Massachusetts
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MTF Session Preview: Tax Policy

Tax policy will be a major topic of conversation and action at the start of the coming session. The combination of a multi-year surge in tax collections, Governor Healey's commitment to tax relief, and the recent passage of the income tax surtax create a complicated tax policy environment that could result in a range of outcomes.

Background

The major sources of state tax in Massachusetts are income, sales, and a variety of taxes on corporations and specific industries. Historically, income taxes make up a majority of total collections (between 56.3 and 57.7 percent between FY 2017 and FY 2021), while the different sales taxes comprise about one quarter of the total and corporate collections between 10 and 12 percent. According to the Tax Foundation, heading into last session Massachusetts ranked in the middle of the pack nationally (30th in 2020) in terms of state and local tax burden.

Heading into the last session, the tax revenue outlook was not strong. The state was less than one year into the pandemic and the expectation was that economic fallout from the public health emergency would reduce state revenues. When the FY 2021 budget was enacted, in December of 2020, it assumed tax collections would fall by more than $1 billion from collections in FY 2020. However, instead of a pandemic-induced decline in revenues, Massachusetts experienced an unprecedented collection boom in FY 2021 and FY 2022.

Between the end of FY 2020 and the end of FY 2022, tax collections grew by $11.5 billion. In the prior decade (FY 2010 to FY 2020), collections grew by $11.1 billion. Collecting a decade's worth of new tax revenue in a two-year period has fundamentally changed the state's fiscal position. The state has made major new investments in a number of policy areas, from early childhood education, to K-12, to the MBTA, to one-time infrastructure. At the same time, the balance of the Rainy Day Fund (RDF) has doubled, and the state has returned $2.9 billion in tax rebates to Massachusetts residents.

Amidst the backdrop of surging collections, Governor Baker proposed a $665 million tax relief plan as part of his FY 2023 budget process. The plan focused on easing the economic burden on residents and improving the state's tax competitiveness:

- Reducing economic burden by:
  - Increasing the 'No Tax Status' for low-income filers
  - Increasing the rent deduction

    - Increasing the tax credit for dependent care
    - Increasing the 'Senior Circuit Breaker'
- Improving the state's tax competitiveness by:
    - Reforming the estate tax to increase the tax threshold and eliminate the cliff effect
    - Lowering the short-term capital gains tax rate.

The plan was subsequently taken up by the legislature as part of larger Economic Development legislation which is discussed in the 'Key Policy Actions' section of the Preview.

Governor Baker's tax relief package was notable because major tax changes have been relatively rare since the state emerged from the Great Recession. At the start of that crisis, when state tax revenues plummeted, the state responded by increasing the sales tax rate from 5 percent to 6.25 percent and in 2013, a $500 million tax package was passed to increase transportation spending. Tax changes between 2013 and 2021 included:

- Reducing the state's income tax rate from 5.25 to 5 percent. This reduction was automatically triggered based of growth in tax collections.
- Temporarily increasing employer health care taxes by $260 million for a two-year period from 2017 to 2018.
- Instituting employer and employee assessments to fund the new Paid Family & Medical Leave program. In FY 2022, the assessment generated ~$950 million in revenue.
- Increasing the state's Earned Income Tax Credit match from 15 percent of the federal level to 30 percent.

Tax deliberations in the prior session were also affected by the state exceeding its allowable tax collection threshold and that effect will continue into the new session. Chapter 62F of the state's general laws establishes a limit on tax revenue growth in any given year and requires any amounts over that limit to be returned to income tax filers. Due to the strength of collections, Massachusetts exceeded the limit in FY 2022 by more than $2.9 billion. Consistent with the law, that overage has been paid back to income tax filers based on a person's tax liability in 2021.

Key Policy Actions, 2021-22

Workaround for federal State and Local Tax deduction – In the FY 2022 budget, Massachusetts followed the lead of several other northeastern states by adopting a Pass-Through-Entity (PTE) tax, which allows taxpayers in partnerships or S-Corporations to pay income taxes at the entity level and thereby avoid the federal cap on state and local tax deductibility. The Massachusetts version of the tax is a revenue raiser for the state, but results in much larger federal tax savings for affected filers. The new tax also changes the method and timing of how some high-wealth filers pay taxes, which makes assessing non-withholding tax trends more challenging.

Film tax credit expansion – The FY 2022 budget made the state's film tax credit permanent. Previously, the credit, which was established in 2006, had a sunset date last set to expire in 2023.

Other FY 2022 budget tax changes – The FY 2022 budget also included smaller tax changes to delay the reinstitution of the state-level charitable tax deduction until tax year 2023 and to make the state's child and dependent care tax credit fully refundable.

Tax relief gains consensus and then stalls – Both the House and the Senate ultimately passed tax relief proposals that were modeled on Governor Baker's original proposal. Both the branches removed the reduction on short-term capital gains and the increase to no-tax status and instead proposed further increasing the state's EITC match. In total, the House and Senate proposals would have provided about $500 million in tax relief. The two plans differed slightly in their approach to the estate tax and in the effective date for relief, but were otherwise identical. However, in spite of the similarity of the two plans, which passed their respective branches unanimously, tax relief never became law last session.

Lawmakers decided to hold off on tax relief, as well as a related middle-income tax rebate program, after they learned that $2.9 billion in 62F tax rebates would be refunded to taxpayers in 2022.

Income surtax passes – In November of last year, voters approved a constitutional amendment to levy a 4 percentage point surtax to income over $1 million. The tax is effective for tax year 2023 and the revenue from the tax is required to go to transportation and education.

