Massachusetts Taxpayers Foundation

News Release

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Update: Tax Revenue Growth Slows

Tax revenues will increase by approximately $521 million, or 1.7 percent, to $31.96 billion in fiscal 2021[1] according to a new forecast released today by the Massachusetts Taxpayers Foundation (Table 1) at the state's annual consensus revenue hearing. The Foundation estimates capital gains tax revenues of $1.64 billion. This figure is $331 million above the estimated capital gains tax threshold for 2021, but a $240 million or 15 percent decline from FY 2020 estimates.

Table 1 – State Tax Revenues by Category
($ Millions)

	Forecast		FY 2021 vs. FY 2020		Actual	FY 2020 vs. FY 2019	
	FY 2021	FY 2020	Change - $	Change - %	FY 2019	Change - $	Change - %
Withholding	14,273	13,779	494	3.5%	13,208	571	4.3%
Non-Withholding							
Capital Gains	1,636	1,877	-241	-14.7%	2,060	-183	-8.9%
Other non-Withholding	1,755	1,787	-32	-1.8%	1,831	-44	-2.4%
Sales	7,166	6,997	169	2.4%	6,798	199	2.9%
Corporate	3,499	3,385	114	3.3%	3,308	77	2.3%
Other Tax Revenues	2,633	2,616	17	0.6%	2,487	129	5.2%
Total	**30,962**	**30,441**	**521**	**1.7%**	**29,692**	**749**	**2.5%**
Cap Gains above Threshold	**331**	**617**					

MTF's forecast assumes that the income tax rate is reduced to 5.0 percent from the current 5.05 percent beginning January 2020 and a deduction for charitable contributions will become effective for tax years beginning January 2021. The decline in the state income rate will result in the loss of $185 million in tax revenues in FY 2021

[1] The Foundation does not include estimates of one-time corporate tax settlements in excess of $10 million in its revenue forecasts. The forecast includes the Department of Revenue's estimate of marijuana tax revenues for FY 2020 and FY 2021.

($88 million in FY 2020 according to the Department of Revenue's estimates) as well as the loss of $64 million from charitable contributions.

Update: *The ban on flavored tobacco products, according to DOR, will reduce sales tax revenues by $20 million and other tax revenues by $73.4 million for a total reduction of $93.4 million from MTF's original analysis*. Taken in whole, the decline in capital gains, income taxes, charitable deductions, and flavored tobacco products will result in the loss of $583 million in revenues in FY 2021.[2]

The largest drag on the FY 2021 forecast and the Massachusetts economy is the ever-tightening labor market. As the number of people aged 16-64 flattens and the number of people 65+ exit the workforce at an accelerated pace, job growth will drop dramatically.

MTF projects job growth to slump from the decade-long average of 1.5 percent (FY 2010-FY 2019) to 0.6 percent in FY 2020 and 0.0 percent in FY 2021 (see Figure 1 – Net New Employment, FY 2010 – FY 2021). Such anemic growth in the number of jobs created is likely to have a material impact on income withholding and sales tax revenue growth going forward.

FY 2020

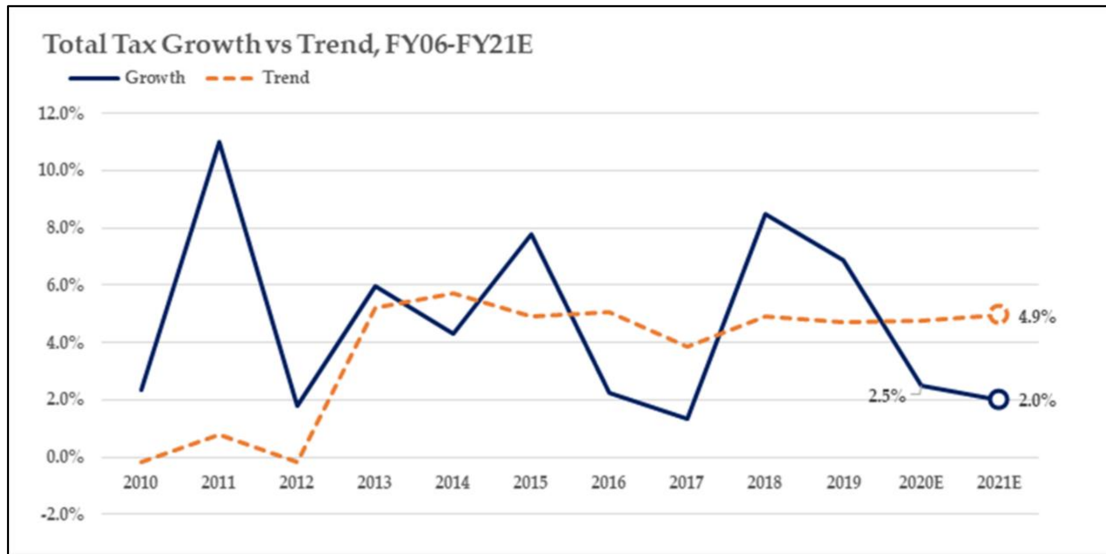
MTF forecasts revenues of $30.44 billion in FY 2020, or $342 million above the current $30.099 billion benchmark. This figure is $749 million above FY 2019 tax revenues and represents a 2.5 percent growth rate. Sales and withholding tax revenues are expected to grow modestly. Capital gains tax revenues will remain quite strong, but will fall from the near record level of $2.06 billion collected in FY 2019 (only the second time capital gains has exceeded the $2 billion figure.[3]) Despite this projected decline of nearly $183 million, it is expected that capital gains tax revenues will exceed the statutory threshold by $600 million (Table 1).

