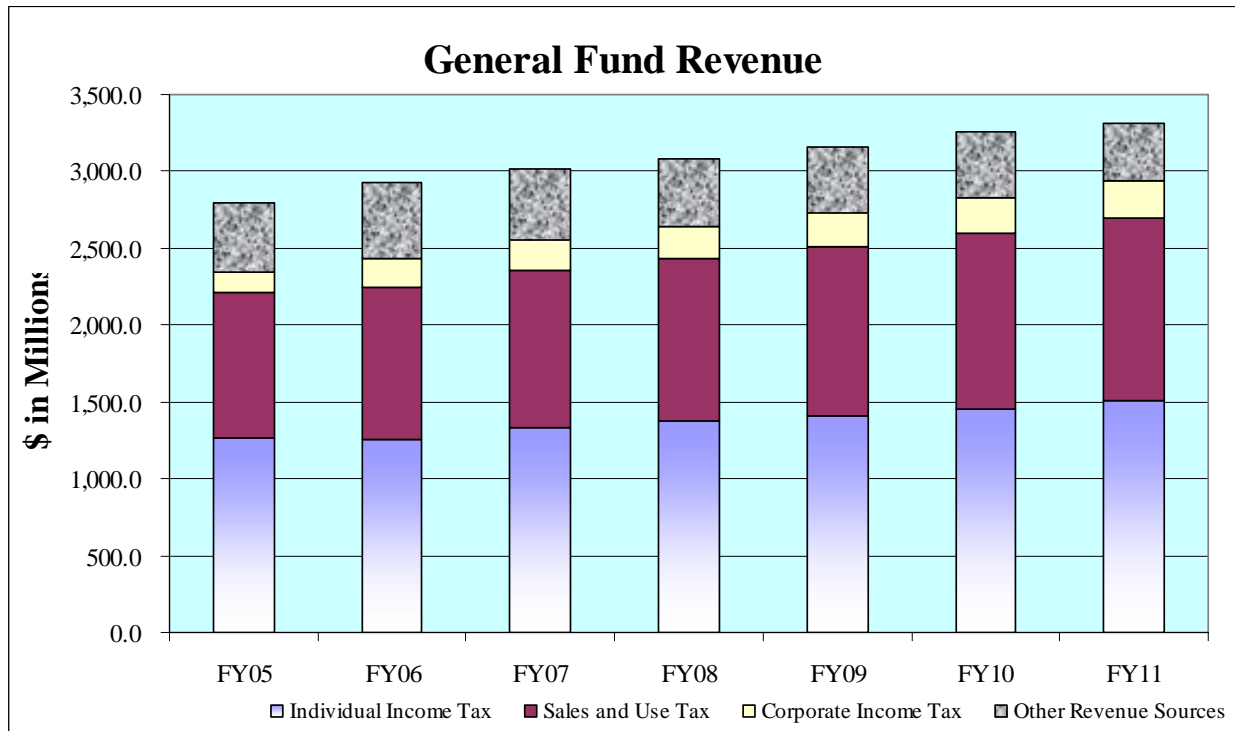


# REPORT OF THE MAINE STATE REVENUE FORECASTING COMMITTEE

December 2006



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# Report of the Maine State Revenue Forecasting Committee December 2006 Forecast

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## I. INTRODUCTION AND BACKGROUND TO REVENUE FORECAST

This report represents the conclusion to the fall forecast for the December 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 establishes the 2008-2009 biennial revenue forecasts for the General Fund and Highway Fund that will be used to determine the biennial budget. This forecast also extends the forecast through the subsequent 2010-2011 biennium to June 30, 2011. This forecast also reflects all legislative changes through the 122<sup>nd</sup> Legislature and incorporates the revised economic forecast presented by the Consensus Economic Forecasting Commission (CEFC) for its November 1<sup>st</sup> reporting deadline. The RFC met on October 24<sup>th</sup> and November 28<sup>th</sup> to deliberate and discuss the recommendations of Maine Revenue Services and other revenue analyses.

