



News Release

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MTF Forecast: Foundation Advises Beacon Hill – ‘Batten Down the Hatches’

Tax revenues will increase by approximately \$740 million, or 2.8 percent, to \$27.59 billion in fiscal 2019¹ according to a new forecast released today by the Massachusetts Taxpayers Foundation (Table 1 and Figure 1). The Foundation estimates capital gains tax revenues of \$1.28 billion.

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

	Forecast		FY 2019 vs. FY 2018		Actual FY 2017	FY 2018 vs. FY 2017	
	FY 2019	FY 2018	Change - \$	Change - %		Change - \$	Change - %
Withholding	13,033	12,472	561	4.5%	11,970	502	4.2%
Other Income	3,062	3,154	-92	-2.9%	2,730	424	15.5%
Sales	6,538	6,398	141	2.2%	6,242	156	2.5%
Corporate	2,627	2,567	60	2.3%	2,497	70	2.8%
Other	2,326	2,254	72	3.2%	2,217	37	1.7%
Total	27,586	26,845	742	2.8%	25,656	1,189	4.6%
Capital Gains	1,281	1,651					
Above Threshold	76	482					

For the current fiscal year, FY 2018, the Foundation projects tax revenues of \$26.85 representing an increase of \$1.2 billion, or 4.6 percent, over the \$25.656 billion in taxes collected in fiscal 2017 with capital gains tax revenues exceeding \$1.6 billion.² The

¹ The Foundation does not include estimates of one-time corporate tax settlements in excess of \$10 million in its revenue forecasts nor does this estimate include marijuana tax revenues. This estimate does not assume a reduction in the income tax rate from the current 5.10 percent to 5.05 percent in FY 2019. The rate change would lower the Foundation’s FY 2019 forecast by \$84 million according to DOR estimates.

² The Foundation’s FY 2018 forecast does not include \$125 million of sales tax revenues collected in June 2018 and remitted in July 2019 to DOR. That \$125 million is included in the Foundation’s FY 2019 sales tax estimate.

Foundation recommends that the current FY 2018 revenue benchmark of \$26.504 billion remain unchanged.

Forecasting state tax revenues 18 months into the future is always risky as unforeseen events often undermine predictions as the past three years have demonstrated. However, predicting revenues in FY 2019 is more daunting than usual because there are several upcoming events over the next 12 months, any one of which will have major impacts on state tax revenues, but those impacts are unknowable right now. Taken together, these events could dramatically alter the state's fiscal health. Foremost among these events are three ballot initiatives in November described later in this analysis.

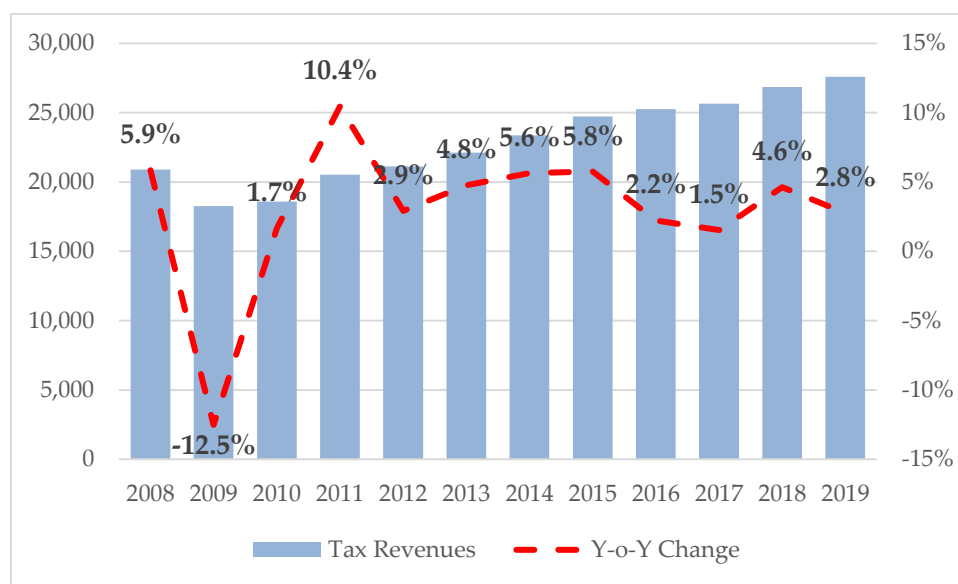
Of more immediate concern is the impact of the Republican tax cut legislation being considered in Washington – at this point passed by both the House and Senate – on investors' decisions to sell assets. Whether the plan is signed into law or fails to pass Congress, investors will finally have clarity on federal tax rates following 14 months of uncertainty.

