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Bulletin

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MTF

Capital Gains Revenue in Massachusetts

Overview

Last fall, the Massachusetts Taxpayers Foundation released a Stabilization Fund report that drew attention to the risks the state runs by failing to rebuild "rainy day" reserves during times of economic recovery. This companion brief explores how reliance on capital gains tax revenues in the operating budget both increases the dangers posed by a fiscal crisis and weakens our ability to respond to one.

Capital gains are particularly sensitive to the larger economic climate, resulting in revenue windfalls during good times and sudden drops in revenues during economic recessions. By focusing on the past two recessions, and the role that capital gains played in the extreme revenue fluctuations during those periods, this report will demonstrate why Massachusetts must not fall into the trap of overreliance on these revenues to cover its operating expenses.

Capital Gains Taxation in Massachusetts

The capital gains tax in Massachusetts applies to income derived from the sale of capital assets such as stocks, bonds, real estate and collectibles. Tax is paid when a capital asset is sold for a gain. The rate of the capital gains tax depends on the length of time an asset is owned prior to sale.[1]

- Short-term assets – assets held for one year or less – are taxed at a rate of 12 percent.
- Long-term assets – assets held for more than a year – are taxed at the same rate as earned income – currently 5.1 percent.[2]

The rate at which Massachusetts taxes capital gains is in line with those of 41 other states that subject capital gains to tax.[3] Where Massachusetts differs is the degree to which it relies on capital gains taxes.

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[1] Mass. Gen. Laws ch. 62, § 4.

[2] The income tax rate, not including short term capital gains, has declined from 5.3 percent to the current 5.1 percent since 2012 based on revenue growth benchmarks. These phased in reductions will continue until the rate is 5 percent.

[3] According to the Tax Foundation, Massachusetts' top capital gains rate ranked 29th highest nationally in tax year 2015.

Massachusetts' tax revenue structure is particularly reliant on the income tax. In the FY 2016 budget that was signed into law, the income tax comprised 58 percent of all tax revenues.[4] Using a more expansive definition of state revenues, the Rockefeller Institute found that the income tax generated 52.49 percent of all state tax revenue in Massachusetts in 2014, the 4th highest share nationally and far above the national average of 35.9 percent.[5] Massachusetts is one of only four states which generates more than half of its tax revenue from the income tax – meaning that swings in income tax collections have a profound impact on the state's fiscal condition.[6]

The same Rockefeller Institute study compared state reliance on capital gains by looking at 2012 IRS data. In that year, capital gains made up 8.36 percent of total income in Massachusetts – the third highest share among the 41 states that tax capital gains. In 24 of those states, capital gains comprises less than 5 percent of all income. The difference between 5 percent and 8.36 percent may not seem large, but it represents approximately $9 billion in total income and more than $450 million in tax revenue.

Because income taxes are the largest source of state tax revenues and an above-average share of that is generated from capital gains, Massachusetts relies on more volatile revenues compared to other states. In fact, a 2014 Pew Charitable Trust report that focused on the need to account for revenue volatility in state efforts to build reserves ranked Massachusetts as having the 11th most volatile revenues among the 50 states.[7] A look at the past two recessions demonstrates the impact that relying on volatile capital gains revenues has had on the state budget.

