Commonwealth of Massachusetts

Testimony of
Christopher C. Harding
Commissioner, Department of Revenue
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Good morning Secretary Heffernan, Chair Rodrigues, Chair Michlewitz, 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 Director of the Office of Tax Policy Analysis at the Department; and Kevin Brown, DOR's 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 FY20 and our forecast for FY21. 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 2020 and 2021, but a brief recap of Fiscal Year 2019 may provide context that would be helpful in understanding our outlook. Since the December 2017 Consensus Revenue hearing, a notable development has been the strong revenue growth in both Fiscal Year 2018 and Fiscal Year 2019. The FY18 revenue growth of 8.5% was the highest growth percentage increase since FY11. The FY19 growth of 6.9% was the third highest, right behind the growth of 7.8% in FY15.

As the Chairs, members of the Committee, and the Secretary all know well, the highly impressive revenue growth seen in both FY18 and FY19 were preceded by two years of disappointing revenue growth, namely FY16 and

FY17. Excluding large certified settlements, FY17 revenue was up 1.3%, and FY16 revenue up 2.2%, over the preceding year. The strong growth in FY18 resulted mostly from the corporate and business taxes and the non-withheld income tax, which in turn resulted from strong taxes on investment income such as capital gains and interests and dividends.

Strong growth in FY19 also resulted mostly from corporate and business taxes and the non-withheld income tax. **We still have incomplete information about the drivers of the Fiscal Year 2019 growth** because individual income taxes for the 2018 tax year can be filed as late as October 2019 with an extension, and become available for research only after processing. Information on corporate returns and federal data comes even later. Higher than expected revenue in estate tax, which is another volatile tax category, also contributed to revenue growth in the last two fiscal years. Nevertheless, we believe additional key factors behind the recent revenue performances are worth mentioning:

Stock market performances, capital gains. Capital gains are an important driver of non-withheld personal income tax[1]. Capital gains occur when taxpayers sell securities and other assets that have risen in value.

In the 18-month period from July 2016 to December 2017, the S&P 500 Index rose more than 23.7%, and in the next 18 months from January 2018 to June 2019, it increased about 9.4%. There is not a one-to-one link between market performance and revenue, but it is highly likely that the changes in non-withheld income tax in FY18 and FY19 were partly due to these stock market performances, which resulted in capital gains.

Federal tax reform. As you know, corporate tax revenues tend to be volatile, making interpretation difficult. It is true that in general, good corporate earnings may have helped to increase revenues in both fiscal years, but we also believe that

[1] Non-withheld tax includes estimated payments, payments with returns and extensions minus refunds.

the 2017 federal tax reform, also known as the TCJA, could have caused an acceleration of revenue to the state on both the corporate income and personal income tax sides. In addition to stronger stock market performances discussed earlier, the TCJA could be another factor contributing to the strong non-withheld and corporate tax revenue collections in FY18 and FY19.

Strong Massachusetts economy. I would like to note that in the past two fiscal years, the fundamentals of the Massachusetts economy have remained 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 Commonwealth. The remaining 30% of total tax revenue, including non-withheld income, corporate, and other taxes, contributes a smaller portion of revenue but represents a higher proportion of volatility and uncertainty. It is worth mentioning that in both FY18 and FY19, estate tax had very strong growth and was well above benchmark.

These three factors: 1) significant gains in the stock market after a period of weaker growth; 2) tax reforms that may have incentivized accelerated tax payments; and 3) the underlying strong Massachusetts economy, appear to have combined to result in exceptionally strong Fiscal Years 2018 and 2019 tax revenue collections. However, the first two factors are less indicative of trends than episodic factors. They may still influence Fiscal Year 2020 tax collections but with somewhat decreasing significance over time. Simply put, both the FY18 and FY19 revenues include one-time events such as tax reform and other unidentifiable factors that may not be repeated in the future.

As history has taught us well, financial market performance is also unpredictable. At present the indicators are not as strong as they were in 2017 and 2018. As of

December 2, 2019, the S&P 500 showed a gain of 5.2% based on average daily closing price[2]. 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 scenarios from Fiscal Year 2018 and 2019.

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 growth in employment may come at a slower pace. Our economic forecast vendors expect growth in state employment, state real GDP, state wages/salaries and state personal income to decelerate in the next two years under their baseline scenarios.

By most measures, the U.S. economy is now in the longest period of growth in its history. Again, history has taught us that 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 input from our economic vendors and colleagues from other states, we are not projecting a recession to begin during FY20 and FY21. 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, be realistic and prudent in our estimates. Please keep in mind that economic and financial market conditions can change rapidly and unpredictably.

Our FY20 and FY21 revenue forecasts are based on preliminary actual tax collections through November 2019 and the economic projections provided by our economic forecast vendors, Moody's Economy.com and IHS Markit (formerly known as Global Insight). The forecasts have been adjusted for the

[2] The gain was 24.2% on a year-to-date basis (percentage change in daily closing price from December 31, 2018 to December 2, 2019). Such gain reflects partially the recovery from the decline of the index by about 14% during the last quarter of 2018 (from September 28, 2018 to December 31, 2018).

incremental impacts of any legislatively mandated tax law changes and revenue initiatives.