It is more likely than not that investors will realign their investments based on this new certainty, resulting in a one-time surge in capital gains tax revenues in tax year 2018. Investors behaved similarly in FY 2013 when, fearing an upcoming federal income tax rate hike, tax planning led to a growth of \$400 million in capital gains tax revenues.

Given that three stock indices have soared to all-time highs, 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 one-time spike of \$450 million or more in FY 2018 tax revenues. Even with this spike, tax revenue growth remains below five percent.

Although tax revenues continue to grow year-over-year as the U.S. enters the ninth year of the economic recovery, as Figure 1 demonstrates, that rate of growth remains modest with years FY 2016 through FY 2019 averaging below three percent.

Figure 1 – State Tax Revenues, 2008 – 2019



Though federal tax legislation could have a major impact on the state’s finances, it is the outcome of three ballot questions – the millionaire’s tax that would add a 4 percent surcharge on income in excess of \$1 million, a proposed reduction in the sales tax rate to 5.0 percent from the current 6.25 percent, and a paid family and medical leave initiative – that could make irrelevant the forecasts presented at today’s hearing eclipsing the various tax revenue forecasts for FY 2019.

There is a possibility that the millionaire’s tax will not appear on the 2018 ballot given the legal challenge before the Supreme Judicial Court. There is also some uncertainty regarding the current estimate of the amount of revenue the state would collect in FY 2019 from the millionaire’s tax given the various changes since DOR’s forecast in 2015. The Foundation suggests that DOR update its estimate for FY 2019 to assist lawmakers in planning accordingly.³

The impact of a lower sales tax rate, on the other hand, is quite clear. The state would lose approximately \$650 million in FY 2019 that would lower total tax revenue growth to less than \$100 million for the year or 0.3 percent over FY 2018.

³ The Department of Revenue’s millionaire’s tax revenue estimate was based on a full tax year rather than one-half a fiscal year and did not assume federal tax rate changes that includes a limitation on the deduction of state and local taxes (SALT). Given the various changes since DOR’s forecast in 2015, an update of the revenue impacts in FY 2019 appears to be warranted.

The paid family and medical leave initiative would likely cost the state \$100 million to \$150 million annually due to reduced taxes, state program administration costs, and participation costs to the state for its employees.

Since lawmakers must construct the FY 2019 budget months before the outcomes of the ballot questions are known, the Foundation urges significant fiscal restraint in spending. Equally important, lawmakers should adhere to the statutory requirements to deposit all capital gains tax revenues above the threshold and all corporate tax settlements in excess of \$10 million to the state Stabilization Fund.

Above all, the state should deposit a minimum of \$500 million from FY 2018 and FY 2019 revenues to the rainy day fund to help mitigate potential losses of state tax revenues and federal funds.

Eileen McAnneny, President of MTF, presented the Foundation's economic and revenue forecast to members of the House and Senate Ways and Means Committees and the Secretary of Administration and Finance at their annual consensus revenue hearing at the State House today.

"Preparing a budget months in advance is difficult in the best of circumstances but this year is particularly challenging given the huge revenue swings that could result from any one of several scenarios in play, including the potential impact on state finances from federal tax cuts and ballot initiatives impacting state tax revenues."

