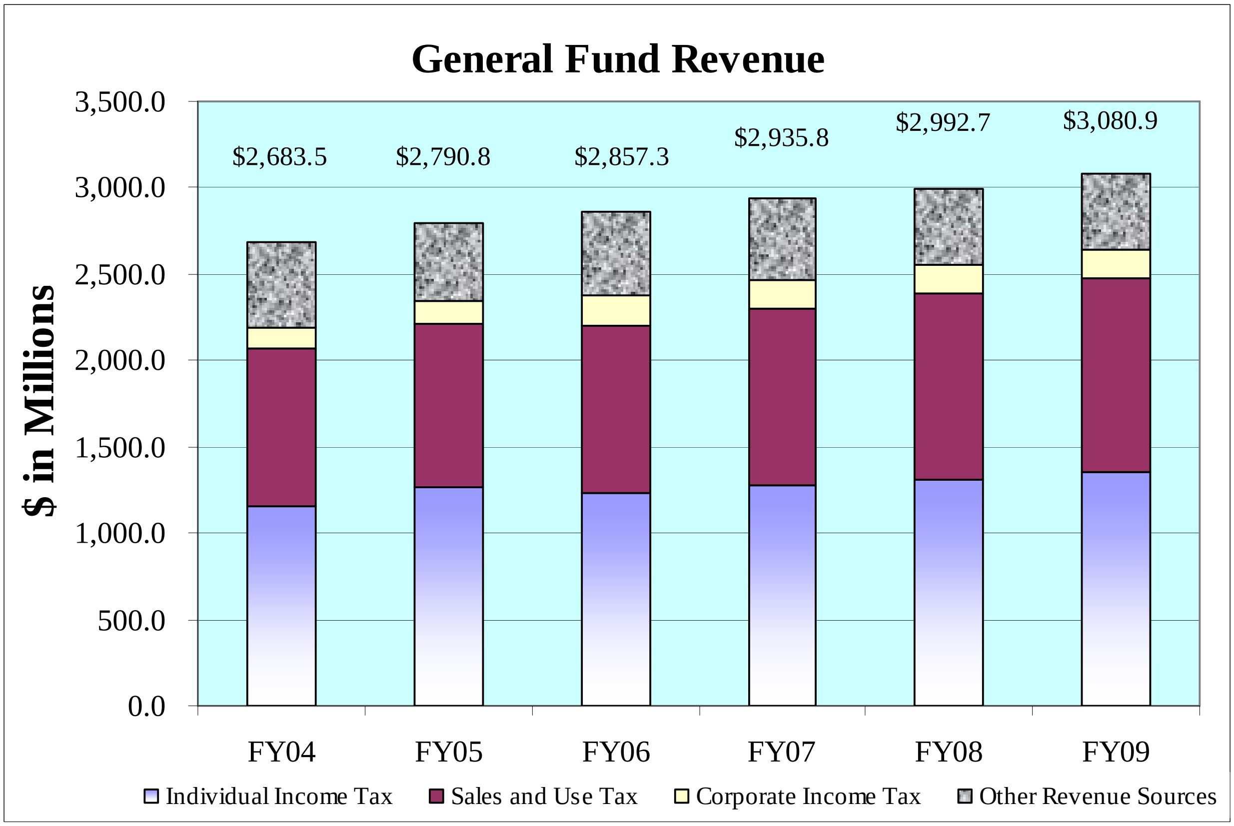
REPORT OF THE MAINE STATE REVENUE FORECASTING COMMITTEE

March 2006



Jerome Gerard, Chair
Acting State Tax Assessor

Dr. James Breece
University of Maine System

Marc Cyr
Office of Fiscal & Program Review

Ryan Low
State Budget Officer

Grant Pennoyer, Director
Office of Fiscal & Program Review

Catherine Reilly
State Economist

Report of the Maine State Revenue Forecasting Committee
March 2006 Forecast

TABLE OF CONTENTS

I. INTRODUCTION AND BACKGROUND TO REVENUE FORECAST

This report represents the conclusion to the winter forecast update for the March 1st statutory reporting deadline of the Revenue Forecasting Committee (RFC). A description of the revenue forecasting process is provided in Appendix F. This report and appendices provide a description of all the key elements of the General Fund and Highway Fund revenue forecasts. In addition to the statutorily required updates of General Fund and Highway Fund, the RFC has recently included forecasts of revenue accruing to the Fund for a Healthy Maine and the dedicated revenue from the Medicaid/MaineCare provider taxes. This updated forecast revises the forecast that was updated in December 2005 and incorporates all enacted legislative changes affecting revenue during the 122nd Legislature to date. The forecast also incorporates the recently revised economic forecast presented by the Consensus Economic Forecasting Commission (CEFC) for its February 1st reporting deadline. The revenue forecasts in this report provide projections through the fiscal year ending June 30, 2009 (FY09). The RFC met on February 23rd for an all day meeting to deliberate and discuss the recommendations of Maine Revenue Services and other revenue analyses.

