Tax Rate Review Committee November 16, 2017 Room 1003

WATERMEIER: [00:03:51] Hi. Mr. Speaker. I will go ahead and open up the Tax Rate Review Committee meeting. I'm Dan Watermeier, Chair of the Executive Board and typically the Chair of this meeting. I guess we'll go around the room here and introduce ourselves, starting with Senator Smith.

SMITH: [00:04:17] Jim Smith, Chair of Revenue Committee and representing District 14, Sarpy County.

TONY FULTON: [00:04:22] Tony Fulton. I'm the Tax Commissioner and an ex officio member of this committee.

STINNER: [00:04:23] John Stinner, Chairman of the Appropriations Committee. I represent District 48.

SPEAKER SCHEER: [00:04:35] Jim Scheer, District 19, and I'm Speaker of the Legislature.

WATERMEIER: [00:04:38] Helping me today is my clerk, Laura Olson. Appreciate her hard work. And also here today is Mike Calvert with the Fiscal Office. And I'm going to turn it over to Mike Calvert. Welcome.

MIKE CALVERT: [00:04:50] Thank you. Good morning.

WATERMEIER: [00:04:52] Good morning.

MIKE CALVERT: [00:04:54] The Tax-Rate Review Committee statutorily is obligated to meet twice a year, in July and November, in a specified time period. Purpose and the statute that is outlined on the second page of the report is basically I characterize as to give you, the legislative leadership, and a representative of the administration a snapshot of the General Fund financial outlook in the foreseeable future. We generally look to a three- to five-year horizon, depending upon the timing of the meeting. The purpose of this meeting is to bring you up to date with respect to financial changes that have occurred since your last meeting in July. And also there is a requirement in law since 2012 that a report, an annual report, is filed with the Clerk of the legislature. And what that report has consisted of is a copy of your July report, this November report, plus a cover letter that just simply says that it also incorporates the tax incentive report the Department of Revenue publishes periodically. The easiest way probably to track through the events since July actually is to go back to sine die. If you go to page 4 of your report, what this does is it tracks changes to the General Fund financial status. Table 2 is the chronology and it starts with sine die 2017. And you will see in that grayed column three-year total $45.4 million. That is an ending balance projected at the end of the legislative session that was above the minimum reserve. The minimum General Fund reserve is, in this biennial period, a 2.5 percent biennial amount over and above funds available or obligations. And at the time of sine die, we were ahead of that minimum. Since that time, actual General Fund receipts in 2016-17 ended about $34.2 million less. We incorporated an assumed lapse of about $20 million in '17-18. A lapse is just simply that portion of the appropriations from the prior year that expire. It's money that's freed up, flows to the bottom line. Therefore, it shows as a positive. The offset was not sufficient to wipe out the fact that revenues were $34.2 million below, so July 17th, July 2017 Tax Rate Review Committee, you may recall, we reported about $22.8 million above minimum reserve. So in round numbers, we were looking at and an obligated General Fund balance of about $240-plus million, so we were above the 2.5 minimum. OK? Subsequent to that and leading up to this October 4, leading up to the October forecast, revenue forecasts were substantially changed in October of 2017: $100.4 million in the first year and $123.5 million reduced from the then certified forecast, i.e., the sine die estimate of General Fund receipts. So we went to a net negative balance over the minimum reserve, so technically, obviously, we were under it of about $195.7. We always use this November meeting as an opportunity to incorporate the revenue forecast, obviously. That happened in October. But then we also take a look at the budget requests that we have and were received in October. This is a midbiennium, so we have a negligible amount of adjustments compared to our normal budget cycle. But all told, the midbiennium budget requests that we have at this point time total about $22.3 million. So if you were to count that against your fund balance and then include an adjustment to the lapse, back in your previous report we estimated roughly about $20 million worth of lapses and it had to be an estimate because we didn't have finalized data until about August, early September. We have, we anticipate and have confirmed through a very formal process in statute another $19.9 million worth of lapses. So that is, again, resources that free up. So the net bottom line at this point in time per this report, after those adjustments, midbiennium adjustments, and we also have school aid adjustment, we're anticipating that next year's TEEOSA appropriation at this point in time we're anticipating could be lowered by about $19.9 million by operation of the formula and data review done by DAS-Budget, our office, Department of Revenue, and I can't recall. There's someone else that formally goes through and reviews this. So at this point in time it looks like there might be an opportunity to make that adjustment. The one caveat is we always have to wait until December with the annual financial reports from the school districts to be able to get to a more finite estimate. So that number could move some and it has in the past, but hopefully it doesn't. So if you look at the bottom line down after those adjustments, and again it assumes that you fund those requests. That may or may not happen. You know, the $20-plus million that I mentioned, that may or may not happen but we use this as an illustration. So all told, we're short of the minimum reserve for the current biennium by about $173.3 million and the largest single event obviously was the revenue forecast that changed this past October. Right now I would say that based on year to date that the revenue, actual revenues are tracking very close to that revised lower forecast. I mean it matches up pretty well. I must, must point out that one of the significant changes that drove at least our forecast to change was two events. One was we had to reevaluate our capital gains estimate in terms of what that contribution was to personal income. We got base year data that we were able to update after about, oh, an August-September time period, review that, and it substantially changed our base year capital gains, which drags down your future estimates. Because you have a lower base, you assume a certain amount of growth into the years in your forecasts. That subsequently eroded our revenue estimates on that, that particular point. The other thing that I think is really important to mention, and I want, I want to bring this to your attention, is that state finances, state revenue are going to be very, very vulnerable to federal policy, whether it be tax or expenditure, and that is an extreme state of flux. And I will give you the example that I use with the Forecasting Board. When we ran our forecast in April and it became the basis of the subsequent report that we filed with you in July, the economic services in both cases-- we use two national economic services-- anticipated significant federal changes in care, and they characterize it as tax reform. They also, they also indicated in their forecasts that they were including fairly significant changes with respect to infrastructure investment. This was back in April. Subsequent to that, when we ran our forecasts in October, the data releases from the two services changed. One service said that due to the certainty of tax reform, we've removed it completely from our forecast in terms of federal policy changes. The other economic service significantly reduced their assumption in terms of future events in terms of tax policy, and they also made some changes with respect to infrastructure investment. People have been concerned about the movement of forecast. Those two changes, they are instrumental in influencing personal income estimates, wage salary estimates, and a whole host of other economic data that drive our forecast. I can't speak to what Department of Revenue had gone through, but those kinds of changes are very, very significant. And that's one of the biggest risks we have going forward right now is not knowing how that is all going to work out.

