Commonwealth of Massachusetts

Testimony of
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Commissioner, Department of Revenue
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Good morning Secretary Gonzalez, Chairman Brewer and Chairman Dempsey, my name is Amy Pitter, and I am the Commissioner 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 FY13 and our forecast for FY14. 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/).

The national economy has been recovering and growing, but at a slower pace than what economists call its *potential* growth pace since the end of the recent Great Recession. The Massachusetts economy and its tax revenue collections have been improving. However, the uncertainty on economic growth and tax revenue growth has increased recently, mostly due to the uncertainty resulting from the global economic slowdown (particularly in the Eurozone economies) and U.S. fiscal policy. In this environment, tax revenue forecasting has still been a difficult and a challenging task all across the country and at the federal level.

Our FY13 and FY14 revenue forecasts are based on actual collections through November 2012 and the economic projections of our vendors: *the Moody's*

Analytics/Economy.com, *IHS Global Insight* and the *New England Economic Partnership*.

Moody's Analytics/Economy.com provides comprehensive and extensive historical and forecast data at the national and subnational/regional levels. They indicate that their services and areas of expertise cover more than 180 countries, over 150 global metro areas, all U.S. states, metro areas and counties. Their databases contain economic, financial, demographic and consumer credit time series, most of which are updated regularly and made available to their clients. They have been well known and respected across the country and other state agencies for their comprehensive and professional macro and state economic forecast modeling, as well as their quality real time technical services.

IHS Global Insight also provides very extensive historical and forecast data at the national, state and industry levels. They indicate that they cover almost all the countries around the world and 170 industries. They are also well known for their credible and reliable services across the country, and many state agencies subscribe to their data.

The New England Economic Partnership (NEEP) is a member-supported, non-profit organization. They provide objective economic analyses and forecasts to their members, businesses, governmental and non-governmental institutions. The organization is well known for its research of economic issues relevant to New England. NEEP meets twice a year: one in the spring and the other in the fall. In fact, they just held their fall meeting last week in Rhode Island. NEEP also publishes macroeconomic forecasts of the New England region and its six individual states, including Massachusetts.

DOR has been subscribing to these vendors and benefiting from their economic data and technical services for quite some time. These data and services have served us and Commonwealth well in our state specific revenue modeling and forecast efforts.

Based on the economic projections received from these vendors, DOR's capital gains projections, and revenues received year-to-date, DOR's revenue estimates for FY13 and FY14 are as follows:

FY13.

- After taking actual tax receipts through November into account, DOR is projecting that revenues will probably end the fiscal year at **$21.462 billion to $21.501 billion**. This range implies that we would be **$34 million below to $5 million** above the revised A&F 12/4/12 FY13 revenue estimate of $21.496 billion.
- As you may know, through the end of November 2012, the Commonwealth has collected $235 million less than the benchmark estimate that is assumed in the GAA tax revenue estimate of $21.011 billion, reflecting a year-to-date actual tax revenue growth of 0.3%, and a baseline tax revenue growth of 1.6%.
- As I mentioned few minutes ago, the national and state economies have been growing but at slower pace. The slow growth will probably remain during the rest of the fiscal 2013.
- The updated FY13 revenue estimate that we are presenting today represents an increase of 1.6% to 1.8% from FY12. The revised A&F 12/4/12 estimate represents an increase of 1.8%.

- Please note that December and January are important months for the Commonwealth’s revenues, as that is when the final corporate payments (for calendar year companies) and personal quarterly taxes are due.

FY14. Based on these slightly revised FY13 revenue estimates and the economic projections, DOR projects FY14 tax revenue collections to be in the range of **$22.15 billion to $22.467 billion**, reflecting an actual growth of 3.2% to 4.5% from the projected FY13 revenues, and baseline growth of 3.5% to 4.9% from FY13.

