

MEMORANDUM

Date: January 17, 2003

To: G. Willard Jenkins  
Oversight and Communications Committee

Re: Revenue Estimating Conference

The attached Summaries #1 and #2 and Exhibit A are furnished to you in response to your request for suggestions for improving the revenue estimating process. Summary #1 sets forth certain steps which would make additional and more timely information available to the Revenue Estimating Conference. Summary #2 sets forth estimated initial and ongoing costs for implementing such steps over a period of three fiscal years. Exhibit A has been prepared by the Department of Revenue and Finance and describes the needs of the Department for personnel and technology for providing additional information to the Revenue Estimating Conference and other departmental purposes.

While it is believed that adoption of the steps described in Summary #1 and the availability of additional and more timely economic and fiscal information should result in more reliable revenue forecasts, there can be no assurance that an improved process will consistently produce estimates of future general fund revenues that do not fall short of or exceed actual receipts in significant amounts and percentages, particularly in a volatile economy. There are also too many unforeseeable and uncontrollable events that can affect the economy and revenues to achieve absolute accuracy. For example, the present uncertainty concerning war with Iraq clearly contributes to the current unfavorable stock market and economy the ultimate outcome of which can result in a significantly improved or worsened status of the market and economy. A further unknown is that any tax bill passed by Congress at this session can have a positive or negative effect on Iowa income tax revenue of unknown extent and may or may not be retroactive.

Copies to:

Dennis C. Prouty  
Legislative Fiscal Bureau

David W. Underwood  
Revenue Estimating Conference

## REVENUE ESTIMATING PROCESS

### SUMMARY #1

#### Findings:

1. The Revenue Estimating Conference should be retained as presently provided for by Iowa law.
2. The number of persons constituting the Iowa Economic Forecasting Council should be increased to permit appointment of senior management representatives of Iowa businesses to the Council including representatives of Iowa businesses sensitive to changes in the economy, and the duties and responsibilities of the Council should be revised consistent with a restated general purpose of advising the Governor, General Assembly, and the Revenue Estimating Conference as to the condition and needs of the Iowa economy.
3. An internal state government working group should be organized to consist of senior personnel of the Departments of Agriculture, Commerce, Economic Development, Management, Natural Resources, Revenue and Finance, Transportation, Treasurer of State and Work Force Development for the general purpose of coordinating and providing assistance and guidance in the economic information gathering and revenue estimating processes.
4. Additional funding should be sought for the additional positions and other needs described in Exhibit A as necessary for the capture and analysis of additional internal data for use by those agencies of state government involved in the revenue estimating process and by the Department of Revenue and Finance and the Legislative Fiscal Bureau for other purposes.
5. Additional funding should be sought for additional positions and other requirements of the Department of Management for coordination of the internal government working group, Iowa Economic Forecasting Council, Revenue Estimating Conference, and other internal and external participants in the collection, analysis and dissemination of economic information.
6. The present practice of obtaining forecasts and other information relating to the global and U.S. economies from outside sources should be continued.
7. Funding should be sought for the employment of an outside source to regularly forecast the economy of the State of Iowa and each geographical and significant business sector of the state and to advise the Governor, General Assembly and Revenue Estimating Conference as to the basis, trends and developments indicated by the forecasts.

REVENUE ESTIMATING PROCESS

SUMMARY #2

ESTIMATED COSTS

	<u>FY2004</u>	<u>FY2005</u>	<u>FY2006</u>
<u>Department of Revenue and Finance (See Exhibit A)</u>			
Staff	\$ 524,400	\$ 826,300	\$1,041,600
Technology	58,000	38,700	10,000
Outside Services	<u>159,500</u>	<u>180,250</u>	<u>54,500</u>
	\$ 741,900	\$1,045,250	\$1,106,100
 <u>Department of Management</u>			
Staff	\$ 91,625	\$ 91,625	\$ 91,625
Outside Services	50,000	50,000	50,000
Other	<u>15,400</u>	<u>15,400</u>	<u>15,400</u>
	\$ 157,025	\$ 157,025	\$ 157,025
 <u>Allocated*</u>			
Internal Working Group	\$ 18,900	\$ 18,900	\$ 18,900
IA Economic Forecasting Council	6,000	6,000	6,000
Revenue Estimating Conference	<u>16,200</u>	<u>16,200</u>	<u>16,200</u>
	\$ 41,100	\$ 41,100	\$ 41,100
 <b>Estimated Total Expense</b>			
	<b>\$ 940,025</b>	<b>\$1,243,375</b>	<b>\$1,304,225</b>
 <u>Reductions</u>			
Interest on Tax Refunds	\$ 750,000	\$ 750,000	\$ 750,000
Fees	<u>15,000</u>	<u>15,000</u>	<u>15,000</u>
	\$ 765,000	\$ 765,000	\$ 765,000
 <b>Estimated Net Total Expense</b>			
	<b>\$ 175,025</b>	<b>\$ 478,375</b>	<b>\$ 539,225</b>

