Commonwealth of Massachusetts

Testimony of
Michael J. Heffernan
Commissioner, Department of Revenue
Consensus Revenue Hearing
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Good morning Secretary Lepore, Chairman Spilka, Chairman Dempsey, and the respective members of both Chambers. My name is Michael Heffernan. 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. We are pleased to present to you the Department's updated outlook on Massachusetts state tax revenues for FY17 and our forecast for FY18. 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 recent months will provide context for the revenue outlook. As you know, we ended FY16 and entered FY17 with some areas of concern in revenue. Most notably, the three related categories of Estimated Payments, Payments sent in with Returns, and Refunds were negative to Benchmark in the last quarter of FY16. 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 13.7% in 2014 to 1.4% in 2015. For many individual taxpayers in Massachusetts, this resulted in lower tax liability on investment-related income, resulting in lower Estimated Payments and higher Refunds, with the negative impact on revenues coming mainly in FY16.

We also noted a slowing growth rate in Sales & Use Tax collections and, to a lesser degree, in Withholding. To be clear, revenue dollars were continuing to rise, but at a somewhat slower rate. Although we study all the revenue categories and the economic forces that drive them, we have naturally had a particular focus on these areas as we look to the end of FY17 and into FY18.

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 we will discuss in more detail, the picture is mixed. There are two notable positives: First, the Massachusetts economy continues to show a small but distinct outperformance relative to both the national and New England economies. Second, the recent performance of the equity markets has been positive. There are also two significant negative factors. The US economy is in the "late cycle" stage of a recovery that has been long-lived but was never very robust. If the US economy slows considerably, then the Massachusetts economy will slow as well. Second, while there has been a recent bounce 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 remains high. In short, we believe that we are currently on-track for FY17, but the outlook for FY18 is perhaps even more uncertain than would normally be the case at this date. We will continue to closely monitor the economy, financial markets, and Federal Reserve policy.

Our FY17 and FY18 revenue forecasts are based on tax collections through November 2016 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 for quite some time. 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.

FY17

- **Our revenue benchmark for FY17 remains unchanged at $26.056 billion**. Based on current economic conditions and on collections so far in the fiscal year, we believe this figure remains appropriate. Our refreshed analysis gives an updated range of $25.979 billion to $26.085 billion. The current FY17 benchmark falls within this range.

- Our FY17 revenue estimate of $26.056 billion represents an increase of 3.1% from FY16. Based on our refreshed analysis, the range represents an increase of 2.8% to 3.2% over FY16.

- Through the end of November 2016, the Commonwealth has collected $72 million or 0.8% less than the year-to-date benchmark estimate. Our collections reflect year-over-year actual revenue growth of 2.2% through the November year-to-date period, and baseline tax revenue growth of 3.4%. These figures exclude $13.5 million in one-time settlement-related payments in the period.

- As you know, we are implementing a major systems upgrade at DOR, moving to the modern GenTax platform and providing taxpayers with the enhanced interface called MassTaxConnect.

- I want to note a temporary impact on reported revenues arising from the systems change. In brief, the implementation process caused a modest overstatement of October revenues and an understatement of November revenues. Let me emphasize two things: First, the timing differences relate only to when revenue is recognized, not to the net amount received in the fiscal year. Second, that timing changes were only a matter of days, but those days happened to include the month-ends.

- We have identified $51 million in payment requests made by taxpayers before November 30th, but which will not be reflected in revenue reports until this week, the first full week of December.

- If this $51 million were reflected in the November revenues, the total collections for the November year-to-date period would be only $21 million or 0.2% less than the benchmark for the period. In effect, we are "virtually on benchmark" for the year-to-date period.

- In addition to the already-noted $51 million pushed into December that I noted, timing changes resulted in higher reported revenues in October, which therefore further lowered November revenues. In short, we believe that the year-to-date figures provide far more meaningful information on revenues, but the month of November figures do not.

- Effective January 1, 2016, the part B income tax rate was reduced from 5.15% to 5.10% after going through a certification process for the baseline revenue growth. The impact of this rate reduction on FY17 revenue collections is about $78 million, which is reflected in our forecasts.

- Please note: December and January are important months for the Commonwealth's revenues because both personal and corporate estimated taxes are due. DOR will monitor these revenues very closely during that period of time.

FY18 Forecast

Based on our FY17 revenue estimates and our vendors' most recent economic projections, the Department of Revenue forecasts FY18 tax revenue collections in the range of **$26.810 billion to $27.104 billion.**

- This represents actual growth of 2.9% to 4.0% over the FY17 benchmark, and baseline growth of 3.7% to 4.7% over the updated FY17 forecasts.
- The actual growth in dollars over the FY17 benchmark ranges from $754 million to $1.048 billion.
- Using the midpoint of our range for discussion purposes, FY18 revenue would be forecast at $26.957 billion, an increase of $901 million or 3.5% over the FY17 benchmark.

Our FY18 estimates reflect two assumptions of note:

- First, we assume that the Part B Income Tax Rate will move from 5.10% to 5.05% during FY18 (effective January 1, 2018). The impact, reflected in the FY18 forecast, is $83 million less in revenue.
- Second, we assume no revenue in FY18 from recreational marijuana sales. Based on the level of taxation specified in the ballot initiative, we estimate that the first twelve months of revenue may range from $50 million to $80 million. However, there is considerable uncertainty about timing; specifically, it remains unclear when the control and licensing procedures will be implemented, and from that point when a sizable market will develop. Because there will be a ramp-up process, we would expect the first months to have a low share of first-year revenues. Given this uncertainty, we have not assumed revenue in FY18.

