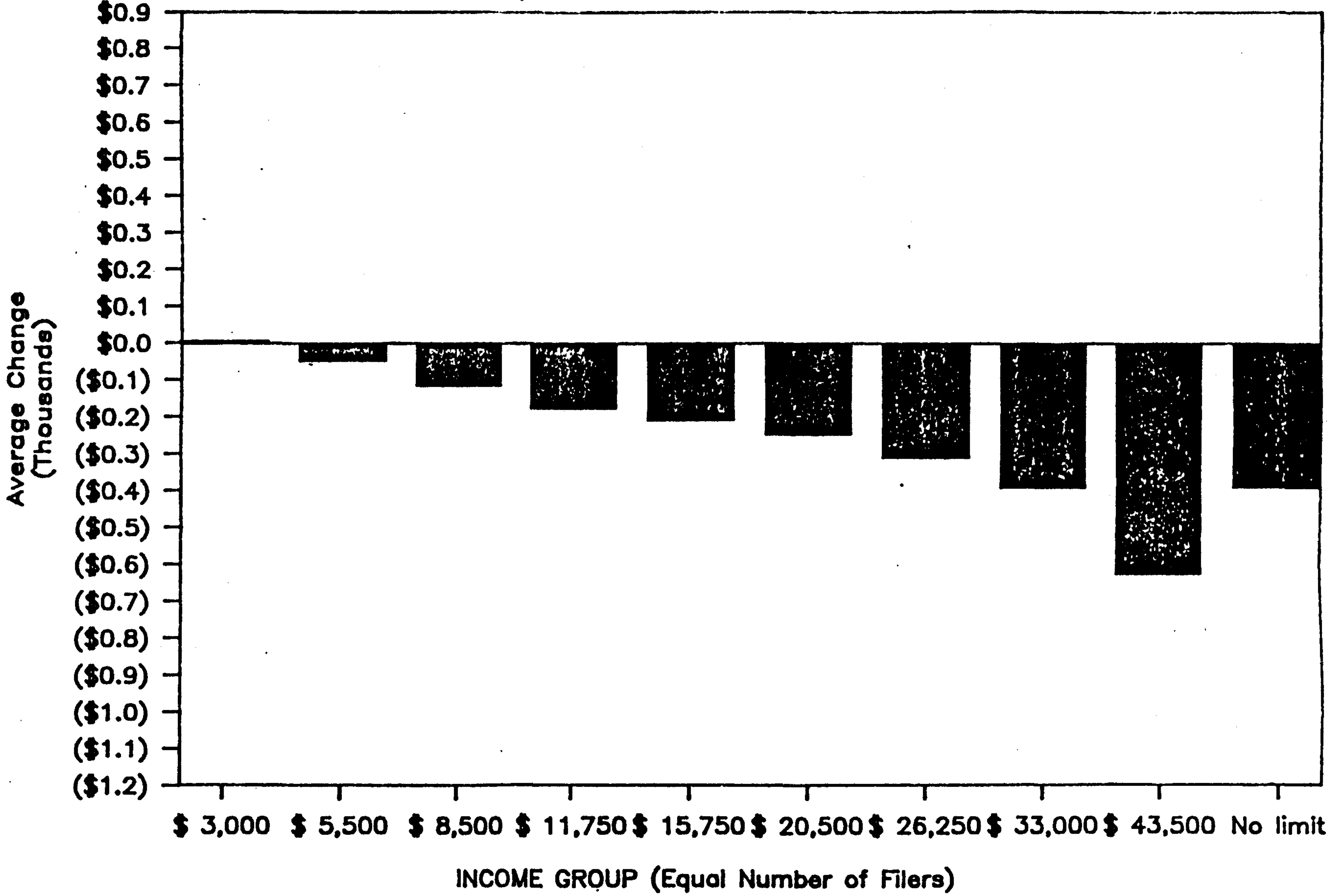
CHANGE IN STATE INCOME TAXES

Graph IIB Old Law to Current Law



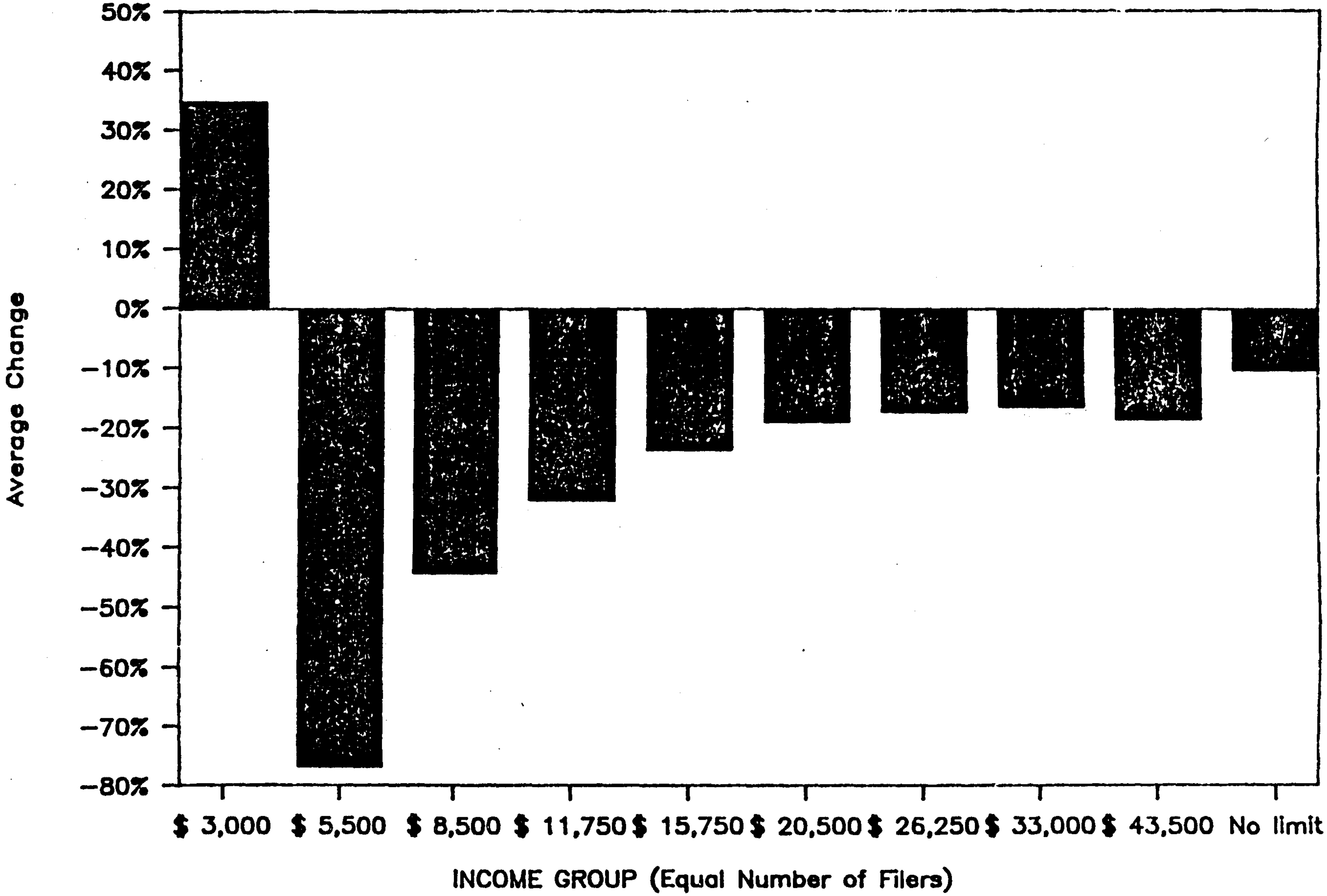
