MONTANA LEGISLATIVE BRANCH

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Director
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DATE: December 5, 2017

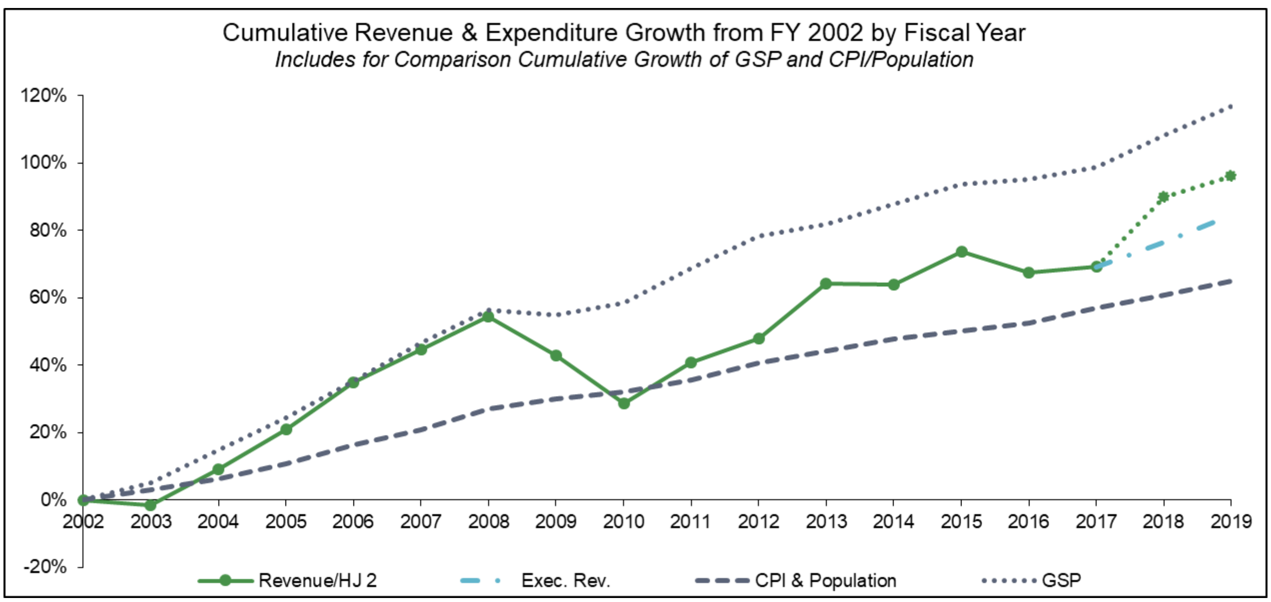
TO: Revenue and Transportation Interim Committee

