Governor's Consensus Revenue Estimating Working Group Final Recommendations

October 4, 2016

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Kansas

State of Kansas

Consensus Revenue Estimating Working Group Purpose and Tasks. Per statute, Consensus Revenue Estimates (CRE) are used as the base for the budget developed by the Legislature and Governor. Due to the significant variances between the original estimates and the actual receipts, it has been difficult to develop and maintain a stable budget. As a result, Governor Brownback asked a working group to convene and make recommendations to improve the State's consensus revenue estimates. The tasks Governor Brownback asked the working group to make recommendations on included the following:

- **The consensus revenue estimating (CRE) process.** There are multiple parts to the CRE process with several agencies involved. All aspects of the process need to be reviewed.

- **Tax policy fiscal notes**. The Kansas Department of Revenue develops fiscal notes when there is tax policy proposed by legislation. After each legislative session, the CRE group adds the relevant fiscal notes to the revenue estimates made in April. If the fiscal note is off, the revenue estimates are adversely affected.

- **The tax policy's effect on revenue estimates.** Major tax policy was passed in 2012 with substantial adjustments made in the 2013 and 2015 legislative sessions. Questions have been raised as to whether certain behavior has been incentivized as a result of the tax policy that would create a "leaky faucet" effect and make the development of accurate revenue estimates more difficult. Examples include whether companies are switching their filing status to an LLC, S-Corporation or Sole Proprietorship and/or shielding their income in some way in order to receive the benefit of the zero income tax for these types of businesses.

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Consensus Revenue Estimates Background. The tool used by both the Governor and the Legislature to determine State General Fund revenue is the "consensus revenue estimate" prepared by the Consensus Revenue Estimating (CRE) Group. This estimate is the base from which the Governor and the Legislature build the annual budget. This group is composed of representatives from the Division of the Budget (DOB), Kansas Department of Revenue (KDOR), Kansas Legislative Research Department (KLRD), and one consulting economist each from the University of Kansas, Kansas State University, and Wichita State University.

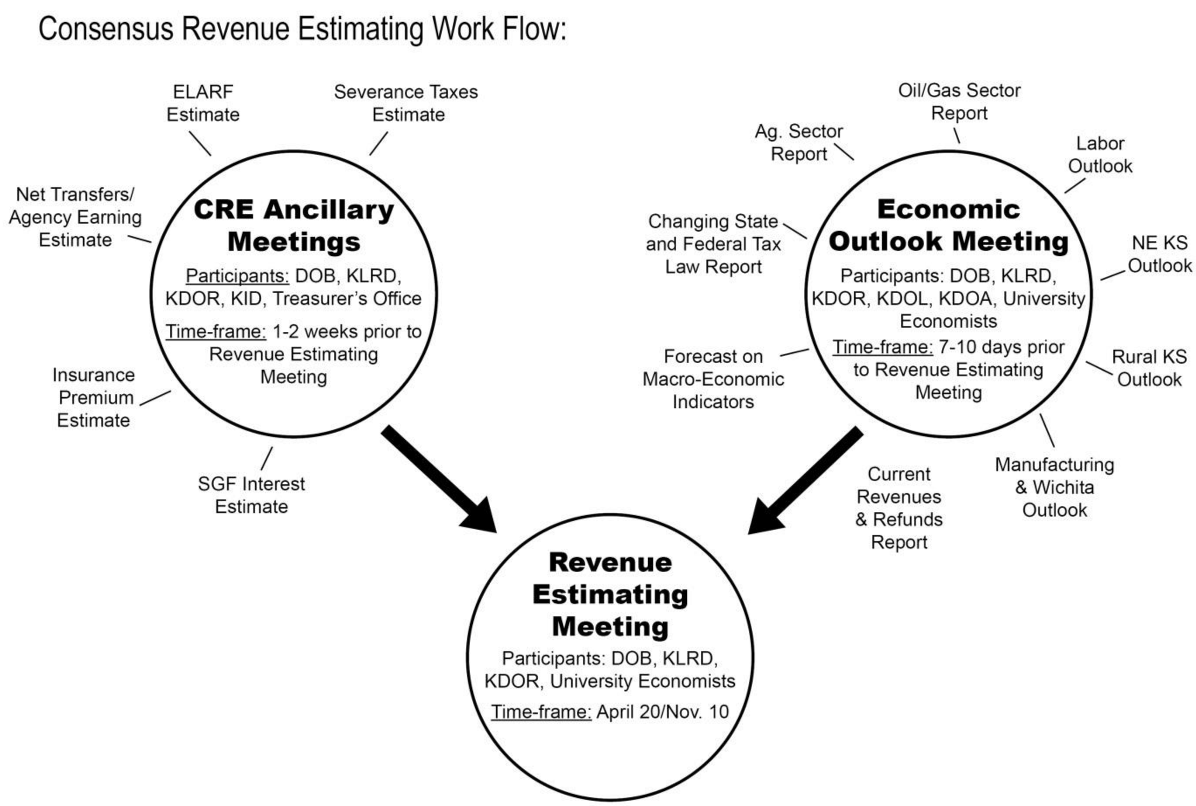
Statutory Requirements. The only statutory requirement for the CRE process is as follows:

