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Bulletin

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Budget Conference Committee: Fiscal Perils Ahead

The House-Senate conference committee deliberating the fiscal 2009 state budget is facing a potential billion-dollar shortfall which threatens to deplete almost half of the Commonwealth's reserves, leaving the state in a precarious position should an economic downturn hit.

Because tax collections have been stronger than expected in recent months, there is no widespread recognition in the State House of the perils facing state finances. However, despite this recent revenue performance, fiscal 2008 will be the first year since the last fiscal downturn that the budget will be balanced using reserves. Fiscal 2009 will be much more difficult given the combination of a weak national economy and the broad decline in the stock market.

Both the House and Senate have shown reasonable restraint in spending growth in their respective 2009 budgets – $31.769 billion or 5.1 percent growth for the House, and $31.637 billion or a 4.7 percent increase for the Senate (see Table 1).

Table 1: Proposed Fiscal 2009 Budget
($ millions)

	Total	Change from 2008	
	Spending	Amount	Percent
House	31,769	1,550	5.1%
Senate	31,637	1,418	4.7%

Nevertheless, the combination of a planned draw on reserves, over-estimates of revenues derived from corporate and other tax increases, and the underfunding of several major programs produce structural deficits in the billion-dollar range in both the House and Senate budgets (see Table 2). The slightly smaller Senate deficit stems from two factors: the Senate spends roughly $130 million less than the House; and the Senate's version of the corporate tax increase generates approximately $80 million more than the House version due to rate reductions occurring a year later.

Table 2: Structural Deficit in Fiscal 2009 House and Senate Budgets
($ millions)

	House	Senate
Underfunding	**$500**	**$500**
Commonwealth Care	$100	$100
MassHealth	$200	$200
Collective Bargaining	$150	$150
Snow and Ice Removal	$50	$50
Revenue Shortfalls	**$200**	**$200**
Corporate Tax Increases	$100	$100
DOR Revenue Enhancements	$100	$100
Reserves	**$503**	**$301**
Stabilization Fund Withdrawal	$412	$210
Stabilization Fund Interest	$91	$91
Total	**$1,203**	**$1,001**

Because of these two factors, the Senate's planned draw on reserves is less than the House's – $301 million compared to $503 million. But that is only the tip of the iceberg for both budgets, which each count on revenue from a series of tax increases that is not likely to be fully realized, and also similarly underfund a series of obligations, principally health care and collective bargaining. In the end, the draw on reserves will be much larger.

Both budgets rely on three categories of tax increases – a major change in corporate taxation, a series of tax changes euphemistically called "revenue enhancements," and a $1 per pack increase in the cigarette tax. A conference committee is working on the corporate tax bill which, based on Department of Revenue estimates, purports to raise $217 million in the House version and $297 million in the Senate version for fiscal 2009.[1] The specificity of the numbers creates the misleading, and unfortunate, impression that DOR has a good handle on how much additional tax revenue combined reporting will produce. That is impossible given the complex nature of combined reporting and the enormity of the changes taking place. Ironically, DOR's push for virtually unfettered discretion in implementing combined reporting would, if successful, produce unnecessary litigation and actually <u>lessen</u> the amount of tax revenue collected in fiscal 2009 and perhaps beyond. DOR's contention that the clarity of the House language would generate less revenue ignores the fact that it is not a static world and that predictability will produce more revenue not less. MTF estimates that DOR's projections for combined reporting will fall at least $100 million short in fiscal 2009.

The Governor's budget included a dozen "revenue enhancements" estimated by DOR to realize an additional $166 million in tax collections. The largest revenue producers include the hiring of 87 new DOR auditors (producing $60.3 million), preventing employers from misclassifying their workers as contractors instead of full-time employees ($30 million), and increasing penalties for late returns ($12 million). With one small exception, all of the 12 proposals are included in both the House and Senate budgets.[2] While these changes will generate some additional revenue, the Foundation estimates that DOR is not likely to realize more than half of the $166 million.

Both the House and Senate adopted a $1 per pack tax increase on cigarettes (from $1.51 to $2.51), which would take effect July 1 and raise an estimated $175 million in fiscal 2009. The $175 million anticipates a 15 percent drop in consumption, which is comparable to the decline that took place in 2003 when the tax was raised from $0.76 to $1.51 per pack.

In addition to overstated revenue estimates, both budgets underfund key accounts by a total of several hundred million dollars. Two health care programs account for an estimated $300 million, $200 million for MassHealth and $100 million for Commonwealth Care. The positive news is that enrollment in Commonwealth Care, the state's subsidized health insurance program, appears to be growing less than anticipated. As a result, the shortfall in the fiscal 2009 budget may be no more than $100 million compared to the most recent official estimate of $200 million.

