Massachusetts Taxpayers Foundation

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# Bulletin

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MTF

## FY 2016 Budget Update

The fiscal year 2016 budget picture became murkier this week with the news that April tax collections fell short of projections by $172 million. This Bulletin assesses the impact that recent tax collections may have on the state's ability to end the year in balance and highlights some possible implications for FY 2017.

**How We Got Here**

Even before the recent slowdown in tax collections, the state had already confronted a sizable budget gap in FY 2016. In the first six months of the year, a combination of spending exposures, shortfalls in non-tax revenue and savings assumptions created a midyear budget gap of approximately $500 million.

**Table 1. FY 2016 Midyear Gap**

| | |
|---|---|
| Identified deficiencies | -$174 |
| ERIP savings shortfall | -$136 |
| Sales tax holiday | -$26 |
| Non-tax revenue downgrade | -$205 |
| Other | -$24 |
| *Initial Gap* | *-$565* |
| Vetoes (net of overrides) | $71 |
| **Post-veto gap** | **-$494** |

In response, the Administration identified more than $400 million in solutions to largely close the gap. As Table 2 shows, key among the gap closing solutions was an upgrade to the assumed FY 2016 tax revenues that were developed as part of the Consensus Revenue agreement with House and Senate Ways and Means.

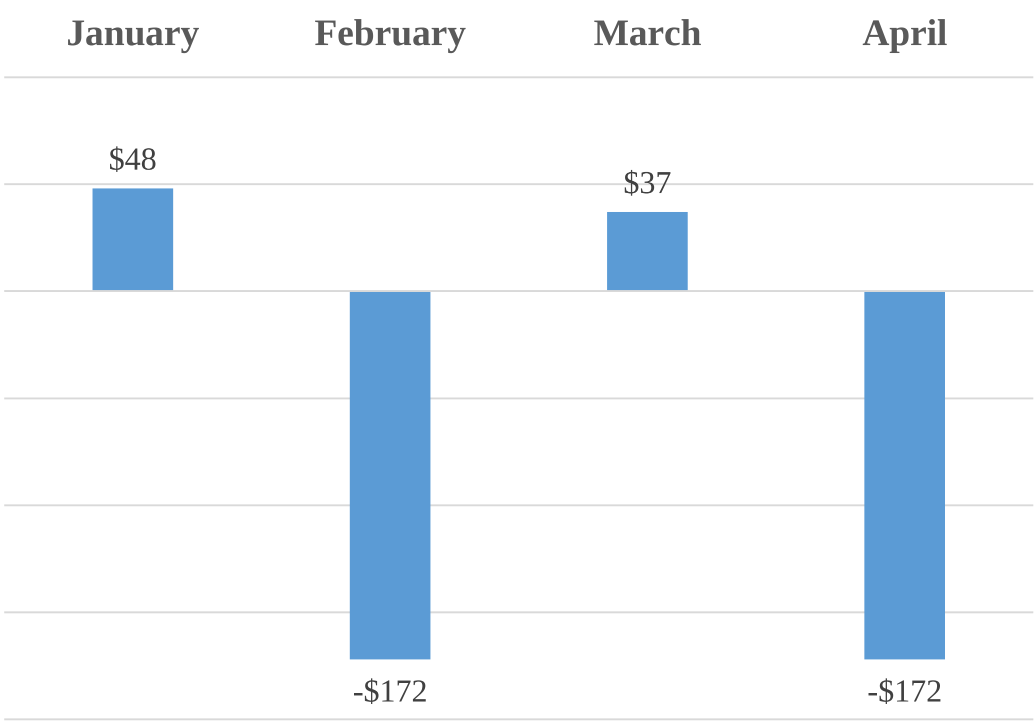
**Table 2. FY 2016 Midyear Gap Solutions**

| | |
|---|---|
| **Initial Gap** | **-$494** |
| **Solutions** | |
| 9Cs | $49 |
| New non-tax revevenues | $55 |
| Reversions | $175 |
| Tax revenue upgrade | $140 |
| *Solution total* | *$419* |
| Additional supplemental spending | -$16 |
| **Gap remaining** | **-$91** |

**FY 2016 – Changing Revenue picture**

Unfortunately, recent tax collections have not aligned with the revised January projections. Revenues in both February and April have fallen well below expectations, leaving the state $261 million under benchmark. The April collections are particularly troubling because April is the largest tax collection month of the year and it leaves only two months in which to get back on track.

**Table 3. Tax Revenues since Upgrade**




It's premature to say definitively that the recent revenue slide has long-term implications. April collections in both FY 2012 and FY 2014 fell approximately $100 million short of benchmarks and rebounded by year-end. What is certain is that the April revenue shortfall creates two challenges for ending FY 2016 in balance. The first is that further midyear appropriation reductions, or 9C cuts as they are called, are an ineffective budget cutting tool this late in the year because most spending decisions have already been made. It also increases the importance that other revenue and savings assumptions come to pass. For example, the state needs to receive approximately $100 million in tax settlement revenue over the next two months to reach its target of $125 million for the year. It is possible that some FY 2016 expenses are delayed until FY 2017 but that will add to the difficulties in FY 2017.

Using the state's Rainy Day Fund to close the gap is not a responsible option given that the balance is already insufficient due to multi-year diversions of money to operating expenses that should have been deposited into the Fund.

**FY 2017 – Implications for Next Year**

The tax collections of the last three months do not necessarily invalidate the tax revenue assumptions being used in the FY 2017 budget, but they should give budget makers pause as they make spending and revenue decisions.

First and foremost, the challenges of FY 2016 underline the danger of using capital gains revenues in excess of the statutory threshold to balance the budget. In FY 2016, the state is relying on $300 million of these revenues. Volatility in the stock market and the recent shortfall in tax collections demonstrate the inherent risk of using these revenues for the operating budget. Both the Governor and the House took a major step forward in their FY 2017 budgets by planning to dedicate the majority of a capital gains revenue in excess of the benchmark to the Rainy Day fund. However, the assumption that $150 million in excess capital gains revenue will be available for next year's budget is by no means certain.

Secondly, the experience in FY 2016 highlights the importance of limiting spending growth in the FY 2017 budget and fully accounting for the cost of all programs. Oftentimes, the initial budget will underfund some programs with the expectation that future tax revenues will be available to offset deficiencies. The shortfall in April revenues shows the substantial risks inherent in this approach. These risks are even more heightened in FY 2017 given the current tax revenue shortfall and the possible need to push some FY 2016 costs into the next fiscal year to close the current budget gap. It is imperative that the FY 2017 budget be based on realistic program cost estimates and account for future deficiencies that will inevitably occur during the year.

FY 2016 is the third consecutive year in which the state has grappled with midyear budget gaps during a time of economic recovery. While the circumstances of each of those three years are unique, there are several lessons that must be applied in the FY 2017 budget. The current economic recovery has not been accompanied by the types of tax revenue windfalls the state relied upon in previous recoveries. Therefore, the budget must reflect this fiscal reality and be built with the flexibility to withstand the type of revenue challenges that have occurred in FY 2016.