Massachusetts Taxpayers Foundation

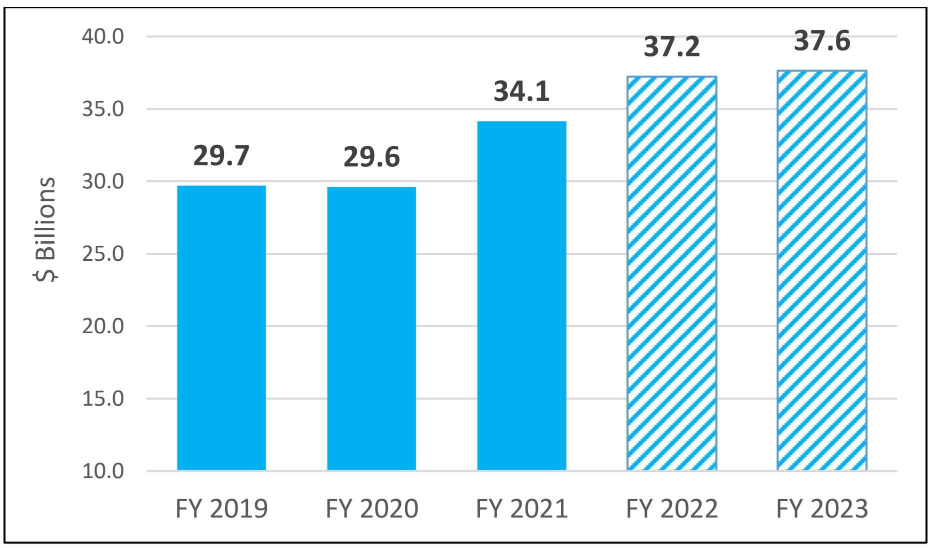
333 Washington Street | Suite 853 | Boston, MA 02108 | 617.720.1000
www.masstaxpayers.com

Tax Revenue Growth Slows in FY 2023 Following Two Extraordinary Years

Massachusetts experienced a startling $4.5 billion surge in tax revenues in FY 2021 representing 15 percent growth in the midst of the pandemic. MTF projects that FY 2022 revenue growth will remain strong, reaching $37.2 billion or $2.9 billion above the current benchmark. What makes this even more noteworthy is the fact that the FY 2022 revenue benchmark was raised to $34.35 billion from $30.12 billion last fall, as lawmakers gained confidence in the upsurge in revenues in FY 2021. MTF was supportive of this revision.

We project revenue growth will moderate in FY 2023, with tax revenues increasing to $37.6 billion (Figure 1).

Figure 1 - State Tax Revenues, FY 2019 - FY 2023



FY 2023 Tax Revenue Growth Comes Back to Earth

MTF projects tax revenue gains to slow to $411 million above FY 2022, or 1.1 percent growth.[1]

MTF estimates that job gains will jump by approximately 70,000, bringing the number of employed back to pre-pandemic levels of 3.7 million. More workers, combined with higher wages as employers navigate an increasingly competitive labor market, will drive withholding income tax revenues up by nearly $600 million in FY 2023 (Table 1).

[1] MTF's FY 2023 revenue estimate includes the loss of $64 million from the reinstatement of the charitable deduction beginning January 1, 2023.