CHANGE IN TOTAL INCOME TAXES

Graph IIC Old Law to Current Law



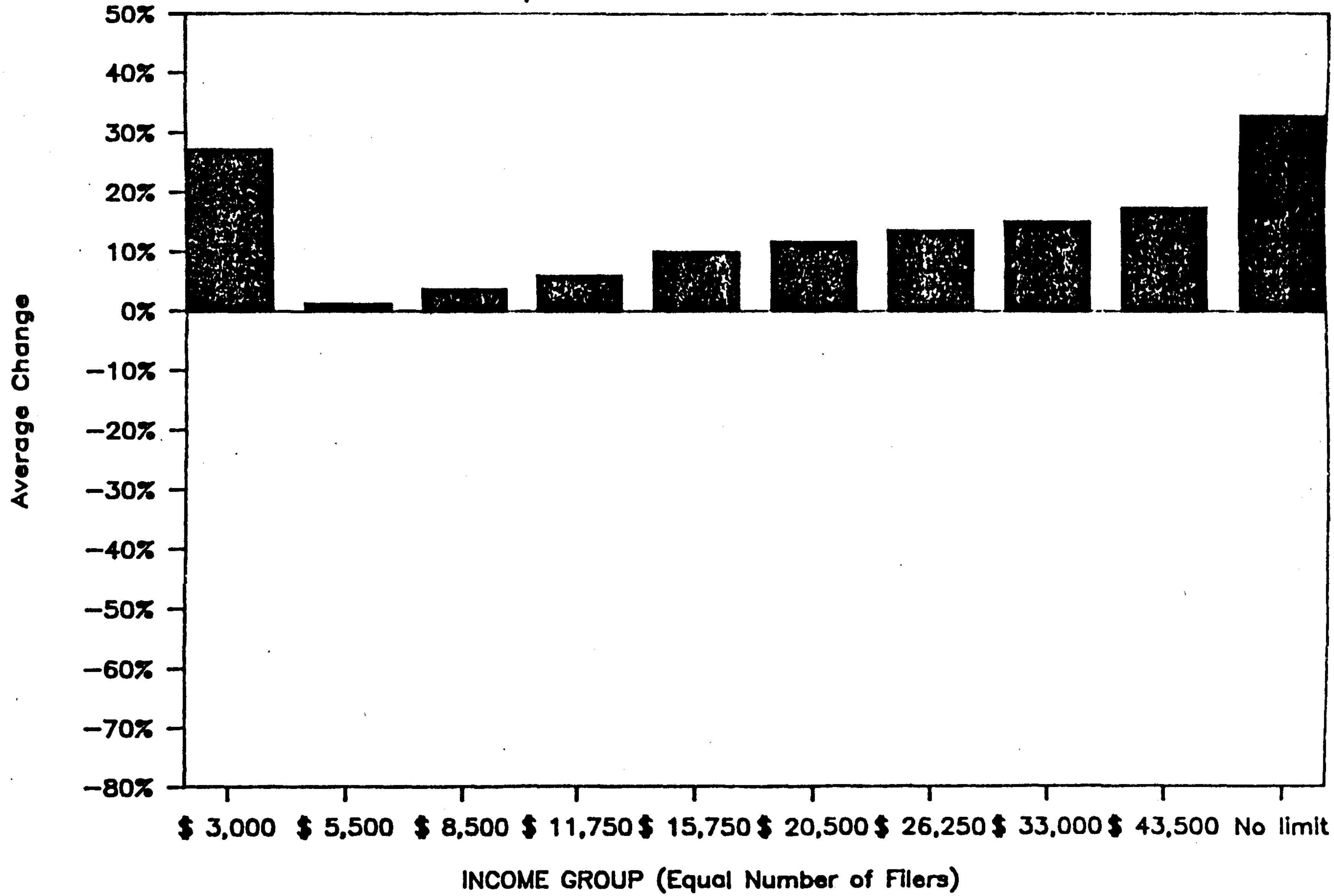
PERCENT CHANGE IN FEDERAL INCOME TAXES

Graph IID Old Law to Current Law



PERCENT CHANGE IN STATE INCOME TAXES

Graph IIE Old Law to Current Law



PERCENT CHANGE IN TOTAL INCOME TAXES

Graph IIF Old Law to Current Law