Massachusetts Taxpayers Foundation

News Release

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Massachusetts Fiscal Challenges Could Last Years

Policy Makers Face Tough Choices in New Reality

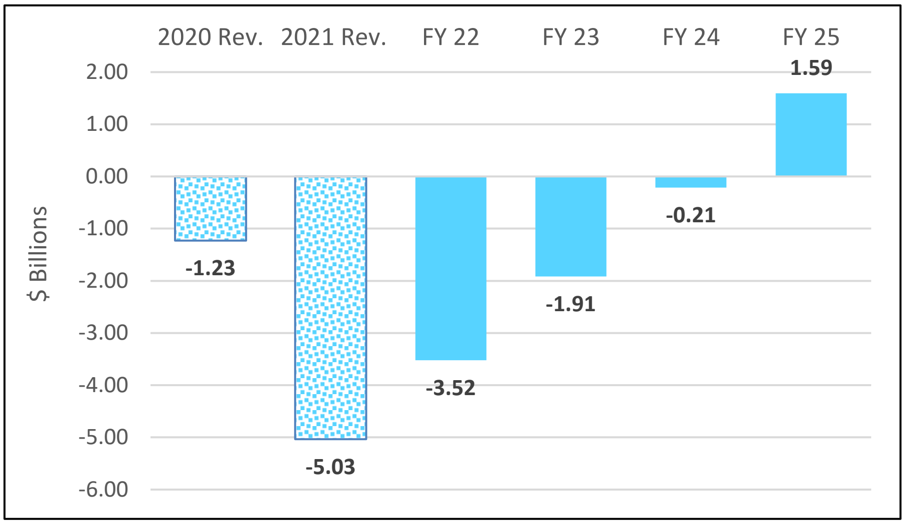
MTF recently downgraded its FY 2021 tax revenue forecast to a loss of $6 billion, representing a nearly 20 percent decline from the $31.15 billion consensus benchmark. At 20 percent, the revised forecast places Massachusetts towards the higher end of preliminary estimates of revenue losses among the states for FY 2021, although many of those state projections are several weeks old.[1]

As a guide for determining how long before Massachusetts tax revenues are restored to pre-pandemic levels, we examined past recessions. Following the recessions of 2002 and 2009, it took three years for state tax revenues to recover to pre-recession levels, putting enormous strains on the Commonwealth's operating budgets during that period. Given the steep and widespread decline in FY 2021 tax revenues, it is reasonable to assume that it will take at least as long to recover as the two previous recessions. When the potential structural changes to key pillars of the economy are considered, it could take considerably longer for the state to recoup tax revenues lost from this pandemic.

[1] *States Grappling with Hit to Collections*, Center on Budget and Policy Priorities, Table 2.

Figure 1 – Tax Revenue Shortfalls from FY 2020 Consensus of $30.29 Billion

Assumes 6% Annual Rate of Growth for FY 22 – FY 25 (Table 1)



As depicted in Figure 1, even if state tax revenues increased 6 percent annually (1 point higher than the average rate of growth over the past decade – 2010-2019) starting in FY 2022, it would take until FY 2025 for the state to surpass the FY 2020 benchmark of $30.289 billion (see Appendix A for a scenario analysis at different growth rates).

To state the implications straightforwardly: the Commonwealth will have limited budgetary flexibility for the next several years as tax revenues slowly rebound, particularly if the demand for safety net services resulting from an ailing economy and an aging population drive up expenditures. Despite the initial hopeful claims of MTF and others that both the economy and everyday life will recover on a faster track, current data, as well as recent history, suggest otherwise.

