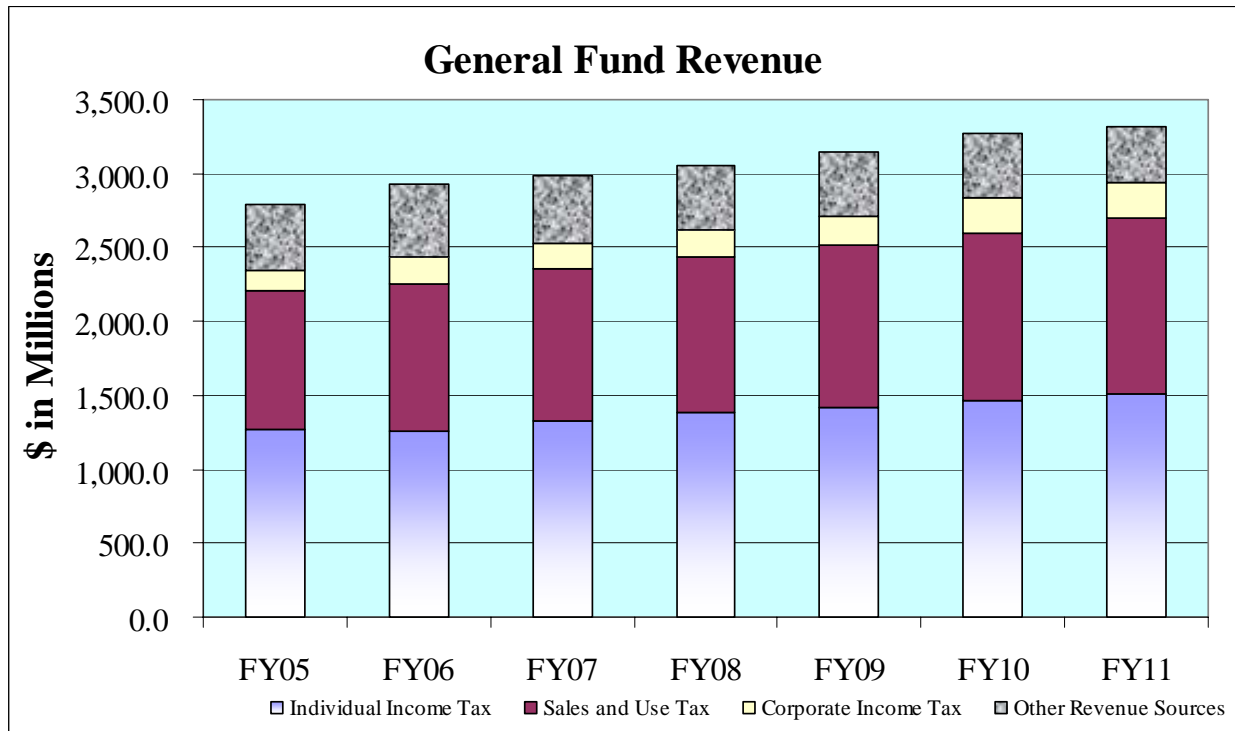


REPORT OF THE MAINE STATE REVENUE FORECASTING COMMITTEE

March 2007



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Report of the Maine State Revenue Forecasting Committee March 2007 Forecast

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I. INTRODUCTION AND BACKGROUND TO REVENUE FORECAST

This report represents the conclusion to the winter forecast 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 forecast incorporates the revised economic forecast presented by the Consensus Economic Forecasting Commission (CEFC) for its February 1st reporting deadline. The RFC met on February 23rd and March 26th to deliberate and discuss the recommendations of Maine Revenue Services and other revenue analyses. The March 26th meeting was timed to allow the RFC to gather additional information about corporate income tax collections after the March 15th filing deadline. The RFC provided a preliminary report prior to the March 1st statutory deadline, but delayed issuing a final report until it had a chance to review the data from the corporate income tax.

A. Economic Forecast Update

The winter revenue update began with the winter economic forecast in January. The Consensus Economic Forecasting Commission (CEFC) met on January 23, 2007 to review and update its November 2006 forecast. After reviewing the most recent economic data, the CEFC forecasted slightly stronger growth in both wage and salary employment and personal income, and slightly lower inflation, as measured by the Consumer Price Index. Table I-A below summarizes the incremental change of the CEFC forecast. The full CEFC report is included in Appendix E.