WATERMEIER: [00:13:28] I have a question, Mike.

MIKE CALVERT: [00:13:30] Yes.

WATERMEIER: [00:13:30] Does that make the validity of their guesstimation, their models, if they were using tax reform-- I think you mentioned that--

MIKE CALVERT: [00:13:37] Yes.

WATERMEIER: [00:13:38] -- in their estimations, if they've been doing that for years and years and years and all of sudden this year they pull it, I mean does that make it?

MIKE CALVERT: [00:13:44] At least they told us.

WATERMEIER: [00:13:47] That's what they told you.

MIKE CALVERT: [00:13:48] I mean it's right in the write-up of the economic service releases and did they do this monthly, IHS and Moody's. So you have to read the notes to understand what goes into their forecasts. Now the implicit assumption is there is a direct connection in terms of economic activity as a result of tax policy or no tax policy, and then that somehow creeps into our revenue stream. OK? Our revenue model is very, very sensitive to personal income, wage salaries, nonproprietors' income, a variety of income-related measures that we use to help forecast and drive our forecasts for revenues. OK? If those economic services had those assumptions back in April, and I remember an explicit statement that said this is going to be positive for the economy. OK? If that's the case and then one of them removes it, that's a significant event. Now can I trace it dollar for dollar? No, I can't do that. My sole purpose is to draw to your attention that there is a vulnerability here, and we're going to be living with this for a while, in terms of a lot of uncertainty as to what happens in Washington, D.C., how it does or does not creep into our tax code, and how it influences taxpayer behaviors.

WATERMEIER: [00:15:13] Yeah. I appreciate that, what you said there. But two questions on my, my thinking process is, one, they just pulled it and so for that short-term number it's going to be different than when they had it in July.

MIKE CALVERT: [00:15:23] That's what I would argue.

