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DYNAMIC REVENUE FORECASTING

House Bill 5315 (Substitute H-1)
First Analysis (11-12-97)

Sponsor: Rep. Kirk A. Profit
Committee: Tax Policy

THE APPARENT PROBLEM:

When a change is proposed to state tax policy, such as raising or lowering a tax rate or granting an exemption from a tax, policy makers want to know what the effect will be on state tax revenues. The effect on revenues can be estimated, say tax specialists, using a "static" approach or a "dynamic" approach. The former assumes the tax change will have little or no impact on the behavior of taxpayers or on overall economic activity while the latter attempts to factor in changes in behavior and in levels of activity. In March of 1997, the House Fiscal Agency, Senate Fiscal Agency, and the Department of Treasury issued a joint report entitled Dynamic Revenue Estimating: Will It Work In Michigan? This report summarizes the findings of a research study on dynamic forecasting conducted by the three entities; explains the advantages and disadvantages of static versus dynamic analysis; contrasts the estimating procedures currently used in Michigan with those in states using dynamic analysis; and discusses other related issues, including the availability of models for use in dynamic analysis.

According to the March 1997 report, tax analysts in Michigan "currently prepare static revenue estimates and adjust the static estimates for the effects of policy-induced changes in taxpayer behavior. The adjustments are based on standard price and income elasticity estimates. For proposed changes to the Single Business Tax or the Individual Income Tax, micro-simulation models that use a sample of actual taxpayer returns are used to produce a static estimate. When appropriate, static estimates derived from the models are also adjusted for policy-induced changes in taxpayer behavior." Legislation has been introduced, based in part on recommendations in the recent report, to move state tax analysts toward dynamic revenue estimating.

THE CONTENT OF THE BILL:

The bill would amend the revenue act to require that, beginning October 1, 1998, the Department of Treasury provide an analysis of the dynamic revenue impact for all proposed changes in tax policy to be taken up in a legislative committee that have a static impact of at least $20 million annually. These analyses would have to be provided to the appropriate House and Senate committees and the House and Senate Fiscal Agencies in a timely manner. A dynamic analysis would have to include estimates of changes in employment attributable to the proposed changes in tax policy.

Also beginning October 1, 1998, the Department of Treasury would have to have in operation micro-simulation models that will produce estimates of the revenue impact and the incidence of the revenue impact for proposed changes in the personal income tax, the sales tax, the use tax, ad valorem property taxes, and the single business tax. The department would have to make available to the House and Senate Fiscal Agencies data sets suitable for use in micro-simulation models measuring the static impact of changes in state tax policy on revenues. Suitable data sets would have to be made available for analysis of the taxes listed above. The data for each tax year would have to be made available to the fiscal agencies as soon as it was made available to analysts in the Office of Revenue and Tax Analysis or its successor.

The term "dynamic revenue impact" would mean the direct impact of a tax law change on revenues and the indirect effects on revenue of a tax law change due to the effects of the proposed change on taxpayer behavior and overall economic activity. The term "static impact" refers to the direct impact that the tax law change would have on revenue and assumes no change in taxpayer behavior or other economic activity.

MCL 205.18

FISCAL IMPLICATIONS:

The House Fiscal Agency reports that the initial cost of developing models would be about $400,000 to $800,000. There would be ongoing costs of $100,000 to $200,000 per year. (Fiscal Note dated 11-3-97)

ARGUMENTS:

For:

The bill would require the improvement and expansion of micro-simulation models that can improve estimates of the revenue impact of proposed major changes in the state's major taxes, including the personal income tax, single business tax, property tax, and sales and use taxes. The Department of Treasury would have to make information available to legislative fiscal agencies so that they could use the models in doing revenue forecasting. These activities are based on a recent joint report by the department and the legislative fiscal agencies. The bill also would require in the near future that administration tax specialists provide an analysis of the dynamic revenue impact of major tax proposals (those with a static impact of at least $20 million). This will provide policymakers with more valuable information than currently exists regarding the effect of changes in the state tax system.

Response:

The March 1997 report from the legislative fiscal agencies and the treasury department noted: "Although it is technically feasible to produce dynamic estimates with an appropriate model, there is still very limited experience with developing and operating [such a model]. No states are currently conducting dynamic analyses on a regular basis (although California will start to do so this year), and only three or four states have any experience in building and operating these types of models." The report also noted, "state of the art dynamic analysis is not yet at the place where reliable long-run estimates of the impact of dynamic feedback effects on revenue are feasible. However, experts are continuing to refine and expand the models and are likely to resolve these problems in the near future."

POSITIONS:

The Department of Treasury has no position on the bill. (11-7-97)

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