Commonwealth of Massachusetts

Testimony of
Navjeet K. Bal
Commissioner, Department of Revenue
Consensus Revenue Hearing
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Good morning Secretary Gonzalez, Chairman Panagiotakos and Chairman Murphy, my name is Navjeet Bal, and I am the Commissioner of Revenue. With me today is Kazim Ozyurt, the Acting Director of the Office of Tax Policy Analysis at the Department. We are pleased to present to you the Department's updated outlook on Massachusetts state tax revenues for FY11 and our forecast for FY12. We have distributed copies of our Briefing Book, which will also be available on our website, www.mass.gov/dor.

With the national economy recovering and growing slowly since the end of the recent Great Recession, the Massachusetts economy and its tax revenue collections continue to improve, reflecting moderate but steady growth.

Our FY11 and FY12 revenue forecasts are based on actual collections through November 2010 and the economic projections of our vendors: Moody's Economy.com, Global Insight and the New England Economic Partnership.

Based on these economic projections, DOR's capital gains projections and revenues received year-to-date, DOR's revenue estimates for FY11 and FY12 are as follows:

FY11. Taking recent settlement payments into account, and actual tax receipts through November, FY11 tax revenue is projected to exceed the GAA FY11 revenue estimate by **$511 million to $603 million**.

- The current GAA FY11 revenue estimate is 19.078 billion, and we are now projecting that revenues will end the fiscal year at **$19.589 billion to $19.681 billion**.
- As you may know, through the end of November, 2010, the Commonwealth had already collected $516 million above the GAA estimate, reflecting a 7.1% growth rate.
- In order to understand our FY11 projections, it is important to focus on two things:
    - One: While the national and state economies have been improving at a moderate pace, that pace is expected to slowdown during the rest of the fiscal year. That slow down in growth is reflective of slow employment growth over the rest of the fiscal year.
    - Two: It is also important to look behind what has been driving that above-benchmark performance on a year-to-date basis, and how much of that is due to one-time payments or other events that are not likely to re-occur this year.
        - Of the $516 million above benchmark, roughly 30% is due to improved withholding, lower income tax refunds and sales tax collections, and 70% (or $355 million) is due to higher than expected corporate and business collections. Approximately half of that amount is due to one-time litigation settlement payments received from business taxpayers, and the rest is due to lower than anticipated corporate refunds. Tax settlement payments are very difficult to predict in terms of their timing

and amount, and are not included in our revenue estimate for the rest of FY11. Corporate refunds have essentially ended for the fiscal year, and there should not be any further “pick-up” from this during FY11.

    - We are also lowering our estimate of the impact of the film tax credit by about $35 million on FY11.

- The updated FY11 revenue estimate represents an increase of 5.6% to 6.1% from FY10. The GAA estimate represented an increase of 2.9%.
- December and January are important months for the Commonwealth as that is when the final corporate estimated tax payments (for calendar year companies) and personal quarterly estimated taxes are due. We will be releasing the December 15 report by next Monday.

FY12. Based on these upwardly revised FY11 revenue estimates, DOR projects FY12 tax revenue collections to be in the range of **$20.211 billion to $20.343 billion**, reflecting baseline growth over FY11 estimates of 4.1% to 5.0%.

- This represents growth of **$570 million to $737 million** over projected FY11 revenues.

Economic conditions underlying the FY11 and FY12 Revenue estimates.

- The national economy started to recover from the Great Recession in the second half of 2009, but the recovery has slowed down recently. After strong growth in the fourth quarter of 2009 (5.0%) and the first quarter of 2010 (3.7%), the growth in real GDP slowed down in the second (1.7%) and third quarter of 2010 (2.5%), and is expected to remain slow until the second half of 2011. FY12 real GDP forecasts range from increases of 2.6% to 3.5%.

- As you know, the main drivers of Massachusetts state tax revenues are income tax (approximately 55% of FY10 revenues), sales tax (approximately 25%) and corporate and business tax (approximately 11%).

- Massachusetts **income tax** is driven by employment, growth (or declines) in wages and salaries and capital gains realizations as well as dividend and interest income. On a year-to-date basis, withholding is up 5.3% (baseline) and income tax estimated payments (cash) are up 3.8% (baseline) reflecting increases in non-wage income.

- **Income tax:** The labor market has shown only slight improvement since the end of the recession.
  - The U.S. unemployment rate edged slightly up to 9.8% in November even though US payroll employment rose by 39,000 jobs in the month. Unemployment rates are expected to remain close to their current levels in 2011 as the recovery in the labor market is expected to be very slow.
  - Massachusetts state employment bottomed out in the first quarter of 2010. Projections for Massachusetts employment range from an increase of 0.5% to 1.2% in FY12, compared to an increase of 1.0% to 1.2% in FY11.
  - Wage and salary disbursements are projected to increase by 2.3% to 3.2% over the remainder of FY11, and increase by 4.4% to 5.2% in FY12.