Table 1 – MA Tax Revenues, FY 2023 vs. FY 2022

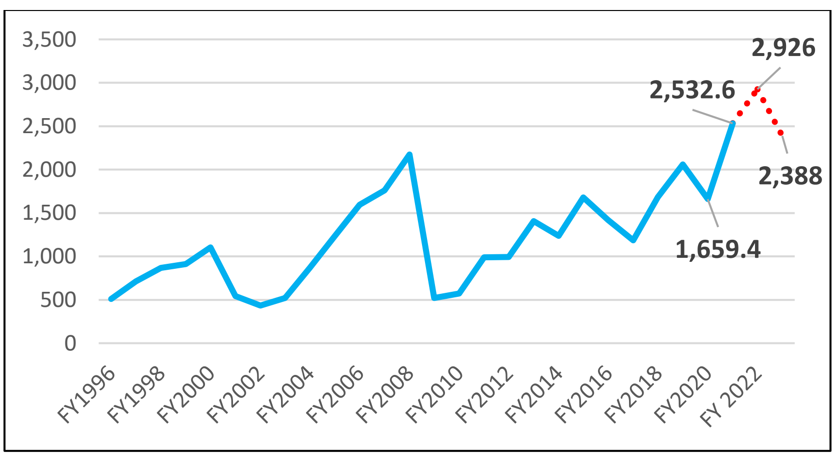
($ Millions)

	FY 2023	FY 2022	$	%
Income	***21,038***	***21,139***		
Withholding	16,311	15,723	588	3.7%
Cap Gains	2,388	2,926	-538	-18.4%
Other Non-with	2,339	2,490	-151	-6.1%
Sales	***8,903***	***8,815***	***88***	***1.0%***
Corporate	***4,988***	***4,623***	***365***	***7.9%***
Other	***2,704***	***2,646***	***58***	***2.2%***
Total	**37,633**	**37,223**	**411**	**1.1%**

Unfortunately, these gains in withholding taxes are offset by steep decline in capital gains and other non-withholding income taxes that together totaled $5.4 billion in FY 2022. Market indexes have risen dramatically from their March 2020 lows. Since then, the S&P 500 (Appendix A) and the Nasdaq have doubled in value as of their closes on December 14, 2021. This in turn has helped fuel the surge in capital gains in FY 2021 and MTF's forecasted surge in FY 2022. Moody's Analytics projects these indexes will either stabilize or decline through 2023, causing capital gains tax revenues to be reduced by over $500 million from the estimated $2.9 billion in FY 2022 to $2.4 billion. Even with this reduction, it would still be the third highest amount ever collected.

Capital gains tax revenues are notoriously volatile, as shown in Figure 2. This volatility creates budget challenges when there is a precipitous drop as has happened several times in the past.

Figure 2 – MA Capital Gains Tax Revenues, FY 1996 – FY 2023

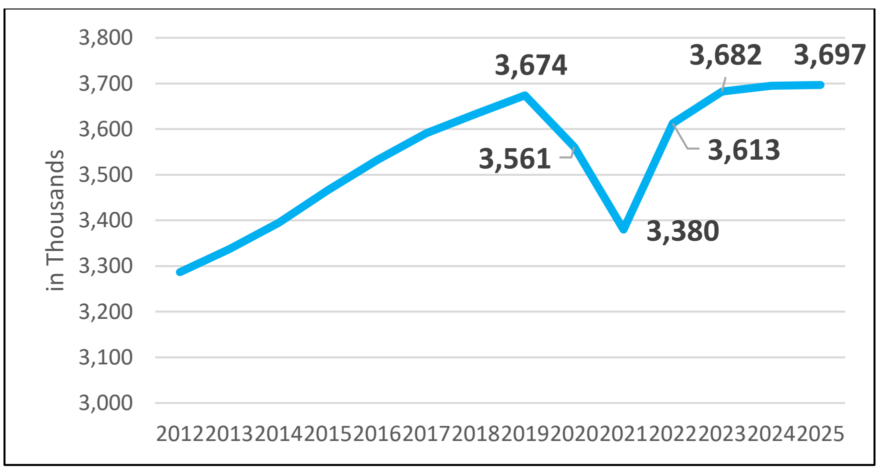


Sales tax revenue growth will moderate in FY 2023 to 1.0 percent for two reasons. After an uptick in spending on durable goods over the past 24 months, consumption will shift from durable goods back to services. MTF also expects inflation rates to slowly decline over the next 18 months from current levels, particularly for some big ticket items such as motor vehicles. This will suppress sales tax revenue growth resulting from higher prices.

