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Bulletin

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MTF

FY 2017 Conference Committee: The Impact of FY 2016 Tax Revenues

With just days left in the fiscal year, tax revenues currently stand at $310 million below benchmark for FY 2016. This shortfall creates major challenges for ending the current fiscal year in balance and calls into question the accuracy of the tax revenue projection used to build the FY 2017 spending plans put forward by the Governor, the House and Senate. As the FY 2017 Budget Conference Committee meets to develop a consensus FY 2017 budget, it's important that the final budget reflects the recent softening of the state's tax revenue landscape.

FY 2017 Consensus Revenue

The consensus revenue process determines the amount of money available for the next fiscal year by looking at the current year's revenue base and applying a projected growth rate. The FY 2017 consensus tax revenue agreement projected a 4.31 percent tax revenue growth rate over FY 2016 and $26.86 billion in total revenues. At the time of the agreement, state tax revenues were $114 million over FY 2016 benchmarks and budget writers decided to revise FY 2016 tax revenues upward by $140 million.

Table 1. FY 2016 and FY 2017 Consensus Revenue Estimates

Original FY 2016 Benchmark	Revision	Updated FY 2016 Estimate	Assumed Growth into FY 2017	FY 2017 Consensus Tax Revenue Figure
$25,611	$140	$25,751	4.31%	$26,860

From the outset, the Consensus Revenue agreement was on the high side – five of the six estimates presented at the December revenue hearing assumed FY 2017 tax revenue growth of less than 4.31 percent – but within the range of expert projections and closely aligned to the estimates of Economy.com, a vendor used by DOR.

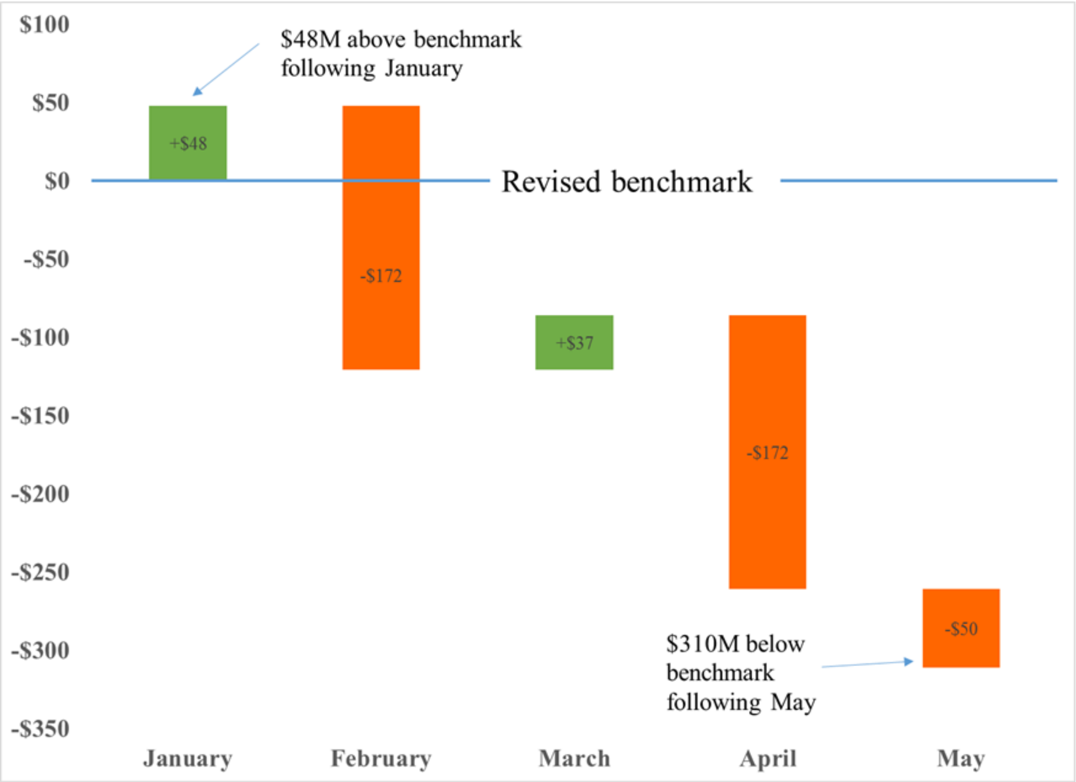
Table 2. Comparison of FY 2016 and FY 2017 Tax Revenue Projections