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

Calendar Years	2006	2007	2008	2009	2010	2011
• Wage & Salary Employment (Annual Percentage Change)						
> Consensus 11/2006	0.5	0.4	0.6	0.8	0.7	0.7
> Consensus 2/2007	0.5	0.7	0.8	0.8	0.7	0.7
Difference	0.0	0.3	0.2	0.0	0.0	0.0
• Personal Income (Annual Percentage Change)						
> Consensus 11/2006	5.2	4.3	4.5	4.5	4.3	4.2
> Consensus 2/2007	5.6	4.3	4.5	4.5	4.3	4.2
Difference	0.4	0.0	0.0	0.0	0.0	0.0
• Consumer Price Index (Annual Percentage Change)						
> Consensus 11/2006	3.5	2.5	2.2	2.2	2.2	2.2
> Consensus 2/2007	3.2	2.1	2.2	2.1	2.1	2.1
Difference	-0.3	-0.4	0.0	-0.1	-0.1	-0.1

The CEFC affirmed its forecast for 2006 wage and salary employment growth to be 0.5%, but increased the estimates for 2007 and 2008 to 0.7% and 0.8%, respectively. The adjustments were based, in part, on stronger than expected preliminary employment figures presented by the Maine Department of Labor (MDOL). In addition, the slowdown in the housing sector was noted as being less severe than originally thought. The commission did not change its job growth forecast for 2009 (0.8%), 2010 (0.7%) and 2011 (0.6%).

Based on new data from the federal Bureau of Economic Analysis (BEA), the commission increased its estimate of 2006 personal income growth from 5.2% to 5.6%, but kept growth rates after that year unchanged.

The CEFC also reduced its inflation estimate for all but one year. New federal data on the prices of goods and services used to measure inflation show that price increases slowed in the second half of 2006. The combination of lower energy costs, higher interest rates and a cooling housing market reduced price pressures. The inflation forecast for 2006 is 3.2%, with future years staying in the 2.1% to 2.2% range.

B. Capital Gains Forecast

A major variable within the tax models that is not included in the economic forecast is a projection of net capital gains. Table I-B on the next page provides a summary of the current assumptions with some historical data. These assumptions remain unchanged from the December 2006 revenue forecast. Starting with the March 2006 forecast, the RFC has assumed that capital gains liability will return to its historical average of approximately 6% of total liability for Maine residents by the end of the forecast period (see far right column in Table I-B).

C. Corporate Profits

A major variable of the tax models that drives the corporate income tax forecast is corporate profitability. Like Capital Gains, this forecast is not part of the CEFC economic forecast. The RFC used Global Insight's February 2007 forecast of pre-tax corporate profits. That national forecast calls for 33% growth in calendar year 2005, 19% growth in calendar year 2006 and relatively flat growth thereafter. Global Insight's February forecast of corporate profits varied slightly from their November forecast which was the basis of the RFC's December revenue forecast. Maine is insulated from significant regional variances in corporate profitability as a result of the State'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.

**Table I-B
Maine Resident - Net Capital Gains**

<u>Tax Year</u>	<u>Capital Gains Realizations (\$ Millions)</u>	<u>Capital Gains Realizations Annual % Change</u>	<u>Capital Gains Tax Liability (\$ Millions)</u>	<u>Capital Gains Tax Liability Annual % Change</u>	<u>Capital Gains % of Resident Tax Liability</u>
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	\$1,069.4	17.7%	\$69.4	17.4%	6.8%
2004	\$1,526.9	42.8%	\$104.9	51.2%	9.2%
2005*	\$1,688.5	10.6%	\$117.0	11.5%	9.8%
2006*	\$1,856.4	9.9%	\$127.6	9.1%	10.1%
2007*	\$1,856.8	0.0%	\$127.8	0.2%	9.8%
2008*	\$1,732.1	-6.7%	\$116.8	-8.6%	8.7%
2009*	\$1,600.9	-7.6%	\$107.3	-8.2%	7.7%
2010*	\$1,486.0	-7.2%	\$95.5	-11.0%	6.6%
2011*	\$1,309.4	-11.9%	\$85.9	-10.1%	5.7%

* Represent Projections

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 energy prices began their steep ascent in the spring of 2005. 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. The forecast of oil prices remains unchanged from the December forecast and relies on Global Insights' November 2006 US economic forecast. While oil prices dropped temporarily to the \$50 per barrel range in the beginning of this calendar year, oil prices have since rebounded back to the \$60 per barrel range. The RFC assumptions remain unchanged that oil prices will increase to \$64 a barrel on average in 2007 then gradually decline to just under \$62 a barrel in 2011. This is consistent with the assumptions of the CEFC.