- This represents growth of **$688 million to $977 million** over projected FY13 revenues.
- Please note that in the light of the Amazon agreement, which was signed this morning, there will be additional sales tax revenues that Massachusetts would start collecting during FY14. Based on a review of public data, the additional collections could be in the lower tens of millions of dollars. Since Amazon will start collecting these taxes as of November 1, 2013, we would receive our first collections in December 2013 (for the November sales activity; sales collections lag a month) so there will be a seven-month impact (December through June collections) in fiscal 2014 collections. The FY14 tax revenue estimates that we presented to you today do not take account of this impact.

Economic conditions underlying FY13 and FY14 revenue estimates.

- The growth of the national economy is expected to remain slow in 2013 but improve in 2014, with real GDP expected to grow by 1.7% in the last three quarters of FY13, and 2.3%~3.0% in FY14. Uncertainties related to the global economic slowdown (particularly in the Eurozone economies) and

U.S. fiscal policies continue to be sources of risk to economic growth. Regarding U.S. fiscal policy, all three vendors expect that the U.S. will probably avoid the fiscal cliff, and a middle ground policy scenario will be reached by the end of the year.

- As you know, the main drivers of Massachusetts state tax revenues are income tax (approximately 56% of FY12 revenues); sales tax (approximately 24%); and corporate and business tax (approximately 11%).

- Massachusetts **income tax** is driven by employment, wages and salaries, and capital gains realizations, as well as dividend and interest income. On a year-to-date basis, withholding is up 3.3% (baseline), but slowed down recently, and income tax cash estimated payments are up 6.1% (baseline), likely reflecting slight improvement in non-wage income.

Personal income taxes generally: The labor market has shown improvement since the end of the recession but recovery has been slow.

- The U.S. unemployment rate fell to 7.7% in November as US payroll employment rose by 146,000 jobs in the month. Unemployment rates are expected to remain stable in 2013 before falling to 7.1%~7.3% in 2014.
- Massachusetts state employment bottomed out in November 2009. Projections for Massachusetts employment range from an increase of 0.8% to 1.2% over the remainder of FY13, compared to an increase of 1.0% to 1.3% in FY14.

- Wage and salary disbursements are projected to increase by 4.1% to 4.7% over the remainder of FY13, and increase by 4.2% to 6.8% in FY14.
- Massachusetts personal income is expected to rise by 3.7% to 3.8% over the remainder of FY13, and 4.3% to 6.0% in FY14.
- Based on economic projections from the three vendors we use, the increase in total income taxes in FY13 is expected to range from 4.5% to 4.8%. The revised A&F 12/4/12 estimate anticipates an increase of 4.6%. Income tax growth in FY14 is expected to range from 4.2% to 6.5%.

Capital Gains: Capital Gains taxes have historically been a volatile revenue source and therefore the most difficult to predict:

- Tax year 2011 capital gains realizations were estimated to be $17.4 billion, a 3.9% increase from tax year 2010 realizations of $16.7 billion.
- After taking into account such an increase 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 FY12 increased by 0.4% or $4 million from FY11, to approximately $994 million.

DOR assumes that the top federal tax rate on realized capital gains will go up from 15% to 18.8% in 2013 due to the introduction of the 3.8% Medicare tax on realized capital gains in the 2010 health care reform laws, and then go up from 18.8% to 23.8% in 2014 due to the expiration of Bush tax cuts. Based on this assumption

DOR projects that Massachusetts capital gains realizations will increase by 17.8% in tax year 2012 compared to tax year 2011, increase by 2.7% in tax year 2013, and then decrease by 13.9% in tax year 2014. DOR capital gains forecast implies tax year 2012 capital gains taxes of $1.167 billion, and tax year 2013 capital gains taxes of $1.198 billion. On a fiscal year basis, capital gains taxes would probably be in the range of $1.05 billion to $1.2 billion in FY13 depending on the timing of such payments, an increase of $56 million to $206 million compared to FY12. FY14 Capital gains taxes would probably be within the same range.