Corporate profits and taxes are projected to remain strong. For many companies, robust consumer demand and lower business costs from reduced travel and real estate holdings will counterbalance higher wage costs, supply chain challenges, and general inflationary pressures.   The one caveat to this positive outlook for companies is the difficulty they may have in filling open jobs that could limit productivity increases, thereby constraining growth.

This may pose a particular challenge for Massachusetts businesses. Long-term demographic challenges that have been exacerbated by the pandemic will make current workforce shortages more pronounced over the next several years. As a result Massachusetts may have to rely on increased productivity per worker to support its economic growth. As shown in Figure 3, steep employment gains in FY 2022 of 233,000 (as measured by the average number of newly employed over the fiscal year) will begin to taper off in FY 2023 (+ 69,000) and then flatten for the foreseeable future. In other words, employment growth recovers to pre-pandemic levels and then stalls.

Figure 3 - Average Employment by Fiscal Year[2]



Workforce Challenges

The limitation is not the result of a slow economy, but rather a diminished and aging workforce – something to which MTF has called attention for the past several years.

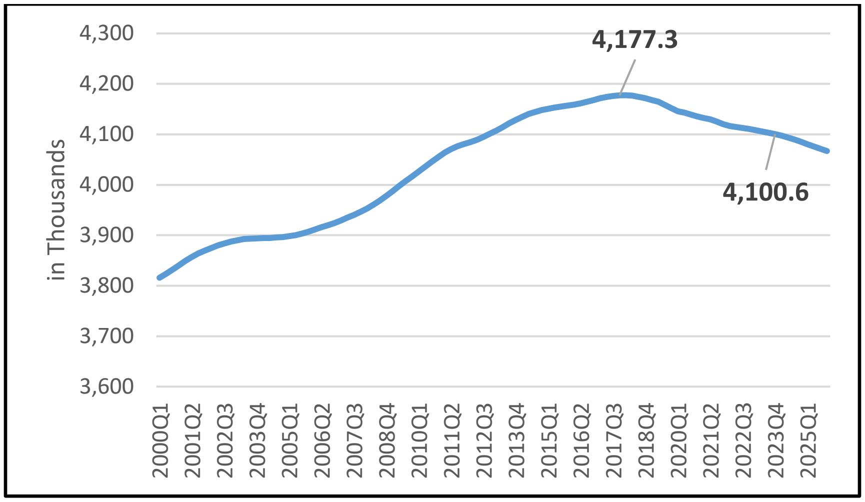
According to Moody's Analytics,[3] the Massachusetts workforce population (aged 20 – 64) peeked in Q4 2018 at 4.18 million and has declined since (Figure 4). By December 2022, that

[2] Source: U.S. Bureau of Labor Statistics and Moody's Analytics.

[3] A caveat: updated data sets from the 2020 U.S. Census results do not appear to be incorporated into Moody's Analytics latest population forecast.

age group is projected to fall to 4.1 million. This loss of approximately 75,000 people over four years is a primary contributor to the constriction of the state's labor supply and an impediment to future economic growth.

Figure 4 – MA Population Aged 20 - 64



Retirements. The pandemic has only accelerated the trend of people at or near retirement age leaving the workforce. Looking at the 12 month moving average of people who are no longer in the labor force, the number of retired increased by 55,000 between September 2019 and 2020 and then jumped another 78,000 to over 1 million in September 2021 (Table 2, highlighted).[4]