FY 2016 Estimate		FY 2017 Estimate	
Beacon Hill Institute	$25,933	Beacon Hill Institte	$27,381
NEEP (DOR vendor)	$25,843	NEEP (DOR vendor)	$26,895
Alan Clayton Matthews	$25,791	***Consensus Agreement***	***$26,860***
Economy.com (DOR vendor)	$25,758	Economy.com (DOR vendor)	$26,858
Consensus Agreement	***$25,751***	Mass. Taxpayers Foundation	$26,689
Mass. Taxpayers Foundation	$25,712	Global Insight (DOR vendor)	$26,657
Global Insight (DOR vendor)	$25,681	Alan Clayton Matthews	$26,651

FY 2016 Revenues since January

After a strong first half of the fiscal year, tax revenues remained strong in January, coming in $48 million above the new revised benchmark. However, since then FY 2016 revenues have performed well below expectation, leaving the state $310 million below benchmark as of the end of May.

Table 3. Monthly Tax Revenue Collections since Revision of FY 2016 Projection



Absent stronger than expected collections in June, the state will end the fiscal year well short of the estimate upon which the FY 2017 Consensus Revenue figure was based. In fact, FY 2016 tax revenues are poised to exceed FY 2015 revenues by just 2.6 percent.[1]

Impact of FY 2016 Revenues on FY 2017

Applying the 4.31 percent consensus revenue growth rate to the revised FY 2016 tax revenue foundation would leave budget-makers with $325 million or so less than they originally anticipated for FY 2017. In fact, in order for the state to achieve tax revenues of $26.86 billion in FY 2017, revenues would need to grow by 5.6 percent over FY 2016, a very unlikely scenario given recent revenue collections.

Table 4. Comparison of Original FY 2017 Tax Growth Projections with updated FY 2016 Information

	Consensus Revenue Assumption	Updated Data	
FY 2016 Tax Revenues	$25,751	$25,441	
Assumed Growth Rate	4.31%	4.31%	5.58%
FY 2017 Tax Revenues	$26,860	$26,536	$26,860

MTF recommends that budget-makers lower the FY 2017 revenue growth percentage to account for recent revenue collections. Table 5 presents the impact of several plausible FY 2017 tax revenue growth rates on total tax revenues.

Table 5. Impact of Various FY 2017 Tax Growth Rates on Total Collections

Current FY 2016 Esimate	FY 2017 Growth Rate	FY 2017 Revenue	Shortfall from CR Estimate
$25,441	3.8%	$26,408	-$452
	3.6%	$26,357	-$503
	3.4%	$26,306	-$554
	3.2%	$26,255	-$605
	3.0%	$26,204	-$656
	2.8%	$26,153	-$707

Depending on the assumed tax revenue growth rate, FY 2017 tax revenues could fall short of the Consensus Revenue estimate by between $450 and $700 million. Given this, it's imperative that the budget conferees act to bring the FY 2017 budget in line with more reasonable revenue estimates.

[1] This revenue growth figure does not include tax settlement revenue in the comparison. If tax settlement revenues for FY 2015 and FY 2016 are included, tax revenue growth is just 1.8%.

Implications for Budget Conference

The next steps for how to address the FY 2017 revenue shortfall are somewhat unclear. Under statute, the January consensus revenue agreement represents the maximum level of tax revenue to be approved in the upcoming budget, but it is silent about the process for a revenue reduction. While the budget-makers have not faced a situation like this in the past 15 years, there are recent examples of how Conference Committees addressed significant reductions in revenue estimates prior to final passage of the budget.

FY 2002 Budget

In FY 2002, the administration and legislature were unable to come to a consensus tax revenue agreement prior to the start of the fiscal year. The legislature used a tax revenue estimate that was $235 million higher than the basis of the Governor's budget recommendations. Due to other differences between House and Senate budgets, conference negotiations were not completed until November of 2001, by which time a recession had begun and tax revenues had deteriorated. Ultimately, the budget conferees reduced tax revenue assumptions by almost $1 billion to account for the changing economic conditions.

FY 2010 Budget

Soon after the establishment of the FY 2010 consensus revenue figure in January of 2009 it was apparent that the impact of the Great Recession would be far larger than initially predicted. The Governor's budget recommendations and the House budget were based on the original revenue forecast, but prior to the Senate budget, all three parties agreed to downgrade assumed FY 2010 revenues by $1.5 billion. The Senate budget was developed based on this new estimate and in June the Governor released a revised set of budget recommendations to reflect the lower revenue forecast. The Conference Committee budget, which used the revised revenue estimate as a foundation, was signed by the Governor on June 29th.

