cSPA testimony at the Economic Roundtable, April 14, 2020

My name is Evan Horowitz and I'm the executive Director of the Center for State Policy Analysis, abbreviated as cSPA. I want to thank you for inviting me to testify today, and for giving me this opportunity to share our findings as you plan for the difficult times ahead.

I'd like to start with the two main takeaways from our recent report--which provided estimates of the likely tax revenue shortfall over the coming 15 months.

1) We estimate that total tax revenues for FY20 will end up 500-750m below the updated benchmark. This shortfall doesn't reflect the impact of deferring tax day.

2) For FY21, we estimate that state tax revenues will amount to roughly $29b, or $2.1b below the consensus revenue estimate from January. However, there is a lot more uncertainty baked into this estimate for FY21, particularly as it depends heavily on the timing of any recovery. That really is the question for the FY21 economy, and for Massachusetts tax revenues: what does life look like in the semi-normal state after we manage to control this first Covid flare-up but before we have a vaccine.

Those are the two key takeaways. Let me now say a little about our new center, and how we reached these conclusions.

The Center for State Policy Analysis is a new initiative at Tufts University, housed at the Tisch College of Civic Life--which is a college focused on civic and political engagement.

Our center--cSPA--launched in February with the goal of providing timely, relevant research on live legislative topics--in a strictly non-partisan way. The model here is something like an independently-housed version of the Congressional Budget Office, but for Massachusetts. We don't lobby; we don't engage in advocacy; we just undertake research that we hope will be useful to you and your colleagues.

Actually, that's half of our mission. The other half is providing research around state ballot questions. But that's a subject for a different time.

As soon as the Covid crisis took hold, we decided that a fiscal assessment should be our top priority, so we set about building a predictive model of state tax revenues. And one of the things we realized, very quickly, is that state tax revenues are shockingly well correlated with US GDP. Year in and year out, there is basically a 1:1 correlation between national GDP and Massachusetts tax revenues.

And while you could try to incorporate additional nuance--for instance you could focus on the the ways that the Massachusetts economy differs from the US economy--or perhaps look at the the differing effects on sales tax vs. withholding vs. capital gains. But the problem is what's called overfitting, which means when you attempt this, you're more likely to be adding noise than real information.

Plus, building an estimate of Massachusetts tax revenues off of US GDP has two, tremendous virtues:
1) it doesn't require too many modeling assumptions, which is especially important at a time like now, when lots of conventional economic assumptions are pretty strained.

2) it basically turns the problem of predicting Massachusetts Tax revenue into a problem of projecting US GDP--and that's a problem lots of smart people are already working on

So once we had this model in place, we could leverage some of the existing projections of US GDP--from reputable sources like Goldman Sachs, JP Morgan, and The Conference Board. And we used those projections to generate estimates of state tax revenue for the reminder of FY2020 and the entirety of FY2021.

For FY20, there's a strong consensus among forecasters that the economy will contract at an unprecedented pace. That means 5-10% contraction for the quarter that just ended, and a 25-35% contraction for the next 3 months (those are annualized numbers, which is the norm for GDP growth.) [show chart: To give some context, a 25-35% quarterly contraction is 4 times steeper than the worst quarter of the great recession--and by far the most severe in the post-WW2 era.]

The effect on state tax revenues will be equally sudden and severe. We find that total FY 2020 tax revenues are likely to fall $500-$750 million short of the updated benchmark.

Let me repeat that our estimate does not reflect the impact of pushing Tax Day into July, which will artificially reduce FY20 tax collections by hundreds of millions of additional dollars (those dollars belong to a different category: deferred revenue rather than lost revenue).

Looking further ahead...for FY 2021, we project total tax revenue of just under $29 billion ($28.97b), a little more than $2 billion below the consensus revenue estimate of $31.15 billion. This reflects a combination of the GDP projections from the sources noted above--which continue through calendar year 2020--along with our assumption of 4% catch-up growth in the first half of calendar year 2021.

This FY21 estimate includes a lot more uncertainty--not just because it extends further in time but because we don't have a good handle on what the world will be like in FY21. Our economy--and our lives--will be in a kind of in-between state--after the current convulsion has passed but before a vaccine is readily available. That will likely bring some kind of ongoing vacillation: periods of greater economic openness followed by flare-ups and periods of temporary lock-down.