Table 2- 12 Month Moving Average of MA Residents Not in the Labor Force

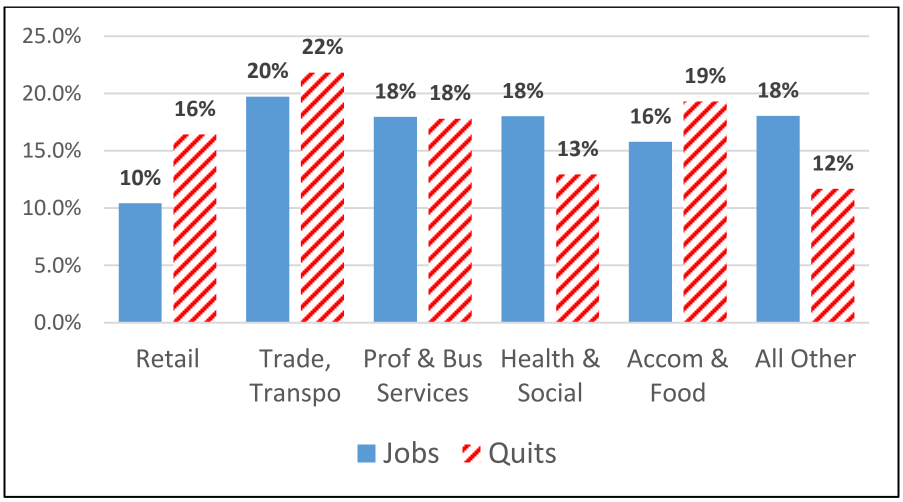
Categories	*19-Sep*	*20-Sep*	*21-Sep*
Total, Not in the Labor Force	**1,828,886**	**1,944,045**	**1,992,570**
Disabled	310,005	285,332	295,672
Ill	12,209	12,535	10,638
In School	355,315	371,881	332,999
Taking Care Of House Or Family	205,619	214,660	249,756
In Retirement	872,933	927,832	1,005,836
Something Else/Other	63,665	117,877	84,115
Not in Universe	9,139	13,929	13,555
Total, Not in the Labor Force	**100.00%**	**100.00%**	**100.00%**
Disabled	17.00%	14.70%	14.80%
Ill	0.70%	0.60%	0.50%
In School	19.40%	19.10%	16.70%
Taking Care Of House Or Family	11.20%	11.00%	12.50%
In Retirement	47.70%	47.70%	50.50%
Something Else/Other	3.50%	6.10%	4.20%
Not in Universe	0.50%	0.70%	0.70%

[4] U.S. Census Bureau, Labor Force-employment status (PEMLR): Retired-Not in Labor Force, Massachusetts, November 16, 2021.

Voluntary Quits. Adding to these woes, the pandemic inspired many people to rethink their participation in the labor force. The 'Great Resignation', as the phenomenon has been called,[5] has resulted in a surge of employees voluntarily leaving their jobs due to several COVID related reasons, such as burnout, access to child care, changes in career paths, aversion to returning to the office and reevaluation of personal priorities.

Key Sectors Affected. This trend is particularly acute in several key sectors that are essential to the Massachusetts economy. As displayed in Figure 5, five sectors – retail, trade and transport, professional business services, health care and social assistance, and accommodations and food services – account for over 80 percent of the 11 million U.S. job openings in October 2021 and nearly 90 percent of the 4.2 million people who quit their jobs. These five sectors employ 2.4 million people in Massachusetts, or two-thirds of all employees.

Figure 5 – U.S. Jobs Available & Quits: Percent of Total by Sector[6]



Mobility. These workforce challenges are amplified by fundamental changes to the way we work and live which makes Massachusetts more vulnerable than many other states.

The growth in remote work and a corresponding increase in mobility poses an additional challenge to Massachusetts, as the state's economic strength comes from our skilled workforce and concentration of talent. Many workers now have greater flexibility in where they live and may opt to reside elsewhere due to Massachusetts high costs of living. This could cause the state to suffer further workforce losses from increased domestic outmigration. Outmigration has been occurring for decades, but until recently, Massachusetts made up for these loses with international immigration. Medical and political curbs on visas and travel has greatly reduced the number of immigrants in recent years.