### A. Economic Forecast Update

The December 2006 revenue update began with the fall economic forecast in October. The Consensus Economic Forecasting Commission (CEFC) met on October 3<sup>rd</sup> to review and update its February 2006 forecast. The commission extended its forecast horizon by two years to encompass the 2010-2011 biennium, and, for the first time, incorporated the economic impact of closing Brunswick Naval Air Station (BNAS). Based on economic data available through the first nine months of 2006, the commission made slight adjustments to its previous forecast. Table I-A below summarizes the incremental change of the CEFC forecast. The full report of the CEFC is included in Appendix E.

**TABLE I-A**

**Consensus Economic Forecasting Commission**

**Comparison of February 2006 and November 2006 Economic Forecasts**

<b>Calendar Years</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
<b>• Wage &amp; Salary Employment (Annual Percentage Change)</b>						
> Consensus 2/2006	0.5	0.6	0.6	0.7		
> Consensus 11/2006	0.5	0.4	0.6	0.8	0.7	0.7
<b>Difference</b>	<b>0.0</b>	<b>-0.2</b>	<b>0.0</b>	<b>0.1</b>		
<b>• Personal Income (Annual Percentage Change)</b>						
> Consensus 2/2006	5.0	4.5	4.5	4.5		
> Consensus 11/2006	5.2	4.3	4.5	4.5	4.3	4.2
<b>Difference</b>	<b>0.2</b>	<b>-0.2</b>	<b>0.0</b>	<b>0.0</b>		
<b>• Consumer Price Index (Annual Percentage Change)</b>						
> Consensus 2/2006	2.8	2.5	2.2	2.2		
> Consensus 11/2006	3.5	2.5	2.2	2.2	2.8	2.8
<b>Difference</b>	<b>0.7</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>		

The commission maintained its projection of 0.5% employment growth in 2006 and reduced its forecast for 2007 based on evidence that the national housing slowdown is reaching Maine. The forecast shows employment growth returning to 0.8% by 2009, and then moderating somewhat in response to the closing of BNAS in 2010-2011. The commission increased its 2006 income growth forecast from 5.0% to 5.2% based on data from the first half of 2006 from the U.S. Bureau of Labor Statistics. It lowered its 2007 income growth forecast, again based on signs of a weakened housing market. Income growth should increase to 4.5% in 2008-2009 before moderating in 2010-2011, again reflecting the closure of BNAS. The CEFC raised its 2006 forecast for the U. S. Consumer Price Index (CPI) based on actual CPI data for the first eight months of 2006. Those data continue to reflect high oil prices.

New to the November 2006 CEFC report were individual growth projections for the three personal income components of dividends, interest, and rent, which were previously aggregated. In particular, dividend income has increased faster than the other two components. The CEFC was requested to provide the additional breakdown to improve income tax revenue forecasts.

## **B. Capital Gains Forecast**

A major variable that is not included in the economic forecast is a projection of net capital gains. Maine's exceptional capital gains growth during the stock market "bubble" of the late 1990's (in excess of 20% annual increases for 5 consecutive years through tax year 2000) came to an abrupt end in tax year 2001, plummeting 54.3%, resulting in a very unpleasant April surprise in 2002. Based on realizations in tax year 2004, Maine received an opposite surprise in April 2005. It is estimated that net capital gains realizations increased by nearly 43% that year, whereas the RFC had assumed they would grow by only 5.5%.

The RFC and Maine Revenue Services, like their counterparts in other states and the federal government, have had much difficulty trying to accurately forecast this variable. Maine data is not captured at the state level and may only be accessed through federal tax data. That information is shared with Maine Revenue Services, but it lags by as much as 2 years. Since November 1999, Maine Revenue Services has been required to provide a report on the net capital gains and losses realized by taxpayers filing Maine individual income tax returns. That report is provided to the Legislature through the RFC and is included in Appendix G of this report. Table I-B on page 3 summarizes the current assumptions. The differences from the assumptions included in the March 2006 report are:

- 2004 data have been updated to actual with the most recent federal data;
- 2005 projections (note they are still projections due to filing extensions that will change the data) have been increased from no growth to 10.6% growth as a result of preliminary data from the IRS;
- 2006 projections have been increased from negative growth to 10% growth based on the strong performance of the stock market during 2006; and
- The negative annual growth in capital gains realizations is now assumed to start in 2008, rather than 2006.