A. Economic Forecast Update

The March 2006 revenue update began with the winter economic forecast in January. The Consensus Economic Forecasting Commission (CEFC) met on January 27th to review and update its forecast of November 2005, which revised the previous forecast of a year ago upward substantially after Maine avoided some potentially disastrous federal military base closure recommendations. Table I-A below summarizes the incremental change of the CEFC forecast. The full report of the CEFC is included in Appendix D.

TABLE I-A
Consensus Economic Forecasting Commission
Comparison of November 2005 and February 2006 Economic Forecasts

Calendar Years	2005	2006	2007	2008	2009
• Wage & Salary Employment (Annual Percentage Change)					
> Consensus 11/2005	0.8	0.9	0.7	0.8	0.8
> Consensus 2/2006	0.0	0.5	0.6	0.6	0.7
Difference	-0.8	-0.4	-0.1	-0.2	-0.1
• Personal Income (Annual Percentage Change)					
> Consensus 11/2005	5.5	5.5	5.0	5.0	5.0
> Consensus 2/2006	5.0	5.0	4.5	4.5	4.5
Difference	-0.5	-0.5	-0.5	-0.5	-0.5
• Consumer Price Index (Annual Percentage Change)					
> Consensus 11/2005	3.2	2.8	2.5	2.2	2.2
> Consensus 2/2006	3.4	3.0	2.8	2.8	2.8
Difference	0.2	0.2	0.3	0.6	0.6

On January 27th, the CEFC was faced with recent data releases that pointed to slower economic growth. Employment and personal income growth were both adjusted downward to reflect the latest 2005 employment estimates provided by the Maine Department of Labor, and income data through the first three quarters of 2005 from the U.S. Bureau of Labor Statistics. The CEFC raised its forecast for the U. S. Consumer Price index, citing the unexpected persistence of high oil prices, the federal deficit and employment growth at the national level.

B. Capital Gains Forecast

A major variable that is not included in the economic forecast is a projection of net capital gains. Maine's exceptional capital gains growth during the stock market "bubble" of the late 1990's (in excess of 20% annual increases for 5 consecutive years through tax year 2000) came to an abrupt end in tax year 2001, plummeting 54.3%, resulting in a very unpleasant April surprise in 2002. In tax year 2004, Maine received an opposite surprise in April 2005. It is estimated that net capital gains realizations increased by nearly 50% that year, whereas the RFC had assumed they would grow by only 5.5%.

TABLE I-B
Maine Resident - Net Capital Gains

Tax Year	Capital Gains Realizations ($ Millions)	Capital Gains Realizations Annual % Change	Capital Gains Tax Liability ($ Millions)	Capital Gains Tax Liability Annual % Change	Capital Gains % of Resident Tax Liability
1995	$551.7		$38.3		6.2%
1996	$799.7	45.0%	$57.3	49.6%	8.4%
1997	$1,218.7	52.4%	$104.5	82.4%	13.6%
1998	$1,551.0	27.3%	$120.0	14.8%	13.9%
1999	$1,867.2	20.4%	$141.7	18.1%	15.5%
2000	$2,360.4	26.4%	$179.6	26.7%	17.3%
2001	$1,079.3	-54.3%	$74.1	-58.7%	7.6%
2002	$908.8	-15.8%	$59.1	-20.3%	6.1%
2003	$1,066.2	17.3%	$69.5	17.6%	6.8%
2004*	$1,593.2	49.4%	$110.1	58.4%	9.9%
2005*	$1,593.2	0.0%	$108.4	-1.5%	9.4%
2006*	$1,553.4	-2.5%	$104.7	-3.4%	8.7%
2007*	$1,485.0	-4.4%	$99.5	-5.0%	8.0%
2008*	$1,398.9	-5.8%	$92.4	-7.1%	7.2%
2009*	$1,301.0	-7.0%	$83.8	-9.3%	6.3%

** Represent Projections*

The RFC and Maine Revenue Services, like their counterparts in other states and the federal government, have had much difficulty trying to accurately forecast this variable. Maine data is not captured at the state level and may only be accessed through federal tax data. That information is shared with Maine Revenue Services, but it lags by as much as 2 years. Since November 1999, Maine Revenue Services has been required to provide a report on the net capital gains and losses realized by taxpayers filing Maine individual income tax returns. That report is provided to the Legislature through the RFC and is typically included in the RFC's December report. That report (see Appendix E) is included in this report as a result of a delay in Maine's processing of the federal tax data that prohibited including it in the December 2005 report.