[5] This phrase has been first attributed to Professor Anthony Klotz of Texas A&M

[6] U.S. Bureau of Labor Statistics, Job Openings and Labor Turnover Survey (JOLTS), December 8, 2021.

In summary, the greatest impediment to future economic growth in Massachusetts is its shrinking workforce and access to talent. Just as the causes of this contraction are numerous, so too are the policies for addressing it. Fortunately, lawmakers have resources at their disposal to attract, retain, and develop our workforce and efforts to do so should be bolstered immediately.

FY 2022 – Déjà vu: Robust Tax Revenue Growth

FY 2022 tax revenues are projected to increase by 9.0 percent to $37.2 billion (Table 3). Income and sales taxes account for over 80 percent of the gains.

State coffers are full, flooded with federal relief funds and tax revenues that widely exceeded projections. This phenomenon began in FY 2021 and continues into FY 2022, driven by an unprecedented amount of financial aid from Washington.

Table 3 – State Tax Revenues by Category, FY 2022 – FY 2021

($ Millions)

	FY 2022	FY 2021	$	%
Income	***21,139***	***19,593***	***1,546***	***7.9%***
Withholding	15,723	14,719	1,004	6.8%
Cap Gains	2,926	2,533	393	15.5%
Other Non-with	2,490	2,341	149	6.4%
Sales	***8,815***	***7,834***	***981***	***12.5%***
Corporate	***4,623***	***4,116***	***506***	***12.3%***
Other	***2,646***	***2,594***	***52***	***2.0%***
Total	**37,223**	**34,137**	**3,086**	**9.0%**

Over the course of one twelve month period (March 2020 – March 2021), the federal government approved three major relief packages - the CARES Act, the Coronavirus Response and Relief Supplemental Appropriations Act (CRRSA Act), and the American Rescue Plan Act (ARPA), which in total provided $5.2 trillion in relief funds. These fund were widely distributed to households, businesses, and states and local governments and represent more than 20 percent of the country's gross domestic product.

ANF estimates the total amount of federal funds flowing into Massachusetts to be $113 billion of which $64 billion was distributed as direct payments and loans to people and employers through Supplemental UI payments and the Payment Protection Program. This infusion of money inflated incomes, savings, consumption, and corporate profits – and boosted state tax revenue growth in FY 2021 and FY 2022.

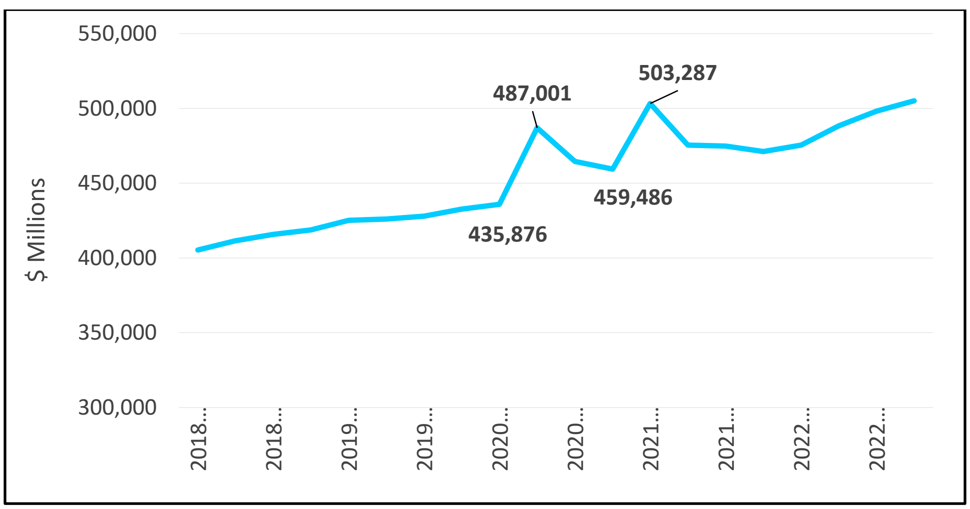
To wit, through the first five months of FY 2022, tax revenues are running $2.15 billion ahead of FY 2021. All three major tax categories - income taxes ($878 million), sales taxes ($577 million), and corporate taxes ($386 million) – are all well above last year's figures to this point.

