



Budget Briefing

January 25, 2016

Massachusetts Budget Woes Continue

In anticipation of the release of the Governor's budget later this week, this briefing provides a status report on fiscal year 2016 and an overview of what we anticipate for fiscal year 2017.

Midway through the 2016 fiscal year, the state faced a \$565 million budget gap, sending a clear signal that fiscal problems persist despite excellent job growth and a recovering economy. While actions have recently been taken to close this FY 2016 budget gap, major challenges remain. This bulletin will outline those challenges for both FY16 and FY17. Most noteworthy for 2017 is the \$700 million to \$900 million structural shortfall that lawmakers will have to bridge according to the Foundation's analysis. It is important to note that they will have to do this without many of the one-time sources that have been available in the past.

The state appears to have entered a new fiscal pattern since the 2008 fiscal crisis marked by slow to modest revenue growth that has not kept pace with increased state spending. In the past 12 months alone, lawmakers confronted a \$1 billion budget shortfall mid-way through FY 2015 and a \$1.8 billion structural gap in the FY 2016 budget buildup. The continued reliance on one-time funds to balance these gaps has perpetuated state budget problems.

FY 2016 – Not Out of the Woods

At the start of the fiscal year, the Governor vetoed \$162.8 million of spending in the original FY 2016 budget to bring budgeted spending in line with resources projected at that time. The Legislature overrode \$92 million of the Governor's vetoes, with the net effect being a \$71 million reduction in spending.

By mid-year, \$565 million in budget exposures had been identified. Once vetoes were accounted for, this created a \$494 million budget gap. The gap is comprised of several components including higher than budgeted spending needs (also referred to as identified deficiencies) on compensation for public counsel services, emergency shelters, and some collective bargaining agreements; lower

than expected savings from cost-cutting initiatives such as the Early Retirement Incentive Program¹; and a \$205 million shortfall in non-tax revenues (Table 1).

Table 1 – Identified FY 2016 Budget Exposures

Identified deficiencies	-174
ERIP savings shortfall	-136
Sales tax holiday	-26
Non-tax revenue downgrade	-205
Other	-24
Total	-565

Earlier this month, the Baker administration took actions to partially address the gap by making \$49 million in 9C cuts and adjusting upward by \$55 million several non-tax revenue projections. In addition, the administration expects \$175 million in reversions (savings due to some budget accounts spending less than their total appropriation). These solutions total \$350 million leaving a \$215 million gap in FY 2016.

Also in January, the Executive Office of Administration and Finance (ANF) and the House and Senate Committees on Ways and Means released the consensus revenue benchmark for FY 2017. As part of this process, the expected FY 2016 tax revenues were increased by \$140 million to \$25.75 billion. With these additional tax revenues, the estimated FY 2016 budget gap stands at \$75 million (Table 2).

Table 2 – FY 2016 Solutions

Initial Budget Gap	-565
Solutions	
Vetoes (net of overrides)	71
Post-veto gap	-494
9Cs (net)	49
New non-tax revenues	55
Reversions	175
Tax revenue upgrade	140
Solution total	419
<i>Gap Remaining = \$75 million</i>	

While the current FY 2016 gap is manageable, it's important to consider what factors caused the FY 2016 gap and what implications they will have on future budgets.

¹ Table 1 presents the \$136 million reduction in gross payroll savings associated with ERIP. This reduction in gross savings, is partially offset by a proportional reduction in additional pension and other costs which are reflected in the veto and 9C solutions in Table 2.

A more precise revenue projection is one such factor. While it would seem that revenues tracking closely to projections is a good thing, this lack of revenue growth over initial estimates is problematic because it provides no financial cushion. Over the course of a fiscal year, unexpected fiscal exposures are unavoidable. Historically, above-benchmark revenue has been a key factor in enabling the state to meet these additional spending requirements. As FY 2015 and FY 2016 have proven, lack of additional revenue growth during the year leaves few options to confront these challenges aside from cuts and use of funds earmarked for reserves.

Per the current estimate, total revenues in FY 2016 will be slightly less than budgeted revenues included in the original FY 2016 budget. As shown in Table 3, even with an increase of \$140 million in tax revenues from the mid-year adjustment, overall revenues are expected to fall by \$9 million due to the steep decline in non-tax revenues.

Table 3 – FY 2016 Net Budgeted Revenues

Non-tax revenue shortfall	-205
Newly discovered non-tax revenues	56
Revised benchmark in tax revenues	140
Net gain / (loss) in revenues	(9)

In FY15, a remarkably similar phenomenon occurred. Although tax revenues in FY 2015 were \$391 million above benchmark, non-tax revenues fell \$338 million below the consensus agreement and one-time tax settlements and judgements were \$14 million less than expected. In all, FY 2015 budget revenues ended the year a mere \$39 million above the original estimate.

FY 2017 – Large Structural Budget Gaps Persist

These budgetary challenges persist in FY 2017. Per the FY 2017 consensus figures, tax revenues are projected to amount to \$26.86 billion, \$1.11 billion more than the revised FY 2016 estimate of \$25.75 billion. However, even with that sizeable increase in tax revenues, the Foundation estimates that lawmakers will have to close a \$700 million to \$900 million budget gap in FY 2017 due to increases in non-discretionary spending obligations. It is important to note that this gap is based on increased non-discretionary obligations only and does not include funding increases for the numerous discretionary accounts in the budget which account for almost half of all annual spending.