The projections for FY 2020 and FY 2021 represent a return to the more limited growth rates of FY 2016 and FY 2017 rather than a continuation of the super-charged growth rates of FY 2018 (8.5 percent) and FY 2019 (6.8 percent) that were likely driven largely by the enactment of federal tax law changes in December 2017.

[2] If not for these reductions, tax revenue growth would exceed 3.5 percent.

[3] Capital gains tax revenues were $2.175 billion in FY 2008 immediately preceding the fiscal crisis.

Figure 1 – Tax Growth Rates vs. Trend, FY 2006 – FY 2021



Like last year, MTF's econometric model projects higher tax revenue in fiscal 2020 than the Commonwealth's $30.099 billion tax revenue benchmark currently indicates; however, MTF does not recommend a formal revision to the full-year estimate at this time. In our view, year-to-date tax collections in fiscal 2020 are strong enough to justify optimism, but insufficient to support changes to the existing FY 2020 budget.

Lessons in Volatility – Reviewing the Past Four Years

Table 2 provides a breakout of year-over-year changes in tax revenues by source. What is noteworthy is the sharp contrast between the steady growth rates for withholding and sales tax revenues that vary only slightly from year to year and the high-volatility of capital gains, other non-withholding and corporate tax revenues (Appendix A) that can differ by double-digit rates from one year to the next.

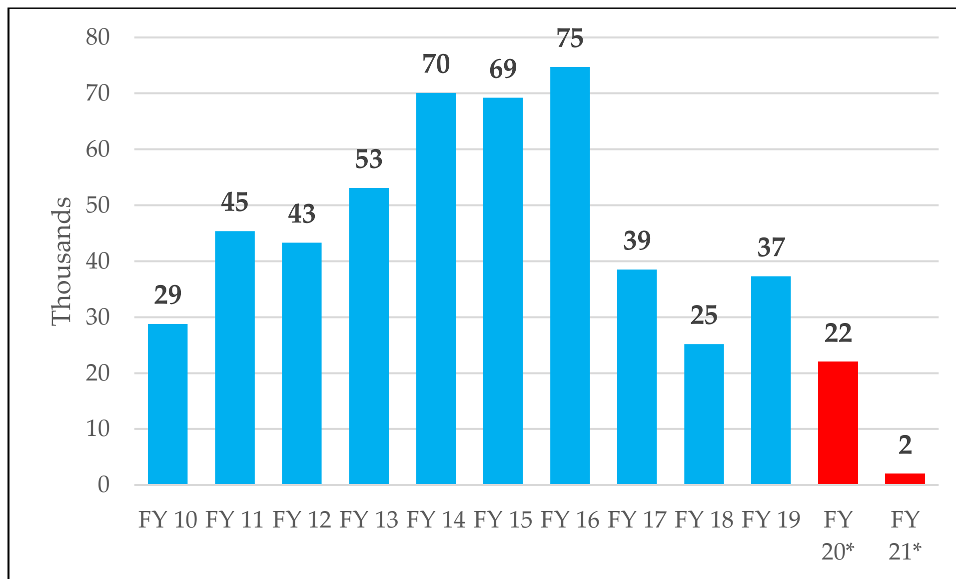
Table 2 – Y-o-Y Changes in Tax Revenues, FY 2016 – FY 2021

	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021
Income						
Withholding	3.26%	4.78%	6.37%	3.74%	4.32%	3.59%
Capital Gains	-15.71%	-16.33%	42.37%	22.12%	-8.88%	-12.84%
Other non-Withholding	-5.08%	-0.44%	17.86%	0.49%	-2.35%	-1.79%
Sales	4.76%	2.65%	3.93%	5.35%	2.93%	2.70%
Corporate	4.63%	-1.46%	11.10%	19.34%	2.33%	3.37%
Other Tax Revenues	6.89%	-3.14%	4.77%	6.74%	2.17%	1.77%
Total	**2.22%**	**1.42%**	**8.46%**	**6.82%**	**2.27%**	**1.87%**

The last category of "other tax revenues" that includes motor fuels, cigarettes, estate tax settlements, and room occupancy taxes, has experienced increased volatility recently after relatively flat growth over the years. This is due primarily to large swings in estate tax collections. Estate tax settlements jumped from $337 million in FY 2017 to $472 million in FY 2018 and to $601 million in FY 2019 representing year-over-year growth rates of 40 and 27 percent respectively.[4]

Historically, job growth has been a common metric used to gauge both the state's economic health and fiscal well-being. Withholding taxes from wages measure the strength of the labor market. A strong labor market also boosts consumer confidence. Strong sales tax collections are directly correlated to employment as it reflect people's willingness to purchase goods, meals and automobiles. Because these two revenue sources – withholding and sales - together account for two-thirds of total state tax revenues, one might expect that job growth would be a reasonably accurate indicator of overall tax revenue performance. In recent years, however, that has not been the case.