FROM: LFD Revenue Team

RE: Montana Tax Structure Sufficiency Research

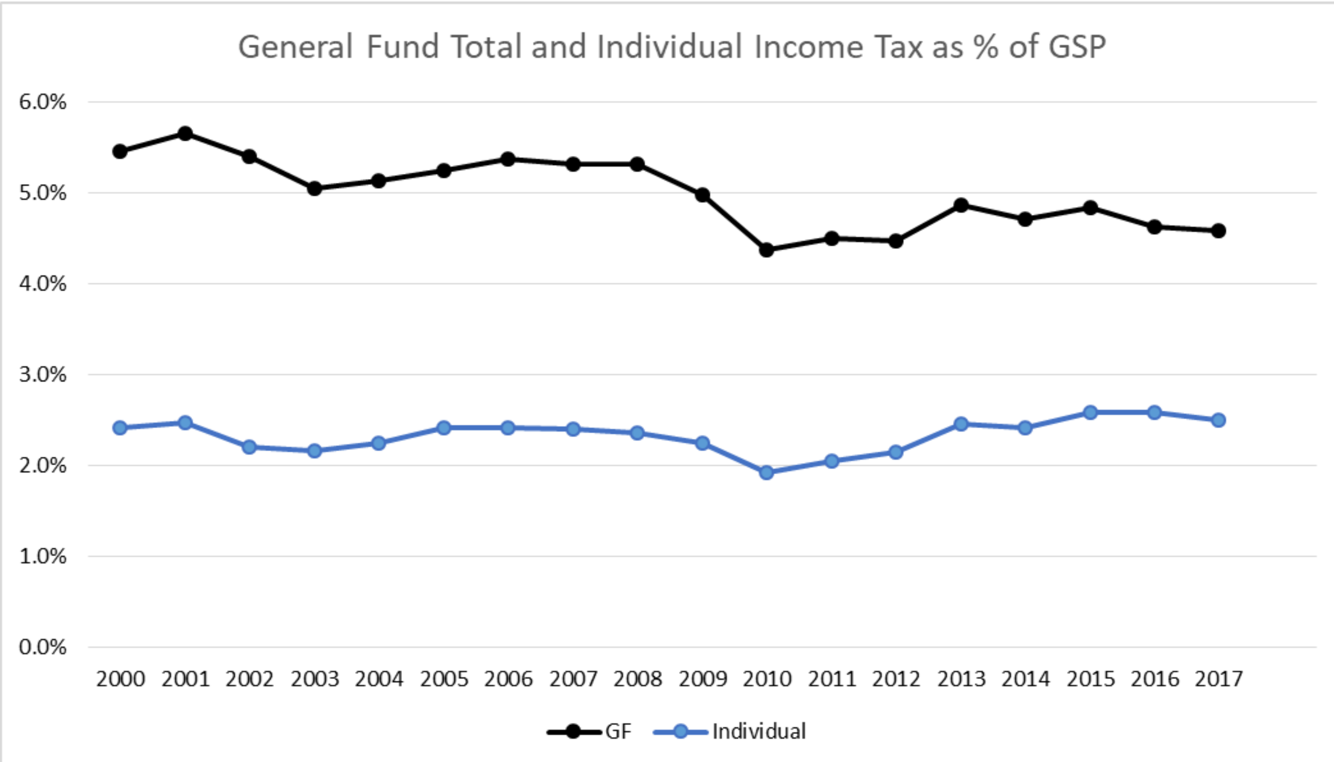
The Legislative Fiscal Division (LFD) is working with the Legislative Finance Committee on several aspects of evaluating Montana tax structure sufficiency. The work has begun with evaluating general fund revenue collections compared to gross state product or GSP. The following chart illustrates cumulative general fund revenue collections from FY 2002 to the forecasted levels for FY 2018 and FY 2019.

The general fund revenue growth is fairly consistent with the growth in gross state product (GSP) from FY 2002 to FY 2008. After FY 2008 general fund revenue fell well below growth in GSP and does not catch up within the forecast window.



In response to this observation and questions from legislators, further research was performed by the LFD to better understand underlying trends of individual sources and how they contribute to the decline in general fund collections as a percentage of GSP. The changes by each major source of revenue is presented in pages 2-7 of this report. In addition, LFD staff recommend further study, which is discussed at the end of this document.

Individual Income Tax
The first comparison is individual income tax, as this is the largest source of general fund revenue, total general fund revenue is shown as a reference point. This analysis is similar to the above analysis which compares revenue collections by source to GSP to get collections as a percent of GSP. This method will be used throughout.