\*Allocated among appropriate agencies of State Government

EXHIBIT A

## Enhanced Tax Revenue and Refund Data Capture and Analysis

**Issue:**

The Department of Revenue and Finance tracks 19 revenue and 12 refund accounts. However, the information system and electronic databases developed and maintained by the Department were designed to support the auditing of tax returns and other compliance activities, not revenue and refund tracking and analysis. Also, due to budget and staff reductions over the past decade, the Department has been forced to economize on the amount of data it captures from tax returns. As a result, much of the type of data that would be useful for fiscal analysis and revenue and refund estimating purposes is not readily available.

In addition, while the number of tax credits, deductions, exclusions, and exemptions has grown dramatically over the past decade, the amount of resources available to track and analyze the impact of these law changes has nearly disappeared. Furthermore, recent staff reductions have resulted in delays in the processing of tax returns and data entry operations causing the time between when returns are filed and when data from the returns becomes available for analysis to increase.

**Response:**

In response to requests from the Governor, the members of the Revenue Estimating Conference, and the Legislature, the Department of Revenue and Finance has identified 19 possible actions that could be undertaken to improve the quality of information available to support the State's tax revenue and refund estimating process. For each identified action the Department has prepared an analysis which identifies the issue(s) the action would address, proposes how to address the issue(s), identifies additional resources that would be required, and provides an estimate of the costs required to implement the proposed action. Also, the Department has identified which actions would likely yield additional benefits in terms of cost savings or additional revenues. The Department is continuing to work on developing estimates for those actions that would likely yield additional revenues. A table summarizing the proposed actions and cost estimates is attached.

Furthermore, the proposed actions have been ranked in terms of the value they would contribute to the revenue and refund estimating process and in terms of their current feasibility. Since it would not likely be possible, or even advisable, to implement all of the actions simultaneously a multi-phased implementation plan has been developed. A proposed implementation plan is summarized below.

## **Phase One – Fiscal Year 2004**

The first phase would focus on adapting existing electronic databases maintained both by the Department of Revenue and Finance and other departments of state government for use in the development of revenue and refund forecasting models. This phase would also involve enhancing the quality of information on capital gains and losses reported by Iowa taxpayers to the federal government. The actions proposed to be undertaken during this phase are:

- The capture and analysis of data from electronically filed (ELF) individual income tax returns,
- Collaboration with the Department of Workforce Development to incorporate the 6-digit North American Industrial Classification System (NAICS) into the Department's Integrated Revenue Information System (IRIS),
- The development of an enhanced refund tracking and forecasting system,
- The development of enhanced economic databases for the State drawing on administrative files from various State and local government entities and the analysis of relationships between the economic and tax data,
- Providing additional resources for the processing of corporate income tax returns in order to reduce data entry and refund claim review times,
- Provide additional resources for the processing of quarterly sales tax returns in order to reduce data entry and error resolution times, and
- The capture and analysis of additional capital gains and losses data from Schedules D and D1 filed with individual income tax returns.

### **Estimated Costs and Benefits**

The actions proposed for this phase would require the addition of 9.35 staff positions for the Department of Revenue and Finance. The total cost to implement this phase is estimated at \$741,900. The breakdown of the costs is: staff, \$524,400; computer hardware and software, \$58,000; and outside services, \$159,500. The cost estimate for computer hardware and software assumes the acquisition of a server for use in maintaining the data extracted from electronically filed returns. The outside services cost estimate pertains primarily to the hiring of additional temporary data entry and returns handling staff, plus some funds for the acquisition of economic data.

