Massachusetts Budget & Policy Center

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Dear Chair Lewis, Vice Chair Hendricks, and distinguished members of the House Committee on Federal Stimulus and Census Oversight,

Thank you for the opportunity to submit testimony here today in support of "An Act to Provide for competitiveness and Infrastructure investment in Massachusetts" (S.2554). I am the Interim President of the Massachusetts Budget and Policy Center, a think tank conducting research and analysis to improve public policy in the Commonwealth for over 35 years.

I want to speak directly to the long-term financial prudence of the bill before you today. The bill both protects the strength of the Commonwealth's Stabilization Fund and leverages its funding for further growth when it has already become sufficient. It is important that the Stabilization Fund should be ample. This act would not draw down the Stabilization Fund or slow its growth when it is insufficient. It would only decelerate the further growth of the Stabilization Fund when it has swollen to sufficient levels.

If the balance of the Stabilization Fund is sufficient, then it is an additional level of caution to restrict the use of funds to debt reduction, which improves the soundness and resilience of state finances without creating new obligations or operational needs. Similarly, making funds available to match and pursue state federal grant dollars would enable us to more nimbly pursue opportunities for federal funds in the next couple years without displacing other funding.

The current balance of the Stabilization has swollen to $8.27 billion, an unprecedent balance and approximately 14.2 percent of the (FY 2024 GAA) budget. I want to speak to how high a balance is adequate and why has the current balance has grown so large.

How High a Balance is Adequate

All else equal, it would always be nice to have a bigger rainy day fund. But all else isn't equal. There are opportunity costs to locking up funds that could be applied to other uses.

A few points of reference:

- In the early 1980s, the Fiscal Affairs and Oversight Committee of the National Conference of State Legislatures recommended that state rainy day funds be brought up to 5 percent of annual general fund expenditure.[1]
- Boston Federal Reserve analysis from 2014 brought an in-depth focus to this question. At the time, all state Stabilization Funds together were totaled 2 percent of all states' aggregate expenditures. They analyzed the revenue volatility of all 50 states and concluded based on their preferred measure that the rainy day funds required to protect

spending without need for tax increases or cuts in the face of a median recession would be 5.5 percent of state expenditures, and 10.2 percent for a maximum rainy day fund need.[2]

- According to the recent National Association of State Budget Officials, Fiscal Survey of the States, in FY 2024 only California and Texas have larger rainy day funds than Massachusetts.[3]

Last year Massachusetts introduced a millionaire surtax that will increase revenue volatility, but the surtax is accompanied by its own separate reserve fund which acts as a separate stabilizer and grows over time to be available to independently supplement Fair Share spending if it stumbles during a recession.

Why Balances Have Grown So Large

There are two reasons our Stabilization Fund has grown so much in recent years. One is the temporary surpluses created by federal pandemic spending which pumped up the economy and coexisted with steep increases in asset markets, most notably stocks and real estate. The sharp increase translated into larger capital gains. A major revenue source for the Stabilization Fund is "excess capital gains": the amount of capital gains tax collections that exceed an annual threshold that is itself pegged to grow with the economy. There were extraordinarily large amounts of capital gains realized in the last few years, meaning large amounts over the slowly rising threshold – and extraordinary deposits into the Stabilization Fund.

There also may be long-term reasons for deposits of capital gains taxes to increasingly swell the Stabilization Fund further over time. The threshold designating "excess capital gains" is increased each year according to the rate of economic growth. But if capital gains outpace the growth of the economy, then increased amounts of capital gains will get designated as "excess," and a growing portion of tax revenues will be diverted away from the General Fund into the Stabilization Fund.

Sure enough, Congressional Budget Office analysis of nationwide capital gains realizations show an unprecedented growth as a portion of GDP since 2009.[4] And Tax Foundation historical data on realized capital gains shows a growing portion as a percent of U.S. GDP over several decades.[5] Another indication of the relative growth of capital gains in the Massachusetts economy is the shrinking relative portion of wages and salaries. Wages and salaries used to be about 70 percent of the Massachusetts economy after World War II, a proportion that fell to around 60 percent throughout the 1980s and has further drifted downwards since. Wages and salaries have been less than 55 percent of Massachusetts personal income every year since 2009.[6]

There are two reasons why capital gains may be a growing portion of the economy long-term. One reason is what has loosely been called the "financialization" of the economy. I refer to a shift since the 1980s from a relative decline of the industrial sector, and the growing importance of financial services and real estate.

Wealthy individuals, on average, collect a far greater share of their income from financial wealth than the rest of us. A large body of research from the Federal Reserve and elsewhere shows that wealth in the United States has become greatly more concentrated in the hands of a few, largely in the form of financial assets. I point this out not as social commentary, but to point out how a secular trend over time impacts a long-standing policy arrangement. As income becomes concentrated at the top, it is more likely to take the form of capital gains and result in large above-threshold deposits into the Stabilization Fund.

The benefits of this bill do not depend on capital gains continuing to outpace the rest of the economy or even a long-term trend toward the Stabilization Fund growing faster than the budget. If these trends were to cease, the Stabilization Fund balance will eventually revert to below 10 percent of budget revenues and the policy changes triggered by the statute will revert to the old status quo. The bill never reduces the Stabilization Fund but adjusts its growth mechanisms depending on its size.

With appreciation,

Phineas Baxandall

Interim President, Massachusetts Budget and Policy Center

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[1] National Conference of State Legislatures, "A Legislator's Guide to Budget Oversight after the Appropriations Act has Passed" (1983) and cited in Boston Federal Reserve (2014), p.4.

[2] Bo Zhao, "Saving for a Rainy Day: Estimating the Appropriate Size of U.S. State Budget Stabilization Funds" Federal Reserve Bank of Boston, Working Paper No. 14-12 (2014) at https://www.bostonfed.org/publications/research-department-working-paper/2014/saving-for-a-rainy-day-estimating-the-appropriate-size-of-us-state-budget-stabilization-funds.aspx

[3] National Association of State Budget Officials, *Fiscal Survey of the States*: An Update on State Fiscal Conditions (Fall 2023), p. 72 at https://higherlogicdownload.s3.amazonaws.com/NASBO/9d2d2db1-c943-4f1b-b750-0fca152d64c2/UploadedImages/Fiscal%20Survey/NASBO_Fall_2023_Fiscal_Survey_of_States_S.pdf

[4] Congressional Budget Office, "CBO's Projections of Realized Capital Gains Subject to the Individual Income Tax" (February 2023) at https://www.cbo.gov/system/files/2023-02/58914_capital_gains.pdf , slide 5.

[5] Tax Foundation, "Federal Capital Gains Tax Collections, Historical Data (1954-2018)" at https://taxfoundation.org/data/all/federal/federal-capital-gains-tax-collections-historical-data/

[6] Bureau of Economic Analysis, "SQINC4: Personal income by major component" accessed at https://apps.bea.gov/iTable/?reqid=70&step=30&isuri=1&major_area=0&area=32000&year=2020&tableid=56&category=356&area_type=0&year_end=-1&classification=non-industry&state=0&statistic=-1&yearbegin=-1&unit_of_measure=levels