MTF's deficit projection is based on the following factors:

Above Benchmark Capital Gains Revenue

The FY 2017 benchmark includes capital gains tax revenues of \$1.484 billion, \$356 million of which is not available for use in the operating budget because of the statutory requirement that income above a certain threshold (\$1.128 billion in FY2017) be deposited into the Stabilization Fund (95%) and the State Retiree Benefit Trust Fund (5%) (Table 4).²

Table 4 – Net Tax Revenues for FY 2017

Revenues	
FY 17 increase in tax revenues	1,109
FY 17 capital gains tax revenues	1,484
Estimated capital gains threshold	1,128
Capital gains tax revenues > threshold	-356
FY 17 net increase in tax revenues	753

FY 2016 One-Time Solutions

Also complicating the FY 2017 revenue situation is the fact that the FY 2016 budget relies on \$629 million of one-time solutions. They include \$300 million from capital gains tax revenues above the statutory threshold, an estimated \$100 million from a tax amnesty program, and \$116 million in MassHealth expenses shifted to the next fiscal year.³ Lawmakers will need to find replacements for these solutions in FY17. Using tax revenues to maintain these programs and services in FY 2017 leaves only \$124 million in available new revenues.

Pre-Budget Transfers

Before constructing the FY 2017 budget, lawmakers must set aside \$276 million in year-over-year increases for the following pre-budget transfers: the state's pension contribution, aid to the MBTA and funding for the Massachusetts School Building Authority (MSBA) (Table 5).

² See [FY 2017 Tax Revenue Agreement Reached](#), Massachusetts Taxpayers Foundation, January 14, 2016.

³ *Commonwealth Information Statement*, December 2015, p. A-66.

Table 5 – FY 2017 Net Increase in Pre-Budget Transfers

Net Increase in Pre-Budget Transfers	
Pensions	-197
MBTA	-16
MSBA	-63
Total	-276

Non-Discretionary Spending Increases

Lawmakers will also have to identify funding for the increased costs of contractually-obligated or entitlement programs, including MassHealth, the State Retirement Benefits Trust Fund, the Group Insurance Commission, Chapter 70 education aid, and debt service costs. The assumptions used to determine these estimate are provided below and summarized in Table 6.

For MassHealth, a \$250 million to \$300 million net increase in costs (after federal reimbursements) would represent a 3.3 percent to 4.0 percent increase in Medicaid spending, far below the average of the last few years. Similarly, for the Group Insurance Commission (GIC), which provides health insurance coverage to the state’s employees, retirees and certain municipal workers, the Foundation used the range of \$60 million to \$120 million, a 3.7 percent to 7.4 percent increase over FY 2016⁴.

In FY 2017, the state is statutorily required to transfer 50 percent (approximately \$125 million) of the annual tobacco settlement revenues to the State Retirement Benefits Trust Fund (SRBTF) to reserve for the states unfunded OPEB obligations. In the 2016 budget, one-time funds were used to make a similar contribution.

Table 6 – FY 2017 Spending Exposures

FY 2017 Spending Exposures	Range	
MassHealth (net)	-250	-300
State Retirement Benefits Trust Fund (OPEB)	-125	-125
Group Insurance Commission	-60	-120
Debt Service	-50	-100
Chapter 70 education aid	-75	-100
Total	-560	-745

Debt service costs have grown by an average of \$70 million each year over the past four years and by an average of \$115 million over the past five years. Similarly, Chapter 70 education aid has increased by an average of \$100 million for the past five years.

⁴ Between FY 2012 and FY 2015, median GIC cost growth was 5.3%

In summary, these five spending areas are expected to grow between \$550 million and \$750 million in FY 2017 (Table 6).

FY 2017 Budget Gap Summary

After accounting for the factors listed above, the Commonwealth is facing a budget gap of between \$700 and \$900 million in FY 2017 (Table 7). It’s important to reiterate that this gap does not account for any increases in discretionary spending which equals almost half of the budget.

Table 7 – FY 2017 Structural Shortfall of \$700 Million to \$900 million

New Tax Revenue	1,109
Cap Gains unavailable	-356
Pre-budget transfers	-276
FY 2016 One-timers	-629
Non-discretionary increases	
<i>Low estimate</i>	-560
<i>High estimate</i>	-745
Budget gap (low)	-712
Budget gap (high)	-897

Although the FY 2017 structural shortfall is roughly half the size of FY 2016, the tools for addressing the gap are also more limited. Many of the solutions that lawmakers used last year – an early retirement program, a tax amnesty program, shifting MassHealth expenses to the next fiscal year, and suspension of capital gains tax revenue transfers to the Stabilization Fund in FY 2015 and FY 2016 – are either unavailable this year or come with substantial fiscal risk.

Since the end of the recession, one-time resources – including \$2.2 billion in funds withdrawn or diverted from the state Stabilization Fund – have been a common tool to address budget challenges. While this course of action may be preferable to cutting programs, these short term remedies have consequences in terms of ongoing structural deficits and insufficient reserves. To address this, the Foundation strongly urges that in FY 2017 the state prioritize a structurally balanced budget based on sustainable revenues while committing to re-build the rainy day fund balance to 10 percent of state tax revenues as soon as feasible.⁵

⁵ [*Stabilization Fund Dip During Recovery Puts State at Risk*](#), Massachusetts Taxpayers Foundation, November 10, 2015.