**Commonwealth of Massachusetts**

**Testimony of**
**Christopher C. Harding**
**Commissioner, Department of Revenue**
**Consensus Revenue Hearing**
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**Good morning Secretary Heffernan, Vice Chair Lovely, Chair Sánchez, and members of the House and Senate**. 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; and Kevin Brown, our General Counsel. Thank you for inviting us here today.

We are pleased to present the Department's updated outlook on Massachusetts state tax revenues for FY19 and our forecast for FY20. 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/).

**Our focus today is on Fiscal Years 2019 and 2020, but a brief recap of Fiscal Year 2018 may provide context that will be helpful in understanding our outlook.** In the year since the December 2017 Consensus Revenue hearing, the most notable development is the exceptionally strong revenue growth in Fiscal Year 2018. The 8.5% growth in FY18 over FY17 was the greatest percentage increase since FY11. In fact, the 8.5% growth figure has been exceeded only three times in the preceding 30 years.

**We still have incomplete information about the drivers of increased revenue in Fiscal Year 2018** because individual income taxes for the 2017 tax year can be filed as late as October 2018 with an extension, and information on corporate returns and federal data comes even later. Nevertheless, I believe we can point to a few key factors:

**As the Chairs, members of the Committee, and the Secretary all know well, FY18 was preceded by two years of disappointing revenue growth**. FY16 revenue was up 2.2%, and FY17 revenue up 1.3%, over the preceding year. In both periods, it was revenue from Non-Withheld Income that was markedly below benchmark.

Poor returns in the stock market in calendar 2015 and the first half of calendar 2016 were a key factor. Capital gains are an important driver of Estimated Payments. Capital gains occur when taxpayers sell securities and other assets that have risen in value.

In the 18 months from January 2015 to June 2016, the S&P 500 Index rose less than 2% in total, which represents very weak performance. This period would have influenced revenues in FY16 and FY17.

In contrast, in the next 18-month period, from July 2016 to December 2017, the S&P 500 Index rose more than 25%. There is not a one-to-one link between market performance and revenue, but it is clear that the jump in Estimated Payments in FY18 was partly due to stronger stock market performance, which resulted in capital gains.

**There is a second factor in FY18 revenues that is worthy of note: federal tax reform**. The Tax Cuts and Jobs Act (TCJA) of 2017 made major changes in business taxation and significant changes to individual taxation. At the Department of Revenue, we do not assess the policy behind the changes, but we seek to understand the impact on state revenue. Corporate tax revenues tend to be volatile, making interpretation difficult. Generally good corporate earnings may have helped to increase revenues, but we also believe that the TCJA caused an acceleration of revenue to the state. On the personal income tax side, there was an incentive to accelerate payment of state and local income taxes (so-called SALT) before the new federal cap on the SALT deduction took effect in 2018. In addition to the stronger stock market returns that I discussed earlier, this is another factor in the strong Estimated Payments in FY18.

**I want to note that throughout this period, the fundamentals of the Massachusetts economy have been strong and supportive of revenue growth**. Steady, moderate economic growth and rising employment have helped Withholding and Sales & Use taxes to increase substantially each year.

Together, these two categories constitute roughly 70% of total tax revenue, so their continued growth is a vital factor for the state. The remaining 30% of total tax revenue, including Non-Withheld Income, Corporate, and Other Taxes, contributes a smaller portion of revenue but represent a higher proportion of volatility and uncertainty.

**These three factors:** significant gains in the stock market after a period of weaker growth; tax reforms that may have incentivized accelerated tax payments as well as stimulated corporate earnings; and an underlying strong Massachusetts economy; appear to have combined to result in exceptionally strong Fiscal Year 2018 tax revenue collections. However, the first two factors are less indicative of trends than episodic factors. They may influence Fiscal Year 2019 tax collections but with somewhat decreasing significance over time. Simply put, both the FY18 revenues, and to some extent, year-to-date FY19 revenues, reflect that one-time events such as tax reform are exactly that -- one-time events – and will not be repeated in the future.

Financial market performance is unpredictable. At present the indicators are not as strong as they were in 2017. As of one week ago, the S&P 500 showed no gain on a year-to-date basis. It has moved upward in the past few days, but financial markets appear to be much more uncertain in 2018 than last year. Given these conditions, the more volatile sources of revenue, including Non-Withheld Income and Corporate, cannot be relied upon to increase, and are not likely to replicate the scenario from Fiscal Year 2018.