DOR has been subscribing to Moody's Economy.com, and IHS Markit, 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 rules 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.

FY20

- **The FY20 revenue benchmark is $30.099 billion.** Based on current economic conditions and tax collections so far in this fiscal year, we believe there is a potential upside to FY20 tax collections. At the higher end, the upside could range from $75 million to $249 million more than the current benchmark of $30.099 billion. However, FY20 is less than half over and in most years, nearly two-thirds of revenue comes in from December through June. In addition to normal fluctuations that can occur in revenue, there remains the possibility of an economic slowdown or some other event that could impact collections. Therefore, this upside potential should be treated with caution.

- Most of the year-to-date surplus, which I will discuss shortly, was from volatile revenue sources, such as estate tax, corporate and business taxes, and non-withholding income tax. Due to their unpredictable nature, the strong performance of these revenue sources may not carry over to the remainder of FY20. 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 FY20 revenue forecasts may indicate some upside revenue opportunities; however, based on the remainder year revenue volatilities and risks, we believe that our prior FY20 benchmark of $30.099B is appropriate.
- Through the end of November 2019, the Commonwealth has collected $271 million or 2.5% more than the year-to-date benchmark (estate tax exceeded benchmark by $160 million). Our collections reflect year-over-year actual growth of 5.4% and baseline growth of 5.0% through the November year-to-date period. So far, we have received $12 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 quarterly estimated taxes are due. DOR will monitor these revenues closely during that period of time.

FY21

Based on our FY20 revenue estimates and our vendors' most recent economic projections, the Department of Revenue forecasts FY21 tax revenue collections in the range of **$30.623 billion to $30.988 billion.**

- This represents actual growth of 1.5% to 2.1% and baseline growth of 2.3% to 2.9% over the updated FY20 forecasts.
- The FY21 actual growth both in percentages and in dollars over the FY20 benchmark estimate of $30.099 billion range from 1.7% to 3.0% and from $524 million to $889 million, respectively.
- The midpoint of the forecast range for FY21 would be $30.805 billion, an increase of $706 million or 2.3% over the FY20 benchmark.
- As you know, DOR forecasts total revenues. Because of statutory mechanisms such as the potential Stabilization Fund transfer of capital gains revenue, the change in budgetable revenue will vary somewhat.

Our FY21 estimate reflects a couple of assumptions of note:

- First, we assume that the Part B Income Tax Rate will decrease from 5.05% to 5.00% effective January 1, 2020 (we have passed 4 of the 5 triggers needed for the rate reduction). Reflected in the forecast, the rate reduction is expected to reduce tax revenue by approximately $88 million in FY20 and approximately $185 million in FY21.

  By statute, if the Part B rate decreases to 5.00%, the charitable deduction would also trigger effective the following tax year, or January 1, 2021 based on the aforementioned assumption on Part B income tax rate reduction. The FY21 forecast assumes a part year revenue loss impact of $64 million due to this change; the full fiscal year impact, or FY22 impact of this deduction could be around $300 million.

- Second, DOR's FY20 and FY21 revenue projections include 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 Commonwealth's portion of the taxes (not including local option) from retail marijuana was $22 million in FY19, and was assumed to be in the range of $93 million to $172 million with a midpoint of $132.5 million in FY20, and $102 million to $189 million with a midpoint of $145.7 million in FY21.

  Retail sales of marijuana began in FY19, and we expect that revenues will continue to accelerate as retail outlets are licensed and open for business. However, from a revenue perspective, the legal marijuana market is not yet fully developed, and uncertainty remains around the rate at which the market will grow and how prices will change over time, both of which will impact revenue patterns.

- Third, DOR's FY20 and FY21 revenue projections include taxes from short-term rentals. As you know, such rentals are subject to state room tax at 5.7%, convention center finance fee at 2.75%, local option room tax up to 6.5%, excise of 2.75% for Cape Cod and Islands Water Protection Fund, and a Community Impact Fee at a rate of up to 3%[3]. The portion of the taxes and fees to be deposited into the state's General Fund was assumed to be $27.5 million in FY20 and $30 million in FY21. During the first four months of FY20, actual collections were roughly consistent with estimates.
- Fourth, DOR's FY20 and FY21 revenue projections include sales taxes from marketplaces. Beginning on October 1, 2019, there are new

[3] https://www.mass.gov/info-details/room-occupancy-frequently-asked-questions

Massachusetts sales and use tax collection requirements that apply to out-of-state "remote" sellers and marketplace facilitators ("marketplaces")[4]. DOR estimated that these new requirements would result in a revenue gain of $41.7 million in FY20 and $62.6 million in FY21.

- Fifth, revenue projections also reflect the impact of recently enacted flavored tobacco products restrictions and a new 75% excise tax on nicotine vaping products.

As we gain more experience with actual tax collections in these new categories, the Department will be able to refine its projections and understand the factors influencing sales and revenues related to retail marijuana sales, short-term rentals, and marketplaces.

