Commonwealth of Massachusetts

Testimony of
Christopher C. Harding
Commissioner, Department of Revenue
Consensus Revenue Hearing
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Good morning Secretary Heffernan, Chair Spilka, Chair Sanchez, and members of both Chambers. My name is Christopher Harding. I am the Commissioner of the Department of Revenue. With me today is Kazim Ozyurt, Chief Economist and the Director of the Office of Tax Policy Analysis at the Department; Kevin Brown, our General Counsel; and Robert Mcconnaughey, Deputy Commissioner of Legislative, External Affairs and Policy. We are pleased to present to you the Department's updated outlook on Massachusetts state tax revenues for FY18 and our forecast for FY19. We have distributed copies of our Briefing Book, which will also be available on our website (http://www.mass.gov/dor/tax-professionals/news-and-reports/state-budget-documents/briefing-book/).

A brief recap of the recent past year will provide context for the revenue outlook. As you know, we ended FY17 and entered FY18 with some areas of concern in revenue. Most notably, in FY17, non-withheld income tax (the net of three related categories of Estimated Payments, Payments sent in with Returns, and Refunds) was negative relative to Benchmark. Our analysis showed that the main driver was the performance of the financial markets. For example, the return on the S&P 500 dropped from 6.8% in 2015 to 1.5% in 2016. In addition, taxpayers may have deferred the realization of capital gains in expectation of possible federal tax cuts under the new administration. This resulted in lower tax liability on investment-related income, resulting in lower Estimated Payments and return payments, with the negative impact on revenues coming mainly in FY17.

Although we saw relatively weak revenue performance in FY17 (mostly due to weakness in the non-withheld personal income tax categories), today we see that the overall revenue growth has somewhat stabilized and is in line with underlying recent moderate economic growth. Although we study all the revenue categories and the economic forces that drive them, we have naturally had a particular focus on non-withheld personal income tax categories as we look to the end of FY18 and into FY19.

The state of the economy, nationwide and in the Commonwealth, is the fundamental driver of revenues. An important secondary role is played by the returns in financial markets. As I will discuss in more detail, the economic growth picture is positive, but comes with moderately rising risks and potential volatility. The global economy seems to be improving. Even long stagnant economies such as Japan are seeing modest but notable pick-up. The globally competitive Massachusetts economy should benefit from this improving tailwind and see improved growth performance in the near future. The recent performance of the US and global equity markets has been very strong. The year-to-date total return on the S&P 500 through November was just over 20%. If the 2017 were to end with this figure, it would be the ninth consecutive year of positive returns, and the best year since 2013. However, after many years of central bank intervention and loose monetary policy, newfound accelerating economic growth may come with attendant risks. The US economy is nine years into a recovery that while modest, was accompanied by very low inflation, interest rates, and market volatility, creating a “Goldilocks” scenario for financial assets (“Goldilocks” meaning attractive by virtue of being “not too hot, not too cold”) . With signs of rising inflation, global central banks are now beginning to reverse their loose monetary policies and to unwind their enormous balance sheets. This change introduces significant unknowns into financial markets and the broader economy. Any setback to the global or US economy would hit the Massachusetts economy as well. Also, while there has been a further improvement in consumer confidence and in the financial markets, it would not be prudent to project these as permanent. The level of uncertainty in both the economic and political spheres is running very high. On top of this, there is uncertainty with respect to the impact of currently debated federal tax reform on the economy. In short, we believe that we are currently on-track for FY18, but the outlook for FY19 is perhaps even more uncertain than would normally be the case at this time. We will continue to closely monitor both the economy and financial markets.

Our FY18 and FY19 revenue forecasts are based on tax collections through November 2017 and the economic projections provided by Moody's Economy.com, and IHS Markit (formerly known as Global Insight). The forecasts have been adjusted for legislatively mandated tax changes.

DOR has been subscribing to these vendors and benefiting from their economic data and technical services since the 1990's. Their data and services have served us and the Commonwealth well in our state-specific revenue modeling and forecasting efforts.

Just a note: Before I outline our forecasts, I would like to point out the difference between two revenue growth measures:

Actual: growth in actual collections over two periods.