WATERMEIER: [00:15:24] And behind the scenes, I don't know what you guys do as far as how it works with the reports you get and then the Department of Revenue, but I assume there's a lot of trend analysis--

MIKE CALVERT: [00:15:35] Sure.

WATERMEIER: [00:15:35] -- that's in there too. Well, all of a sudden you pull something out like that, I mean it throws it [INAUDIBLE] .

MIKE CALVERT: [00:15:38] The way, yeah, the way a forecast works is as you march through time you add actual revenue data.

WATERMEIER: [00:15:44] Yeah.

MIKE CALVERT: [00:15:44] You add any data that you might have statistically in terms of economic measures. OK? So in terms of a trend component, a lot of that comes from actual results as you move through time.

WATERMEIER: [00:15:57] Right.

MIKE CALVERT: [00:15:57] Because then you build a forecast that basically says what future changes off of that baseline potentially could occur. So, yes, I mean I can't point to dollar for dollar--

WATERMEIER: [00:16:12] Yeah.

MIKE CALVERT: [00:16:12] -- how our forecasts changed because of that change in assumption. But if underlying it was a belief that this was going to be a positive as far as the economy and it was probably going to drive tax receipts, and then when you take it out I can't help but believe there's some vulnerability there. Now the other thing, too, is it doesn't-- I'm not saying that I know for certainty how those future events, if anything happens with respect to tax policy, how it's going to flow through our system because some of them are going to be driven by statutory connections. Something in the federal law will change a tax liability and it may or may not impinge upon our tax system, depending upon what is designed at the federal level. So it's kind of a structural relationship. The other part you have, you have to watch for is behavioral. Changes in tax policy could drive behaviors. I've had one instance where an individual said, well, it may cause tax receipts to improve in the current year because my advice is, from my accountant, that I should accelerate income into this year because I won't have the state and local tax deductions going into the future; whereas, another one says, well, future liability with respect to investment income or capital gains is going to be so much lower in the future if there's tax changes, I'm not cashing out this year, I want to wait until later. So then you shift income that way. So I don't know how that's all going to shake out and that's going to take time.

WATERMEIER: [00:17:47] Yeah. Senator Stinner, you have a question?

STINNER: [00:17:48] Well, actually I think Mike covered it pretty well in terms of behavioral aspects of a change in tax code plus the real change in tax code. We have to deal with both of those uncertainties, and it's hard to measure those things. But I think that, I think that you had a number of deferred capital gains where we were running behind somewhere close to $700 million--

WATERMEIER: [00:18:11] Oh.

STINNER: [00:18:12] -- than normally we would have in capital gains. Now that's $700 million times a tax rate. So it's--

MIKE CALVERT: [00:18:19] Yeah.

STINNER: [00:18:19] -- 20-30-40 million [INAUDIBLE] .

MIKE CALVERT: [00:18:22] And that goes to my first, first comment with respect to how our forecasts have changed is what we have to do is we have to do, calculate a tax liability, but then we have to add factor an estimate on capital gains and then use that to derive an additional tax estimate and how it impacts your main stream. And the data that we had received from the Department of Revenue gave us the opportunity to reevaluate the most recent year base year. And it was clear that capital gains were well below what we had used in our forecast back in April. So part of the decline in the revenue estimate, particularly on individual income, was driven by that change in capital gains. It was a, it was 6, $700 million drop in aggregate gains, not the tax, in the aggregate. So I mean that turns into a fair amount of money with respect to tax liability.

WATERMEIER: [00:19:14] Yeah. Thank you for answering the question.

MIKE CALVERT: [00:19:15] Yeah. Beyond that, the rest of the report really, and I, I mean, this is a little bit different for me. I've never had this kind of a discussion before. But I think the risks are really, really significant because of the uncertainty. And I feel like a little bit, have to defend a little bit how the forecasts behaved this last Forecast Board meeting, because it was, it was driven by some things that were outside of our control, in my estimation. So there's a, I mentioned the TEEOSA adjustment. We'll be able to pick up about $19 million. It's actually two pieces. And I think this kind of gets into the revenue side. TEEOSA and the distribution is a combination of a General Fund appropriation and plus insurance premium. We actually had a decline in estimated insurance premium taxes so that we would have had about a $24 million add, or reduction to the General Fund TEEOSA except for we had to backfill on the loss in insurance premium tax. And I suspect it kind of goes back to you may recall where an insurance company went belly up. I think it was based in Iowa and there was a--

WATERMEIER: [00:20:34] CoOpportunity.

