Massachusetts Taxpayers Foundation

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FY 2018 Fiscal Update: Closing out the Year

Fiscal year (FY) 2018 ends in less than a month and final action to officially close out the year will likely occur before legislative session ends at the end of July. For the first time in several years, the year will end with tax revenues that significantly exceed expectations. This brief takes a closer look at what conclusions should – and should not – be drawn from recent tax collections and previews the decisions policy makers will face as the fiscal year concludes.

FY 2018 Tax Collections

Through May, tax collections are $879 million ahead of the $26.661 billion benchmark for the year. FY 2018 is on track to realize the greatest tax revenue growth since FY 2011, when the state economy was just emerging from the Great Recession. Strong collections are great news, especially after two straight years of lower than expected tax revenues that have wrought havoc on the state budget, requiring painful budget cuts while impeding efforts to improve the state's fiscal footing. Tempting as it may be to view these tax numbers as the sign of a more promising revenue trend, a look at the larger economic context casts some doubt on that conclusion.

Putting collections in the Massachusetts context

Fiscal year 2018 began with a $650 million tax revenue downgrade. For the second straight year, but unprecedented in the 15 years prior, budget makers reduced tax estimates by more than $500 million from the amounts used in both the House and Senate budgets, thus requiring major budgetary revisions in conference committee. After a relatively strong FY 2015, tax revenues grew by just 2.2 percent in FY 2016 and 1.3 percent in FY 2017 despite the state's strong economy performance. Several theories were used to explain the disconnect between the underlying economy and tax collections, and no one can say for certain why that was, but it was clear that lowering FY 2018 tax expectations in light of this information was necessary.

The expected tax revenue growth rate of seven to eight percent in FY 2018 must be considered in this broader context of the recent anemic tax revenue growth of the past two years. The chart below compares actual revenue growth over the last three years with tax revenues if they had grown at 3.9 percent each year (the average rate of tax growth between FY 2012 and FY 2017).

Figure 1. Tax Collections, FY 2016 – FY 2018

	FY 2016	FY 2017	FY 2018
Actual collections	$25,269	$25,604	$27,540
Collections w/3.9% growth	$25,680	$26,681	$27,722

Numbers in millions, net of tax settlements

Even with the expected revenue rebound, the state is still likely to end FY 2018 with less in tax collections than would have been the case had revenues simply grown at a steady 3.9 percent over the last few years.

Putting collections in the national context

Could strong collections in FY 2018 be the result of the recently enacted federal tax reform law? There are two reasons to believe that this new law has prompted a temporary uptick.

More than three quarters of this above-benchmark tax revenue was collected in December and January, the period immediately subsequent to enactment of the Tax Cut and Jobs Act (TCJA) and may be caused by taxpayer reaction to these changes. For example, federal changes to the deductibility of state and local taxes incented high income earners to prepay those taxes before the limitation became effective in order to take advantage of full deductibility for one more year. The data bear this out. Non-withholding income tax payments, where these prepayments would be counted, more than doubled in December of 2017 compared to December of 2016 and accounted for 78 percent of all above-benchmark revenue.

Secondly, federal tax certainty, and rate reductions, following the TCJA encouraged the sale of capital assets that resulted in a surge of capital gain tax revenue. One of the theories behind poor collections in FY 2016 and FY 2017 was that many filers waited to sell capital assets until they had more certainty regarding pending federal tax changes. Passage of the Tax Cuts and Jobs Act has spurred increased activity.

Figure 2. Non-Withholding Tax Revenue v. Benchmark, FY 2016-FY 2018

	FY 2016	FY 2017	FY 2018
Non-withholding income	-$418	-$311	$642
All other tax	-$66	-$100	$237
Non-wittholding as % of total	86%	76%	73%

Numbers in millions

To understand the magnitude of the revenue swing, consider that between FY 2016 and FY 2017 lower than expected non-withholding income (where capital gains are counted) accounted for 81 percent of the tax shortfall. Through May of 2018, that same income category constitutes 73 percent of above-benchmark collections.