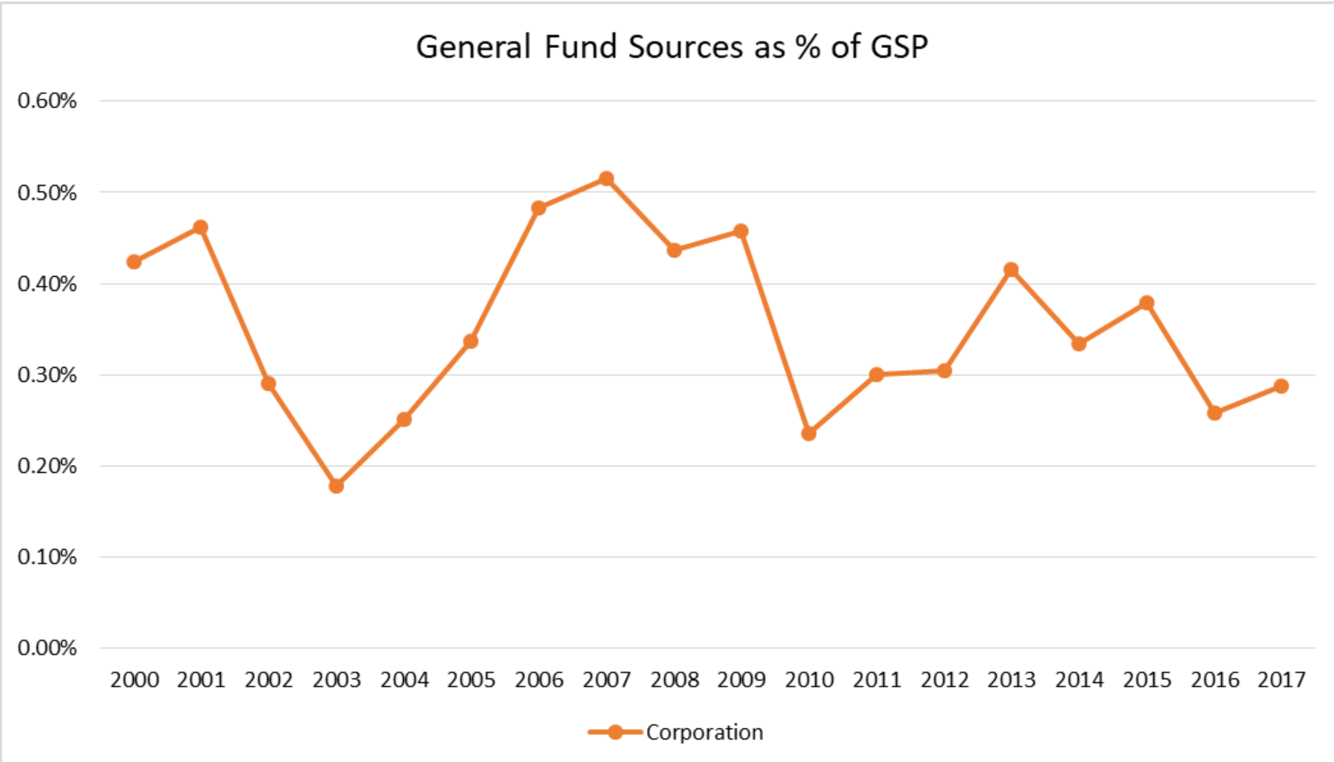
As shown in the previous chart, this analysis shows the same decline in overall general fund collections as a percentage of gross state product.

In addition, the chart highlights that while year to year, individual income tax collections vary considerably between 1.9% and 2.6% of GSP, but over the longer 18 year period, income tax maintains a relatively consistent percentage of GSP.

The accumulation of several other sources of revenue cause the decline in general fund collections as a percentage of GSP. Key areas of decline include: corporation tax; vehicle tax; property tax; and others.

Corporation Tax
Corporation tax has traditionally been Montana's third largest general fund revenue source, trailing only individual income tax and property tax. Corporation income tax collection varies substantially from 0.18% to 0.52% as a percentage of GSP. In recent years, it appears to not be keeping pace with the Montana economy as measured by gross state product (GSP).

The first 9 years of the 18 year period the average percent of GSP was 0.38% and the last 9 years has been 0.33%. While this percentage difference may seem small, it actually is about $23 million per year. If the collections continue at the level of the previous two years, which have been lower than typical, the difference would be about $50 million per year.



Two possible explanations for the decline may be worth additional research:

1) E-commerce may hinder corporation income tax growth in Montana as corporation tax revenue may accrue to another state.

   For a corporation doing business in multiple states, the tax owed to a particular state is calculated based upon the state's relative payroll, property, and sales compared to the corporation's total across all states. This is known as a state's apportionment factor, and is applied to a corporation's net income to calculate taxable income in that state. It is possible that over the years e-commerce sales have reduced corporation tax liability owed to Montana. As goods are purchased online, this would reduce the need for a physical presence (property, payroll, and sales) in the state, thus ultimately reducing Montana's apportionment factor for certain sectors of the economy. Possible areas of research in corporation tax would be exploring sector-by-sector changes in Montana's corporate apportionment factor and studying if there is a significant change that may be explained by e-commerce.