75-6701. Joint estimates of revenue to state general fund. (a) On or before each December 4 and on or before each April 20, the director of the budget and the director of the legislative research department shall prepare a joint estimate of revenue to the state general fund for the current fiscal year and the ensuing fiscal year.

(b) If prior to final adjournment of any regular session of the legislature any law is enacted providing for additional or less revenues to be deposited in the state treasury to the credit of the state general fund, the director of the budget and the director of the legislative research department shall prepare a joint estimate of such revenues.

(c) In the event of a disagreement or failure to agree upon a joint estimate of revenue pursuant to subsection (a) or (b), the legislature shall utilize the estimates of the director of the legislative research department and the governor shall utilize the estimates of the director of the budget.

Current CRE Process. The process that the CRE group currently utilizes includes ancillary meetings, an economic outlook meeting and the revenue forecasting meeting.



The ancillary meetings involve staff from KLRD and DOB with staff from other agencies to set the revenue estimates for some of the more minor revenue categories. The expenditure projections are also set for school finance and human services caseloads.

The economic outlook meeting takes place approximately one week prior to the revenue forecasting meeting and all members of the CRE group attend and participate. The economic outlook meeting includes several reports on various economic sectors and regions.

The revenue forecasting meeting includes all members of the CRE group and is where the official estimates are developed. In November, the CRE group estimates revenue for the current fiscal year and also out years. The meeting is required by statute to occur on or before December 4th, but traditionally occurs in early November. In April, the CRE group revises the November estimate. The meeting is required by statute to occur on or before April 20 and traditionally occurs on that date. After the Legislature adjourns, the April CRE is adjusted for legislation enacted after the date of the April CRE meeting. Legislation is required to make any adjustments to the April CRE and adjustments cannot be made for a new interpretation of current law or status of actual receipts.

Each CRE group member develops a confidential estimate of each major tax source for each fiscal year. Each major tax source is discussed individually with each member discussing how estimates were calculated. While all CRE group members participate in the discussion, only the KLRD Director and Budget Director are required to agree on the estimate. If no agreement is reached, then the Legislature would rely on the estimate from KLRD and the Governor would rely on DOB's estimate. This has never happened.

CRE Results. The comparison of receipts to projections for the last three fiscal years is as follows:

Table 1
Total Tax Estimates
(Dollars in Millions)

	FY 2014	FY 2015	FY 2016
Original Estimate (Nov. 2012)	5,555.5		
FY 2014 Actual Receipts	5,632.1		
Original Estimate (Nov. 2013)		5,975.2	
FY 2015 Actual Receipts		5,717.4	
Original Estimate (Nov. 2014)			5,970.6
FY 2016 Actual Receipts			5,758.3
Difference from Original Estimate	76.6	(257.8)	(212.3)
Percent Difference	1.4	(4.3)	(3.6)

Table One provides a comparison of the original estimates made for fiscal years 2014, 2015 and 2016 to the actual receipts for the same fiscal years. Total taxes were 1.4% above the original estimates in fiscal year 2014, 4.3% below the original estimates for fiscal year 2015 and 3.6% below the original estimates for fiscal year 2016.

