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MTF

MTF's Analysis of FY2016 Budget Shortfall

Heading into October, the state is preparing to close the books on fiscal year (FY) 2016. It was a challenging year in which the revenues exceeded expectations in the first half of the year and then dropped precipitously in the final months. The Legislature is expected to pass a final supplemental budget that will resolve outstanding spending deficiencies and codify several budgetary solutions.

This brief frames the final FY 2016 budget shortfall and takes a closer look at some of the factors that created the gap. It will also preview some of the solutions likely to be used to close the gap and outline possible implications for FY 2017.

Budget gap – background

In January, seven months into FY 2016, the Administration identified a budget gap of approximately $500 million and took several steps to address it.

Table 1. Initial FY 2016 Budget Gap

Identified deficiencies	-174
ERIP savings shortfall	-136
Non-tax revenue downgrade	-205
Other	-50
Initial gap	***-565***
Vetoes	71
January 9Cs	49
Tax revenue upgrade	140
Reversions	175
Other	55
New spending	-16
Gap as of February	***-91***

This budget shortfall was not caused by poor tax revenue assumptions; rather, it was a combination of uncovered expenses, overly optimistic assumptions related to the early retirement program and lower than expected non-tax revenue in several areas.

When midyear budget shortfalls arise, it is primarily the responsibility of the executive branch to identify solutions. The Baker Administration's solutions partially relied on vetoes and midyear 9C cuts, but these measures comprised a small part (21 percent) of the solution. The Administration relied heavily (65 percent) on revenue and spending reforecasts to close the gap. As part of the Consensus Revenue process for FY 2017, tax revenues for FY 2016 were increased by $140 million. The Administration also identified $55 million in non-tax revenue increases and $175 million from funds that were budgeted but not likely to be expended (reversions). This approach minimized cuts to programs and benefit levels, but placed a heavy bet on the accuracy of revised projections. While the Administration's projected *spending* needs proved largely accurate, *tax revenue* projections did not.

Budget gap – changing the tax revenue landscape

The decision in January to upgrade FY 2016 estimated tax collections by $140 million was supported by revenue collections to date. At the time of the revenue reforecast, tax collections exceeded benchmark by $113 million and January looked to be another strong month. As recently as the end of January, collections stood $191 million over initial benchmarks.

Unfortunately, beginning in February, a sustained trend of weak tax collections began. Between February and the end of the fiscal year, taxes fell short of original benchmarks by $379 million and $532 million below the revised benchmark.[1] These collections resulted in end of year tax collections which fell short of the revised benchmark by $484 million.

The magnitude of this shortfall is unprecedented. Not since FY 2009, the height of the Great Recession, have collections over a five month period slumped by so much and never in the midst of an economic recovery. FY 2016 is the first year in over a decade in which tax revenues were upgraded during the year only for collections to fall short of the original benchmark.

The timing of collections in FY 2016 contributed to the delay and difficulty in addressing this shortfall. Poor collections began in February, but were followed by a strong month in March. Because February is typically the smallest revenue collection month of the year, soft revenues did not raise a red flag. It was not until early May (when April revenues were released) that the scale of the budget problem became apparent. With less than two months remaining in the fiscal year, the Administration had limited options for closing the growing revenue gap.

Budget gap – impact of tax shortfall

Lower than anticipated tax collections always create a challenge. In FY 2016, that challenge was compounded by the fact that the state was relying on higher than anticipated revenues as its primary way to address the midyear deficit. In essence, the state was not only forced to solve for poor tax collections in the latter part of the year, but also had to find an additional $140 million to cover the January tax revenue upgrade.

[1] Comparison to benchmarks does not include tax settlement revenue collections – which are not part of monthly benchmark forecasts.

Closing the budget gap was made more difficult by the limited options available to the Administration so late in the fiscal year. To control spending, the Administration has two primary options: making midyear cuts and controlling spending to maximize reversions.

Midyear cuts, done through the 9C process, entail reducing or eliminating specific programs or not making planned expenditures, such as earmarks. These cuts are most effective earlier in the year when money has not yet been spent and savings from program changes are maximized. Conversely, the later in the year that cuts are made, the more likely earmarks have already been paid and the more limited the savings that can be generated by changing a program's eligibility criteria.

Reversions occur when a budget account spends less than expected and the money reverts to the General Fund. Each year millions of dollars in accounts remain unspent due to reasons such as program usage falling short of expectations, staff departures or delays in hiring. In difficult fiscal times, the Executive Office for Administration and Finance works with agencies to adopt spending controls that maximize reversions. However, the Baker Administration had already assumed $175 million in reversions as a solution to the initial midyear budget gap, meaning that only savings greater than that amount would offset the more recent drop in poor tax collections.

Budget gap – where it stands

The books have yet to be closed on fiscal year 2016 and so neither the final budget gap, nor the mix of solutions to address it are known. This delay is not uncommon as it typically takes several months for all financial activity related to a fiscal year to conclude. In addition, the Administration and the Comptroller's office must reconcile and finalize all fiscal transactions before the exact size of the budget shortfall can be determined and the necessary solutions identified.

Based on final tax collections, the Foundation estimates the final FY 2016 budget gap at $575 million. More than 80 percent of this gap is due to the shortfall in tax collections. The remainder reflects the amount of the initial budget gap in January that remained unsolved.