Baseline revenue growth measure: growth had there been no tax law or administrative changes that affected tax collections. Baseline growth also adjusts for fluctuations in the timing of tax collections. Baseline growth is a better measure of the change in the underlying tax base and the economy.

FY18

- **Our revenue benchmark for FY18 remains unchanged at $26.504 billion**. Based on current economic conditions and on collections so far in this fiscal year, we believe this figure remains appropriate. Our refreshed analysis gives an updated range of $26.530 billion to $26.596 billion, slightly better than the current benchmark. This range represents an increase of 3.6% to 3.9% over FY17.
- Our FY18 revenue estimate of $26.504 billion represents an increase of 3.5% from FY17.
- Through the end of November 2017, the Commonwealth has collected $204 million or 2.1% more than the year-to-date benchmark. Our collections reflect year-over-year actual and baseline revenue growth of 4.8% through the November year-to-date period. So far, we have received no one-time settlement-related payments in excess of $10 million each.
- Please note that some of the YTD growth was due to one-time non-settlement-related revenue payments.
- Please also note: December and January are important months for the Commonwealth's revenues because both personal and corporate estimated taxes are paid. DOR will monitor these revenues very closely during that period of time.

FY19

Based on our FY18 revenue estimates and our vendors' most recent economic projections, the Department of Revenue forecasts FY19 tax revenue collections in the range of **$27.374 billion to $27.582 billion.**

- This represents actual growth of 3.3% to 4.1% and baseline growth of 4.1% to 4.9% over the FY18 benchmark.
- The actual growth in dollars over the FY18 benchmark ranges from $870 million to $1.078 billion.
- DOR's hybrid forecast of FY19 revenue would be $27.392 billion, an increase of $888 million or 3.4% over the FY18 benchmark.

Our FY19 estimate reflects a couple of assumptions of note:

- First, we assume that the Part B Income Tax Rate will move from 5.10% to 5.05% during FY19 (effective January 1, 2019). The impact, reflected in the FY19 forecast, is $84 million less in revenue.
- Second, we are assuming that the Legislature will authorize accelerated sales tax revenue in FY19, as was done in FY18.
- Third, DOR's FY19 revenue projections did not include any potential taxes from recreational marijuana sales at this time. However, DOR analyzed the possible impact. DOR's analysis assumes that, effective July 1, 2018, there will be a reasonable number of retail establishments that would be operational during FY19, and that Massachusetts's experience in terms of per capita consumption and the pace of sales ramp-up would likely be similar to that of other states where legalization has occurred such as Colorado and Washington. Based on these simplified assumptions and the most recently passed level of taxation (6.25% sales tax, 10.75% excise tax, and 3% local option tax with a total rate of 20%), DOR estimates that the state's portion of the taxes (not including local option) from retail marijuana in FY19 may range from $44 million to $82 million with a midpoint of $63 million. Please note that there is considerable uncertainty about timing; specifically, it remains unclear the pace at which a sizable market will

develop. Therefore these numbers should be used with caution for budgeting purposes.

- Fourth, we do not include any potential impact of sales tax ballot and the income surtax ballot questions in our FY19 revenue forecasts.

Economic conditions underlying FY18 and FY19 revenue estimates.

- The national economy is forecasted to grow faster but still moderately in 2018 and 2019, with real GDP forecasted to grow by 2.7% to 2.9% in the last three quarters of FY18, and 2.6% to 2.7% for the full year FY18. The major sources of forecast uncertainty include federal tax reform, global political risks, including changes due to Brexit, and a changing global interest rate environment.

- The main drivers of Massachusetts state tax revenues are income tax (approximately 57.3% of FY17 revenues); sales tax (approximately 24.3%); corporate and business tax (approximately 10.2%), and other taxes (approximately 8.2%).

- Massachusetts **income tax** is driven by employment, wages and salaries, capital gains realizations, and income from dividends, interest, pass-through income, and others. On a FY18 year-to-date basis, baseline withholding collections are up 6.3%, while baseline estimated payments are up 0.7%.

General trends affecting income taxes: The labor market has performed well in calendar year 2017 in terms of employment and unemployment rates.

- According to the data from the U.S. Bureau of Labor Statistics, U.S. nonfarm payroll employment rose by about 2 million in the year ended in October 2017. The unemployment rate, which was 4.1% in October 2017, is forecasted to be 4.1% in FY18, and 3.7% to 4.0% in FY19.