Table 2
Tax Adjusted Estimates after Tax Legislation Passed
(Dollars in Millions)

	FY 2014	FY 2015	FY 2016
Legislative Adjustments (June 2013)	5,873.3		
FY 2014 Actual Receipts	5,632.1		
Legislative Adjustments (June 2014)		6,034.5	
FY 2015 Actual Receipts		5,717.4	
Legislative Adjustments (June 2015)			6,223.0
FY 2016 Actual Receipts			5,758.3
Difference from Original Estimate	(241.2)	(317.1)	(464.7)
Percent Difference	(4.1)	(5.3)	(7.5)

Table two provides a more accurate picture of revenue estimating results as it includes a comparison of the actual receipts to the total tax estimates made following tax policy adjustments. Following the legislative session, the fiscal notes for tax legislation passed are added to the consensus revenue estimates completed in April. This comparison shows that the revenue the budget was based on following major legislative tax adjustments was 4.1% below estimates in fiscal year 2014, 5.3% below estimates in fiscal year 2015 and 7.5% below estimates in fiscal year 2016.

Working Group Methodology. The Governor's Consensus Estimating Working Group convened four meetings to study the State's consensus revenue estimating and to make recommendations on the tasks assigned. The working group met with members of the CRE group and extensively researched best practices in other states. The group also spent much time analyzing data related to consensus revenue estimates, fiscal notes and state tax policy.

Task One: Consensus Revenue Estimating Process Recommendations

The Consensus Revenue Estimating Group has faced a daunting task over the last couple of years of estimating revenue in an environment where tax policy had significantly changed at the same time the Kansas economy faced significant headwinds from the oil and gas and agriculture sectors. The revenue estimates have not been accurate and the process had led to estimates that were 4.1%, 5.3% and 7.5% more than the actual receipts in fiscal years 2014, 2015 and 2016 as shown in table two. The challenging and rapidly changing environment at the state and federal level is why this working group believes that the revenue estimating process should become more sophisticated and able to more accurately reflect inflection points with tax policy and the economy. We offer the following recommendations:

Policy Recommendations

1. **Provide more timely, diverse and accurate information** during the economic outlook meeting and revenue forecasting meeting.
    a. **Utilize outside macro-economic reports** from Moody's Analytics that have been recently purchased in order to augment the economic information currently provided by economists.
    b. **Utilize more industry experts from various sectors** to provide a more diverse economic outlook. Industry experts should include representatives from Kansas CPAs, Kansas bankers and wealth management representatives. Reports from the Kansas City Federal Reserve should also be made available. The Department of Agriculture should incorporate outside feedback into its agriculture sector report.
    c. **Develop a better process for the sharing of information between the Department of Commerce and CRE group.** The group must have a comprehensive understanding of outstanding liabilities and tax incentives.
    d. **More information and analysis from KDOR** should be provided to the CRE group prior to the revenue forecasting meeting and should include, but not be limited to, the following:
        a. An industry breakdown of tax receipts that will provide information on trends per industry for the sales tax (vehicles, retail, manufacturing, etc.) and by adjusted gross income brackets for the individual income tax. More information should be provided on regional and county trends for both the individual income tax and sales tax.
        b. Utilize more real time information from year-to-date state tax receipts instead of relying on federal data that is one to two years old. An analysis and comparison of federal adjusted gross income, Kansas adjusted gross income and tax liability should be made to previous years.
        c. A better understanding of changing federal tax policy that may affect state revenue.