Volatility of Capital Gains

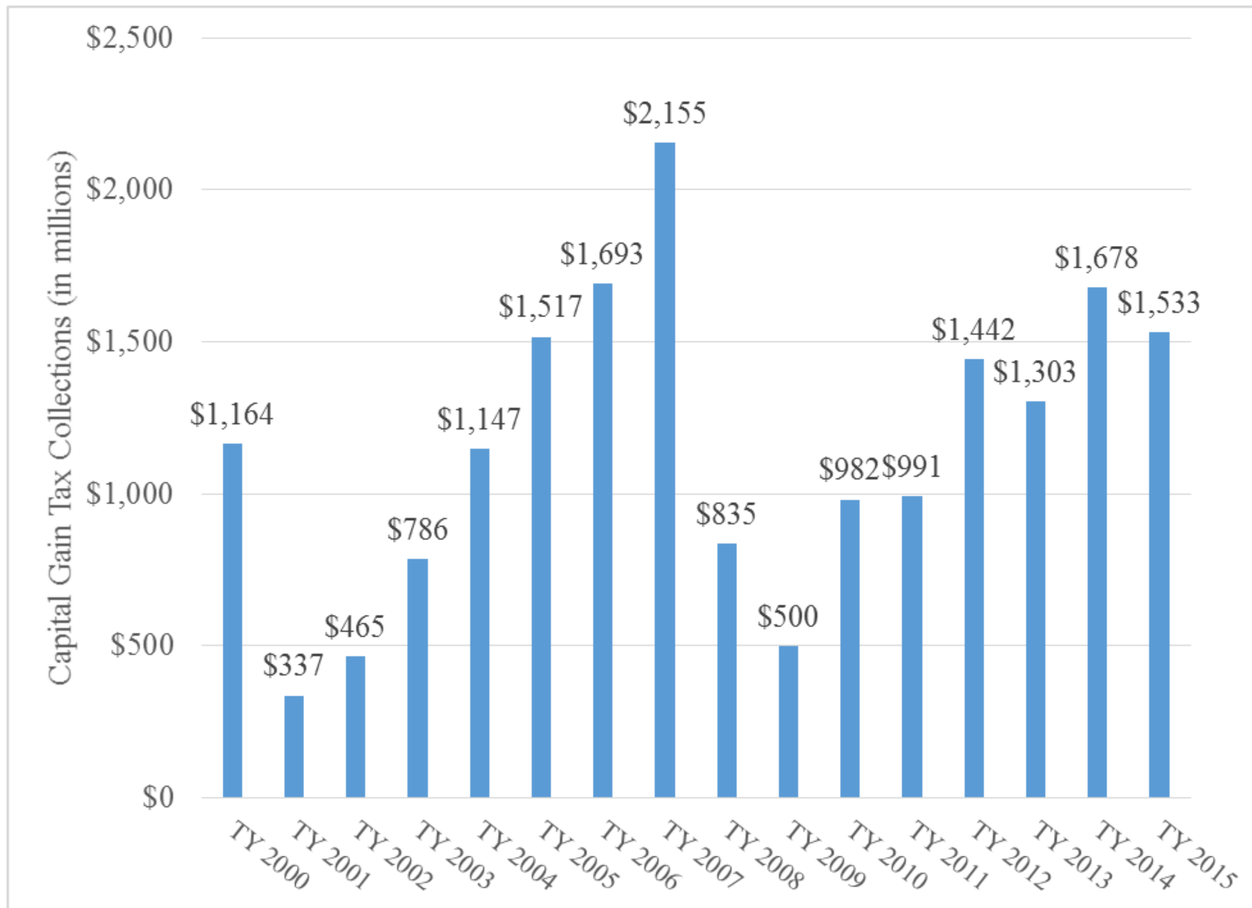
All tax revenues ebb and flow in relation to larger economic factors. If the economy is not doing well, sales and meals tax may decrease because consumers purchase less. Withholding taxes may drop if unemployment increases. Motor vehicle excise taxes wane as fewer people purchase new cars. Two factors unique to capital gains, however, make them particularly sensitive to the economy and therefore more volatile. One has to do with the timing of asset sales that are often discretionary. People make capital investments for the expected return they will realize in the future, and prefer to sell stocks, real estate or collectibles when the market is most favorable; conversely, they may postpone those sales if a poor economy means a weak market. And the timing of a sale of a capital asset is often more directly correlated to the overall strength of the economy because robust capital gains revenues are far more likely in a growing economy with favorable market conditions and less likely in periods of economic contraction.

Secondly, capital gains taxes are only collected if an asset gains in value. A consumer who buys a less expensive meal or car still pays sales tax; a worker who suffers a pay cut still pays withholding. But if, as happens more frequently during a recession, a stock, a home or other

[4] In the FY 2016 Consensus Revenue income taxes comprised $14.727 billion of $25.479 billion in ongoing tax revenue.
[5] "Windfall 'April Surprises,'" The Rockefeller Institute, June 2015.
[6] As of 2014, New York, Oregon and Virginia also generated more than 50 percent of tax revenue through the income tax.
[7] The Pew Charitable Trusts, Building State Rainy Day Funds, July 2014.

capital asset is sold at a loss, no tax is collected as no gain has been realized. These factors – the ability to postpone capital transactions in unfavorable times and the fact that tax is only applied when a gain has been realized – make the capital gains tax unique among sales and income taxes. As shown in Figure 1, capital gains tax collections have proven extremely sensitive to the larger economy.