The short-term impact of the TCJA on tax revenues was not unexpected. In fact, the Foundation's projection of FY 2019 tax revenue stated, "…driven in part by speculation around passage of the Republican tax plan, the Foundation's revenue model anticipates asset sales to occur in the first half rather than the second half of 2018 leading to a onetime spike of $450 million or more in FY 2018 tax revenues." Moreover, weak tax collections in FY 2016 and FY 2017 indicated pent-up activity related to capital gains tax revenue. These two factors, neither of which is likely to recur, are the primary causes of the surge in tax revenue in FY 2018. Therefore, it would be a mistake to assume that this surge is sustainable or should be used to support annual operating expenses.

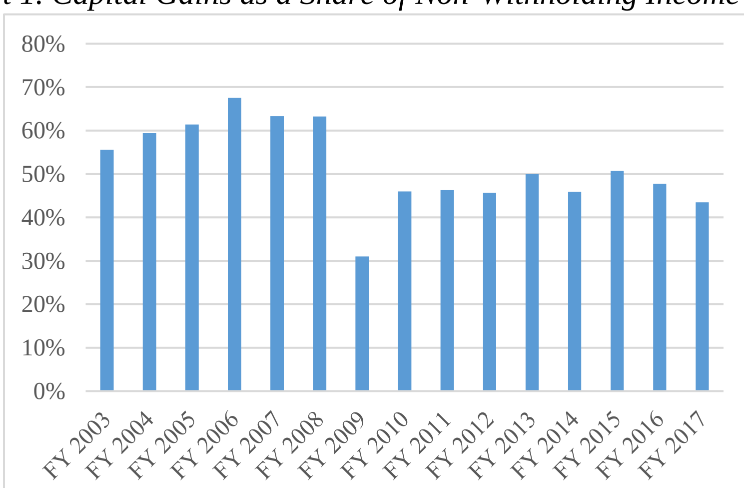
Estimating the budget surplus

There is an important distinction between a tax revenue surplus and a budget surplus; any final FY 2018 budget surplus will be far less than the amount of tax collections over benchmark. That is because some capital gains tax revenues will be deposited into the Stabilization Fund and other reserve funds in compliance with statutory requirements. In addition, the state has a number of other spending and revenue obligations that need to be addressed and will offset a large portion of the tax revenue surplus.

Capital gains revenue

In FY 2018, any capital gains tax collections in excess of $1.22 billion will automatically be deposited into the Stabilization Fund, with 10 percent of that amount then transferred to other state reserves.[1] The actual amount of the transfer is unlikely to be known for some time, but a rough estimate is possible.

Chart 1. Capital Gains as a Share of Non-Withholding Income Taxes



[1] Five percent to the State Retiree Benefits Trust and five percent to the Pension Liability Fund

Using historic data to guide them, budget makers should assume that capital gains taxes exceed the $1.22 billion threshold by between $400 and $500 million.

Figure 3. Capital Gains Revenue Scenarios in FY 2018

Non-Withholding Income			
	Low	Middle	High
	$3,222.0	$3,522.0	$3,822.0
Capital gains share			
44 percent	$1,417.68	$1,549.68	$1,681.68
48 percent	$1,546.6	$1,690.6	$1,834.6
52 percent	$1,675.4	$1,831.4	$1,987.4
Above threshold			
Minimum	$197.9	$329.9	$461.9
Maximum	$455.7	$611.7	$767.7

Over the past fifteen fiscal years, with the exception of FY 2009 during the height of the Great Recession, capital gains have comprised at least 44 percent of all non-withholding income taxes. As Chart 1 shows, capital gains have not yet returned to their pre-Great Recession share of revenue, but over the past 5 years have averaged 47.8 percent of all non-withholding taxes.

Under the most conservative assumptions, at least $198 million in tax revenue will be deposited directly into the Stabilization Fund and it is easy to foresee a scenario in which more than $600 million in tax revenues is set aside from the operating budget.

Revenue and Spending Exposures

The state budget must also accommodate a number of spending needs and revenue shortfalls not anticipated in the original budget. Cost drivers include snow removal reimbursements, caseload for Department of Transitional Assistance benefits, new program requirements from recently enacted criminal justice reform legislation, MassHealth and collective bargaining agreements. In the meantime, several revenue sources (most notably the state lottery and tax settlement collections) are unlikely to meet budget targets. Finally, a recent supplemental budget added $30 million in spending not previously accounted for. In total, about $200 million of above-benchmark tax revenues will be needed to address these spending increases and revenue shortfalls.