2. **Invest in new economic and revenue modeling software**. Most states have one or more special models to track tax collections and forecast tax receipts. Components of the software should include the following:
    a. Utilization of taxpayer data
    b. Exogenous economic variables based on macro-economic forecasts
    c. Micro-simulation models to forecast the major tax sources and the various components within each major tax source
    d. Forecasting models that are assessed against historical data to validate accuracy levels and model sensitivity

3. **Utilize statistical methods to develop a base projection for the major tax sources.** The CRE group has primarily used trend analysis to develop revenue estimates. Most states use time series analysis and/or causal models to develop estimates.

4. **Continue to restructure KDOR to build expertise** and capacity within the Office of Research and Analysis. This is necessary in order for the CRE and fiscal note process to become more sophisticated through the development of statistical methods and use of economic modeling software.

5. **Separate capital gains from the individual income tax forecast and estimate it separately**. Approximately 80% of the individual income tax receipts are payroll withholding taxes. Much of the remaining 20% is capital gains and is a volatile revenue source. The CRE group should consider estimating the income tax capital gains separately and also providing a range for the estimates that could be used during budget and policy decisions.

6. **Change the composition of the CRE group**. Most states utilize economists during their respective economic outlook or macro-economic forecasting process. Fewer states utilize economists during the revenue forecasting process. We recommend putting out a request for proposals (RFP) for one economist for both the economic outlook and revenue forecasting meetings. Utilize the RFP to evaluate respondent's experience with economic forecasting, revenue forecasting and the methods used for both.

7. **Build greater transparency into the CRE process.** Communicate to legislators and the public the following:
    a. Change format of the long memo published after each CRE to make it more transparent. Use a comprehensive report similar to what the state of Indiana publishes and include information on assumptions used during the economic outlook and revenue forecasting meetings. Assumptions published should include, but not be limited to, economic forecasting assumptions, key economic indicators, statistical models used in the forecast, growth rates in out years, historical revenue data for prior years and forecast revenue data.
    b. Change the structure of the monthly SGF revenue report:
        i. Provide an actuals-to-actuals comparison by reporting the monthly actual SGF revenues compared to the actuals from the previous year.
        ii. Monthly estimates (SGF spreads) relating to the official CRE estimate should not be used to avoid trend analysis bias in revising future official estimates by the CRE group.

Statutory Recommendation

1. **Provide flexibility to push the April CRE back to May 1.** By statute, the revenue estimates must be completed on or before April 20. The CRE group has little information about the income tax collections from the mid-April tax filing deadline when they meet on April 20. Pushing the deadline back approximately 10 days would provide the group with a better view of income tax collections for the last quarter of the fiscal year. The revenue estimates for out years are based largely on an expected growth percentage from the current fiscal year. A higher level of accuracy for the current fiscal year, due to a more complete picture of tax deadline receipts, will also improve the accuracy of income tax projections for the out years.

Tax Policy Fiscal Note Background

During the legislative session, DOB staff writes fiscal notes on all legislation prior to the bill's hearing or within seven days of the bill's introduction. DOB staff first figures out which agencies, local governments, or other organizations might be affected by the bill and requests fiscal statements from them using a standard fiscal note response template. The fiscal note responses should be sent to the DOB within three days. State law requires DOB to consult with the League of Kansas Municipalities, Kansas Association of Counties, and the Kansas Association of School Boards, as appropriate, when preparing fiscal notes. All bills that could affect tax policy are sent to the Department of Revenue for a fiscal note response. The Department of Revenue typically sends its fiscal note response to DOB, KLRD, the Revisor of Statutes and directly to the legislative committee that could hold a hearing on the bill. DOB uses the fiscal note response information from the Department of Revenue and other affected agencies to write the official fiscal note that is sent to the legislative committee and published on the Kansas Legislature's website. The Division of the Budget estimates that 500-800 fiscal notes are prepared during each legislative session, approximately 75-100 fiscal notes dealing with tax legislation.

