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Would You Bet on the Odds of the REC?

By Jennifer L. Crull

The Revenue Estimating Conference (REC) has been in the news quite a bit these last several months. Most of the time, the REC quietly meets and projects the budget for the current and coming fiscal years. Usually, the committee is under or about even in its prediction, and not much notice is given to how well it performs its job. But the slowed growth in tax revenues this last fiscal year has required the REC to reduce the current fiscal year's budget projection three times. This raises the following question: is the REC using the best data possible to make its predictions, and if so, does the state need a new approach to determining the budget for the coming year?

As you remember from the February IOWA TRANSPARENCY NEWSLETTER:

> The Revenue Estimating Conference "was established in Iowa Code 8.22A as a way to arrive at consensus General Fund Revenue estimates to be used by both the Governor and Legislature for the budget process." The three-member body is made up of "two individuals representing the Legislative and Executive branches [of Iowa government] . . . and a third member of the general public chosen by the other two members." The current REC members are:
>
> - David Roederer, Director of the Iowa Department of Management (Governor's designee)
> - Holly Lyons, Fiscal Services Division Director of the Legislative Services Agency
> - David Underwood, retired Chief Financial Officer and Treasurer, AADG, Inc., in Mason City, Iowa[1]

As we consider the job the REC has done predicting the General Fund Revenues, let's consider the components the REC must consider to forecast revenue. The General Fund Revenue combines tax receipts, other receipts, accruals, and transfers to reach the Net General Fund Revenue amount for budgeting purposes. The three largest contributors to the General Fund are personal income tax, sales/use tax, and corporate income tax. These are all tax receipts.[2]

Usually, the tax receipts portion of the General Fund Revenue is larger than the Net General Fund will be. The other receipts portion of the General Fund Revenue is usually only 3 to 5 percent of the Net General Fund. The last portion, which usually decreases the General Fund Revenue, is accruals and transfers. Refunds, the Secure an Advanced Vision for Education (SAVE) fund transfer, and other items such as lottery transfers are accounted for in accruals and transfers

When we take the time to examine the projections for tax receipts, since this is where the money comes from, it is important to think about the Iowa economy in general. Our economy is slowly growing; this is reflected in the Iowa Leading Indicators Index (ILII). The ILII data is steadily increasing, but it is not growing by