Economic conditions underlying FY17 and FY18 revenue estimates.

- The national economy is forecast to grow moderately in 2017 and 2018, with real GDP forecast to grow by 2.1% to 2.7% in the last three quarters of FY17, and 2.0% to 2.4% for the full year FY17. The major sources of forecast uncertainty include the economic policies of the incoming Trump administration, political risks in Eurozone including changes due to Brexit, the impact of the strong U.S. dollar, the potential for Federal Reserve rate hikes, and slower global economic growth.

- The main drivers of Massachusetts state tax revenues are income tax (approximately 57% of FY16 revenues); sales tax (approximately 24%); corporate and business tax (approximately 10%), and other taxes (approximately 9%).

- Massachusetts **income tax** is driven by employment, wages and salaries, capital gains realizations, and income from dividends and interest. On a FY17 year-to-date basis, baseline withholding collections are up 6.3%, while baseline estimated payments are down 6.9%.

General trends affecting income taxes: Labor market conditions have improved in calendar year 2016 in terms of employment and unemployment rate.

- According to the data from the U.S. Bureau of Labor Statistics, U.S. nonfarm payroll employment rose by 2.25 million in November 2016 compared with November 2015 on a year-over-year metric. The unemployment rate, which was 4.6% in November 2016, is forecast to be in the range of 4.8% to 4.9% in FY2017, and 4.7% to 4.8% in FY2018.

- Massachusetts employment has shown recent strength. According to the Bureau of Labor Statistics (BLS) data, total nonfarm payroll employment increased by 71,400 (2.0%) in October 2016 compared with October 2015.

State employment is forecast to grow by 1.8% to 1.9% in FY2017 and 0.7% to 1.2% in FY2018.

- The state unemployment rate is impressively low (3.3% in October 2016) and forecast to be 3.9% to 4.2% in FY2017 and 4.1% to 4.4% in FY2018, which are lower than the forecasted U.S. unemployment rates. 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, which currently has very low unemployment, this could actually result in a positive longer-term impact as our base of employed individuals continues grow.
- Estimates from the U.S. Bureau of Economic Analysis suggest that, Massachusetts wage and salary disbursements grew by 4.9% in FY2016. The growth of state wage and salary disbursements is forecast to be from 3.6% to 3.9% in FY2017 and from 4.8% to 5.5% in FY2018. The growth of the state's personal income is forecast to be from 3.6% to 3.8% in FY2017, and from 4.4% to 5.1% in FY2018.
- Based on economic projections from the two vendors we use, the increase in total income taxes in FY17 is expected to range from 3.9% to 4.1%. The current FY17 revenue estimate anticipates an increase of 4.1% growth from FY16. Income tax growth in FY18 is expected to range from 3.5% to 4.3%.

Capital Gains: Capital gains taxes continue to be a volatile revenue source and therefore the most difficult to predict.

- Tax year 2015 capital gains realizations were estimated to be $26.4 billion, a 13.5% decrease from tax year 2014 realizations of $30.5 billion.

- After taking into account such a decrease in capital gains realizations, and timing issues related to when in the fiscal year taxpayers "true up" their taxes on capital gains for state income tax purposes, we were able to determine that capital gains taxes received in FY16 decreased by 15.7% or $264 million from FY15, to approximately $1.416 billion.
- DOR projects that Massachusetts capital gains realizations will decrease by a range of 9.5% to 10.1% in tax year 2016 compared to tax year 2015. For tax year 2017, we project a change of -9.7% to +5.4% compared to tax year 2016. For tax year 2018, the projected change ranges from -2.9% to 0.0%.
- To put that in dollar terms, DOR forecasts tax year 2016 capital gains ranging from $1.305 billion to $1.314 billion, and tax year 2017 capital gains taxes ranging from $1.178 billion to $1.385 billion. On a fiscal year basis, capital gains taxes are estimated to range from $1.288 billion to $1.330 billion in FY17, and from $1.188 billion to $1.365 billion in FY18.

Sales tax receipts through the first five months of FY17 have increased by 2.6% actual and 1.8% baseline:

- Massachusetts retail sales are forecast to grow by 2.9% to 3.9% in FY2017 and by 3.5% to 6.0% in FY2018. Baseline sales tax receipts are projected to increase over the remainder of FY17 in a range of 1.6% to 3.0%, and increase in a 3.2% to 4.4% range in FY18.

Corporate and Business Taxes: Excluding the $13.5 million tax-related settlements & judgments exceeding $10 million each, year-to-date corporate and business tax collections are up 11.0% actual and 14.2% baseline.

- Nationally, the annual growth of the corporate profits before tax is predicted to be from 7.5 % to 7.9% in FY2017 and from 3.1% to 10.8% in FY2018.

- Excluding large one-time tax settlement and judgment payments*, baseline growth in corporate and business tax receipts is projected to range from 3.7% to 4.7% over the remainder of FY17 and 3.5% to 4.0% in FY18.

Other Taxes:

- All other tax collections through the first five months of FY17 have increased by 0.1% actual and 0.7% baseline, and baseline growth is projected to range from 1.7% to 1.8% over the remainder of FY17 and 1.1% to 1.3% in FY18.

* DOR does not make assumptions about one-time payments for the remainder of this fiscal year and FY18.

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