Figure 2 – Net New Employment, FY 2010 – FY 2021



* FY 2020 and FY 2021 – MTF forecasts

Massachusetts experienced robust growth in the decade following the 2008 fiscal crisis, adding 486,000 jobs. Although the pace of employment expansion has slowed in recent years, the state created an additional 113,000 jobs in FY 2016 and FY 2017. In the last two fiscal years, the state's job growth has slowed even more so, with just 63,000 jobs

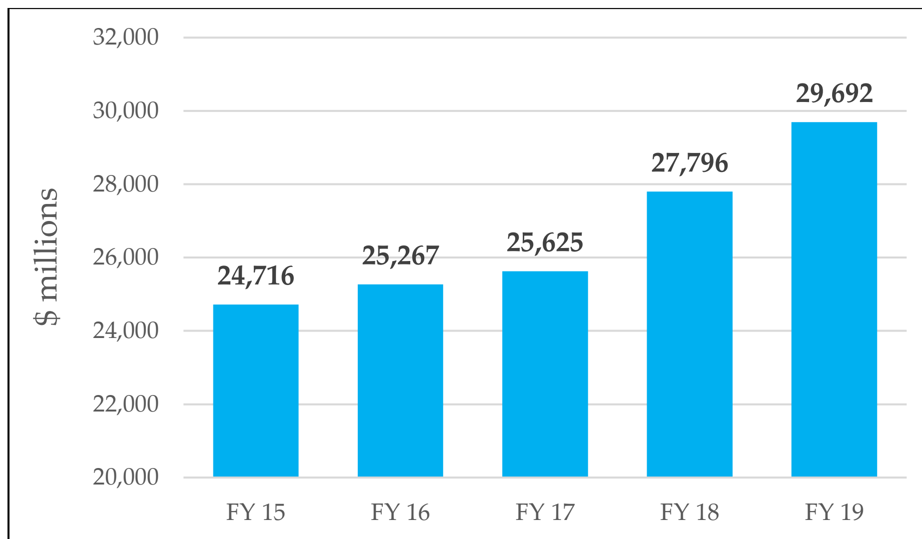
[4] Estate tax collections are running nearly $50 million more in FY 2020 than during the same period in FY 2019.

created in FY 2018 and FY 2019, representing the lowest two-year total since the recovery began (Figure 2).

Revenue growth patterns over this recovery period did not mirror the job growth patterns. For example, robust job growth in fiscal year 2016 and 2017 did not translate into robust revenue growth for the Commonwealth. In fact, despite adding nearly twice as many jobs in fiscal years 2016 and 2017 than in the past two fiscal years, the state suffered through truly anemic growth in tax revenues during that period. At $25.625 billion, FY 2017 tax revenues were just $900 million or 3.7 percent higher than in FY 2015.

In contrast, FY 2018 and FY 2019 revenues soared far beyond projections even as job growth waned. Tax revenues in FY 2019 surged $4.07 billion (Figure 3) or 16 percent over FY 2017 – a more than fourfold jump during a period of very modest job growth.

Figure 3 – Total Tax Revenues, FY 2015 – FY 2019



As shown in Table 3, FY 2019 tax revenue growth (versus FY 2017) out performed FY 2017 revenue growth (versus FY 2015) by $3.158 billion despite the significantly higher job growth rate in FY 2017. Non-withholding income (capital gains, interest, dividends, Schedule E, and other non-wage sources) and corporate taxes contributed $2.5 billion or 80 percent of that revenue increase.

Table 3 – Increase in State Tax Revenues, FY 2015 – FY 2019

	FY 17 vs FY 15	FY 19 vs FY 17	Change $	Change %
Withholding	907	1,238	331	10.5%
Non-withholding	-611	1,191	1,802	57.1%
Sales	468	556	89	2.8%
Corporate	75	814	739	23.4%
Other	71	268	197	6.2%
Total	**909**	**4,067**	**3,158**	**100%**

While the precise cause of the volatility in tax revenues remains uncertain[5], two exogenous events may help to explain the unusual tax revenue growth patterns in recent year. First, in reviewing industrial production data, the Federal Reserve revised estimates of manufacturing production and discovered the onset of a mini-recession in 2015 and 2016 (Appendix B). Unnoticed at the time, this would suggest that a slowdown in the economy may be responsible for the constrained revenue growth in FY 2016 and FY 2017.

The mini-recession was soon followed by passage of the Tax Cuts and Jobs Act (TCJA) that had profound impacts on income and corporate tax revenue collections in FY 2018 and FY 2019. Income taxes surged by nearly 11 percent in FY18 as individuals seeking to maximize tax savings before the statutory cap of $10,000 on state and local tax (SALT) deductions took effect made estimated payments in December, 2017 and January, 2018. Enactment of the TCJA broadened the corporate tax base at both the federal and state level, leading to an uptick in corporates in each of the past two years and on an ongoing basis going forward.[6] Other federal tax changes, such as a mandatory tax on past earnings held abroad (deemed repatriated income), likely resulted in a non-recurring spike in corporate tax collections.

FY 2021 – Increased Global Warnings Suggest Caution

In summary, modest revenue growth for withholding and sales tax, coupled with more volatility in other revenue sources, makes estimating tax revenues for FY 2021 more challenging than in previous years. This in turn, makes the state more susceptible to larger year-over-year fluctuations. Thus, the fiscal underpinnings of the state would suggest caution. In addition, there are numerous external economic forces that could

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[5] A Department of Revenue analysis of taxpayer-level collection data would be needed to determine these impacts.