Economic conditions underlying FY20 and FY21 revenue estimates.

- Growth in the national economy is forecasted to slow down somewhat in 2020 and in 2021, with real GDP forecasted to grow by 2.0% in the last three quarters of FY20 and for the full year of FY20. The major sources of forecast uncertainty include the fading impact of federal tax reform, trade policies, and concerns about global economic growth.

- The main drivers of Massachusetts state tax revenues are income tax (approximately 57.5% of FY19 revenues); sales tax (approximately 22.9%); corporate and business tax (approximately 11.3%); 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.

[4] https://www.mass.gov/info-details/remote-seller-and-marketplace-facilitator-faqs

General trends affecting income taxes: The labor market has performed well so far in calendar year 2019 in terms of employment and unemployment rates.

- According to the U.S. Bureau of Labor Statistics, U.S. nonfarm payroll employment rose by about 2.1 million in October 2019 compared with October 2018. The U.S. unemployment rate, which was 3.6% in October 2019, is forecasted to be 3.5% to 3.6% in FY20, and 3.4% to 3.9% in FY21.
- Massachusetts employment has grown moderately. According to the most recent Bureau of Labor Statistics (BLS) data, total nonfarm payroll employment increased by 51,700 (1.4%) in October 2019, compared with the same period last year. Massachusetts employment is forecasted to grow by 1.0% to 1.1% in FY20 and 0.2% to 0.8% in FY21.
- The Massachusetts unemployment rate is impressively low (2.9% in October 2019) and forecasted to be 2.8% in FY20 and 2.8% to 3.1% in FY21.
- According to the U.S. Bureau of Economic Analysis, Massachusetts wage and salary disbursements grew by 4.9% in FY19 compared to prior year. The growth of state wage and salary disbursements is forecasted to be from 5.0% to 5.1% in FY20 and from 3.2% to 4.5% in FY21. The growth of the state's personal income is forecasted to be from 4.4% to 4.5% in FY20, and from 3.4% to 3.9% in FY21.
- Based on economic projections from the two vendors the Department uses, the increase in total income taxes in FY20 is expected to range from 1.9% to 2.9%. The current FY20 benchmark anticipates an increase of 1.7% income tax growth from FY19. Income tax growth in FY21 is expected to range also from 2.0% to 2.9%.

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 growing reserves of potential gains exist, but importantly, the timing of taxable realization of those gains is impossible to predict precisely. Particular after two years of strong realization of capital gains, it is unclear how much more potential gains have not been realized. But 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 $1.75 to $1.85 billion in FY20, and $1.6 to $1.75 billion in FY21.

Sales tax receipts through the first five months of FY20 have increased by 5.1% actual and 4.5% baseline:

- Massachusetts retail sales are forecasted to grow by 4.3% to 4.5% in FY20 and by 2.7% to 3.8% in FY21. Baseline sales tax receipts are projected to increase over the remainder of FY20 in a range of 3.8% to 4.1%, and increase in a range of 2.4% to 3.3% in FY21.

Corporate and Business Taxes: Year-to-date corporate and business tax collections, one of the more volatile revenue categories, are up 1.2% actual and 2.4% baseline. During the first five months of FY20, we received about $12.5 million in tax-related settlements and judgments exceeding $10 million each.

- Nationally, the annual growth of corporate profits before tax is predicted to be from -0.4 % to 4.1% in FY20 and from 4.3% to 6.5% in FY21.
- Excluding large one-time tax settlement and judgment payments*, baseline growth in corporate and business tax receipts is projected to range from -9.7% to -10.2% over the remainder of FY20 (reflecting the strong growth

in FY19, part of which is believed not to repeat in the future) and 4.3% to 5.6% in FY21.

(* DOR does not make assumptions about one-time payments for the remainder of this fiscal year and FY21)

Other Taxes:

- All other tax collections through the first five months of FY20 have increased by 7.2% actual and by 2.6% baseline, and baseline growth is projected to range from -2.9% to -3.8% over the remainder of FY20 and -5.8% to -6.2% in FY21.
- The largest components of the "Other" category are revenue from Motor Fuels, Tobacco, Estate, and Deeds. During FY20 year-to-date, the Estate tax has been much 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 FY20 YTD revenue results have exceeded benchmark, we believe that our prior FY20 benchmark of $30.099 B remains appropriate given that 1) most of the YTD surplus was driven by volatile revenue sources, such as estate tax and corporate/business taxes, which may not recur in the remainder of the FY20; 2) in general revenue volatility increases during the second half of fiscal year; and 3) more and more economists seem to be pointing out increased levels of uncertainty in the economic activity.
- DOR's midpoint forecast for FY21 is $30.805 billion, representing actual growth of 2.3% and baseline growth of 3.2% over the FY20 benchmark.
- The FY21 forecast assumes a deceleration in the economic growth environment and a moderate decrease in the non-withheld personal income

tax category, which is mostly from investment, business, pass-through and other income, including capital gains, which at this time, is a potentially volatile swing factor.

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