**Fortunately, the Massachusetts economy and business climate continue to show strength**. As we will discuss, the outlook for growth in revenues from Withholding and Sales & Use Taxes remains positive. Given that we are nearing full employment, further improvements in the unemployment rate may come more slowly, but the workforce is projected to continue to grow moderately. Recently, some economic observers are seeing signs of increases in wages, which is positive. At the same time, the outlook for economic growth nationwide remains positive but has dampened. Slower growth in the U.S. would, at some point, slow the growth in Massachusetts as well.

By most measures, the U.S. economy is now in the second-longest period of growth in its history. All expansions come to an end; the question is when the decline will start and how hard the fall will be. Based on the analysis and inputs from our sources, we are not projecting a recession to begin during FY20. We are however being realistic in our expectations for growth, and we will be monitoring both revenues and the economic environment carefully.

In our outlook, we have sought to use the best information available, to be realistic and prudent in our estimates, and to keep in mind that economic and financial market conditions can change rapidly and unpredictably.

**Our FY19 and FY20 revenue forecasts are based on actual tax collections through November 2018 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 1990s. Their data and services have served the Department and the Commonwealth well in our state-specific revenue modeling and forecasting efforts. We should note, however, that like all economic models and projections, they are limited in their power to project future trends.

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

**Actual growth means** growth in actual collections over two periods. Often we compare Year Over Year, meaning one year and the next, or a specific part of a year, like a month or a fiscal quarter, from one year to the next. Actual growth is the growth in real dollars.

**Baseline revenue growth is the measure of** growth that there would have been, had there been no tax law or administrative changes that affected tax collections in the period being measured. 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, because it excludes rule changes and timing anomalies that would otherwise cloud the data when comparing one year to another. Baseline revenue growth allows us to make more of an "apples to apples" comparison for purposes of economic analysis.

**FY19**

- **The FY19 revenue benchmark is $28.392 billion.** Based on current economic conditions and tax collections so far in this fiscal year, we think that there is a potential upside to FY19 tax collections. At the higher end, the upside could range from $256 million to $351 million more than the current benchmark. Given that the FY19 is less than half over, and the level of uncertainty in the remaining months, this upside potential should be treated with caution.

- We believe that some of the year-to-date surplus, which I will discuss shortly, was borrowed from the remainder of the fiscal year, and will give back later. As a result, we anticipate that the full year FY19 surplus will be smaller than the YTD surplus measured at the end of November. I would like to point out that revenue volatility tends to be a major issue during the December-June period; this year will not be any different. Our FY19 revenue forecasts may indicate some upside revenue opportunities. However, based on the remainder year revenue volatilities and risks, we believe that our prior FY19 benchmark of $28.392B remains appropriate.

- Through the end of November 2018, the Commonwealth has collected $423 million or 4.1% more than the year-to-date benchmark. Our collections reflect year-over-year actual growth of 8.4% and baseline growth of 7.9% through the November year-to-date period. So far, we have received $39 million in one-time settlement-related payments in excess of $10 million each, which are certified.

- Please 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 closely during that period of time.

## FY20

Based on our FY19 revenue estimates and our vendors' most recent economic projections, the Department of Revenue forecasts FY20 tax revenue collections in the range of **$29.217 billion to $29.384 billion.**

- This represents actual growth of 2.0% to 2.2% and baseline growth of 2.9% to 3.1% over the updated FY19 forecasts.
- The actual growth both in percentages and in dollars over the FY19 benchmark range from 2.9% to 3.5%, and from $825 million to $992 million, respectively.
- The midpoint of the forecast range for FY20 would be $29.301 billion, an increase of $908 million or 3.2% over the FY19 benchmark.

Our FY20 estimate reflects a couple of assumptions of note:

- First, we assume that the Part B Income Tax Rate will decrease from 5.10% to 5.05% effective January 1, 2019. Reflected in forecast, the rate reduction is expected to reduce tax revenue by approximately $84 million in FY19 and approximately $175 million in FY20.
- Second, we assume that the Part B Income Tax Rate will continue to decrease from 5.05% to 5.00% effective January 1, 2020. This change is expected to reduce tax revenue further by approximately $88 million in FY20 and approximately $185 million in FY21.
- Third, DOR's FY19 and FY20 revenue projections included taxes from recreational marijuana sales. As you know, such sales are subject to sales tax at 6.25%, excise tax at 10.75% at the state level, and up to 3% tax at the local level. The state's portion of the taxes (not including local option) from retail marijuana is assumed to be in the range of $44 million to $82 million with a midpoint of $63 million in FY19, and $93 million to $172 million with a midpoint of $132 million in FY20. DOR has not revisited these estimates at this time.

  Retail sales of marijuana have just begun, and we expect that revenues will continue to accelerate as retail outlets are licensed and open for business.