- Massachusetts personal income is expected to rise 2.8% to 2.9% in FY11, and 3.5% to 5.0% in FY12.
- Based on projections from the three vendors we use, the increase in total income taxes in FY11 is expected to range from 6.7% to 7.1%. The GAA estimate anticipates an increase of 5.9%. Income tax growth in FY12 is expected to range from 5.6% to 6.4%.

Capital Gains. Over the past two fiscal years, Capital Gains taxes have continued to be a volatile revenue source in Massachusetts.

- For example, tax year 2009 capital gains realizations were estimated to be $8.4 billion, a 43.3% decrease from tax year 2008 realizations of $14.7 billion.
- After taking into account such a decline in capital gains realizations and timing issues related to when in the FY taxpayers "true up" their capital gains for state income tax purposes, capital gains taxes received in FY10 declined by 5.1% or $27 million from FY09 to approximately $497 million.
- DOR's capital gains model, which takes into account such timing factors, is currently projecting an increase of $147 million in capital gains tax receipts for the Commonwealth in FY11 as compared to FY10 (29.5% increase) for an estimated total of $644 million, compared with a projected 17.4% increase in capital gains realizations in tax year 2010. The same model is projecting a 16.4% increase in tax year 2011 capital gains realizations and a 15.5% increase ($100 million) in FY12 capital gains tax receipts for an estimated total of $744 million.

Sales tax receipts through the first five months of FY11 have increased by 12.7% on an actual basis, reflecting the sales tax rate increase and the lifting of the sales tax exemption for alcohol sales in liquor stores. If you back out these tax law changes, sales tax receipts have increased 3.0% for the year-to-date. This increase is in line with data from other states that experienced sales tax revenue increases at an average of 2.2% in the third calendar quarter of this year.

- Massachusetts retail sales are projected to grow by 4.5% to 5.0% over the remainder of FY11 and by 5.0% to 5.5% in FY12.
- Baseline sales tax receipts in MA are projected to increase over the remainder of FY11 in a range of 3.0% to 4.7%, and 3.5% to 4.4% range in FY12.
- The voter repeal of the sales tax on alcohol sold in liquor stores will lead to an estimated decline of $46 million in FY11, and $110 million in FY12.

Corporate and Business taxes: On a year-to-date basis, corporate and business tax receipts are up 34.0% actual and 32.4% baseline, with estimated payments (an indicator of current business conditions) up 20.5%.

- Nationally, corporate profits are expected to grow by 1.1% to 5.8% in FY12, compared to growth of 10.4% to 12.4% in FY11.
- Growth in corporate and business tax receipts is projected to range from 9.1% to 9.7% over the remainder of FY11 and to increase a further 1.1% to 2.0% in FY12.

Proposed Federal Tax law changes. I would like to spend just a minute on the proposed extensions of federal tax law extensions or other changes that are being discussed in Washington D.C., and their potential impact on Massachusetts revenues in FY11 and FY12.

For the most part, Massachusetts revenues will not be affected by the extension of the so-called "Bush tax cuts". In particular, the extension of the lower federal income tax rates for the various brackets will not affect Massachusetts revenue collections. It is worth noting that the economic forecasters that we work with had already assumed the extension of most of the Bush tax cuts and the extension of the unemployment benefits when they were preparing their economic forecasts, so any revenue upside from these extensions (caused by the economic stimulus these extensions are thought to provide) has already been factored into our revenue estimates for Massachusetts. The one major item that had not been included in the economic forecasts is the proposed payroll tax deduction that would lower employees' share of social security payroll taxes by two percentage points. The anticipated stimulative effects of this change, assuming it passes, will have to be incorporated into the economic forecasts.

Massachusetts revenues will be directly affected by some of the federal tax law extensions and other changes, although in most cases, those federal provisions will have minimal-to-no effect because our current revenues and revenue estimates already include the impact of such federal tax law provisions or the Massachusetts impact of these proposed changes is not material. The one change that is expected to have a more material effect would be the extension of the so-called Section 179 expensing provisions, which allow a small business to expense certain equipment purchases in the year of purchase. The amount that can be expensed and the cap on such amount were both raised for calendar years 2010 and 2011 as a way to stimulate the economy by encouraging businesses to purchase equipment and software. Those amounts and caps were scheduled to go back down to their original levels in calendar year 2012. The current federal proposal is to set the new limits for calendar 2012 at a level that is lower than the current rates for calendar 2010 and 2011, but, higher than had been anticipated for calendar 2012. This is expected to have an impact of approximately $4.8 million on Massachusetts revenue collections in FY12.

The proposed changes to the federal **estate** tax will not have a direct impact on the Massachusetts estate tax because the Massachusetts estate tax is not tied to current federal law. However, based on the federal proposal, there may be a disconnect in 2010 with respect to the measure of an estate's basis in assets for certain taxpayers for income tax purposes. For estates created in 2011 and beyond, this will not be an issue, and there should not be any material adverse Massachusetts revenue impact from the federal estate tax law changes.