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Chart 1

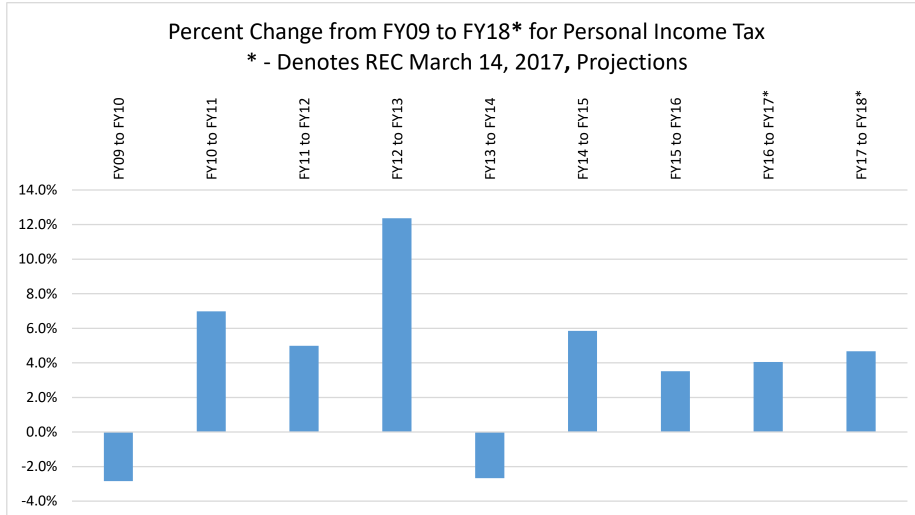


Chart 2

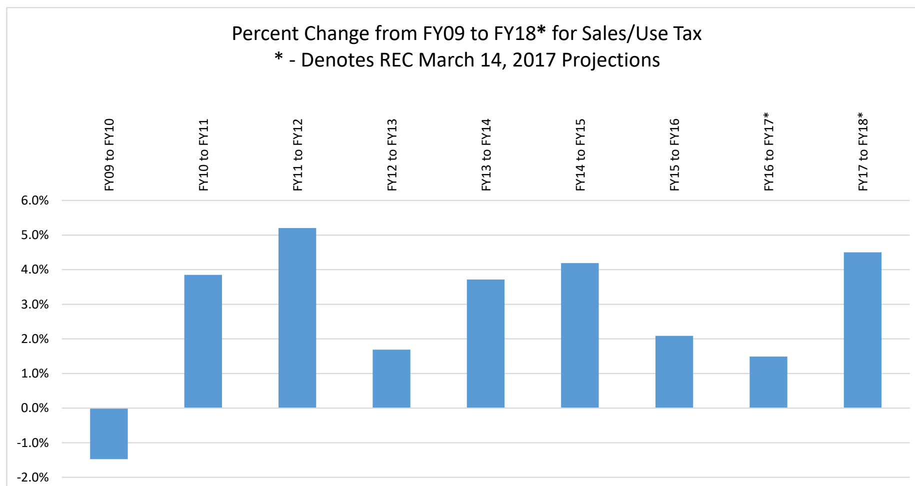
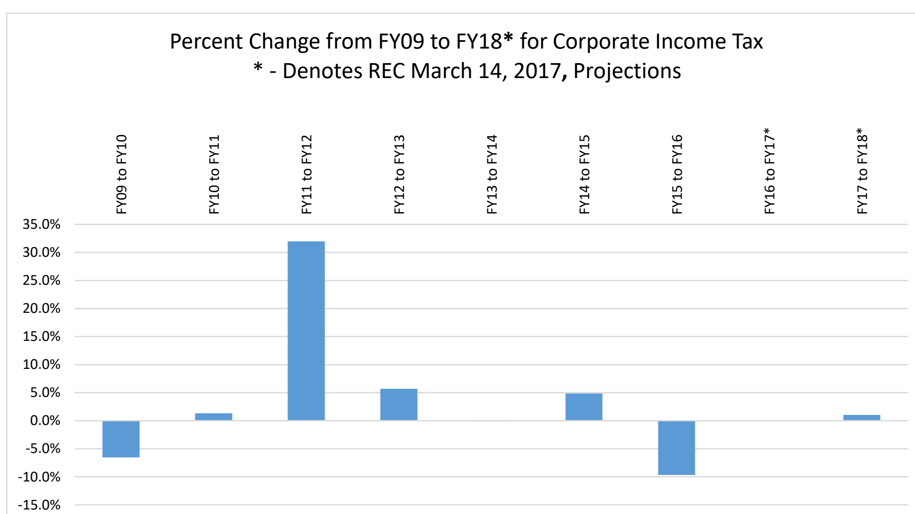


Chart 3



leaps and bounds. The ILII was created to provide data to our leaders that would estimate what would be accruing for the state in our economy. The opening paragraph of the ILII's tenth annual assessment shows why the REC might want to be conservative in its predictions based on ILII data:

> In 2006, the Iowa Department of Revenue (IDR) created the Iowa Leading Indicators Index (ILII) as a tool to predict turning points in Iowa employment. By foreshadowing changes in the level of employment, which is closely linked to the level of individual income tax and sales tax receipts, the ILII also provides a signal of changes in these major revenue sources for the State. IDR has issued monthly ILII reports since the start of fiscal year (FY) 2007 and posted the reports on the IDR website. During FY2016, the ILII exhibited three months with positive changes and nine months with negative changes, ending down 1.5 percent from the end of FY2015. In contrast, employment increased throughout the year, with the gains ranging from 0.03 to 0.12 percent and averaging 0.09 percent per month. Despite the steady employment growth, State tax receipts increased only 2.2 percent during FY2016.[3]

The thing we should understand about this process is that it is a guess, estimate, or projection of what the experts on the REC Board believe is going to happen with our economy, with most of the guessing happening with tax receipts since this is where the bulk of the state's revenue comes from. If we take the time to review the predictions that have been put forth by the REC, there are a few anomalies that would cause most people to pause and question what they were thinking.