Statutory Requirements. The statutory requirement for the tax fiscal notes is as follows:

75-3715a. Fiscal notes for certain legislative bills. *Fiscal notes shall be provided for all bills increasing or decreasing state revenues or the revenues of counties, cities and school districts, making state appropriations or increasing or decreasing existing appropriations or the fiscal liability of the state, or imposing functions or responsibilities on counties, cities and school districts which will increase their expenditures or fiscal liability. The director of the budget, or the director's designee, shall consult with the League of Kansas municipalities, Kansas association of counties and the Kansas association of school boards, as appropriate, when preparing such fiscal notes. Not more than seven days following the first reading of any such bill, the director of the budget shall furnish to the committee or committees to which such bill was referred a statement explaining the fiscal effect of such bill. Fiscal notes are required for original bills only and not for amendments.*

The fiscal note, if possible, shall include a reliable estimate in dollars of the anticipated change in revenue, expenditures, or fiscal liability under the provisions of the bill. It also shall include a statement as to the immediate effect and, if determinable or reasonably foreseeable, the long-range effect of the measure. If, after careful investigation, it is determined that no dollar estimate is possible, the note shall contain a statement to that effect, setting forth the reasons why no dollar estimate can be given. Every agency and department of the state is directed to cooperate with the division of the budget in preparation of any fiscal note provided for by this act when, and to the extent, requested by the director of the budget.

No comment or opinion shall be included in the fiscal note regarding the merits of the measure for which the note is prepared.

Task Two: Tax Policy Fiscal Note Recommendations

The development of accurate tax fiscal notes is an important part of consensus revenue estimating accuracy as the fiscal notes are added to the estimates following each legislative session. Similar to the consensus revenue process, the working group believes that the process for tax fiscal note development must become more sophisticated and also provide more transparency and clarity on how the fiscal note is developed. How the fiscal notes are used is inherently a legislative matter. If adopted, we believe these recommendations will improve the quality, relevancy and timeliness of the tax fiscal note information provided by the executive branch to the legislature.

Policy Recommendations

1. **Invest in new software that will develop microsimulations for tax fiscal notes**. Microsimulations is a model that utilizes “micro” level data to simulate a tax change by recalculating each taxpayer’s tax liability on an “as if” basis under a hypothetical set of new tax laws in order to estimate the effect of the hypothetical changes on tax collections.

2. **Redesign tax fiscal notes to be more representative of the information and assumptions used**. Be clear in the fiscal note if there is a limitation of data or basis on which to make assumptions. Included in the assumptions published should be the growth rates used in the out years. The Legislature should understand the fiscal note and challenge the assumptions built into the fiscal note if warranted. The Legislature should request an amended tax policy fiscal note if they believe the assumptions used are flawed. The CRE group should review the assumptions during the bi-annual CRE meetings.

3. **Move tax policy fiscal note development to office of research and analysis at KDOR**. As expertise and capacity is built at KDOR with ongoing research and analysis and new economic and revenue modeling software, the tax policy fiscal notes should become a product of this office.

4. **Involve non-KDOR staff in the review of tax policy fiscal notes**. A first step would be to have DOB and KLRD meeting with KDOR prior to the publishing of the fiscal note for proposed major tax legislation in order to take a broader look at assumptions. A second step could be to involve an outside group such as Kansas Society of CPAs to review the assumptions and receive feedback.

Statutory Recommendation

1. **Consider a statutory change to provide more flexibility to the timeline for development of tax related fiscal notes.** The tax policy fiscal notes have broad implications for the consensus revenue estimates as the fiscal notes are added to the previous revenue estimates after the Legislative session ends. Providing more flexibility allows there to be more analysis and should increase the accuracy of the fiscal notes.

Task Three: Effect of tax policy on consensus revenue estimating

Questions have been raised as to whether certain behavior has been incentivized as a result of the tax policy that would create a "leaky faucet" effect and make the development of accurate revenue estimates more difficult. Based on the data reviewed, we do not believe this is occurring as a result of the tax policy. On the following pages is the data that was reviewed and analyzed to develop this conclusion.