Lessons from the Past Two Recessions

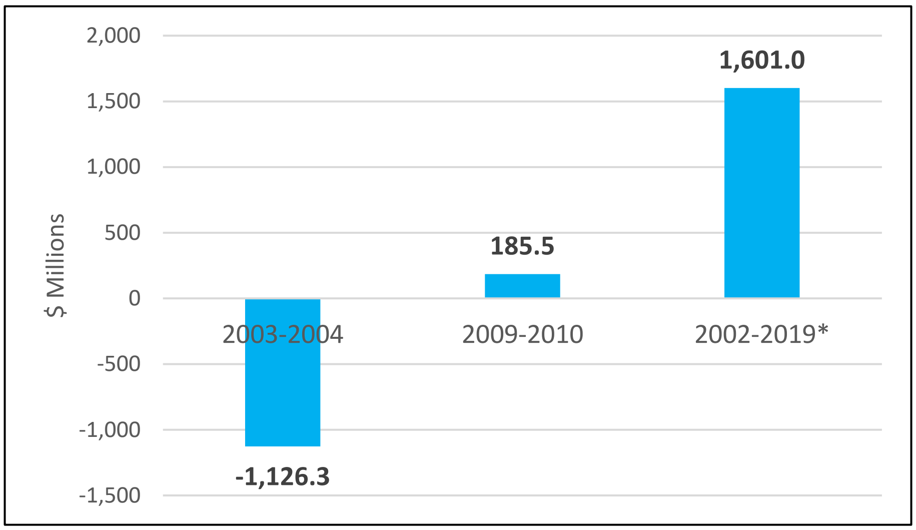
During the recession of the early 2000s, state tax revenues fell from $16.73 to $14.29 billion between FY 2001 and FY 2002, a drop of 14.6 percent. It took three years – until FY 2005 – for tax revenue collections of $17.09 billion to exceed the pre-recession peak of $16.73 billion (Appendix B).

Similarly, during the more recent recession caused by the financial crisis, tax revenues peaked at $20.89 billion in FY 2008 before falling 12.5 percent to $18.27 billion in FY 2009. Even with a 25 percent hike in the sales tax rate from 5.0 percent to 6.25 percent in 2009 that added approximately $1 billion in annual sales tax revenues, it took three years before FY 2012 tax collections surpassed FY 2008.

Despite infusions of one-time revenues from trust fund sweeps, Stabilization Fund withdrawals, and federal assistance, that represented about $2 billion during the 2002 recession and $6 billion during the 2009 recession, other measures were necessary to balance the budgets. In 2002 and 2009, tax and fee increases provided an additional $1 billion or more in annual revenues, but spending cuts were still necessary to balance the budgets.

Notwithstanding these measures, spending in FY 2004 was 5 percent, or about $1.1 billion, below what it was in FY 2002. While less severe, the 2010 budget depicts a similar story. It was only $185 million higher than that of FY 2008, representing an increase of less than 1 percent. In contrast, expenditures grew by an average of $1.6 billion, or 5.4 percent, every year for all other budgets from 2001 through 2019 (Figure 2).

Figure 2 – Change in Operating Expenses Past Two Recessions



The past two recessions make it clear that austere budgets will be virtually impossible to avoid for FY 2021 and FY 2022, and maybe longer. Ultimately, the duration of the current recession will be directly correlated to the pace of the recovery.

Changing Views on the Shape and Length of the Recovery

As economists began analyzing the impacts of the pandemic on the nation's economy in early March, there was a confident consensus of a 'V' shaped rebound – a quick bounce back to pre-pandemic engagement. This consensus stemmed from the notion that since there was nothing wrong with the economic fundamentals, economic activity would spring back to previous levels once pandemic restrictions were lifted and the economy was re-opened.

That analysis has evolved. Medical and economic experts alike agree that a full recovery will not occur until there is an effective and widely disseminated vaccine. Despite recent hopeful headlines, it could take 12 to 18 months or more to develop and distribute one. Others are concerned that a recovery could lag for years due to structural changes to many economic bedrocks, including higher education, retail establishments, and hospitality and entertainment venues.

