Massachusetts Taxpayers Foundation

News Release

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Are the Good Times Already Over?

Tax revenues will increase by approximately $680 million, or 2.4 percent, to $29.47 billion in fiscal 2020[1] according to a new forecast released today by the Massachusetts Taxpayers Foundation (Table 1 and Figure 1) at the state's annual consensus revenue hearing. The Foundation estimates capital gains tax revenues of $1.23 billion, a figure that is below the formulaic capital gains tax threshold projection for 2020.

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

	Forecast		FY 2020 vs. FY 2019		Actual	FY 2019 vs. FY 2018	
	FY 2020	FY 2019	Change - $	Change - %	FY 2018	Change - $	Change - %
Withholding	13,730	13,145	585	4.3%	12,732	413	3.2%
Non-Withholding							
Capital Gains	1,232	1,620	-388	-31.5%	1,683	-63	-3.7%
Other non-Withholding	2,190	1,990	200	9.1%	1,825	165	9.0%
Sales	6,986	6,709	278	4.0%	6,454	255	4.0%
Corporate	2,888	2,836	52	1.8%	2,772	64	2.3%
Other Tax Revenues	2,443	2,490	-47	-1.9%	2,330	160	6.9%
Total	**29,469**	**28,789**	**680**	**2.4%**	**27,796**	**993**	**3.6%**
Cap Gains above Threshold	**-12**	**414**			**514**		

MTF does not recommend any revisions to the current consensus revenue figure for FY2019, the current fiscal year. The Foundation projects tax revenues of $28.79 billion for FY 2019, representing an increase of $993 million or 3.6 percent, over the $27.79 billion in taxes collected in fiscal 2018. Capital gains tax revenues are projected to exceed $1.6 billion, surpassing the capital gains threshold by $400 million; however, that

[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 assumes a reduction in the income tax rate from the current 5.10 percent to 5.05 percent beginning January 1, 2019.

additional money will be transferred to the Stabilization Fund automatically per statutory requirements.

The Massachusetts economy has experienced strong economic growth since the 2009 fiscal crisis. Job growth increased an average of 1.7 percent annually for the period beginning January 2010 through October 2018. This equates to 484,000 new jobs, with nearly 3.7 million people currently employed in the commonwealth.

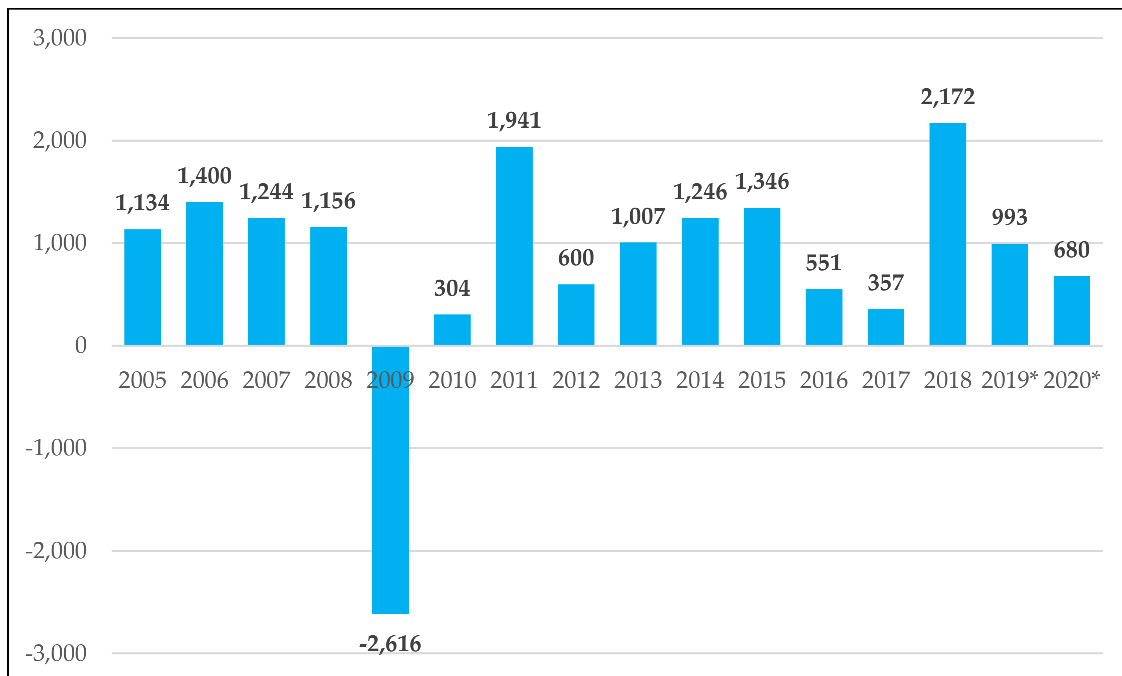
However, that growth in jobs has not always translated into robust tax revenue growth. Fiscal years 2016 and 2017, in particular, yielded growth of just 2.2 and 1.4 percent respectively for an average of $454 million in new tax revenues over the previous year.

