Office of the Legislative Fiscal Analyst

Report to the Executive Appropriations Committee

June 19, 2001

Revenue and Economic Update

Summary

- Revenues for FY 2001 are expected to be lower than originally anticipated by $30 to $46 million.
- The latest TC-23 projects a total FY 2001 shortfall of $46 million.
- Projections for FY 2002 revenue will be more definitive after the June meeting of the Revenue Assumptions Committee. However, any shortfall in FY 2001 will reduce the base for FY 2002 in addition to any other adjustments that might be made.

General Fund

Sales and Use

- Sales tax receipts remain solidly stronger than anticipated in February. The current growth rate shown on the most recent TC-23 is 4.6 percent. This is down from 5.2 percent in the May TC-23 but still stronger than the forecasted rate of 3.8 percent. This stronger rate of growth will contribute to a surplus in the General Fund.
- Despite the general slowdown in the economy, consumers continue to buy nationwide, although analysts anticipate that durable good purchases will slacken.
- Sales taxes have lagged behind the growth observed in income taxes. The growth rates of sales and income taxes are now closer to the historically observed patterns.

Oil and Gas Severance

- High energy prices have encouraged production and exploration for oil and natural gas. The most current TC-23 reports net collections of $41.9 million, which is already well above the adopted amount of $30 million.
- Because energy prices are likely to stay high in the near future, this will continue to be a source of revenue that exceeds adopted amounts.

General Commentary

- Insurance premiums and beer, cigarette, and tobacco collections are slightly less than anticipated amounts.
- Inheritance taxes exceed forecasted amounts.
- Investment income is stronger than estimated.
- Because of sales and severance taxes, the General Fund should have surpluses for FY 2001 and FY 2002.

Uniform School Fund

Individual Income

- Both withholding and final payments lag behind forecasts made during February and will be a major contributor to a deficit in the Uniform School Fund.
- Following a nationwide trend, income taxes total less than expected amounts.
- The robust economy of FY 2000 caused final payments to increase by almost 40 percent over the previous year. This same phenomena also caused withholding to increase by 10.2 percent.
- Decreases in capital gains, bonuses, partnership income, etc. from the exceptional growth in the previous year mean that final payments are down by 10 percent.
- The rate of growth in withholding has steadily decreased by 7.1 percent in February to the current rate of 5.6 percent reported on the most recent TC-23.

Corporate Franchise

- The most recent TC-23 shows that receipts are down approximately 8 percent. This follows the pattern of steady deterioration since the budget was adopted. Receipts were up 13 percent as reported in the February TC-23.
- This pattern is consistent with disappointing earnings reports that have impacted equity markets.
- Recent earnings reports that have adversely affected equity markets also suggest that this will be a continued reason the Uniform School Fund will show a deficit in relation to adopted amounts.

Mineral Production

- Slightly mitigating the disappointing results for personal income and corporate franchise shortfalls are the strong receipts in mineral production.
- The amount anticipated in February was $13 million. The most recent TC-23 shows net receipts of $19.4 million.

General Comments

- A significant shortfall will occur in the Uniform School Fund.
- The revenue from the Olympics will not cause this situation to change.
- Slower, yet steady growth in the economy is the reason for the shortfall.
- A nationwide slowdown could cause this situation to deteriorate even further for FY 2002.

Transportation Fund

- The most current TC-23 reports motor fuel receipts growing at 1.8 percent. The adopted revenues anticipated a growth rate of 3 percent.
- In addition to the lower than expected growth, a $7 to $8 million refund is expected to occur.
- Special fuels receipts are slightly higher than expected.
- Motor vehicle registration receipts are slightly lower than expected.
- The combination of the lower than expected growth rate in motor fuel and the anticipated refund will cause a significant deficit in this fund.

Mineral Lease

- ♦ Consistent with higher mineral production receipts and severance taxes, receipts are much higher than anticipated.
- ♦ A surplus of $10 million or more could occur in this fund.

<u>Spending Limit</u>

The Spending Limit was originally established in 1989 and places an "upper bound" each year on the amount of monies that can be spent from state tax unrestricted revenues. The Spending Limit itself is based on population, inflation, and personal income formulas. These formulas are adjusted up or down for program or service additions or deletions specified in UCA 63-38c-203.

Most state appropriations are subject to the Spending Limit, including, unrestricted appropriations from the Uniform School Fund, General Fund and Transportation Fund. The law does exempt certain types of appropriations from the Spending Limit, such as debt service and financial responsibility taken from another area of government.

The Spending Limit has not been a constraint historically. In recent years, however, Utah's strong revenue performance has caused the "room" under the limit to shrink.

In the 2000 General Session H.B. 194 was passed. The bill takes effect July 1, 2002 (FY 2003) and the result will be to no longer allow unrestricted monies appropriated to the Centennial Highway Fund to be excluded from the appropriations limit calculations. The allowable growth in unrestricted appropriations in FY 2003 is estimated at $201.5 million. . The budget for FY 2002 is $108.4 million under the limit. Unrestricted General and Transportation Fund Centennial Highway Fund monies in FY 2003 are estimated at $221.7 million. Therefore, only $88.2 million will be available for expenditure in FY 2003.