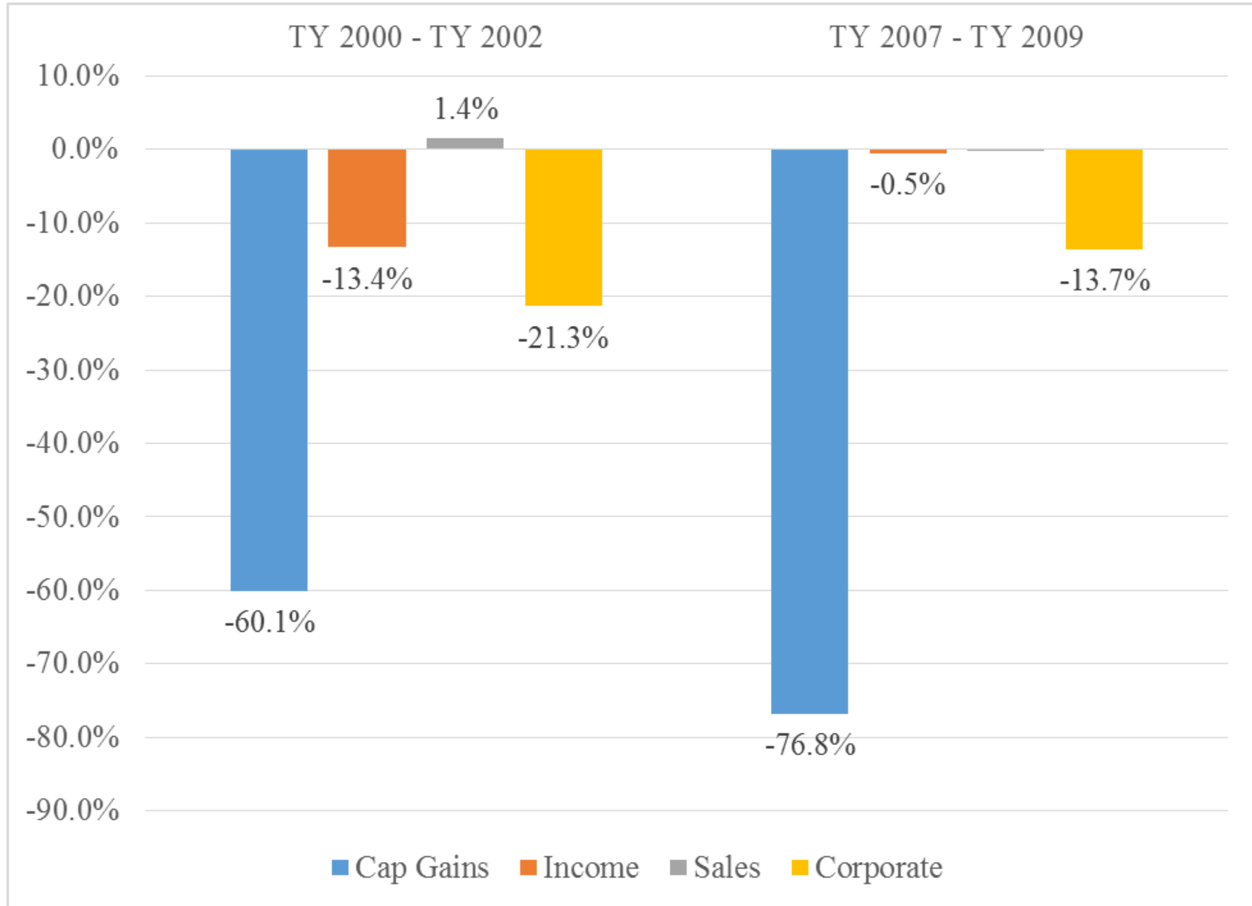
Figure 1. Capital Gains Collections by Year (Tax Years 2000 – 2015)



During the 2001 recession, capital gains tax revenues declined by more than 70 percent resulting in revenue declines of $827 million in the first year of the recession. Similarly, in the Great Recession, capital gains revenue plummeted by $1.3 billion, or more than 60 percent between tax years 2007 and 2008.