However, it still remains unclear when exactly Massachusetts will reach a fully developed market. The trends in retail marijuana prices are also important. Therefore, these figures should be used with caution for budgeting purposes.

As we gain experience with actual tax collections in this new category, the Department will be able to refine its projections and understand the factors influencing sales and excise revenues related to retail marijuana sales.

**Economic conditions underlying FY19 and FY20 revenue estimates.**

- The national economy is forecasted to slow down slightly in 2019 and considerably in 2020, with real GDP forecasted to grow by 3.0% to 3.2% in the last three quarters of FY19, and 1.9% to 2.4% for the full year FY20. The major sources of forecast uncertainty include the fading impact of federal tax reform, trade policies, changing global interest rate environment, and concerns about global economic growth.
- The main drivers of Massachusetts state tax revenues are income tax (approximately 58.4% of FY18 revenues); sales tax (approximately 23.2%); corporate and business tax (approximately 10.0%), and other taxes (approximately 8.4%).
- Massachusetts **income tax** is driven by employment, wages and salaries, capital gains realizations, and income from dividends, interest, pass-through income, and others.

**General trends affecting income taxes:** The labor market has performed well so far in calendar year 2018 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 2.5 million in the year ended in

October 2018. The U.S. unemployment rate, which was 3.7% in October 2018, is forecasted to be 3.6% in FY19, and 3.4% in FY20.

- Massachusetts employment has grown strongly. According to the most recent Bureau of Labor Statistics (BLS) data, total nonfarm payroll employment increased by 64,400 (1.8%) in the year ended in October 2018. State employment is forecasted to grow by 1.8% in FY19 and 0.9% to 1.2% in FY20.
- The state unemployment rate is impressively low (3.5% in October 2018) and forecasted to be 3.3% to 3.5% in FY19 and 3.0% to 3.4% in FY20.
- Estimates from the U.S. Bureau of Economic Analysis suggest that Massachusetts wage and salary disbursements grew by 5.1% in FY18 compared to prior year. The growth of state wage and salary disbursements is forecasted to be from 4.8% to 5.4% in FY19 and from 4.8% to 5.8% in FY20. The growth of the state's personal income is forecasted to be from 4.4% to 4.8% in FY19, and from 4.6% to 4.8% in FY20.
- Based on economic projections from the two vendors we use, the increase in total income taxes in FY19 is expected to range from 3.0% to 3.1%. The current FY19 revenue estimate anticipates an increase of 2.4% growth from FY18. Income tax growth in FY20 is expected to range from 2.4% to 2.7%.

**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 $1.618-$1.651 billion in FY19, and $1.534-$1.604 billion in FY20.

**Sales tax** receipts through the first five months of FY19 have increased by 5.5% actual and 4.9% baseline:

- Massachusetts retail sales are forecasted to grow by 4.4% to 4.6% in FY19 and by 3.4% to 4.6% in FY20. Baseline sales tax receipts are projected to increase over the remainder of FY19 in a range of 3.4% to 4.4%, and increase in a 2.9% to 3.7% range in FY20.

**Corporate and Business Taxes:** Year-to-date corporate and business tax collections, one of the more volatile revenue categories, are up 20.5% actual and 18.5% baseline. About $39 million in tax-related settlements & judgments exceeding $10 million each, which are certified, were received during the first five months of FY19.

- Nationally, the annual growth of corporate profits before tax is predicted to be from 4.9 % to 5.7% in FY19 and from 3.0% to 4.4% in FY20.
- Excluding large one-time tax settlement and judgment payments*, baseline growth in corporate and business tax receipts is projected to range from 2.8% to 5.3% over the remainder of FY19 and 2.5% to 3.6% in FY20.

(* DOR does not make assumptions about one-time payments for the remainder of this fiscal year and FY20)

**Other Taxes:**

- All other tax collections through the first five months of FY19 have increased by 19.3% actual and 17.5% baseline, and baseline growth is projected to range from -4.3% to -4.8% over the remainder of FY19 and -3.2% to -3.7% in FY20.
- The largest components of the "Other" category are revenue from Motor Fuels, Tobacco, Estate, and Deeds. During FY19 year-to-date, the Estate

tax has been higher than projected, driving up "Other" in total.  It is unclear whether Estate revenues will continue to be strong through fiscal year end.

**Conclusion:**

- While FY19 YTD revenue results have exceeded benchmark, we believe that our prior FY19 benchmark of $28.392 B remains appropriate.
- DOR's midpoint forecast for FY20 is $29.301 billion representing actual growth of 3.2% and baseline growth of 4.2% over the FY19 benchmark.
- The FY20 forecast assumes a slowing economic growth environment, and therefore only moderate increase 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.