MIKE CALVERT: [00:20:34] Yeah. Yeah. And then there was a safety net fund that was able to backfill in terms of some liabilities. But yet these companies, insurance companies, can then subsequently claim over the next five or six years a tax credit. Well, that's starting to show up. And we saw that on the revenue side and it's starting to materialize on the expenditure side through the TEEOSA formula. So that's the aspect there. I don't know if there's any more questions, anything you'd like to get into with respect to the revenue pattern. Some of this we're going to cover this afternoon at the legislative symposium.

WATERMEIER: [00:21:20] Very good. Questions from committee? Commissioner.

TONY FULTON: [00:21:29] Yeah, I just, Michael covered it, the capital gains lag that we saw in last year. He's adequately covered that. Dr. Tran covered that for us when we finally got information back from the federal government. Recognize that the data that we have with respect to this data that we get from the federal government puts us a year behind revenues that we're reporting. It's a year in lag. So, yeah, there's a great deal of uncertainty. I mean even if we knew what the tax package, even if we knew that a tax package was going to pass and we knew exactly what it was, there's still uncertainty with that because there are behavioral changes that, I mean, I said it the last time we met. We could see an upside surprise with respect to capital gains simply because, I mean next year in April, simply because now people know. The uncertainty of a dearth of knowledge makes it such that people are hanging on to their gains. And when we know what they're going to do, regardless of what they do, then I've seen theories that say we're going to see an upside surprise in April. But at same time, we don't know that, because I've heard the same thing, that you need to, ooh, you don't have a salt deduction. Well, now wait a minute. We might want to capture those gains in this year. I don't know. But the way you can say it is that the beta is very high. The potential to go up or down, it's pretty high. And so I, he covered it. I just want to echo what he's saying.

WATERMEIER: [00:23:03] Thank you.

MIKE CALVERT: [00:23:10] And to follow up, there are safety nets. We have a positive General Fund balance. It is projected to remain positive through most of this year. With the revised forecast, there's some downside risk sometime in April, perhaps running a negative General Fund balance. But on the other hand, we have a substantial Cash Reserve Fund balance. And one of the functions of the Cash Reserve Fund is an automatic safety net. It is an automatic borrowing mechanism that if the General Fund balance runs to negative, you don't have the cash flow, there's an automatic transfer from the Cash Reserve Fund to the General Fund. And when the General Fund becomes liquid enough to pay it back, it's automatically paid back. There's no proactive mechanism, there's no necessity of legislative action. That is an automatic that's been the origins of the Cash Reserve Fund. And through the end of this current fiscal year the Cash Reserve Fund balance is projected to end at about $437.6 million, and it does not decline until the subsequent, following subsequent year or two after that. So in terms of a safety net, you've got a substantial safety net. And we've borrowed against the Cash Reserve Fund before, up to about $60 million for an extended period of time. So it has happened before.

WATERMEIER: [00:24:34] Well, thanks, Mike, for the report.

MIKE CALVERT: [00:24:36] Sure.

WATERMEIER: [00:24:36] At this time are their motions or directions from this body, from the Tax Rate Review Committee? I would ask for, if not seeing none, then I would ask for a motion to direct the Fiscal Analyst for an electronic copy of the annual report to the Legislature, the Governor, as required by statute.

STINNER: [00:24:53] So move.

WATERMEIER: [00:24:54] Motion by Senator Smith, seconded by Senator Stinner. Is there discussion? Call the roll.

LAURA OLSON: [00:24:58] Speaker Scheer.

SPEAKER SCHEER: [00:25:04] Yes.

LAURA OLSON: [00:25:05] Senator Smith.

SMITH: [00:25:05] Yes.

LAURA OLSON: [00:25:07] Senator Stinner.

STINNER: [00:25:07] Yes.

LAURA OLSON: [00:25:08] Senator Watermeier.

WATERMEIER: [00:25:08] Yes. All right. We are adjourned.

MIKE CALVERT: [00:25:12] Thank you.