Revenues generally grow by more that $88 million annually. Therefore, the Legislature may choose to implement changes which would loosen the limit. Some ideas to loosen the limit are listed below:

1. Reverse all or part of HB 194, 2000 General Session
2. Exempt transfers out of the Centennial Highway Fund for debt service
3. Exempt one-time appropriations from the spending limit
4. Spend only what is allowable

Federal Tax Changes

Congress recently approved a package which reduces federal taxes for the majority of Americans. Because Utah allows the deduction of 50 percent of federal taxes from state tax liability, when federal taxes are reduced, the amount allowed as a deduction also decreases, which increases the taxable base. Utah also mirrors federal Adjusted Gross Income (AGI) and standard deductions. Therefore, any federal tax changes which decrease AGI or increase standard deductions would decrease Utah's tax base.

A preliminary review and analysis by the Tax Commission of the federal tax changes indicates there could be a loss in state revenues over most of the 10 year implementation period. The loss is potentially as low as $1,000,000 in FY 2002 and as high as $16,600,000 in FY 2007.

A brief description of the federal tax changes follows:

Tax Refunds

The Treasury Department is going to mail taxpayers checks beginning this summer: up to $300 for an individual, $500 for a single parent and $600 for a married couple. Actual amounts are based on income tax liability. The timing of the checks depends on last two digits of an individuals Social Security number, starting with 00 to be mailed July 20. All checks are to be mailed by September 28.

Utah Impact
The IRS will not list the refund credit on the 2001 federal tax form. Hence there will be no change in federal deductibility on state forms and no significant windfall to the state from this provision.

Ten Percent Tax Rate

The new 10 percent tax rate applies to the first $6,000 of taxable income for single people and the first $12,000 for married couples filing jointly. Provisions are effective January 1, 2001.

Utah Impact
This change will increase state revenue because federal tax liability will decrease leading to an increase in state tax liability. The preliminary estimate of this change is an increase of $7,500,000 for the first few years up to $8,600,000 in the out years.

Other Tax Rate Changes

Other rate cuts begin taking effect July 1. The top 39.6 percent rate drops to 35 percent by 2006. Other rates drop gradually through 2006 from 36 percent to 33 percent; 31 percent to 28 percent; 28 percent to 25 percent.

The 5 percent rate remains the same.

Utah Impact
This will increase state revenue because federal tax liability will decrease leading to an increase in state tax liability. The preliminary estimate of this change is an increase of $3,300,000 the first year up to a $12,700,000 in the out years.

Deduction Increases

Income limits on claiming itemized deductions are adjusted upward beginning in 2006.

Utah Impact
This provision will result in a net loss of state revenues. There will be a decrease in revenue because increased deductions on the federal level also increase deductions on the state level. However, since the provision also decreases federal tax liability there will be an increase in state revenue. The loss of revenue begins in FY 2006 at $8,200,000 and increases to potentially $33,800,000.

Child Credit Provisions

The child credit rises from $500 to $600 effective in 2001, meaning it could be claimed on next year's tax forms. The credit increases to $700 in 2005, $800 in 2009 and $1,000 in 2010.

Taxpayers earning more than $10,000 could claim a credit of 10 percent of earnings, rising to 15 percent over time, above that income level. They cannot claim the credit now.

Utah Impact
This provision will increase state revenue because federal tax liability will decrease leading to an increase in state tax liability. The preliminary estimate of this increase is $2,400,000 in FY 2003. This impact will grow each year.

Marriage Penalty Provisions

The standard deduction for married couples will gradually rise beginning in 2005 until it is equal to twice that of single taxpayers.

The 15 percent tax bracket is gradually enlarged beginning in 2005 so it applies to more of a married couple's income, equal to twice that of singles.

The income limit for earned income tax credit is expanded by $3,000, and fully phased in by 2008.

Utah Impact
This will increase state revenue because federal tax liability will decrease leading to an increase in state tax liability beginning in FY 2006. The preliminary estimate of this increase is $640,000 to $1,300,000 depending on the year.

Estate Tax Provisions

The federal tax is fully repealed in 2010.

The top 55 percent rate is immediately dropped to 50 percent, and eventually to 45 percent.
The current $675,000 individual exemption is raised to $1 million in 2002, $1.5 million in 2004, $2 million in 2006, $3.5 million in 2009.

The tax is retained on certain gifts but the rate is reduced to 40 percent.

Utah Impact
The phase out of the federal estate tax in turn phases out the state inheritance tax. When fully phased in the loss to state revenues will be approximately $16,000,000.

Retirement Provisions

Tax-favored contribution limits for individual retirement accounts and Roth IRAs are gradually raised from $2,000 to $5,000 by 2008. There is no change in income limits.

The tax-deferred contribution limits for 401(k)-type plans are gradually increased from $10,500 to $15,000 in 2006.

Utah Impact
This provision will result in a net revenue loss. There will be a decrease in revenue because increased deductions flow through to the state. However, since the provision also decreases federal tax liability there will be an increase in state revenue. The initial estimate of this provision is a loss of state revenue beginning in FY 2002. The loss begins at $1,700,000 and could be as much as $10,400,000 in the out years.

Education

The maximum $3,000 deduction for higher education tuition, is rising to $4,000. This provision is in effect from 2002 through 2005. The deduction is not available for individual taxpayers with incomes above $65,000, or married couples with incomes above $130,000.

The income limitation is raised for deductibility of student loan interest.

The contribution limit for tax-favored education savings accounts is raised from $500 to $2,000.

Utah Impact
These provisions will cause a net loss in State revenues. There will be a decrease in revenue because increased deductions flow through to the state. However, since the provision also decreases federal tax liability there will be an increase in state revenue. The initial estimate of this provision is a loss of state revenue beginning in FY 2002. The loss begins at $3,300,000 and could be as much as $8,400,000 in the out years.

Sunset

Under budget rules, most tax cuts expire on Dec. 31, 2010, unless renewed by a future Congress.