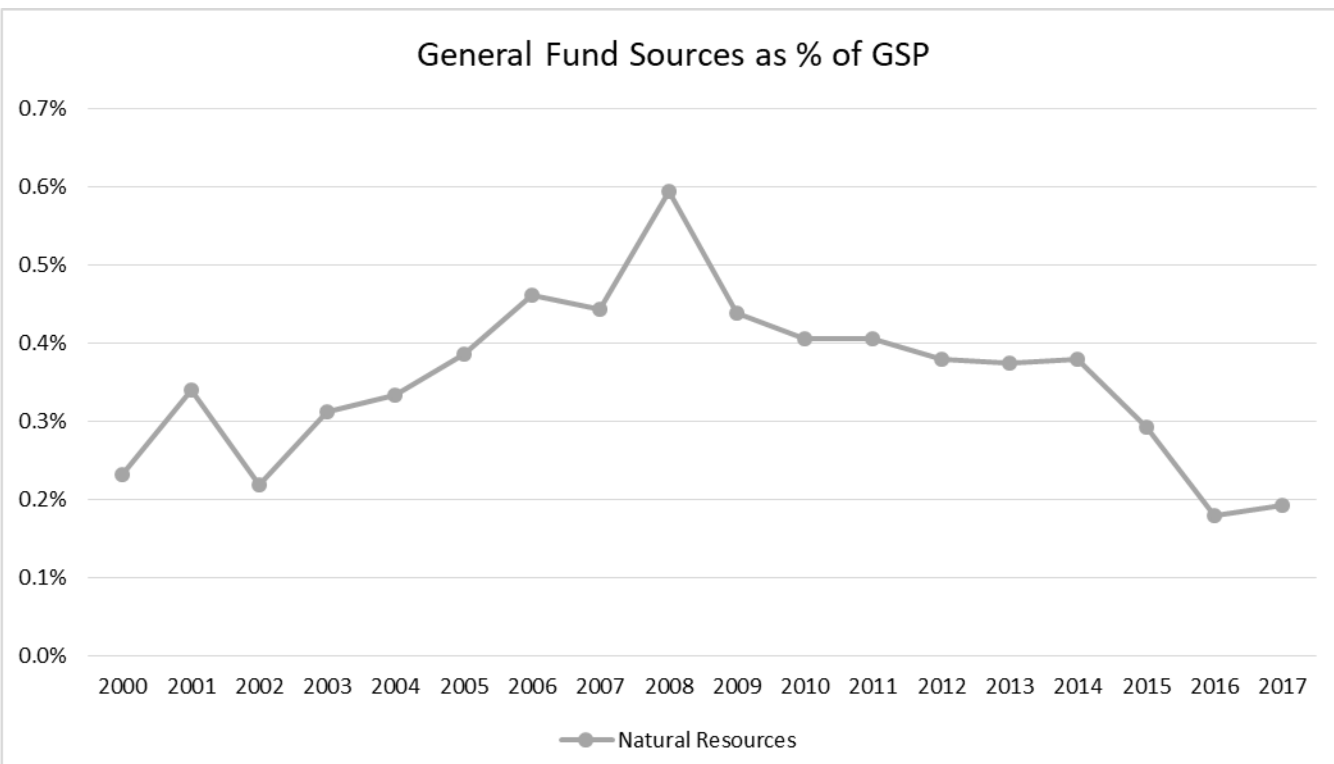
2) International accounting for profits may result in a disproportionate share of profits to be recorded in another country.

   There appears to be a trend of international corporations storing profits overseas and not recognizing profits in the U.S. According to the Economic Policy Institute (EPI), at the trough of the recession in 2008 after-tax corporate profits as a percent of GDP were 6.6% and had grown to 8.5% in 2015. In comparison, federal corporate income tax revenue in 2008 as a percent of GDP was 2.1% and by 2015 was 1.9%. The EPI states that "The driving force behind the recent erosion of the corporate income tax base is the largest corporate loophole—deferral of taxes paid on profits booked abroad."

   Montana's apportionment factor is applied to a corporation's U.S. income. If a corporation has income outside of the United States they have the ability to file for a "water's edge" election. This allows them to apply Montana's apportionment factor to only income earned within the United States. If a corporation chooses to file for a water's edge election, they pay a tax rate of 7.0% instead of 6.75%. However, if income outside of the United States is large enough, it is beneficial for a corporation to pay the higher rate, as they would be paying it on a much smaller taxable income. Research could be performed to explore the effects of removing the "water's edge" election as well as effects of increasing the tax rate for those corporations that choose to file for this election.

