TESTIMONY

December 2021

cSPA Testimony, FY 2023 Consensus Revenue Hearing

I want to thank you for inviting me to testify today. It's a privilege to be able to help the Commonwealth prepare for the future.

My name is Evan Horowitz and I'm the Executive Director of the Center for State Policy Analysis at Tufts University, abbreviated as c-S-P-A and pronounced “sea spa.”

cSPA provides timely, relevant research on live policy issues — in a strictly non-partisan way. We have done work on fiscal and economic policy, assessed the impact of ballot questions, and provided consulting services and technical support to state legislative committees.

Today, I want to talk about three things. First, I'll summarize our tax revenue projections for FY 2023. Second, I'll share some thoughts on how the state's fiscal situation — while relatively healthy — is not quite as secure as it might seem. Finally, I'll say a few words about the role of inflation.

For FY 2023, we estimate that state tax revenues will amount to roughly $36.5b, about 6 percent above the current FY 2022 benchmark.

Our estimate is based on a predictive model that uses US GDP to gauge likely state taxes. Historically, there's been a nearly 1:1 correlation between national GDP and Massachusetts tax revenues — because GDP reflects exactly the kinds of things that the state tends to tax, namely income and spending.

Building off this relationship, we can project state tax revenues using existing estimates of US GDP, which are produced by a range of reputable private and public organizations, including the Conference Board and the Wall Street Journal Economic Forecasting Survey.

Gathering these together, we find a general consensus that real GDP will grow just over 3 percent in FY 23, which would translate into state tax revenues of $36.5 billion, our central estimate.

That's the first main point I want to make. The second is about the unappreciated risks and weaknesses in our current fiscal situation.

Over the past few years, pandemic uncertainty has created a mix of downside economic risks and hopeful possibilities. When we met last year, we talked about the dire prospect of new strains but also the odds that faster-than-expected vaccine production could push revenues higher than anticipated.

At this point, however — with consumer spending above its long-term trend, the job market approaching pre-pandemic highs, asset prices at extremely high valuations, and the federal reserve planning to raise rates — there are many more downside risks than upside possibilities. Put differently, there are a lot more ways for our economy to stumble and a lot fewer chances to accelerate.

In terms of state tax revenue, Massachusetts may already be overdue for a correction, with the volatile parts of our tax system, like capital gains and estimated taxes, having outrun the more stable parts, like income withholding and the sales tax.

Focusing on these more stable pieces — especially income tax withholding — was key to understanding the surprising strength of revenues in FY21; steady gains in those areas proved that the forces driving revenue growth last year were deep-seated, not incidental.

The same logic applies now, only in the opposite direction. Thus far in FY22, the more stable revenue streams are only slightly above the state benchmark. Meanwhile, estimated income payments (including from pass-through businesses) are 16 percent above benchmark and corporate taxes are 25 percent above.

Such high corporate tax collections and estimated income payments are unlikely to be sustainable or reflect some "new normal" for the state. More probably, they reflect a one-time, pandemic-era jump in profits and asset prices, which will either fade out or get clawed back.

Exactly when the overheated parts of our tax system will revert to trend — or fall below — is hard to say. But the risk that today's high collections will be matched by tomorrow's disappointing ones is a reason to maintain a healthy balance in the stabilization fund.

For FY22, enough revenue has been banked that we think it makes sense to raise the benchmark for the year by $1 billion, from $34.4b to $35.4b. That adjustment still allows for the possibility that collections could slow in the second half of the year, but also enables targeted spending increases to areas that are struggling with hiring and other pandemic challenges.

In FY23, however, we are much more likely to see a reversion in estimated payments and corporate taxes, which is the big reason our central estimate envisions a relatively meager increase in total tax revenue between FY22 and FY23.

The last point I want to make is about inflation, which adds another dark cloud to the state's revenue situation.

I want to clarify, from the outset, that I'm not particularly concerned about runaway inflation or stagflation or any of the more dire economic scenarios. Our read of the latest data is that inflation is likely to slow in the coming year, particularly with the more hawkish stance of the federal reserve.

But it's still the case that inflation is much higher than anticipated, which means that while the state may be collecting many more dollars than expected, each of those dollars is also less valuable than expected.

Another way to phrase it is that the cost of running state government has risen more rapidly than we've seen in a generation. Even a maintenance budget for FY23 — designed simply to maintain current government programs — will have to reckon with the fast-growing cost of hiring people, procuring materials, providing housing support, and a great deal besides.

All this makes the current revenue collection numbers less cheering than they might otherwise be.

To add some concreteness, I noted earlier that our estimate of $36.5b in FY23 revenue is about $1 billion more than we think the state can count on for FY22. But once you account for inflation, that's actually a slight decline in revenue, meaning the state could have fewer real dollars to work with for FY23.

I'd like to thank you for your time. I'm happy to answer any questions you may have. And more generally I'd like to say that cSPA is ready to provide additional research on any topic or issue that you think useful.