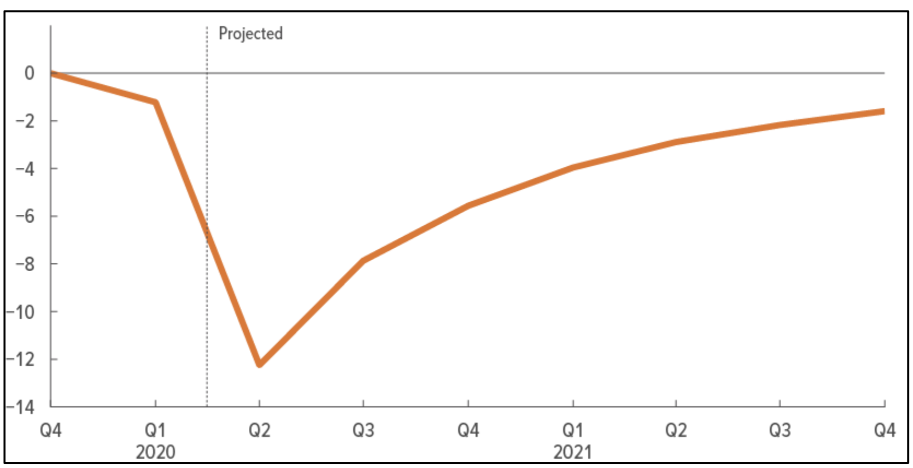
For many reasons, the letter "V" no longer represents the shape of the recovery. The letter "U" that signals a longer period of economic stagnation before a recovery begins; the letter "L" that suggests a more ominous prolonged recession, and the letter "W" that incorporates the likelihood of a second pandemic wave requiring future lockdowns as the economy and virus return, are now being used to describe what shape the recovery could resemble.

The reasons for this prolonged recovery are best summarized in the Congressional Budget Office's (CBO) most recent economic update. The report highlights a number of impacts from the pandemic and assesses the path of several economic indicators that include labor markets, labor force participation rates, unemployment, interest rates, economic output, and GDP. The CBO's projection of real output (the quantity of goods and services produced, adjusted for inflation) states:

> "The coronavirus pandemic and the social distancing measures implemented to contain it have adversely affected both the overall demand and overall supply of goods and services in the economy, causing output to plunge. Although economic conditions improve markedly by the fourth quarter of 2021 in CBO's projections, inflation-adjusted output remains 1.6 percent lower than it was in the fourth quarter of 2019." [2]

The CBO findings introduce an entirely new metaphor for the recovery, the Nike "swoosh." As Figure 3 depicts, following the steep plunge we are in the midst of, we could see a long-tailed slow recovery resembling Nike's iconic symbol.

Figure 3 – Real Output Measured as the Difference from the Fourth Quarter 2019 (percent)



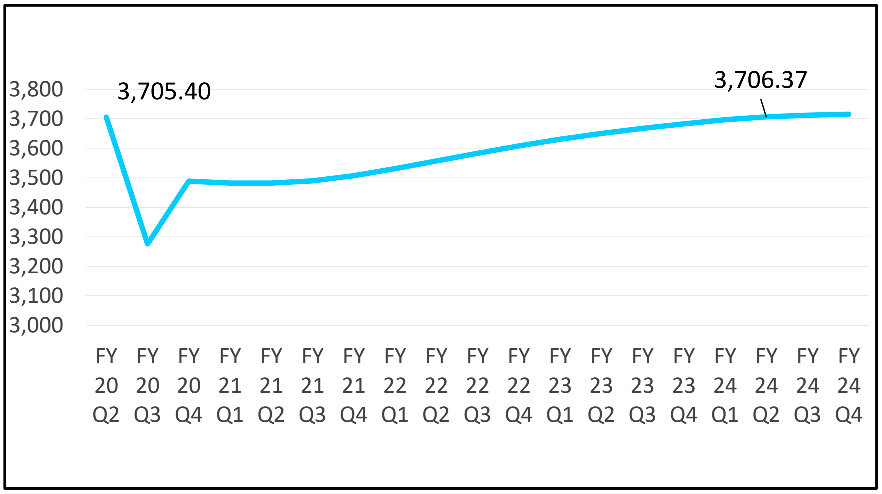
Like the CBO's output projection, the most recent Massachusetts employment forecast from Moody's Analytics also resembles the Nike swoosh. It shows a stark decline in FY 2020 Q3 followed by a quick uptick in FY 2020 Q4. While its timeframe may be more abbreviated than

[2] *Interim Economic Projections for 2020 and 2021*, Congressional Budget Office, May 2020.

the CBO, Moody's sees a long, slow recovery tail, that requires four years for employment to return to 3.7 million (Figure 4).