Table I-B on page 2 summarizes the current assumptions. The differences from the assumptions included in the December 2005 report are:

- 2003 data have been updated to actual with the most recent federal data;

- 2004 projections (note they are still projections due to filing extensions that will change the data) have been reduced as a result of preliminary data from the IRS; and

- 2005 projections have been lowered from 5.5% annual growth to no growth as one explanation for the small increase in the final payment.

The effect of these changes of assumptions is to lower the percentage of resident tax liability from capital gains each year from tax year 2005 to 2009 (see far right column in Table I-B). This change brings this percentage much closer to the longer term trend, which was the goal of the Revenue Forecasting Committee in its December 2005 forecast. The approach that the RFC used for the December 2005 forecast and this forecast was to adjust this variable so that over the course of the forecast period, the percentage of resident tax liability returns to a longer-term average, factoring out the recent "tech bubble." With the bursting of the "bubble," the extent of the Maine resident individual income tax liability derived from net capital gains had dropped down from its peak in 2000 of 17.5% to a level more in line with historical patterns before the "bubble," in the range of 6% to 7% of tax liability. This resulted in a decrease in net capital gains realizations each year of the forecast.

It is this variable that introduces the greatest risk in the revenue forecast. The other aspect of capital gains realizations that makes it difficult, particularly in Maine, is the fact that these gains are very discretionary and concentrated in the top 4%, or 25,000, of Maine's individual income tax filers. That top 4% accounts for approximately 40% of total individual income tax liability. The RFC again struggled with this vexing variable in this forecast.

C. Corporate Profits

A major variable of the tax models that drives the corporate income tax forecast is corporate profitability. Again, this forecast is not part of the CEFC economic forecast. The RFC used the forecast used by the federal government of before-tax corporate profits. That national forecast calls for 35% growth in calendar year 2005 and relatively flat growth thereafter. Maine is insulated from significant regional variances in corporate profitability as a result of Maine's method of corporate income taxation. For national companies operating in Maine, the amount of corporate income tax due to Maine is calculated by apportioning total profits earned in the continental United States by the amount of business that they conduct in Maine based on sales, payroll and property.

D. Oil Prices

The recent experience in Maine's sales tax collections seemed to demonstrate a substantial effect from variations in oil prices. Sales tax collections dropped below budgeted projections at about the same time as the heating oil season began in the fall of 2004. With the recent tax model updates, Maine Revenue Services has added this variable to the sales and excise tax model so that the model might better capture the effect that oil and fuel price changes have on taxable sales and fuel purchases. Again, relying on Global Insights' November 2005 US economic forecast, the RFC used the assumption that oil prices, which are currently in the $60 per barrel range would fall to approximately $45 per barrel by calendar year 2008. This is consistent with the assumptions of the CEFC.

E. Legislative Changes

The RFC bases the revenue forecast on current law. The December 2005 forecast included all legislative changes through the 122nd Legislature's 2nd Special Session. This forecast does not include the effect of any legislative changes pending in the 122nd Legislature's 2nd Regular Session.

II. OVERVIEW OF REVENUE PROJECTIONS

This section provides a summary of the revenue projections in this forecast. These summaries are supplemented by additional detail in the 3 appendices, which provide summaries of the major categories in each of the funds that have been modified in this forecast. In addition, Appendix G contains the materials presented by Maine Revenue Services on February 23, 2006 to support the forecast recommendations.