FY 2011 Budget

The FY 2011 budget relied heavily on a temporary increase in Medicaid revenues included as part of the federal stimulus plan. The House and Senate budgets assumed 12 months of enhanced reimbursements when only six had been approved. Due to the uncertainty of federal action, the administration advocated for a final budget that reduced the stimulus revenue assumption by $687 million – six months of enhanced reimbursements. The Conference Committee budget did not change the federal stimulus revenue assumption, but instead made hundreds of millions of dollars in expenditures contingent upon federal stimulus revenue being received. Governor Patrick vetoed more than $700 million from the Conference budget, but most of this funding was restored in a later supplemental budget when the additional federal funds were received.

As these three examples illustrate, there is no standard way for handling unexpected declines in revenue prior to the completion of the Conference Committee budget. State finance law directs the administration to amend budget recommendations in light of new revenue information, but there is no requirement that budget conferees take this information into account or agree to the same revenue assumptions. It is important that the administration and House and Senate budget-makers work together to agree to a new revenue estimate to ensure that the FY2017 final budget and the Governor's vetoes use the same set of fiscal assumptions.

Once a new FY 2017 revenue estimate is established, conferees can assess the level of spending reductions that will be necessary to put forward a balanced FY 2017 budget. It is possible that the budget conference will identify non-tax revenue offsets to the overall tax revenue reduction thereby reducing the level of cuts necessary.

However, it's vital that they avoid the use of additional one-time budget solutions to address the reduction in projected FY 2017 tax revenues.

MTF Recommendation

While final FY 2016 tax revenues will not be known until early July, budget-makers must make adjustments to the FY 2017 budget now to reflect the changed tax revenue picture. The Foundation suggests utilizing the more conservative revenue growth rate of 3.80%, the number we recommended at the original consensus revenue hearing. This approach would reduce FY2017 revenues by $521 million from the original Consensus estimate.

Table 6. MTF FY 2017 Tax Revenue Recommendation Compared to Consensus Revenue

	Original Consensus Agreement	MTF Recommendation	Difference
FY 2016 tax revenues	$25,751	$25,375	-$376
FY 2017 tax revenue growth	4.31%	3.80%	-0.51%
FY 2017 tax revenue	$26,860	$26,339	-$521
Assumed Capital Gains Revenues	*$1,484*	*$1,100*	*-$384*

The MTF's recommended revision falls within the $400 million to $750 million shortfall range identified by the Administration in a recent update to the state's Information Statement and would put the state on firmer fiscal footing to start FY 2017. [2] It also would provide policymakers with time to review early year collections to determine if further action is necessary.

Solving this budget gap will pose a major challenge, but not an insurmountable one. Conferees must first consider the implications of a tax revenue downgrade on particular areas of the budget and then look to spending cuts and other sustainable solutions to close the gap.

Impact of Tax Revenue Revision on the Budget

A revised tax agreement impacts assumptions regarding capital gains, the income tax rate and pre-budget spending. The Foundation believes that the Consensus Revenue assumption of $1.484 billion in FY2017 capital gains tax revenues is greatly inflated and should be lowered as part of any revision. Such a downgrade will likely reduce the statutory deposit of excess capital gains revenue to the Stabilization Fund, but will also lessen the impact of the tax revision on the operating budget.

The FY 2017 consensus revenue agreement assumed that revenue growth benchmarks would trigger a reduction in the state's income tax from 5.1% to 5.05% on January 1st. However, that reduction is much less certain now. If June tax revenues do not exceed benchmark, the income tax reduction will almost certainly not occur thereby

[2] The FY 2017 shortfall in this estimate differs from that of Table 5 because this estimate incorporates MTF's projection of FY 2016 final revenues. The FY 2016 revenue used for Table 5 assumes the current $310 million shortfall remains unchanged at the end of the year.

providing an additional $80 million in FY 2017 tax revenues. In addition, a revised tax revenue estimate will reduce the required sales tax transfers to the MBTA and the state's School Building Assistance program.

Spending Cuts and Other Solutions

Once all tax revenue implications are agreed upon, spending levels in the FY 2017 budget must be lowered. One potential method is for Conferees to use the lower of the House and Senate appropriations for each line item to establish an initial bottom line spending cap. This approach could generate $200 million in savings. Conferees can also look to current caseload and staffing information provided by the administration to identify some potential spending reductions that do not entail cuts to programs.

Balancing the FY 2017 budget without increasing the use of one-time solutions in the budget is vital. Relying on short-term fixes to close budget holes only increases future deficits while diminishing the state's ability to respond to future fiscal challenges. The balance of the State's Stabilization Fund is $400 million smaller than it was fifteen years ago, while the size of the budget has doubled. Further depleting these reserves during a period of economic recovery is inconsistent with responsible fiscal management.