The larger issue facing state fiscal leaders is the outcome of a new federal waiver for the MassHealth program beginning July 1. The state is in intensive discussions with the federal government to determine the extent of federal reimbursement for the state's health reform program. Any shortfall in what the state is seeking would produce an even larger hole in the 2009 budget.

Tax Revenues

The billion-dollar structural deficit may turn out to be a best case scenario when taking into account the larger revenue risks in the 2009 budget.

[1] The Senate version expects to raise $80 million more than the House because the Senate's tax rate reductions do not take effect until 2010.

[2] The Senate budget does not include the elimination of the aircraft sales tax exemption, estimated by DOR to raise $9 million.

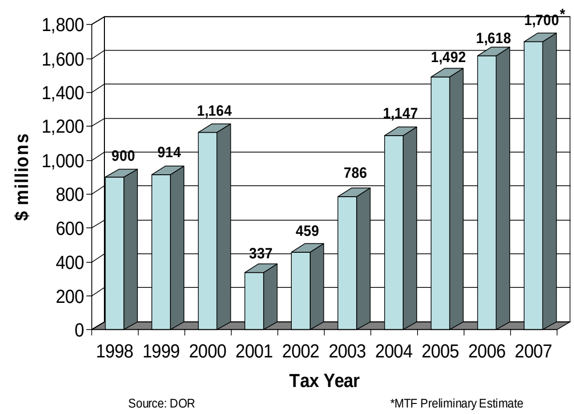
While tax revenues for the 2008 fiscal year have been relatively strong – $632 million over the administration's October forecast of $20.225 billion – this performance is not likely to continue in fiscal 2009.[3] The 2009 budget is based on a consensus tax revenue forecast of $20.987 billion which, when it was agreed upon in December, represented a 3.8 percent increase over estimated fiscal 2008 revenues. Because 2008 revenues have come in better than expected, revenues for 2009 would need to grow by only 1.7 percent to meet the consensus forecast – assuming that 2008 tax revenues will exceed the forecast by $600 million as they have through May and subtracting $218 million for the three one-time payments from financial institutions in 2008 (see Table 3).

Table 3: Fiscal 2009 Revenue Growth
($ millions)

	FY08	FY09	Growth
October Forecast	20,225	20,987	3.8%
Revenue in Excess of October Forecast through May	632		
Total Tax Revenue	20,857	20,987	0.6%
Three One-time Payments from Financial Institutions	(218)		
Total Baseline Revenue	20,639	20,987	1.7%

This 1.7 percent forecast would in normal times be exceedingly conservative. However, these are anything but normal times. The U.S. is facing an unusually wide array of economic problems which will impact Massachusetts to some degree. Of even greater concern, the broad decline in the stock market is likely to have a significant impact on capital gains taxes in fiscal 2009. While no one anticipates anything close to the 70 percent drop in capital gains taxes which hit the state in 2001, a decline of 25 percent would mean a loss of at least $400 million in capital gains tax collections next fiscal year (see Figure 1).

Figure 1: Capital Gains Tax Collections



That reduction combined with a national recession could well produce an overall drop in tax revenues in 2009, exacerbating the large structural deficit and requiring an even bigger draw on reserves. Unfortunately, we are not likely to know the size of the revenue problem until late in 2008 which will make any budget trimming all the more difficult six months into the fiscal year.

As mentioned above, the state will need to draw on reserves to balance the 2008 budget.[4] The initial budget relied on a total of $509 million in reserves, including $240 million from the stabilization fund. Depending on June revenues and several other variables, the state may not need to use the full $509 million in closing the books on 2008. Nevertheless, there will be some draw on reserves, which the April 16 Information Statement estimates at $215 million from the stabilization fund, leaving a balance of $2.12 billion at the end of 2008 (see Table 4).

[3] The state's positive revenue picture in fiscal 2008 is due largely to strong performance of financial markets in the first half of calendar 2007, reflecting past economic activity rather than future economic growth. In addition, $218 million came from three one-time payments from financial institutions that will not re-occur in fiscal 2009.

[4] See MTF's May 13, 2008 *Bulletin*, "State Faces Large Deficits in Both Fiscal 2008 and 2009: Threatens Rapid Depletion of State's Reserves."

Based on the Foundation's estimates, the House and Senate budgets would require a $1.2 billion and $1.0 billion draw, respectively, on reserves in 2009. The House draw would leave a balance of $1 billion in the stabilization fund at the end of 2009; the Senate draw would leave a balance of $1.2 billion.

Table 4: Stabilization Fund Balance
($ millions)

FY07 Ending Balance	$2,335
FY08 Projected Balance	$2,120
FY09 Interest Earnings	$90
FY09 Deficit	($1,000)
FY09 Projected Balance	**$1,210**

Given the uncertainties of the national economy and the stock market, as well as the question of the federal Medicaid waiver, the state could face much greater risks in the 2009 budget, perhaps requiring a $1.5 billion draw on reserves at the level of spending in the House and Senate budgets. The day of reckoning may be approaching.