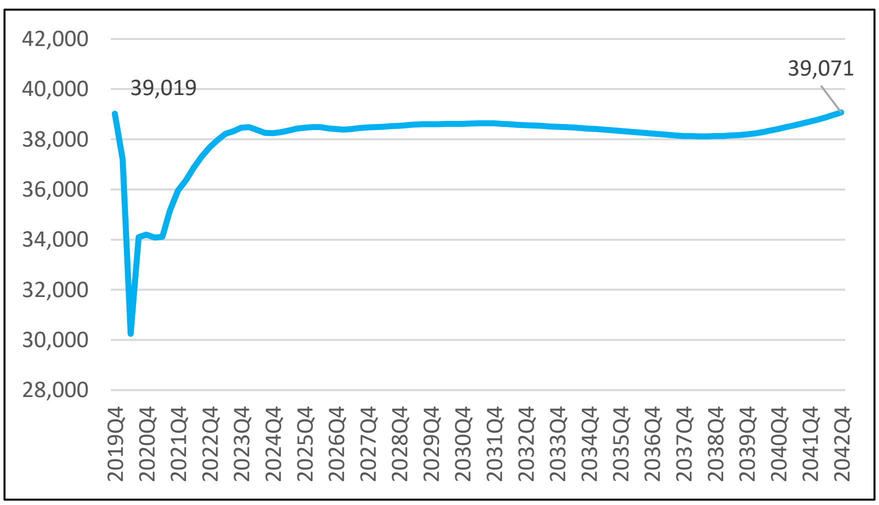
Figure 4 – Massachusetts Employment Forecast

(Source: Moody's Analytics, May 15, 2020)



The forecast for Massachusetts personal consumption expenditures (PCE) of durable goods, a gauge of future sales tax revenues, appears quite similar to the employment projection above, with one significant exception – the amount of durable goods purchased (measured in $ millions) does not recover to pre-recession levels until **2042**. This suggests a momentous structural change in consumption from the pandemic or changing demographics, or both (Figure 5).

Figure 5 – Massachusetts PCE of Durable Goods[3]



[3] Source: Moody's Analytics, Massachusetts - Baseline Scenario (May 2020): Personal consumption expenditure - Durable goods, May 15, 2020.

Conclusion – Lawmakers Face a Litany of Unanswered Questions and Tough Decisions

A common thread among all the various projected shapes of the recovery, is that it will take some time, indicating that the state faces stark fiscal and economic challenges over the next two to three years. Key sectors of the Massachusetts economy, including health care, higher education, tourism, and commercial real estate, will likely emerge from the pandemic fundamentally altered and those changes could further prolong the time it takes for the economy to bounce back.

A complete and accurate picture of the state's budgetary challenges may elude us for some time. Ongoing adjustments will be necessary as we follow the trajectory of the virus, the timing of a vaccine, the ability of the economy to regain traction and consumers to regain confidence through inevitable fits and starts The willingness of Congress and the administration to keep state and local governments functioning will also be critical.

One of the few certainties ahead is uncertainty. We do not yet know the full scope of the pandemic's fiscal and economic impacts, but they will be acute, impeding the state's ability to fund all programs and services at current levels. If past is prologue, tools deployed in past recessions – use of some portion of the $3.4 billion in the Stabilization Fund, reversions, sweeps of trust funds and an infusion of federal assistance, will still leave the state with immense revenue gaps.

We all hope that the people and businesses of the Commonwealth will prove as resilient now as they have in the past, and that this collective resiliency accelerates restoration of the Massachusetts economy to the vibrant health enjoyed just months ago. But just as families and businesses across the state have had to adapt to a very different normal, so too must public sector leaders prepare to respond to the harsh realities of the state's increasingly precarious fiscal situation.

Appendix A

Tax Revenue Losses from FY 2019 $30.29 Billion Benchmark
At annual growth rates of 3.0, 4.0, 5.0, 6.0, and 7.0 percent

	3.0%	4.0%	5.0%	6.0%	7.0%
2020 Rev.	-1.23	-1.23	-1.23	-1.23	-1.23
2021 Rev.	-5.03	-5.03	-5.03	-5.03	-5.03
FY 22	-4.28	-4.02	-3.77	-3.52	-3.27
FY 23	-3.50	-2.97	-2.45	-1.91	-1.38
FY 24	-2.69	-1.88	-1.05	-0.21	0.65
FY 25	-1.87	-0.75	0.41	1.59	2.81
Cumulative Loss	**-16.73**	**-15.14**	**-13.54**	**-11.91**	**-10.26**

Appendix B

State Tax Revenue Recovery Following Two Recessions