A. General Fund

For the General Fund, this forecast results in a partial reversal of the substantial upward revision of the December 2005 forecast. Over the 2006-2007 biennium, this reversal driven by the downward revision to the economic forecast reduces the General Fund revenue by $14.8 million, approximately 9% of the $164.4 million increase recommended by the December 2005 revenue forecast. The downward impact of the economic forecast change on the Individual Income Tax and Sales Tax revenue lines was dampened in the short term by the recognition of positive variances in several revenue sources not as directly tied to the economic forecast, largely the Corporate Income Tax, Estate Tax and the Cigarette Tax lines. In fact, the revenue forecast for FY06 is actually increased in this forecast by $1.4 million. The impact of the February 2006 economic forecast on the Sales Tax line was lessened by the addition of a fuel price variable in the model for the December 2005 forecast. At that time, the committee reduced the revenue estimate for Sales Tax despite a substantial increase in the Personal Income growth assumptions of the November 2005 economic forecast. The downward economic forecast revision that was more pessimistic for each year of the forecast period had a compounding effect on the revenue forecast in future fiscal years. Without the offsets of the FY06 positive variances, the downward revisions grow worse each year. For the 2008-2009 biennium, the downward revisions total $53.0 million, increasing the 2008-2009 structural gap. Table A below provides a summary of the changes for each of the major revenue categories (additional detail of the General Fund changes is provided in Appendix A).

Table II-A General Fund Summary

	FY05 Actual	FY06	FY07	FY08	FY09
Current Forecast	$2,790,845,053	$2,855,420,638	$2,952,015,876	$3,015,653,150	$3,110,929,801
Annual % Growth		2.3%	3.4%	2.2%	3.2%
Net Increase (Decrease)		$1,889,771	($16,173,721)	($22,940,461)	($30,066,929)
Revised Forecast	$2,790,845,053	$2,856,810,409	$2,935,842,155	$2,992,712,689	$3,080,862,872
Annual % Growth		2.4%	2.8%	1.9%	2.9%
Summary of Revenue Revisions by Major Revenue Category					
Sales and Use Tax		($3,060,000)	($5,120,000)	($4,270,000)	($4,940,000)
Individual Income Tax		($10,990,000)	($15,350,000)	($19,530,000)	($27,760,000)
Corporate Income Tax		$9,930,000	$8,850,000	$6,970,000	$8,030,000
Cigarette and Tobacco Tax		$4,500,000	$0	$0	$0
Insurance Companies Tax		($5,000,000)	$0	$0	$0
Estate Tax		$6,019,529	$0	$0	$0
Income from Investments		$2,277,520	$385,512	$1,341,762	$1,341,762
Transfer to Municipal Rev. Sharing		$210,120	$592,620	$875,160	$1,282,840
Other Revenue		($1,997,398)	($5,531,853)	($8,327,383)	($8,021,531)
Total General Fund Revisions		$1,889,771	($16,173,721)	($22,940,461)	($30,066,929)

B. Highway Fund

For the Highway Fund, this forecast decreases the 2006-2007 biennium's budgeted revenue by $5.1 million. In FY06, the committee reversed $3.0 million of a $3.6 million gas tax audit assessment that was recognized in the December 2005 forecast. The forecast also recognizes the effect on the Highway Fund investment earnings of cash balances that have been drained by the budget problems in the Department of Transportation's capital program. Unlike the General Fund, the Highway Fund revenue downward revisions do not worsen over the long run as the higher inflation assumptions of the current economic forecast offset the lower economic growth assumptions as a result of the indexing of fuel tax rates to inflation. The downward revenue revisions for the 2008-2009 biennium total $0.1 million, with the FY09 revenue revision being positive.

Table II-B Highway Fund Summary

	FY05 Actual	FY06	FY07	FY08	FY09
Current Forecast	$326,078,155	$335,352,879	$340,999,732	$346,517,898	$353,462,015
Annual % Growth		2.8%	1.7%	1.6%	2.0%
Net Increase (Decrease)		($4,445,720)	($615,999)	($273,751)	$169,747
Revised Forecast	$326,078,155	$330,907,159	$340,383,733	$346,244,147	$353,631,762
Annual % Growth		1.5%	2.9%	1.7%	2.1%
Summary of Revenue Revisions by Major Revenue Category					
Fuel Taxes		($4,145,720)	($165,999)	$176,249	$619,747
Income from Investments		($300,000)	($450,000)	($450,000)	($450,000)
Total Highway Fund Revisions		($4,445,720)	($615,999)	($273,751)	$169,747