Policy Context

The policy context for tax will be shaped by the start of the new income surtax and the uncertainty surrounding future collection trends. The income surtax is the largest tax change in Massachusetts in two decades and it has major revenue, spending, and economic implications for policy decisions in the coming session.

Implications of the Surtax

First, the level and timing of surtax revenue is unknown. DOR last made an estimate on surtax revenue using 2014 data and the tax will largely affect volatile non-withholding revenues. This means that policymakers will have little concrete sense as to how much revenue the new tax will actually raise in the near-term. Further, due to the timing of income tax payments, surtax revenues may not fully materialize until late into FY 2024. These two factors will make it very challenging to include a credible revenue estimate for the surtax in the FY 2024 budget. In the FY 2024 consensus tax revenue agreement, announced in late January, state budget writers opted instead to institute a $1 billion cap on the use of income surtax revenues in the FY 2024 budget.

Second, the surtax revenues must be dedicated to education and transportation spending. The Healey administration and House and Senate Ways and Means must devise a transparent process to demonstrate that all revenues are being spent appropriately to increase investment in those areas.

Finally, policymakers must be very sensitive to the economic impact of the tax. MTF has raised a number of concerns with the potential behavioral effects of the tax on wealthy filers and businesses. It will take several years to develop a solid understanding of how the surtax has influenced location decisions, but policymakers can act more quickly to make offsetting tax changes that reduce the likelihood of potential flight, such as estate or capital gains tax reform.

The external perception of the tax climate in Massachusetts may have already changed. In November, the Tax Foundation wrote that Massachusetts' business tax climate was likely to fall from 34^{th} to 46^{th} in the next edition of its state by state rankings, which would end a two decade trend of Massachusetts' tax climate in the middle of the pack.

MTF recently published an analysis of how the surtax will affect the budget, which also makes recommendations for how to use surtax revenues going forward and identifies critical implementation questions for policymakers.

Tax Trends

Outside of the surtax, the future trend of tax collections looms large over the new session. The FY 2023 budget already makes a responsible bet that tax collections will decline from FY 2022 levels. Learning from the enormous declines in capital gains tax revenues during the Great Recession, House and Senate Ways and Means build a budget that assumes that non-withholding income tax collections will fall by $1.8 billion from last year's level. To date, that assumption has put the current budget on strong footing. Through December, while tax collections have remained flat compared to FY 2022, they are $1.1 billion over benchmark.

The interaction between the effects of the surtax and expected revenue trends will determine not only the consensus revenue agreement used to build the FY 2024 budget, but also will shape tax legislation early in 2023.

Key Questions for the Upcoming Session

How will the state address unanswered questions regarding surtax implementation?

As laid out in a recent MTF Bulletin, there are a number of open questions as to how the surtax will apply to different forms of income, different types of filers, and how it will interact with other tax laws. Clarifying these questions is essential to minimize taxpayer uncertainty. One way to address these questions is through legislation that incorporates the surtax into the state's tax administration laws. Without legislation, it will be up to the Department of Revenue and the legal system to figure out how the biggest tax change in twenty years is to be applied.

What is the future of last session's tax relief legislation?

Both House and Senate leaders have indicated that they want to revive tax relief in the new session and Governor Healey has been clear that tax relief, specifically for dependent care and childcare, is a priority. The need to pass a bill to implement the income surtax creates a perfect opportunity to add in tax relief provisions. The House and Senate proposals from last summer offer an obvious starting point, but the passage of the income surtax changes the policy environment in a meaningful way and policymakers should expand their scope to other areas where Massachusetts' tax code is an outlier compared to other states.

How will the FY 2024 budget incorporate surtax revenue?

MTF noted in its FY 2024 tax revenue projections that lack of quality data and the timing of collections make it unwise to simply spend a projected surtax revenue amount in the FY 2024 budget. Instead, MTF laid out an FY 2024 approach to the surtax which would cap the use of revenue at $500 million, allowing additional revenue to be used in subsequent years, thereby minimizing the negative fiscal impact surtax volatility poses. The FY 2024 Consensus Tax Revenue Agreement follows MTF's recommendation, and caps the total use of surtax revenues in the FY 2024 budget at $1 billion.

How will the state track surtax revenue and spending?

Surtax revenues are constitutionally dedicated to education and transportation and the contention of supporters was that revenue would go to new investments in these areas. Given the constitutional requirement and intent underlying the proposal, it is vital that the use of surtax revenue be carefully tracked going forward. The best way to do that is for surtax revenue to be segregated in a separate fund and expenditures from that fund clearly articulated in spending bills. MTF has put forward a series of recommendations for how to transparently track surtax revenue and use that process to incorporate the funds more reliably in the annual budget process.

Will the surtax trigger a further round of 62F rebates?

Even without the income surtax, 62F rebates could be triggered again in FY 2023. In FY 2022, tax collections exceeded the benchmark by 7.6 percent. According to MTF's recent analysis, while it is possible that the state exceeds the 62F threshold in either FY 2023 or FY 2024, it is by no means certain. Given recent wage growth trends, state revenues, even after accounting for the surtax, would have to grow significantly in both years to trigger the next round of rebates.

Will lawmakers change the 62F rebate law?

House and Senate members have criticized several aspects of the 62F law, from the calculation to determine the limit to the way rebates are distributed. It is quite possible that as part of a larger tax package, they move to amend or eliminate 62F. However, given that millions of Massachusetts taxpayers just received close to $3 billion in payments under the law, major changes to the calculation will be challenging. A move to make the distribution method of the rebates more progressive or to use excess collections to support long-term tax relief could gain more traction.