First, let's start by looking at the prediction of personal income tax. The growth in personal income tax over the last 10 years is summarized in Chart 1. As you can see, personal income tax has grown from year to year, except for FY10 and FY14 when there was a 2.8 percent and a 2.7 percent reduction in the amount of personal income tax collected.[4]

The economy is good, and revenue is going up. The problem is the rate at which revenue is growing. When examining the growth in personal income tax from the FY09 projection to the FY18 projection, we see the growth amounts to over 42 percent change. But when we look at the year-to-year change, we see the biggest growth in one year is from FY14 to FY15, which saw 12.4 percent growth. However, the average growth we see year to year from FY09 to FY18 using the March 14, 2017, REC data is 4.1 percent. The average change from FY09 to FY16 from actual revenue is 4.0 percent. This poses the question: why did the REC project at the October 2016 REC meeting that personal income tax growth for FY17 would be 8.9 percent? The data do not back up this projection! The important note is that personal income tax makes up 63.8 percent of the revenue of the General Fund. Therefore, being off on an estimate can have a huge impact on the budget for the year.[5]

The next largest contributors to the General Fund are sales/use tax and corporate income tax, in that order. Both categories are having similar issues to personal income tax. The average percent change of sales/use tax is 2.8 percent from FY09 to FY18 (Chart 2).[6] Yet the October 2016 REC meeting set the growth at 3.3 percent over FY16, and the estimate for FY18 was 3.9 percent.[7]

Corporate income tax is a very volatile category. This area has seen a 32 percent change one year and a 9.7 percent loss another year. Chart 3 shows the up-and-down nature of corporate income tax. When we average the percent changes from year to year, we see the data backs up an average annual growth of 3.2 percent. Yet when we look at the REC's predicted growth for FY18 in October 2016, the percent increase is 4.4 percent.[8]

We have looked at just the three largest areas of the General Fund. But as you can see, if you are off by just

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2 percent in these areas, you are already $100 million off in the Net General Fund, or one third of the approximately $300 million in new money you have to work with. This can have lasting effects on the budgeting process. To see the REC estimates from March 14, 2017 visit https://dom.iowa.gov/sites/default/files/documents/2017/03/17-03_rec_final_0.pdf.

How do we avoid the cuts that had to be made this year? If we change our procedure and use the 98 percent rule of forecasted revenues instead of the 99 percent rule, we will be better able to react to these changes. We should only have to use our "rainy day" funds in the event of a major recession or some unforeseen disaster, not handling poor predictions. But the important takeaway is that our revenues are growing. The REC just needs to do a better job of predicting what that growth will truly look like.

(Endnotes)
[1] Amy K. Frantz, "Iowa's Tax Receipts are Still Rising, Even With Calls for Budget Cuts," *IOWA TRANSPARENCY NEWSLETTER, Public Interest Institute*, February 2017, <http://www.iowatransparency.org/feb17newsletter.html> accessed on April 5, 2017.
[2] Iowa Department of Management, "March 14, 2017 Projection," *REC Meeting*, <https://dom.iowa.gov/sites/default/files/documents/2017/03/17-03_rec_final_0.pdf> accessed on April 3, 2017.
[3] "Iowa Leading Indicators Index: Tenth Annual Assessment and Update," *Iowa Department of Revenue*, September 2016, <https://tax.iowa.gov/sites/files/idr/IDR%20%20Iowa%20Leading%20Indicators%20Index%20update% 202016.pdf> accessed on April 10, 2017.
[4] Iowa Department of Management.
[5] Ibid.
[6] Ibid.
[7] Iowa Department of Management, "October 13, 2016 Projection," *REC Meeting*, <https://dom.iowa.gov/sites/default/files/documents/2016/10/rec_final_2016-10.pdf> accessed on April 3, 2017.
[8] Ibid.