Table 2. Impact of Tax Shortfall on Budget Gap

FY 2016 Budget Gap	
January budget gap	-494
January budget solutions	403
Gap remaining	***-91***
Tax revenue shortfall	-484
Final FY 2016 gap	***-575***

Supplemental Budget Solutions

Lacking final data on the fiscal year, it's still possible to outline a number of options that the Administration may choose to balance the budget. The final supplemental budget filed by Governor Baker in July provides some clues about the Administration's strategy. The supplemental budget included up to $111 million in budget solutions outlined in Table 3:

Table 3. Budget Solutions in Governor Baker's Supplemental Budget

Supplemental Budget Solutions	
One Time	
Convention Center Fund	$60,000,000
Legal settlement revenues	$20,000,000
Contributions from housing agencies	$9,000,000
Other Solutions	
FY 2014 & FY 2015 funds still available	$22,000,000
Maximum possible solutions	***$111,000,000***

It is worth noting that the solutions proposed in the supplemental budget represent the maximum amount available; it is possible that actual savings may be much less. For example, the Governor asked for authority to transfer up to $60 million from the state's Convention Center Fund, but it is likely that the actual transfer will be less to ensure that the fund is still able to cover debt service requirements.

Also noteworthy is the fact that $89 million of the supplemental budget's $111 million in solutions are one time in nature. In addition to the Convention Center sweep, the Governor's supplemental budget also proposes reserving revenue from recent legal settlements to FY 2016 and asking state agencies to provide one-time payments to the General Fund. The elimination of $22 million in appropriations made in legislation from 2014 and 2015, but not yet expended, is the only measure that provides recurring savings.

Other Known Solutions

The Administration has identified other ways to address the budget shortfall in reports to the Legislature and financial disclosures:

Table 4. Other Known Budget Solutions

Identified Solutions	
One Time	
Trust fund sweeps	$100,000,000
MBTA contribution	$31,000,000
Excess tax & legal settlements	$64,000,000
Community First Trust Fund payment	$22,000,000
Other Solutions	
Lottery and tobacco settlement revenues	$34,000,000
SBA transfer savings	$16,000,000
Maximum Possible Solutions	***$267,000,000***

This list, which generates a maximum of $267 million in savings is also heavy on one-time solutions. These include further use of trust fund balances: sweeping an additional $100 million from 38 trust funds as well as requiring the Community First Trust Fund to reimburse the General Fund $22 million for spending earlier in the year. State lottery and tobacco settlement revenues, which go to the General Fund, have both come in above projections, while slow sales tax growth reduces the state's payment to the School Building Authority by $16 million.

These proposals included in the supplemental budget, information statements and other public documents could offset close to $400 million of the budget shortfall, but would do so through a number of one-time solutions that will increase the fiscal challenges in FY 2017. It would be preferable for the Administration and Legislature to first use non-tax revenue increases and further savings on spending before using only those other available solutions as are necessary.

Non-tax revenues

When tax revenues first declined, the Administration announced efforts to improve the process of collecting departmental revenues (fees, etc.). Rather than merely expediting payments, the improvements are designed to increase FY 2016 revenues without reducing collections in the future. It appears that these efforts have been successful and that departmental revenues will exceed earlier projections by more than $100 million. Furthermore, several sources of federal Medicaid revenue are now expected to generate approximately $50 million more previous estimates.

Reversions

The administration has been very active in controlling spending throughout FY 2016 in order to maximize the amount of money that will revert to the General Fund. Due to those efforts, not only is the original $175 million reversion target achievable, but further savings – possibly as much as $100 million – now appear likely.

Budget gap – bottom line

Some combination of spending reductions and revenue increases will be necessary before the fiscal year closes to offset a budget gap of more than $500 million. Ideally, non-tax revenue increases or spending reversions will be used because these measures are more sustainable. If necessary, however, the Administration has identified close to $400 million in other budget solutions that can also be brought to bear to close out FY 2016. The mix of these strategies will ultimately depend on final revenue and spending numbers.

Impact on FY 2017

The FY 2016 shortfall in tax revenues has a direct impact on FY 2017. In June, budget conferees, in conjunction with the Administration, reduced the consensus tax revenue estimate agreed to in January. This revised number was considerably less than the amount used to craft each of the previous budget proposals.

Table 5. Conference Committee Downgrade of FY 2017 Tax Revenue

Original tax consensus	**$26,860**
Life science cap	$5
Tourism formula adjustment	$37
Conference downgrade	-$750
No income tax rate reduction	$79
Current tax benchmark	***$26,231***

In fact, the final budget relies on $629 million less in tax revenue than initially projected. The new estimate of $26.231 billion will likely require further revision as it assumes revenue growth of 3.8 percent over FY 2016 – a growth rate that has not been met in any of the last five months. Should revenues grow at the same rate they grow in FY 2016 (2.2 percent), it would mean a $400 million shortfall from the current benchmark.

September is one of the largest revenue months and so its collections will be crucial in determining how the current tax revenue estimate should be adjusted. Even if September revenues come in close to benchmark, the Foundation still believes that a downward adjustment is necessary to reflect recent collection trends.

The solutions that are used to close the books in FY 2016 will also impact finances in FY 2017. One-time revenues used in one fiscal year create an immediate budget gap in the next as the state needs to replace those resources through identification of other one-time solutions, sustainable cuts or increased revenues. If FY 2016 can be balanced without many of the one-timers that are being considered, it will reduce the FY 2017 budget gap and preserve these options for future budget problems.

Finally, the spending controls used by the Administration to maximize FY 2016 savings could have a major impact on FY 2017 spending needs. Many of the staffing and service assumptions used in the FY 2017 budget may no longer be accurate if FY 2016 spending comes in more than $200 million below original expectations and will need to be revised downward. This spending disconnect could make it difficult to assess the impact of any midyear budget cuts that lay ahead.

Already it is evident that the state's fiscal challenges will continue into FY 2017. The path taken to balance the books in FY 2016 will go a long way toward determining just how daunting those challenges will be.