E. Legislative Changes

The RFC bases the revenue forecast on current law. This forecast includes all legislative changes through the 122nd Legislature and also includes the revenue impacts that were enacted by PL 2007, c.1, the Emergency FY07 Supplemental Budget, which was enacted in mid-February. Table I-E below summarizes the adjustments to budgeted revenue enacted by PL 2007, c. 1.

Table I-E
Summary of 123rd Legislature's Changes - PL 2007, c. 1
General Fund

	FY07	FY08	FY09	FY10	FY11
Individual Income	\$74,237	\$469,647	\$1,006,440	\$994,266	\$603,727
Corporate Income	\$188,755	\$1,127,650	\$2,247,116	\$2,388,947	\$1,531,035
Revenue Sharing	(\$13,413)	(\$83,060)	(\$169,185)	(\$175,927)	(\$111,008)
Other Revenue	\$90,626	\$697,000	\$697,000	\$697,000	\$697,000
Totals	\$340,205	\$2,211,237	\$3,781,371	\$3,904,286	\$2,720,754

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 4 corresponding appendices, which provide descriptions of the major revenue categories that are being modified in this forecast. Appendix G contains the materials presented by Maine Revenue Services on February 23, 2007 to support the forecast recommendations for the major tax categories.

A. General Fund

For the **General Fund**, the revisions, driven primarily by the Corporate Income Tax changes, represent a \$74.3 million decrease of budgeted revenue for the budget period under consideration by this Legislature. The changes to the Corporate Income Tax represent a reversal of a substantial portion of the upward revision that the RFC recommended in its December 2006 forecast. At that time, the indications were that corporate income tax payments were showing very healthy growth consistent with national trends. It now appears that the spike in receipts at the end of FY06 was a timing issue that is being reversed as this fiscal year moves forward. It is important to note that, while Maine's corporate income tax is growing at a slower rate than the nation as a whole, the annual growth rate implicit in this forecast is still a solid 11% between FY05 and FY08. Consistent with most national forecasts, the RFC is forecasting much slower growth in corporate receipts beyond FY08.

Apart from the downward revision to the Corporate Income Tax, the modest changes in the economic forecast resulted in only slight changes to the other categories in the General Fund revenue forecast. However, during the current fiscal year ending June 30, 2007 (FY07), this forecast does represent an unanticipated downward revision for budget decision makers. In addition to the Corporate Income Tax change, Individual Income Tax was adjusted downward by

\$1.5 million for timing issues related to bonus depreciation recapture and \$5.0 million related to additional Business Equipment Tax Reimbursement program expenditures above expectations. The Telecommunications Personal Property Tax (within the Public Utilities Tax category) was adjusted for changes in the valuation of those assets. Income from Investments was adjusted downward by just over \$3.0 million annually to reflect a reduction in cash balances and consequently earnings as a result of utilizing internal borrowing rather than Tax Anticipation Note financing.

These negative adjustments were partially offset by some positive adjustments in the General Fund. Revenue from Liquor Sales and Operations and revenue from Liquor Taxes were adjusted upward as were Racino revenues. Revenue collected by the Department of Health and Human Services was also adjusted upward in each year of the forecast.

The amount of revenue realized by the Milk Handling Fee and the Transfer to the Maine Milk Pool are directly determined by milk prices. Because milk prices are very volatile and difficult to forecast, the committee plans to revisit these revenue sources during each forecast session. These revenue sources were first effective in FY06, but became significant revenue items in FY07 when milk prices dropped. The inverse relationship between milk prices and these revenue sources increased the magnitude of these revenue items. Milk prices are now projected to be higher than the December forecast, resulting in a decline in magnitude and a net positive increase to revenue for these 2 categories.