FY2018

In contrast to the anemic 2016 and 2017 results, tax revenues in FY 2018 surged by $2.17 billion (Figure 1) or 8.5 percent. This was largely driven by federal tax reforms passed in December 2017.

Figure 1 – Year-over-Year Growth in State Tax Revenues, 2005 – 2020

(* 2019 and 2020 are forecasts)



Withholding income tax revenues and sales taxes, are excellent gauges of the current condition of the state's economy as barometers of the strength of the labor market and people's willingness to purchase goods, autos, and meals. Together these two revenue

sources represent 70 percent of total state tax revenue and they accounted for $1 billion or nearly half of the $2.17 billion in revenue growth. Withholding (6.4 percent) and sales (3.9 percent) grew at a combined 5.5 percent rate in FY 2018, the second highest increase in the past 15 years, and a strong bounce from a 3.9 percent average in 2016 and 2017.

Table 2 – Tax Revenue Growth, FY 2018 vs. FY 2017

	2018 vs. 2017	
	$	**%**
Income		
Withholding	762	6.4%
Cap gains	493	41.4%
Other non-withholding	285	18.5%
Sales	245	3.9%
Corporate	277	11.1%
Other	106	4.8%
Total	**2,168**	**8.5%**

Yet it was the more volatile sources that pushed 2018 to the highest growth in tax revenues in recent years. As shown in Table 2, capital gains tax revenues increased by over 40 percent. Other non-withholding income taxes (interest, dividends, and self-employment income) grew by nearly 20 percent, and corporate tax payments increased by 11 percent.[2] These three sources – largely driven by changes to the federal tax code – added $1.06 billion in 2018 revenues.

[2] MTF's December 6, 2017 tax revenue forecast stated: "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 onetime spike of $450 million or more in FY 2018 tax revenues. Even with this spike, tax revenue growth remains below five percent." While we were correct in our estimate of capital gains, we did not anticipate the substantial increases in other non-withholding and corporate taxes that pushed revenue growth to 8.5 percent in 2018.

Table 3 – Comparison of Year-over-Year Growth in Tax Revenues

	2018	2019	2020
Income			
Withholding	6.37%	3.24%	4.26%
Cap gains	41.44%	-3.74%	-31.49%
Other non-withholding	18.50%	9.03%	9.15%
Sales	3.95%	3.95%	3.97%
Corporate	11.10%	2.30%	1.82%
Other	4.77%	6.86%	-1.94%
Total	**8.46%**	**3.57%**	**2.36%**

FY 2019

While FY2019 is off to a strong start, several factors caution against revising projections upward at this time. Those same volatile sources responsible for driving above-average revenue growth in FY2018 have propelled revenue growth in FY 2019 of 8.5 percent through the first four months. This includes $174 million more in non-withholding income tax, $123 million more in corporate taxes, and $177 million more in all other taxes than originally estimated. Approximately $250 million in corporate and other taxes are believed to be one-time revenues coming from large estate tax settlements and corporate deemed repatriation from federal tax changes.

The Foundation expects revenue growth to slow over the remainder of FY 2019, running at benchmark for the remainder of the fiscal year. The result will be a more modest 3.6 percent annualized growth in tax revenues over FY 2018, although this rate is still higher than the original consensus growth figure. An existing structural deficit and some underfunded accounts may consume this extra revenue. It is also possible that some of the current gains in non-withholding revenues are lost before the end of the fiscal year due to timing issues.