C. Fund for a Healthy Maine (FHM)

The Fund for a Healthy Maine (FHM) was revised significantly downward for the 2006-2007 biennium by the December 2005 revenue forecast, based on an assumed delay in the receipt of tobacco settlement payments pending the outcome of "significant factor proceedings" under the Master Settlement Agreement. There has been no change in that assumption in this forecast. This forecast once again adversely affects the FHM as a result of updated assumptions related to the "Racino" in Bangor. With 3 months of actual revenue data, the committee revised a central assumption about the player payback percentage. That percentage was substantially higher than the 89% required by law and assumed as part of the previous forecast. As a result, the FHM revenue forecast for the 2006-2007 biennium is reduced by an additional $1.1 million. With an additional 6-month delay in the assumed opening of the permanent facility compounding the reduction from the change in the payback percentage the downward reduction for the 2008-2009 biennium is $5.2 million, the impact of these assumptions on the General Fund revenue forecast was offset in the short-term by an increased forecast of the General Fund's 1% share of the total adjusted slot machine income ("coin-in").

Table II-C Fund for a Healthy Maine (FHM) Summary

	FY05 Actual	FY06	FY07	FY08	FY09
Current Forecast	$49,124,793	$43,353,622	$44,409,679	$76,504,714	$78,434,308
Annual % Growth		-11.7%	2.4%	72.3%	2.5%
Net Increase (Decrease)		($335,591)	($720,395)	($2,643,362)	($2,589,850)
Revised Forecast	$49,124,793	$43,018,031	$43,689,284	$73,861,352	$75,844,458
Annual % Growth		-12.4%	1.6%	69.1%	2.7%
Summary of Revenue Revisions by Major Revenue Category					
Racino Revenue		($335,591)	($720,395)	($2,643,362)	($2,589,850)
Total FHM Revisions		($335,591)	($720,395)	($2,643,362)	($2,589,850)

D. MaineCare Dedicated Revenue Taxes

Because of their significant interrelationship with the General Fund budget, the RFC has recently been including a forecast of revenue from the MaineCare dedicated revenue taxes. Those estimates are not being revised in this report, leaving the December 2005 forecast unchanged.

III. CONCLUSIONS

Revenue Change Not as Substantial as Economic Forecast Normally Would Indicate. The RFC was pleasantly surprised at the modest short-term effect of a substantial downward revision in the economic forecast. Actions taken in last December's forecast to add the additional variable in the models to capture the effect of higher fuel prices on consumer spending depressed the estimates of the Sales Tax line last December despite an economic forecast that would normally have driven the estimate of that line substantially upward. The Corporate Income Tax line, which is insulated from significant regional differences, offset the Individual Income Tax reductions. Estate Tax collections have been a pleasant surprise each month this fiscal year as many unusually large estate tax payments have produced positive variances. With the exception of the December and January estimated tax payments, the major lines had, at least in the short-term, been very close to budget under the more optimistic November 2005 economic forecast.

Reversing Revenue Increases Associated With Legislative Changes

In both the December 2005 revenue forecast and this revenue forecast, the RFC found that it had to reverse many revenue increases that were associated with recent legislative changes. The Office of Fiscal and Program Review (OFPR) scores revenue increases associated with legislative changes through the fiscal note process, which works integrally with the revenue forecasting process. OFPR, which has 2 staff members serving on the RFC, noted the unusually large number of these reversals recently. Judicial Fine Revenue estimates from unpaid fines, Correctional Fee revenue, Conservation revenue from park operations changes and revenue from on-line burn permits are some examples of agency revenue increases that were not realized. OFPR will increase its scrutiny of proposed revenue estimates associated with legislation to minimize the number of reversals.

Capital Gains Still Present Substantial Risk

Although the RFC forecast for net capital gains projects significant improvement over the previous forecast, the RFC remains cautious about the unpredictable nature of income from this revenue source. The significant lag in historical data (Federal tax data is often not finalized until a year or more after the close of a tax year) creates great uncertainty. The RFC is assuming that the positive unexplained variance in April 2005 individual income tax was related to a 49.4% increase in net capital gains income in tax year 2004. We will not be able to verify that until late fall of 2006 when all income tax filing extensions have run their course. In Maine, the decisions of a relatively small number of taxpayers can substantially affect individual income tax revenue. The percentage of income tax liability of this higher income group has been increasing in recent years and as a result can create significant volatility in revenue from the individual income tax. In addition to the volatility related to capital gains, the very uncertain global economic and geo-political environment adds the potential for significant "shocks" to the forecast that could significantly affect revenue.

Although the RFC will be closely monitoring the economic situation, the final payments due in April provide the potential for wide swings that cannot be fully anticipated at this time. The RFC expressed caution regarding these April payments.