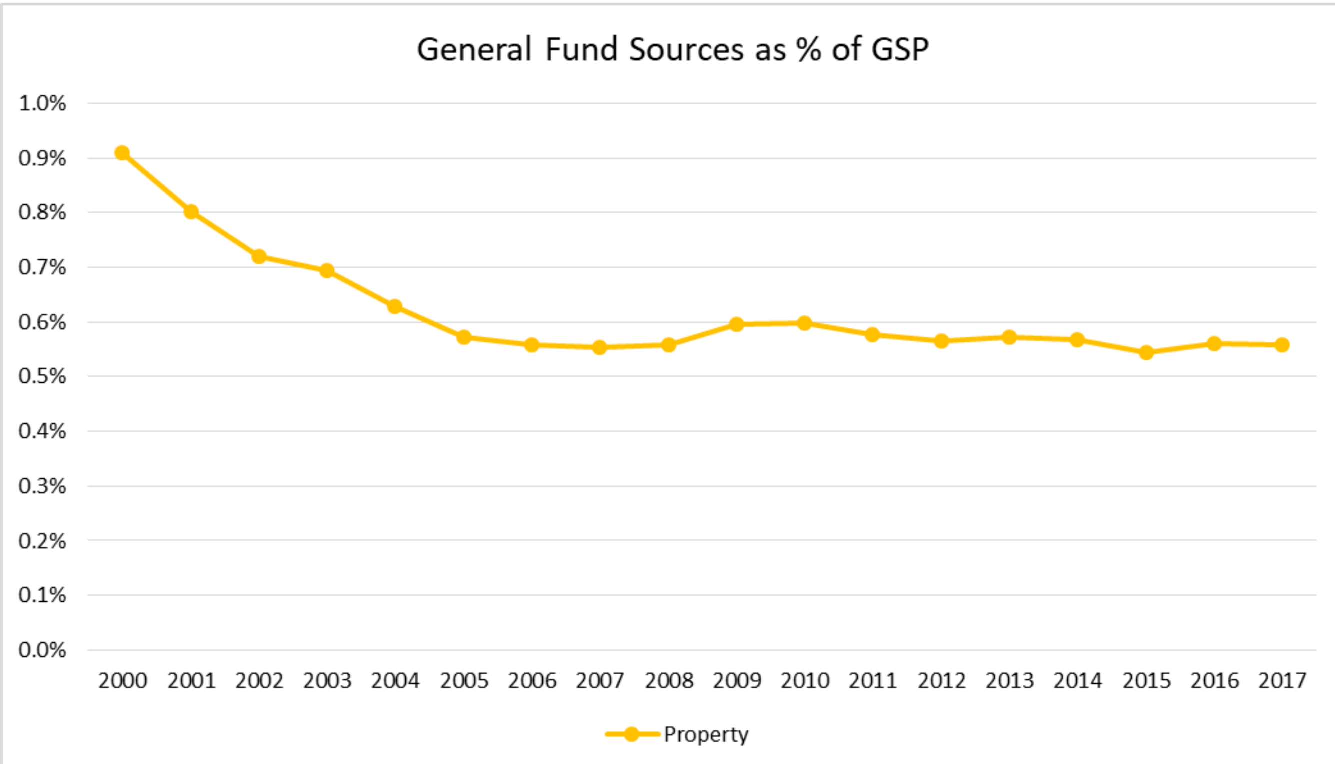
Oil and Gas and other Natural Resources

General fund natural resource taxes vary considerably, from 0.18% to 0.59% of GSP. In the early 2000's collections were about 0.26%, in the last two years collections have averaged 0.19% of gross state product. No additional research is proposed.