MTF projects that FY 2022 tax revenues will outpace FY 2021 by another $900 million during the remaining months of this fiscal year, bringing total revenues to $37.3 billion. This is $3.1 billion, or 9.0 percent, more than tax revenues collected last year (Table 3).

The reasons for the high growth are evident:

- Income taxes – strong gains in employment, hourly earnings (Appendix B), bonuses, housing prices, increased day trading[7], and robust stock portfolios.
- Sales taxes – increased demand for durable goods, take-out and in-restaurants meals, and motor vehicles. (Appendix C), all boosted by the fastest inflation jump in 30 years and sizable increases in disposable personal income (Figure 7).
- Corporate taxes – booming corporate profits that increased by over 20 percent in Q3 2021 from a year earlier.[8]
- Other taxes including estate taxes (+ $140 million), room occupancy taxes (+ $66 million), motor fuels (+ $28 million) and deeds (+ $28 million are running $300 million or 30 percent ahead of FY 2021 through November.

Figure 7 – Massachusetts Disposable Personal Income, 2018 - 2022[9]



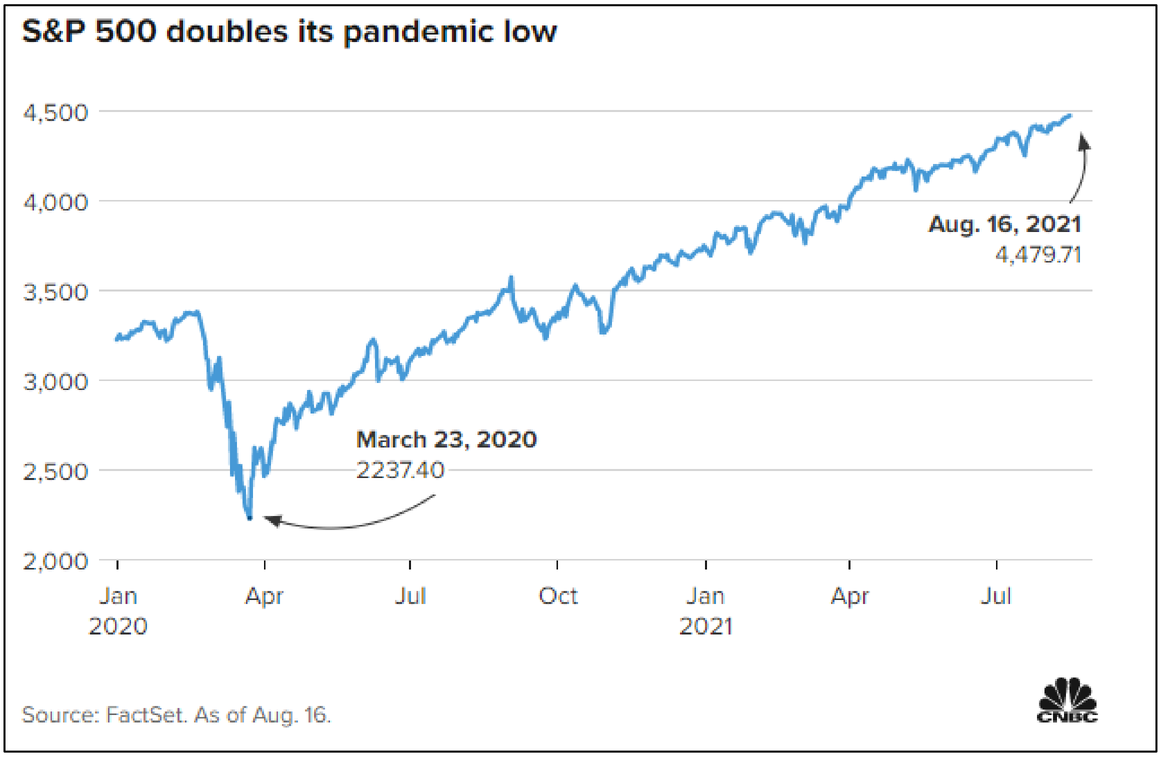
[7] Short-term capital gains reached $494 million in FY 2021 which had not exceeded $200 million previously.