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

<b><u>Tax Year</u></b>	<b><u>Capital Gains Realizations (\$ Millions)</u></b>	<b><u>Capital Gains Realizations Annual % Change</u></b>	<b><u>Capital Gains Tax Liability (\$ Millions)</u></b>	<b><u>Capital Gains Tax Liability Annual % Change</u></b>	<b><u>Capital Gains % of Resident Tax Liability</u></b>
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*

With the bursting of the stock market “bubble,” in 2001 the extent of the Maine resident individual income tax liability derived from net capital gains had dropped down from its peak in 2000 of 17.3% to a level more in line with historical patterns before the “bubble,” in the range of 6% to 7% of tax liability. The recent double-digit growth in capital gains realizations is estimated to have returned that ratio back to over 10%. Starting with the March 2006 forecast, the RFC has assumed 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).

It is this variable that introduces the greatest risk in the revenue forecast. The other aspect of capital gains realizations that makes it difficult, particularly in Maine, is the fact that these gains are very discretionary and concentrated in the top 4%, or 25,000, of Maine’s individual income tax filers. That top 4% accounts for approximately 40% of total individual income tax liability. The RFC again struggled with this vexing variable in this forecast.

### **C. Corporate Profits**

A major variable of the tax models that drives the corporate income tax forecast is corporate profitability. Again, this forecast is not part of the CEFC economic forecast. The RFC used Global Insight's November 2006 forecast of pre-tax corporate profits. That national forecast calls for 35% growth in calendar year 2005, 16% growth in calendar year 2006 and relatively flat growth thereafter. Maine is insulated from significant regional variances in corporate profitability as a result of Maine'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.

### **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. Again, relying on Global Insights' November 2006 US economic forecast, the RFC used the assumption that oil prices, which are currently in the \$60 per barrel range, will increase to \$64 a barrel on average in 2007 then gradually decline 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 122<sup>nd</sup> Legislature. Table I-E below summarizes the adjustments to budgeted revenue from legislative changes during the 2<sup>nd</sup> Regular Session, providing total annual changes in each of the major revenue categories. With the exception of the implementation of a new municipal tax reimbursement program for the personal property tax exemption for business equipment beginning in FY09, the legislative changes to revenue were not significant in this forecast. Appendix A provides a summary of this new tax reimbursement program.

**Table I-E**  
**Summary of 122nd Legislature's Changes - 2nd Regular Session**

**General Fund**

	<b>FY06</b>	<b>FY07</b>	<b>FY08</b>	<b>FY09</b>
<b>Sales Tax</b>	\$0	\$1,010,576	(\$1,594,805)	(\$1,641,131)
<b>Individual Income</b>	\$0	(\$2,247,984)	(\$2,950,230)	(\$15,254,207)
<b>Corporate Income</b>	\$0	(\$111,003)	(\$146,574)	(\$201,835)
<b>Estate Tax</b>	\$0	\$135,800	\$196,721	\$278,584
<b>Revenue Sharing</b>	\$0	\$68,770	\$243,964	\$297,629
<b>Other Revenue</b>	\$427,695	(\$507,944)	\$535,647	\$522,638
<b>Total – Legislative Changes</b>	<b>\$427,695</b>	<b>(\$1,651,785)</b>	<b>(\$3,715,277)</b>	<b>(\$15,998,322)</b>

**Highway Fund**

	<b>FY06</b>	<b>FY07</b>	<b>FY08</b>	<b>FY09</b>
<b>Fuel Taxes</b>	\$0	(\$19,908)	(\$8,114)	\$0
<b>Motor Vehicle Reg. &amp; Fees</b>	\$0	\$28,200	\$32,800	\$33,260
<b>Totals – Legislative Changes</b>	<b>\$0</b>	<b>\$8,292</b>	<b>\$24,686</b>	<b>\$33,260</b>

## 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. Appendix G contains the materials presented by Maine Revenue Services on November 28, 2006 to support the forecast recommendations for the major tax categories.