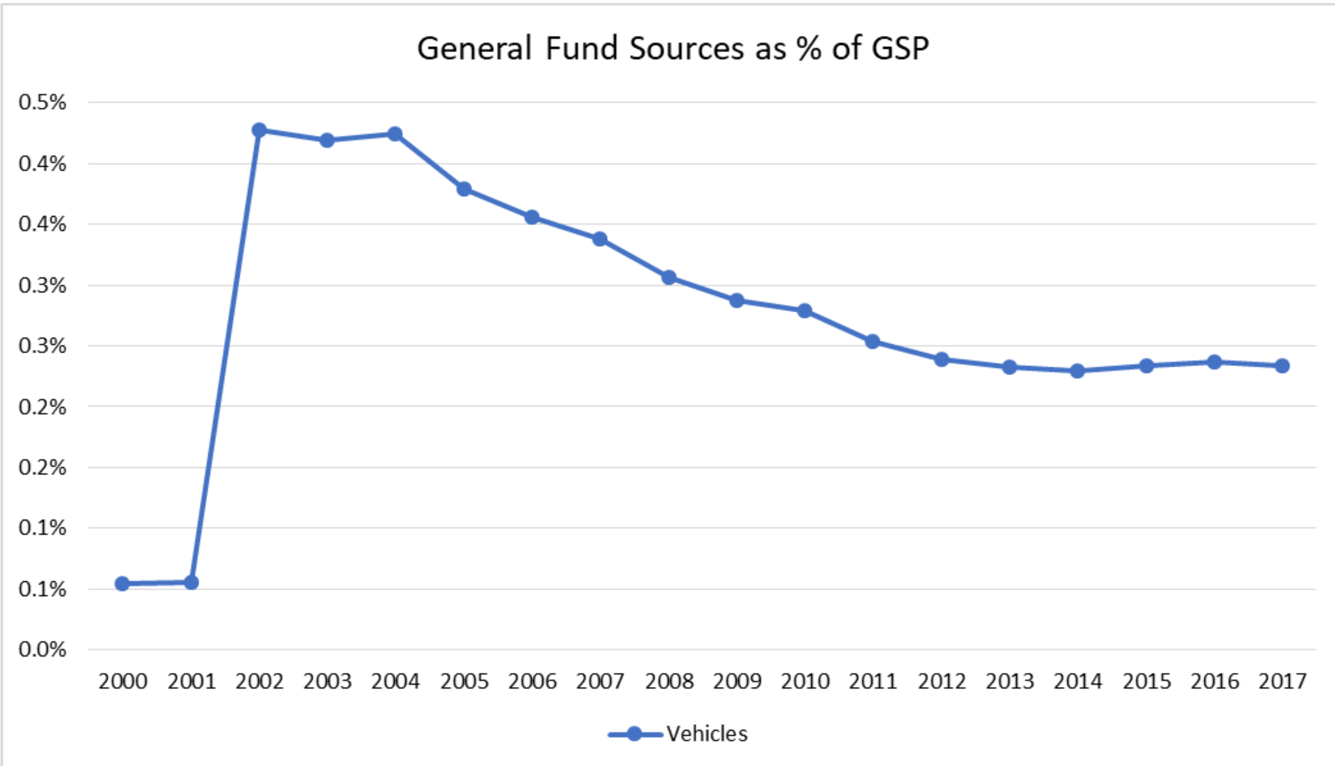
Property Tax

Property taxes have declined as a percentage of gross state product from about 0.9% of gross state product to 0.56% of gross state product. Property taxes have been the subject of legislatively approved tax decreases. If property taxes would have kept up with the pace of growth in GSP since FY 2002 (not counting early 2000s adjustments), an additional 0.16% of GSP or $75 million would have been received in FY 2017.