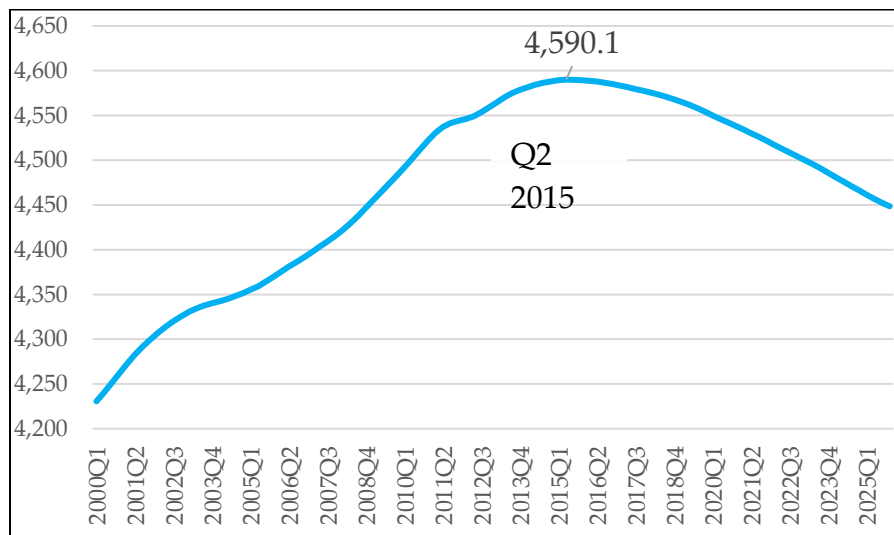
Acknowledging that this puts lawmakers in a difficult dilemma, McAnneny recommends that

"the only sound course is a return to fiscal discipline that limits state spending growth, delivers needed reforms and savings in MassHealth, and deposits all excess capital gains and corporate tax settlements into the rainy day fund. It's far easier to increase spending than to be forced to eliminate hundreds of millions from the budget mid-way through the fiscal year. Let's not repeat the experiences of the past few years."

DEMOGRAPHICS CONSTRAIN MASSACHUSETTS' GROWTH; DRIVE UP SAFETY NET COSTS

Massachusetts has a daunting workforce hurdle that will increasingly hinder economic growth. The number of Massachusetts residents between the ages of 16 and 64 peaked in June 2015 and will continue to decline over the next decade, limiting growth as businesses struggle to recruit workers (Figure 2). In fact, the latest AIM business confidence index cites the inability to recruit talent as a reason for the month-over-month drop in employers' confidence level.⁴

Figure 2 – Massachusetts Population Age 16 – 64⁵
(in thousands)