[6] *The impact of federal tax reform on state corporate income taxes*, Andrew Phillips and Steve Wlodychak, EY, March 2018, p.17. Study estimates that the Massachusetts' corporate tax based was expanded by 12 percent as a result of the TCJA.

impact the Massachusetts economy and affect tax revenue growth that must be considered including[7]:

- World Bank warns of deteriorating global economic outlook
- IMF lowers 2019 growth rate to 3.0% down from 3.3% in April, the lowest since the global financial crisis
- UNCTAD reduced growth estimate to 2.3%, lowest rate since 2009
- OECD lowers economic forecast to 2.9% in 2019, down from 4.0% in April
- OECD lowers global growth estimate to 2.9% in 2020, down from September's forecast of 3.0%
- WTO reduced global merchandise trade to 1.2% down from 2.6% in April
- China imports declined 8.6% in September and 6.4% in October; down 10 of last 11 months
- U.S. manufacturing falls to 10-year low with the weakest production level since the last recession; contracted 3 successive months
- IMF warns that global economy faces a $19 T corporate debt time bomb from a downturn half as severe as the 2008 financial crisis
- "Overall, the global environment is becoming less predictable for the 142 sovereigns we rate, encompassing $63.2 trillion in debt outstanding."[8]
- CEO Confidence at Record Lows; Consumer Confidence Climbs (Appendix D)
- A Majority of Banks Globally May Not Be Economically Viable (Appendix E)
- There's an "uncomfortably high" chance that a recession could hit the global economy in the next 12-18 months[9]

Ignoring these risks places the state's fiscal condition in jeopardy – especially since solutions to mitigate the impacts of an economic downturn will likely fall squarely on the Commonwealth.

Preparing for Future Shocks – The Federal Government May Be Short on Solutions

While the timing and severity of the next economic downturn is unknowable, the state's experience with past recessions clearly demonstrates how quickly and harshly fortunes can turn. Monitoring the warning signs and analyzing potential revenue impacts that

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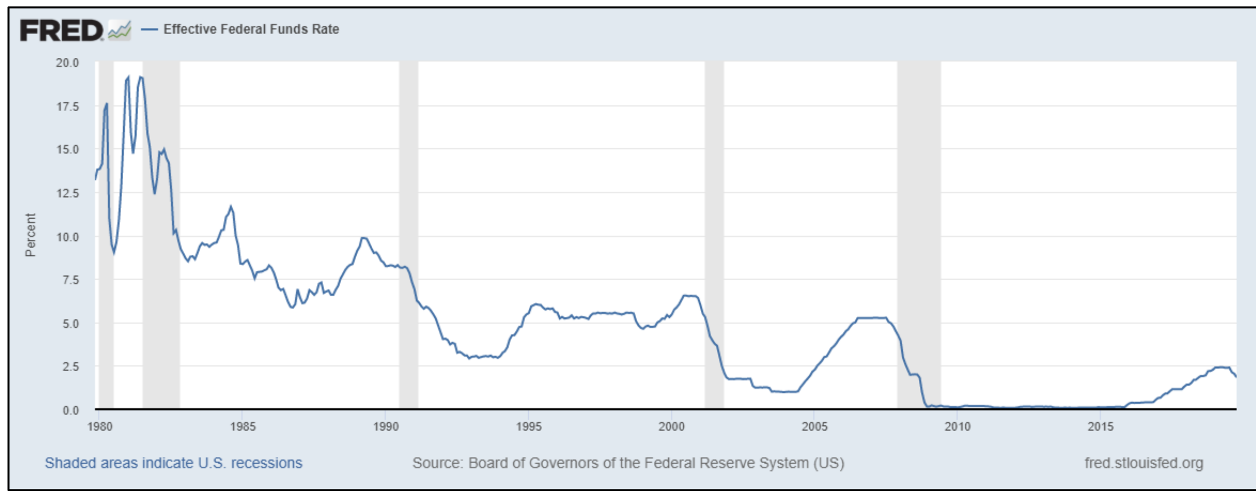
[7] See the IMF recently published, *The World Economy: Synchronized Slowdown, Precarious Outlook*.
[8] Moody's offers bleak outlook for government debt amid political instability, CNBC, November 11, 2019.
[9] Mark Zandi, Moody's Analytics, CNBC Squawk Box Asia, October 16, 2019

align with previous experiences provides lawmakers with a better gauge of risks they may confront.

This is especially important as the state may not be able to rely on federal monetary or fiscal policies to help mitigate the losses. For example, in the previous five recessions, the Federal Reserve lowered the cost of capital by at least 5 percent to stimulate growth. The current rate stands at 1.50% - 1.75% meaning there is very little room for stimulus (Figure 4).