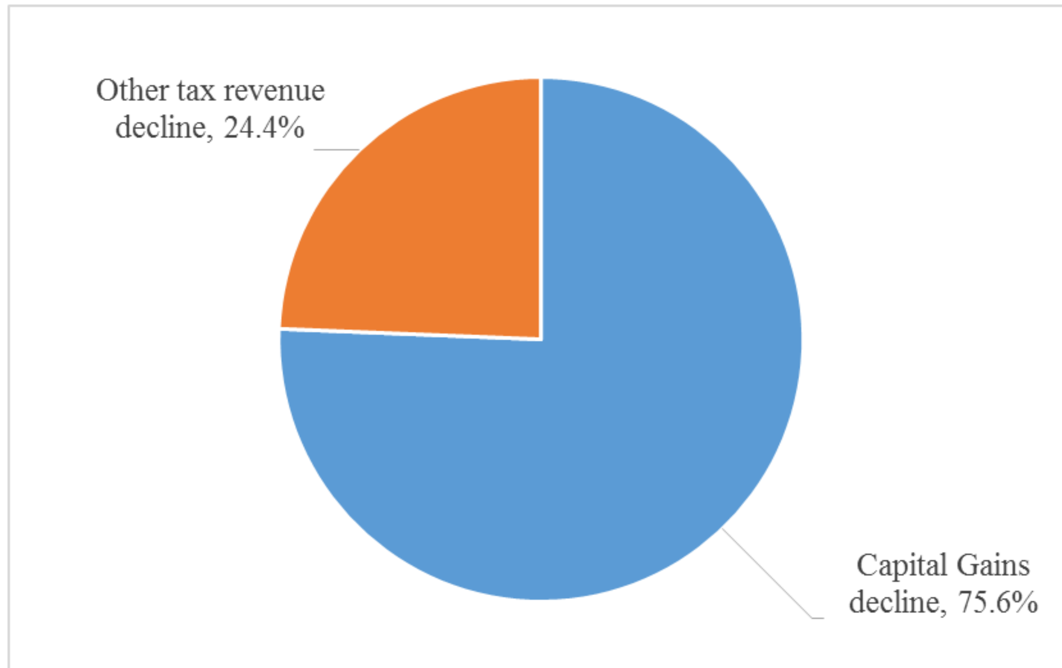
While it is expected that tax revenue sources mirror the larger economy, the magnitude of those changes in the capital gains tax is vastly disproportionate to other major sources of tax revenue. As shown in Figure 2, the proportional decline in capital gains revenues during each of the past two recessions has far outweighed all other sources of revenue.

Figure 2. Tax Revenue Source Declines during the Last Two Recessions



The size of these decreases meant that although capital gains makes up a relatively small share of total tax revenue (6 percent on average between 2000 and 2014), it had a major impact on revenue loss in both recent recessions. Between tax years 2000 and 2002, capital gains accounted for 35 percent of a $2 billion reduction in tax revenue. And during the most recent recession, as shown in Figure 3, the role of capital gains in the loss of tax revenue was even more pronounced – accounting for 75 percent of all tax revenue lost.

Figure 3. Tax Revenue Decline by Source, Tax Years 2007 – 2009



These sharp decreases in capital gains collections have been a primary factor in creating gaping budget shortfalls in recent recessions – a persistent factor that should inform our current fiscal policy.

Implications for the Budget

The extreme volatility of capital gains tax revenues has two major implications for the state budget. The most obvious one is that capital gains revenue essentially disappears during economic downturns creating a large void in the operating budget. This means that spending predicated on these revenues during good times must be either eliminated or supported by unsustainable one-time sources during difficult times. The failure to take this phenomenon into account prior to the downturns of 2001-2003 and 2008-2010 greatly exacerbated the budget challenges faced by the state, requiring bigger cuts and a heavier reliance on one-time revenues.

The other implication of overreliance on capital gains is that by using unreliable revenues for operating expenses the state is forgoing the opportunity to save that money for capital investments or replenish its reserves. When capital gains revenues drop, not only does the Commonwealth need to find replacement revenue to plug the hole in the operating budget, it also has less available in the Stabilization Fund to better withstand economic downturns.

To address this practice, lawmakers adopted a policy in the FY2011 budget under which all capital gains collections above a certain threshold (originally set at $1 billion and since adjusted for inflation) are used for reserves. Under this policy, 90 percent of any amount exceeding the

threshold is transferred to the Stabilization Fund, with the remaining amount split evenly between the State Retiree Benefit Trust Fund and the state's pension liability.

This fiscally prudent measure was positively recognized by the credit rating agencies. Standard & Poor's indicated that Massachusetts's commitments to implementing financial reforms and rebuilding reserves were important factors in its decision to upgrade the state's credit rating in 2011. However, that policy has not been followed since FY 2014. In FY 2015, more than $600 million in excess capital gains revenues were tapped to close a midyear budget gap. In FY 2016, the budget relies on an additional $300 million in assumed above threshold capital gains revenues to support the operating budget.

Most recently, Governor Baker's FY 2017 budget proposes retaining $150 million in above threshold capital gains revenue for the operating budget, while directing the remaining $206 million in estimated above threshold revenues to the Stabilization Fund and long-term liabilities. Unlike in FY 2015 and FY 2016, this approach will ensure that the majority of unsustainable capital gains revenues are set aside for deposit into the Stabilization Fund.