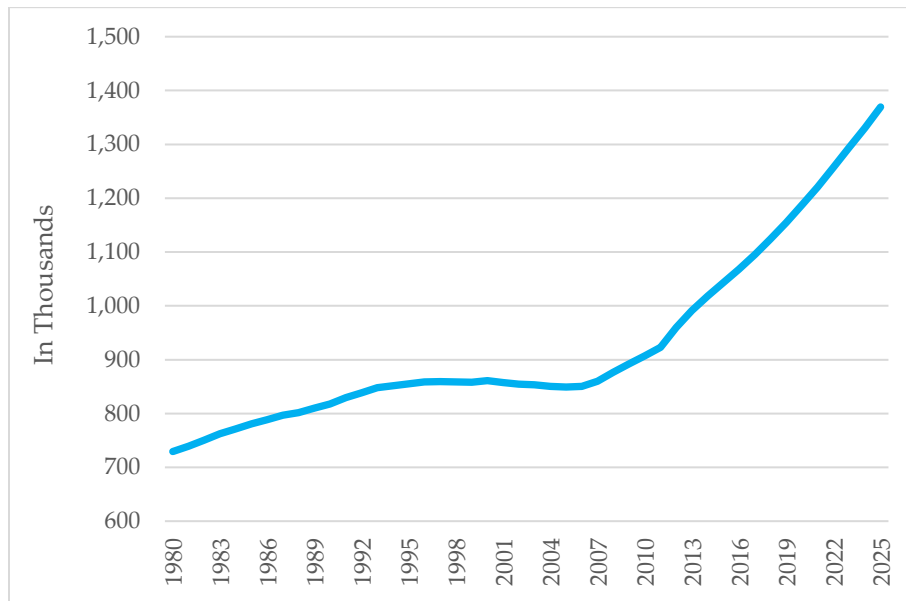


Relatedly, the number of Massachusetts residents age 65 or older began to soar in 2011. As people transition from work to retirement, income and sales tax revenues will decline while the cost of healthcare and other government services for this aging population will climb.

⁴ "Analysts on the AIM Board of Economic Advisors (BEA) believe that Massachusetts may be suffering from too much of a good thing – a 3.7 percent unemployment rate that threatens to derail the ability of employers to find the workers they need to grow at a time when large number of baby boomers prepare to leave the work force." The Associated Industries of Massachusetts Business Confidence Index, November 2017.

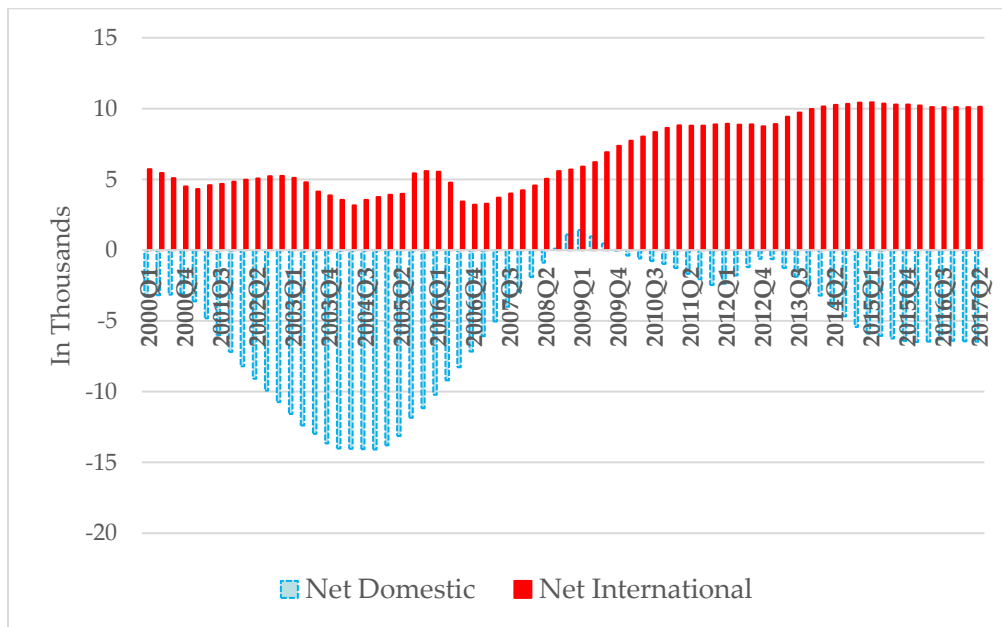
⁵ Moody's Analytics, November 28, 2017

Figure 3 – MA Population Age 65+



In the past, Massachusetts population challenges have been aided by international migration which has exceeded a net of 10,000 per year since 2013 more than offsetting the thousands of people who leave the state annually (Figure 4).

Figure 4 – Massachusetts Population – Net Domestic and International Migration⁶
(in thousands)



⁶ Moody's Analytics, November 28, 2017

President Trump's travel bans and Republican efforts to limit the number of H-1B visas and the ability for spouses of H-1B visa recipients to work in the United States will eventually shrink the number of talented individuals coming to the state's universities and businesses thus impairing economic growth.⁷

REPUBLICAN TAX PACKAGE AND POLICIES WILL LIKELY BE DISADVANTAGEOUS TO MASSACHUSETTS

The Republican tax cut legislation and several policy proposals will test the state's fiscal condition and will likely have negative effects on state finances, health care coverage, higher education, transportation, research, and state exports.