Figure 4 – Effective Federal Funds Rate, 1980 - 2019



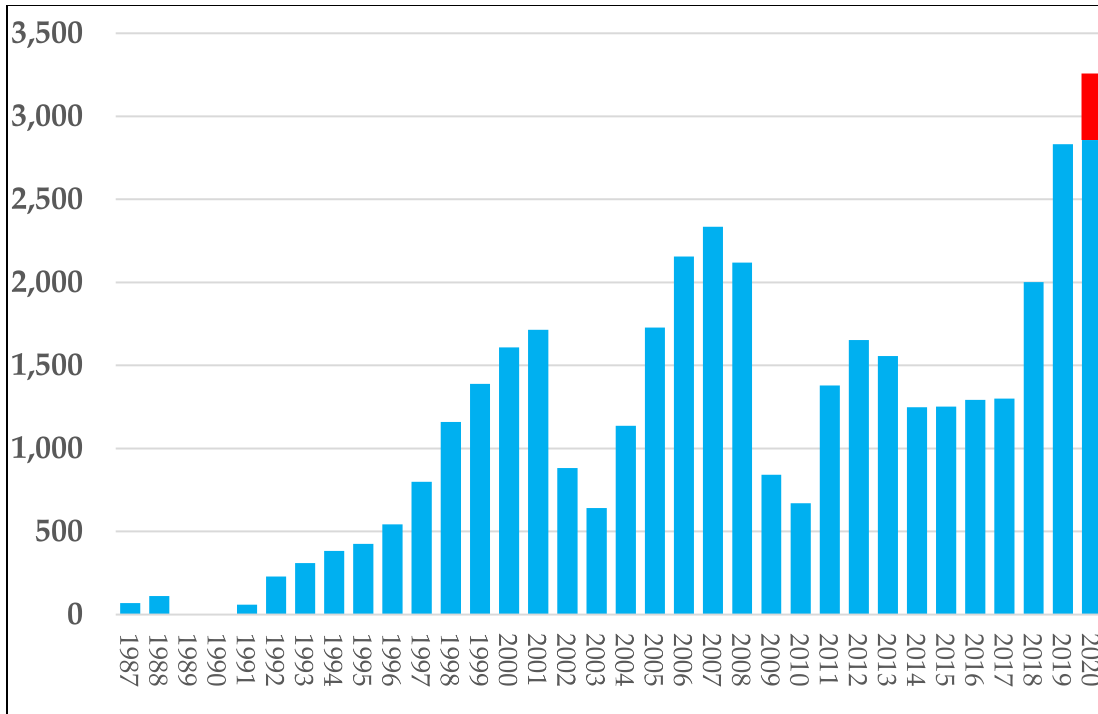
Equally, the federal government has little ammunition remaining following the TCJA which is expected to drive average annual budget deficits to $1.2 trillion between 2020 and 2029.

<u>Stabilization Fund Balance Offers Best Insurance</u>

Following three strong years of growth in capital gains tax revenues, and subsequent deposits into the Stabilization Fund, the balance should exceed $3 billion when the books are closed on FY 2019. This would represent the highest balance in the history of the fund (Figure 5). Despite this accomplishment, the state would find the Stabilization Fund balance insufficient to weather the two recessions of the past decade.

Figure 5 – Stabilization Fund Balance, 1987 – 2019

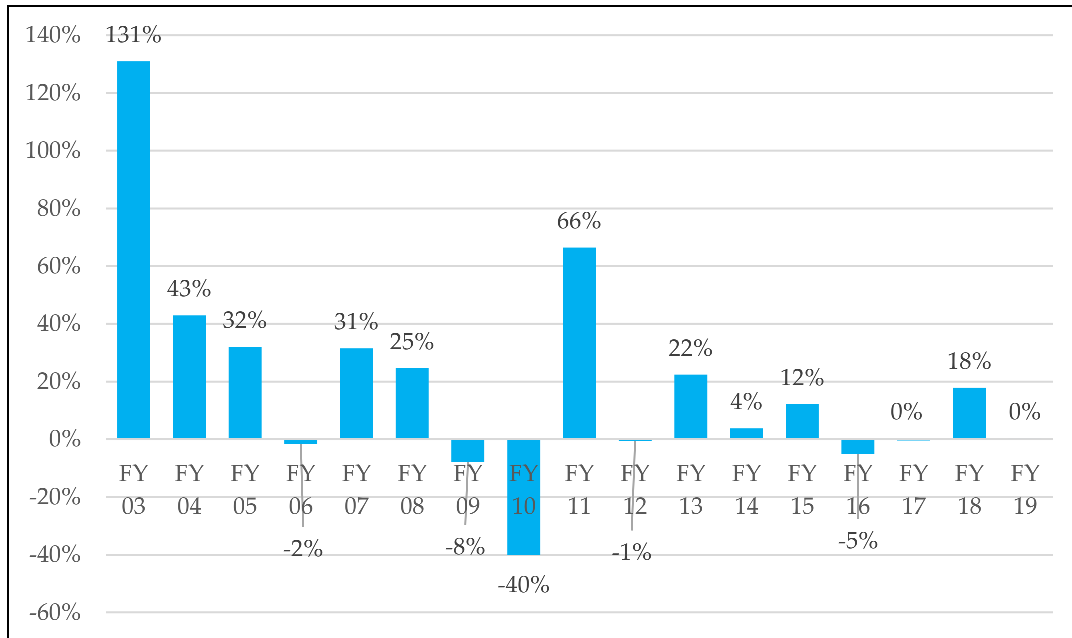
(In millions, 2019 is an estimate)