Sales tax receipts through the first five months of FY13 have increased by 2.9% actual and 3.0% baseline,

- Massachusetts retail sales are projected to grow by 3.6% to 4.4% over the remainder of FY13 and by 2.6% to 4.2% in FY14.
- Baseline sales tax receipts in MA are projected to increase over the remainder of FY13 in a range of 1.8% to 2.0%, and 2.7% to 3.1% range in FY14.

Corporate and Business Taxes: On a year-to-date basis, corporate and business tax receipts are down 20.1% actual and 18.3% baseline (mostly due to one-time revenues that were received last year but do not repeat this year), with cash estimated payments (an indicator of current business conditions) up 15.5%.

- Nationally, corporate profits are expected to grow by 2.1% to 4.8% in FY14, compared to growth of 6.8% to 12.1% in FY13.
- Baseline growth in corporate and business tax receipts is projected to range from -8.2% to -7.2% over the remainder of FY13, but increase by 1.4% to 2.3% in FY14.

I would like to highlight a few additional points:

Will the Part B individual income tax rate be reduced for Calendar Year 2014?

As you know, the certification process that we just went through indicated that we **could not** lower the income tax rate from 5.25% to 5.2% for CY2013. In order for the Part B income tax rate to go down in calendar year 2014 from current 5.25% to 5.2%, we would have to go through the same certification process that we just did. Our quick calculations indicate the following: 1) the projected FY13 baseline tax revenue growth figures will probably be between 2.5% to 2.7%, which are very close to the projected inflation growth figures received from our vendors (between 1.5% to 3.2%) for the respective periods that would be relevant in the rate reduction determination process, 2) using these growth figures, the FY13 inflation adjusted baseline revenue growth would **not exceed** the 2.5% threshold as of today. As usual, there is a great degree of uncertainty about these growth figures. So we did not make an explicit rate reduction assumption in building our FY14 estimates at this time.

If the "fiscal cliff" occurs (we go off the cliff), what would be the additional risk to our state tax revenues?

Two of our vendors (Economy.com and Global Insight) have been able to run their models under the alternative or so-called "fiscal cliff" scenarios, and provide us with the data for alternative economic forecasts. Using these alternative economic forecast data series, we were able to run our revenue models and be able to estimate that our revenue exposure could be as high as $200 to $300 million during the FY13, which could increase to a billion dollars in FY14.

Are there any risks to your FY13 and FY14 estimates?

Yes, there are always risks to the estimates:

We are hearing from the general news media that many large companies have been announcing and/or in the process of moving *dividend distributions* to this year in order to partially protect their shareholders from the impact of a possible rate increase next year. If the companies move dividends that they had originally planned to distribute from early next year to this year (2012), then we would probably not have a net revenue impact on FY13 revenue estimates (assuming an increase in 2012 payments with an equal decline in tax payments early next year). However, if the companies not only move ahead and distribute their originally planned dividends in 2012, but also increase the distribution amounts above what they were originally planning, then this could be considered an upside risk to the FY13 revenue estimates.

Although we have not heard much about the *bonus related income* shift in general news media, similar shift in bonus related activities could also have similar impact on FY13 revenues.

These changes could affect our income estimated payments and/or withholding collections.

With respect to the capital gains related income, it is unknown at this time how investors are reacting to the possible rate increase that could occur as of January 2013. If many more individuals, especially those who have been holding appreciated assets for quite some time, decide to sell those assets now (or before January 1st), we could see a surge in income estimated payments in December and January. This could potentially result in FY13 capital gains related tax collections to increase above and beyond what is assumed in our forecasts, and therefore it is an upside risk to the FY13 estimates. However, such response could potentially be considered a downside risk to the FY14 estimates, too (e.g., individuals would have fewer appreciated assets in the future and therefore less realized gains, which would mean less capital gains tax collections in FY14). Quantifying the impacts of such behavioral responses on revenues with a great degree of accuracy is almost impossible. Those changes could affect income estimated payments in December and January; estimated payments and payments with returns and extensions during the filings season could also be affected.

Thank you for listening to my testimony. I will be pleased to accept your questions now.