Table II-A - General Fund Summary

	FY07	FY08	FY09	FY10	FY11
Current Forecast	\$3,020,947,915	\$3,078,691,800	\$3,162,051,521	\$3,265,921,996	\$3,320,959,326
Annual % Growth	3.0%	1.9%	2.7%	3.3%	1.7%
Net Increase (Decrease)	(\$33,736,442)	(\$21,003,856)	(\$19,583,936)	(\$20,190,670)	(\$11,407,826)
Revised Forecast	\$2,987,211,473	\$3,057,687,944	\$3,142,467,585	\$3,245,731,326	\$3,309,551,500
Annual % Growth	1.9%	2.4%	2.8%	3.3%	2.0%
Summary of Revenue Revisions by Major Revenue Category					
Sales and Use Tax	\$0	\$0	\$0	\$0	\$0
Service Provider Tax	\$0	\$0	\$0	\$0	\$0
Individual Income Tax	(\$6,527,000)	\$2,296,000	\$6,824,000	\$7,340,000	\$4,951,000
Corporate Income Tax	(\$27,320,000)	(\$26,460,000)	(\$30,520,000)	(\$31,240,000)	(\$19,240,000)
Cigarette and Tobacco Tax	\$0	\$0	\$0	\$0	\$0
Public Utilities Tax	(\$2,803,254)	(\$1,043,013)	(\$995,603)	(\$948,193)	(\$948,193)
Insurance Companies Tax	\$0	\$0	\$0	\$0	\$0
Estate Tax	\$0	\$0	\$0	\$0	\$0
Prop. Tax - Unorganized Territory	\$0	\$0	\$0	\$0	\$0
Income from Investments	(\$3,047,681)	(\$3,076,000)	(\$3,076,000)	(\$3,076,000)	(\$3,076,000)
Transfer to Municipal Rev. Sharing	\$1,726,197	\$1,256,528	\$1,232,192	\$1,242,800	\$743,028
Transfer from Lottery Commission	\$0	\$0	\$0	\$0	\$0
Other Revenues	\$4,235,296	\$6,022,629	\$6,951,475	\$6,490,723	\$6,162,339
Total Revisions - Increase (Decrease)	(\$33,736,442)	(\$21,003,856)	(\$19,583,936)	(\$20,190,670)	(\$11,407,826)

B. Highway Fund

For the **Highway Fund**, some modest downward revisions in Fuel Taxes resulted from the lower inflation projections in the Consensus Economic Forecasting Commission forecast. The adjustments result in a \$5.0 million downward revision for the 2008-2009 biennium.

Table II-B - Highway Fund Summary

	FY07	FY08	FY09	FY10	FY11
Current Forecast	\$330,757,329	\$340,996,299	\$347,196,520	\$350,245,413	\$356,494,765
Annual % Growth	1.3%	3.1%	1.8%	0.9%	1.8%
Net Increase (Decrease)	\$0	(\$2,100,239)	(\$2,912,734)	(\$2,990,234)	(\$3,643,229)
Revised Forecast	\$330,757,329	\$338,896,060	\$344,283,786	\$347,255,179	\$352,851,536
Annual % Growth	1.3%	2.5%	1.6%	0.9%	1.6%
Summary of Revenue Revisions by Major Revenue Category					
Fuel Taxes	\$0	(\$2,100,239)	(\$2,912,734)	(\$2,990,234)	(\$3,643,229)
Motor Vehicle Registration & Fees	\$0	\$0	\$0	\$0	\$0
Inspection Fees	\$0	\$0	\$0	\$0	\$0
Fines, Forfeits and Penalties	\$0	\$0	\$0	\$0	\$0
Income from Investments	\$0	\$0	\$0	\$0	\$0
Other Revenues	\$0	\$0	\$0	\$0	\$0
Total Revisions - Increase (Decrease)	\$0	(\$2,100,239)	(\$2,912,734)	(\$2,990,234)	(\$3,643,229)

C. Fund for a Healthy Maine (FHM)

The **Fund for a Healthy Maine (FHM)** received modest upward adjustments in revenue projections from additional interest earnings and from the strong performance of the Racino revenue. Over the 3 year budget period, this will increase revenue by just under \$640,000.