1. Is the number of pass through entities growing due to the implementation of the tax policy?

Table 3
Pass-Through Entities Outlook

	Number of Entities*	Number of W-2's **	Gross Wages
TY 2007	74,648	449,047	$7,093,822,068
TY 2008	77,053	465,665	$8,067,357,464
	3.2%	3.7%	13.7%
TY 2009	78,348	420,814	$7,953,514,696
	1.7%	-9.6%	-1.4%
TY 2010	80,278	469,386	$9,191,452,879
	2.5%	11.5%	15.6%
TY 2011	82,616	508,449	$10,231,458,075
	2.9%	8.3%	11.3%
TY 2012	85,400	536,946	$11,090,310,462
	3.4%	5.6%	8.4%
TY 2013	87,943	579,002	$11,937,866,014
	3.0%	7.8%	7.6%
TY 2014	90,084	605,943	$12,587,097,859
	2.4%	4.7%	5.4%

*Number of entities represents core business and does not include sole proprietorships, partners, shareholders, etc. KDOR has reported 331,173 entities are taking advantage of the small business tax policy.

**Number of W-2's does not represent the number of jobs as there could be multiple W-2's for the same individual or duplicate W-2's.

The tax policy was implemented in tax year 2013. The growth in pass through entities after the tax policy was implemented is consistent with the growth prior to the tax policy change.

2. Are companies filed as C-Corporations switching their filing status to LLCs, S-Corporations or Sole-Proprietorships due to the tax policy?

Table 4
C-Corporations Outlook

	Number of Entities	Number of W-2's *	Gross Wages
TY 2007	30,075	429,587	$11,184,942,564
TY 2008	29,431	426,525	$11,706,742,107
	-2.1%	-0.7%	4.7%
TY 2009	28,810	377,757	$11,219,432,122
	-2.1%	-11.4%	-4.2%
TY 2010	28,532	392,617	$11,946,362,252
	-1.0%	3.9%	6.5%
TY 2011	28,240	412,951	$12,863,710,506
	-1.0%	5.2%	7.7%
TY 2012	28,187	425,951	$13,788,502,128
	-0.2%	3.1%	7.2%
TY 2013	27,532	418,406	$13,365,344,975
	-2.3%	-1.8%	-3.1%
TY 2014	26,949	415,195	$13,220,435,012
	-2.1%	-0.8%	-1.1%

*Number of W-2's does not represent the number of jobs as there could be multiple W-2's for the same individual or duplicate W-2's.

The tax policy was implemented in tax year 2013. The decline in the number of C-Corporation after the tax policy was implemented is consistent with the range of decline prior to the tax policy change.

Table 5

W-2's and Income Associated with "Switchers"

	1	2	3	4	5	6	7	8	9	10
	Number of Entites that switched to Pass-Through Entity**	Share of Switchers	Number of W-2s	Gross Wages	KS Taxable Income earned in the previous year (K120)	Total Corp. Income Tax paid in the previous year (K120)	KS Income of the year (K120S)	Effective Individual Income Tax Rate	Estimated Individual Income Tax Gain	Estimated Impact of Switching
TY 2010	346	1.2%								
TY 2011	353	1.2%	3,766	$104,016,492	$38,825,105	$2,800,197	$46,965,038	3.50%	$1,643,776	($1,156,421)
TY 2012	343	1.2%	4,520	$122,131,255	$28,940,824	$2,076,664	$42,379,942	3.57%	$1,512,964	($563,700)
TY 2013	575	2.0%	8,298	$257,718,045	$57,870,071	$4,008,128	$121,506,896	2.93%	$0	($4,008,128)
TY 2014	369	1.3%	3,393	$126,146,042	$15,761,734	$1,160,407	$35,218,909	2.75%	$0	($1,160,407)

(9) Estimated Individual Income Tax Gain = (7) KS Income of the year x (8) Effective Individual Income Tax Rate

(10) Estimated Impact of Switching = (9) Estimated Individual Income Tax Gain - (6) Total Corporate Income Tax Paid in the Previous year

Column 2 indicates that the number of C-Corporations that have switched to a pass through entity after the tax policy was implemented in 2013 is consistent with the percentage switching prior to the tax policy.