Finally, while capital gains tax revenues are projected to run $400 million above the 2019 threshold, $350 million of these revenues would be transferred to the state's Stabilization Fund per statute, and therefore unavailable for 2019 budgetary spending.

FY 2020

Capital gains tax revenue growth will continue to taper off in FY2020 with an expected decline of nearly $400 million (Table 1). While withholding income tax and sales tax revenues continue to grow modestly at approximately 4 percent, overall revenue growth slows to 2.4 percent as a result of the decline in capital gains.

More ominously, economic activity continues to slow amid mounting fears of a recession.

Employment growth in Massachusetts stalls from the aforementioned 1.7 percent annual average over the past eight years to just 0.4 percent due to a slowing economy and demographic challenges.

Demographic headwinds, previously analyzed in several MTF reports[3], continue to pose obstacles to economic expansion. Business must contend with an aging and declining workforce due to the state having one of the lowest birth rates in the country, an increasing percentage of the population age 65 or older, a decline in the number of work aged people (ages 16 to 64), large domestic out-migration, and the negative impacts of the opioid epidemic on the size and productivity of the state's workforce. All of these issues make it increasingly difficult for businesses to find qualified workers.

But of far greater concern to the state are the number of pre-recession warning signs. Labor markets, home sales, autos, business investments, and oil prices – all are showing signs that the second longest US economic expansion on record may be coming to an end:

- **Labor markets**. Initial signs of strain surface as jobless claims climb to six month highs and job openings decline amid continued sluggish worker productivity growth
- **Home sales.** Pending home sales in the U.S. dropped to their lowest level in four years and fell for the 10th consecutive month compared to the previous year
- **Autos.** A slowing economy in China, increased costs from tariffs on imported steel and aluminum, higher interest rates, transitions in auto technology, and sagging interest in cars versus trucks and SUVs is disrupting the auto sector leading to scaled back car production, layoffs, and plant closings
- **Business investment.** The $1.2 trillion tax cut on capital spending from federal tax changes has resulted in the biggest year of stock buybacks ever and could reach $1 trillion limiting new capital investments that would stimulate economic expansion
- **Oil prices.** Fears of oversupply and slowing demand have driven oil prices down since October highs with November price declines the worst since 2008. West Texas Intermediate (WTI) fell from $75 a barrel in early October to $50 at the end of November

On top of these warning signs, there are the ongoing global risks of potential hot wars,

[3] See, for example: MTF December 2016 Tax Revenue Forecast and The Massachusetts Opioid Epidemic – An Issue of Substance.

cold wars and trade wars – all of which could severely disrupt the global economy.

Geopolitical tensions are rising in Russia/Ukraine, the South China Sea, and the Middle East. The U.S. and China appear to have reached a temporary truce over trade protections, but concerns with investments, intellectual property protection, and China's growing global influence remain.

The EU must navigate the implementation of Brexit and the growing populist sentiment among many EU countries, contracting economies in Germany and Italy, and the diminishing power of Germany's Prime Minister Merkel as a centrist leader. All of this is occurring against the backdrop of d US threats to increase tariffs on European auto exports and OECD's deteriorating outlook for emerging market economies.

Looking Ahead

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 preparing for the next recession is the only prudent policy. This entails limiting spending growth and increasing the Stabilization Fund balance.

While Massachusetts has made progress – the Stabilization Fund balance has recently reached $2 billion – it is important to remember that this figure represents approximately 4.4 percent of state spending, far less than the balances preceding the 2002 and 2009 recessions or what credit rating agencies would recommend.

These concerns are amplified by Moody's Analytics latest report on state finances. Entitled "*Stress Testing States 2018,*" this report, analyzes the 50 states' ability to withstand a 'moderate' and a 'severe' recession.

In the moderate recession scenario, a decline in tax revenues of 5.7 percent is assumed, which equates to the state losing $2.4 billion. In the severe recession case, tax revenues would fall by $4.6 billion, or 10.7 percent. These assumptions are consistent, albeit perhaps conservative, when compared to Massachusetts' actual experience in previous recessions. In 2002, Massachusetts saw a decline of 14.5 percent, and in the Great Recession of 2009, the state's revenues plummeted by 12.5 percent.

What is also clear from the Moody's Analytics report is that the state's rainy day fund balance is inadequate to manage the budgetary impacts from a moderate recession while a severe recession would be near catastrophic to most programs and services supported by the state.