Figure 4. Capital Gains Revenue Diversions, FY 2015 – FY 2017[8]

	Above Benchmark Capital Gains	Amount diverted to operating budget	End of year surplus to Stabilization Fund
FY 2015	$621.0	$621.0	$123.5
FY 2016	$300.0	$300.0	NA
FY 2017 (Gov proposed)	$356.0	$150.0	NA

While certainly a step in the right direction, this proposal, if adopted, would mark the third straight year that the state has diverted capital gains from reserves to balance the budget, during relatively good economic times – a trend that has consequences for the Commonwealth's long-term fiscal health. One way to understand the potential ramifications of continuing to divert capital gains revenues from the Stabilization Fund to balance the budget is to consider how the state is currently positioned to withstand a drop in capital gains revenues of the magnitude of recent recessions.

Today, a recession which saw single year declines in capital gains revenues proportional to either of the last two recessions would result in a loss of between $850 million and $1 billion in tax revenues and an impact of up to $800 million to the operating budget. In previous recessions, the state has relied on the Stabilization Fund to mitigate unexpected drops in capital gains. However, there is a big difference between our current Stabilization Fund and the size of our reserves when confronted with earlier recessions.

[8] FY 2017 data is based on Governor Baker's FY 2017 budget proposal.

Figure 5. Comparison of Stabilization Fund Balance, Fiscal Years 2002, 2009 & 2017

	2002	2009	2017 Projected
Stabilization Fund Balance at start of FY	***$1,715***	***$2,119***	***$1,258***
Reserves used during fiscal year	-$833	-$1,278	
Stabilization Fund Balance at end of FY	***$882***	***$841***	

The projected Stabilization Fund balance entering FY 2017 is $457 million short of the balance entering FY 2002 and $861 million short of the start of FY 2009. This difference means that the state would be much more limited in the ability to use reserves to plug budget holes in any fiscal downturn – in spite of the fact that the state budget has grown by more than $10 billion since the start of FY 2009. During FY 2009 the net withdrawal of reserves used to balance the budget was $1.278 billion – more than our entire current Stabilization Fund balance. Had capital gains revenues not been diverted from the Stabilization Fund in recent years, its balance would be $2.06 billion.

Clearly, the Commonwealth does not have the same ability to offset an unexpected decline in capital gains tax revenues similar to what was required in FY 2002 and FY 2009 with its current reserves. The policy put in place to dedicate unsustainable capital gains revenues to the Stabilization Fund provides a roadmap for rebuilding reserves, but unless that roadmap is followed, the next recession – whenever it occurs – will find the Commonwealth unprepared.

Conclusion

Massachusetts' budget is heavily reliant on capital gains tax revenues. While this reliance can result in revenue windfalls during good times, sudden declines in these revenues have been the single largest contributing factor to fiscal stress in the last two recessions. If the next recession is comparable to the previous two, the state stands to lose between $850 million to $1 billion in tax revenue attributable to capital gains.

By adopting a system whereby excess capital gains revenues are used to build reserves – and not used to balance the operating budget – policymakers have created a strategy to mitigate the impact of the next recession on the budget. However, in order for the policy to be effective, policymakers must adhere to it consistently. When this policy is set aside to meet short term budget needs, the time available to rebuild reserves diminishes and the amount of rebuilding required increases. Recent history and fiscal prudence demonstrate the dangers of using unsustainable capital gains revenues to balance the budget. More than six years out from the end of the last recession, amid a great deal of economic turbulence, the Foundation urges the Legislature to eliminate the use of capital gains revenue above the threshold in FY 2017 so that the state can better prepare for the next downturn.

Recommendations

1. Eliminate the use of all excess capital gains revenue in the operating budget in FY 2017. Fully adhering to the statute that limits the use of capital gains revenues in the operating budget would result in an estimated $320.4 million deposit in the state's Stabilization Fund and provide $35.6 million to address other long-term liabilities. Just as importantly as rebuilding reserves, this approach would also limit the extent to which the operating budget is built upon unsustainable revenue sources.

2. Reassess the threshold on sustainable capital gains with the goal of minimizing the use of these revenue for the operating budget. Currently, the cap is adjusted annually to account for economic growth. In FY 2017, this adjustment increased the capital gains threshold by $41 million. However, the volatility of capital gains is inconsistent with this type of growth adjustment. The more fiscally prudent approach would be to implement a fixed cap on capital gains in the operating budget that is not subject to annual adjustment.

3. Longer-term, policy makers should consider limiting the use of capital gains revenue to non-recurring spending needs, such as pay-go capital.