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FY 2026 Fiscal Update & Opportunities for Action

Last week, MTF published a fiscal update brief reviewing Fiscal Year (FY) 2025 tax revenue collections, the current budget balance estimate, and the Healey-Driscoll administration's closeout supplemental budget. It included MTF's recommendation for swift action by the Legislature on the final spending bill of the year and it encouraged policymakers to set aside surplus revenues now to prepare for federal action or economic slowdowns in the future.

In this follow-up brief, MTF expands on that analysis to offer an update on FY 2026. In addition to assessing state tax revenue collections trends through September, it also summarizes a range of revenue and spending exposures that policymakers must monitor and adapt to in the months ahead. When that information is paired with reasonable assumptions, it is clear that the Commonwealth should prepare for an FY 2026 and FY 2027 that will be marked by uncertainty and challenging financial decisions. Fortunately, there are several opportunities for policymakers to take action now and put the state in a stronger position to react, respond, and recover from adverse federal action or economic trends.

FY 2026 Tax Revenue Collections to Date

State tax revenue collections through September total $10.082 billion; a $309 million (3.2 percent) increase over collections through the same period in FY 2025, but $64 million (-0.6 percent) below the year-to-date revenue benchmark. Revenues have exceeded prior-year collections in each of the first three months of the fiscal year. However, revenues in September, the first month measured against benchmarks, fell short of budget expectations.

FY 2026 State Tax Collections v. FY 2025 and Benchmark

	FY 2025 YTD	FY 2026 YTD	FY 2025 v. FY 2026	FY 2026 Benchmark	FY 2026 YTD v. BM	Growth to Date v. BM
Withholding	$4,328	$4,573	$245	$4,652	-$79	-1.7%
Non-Withholding	**$1,307**	**$1,465**	**$158**	**$1,341**	**$124**	**9.3%**
Sales	$2,397	$2,439	$42	$2,407	$32	1.3%
Corp./Business	$1,081	$864	-$217	$1,055	-$191	-18.1%
Other	$661	$741	$80	$692	$49	7.1%
Total	**$9,774**	**$10,082**	**$309**	**$10,146**	**-$64**	**-0.6%**

$ in millions

Revenue collection trends reflect steady growth compared to FY 2025, but uneven results across major tax categories. Compared to benchmark, income tax collections are up 0.8 percent; however, that growth is buoyed by non-withheld income tax collections, which are 9.3 percent ahead of benchmark. This is driven by capital gains and surtax revenues, two volatile revenue sources that fluctuate with financial market trends. Withholding collections fell below benchmark, reflecting slower growth in wage income and current labor market trends.

Sales and use taxes are 1.3 percent ahead of benchmark, reflecting ongoing consumer spending and normal timing factors. “All other” taxes rose 7.1 percent above benchmark, primarily due to higher estate tax receipts, which tend to vary significantly from month to month.

Corporate and business tax collections are falling below both benchmark and prior year levels due to lower estimated and return payments, partially offset by reduced refunds. The decline in corporate and business tax collections warrants monitoring as continued underperformance in upcoming months could indicate pressure on overall revenue growth.

Overall, FY 2026 revenues remain modestly above prior-year levels but slightly below benchmark, underscoring a stable yet uncertain fiscal position.

State Fiscal Exposures

In addition to continued monitoring of FY 2026 revenue collection trends, policymakers must also contend with a range of revenue and spending exposures created by both external and internal factors; namely, federal policy actions and decisions made in the FY 2026 General Appropriations Act (GAA).

The downside risks related to state revenues are more challenging to quantify, particularly given the uncertainties surrounding national and state-level economic trends, as well as the unpredictability of taxpayer behavior. These factors should give budget officials pause and suggest deferring action related to the state’s compliance with the federal tax code or revising revenue benchmarks until later in the fiscal year.

However, uncertainty on the revenue-side of the ledger should not preclude action on the spending side; and in fact, there are several clear steps that policymakers can take now to manage spending growth in FY 2026 and prepare for a more balanced FY 2027.

State Revenue Exposures

<u>Non-Surtax Revenues in FY 2026</u>

Based on actual tax revenue trends in FY 2025 and several national and state-level economic indicators, policymakers should be prepared to adjust revenues downward in FY 2026. However, if and when such a downgrade would be appropriate remains an open question.

In FY 2025, withheld income taxes exceeded benchmark by 1.8 percent, and sales and corporate tax collections both missed benchmark by 2.2 percent and 7.1 percent respectively.

Layer on top of those trends that Moody's chief economist has identified Massachusetts as one of the state's at high-risk of entering a recession[1], Price Waterhouse Coopers estimates that consumer spending will be down by 5.3 percent compared to 2024[2], and state private employment growth in Massachusetts has been stagnant for the last two years[3], and it is reasonable to prepare for a scenario where non-surtax revenues in FY 2026 do not meet the current benchmark of $41.214 billion. At a recent economic forum convened by administration, House, and Senate budget makers, MTF discussed how a set of reasonable economic assumptions could translate to a revenue shortfall of at least $1 billion.