### A. General Fund

For the **General Fund**, this forecast increases the previous forecast primarily as a result of the recent positive variances in FY06 in the Corporate and Individual Income Tax categories. It was the view of the committee that strong income gains among upper income earners, a continuation of solid corporate profits growth and double-digit stock market gains in 2006 will not only sustain the level of income tax receipts in FY06, but result in modest growth during the upcoming biennium. Positive variances in the current fiscal year led to a substantial revision upward in the Estate Tax in the current year and smaller upward revisions in future years.

Unlike income and estate taxes, the Sales and Use Tax was adjusted down in this forecast. While the recent decline in energy prices has certainly helped household budgets, the on-going correction in the housing market, high consumer debt and a weak market for automobile sales are projected to keep the growth in sales tax receipts well below the growth in household income during the next 12 to 18 months. Insurance Companies Tax was also revised downward.

Other changes worth noting include upward revisions to the Real Estate Transfer Tax, Parimutuel and Gaming Revenue and the State Cost Allocation Program. Notable reductions include revenue from Targeted Case Management at the Department of Health and Human Services and the recently enacted Transfer to the Maine Milk Pool.

**Table II-A - General Fund Summary**

	<b>FY06 Actual</b>	<b>FY07</b>	<b>FY08</b>	<b>FY09</b>	<b>FY10</b>	<b>FY11</b>
Current Forecast	\$2,931,825,687	\$2,934,190,370	\$2,988,997,412	\$3,064,864,549		
Annual % Growth	5.1%	0.1%	1.9%	2.5%		
Net Increase (Decrease)		\$86,417,340	\$87,483,151	\$93,405,601		
Revised Forecast	\$2,931,825,687	\$3,020,607,710	\$3,076,480,563	\$3,158,270,150	\$3,262,017,710	\$3,318,238,572
Annual % Growth	5.1%	3.0%	1.8%	2.7%	3.3%	1.7%
<b>Summary of Revenue Revisions by Major Revenue Category</b>						
Sales and Use Tax		(\$3,401,816)	(\$16,907,151)	(\$20,448,344)	N/A	N/A
Service Provider Tax		\$0	\$0	\$0	N/A	N/A
Individual Income Tax		\$59,042,583	\$66,172,650	\$63,284,176	N/A	N/A
Corporate Income Tax		\$31,491,003	\$46,876,574	\$55,561,835	N/A	N/A
Cigarette and Tobacco Tax		(\$963,901)	(\$622,497)	(\$700,395)	N/A	N/A
Public Utilities Tax		(\$800,000)	(\$800,000)	(\$800,000)	N/A	N/A
Insurance Companies Tax		(\$3,308,036)	(\$4,397,615)	(\$5,514,545)	N/A	N/A
Estate Tax		\$14,177,453	\$3,114,077	\$5,047,439	N/A	N/A
Prop. Tax - Unorganized Territory		\$0	\$0	\$0	N/A	N/A
Income from Investments		(\$1,598,582)	(\$1,663,582)	(\$1,663,582)	N/A	N/A
Transfer to Municipal Rev. Sharing		(\$4,443,720)	(\$4,999,388)	(\$5,116,678)	N/A	N/A
Transfer from Lottery Commission		\$0	\$0	\$0	N/A	N/A
Other Revenues		(\$3,777,644)	\$710,083	\$3,755,695	N/A	N/A
<b>Total Revisions - Increase (Decrease)</b>		<b>\$86,417,340</b>	<b>\$87,483,151</b>	<b>\$93,405,601</b>	N/A	N/A

