Commonwealth of Massachusetts

Testimony of
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Commissioner, Department of Revenue
Consensus Revenue Hearing
December 11, 2013

Good morning Secretary Shor, 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 FY14 and our forecast for FY15. 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/).

Although the Massachusetts' economic growth was negatively impacted this year by federal fiscal policy changes (sequestration spending cuts, payroll tax increases, federal government shutdown in October, etc.), state tax revenues have improved significantly in FY13 and the first 5 months of FY14, due to several factors, such as investment activity and capital gains activity in response to federal tax changes at the beginning of 2013, and the improvement of economic fundamentals, such as the housing market. Federal fiscal policy challenges and the faltering recovery from the Eurozone's recession still remain the major sources of uncertainty for economic growth and tax revenues in the near future. In this environment, there is still a great deal of uncertainty surrounding revenue forecasts.

Our FY14 and FY15 revenue forecasts are based on actual collections through November 2013 and the economic projections of our vendors: *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 are 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: once in the spring and the other in the fall.

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. Their data and services have served us and the 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 revenue collections received year-to-date, DOR's revenue estimates for FY14 and FY15 are as follows:

FY14.

- After taking actual tax receipts through November into account, DOR is projecting that revenues will probably end the fiscal year at **$23.069 billion to $23.18 billion**. This range implies that we would be **$272 million to $383 million** above the FY14 GAA revenue estimate of $22.797 billion.
- As you may know, through the end of November 2013, the Commonwealth has collected $359 million more than the benchmark estimate that is assumed in the GAA tax revenue estimate of $22.797 billion, reflecting a year-to-date actual tax revenue growth of 9.7%, and a baseline tax revenue growth of 8.3%.
- The updated FY14 revenue estimate that we are presenting today represents an increase of 4.3% to 4.8% from FY13. The GAA estimate of $22.797 billion represents an increase of 3.0%.

- According to the Amazon agreement, which was signed last December, Amazon started collecting Massachusetts sales taxes as of November 1, 2013. We will begin receiving 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 take into account this impact.
- Effective January 1, 2014, the part B income tax rate will decrease from 5.25% to 5.20%. The impact of this rate reduction on FY14 revenue collections is included in our forecasts.
- Please note that December and January are important months for the Commonwealth's revenues, as this is when final corporate payments (for calendar year companies) and personal quarterly estimated taxes are due.

FY15. Based on these updated FY14 revenue estimates and economic projections, DOR projects FY15 tax revenue collections will be in the range of **$24.062 billion to $24.352 billion**, reflecting an actual growth of 4.3% to 5.2% from projected FY14 revenues, and baseline growth of 4.4% to 5.3% from FY14.

- This represents growth of **$993 million to $1.202 billion** over projected FY14 revenues.
- As I just mentioned, effective January 1, 2014, the part B income tax rate will decrease from 5.25% to 5.20%. The impact of this rate reduction on FY15 revenue collections is also included in our forecast. However, a further rate reduction was not assumed.

Economic conditions underlying FY14 and FY15 revenue estimates.

- The growth of the national economy is expected to improve gradually in 2014 and 2015, with real GDP expected to grow by 2.3% to 2.4% in the last three quarters of FY14, and 2.8% to 3.9% in FY15. Uncertainties related to the global economy (particularly in the Eurozone economies) and U.S. fiscal policies continue to be sources of risk to economic growth.

- As you know, the main drivers of Massachusetts state tax revenues are income tax (approximately 58% of FY13 revenues); sales tax (approximately 23%); and corporate and business tax (approximately 10%).

- 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, the baseline withholding collections are up 5.3%, and the baseline income tax cash estimated payments are up 12.2%, likely reflecting both strong non-wage income in 2012 in response to federal tax changes and the strong stock market and housing market so far in 2013.

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 7.0% in November as US payroll employment rose by 203,000 jobs in the month. Unemployment rates are expected to gradually fall to 6.6% to 6.7% in FY2015.

- Massachusetts employment bottomed out in October 2009.
  Projections for Massachusetts employment range from an increase of 0.9% to 1.3% over the remainder of FY14, compared to an increase of 1.3% to 1.5% in FY15.
- Wage and salary disbursements are projected to increase by 3.2% to 4.6% over the remainder of FY14, and increase by 4.7% to 7.6% in FY15.
- Massachusetts personal income is expected to rise by 3.5% to 4.6% over the remainder of FY14, and 4.8% to 7.0% in FY15.
- Based on economic projections from the three vendors we use, the increase in total income taxes in FY14 is expected to range from 2.0% to 2.7%. But the FY14 GAA estimate anticipated an increase of 0.9% growth from FY13.
  Income tax growth in FY15 is expected to range from 5.2% to 7.1%.