- Massachusetts employment has grown strongly. According to the most recent Bureau of Labor Statistics (BLS) data, total nonfarm payroll employment increased by 69,000 (1.9%) in the year ended in October 2017. State employment is forecasted to grow by 1.4% to 1.5% in FY18 and 0.8% to 1.0% in FY19.

- The state unemployment rate is impressively low (3.7% in October 2017) and forecasted to be 3.9% to 4.0% in FY18 and 3.7% to 3.8% in FY19. Please note that these projections of higher reported unemployment do not necessarily reflect a weaker jobs outlook. The unemployment rate may change as individuals re-enter the workforce or job-seekers come to the state. For Massachusetts, this could actually result in a positive longer-term impact as our base of employed individuals continues to grow.

- Estimates from the U.S. Bureau of Economic Analysis suggest that Massachusetts wage and salary disbursements grew by 3.1% in FY17 compared to prior year. The growth of state wage and salary disbursements is forecasted to be from 3.7% to 4.4% in FY18 and from 4.7% to 5.6% in FY19. The growth of the state's personal income is forecasted to be from 3.3% to 3.8% in FY18, and from 4.5% to 4.8% in FY19.

- Based on economic projections from the two vendors we use, the increase in total income taxes in FY18 is expected to range from 3.6% to 4.2%. The current FY18 revenue estimate anticipates an increase of 4.3% growth from FY17. Income tax growth in FY19 is expected to range from 4.8% to 5.3%.

Capital Gains: Capital gains taxes are a volatile revenue source and therefore the most difficult to predict. With years of rising financial markets, we recognize a growing reserve of potential gains exists, but, importantly, the timing of taxable realization of those gains is impossible to predict precisely. Even for a historically volatile item, the range of current potential outcomes is likely larger than average.

- On a fiscal year basis, we project capital gains taxes to be approximately $1.1 billion in FY18, and $1.3 billion in FY19.

Sales tax receipts through the first five months of FY18 have increased by 3.1% actual and 2.7% baseline:

- Massachusetts retail sales are forecasted to grow by 3.4% to 5.0% in FY18 and by 3.3% to 5.1% in FY19. Baseline sales tax receipts are projected to increase over the remainder of FY18 in a range of 1.7% to 2.5%, and increase in a 2.1% to 4% range in FY19.

Corporate and Business Taxes: Year-to-date corporate and business tax collections, one of the more volatile revenue categories, are up 13.0% actual and 8.4% baseline. No tax-related settlements & judgments exceeding $10 million each were received during this period. However, some large non-settlement-related one-time payments, not requiring certification, boosted the year-to-date growth.

- Nationally, the annual growth of the corporate profits before tax is predicted to be from 4.4 % to 7.5% in FY18 and from 4.9% to 8.7% in FY19.
- Excluding large one-time tax settlement and judgment payments*, baseline growth in corporate and business tax receipts is projected to range from 3.4% to 4.5% over the remainder of FY18 and 1.7% to 3.3% in FY19.

  (* DOR does not make assumptions about one-time payments for the remainder of this fiscal year and FY19)

Other Taxes:

- All other tax collections through the first five months of FY18 have increased by 3.3% actual and 2.3% baseline (the strength mostly comes from estate tax), and baseline growth is projected to range from -0.4% to -1.6% over the remainder of FY18 and 0.5% to 1.0% in FY19.

Conclusion:

- While FY18 YTD revenue results have exceeded benchmark amidst a moderately accelerating economic backdrop, we believe that our prior FY18 benchmark of $26.504B remains appropriate.
- Our FY19 forecasts are in the range of $27.374 billion to $27.582 billion, representing actual growth of 3.3% to 4.1% and baseline growth of 4.1% to 4.9% over the FY18 benchmark. DOR's hybrid forecast for FY19 is $27.392 billion representing actual growth of 3.4% and baseline growth of 4.2% over the FY18 benchmark.
  - The FY19 forecast assumes a modestly improving economic growth environment, but importantly, no outsized surge in non-withheld personal income tax category, which is mostly from investment, business, pass-through and other income, including capital gains, at this time, which is a potentially volatile swing factor.

Thank you for your time. I am happy to respond to any questions you may have.