CBO takes a rough estimate that social distancing measures will decrease by an average of 75% during the second half of the year--but there's a lot of guesswork behind that number.

Our tax revenue estimate--really, any estimates for FY21--depend on the uncertain nature of this up-and-down world, and they therefore include a lot of downside risk. The GDP projections we work with tend to envision an economic turaround in Q3 or Q4--but it's easy to imagine less rosy scenarios where Covid-19 continues to flare up throughout the fall and winter, keeping the economy in check. Under such conditions, state tax revenues could fall by another $1-2 billion.

One positive sign, in all this, is that the federal government has taken very fast, and very aggressive action--mobilizing several trillion dollars in what is essential emergency economic aid--far more than was made available during the great recession.

Massachusetts will get a substantial amount of timely federal support via additional funds for MassHealth, direct aid to the state and to Boston, an education stabilization fund for schools and colleges--and possibly more. This should go a long way toward helping the state address the likely revenue shortfall--though it's too early to know exactly how much of a cushion federal support will provide.

This is one reason I think I'm slightly more optimistic than many of the other presenters today--though it's strange to call a $3 billion shortfall over 15 months optimistic. The scale of federal action is much closer to economic need than it was in 2008, both in terms of congressional action and also from the federal reserve.

The effect is that the recessionary cycle should be blunted--that is, the cycle where a sudden shock makes people suddenly poorer, which then limits spending and economic activity for years. Instead, expanded UI benefits will keep millions of workers whole (or closer to whole) for far longer; forgivable small business loans will keep most business afloat. etc. Not that this will prevent a recession but it brightens hope for a medium-term recovery and should be factored into any estimates.

Nevertheless, I believe it may make sense to draw from the state stabilization fund. Indeed, the prime rationale for this fund is to help fill temporary budget gaps from sudden economic downturns--precisely today's situation. The only caveat is that withdrawals need to be calibrated to ensure adequate reserves for multiple years--to guard against a downturn that proves more protracted than anticipated.

There may also be opportunities for savings across the budget, from programs that are either unnecessary or impossible in current conditions. As an example, the cancellation of elective medical procedures may result in some reduced state spending in the near term.

When seeking out savings opportunities, however, it is important to look for areas where spending genuinely can't happen (or really doesn't need to happen). Otherwise, cuts risk exacerbating the tendency of economic crises to hit vulnerable populations first and hardest. That's true on the economic front--where the shut-down of the service sector is affecting lots of low-wage workers--and also on the public health front where poorer families--and communities of color--are less likely to have insurance and more likely to have underlying health risks.

And while there may be opportunities for saving, there may also be unexpected costs.

For the reminder of FY20, that primarily means urgent spending on health care and other public health needs--to help people in the throes of this crisis--and perhaps start transitioning to a system of aggressive contact tracing.

But in FY21, the spending landscape may look quite different, as issues that seem like distant concerns today come to seem newly urgent when the immediate crisis passes and we move into the new post-shutdown, pre-vaccine reality. I'm just going to list a few:

a) the November election, which could require a wholesale rethinking of how we vote in Massachusetts (possibly by expanding vote-by-mail).

b) Support for cities and towns, which rely heavily on state funding via local aid and education support.

c) Broadband equality, if e-learning becomes a longer-term norm and poorer (or more rural) communities find themselves with limited access to education.

d) retail entrepreneurship and the need to rebuild main street businesses, if many of today's businesses prove unable to outlast the current storm

e) Small colleges, which were already under intense financial pressure and which may not be able to survive another empty semester.

f) Transit systems and roadways, where a lack of toll-paying drivers and fare-paying riders risks setting off a vicious circle of declining revenue leading to reduced investment

g) The unemployment insurance trust fund, which is likely to be strained by the surge in unemployment and will eventually need to be replenished by employers

Stepping back, and considering this full range of concerns and uncertainties, it may make sense to consider some of the following:

1) establishing a relatively conservative revenue estimate for FY21--given that the downside risks seem greater than the upside potential

2) developing a plan for mid-year review/adjustment, independent of the usual 9c approach. Even by early fall we are likely to have a much sharper sense of what it means socially and economically to live with Covid-19 for an extended time.

3) convening some kind of group to gather insight into the post-crisis crises, all those knock-on effects that are hard to see as the case-loads climb but which will be inescapable once the current outbreak has peaked and receded.

At this point, let me 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 research on any topic or issue that you think could be useful.