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

- Tax year 2012 capital gains realizations were estimated to be $25.0 billion, a 42.8% increase from tax year 2011 realizations of $17.5 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 FY13 increased by 41.5% or $413 million from FY12, to approximately $1.407 billion.

- DOR projects that Massachusetts capital gains realizations will decrease by 31% in tax year 2013 compared to tax year 2012 (due to the accelerated realization of capital gains at the end of 2012 in response to the federal tax changes at the beginning of 2013), and then increase by 22% in tax year 2014 and 6% in tax year 2015. DOR capital gains forecast implies tax year 2013 capital gains taxes of $1.001 billion, and tax year 2014 capital gains taxes of $1.221 billion. On a fiscal year basis, capital gains taxes would be about $1.065 billion in FY14, a decrease of $342 million compared to FY13. FY15 capital gains taxes would probably be about $1.231 billion, an increase of $166 million from FY14.

Sales tax receipts through the first five months of FY14 have increased by 6.2% actual and 6.3% baseline,

- Massachusetts retail sales are projected to grow by 2.5% to 4.8% over the remainder of FY14 and by 3.6% to 6.1% in FY15.
- Baseline sales tax receipts in MA are projected to increase over the remainder of FY14 in a range of 4.5% to 6.2%, and 4.3% to 5.6% range in FY15.

Corporate and Business Taxes: On a year-to-date basis, corporate and business tax receipts are up 28.9% actual and 30.2% baseline. This increase is mostly because we received more one-time tax settlement and judgment payments year-to-date than the same period last year. Year-to-date corporate and business cash estimated payments, which reflect current economic activity, are up only 3.7% actual and baseline.

- Nationally, corporate profits are expected to grow by 5.9% to 8.5% in FY15, compared to growth of -1.6% to 8.0% in FY14.
- Baseline growth (excluding large one-time tax settlement and judgment payments*) growth in corporate and business tax receipts is projected to range from 4.1% to 6.3% over the remainder of FY14 and 4.2% to 5.3% in FY15.

* DOR does not make assumptions about one-timers for the remainder of this fiscal year and FY15.

I would like to highlight a few additional points:

Will the Part B individual income tax rate be reduced for Calendar Year 2015?

On December 4, 2013, DOR certified that FY13 tax revenue growth met the five thresholds for lowering the Part B income tax rate as set forth in the law. Therefore, the Part B income tax rate will be reduced from 5.25% to 5.20% for the taxable years beginning on January 1, 2014. One question is if the rate will be further reduced from 5.20% to 5.15% effective January 1, 2015 given the strong FY14 YTD tax revenue growth (8.3% baseline).

As you know, in order for the Part B income tax rate to go down in calendar year 2015 from 5.20% to 5.15%, we would have to go through the same certification process that we just did. Our quick calculations indicate the following: 1) the projected FY14 baseline tax revenue growth figures will probably be between 3.4% and 3.9%. The projected inflation growth figures received from our vendors are between 1.4% to 1.7%; and 2) using these growth figures, the FY14 inflation adjusted baseline revenue growth would be between 1.7% and 2.5%. Therefore the chance that inflation adjusted baseline growth exceeds 2.5% threshold seems very small based on vendors' current forecasts and DOR data. As usual, there is a great degree of uncertainty about these growth figures. So we did not make an explicit assumption of further rate reduction in building our FY15 estimates at this time. Please note that any unexpected changes in revenues during the remainder of this fiscal year and during the first half of FY15 could easily change this picture.

Are there any risks to your FY14 and FY15 estimates?

Yes, there are always risks to the estimates:

The federal fiscal policy challenges and the faltering recovery from Eurozone's recession still remain the major sources of uncertainty for economic growth and tax revenues in the near future. Some other risks are as follows:

At the end of 2012, taxpayers moved dividend distributions and capital gains realization from 2013 and beyond to 2012, in response to the federal tax changes at the beginning of 2013. Such taxpayer behavior shifted investment related income in 2013 and beyond to 2012, and therefore negatively impacted FY14 (major impact) and FY15 (minor impact) non-withholding income tax collections. However it is very difficult to estimate such an income shift, especially when we have no data from 2013 tax returns. This can pose either an upside risk or a downside risk to the FY14 revenue estimate.

In addition, so far this fiscal year we have seen strong growth in withholding collections (6.5% actual and 5.3% baseline). This does not seem to be consistent with the BLS employment data (for example, Massachusetts nonfarm payroll employment has grown moderately at 1.5% in the first 10 months of 2013 compared with the same period of last year; Massachusetts unemployment rate has increased from 6.4% in April to 7.2% in October, although some of this increase appears to be due to more people joining the labor force). Our vendors also project a slow to moderate growth in employment (0.9% to 1.3%) and in wages and salaries (3.2% to 4.6%) during the last 3 quarters of FY14. So this mixed picture of state's labor market does pose a risk to our withholding forecasts in both FY14 and FY15.

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