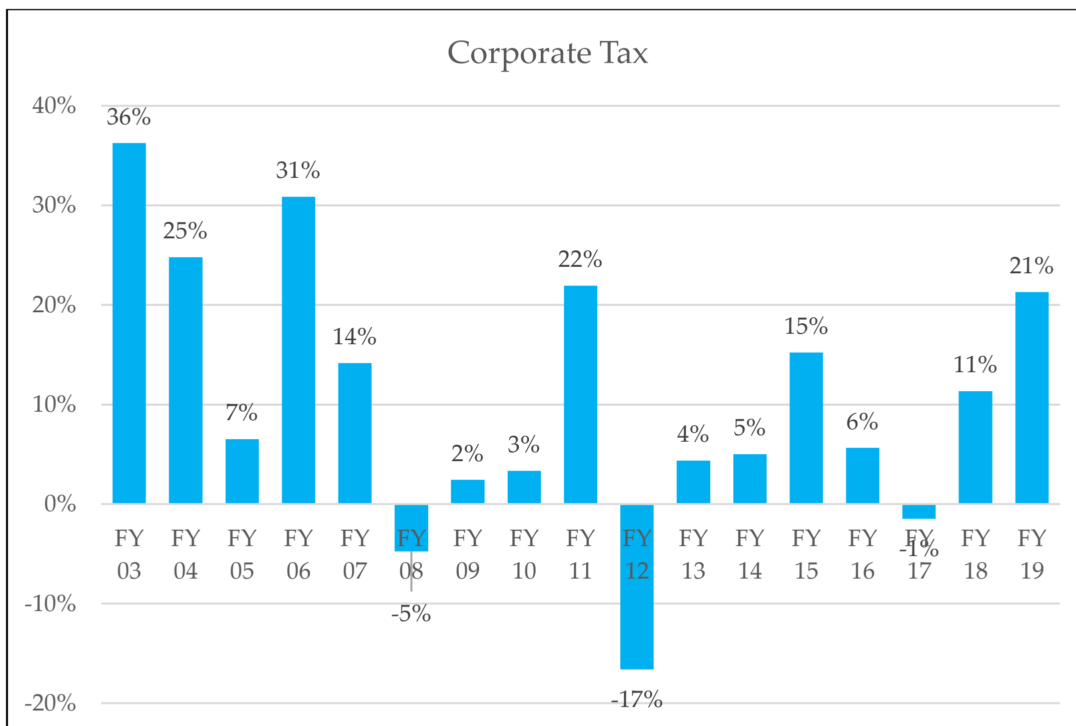


In the recessions of 2002 and 2009, the state was able to withdraw a billion dollars or more to help alleviate the loss in revenues which fell 14.6 percent and 12.5 percent respectively. Should the state suffer a modest economic downturn that resulted in the loss of 5 percent revenues, the gap would reach approximately $1.5 billion and would deplete the balance in two years. If the state were to experience another recession equal to either 2002 or 2009, revenue losses could exceed $4 billion in the first year alone. A robust Stabilization Fund is the state's best insurance policy against the risks we face.

Appendix A – Y-o-Y Change in Non-withholding Income and Corporate Tax Growth

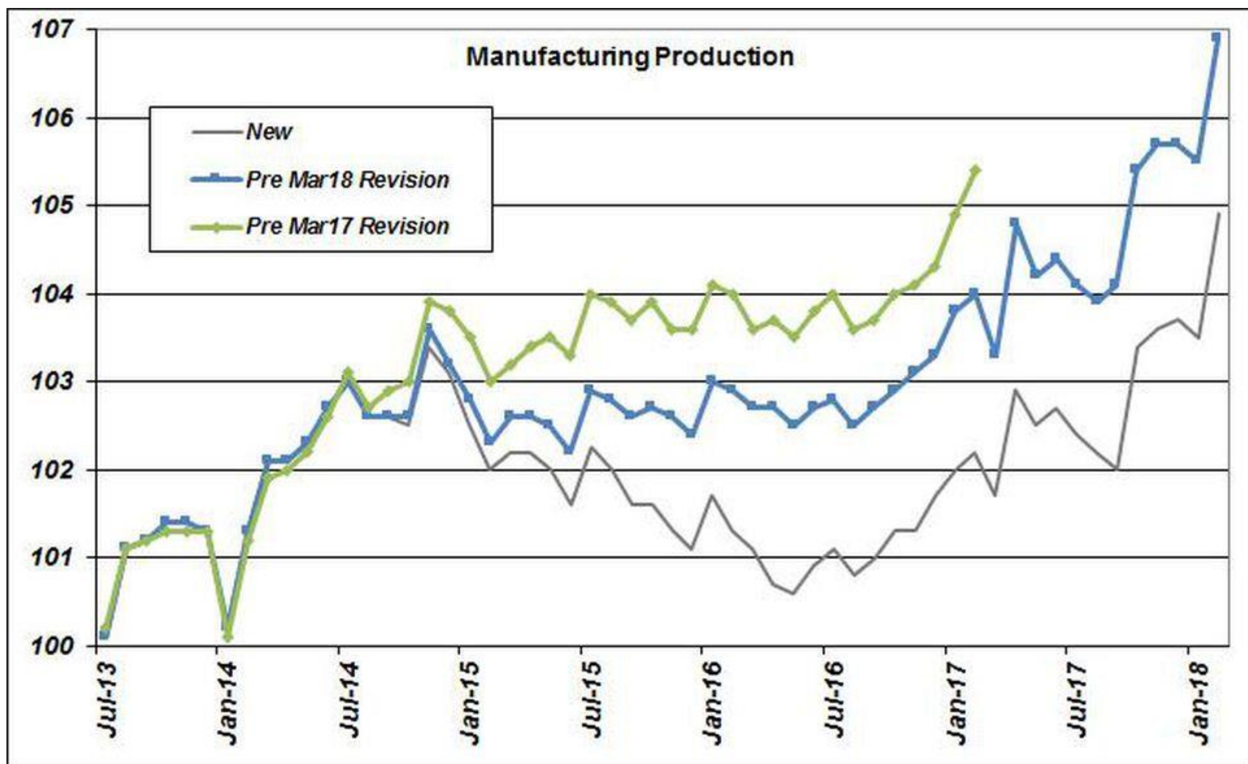
A review of Y-o-Y tax growth of other non-withholding tax revenues (excluding capital gains) and corporate taxes shows a remarkable trend to the upside with only 8 years combined since 2003 of negative growth.