Higher education – a pivotal component of the Massachusetts success story – is likely to take a hit under the Republican tax legislation. Tax law changes could include a levy on college endowments of the largest private colleges and universities, elimination of tax deductions for student loan interest, and taxing tuition waivers as income for graduate students.

The tax package also eliminates tax exempt private activity bonds (PABs) removing the underpinnings of President Trump's proposed \$1 trillion infrastructure plan. PABs are a required part of most public-private partnerships and supported by the Federal Highway Administration to encourage private investments in transportation projects.

While Massachusetts has a state-level mandate on the books, elimination in the tax plan of the Affordable Care Act's requirement that people have health insurance could cause a significant increase in health care premiums, according to the Congressional Budget Office (CBO).

Less clear is the impact of the tax cuts on federal spending. The statutory Pay-As-You-Go Act of 2010 requires that all new legislation, including tax law changes, must not increase the federal budget deficit. Since the tax plan is expected to add \$1.5 trillion to the federal debt over ten years, federal law stipulates that spending be reduced by the same amount to avoid increasing the federal deficit, amounting to an average of \$150 billion each year over the next ten years. These cuts will likely affect Medicare spending (up to a \$25 billion annual cap) along with important investments in health, education and research.

⁷ In 2016, Massachusetts certified over 40,000 H-1B visas: Office of Labor Certification, Annual Report, U.S. Department of Labor, 2016, p. 74.

Federal funding for the Children’s Health Insurance Program (CHIP) lapsed on September 30, 2017, leaving the state on the hook for the program’s \$250 million annual cost should Congress fail to reauthorize the program and make it effective retroactively. Meanwhile, Republicans continue their efforts to restructure Medicaid into a block grant program that would cost the state billions in federal matching funds in the years ahead.

A number of President’s Trump’s trade policies – backing out of the Trans-Pacific Partnership, demanding concessions from Mexico and Canada in NAFTA negotiations, threatening to tear up the U.S.- Korea Free Trade Agreement, threats to launch a trade war with China, questioning trade relations with Japan – could adversely affect some or all of Massachusetts major trade partners. Massachusetts leading export markets are Canada, Mexico, and China with Germany, the U.K., Japan and Korea in the top ten destinations for state products.

RISKS OF AN EXTERNAL SHOCK INTENSIFY

While the U.S. and global economies continue to experience solid growth, there has not been a significant external shock or economic downturn since the last recession. There are several geopolitical risks that could alter that positive trend, most notable among them the intensifying tension with North Korea and the relatively few options to avoid armed conflict.

As the Trump administration reevaluates its global commitments in foreign policy and trade, Russia and China have moved adroitly to fill these vacuums. Both countries are extending their spheres of influence creating additional pressures on alliances and countries with borders on the South China Sea, in the Middle East, and the Balkans.

Growing wariness with Iran has led to an alignment of interests between Israel and Saudi Arabia that could lead to open skirmish that would rapidly draw many of their neighbors currently engaged in proxy wars into a larger conflict.

Another major risk – recently reported by NATO – is the growing threat of global assaults against computers and information networks led by advances in artificial intelligence and fueled by cyber-attacks from North Korea, Russia, and China.

CONCLUSION – THE STATE HAS LITTLE TIME TO PREPARE

Massachusetts is unprepared for any significant disruption to its economy and finances. Yet the chances of an economic shock continue to rise.

For the past few years, Massachusetts has grappled with stalled growth in tax revenues, the threat of declining federal funding, and insufficient reserves to mitigate the budgetary impacts – all during a period of continued economic expansion. Massachusetts has thrived despite being a high cost state with challenging demographics. Counting on these conditions to continue would be imprudent at best.

It is time to conserve resources, control state spending, and prepare for a transition where the state must increase its reliance on its own resources – that is the only sensible course given the growing uncertainties confronting the state.