On October 15th, the statutory deadline for administration budget officials to downgrade revenue expectations based on collection trends through September, the Executive Office for Administration and Finance decided against an adjustment to the revenue benchmark for FY 2026; but that decision does not preclude a downgrade later in the fiscal year.

Federal Tax Policy Changes

The federal reconciliation bill, known as the "One Big Beautiful Bill Act" or "OBBBA," included more than 100 changes to the federal Internal Revenue Code, approximately 30 of which are anticipated to impact Massachusetts tax collections.

In early October, the Department of Revenue (DOR) released a memo outlining six of the largest tax policy provisions in OBBBA and estimated that they could decrease Massachusetts tax revenues in FY 2026 by as much as $650 million. While these projections are likely to fluctuate, two of the provisions related to research and experimental expenditures and a change to the State and Local Tax (SALT) deduction cap account for $510 million (77 percent) of the estimated FY 2026 impact.

Summary of OBBBA Tax Policy Provisions

	FY 2026	FY 2027	FY 2028	FY 2029	FY 2030	FY 2031	FY 2032	FY 2033	FY 2034
R&E Expensing	($288)	($87)	($56)	($33)	($16)	($9)	($8)	($8)	($9)
SALT Cap Change	($222)	($48)	($48)	($48)	($48)	($48)	($48)	($48)	($48)
Other	($154)	($147)	($147)	($127)	($82)	$142	$8	$37	$38
Total	($664)	($282)	($251)	($208)	($146)	$85	($48)	($19)	($19)

$ in millions

To reduce the revenue impacts of these policy changes, state budget writers may consider changes to Massachusetts' conformity with the federal code. However, in evaluating the impact and outcome of decoupling from certain provisions, MTF urges policymakers to exercise caution.

[1] https://economictimes.indiatimes.com/news/international/us/recession-fear-is-back-or-u-s-economy-expert-sounds-alarming-warning/articleshow/123679455.cms?from=mdr
[2] https://www.reuters.com/business/retail-consumer/us-holiday-spending-set-steepest-drop-since-pandemic-pwc-survey-shows-2025-09-03/
[3] Massachusetts Taxpayers Foundation, *Massachusetts Competitive Index 2025*. https://www.masstaxpayers.org/massachusetts-competitiveness-index-2025

Making piecemeal adjustments to the Commonwealth's conformity with the federal tax code under an expedited timeline may lead to adverse policy outcomes that are inconsistent with the state's broader federal response strategy. Furthermore, policy decisions that have a direct impact on state tax revenue collections should be made in conjunction with the FY 2027 budget development process.

By allowing for additional time to fully understand the implications of federal tax policy changes on taxpayer behavior and state resources, policymakers can develop a more thoughtful approach that alleviates budget pressures in the short-term and improves budget resiliency in the long-term.

State Budget Exposures

<u>Underfunded Accounts</u>

The FY 2026 budget enacted by the Legislature included $61.03 billion in line-item spending, a total that is nearly $1 billion less than the budget originally filed by Governor Healey, $443.4 million less than the House budget, and $395.1 million less than the Senate. While the decision to reduce spending was appropriate given the economic uncertainties faced by the state, it is important to note that the FY 2026 GAA underfunds programs that have historically required supplemental appropriations throughout the year.

An initial analysis by MTF identified up to $950 million in spending reductions compared to the administration's original recommendations for programs related to MassHealth, transportation, caseload, Emergency Assistance (EA) shelter, and administrative costs.

MTF Estimated Spending Exposures in the FY 2026 Conference Budget

Category	FY 2026 Governor	FY 2026 Conference	Conference v. Governor
MassHealth	$9,544.7	$9,048.5	-$496.2
Transportation	$1,304.6	$1,043.1	-$261.5
Administrative	$2,004.1	$1,923.1	-$81.0
Caseload	$575.0	$508.1	-$66.9
Emergency Assistance Shelter	$325.3	$276.4	-$48.9
Est. Spending Deficiencies	**$13,753.7**	**$12,799.2**	**-$954.5**

$ in millions

It's also important to note that spending-side exposures created by underfunding are likely to fluctuate throughout the fiscal year, and in certain cases may exceed initial estimates significantly. For example, if recent MassHealth caseload and acuity trends continue, MTF's initial $500 million underfunding estimate could increase drastically. In the FY 2025 closeout supplemental budget, MassHealth required an additional $2 billion (gross) in state funding to meet demand.

<u>One-Time Revenues</u>

The FY 2026 budget relies on $1.5 billion in one-time revenue solutions to support spending, including $566 million in above-threshold capital gains, $350 million in COVID-era grant recoupments, and $315 million in trust fund resources. One-time resources are not ongoing sources of revenue, and so provide a rough estimate of the structural deficit of the budget. Importantly, this level of one-timers is more than 50 percent higher than the FY 2025 GAA, and the level of one-timers in FY 2025 was higher than the amount used in FY 2024. This increasing reliance on one-time resources must be controlled in future fiscal years.