[8] *Gross Domestic Product (Second Estimate) Corporate Profits (Preliminary Estimate) Third Quarter 2021*, Bureau of Economic Analysis, November 24, 2021.

[9] Moody's Analytics, November 15, 2021.

To sum up, the Commonwealth will enjoy robust tax revenue growth through the end of FY 2022, but revenue growth will slacken in FY 2023. This is due to labor shortages that offset inflationary wage growth, less capital gain revenues, and only modest growth in sales tax revenue. While MTF did not enumerate external threats, it is worth noting that all of this takes place against a backdrop of inflation uncertainty, a persistent pandemic, and rising global geopolitical risk, any one of which could materially impact our forecast.

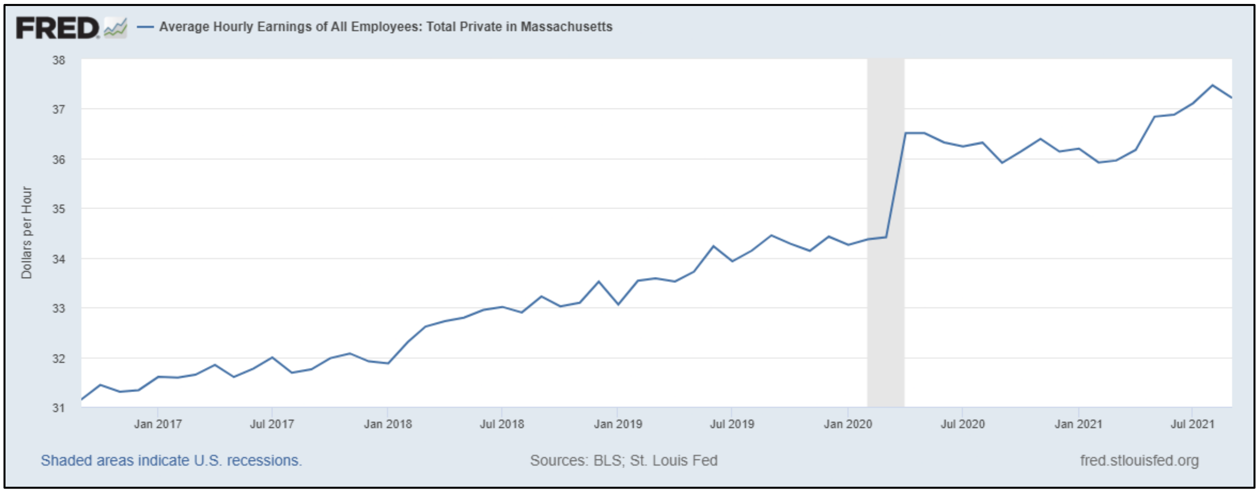
Appendix A – S&P 500 Index, January 2020 – August 2021[10]



[10] S&P 500 doubles from its pandemic bottom, marking the fastest bull market rally since WWII, Yuni Li and Nate Rattner, CNBC, August 26, 2001.

Appendix B – Massachusetts Average Hourly Earnings of All Employees – Private

Dollars per hour: Economic Research from the Federal Reserve Bank of St. Louis (FRED)



Appendix C – Massachusetts Monthly Retail Sales of Motor Vehicle and Parts Dealers

Percent change from 12 months ago: FRED)