Table II-C - Fund for a Healthy Maine Summary

	FY07	FY08	FY09	FY10	FY11
Current Forecast	\$46,189,344	\$60,408,950	\$62,815,948	\$67,818,647	\$71,548,715
Annual % Growth	-1.5%	30.8%	4.0%	8.0%	5.5%
Net Increase (Decrease)	\$231,280	\$167,761	\$239,938	\$239,938	\$239,938
Revised Forecast	\$46,420,624	\$60,576,711	\$63,055,886	\$68,058,585	\$71,788,653
Annual % Growth	-1.0%	30.5%	4.1%	7.9%	5.5%
Summary of Revenue Revisions by Major Revenue Category					
Base Payments	\$0	\$0	\$0	\$0	\$0
Racino Revenue	\$211,280	\$147,761	\$219,938	\$219,938	\$219,938
Income from Investments	\$20,000	\$20,000	\$20,000	\$20,000	\$20,000
Total Revisions - Increase (Decrease)	\$231,280	\$167,761	\$239,938	\$239,938	\$239,938

D. MaineCare Dedicated Revenue Taxes

In aggregate, the forecast for **Medicaid/MaineCare Dedicated Revenue Taxes** were also revised upward in aggregate based on recent experience. As noted in the committee's February letter, the adjustment to the MaineCare Taxes does not take into account a recent federal restriction added to these taxes that must be addressed by legislative action to change the rate of the tax to bring it within the federal restrictions.

Table II-D - Medicaid/MaineCare Dedicated Revenue Taxes Summary

	FY07	FY08	FY09	FY10	FY11
Current Forecast	\$121,526,004	\$122,825,633	\$124,157,752	\$125,523,174	\$126,922,732
Annual % Growth	2.9%	1.1%	1.1%	1.1%	1.1%
Net Increase (Decrease)	\$3,895,963	\$4,244,849	\$4,602,459	\$4,969,007	\$5,344,719
Revised Forecast	\$125,421,967	\$127,070,482	\$128,760,211	\$130,492,181	\$132,267,451
Annual % Growth	6.2%	1.3%	1.3%	1.3%	1.4%
Summary of Revenue Revisions by Major Revenue Category					
Nursing Facility Tax	(\$2,323,466)	(\$2,381,553)	(\$2,441,091)	(\$2,502,119)	(\$2,564,672)
Residential Treatment Facilities Tax	\$16,789	\$17,209	\$17,639	\$18,080	\$18,532
Hospital Tax *	\$3,268,453	\$3,268,453	\$3,268,453	\$3,268,453	\$3,268,453
Service Provider Tax (PNMIs)	\$2,934,187	\$3,340,740	\$3,757,458	\$4,184,593	\$4,622,406
Total Revisions - Increase (Decrease)	\$3,895,963	\$4,244,849	\$4,602,459	\$4,969,007	\$5,344,719

III. CONCLUSIONS

While the adjustments made during the March forecast update certainly create challenges for the Administration and the Legislature as they work toward a biennial budget, it only represents a 1% change in the total annual forecast of General Fund revenues. Nothing in the national or state economies has fundamentally changed during the intervening months between the December and March revenue forecasts to materially affect this forecast. The recommendations in this forecast correct for a misinterpretation of last year's corporate receipts, and should be viewed as such.

As noted in the December 2006 report, the RFC remains cautious about the unpredictable nature of income from capital gains. In Maine, the decisions of a relatively small number of taxpayers can substantially affect individual income tax revenue through capital gains realizations. 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. The latest data from state and federal income tax returns show that the vast majority of recent taxable income gains have gone to households with incomes greater than \$100,000 a year. The source of these gains has been from bonus income, capital gains, dividend, and business income that traditionally go to upper-income taxpayers.

Any shock to the U.S. economy, either internally or externally, could result in a reversal of these revenues that is disproportionate to the underlying impact on traditional economic measures. It

is with this understanding that the committee once again wants to convey to the Administration and the Legislature that there is a high level of risk that surrounds this aspect of the forecast. In addition to the volatility related to capital gains, the very uncertain global economic and geopolitical environment adds the potential for significant “shocks” to the forecast that could significantly affect revenue.