Surtax Spending in FY 2026

In the FY 2026 GAA, the House and Senate agreed to use the entire surtax revenue assumption of $2.4 billion to support operating spending – an increase of $450 million over the original surtax spending cap of $1.95 billion. This decision marked the first time that budget writers agreed to increase the surtax spending cap during the Conference Committee process, and there are several reasons why this decision creates budget exposures.

First, according to the process established in FY 2024 to collect and spend surtax revenue, the surtax spending cap in the operating budget is purposefully set at a lower level than actual revenue projections to protect against volatility and ensure that resources are available to build reserve balances and support capital spending priorities.

Second, while FY 2025 surtax revenues are projected to reach $3 billion, there is no guarantee that the surtax will meet that level in FY 2026. In fact, because the majority of surtax revenues are collected through non-withheld income taxes which are closely tied to stock market performance, they may experience more pronounced declines if the economy falters.

Key Decision Points & Opportunities for Policymakers

In assessing the range of financial risks and exposures facing the state in FY 2026, there are clearly varying degrees of certainty related to what is known and how to respond.

Summary of Revenue and State Budget Exposures

Revenue Exposures	State Budget Exposures
• FY 2026 State Tax Revenue Trends • Federal Tax Policy Changes • Broader Economic Trends	• FY 2026 GAA Underfunding • One-Time Revenues • Surtax Revenue Volatility

On the revenue side, economic experts and state budget officials have only a moderate degree of insight into state tax revenue trends and the impacts of federal tax policy changes. There also remains a high-degree of uncertainty related to broader economic trends and taxpayer behavior, which makes quantifying these exposures difficult.

Related to the state budget, there are clear challenges related to underfunded accounts, an overreliance on one-time revenues, and the volatility of surtax revenues.

But despite this ranging scale of certainty, MTF asserts that there are opportunities for policymakers to take timely action and put the state in a stronger position to adapt to funding and policy challenges.

Opportunities for Action

- **FY 2025 Closeout Supplemental Budget** – Timely action on the FY 2025 closeout supplemental budget will allow the Healey-Driscoll administration and Legislature to focus on managing spending and revenue assumptions in FY 2026, and prepare for the FY 2027 budget development process. Additionally, keeping spending within the closeout supplemental budget to no more than the $2.4 billion proposed by the administration will ensure that there are sufficient resources available to set aside in preparation for declining revenues or federal funding losses. On October 15th, the House adopted a closeout supplemental budget that included $2.25 billion in direct spending, approximately $200 million less than the Governor's original proposal. The Senate has not yet acted on the spending bill.

- **FY 2026 Spending Vetoes & 9C Cuts** – Opportunities to manage spending growth in FY 2026 through spending vetoes or mid-year spending cuts (known as "9C cuts") should be maximized. Governor Healey vetoed $130.2 million in spending from the FY 2026 budget, and those cuts primarily targeted accounts that exceeded the Governor's original recommendation, have access to alternative resources, or are deemed unaffordable in the current fiscal climate. The Legislature should maintain these vetoes to the greatest extent possible. Furthermore, with the expectation that non-surtax revenues could fall significantly below benchmark, mid-year budget cuts should be considered. In FY 2024, when the administration downgraded the non-surtax revenue benchmark by $1 billion, a portion of the projected budget shortfall was solved using $375 million in net 9C cuts.

- **State Fiscal Response Strategies** – On the same day that Governor Healey signed the FY 2026 GAA and sent back $130.2 million in spending vetoes, she also filed a supplemental budget proposing several fiscal management tools to help the state address revenue volatility or unmet spending needs in the months ahead. This supplemental spending bill included a range of general and agency-specific budget management proposals, including expanded 9C authority. While the Legislature may wish to define the circumstances under which certain budget management tools can be used, they must also recognize that there are benefits to allowing the administration to act quickly and decisively to balance the budget and protect core services.

- **FY 2027 Budget Development Process** – At the same time that policymakers are actively monitoring FY 2026 revenues and spending, they will also begin building the FY 2027 state budget. The first steps in that process will be the Consensus Revenue hearing and agreement, which will determine the level of tax revenue growth that state budget writers can expect in the upcoming fiscal year. In preparing for those conversations, the administration and Legislature should note the impacts of non-withheld and surtax revenues on FY 2026 revenue collections to date. Nearly all of the revenue growth compared to the prior year and benchmark through September has been driven by non-withheld income, and a significant portion of those revenues are not available to support general budgeted spending. After assessing tax revenue growth trends absent the surtax and capital gains, and accounting for planned increases to several pre-budget transfers, it is possible that state budget writers will need to build an FY 2027 budget using a tax revenue base that is smaller compared to prior years.