Appendix B - Revised industrial production data reveals mini-recession in 2015-2016

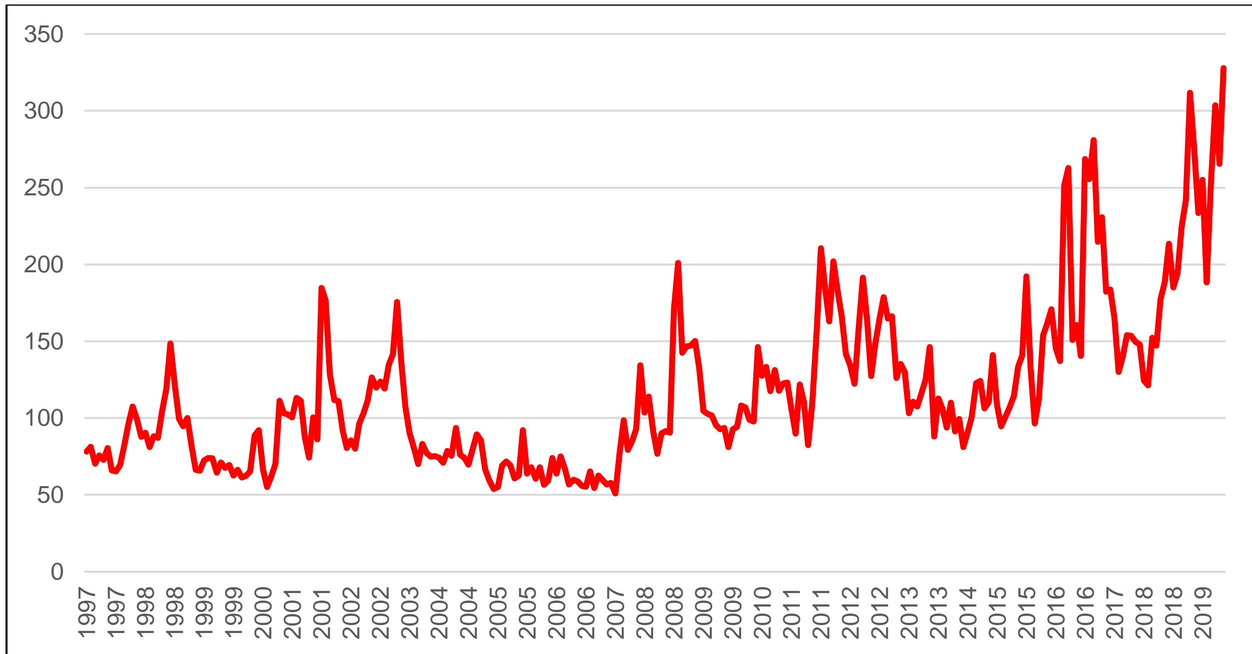
Source: Federal Reserve[10]



[10] *Revisions Show U.S. Industrial Mini-Recession In 2015*, Jon Vail, Forbes, March 27, 2018.

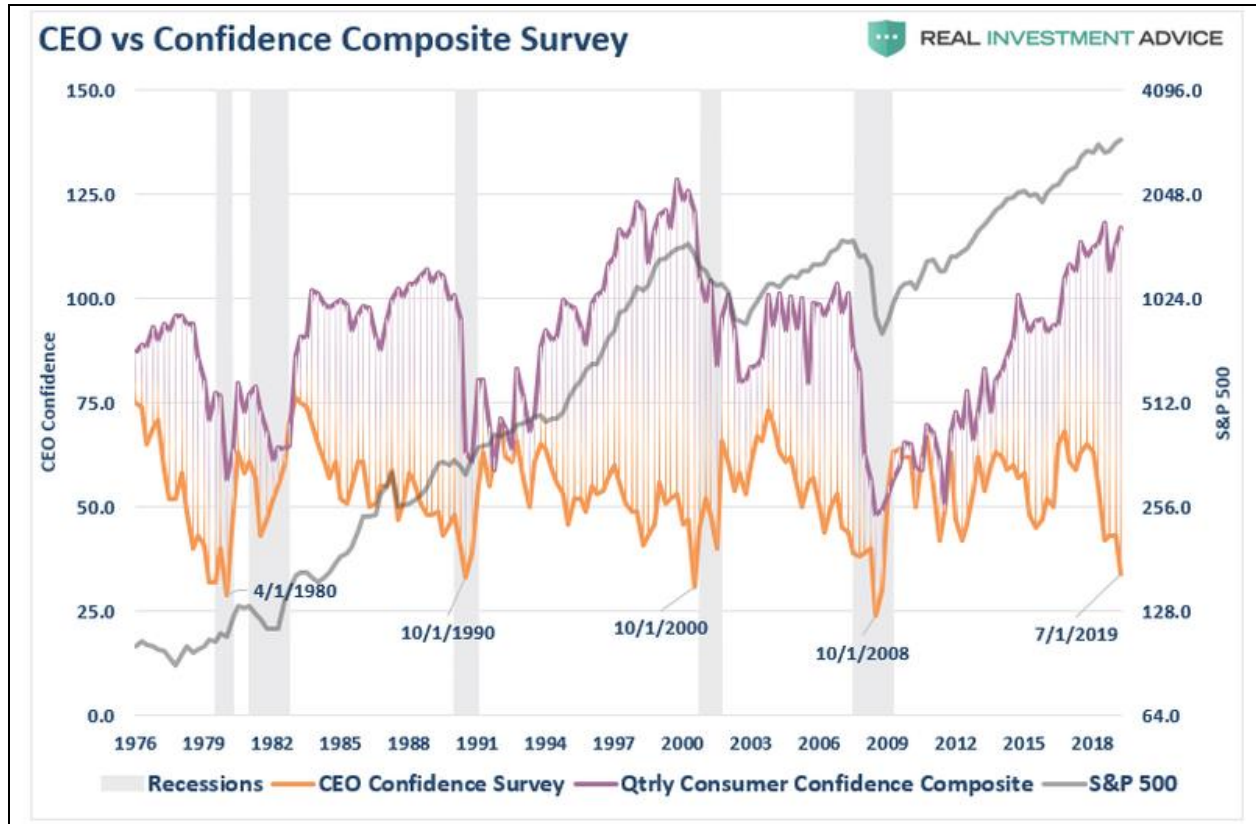
Appendix C - Global Economic Policy Uncertainty Index Spikes to New Highs