## **B. Highway Fund**

For the **Highway Fund**, this forecast decreases FY07 budgeted revenue by \$9.6 million and decreases the previous projections for the 2008-2009 biennium by \$11.7 million. The downward revisions to Fuel Taxes are the major driver of the Highway Fund changes. Higher fuel prices have decreased demand for gasoline and diesel fuel. The tax models have added fuel prices as an additional variable to help better capture the effect on fuel tax revenue. The forecast also recognizes the effect on the Highway Fund investment earnings of cash balances that have been drained by budget problems in the Department of Transportation's capital program.



**Table II-B - Highway Fund Summary**

	<b>FY06 Actual</b>	<b>FY07</b>	<b>FY08</b>	<b>FY09</b>	<b>FY10</b>	<b>FY11</b>
Current Forecast	\$326,546,157	\$340,392,025	\$346,268,833	\$353,665,022		
Annual % Growth	0.1%	4.2%	1.7%	2.1%		
Net Increase (Decrease)	\$0	(\$9,634,696)	(\$5,272,534)	(\$6,468,502)		
Revised Forecast	\$326,546,157	\$330,757,329	\$340,996,299	\$347,196,520	\$350,245,413	\$356,494,765
Annual % Growth	0.1%	1.3%	3.1%	1.8%	0.9%	1.8%
<b>Summary of Revenue Revisions by Major Revenue Category</b>						
Fuel Taxes		(\$7,284,441)	(\$5,922,257)	(\$7,016,782)	N/A	N/A
Motor Vehicle Registration & Fees		(\$1,930,000)	\$670,000	\$420,000	N/A	N/A
Inspection Fees		(\$35,000)	(\$35,000)	(\$35,000)	N/A	N/A
Fines, Forfeits and Penalties		\$0	\$0	\$0	N/A	N/A
Income from Investments		(\$555,000)	(\$555,000)	(\$555,000)	N/A	N/A
Other Revenues		\$169,745	\$569,723	\$718,280	N/A	N/A
<b>Total Revisions - Increase (Decrease)</b>		<b>(\$9,634,696)</b>	<b>(\$5,272,534)</b>	<b>(\$6,468,502)</b>	N/A	N/A

**C. Fund for a Healthy Maine (FHM)**

The **Fund for a Healthy Maine (FHM)** revenue forecast was revised downward for the 2008-2009 biennium primarily based on an assumed continued delay in the receipt of tobacco settlement payments pending the outcome of litigation concerning the Master Settlement Agreement. The FHM revenue forecast also reflects a negative adjustment resulting from changes in Global Insight's economic modeling for the forecast period. These negative adjustments are partially offset by assumed increases resulting from the FHM's share of the projected increase in gaming revenue from slot machines operated in association with the commercial race track in Bangor, and from assumed income from investments. The net result for the 2008-2009 biennium revenue forecast for the Fund for a Healthy Maine is a downward revision of \$26.5 million (\$13.5 million in FY08 and \$13.0 million in FY09). The projections for the 2010-2011 biennium are for growth of 8.0% and 5.5%, respectively, and assume for projection purposes that the State will prevail in the legal proceedings.

*Note: The growth expected in the 2008-2009 biennium in tobacco settlement payments from the addition of the 10 annual "Strategic Contributions Payments" that begin in FY08 was already reflected in the base forecast.*