Other Considerations

The FY 2018 budget currently relies on $125 million in sales tax revenue that will be collected in FY 2019 related to the inability to implement a Baker Administration proposal to change how the state collects the sales tax for debit and credit card purchases. This shift, if allowed to occur, creates a budget problem for FY 2019 and subsequent budget years. The Senate has wisely proposed eliminating this shift because the revenues are not necessary to balance the FY 2018 budget, add to the state's long-term structural deficit and have a negative impact on FY 2019. Adopting the Senate solution will reduce the budget surplus, but solve the problem permanently.[2]

The year-end budget surplus will likely be further reduced by earmarks for specific programs. In recent years, a part of the surplus has gone to fund the Massachusetts Life Sciences Center and the Community Preservation (CPA) Trust Fund. The House's FY 2019 budget proposes dedicating $5 million of the FY 2018 surplus to the CPA, while the Senate has not yet indicated any surplus spending plans.

In summary

A number of unknowns, including actual June revenue collections, make estimating the FY 2018 fiscal picture an inexact science. However, it is clear that many demands on above-benchmark tax revenue will significantly reduce any budget surplus. The transfer of capital gains revenue to the Stabilization Fund, paying for spending obligations already incurred and making up for revenue sources that were lower than expected, will amount to more than $600 million, leaving little money for new spending.

Figure 4. Estimating the FY 2018 Budget Surplus

Tax revenues above benchmark (through May)	**$879**
Tax revenue offsets	
Capital gains offset	-$450
SBA offset	-$10
Spending exposures	
Snow & ice	-$30
New supp spending	-$30
Criminal justice reform	-$15
Other spending exposures	-$58
Revenue shortfalls	
Tax settlements	-$90
Lottery	-$15
Other items	
Real time sales solution	-$105
Consolidated net surplus	-$5
Total adjustments	***-$808***
Estimated surplus	**$71**

[2] Part of the $125 million would be dedicated to the state's School Building Authority and so the actual budget impact of eliminating the transfer is $105 million.

A unique opportunity to rebuild reserves

Undoubtedly, the biggest short and medium term fiscal risk the state faces is its insufficient reserves. Failure to rebuild reserves has already impacted the state in the form of a bond rating downgrade by S&P. The credit rating agency explicitly cited the state's inability to follow its reserves policy in a period of economic recovery as the reason for doing so. Given that Massachusetts is ill-prepared for the next economic downturn; policy makers should use whatever excess FY 2018 revenues remain at the end of the fiscal year to replenish the Stabilization Fund.

The Stabilization Balance stands at $1.318 billion – slightly less than the $1.379 balance achieved in the first full year of economic recovery in FY 2011. Since FY 2014 the Stabilization Fund balance has grown by just $70 million – an average of less than $20 million per year. Comparisons to previous economic recoveries make clear just how anemic and inadequate Stabilization Fund growth has been during this recovery.

Figure 5. The Stabilization Fund in the Three Previous Recoveries

	FY 1991 - FY 2001	FY 2004 - FY 2008	FY 2011 - present
Ending balance	$1,715	$2,119	$1,318
As share of appropriations	*7.8%*	*7.7%*	*3.2%*
Amount deposited	$1,715	$1,478	$648
Average deposit	$156	$296	$81
Deposits of Less than $50M	1	1	5

$ in Millions

The lack of year-end budget surpluses has been a major factor in the failure to rebuild reserves. In the 2000s, end-of-year surpluses allowed $400+ Stabilization Fund in three separate years; in contrast, only one such deposit has occurred during this recovery (in FY 2011). Adherence to the state's capital gains statute will likely result in a Stabilization Fund deposit in the $400-$500 million range. It is imperative that budget makers commit to a total deposit of no less than $500 million in FY 2018 to make up for lost time.

Summing up

Tax revenues have far exceeded initial projections after more than two years of sluggish growth and budget troubles and that is certainly a welcome change. Strong tax collections allow the state to improve its long-term fiscal footing if used appropriately. As lawmakers contemplate what to do with the surplus revenue, there are three things to keep in mind:

- Strong tax collections today do not guarantee strong collections tomorrow and there are several indications that the recent surge is not sustainable;
- A tax revenue surplus and a budget surplus are not the same thing and more than $600 million of above-benchmark collections may already have claims upon it; and
- FY 2018 is a rare opportunity to rebuild reserves that cannot be missed.