A GDP-weighted average of national EPU indices for 20 countries: Australia, Brazil, Canada, Chile, China, France, Germany, Greece, India, Ireland, Italy, Japan, Mexico, the Netherlands, Russia, South Korea, Spain, Sweden, the United Kingdom, and the United States.



Appendix D – CEO Confidence at Record Lows; Consumer Confidence Climbs

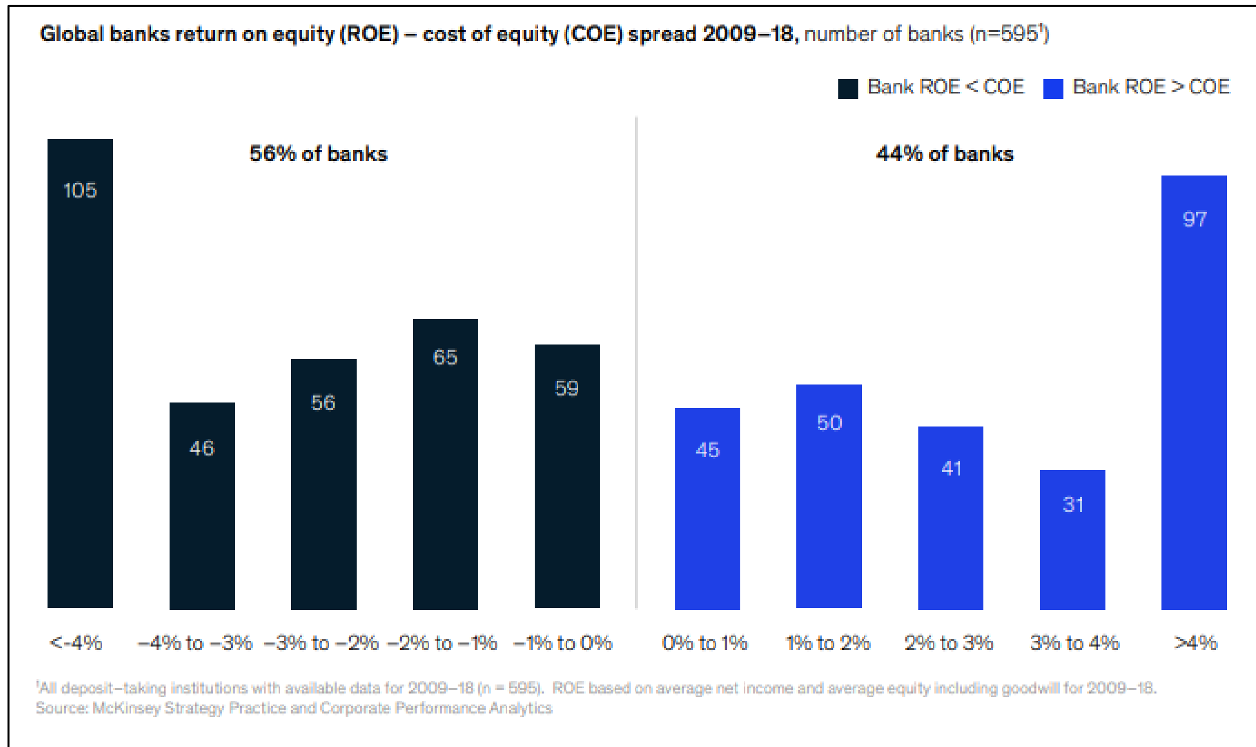
Historically, when the spread between consumer and CEO confidence becomes too large, consumer confidence collapses and a recession starts. The gap is wider today than it was in three of the previous four recessions including 2008.



Appendix E – A Majority of Banks Globally May Not Be Economically Viable

56% percent of 595 banks across the world will likely reach the point where their cost of equity is greater than their return on equity making them systemically vulnerable:

> While the jury is still out on whether the current market uncertainty will result in an imminent recession or a prolonged period of slow growth, the fact is that growth has slowed. As growth is unlikely to quicken in the medium term, we have, without question, entered the late cycle. Compounding this situation is the continued threat posed by fintechs and big technology companies, as they take stakes in banking businesses. The call to action is urgent: whether a bank is a leader and seeks to "protect" returns or is one of the underperformers looking to turn the business around and push returns above the cost of equity, the time for bold and critical moves is now.[11]



[11] *The last pit stop? Time for bold late-cycle moves*, McKinsey Global Banking Annual Review 2019, McKinsey & Company, October 2019.