Offsetting the costs associated with this phase would be savings of approximately \$750,000 per year resulting from the more rapid processing of corporate income tax refund claims. These savings would result from a reduction in interest expense that accrues when refunds are issued more than one month after the tax return due date for timely filed returns. In addition, additional revenue may be expected to result from capturing more capital gains and losses data as this information can be expected to yield additional leads for compliance efforts.

## **Phase Two – Fiscal Year 2005**

Actions proposed for this phase focus on the capture of additional individual, corporate, inheritance and estate, and insurance premiums tax information. Also, many of the Phase One actions would be expected to continue. However, the cost of many of the continuing Phase One actions would likely be less than for the prior year. This is because the first year costs cover some activities that would only have to be undertaken once or every few years. The new actions proposed for this phase include:

- The capture and entry into an automated database of information from inheritance and estate tax returns and the analysis of these data,
- The development of a business tax credits tracking system,
- The capture and analysis of additional data pertaining to non-corporate business income and expenses from federal Schedule C filed with individual income tax returns,
- The capture and analysis of additional data on credits claimed by corporate taxpayers,
- The capture and analysis of data from insurance premiums tax returns which is currently not captured by either the Department of Revenue and Finance and the Insurance Division, Iowa Department of Commerce, which is responsible for administering this tax,
- The capture and analysis of additional data on farm income and expenses from federal Schedule F filed with individual income tax returns, and
- The capture and analysis of additional data on sources of supplemental income (rent, royalties, partnerships, s-corporations, trusts, and mortgage investment conduits) from federal Schedule E filed with individual income tax returns.

### **Estimated Costs and Benefits**

The costs associated with the additional actions proposed for implementation during Phase Two equals \$520,850. The breakdown of the costs is: staff, \$301,900; computer hardware and software, \$38,700; and outside services, \$180,250. The outside services costs would be associated with the hiring of temporary data entry, document handling, and programming staff. In addition, there would be about \$500,000 of continuing costs associated with actions implemented during Phase One.

Offsetting the costs would be a continuation of the \$750,000 annual interest savings from processing corporate refund claims more rapidly. In addition, the additional farm income, business income, and supplemental income data captured from federal Schedules C, E, and F can be expected to yield leads for compliance programs. Furthermore, the development of a system for tracking business tax credits should yield considerable savings. For example, this year three corporations have voluntarily repaid almost \$4 million in tax credits that

were inappropriately claimed during prior years. One may logically expected that if a few companies are voluntarily making such repayments there are others that have not done so.

### **Phase Three – Fiscal Year 2006**

This phase would focus on adding the final four actions identified by the Department. The implementation of most of these are not currently feasible and thus should be delayed until the Department completes work on automating the filing of business tax returns and updating the IRIS system. The Department hopes to accomplish this by the end of FY 2005. The new actions proposed to be implemented during this final phase are:

- The redesign and expansion of the consolidated schedule for sales tax permit holders that have more than one location in the State of Iowa,
- The capture and analysis of additional information on tax credits claimed by individuals that are now reported on two "other tax credits" lines of the Iowa Schedule 1040,
- Revival of the corporate income tax statistical report that has not been produced since 1992, and
- The capture and analysis of additional information on sales exempted from sales and use taxes.

### **Estimated Costs and Benefits**

The implementation of the final four action steps will cost an additional \$279,800. The breakdown of costs is: staff, \$215,300; computer hardware and software, \$10,000; and outside services, \$54,500. The outside services costs would be associated with the hiring of temporary programmers to modify IRIS to accommodate additional sales tax and individual income tax credits data. Also, there would continue to be approximately \$850,000 of ongoing costs associated with the returns processing, credit and refund review, database management, data analysis, and revenue and refund modeling enhancements implemented during Phase One and Phase Two.

The annual \$750,000 in interest cost savings arising from the more timely review of corporate refund claims would continue. Also, both the savings from the closer monitoring of business tax credits and new revenue generated by additional compliance efforts made possible through the capture of additional individual income tax, corporate income tax, and sales tax data can be expected to increase.

### **Additional Benefits**

Although the primary intent of the actions proposed above is to enhance the State's revenue and refund estimating capabilities, the implementation of the proposed actions can be expected to yield other benefits. One benefit would be the development of a common linkage between the Department's tax data and