**Table II-C - Fund for a Healthy Maine Summary**

	<b>FY06 Actual</b>	<b>FY07</b>	<b>FY08</b>	<b>FY09</b>	<b>FY10</b>	<b>FY11</b>
Current Forecast	\$46,907,751	\$43,689,284	\$73,861,352	\$75,844,458		
Annual % Growth	-4.5%	-6.9%	69.1%	2.7%		
Net Increase (Decrease)	\$0	\$2,500,060	(\$13,452,402)	(\$13,028,510)		
Revised Forecast	\$46,907,751	\$46,189,344	\$60,408,950	\$62,815,948	\$67,818,647	\$71,548,715
Annual % Growth	-4.5%	-1.5%	30.8%	4.0%	8.0%	5.5%
<b>Summary of Revenue Revisions by Major Revenue Category</b>						
Base Payments		\$1,256,100	(\$14,535,116)	(\$14,560,946)	N/A	N/A
Racino Revenue		\$1,198,960	\$1,057,714	\$1,507,436	N/A	N/A
Income from Investments		\$45,000	\$25,000	\$25,000	N/A	N/A
<b>Total Revisions - Increase (Decrease)</b>		<b>\$2,500,060</b>	<b>(\$13,452,402)</b>	<b>(\$13,028,510)</b>	N/A	N/A

## D. MaineCare Dedicated Revenue Taxes

In aggregate, the forecast for **Medicaid/MaineCare Dedicated Revenue Taxes** was revised upward for the forecast period. This revision was driven primarily by an upward adjustment in service provider tax dedicated revenue (i.e., that portion of the tax applied to private non-medical institutions (PNMI's), community support, day habilitation, personal support and residential training services) based on actual FY06 revenue and FY07 collections to date. The revised forecast also assumes a slight upward adjustment in hospital tax revenue. These positive adjustments in the MaineCare tax forecast are partially offset by downward revisions in nursing facility and residential treatment facility tax revenue based on actual experience.

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

	<b>FY06 Actual</b>	<b>FY07</b>	<b>FY08</b>	<b>FY09</b>	<b>FY10</b>	<b>FY11</b>
Current Forecast	\$118,096,040	\$120,142,902	\$121,472,242	\$122,834,815		
Annual % Growth	23.6%	1.7%	1.1%	1.1%		
Net Increase (Decrease)	\$0	\$1,383,102	\$1,353,391	\$1,322,937		
Revised Forecast	\$118,096,040	\$121,526,004	\$122,825,633	\$124,157,752	\$125,523,174	\$126,922,732
Annual % Growth	23.6%	2.9%	1.1%	1.1%	1.1%	1.1%
<b>Summary of Revenue Revisions by Major Revenue Category</b>						
Nursing Facility Tax		(\$1,027,690)	(\$1,053,382)	(\$1,079,716)	N/A	N/A
Residential Treatment Facilities Tax		(\$140,100)	(\$143,602)	(\$147,192)	N/A	N/A
Hospital Tax		\$393,609	\$393,609	\$393,609	N/A	N/A
Service Provider Tax (PNMIs)		\$2,157,283	\$2,156,766	\$2,156,236	N/A	N/A
<b>Total Revisions - Net Increases (Dec.)</b>		<b>\$1,383,102</b>	<b>\$1,353,391</b>	<b>\$1,322,937</b>	N/A	N/A

## III. CONCLUSIONS

### Modest Growth from a Higher Base

While the level of adjustments made to the General Fund in this forecast may be surprising to many observers, it is important to remember that the General Fund ended FY06 with a revenue surplus of \$74.1 million. Furthermore, the economic forecast combined with other key assumptions results in a General Fund revenue forecast that is projected to grow at very modest levels during upcoming biennia.

### Fuel Prices

Energy prices have become an important issue during the last few RFC meetings. While high volatile energy prices have the greatest effect on fuel taxes, which primarily accrue to the Highway Fund, they are also affecting other taxable sales. Maine's dependence on oil for home heating and fueling vehicles for travel in a rural state makes Maine's economy vulnerable to events in unstable areas throughout the world. These higher fuel prices are diverting disposable income from what otherwise would be available for other purchases.

## **Greatest Risks**

Although the RFC forecast for net capital gains projects significant improvement over the previous forecast, the RFC remains cautious about the unpredictable nature of income from this revenue source. 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. In addition, recent increases in corporate income tax receipts are unprecedented.

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 forecast. In addition to the volatility related to capital gains, the very uncertain global economic and geo-political environment adds the potential for significant “shocks” to the forecast that could significantly affect revenue.