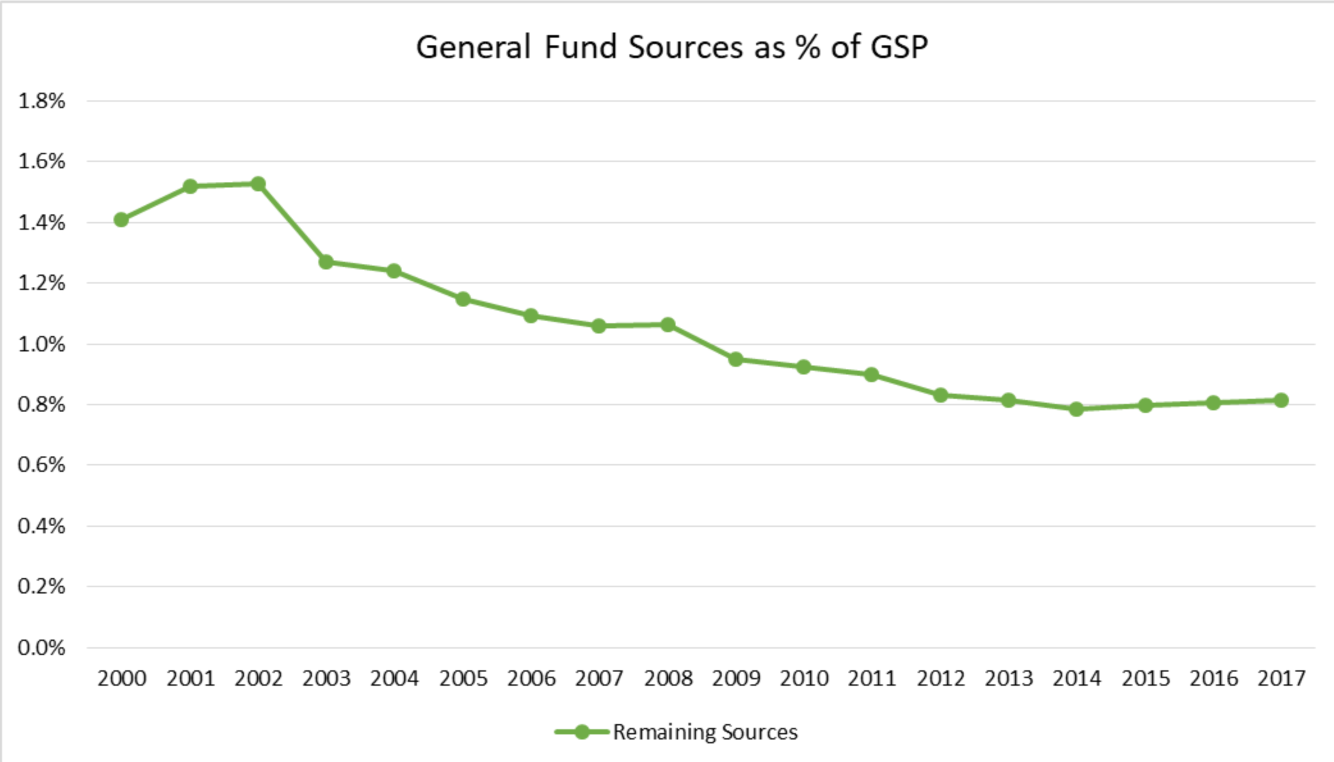


Vehicles
The vehicle tax collection increase from FY 2000 to FY 2002 was due to the restructuring of the tax allocations between state and local governments in FY 2002. This increase in revenue was offset by an increase in expenditures for local governments. Since FY 2002, vehicle revenues have declined from 0.43% to 0.23% of GSP or approximately $93 million per year.

Flat fee
Permanent registration



All other sources
All other sources of revenue have also declined for a number of reasons.



The decline from 2000 to 2003 largely comprised of shifting sources of revenue per HB 124 (2001 session) and other technical adjustments. Measuring from FY 2003 to present shows a reduction of over 0.4% of GSP or over $200 million in lower general fund revenue collections.

Impacting revenue streams:

- Consumer behavior changes such as gambling and smoking less which were influenced by policy changes such as the smoking ban in public spaces
- Revenue diversions such as insurance tax and tobacco interest diverted to state special funds through voter initiative and legislation
- Flat fee structure for several consumption taxes: beer; wine; liquor; and tobacco
- Current low interest rates attribute to over $40 million of current differences
- Federal tax changes such as elimination of the estate tax

The largest of which include changes in consumer behavior, diversions of revenue away from the general fund, lower interest rates, and flat fees for several consumptions taxes.

<u>Changes in consumer behavior</u>
The decline in gambling deserves additional research. Video gambling revenue is currently taxed at a rate of 15% of total profits. Though the percentage-based tax rate more easily allows this source to grow with inflation, over the past few years growth has been flat. Slowed gambling revenue is not unique to Montana as recent literature suggests that this source is declining in real terms across many states, and is a trend that may continue.

The LFD suggests doing a literature review of this topic which would explore reasons for the decline as well as other states' possible solutions.

Flat fee structure

The LFD followed up with this analysis with evaluation of individual sources and provided to the Legislative Finance Committee (LFC) in October. Results are in the following links: Inflation Adjusted Revenue Impacts and Other Revenue Adjustments

Additional Potential Research

Outside the evaluation of changes in revenue relative to GSP, other additional research being considered by the Legislative Finance Committee includes:

Expand sales taxes to goods desired by tourists

Currently Montana levies a sales tax on both rental cars and lodging, two items that are desired by tourists. Are there additional items that would make sense to levy a sales tax on that would be directed towards tourists? What would be the impact of additional sales taxes on Montana residents?

Consider study of a value-added tax (VAT).

Next Steps

Next LFC meeting is scheduled for December 11 where the work plan will be updated given current findings.

Additional background materials

Further analysis is available here: General Fund Revenue & Expenditure Trends

Interesting historical comparison:
http://www.pewtrusts.org/en/research-and-analysis/analysis/2017/07/12/over-long-term-revenue-falls-short-of-expenses-in-11-states