Costly Benefit Expansion

In a stroke of stunning fiscal irresponsibility, both the House and Senate budgets include outside sections which would increase the base for cost-of-living adjustments (COLAs) for state retirees by 33 percent, from $12,000 to $16,000. The Senate goes further and extends the expanded benefit to municipal retirees as well.

While these provisions would cost billions of dollars, strikingly, there has been no analysis of their costs and no means to pay for them – other than simply placing the obligation on future taxpayers by extending the period for eliminating the unfunded pension liability.

The state and cities and towns are all struggling to deal with a relentless fiscal squeeze in which costs are growing faster than revenues year by year. In addition, both the state and municipalities are already facing a time bomb around the large unfunded liability for retiree health benefits.

The credit rating agencies will carefully scrutinize this costly expansion of benefits because it has no funding plan other than to extend payments by three years, at a time that the state is facing at least a billion-dollar structural deficit.

Nor is the public likely to respond charitably at the ballot box in November when voting on the proposal to repeal the income tax, while most of their employers are cutting back on retirement benefits, and the costs of energy, food and other essentials are skyrocketing.

Rather than approving the COLA proposal, the conference committee should propose an independent study of the entire pension system.

BUDGET SUMMARY [1]

($ Millions)	FY08 Spending	FY09 Governor	FY09 House	FY09 Senate	Senate vs. 2008 Diff.	Senate vs. 2008 % Chg.	House vs. 2008 Diff.	House vs. 2008 % Chg.
Investment in Children	**$6,856.6**	**$7,232.8**	**$7,231.8**	**$7,229.4**	**$372.8**	**5.4%**	**$375.2**	**5.5%**
Education Local Aid	4,290.7	4,563.9	4,539.6	4,540.9	250.2	5.8%	248.9	5.8%
Higher Education	1,048.7	1,083.9	1,098.3	1,100.7	52.0	5.0%	49.6	4.7%
Services to Children	805.8	838.0	841.2	835.9	30.1	3.7%	35.4	4.4%
Youth Services	161.9	163.0	163.0	163.1	1.2	0.7%	1.1	0.7%
Child Care Services	549.5	584.0	589.7	588.8	39.3	7.2%	40.2	7.3%
Criminal Justice and Law Enforcement	**$2,221.9**	**$2,421.0**	**$2,318.9**	**$2,309.1**	**$87.2**	**3.9%**	**$97.0**	**4.4%**
Corrections	994.5	1,150.7	1,048.1	1,045.7	51.2	5.1%	53.6	5.4%
Judiciary	797.9	816.2	822.2	819.3	21.4	2.7%	24.3	3.0%
Police	288.7	309.5	304.2	298.6	9.9	3.4%	15.5	5.4%
DAs	99.6	101.3	101.3	101.8	2.2	2.2%	1.7	1.7%
Attorney General	41.2	43.3	43.2	43.7	2.5	6.1%	2.0	4.9%
Local Government	**$1,579.7**	**$1,580.7**	**$1,591.5**	**$1,576.5**	**-$3.2**	**-0.2%**	**$11.8**	**0.7%**
Assistance to the Poor	**$10,815.8**	**$11,450.9**	**$11,569.9**	**$11,552.6**	**$736.8**	**6.8%**	**$754.1**	**7.0%**
Medicaid/Other Health Care [2]	9,633.1	10,239.2	10,342.4	10,330.3	697.2	7.2%	709.3	7.4%
Cash/Housing Asst.	889.3	918.1	932.3	927.1	37.8	4.3%	43.0	4.8%
Elderly	293.5	293.6	295.2	295.2	1.7	0.6%	1.7	0.6%
Assistance to the Sick and Disabled	**$2,444.1**	**$2,529.4**	**$2,530.5**	**$2,526.4**	**$82.3**	**3.4%**	**$86.4**	**3.5%**
Mental Retardation	1,229.4	1,267.4	1,272.8	1,267.6	38.2	3.1%	43.4	3.5%
Mental Health	667.4	686.3	683.8	685.2	17.8	2.7%	16.4	2.5%
Public Health	547.3	575.7	573.9	573.6	26.3	4.8%	26.6	4.9%
Transportation	**$290.8**	**$216.3**	**$211.1**	**$208.2**	**-$82.6**	**-28.4%**	**-$79.7**	**-27.4%**
Regional Transit	58.3	56.6	60.1	56.6	-1.7	-2.9%	1.8	3.1%
Highways	169.7	88.7	83.8	86.0	-83.7	-49.3%	-85.9	-50.6%
Registry	62.8	71.0	67.2	65.6	2.8	4.5%	4.4	7.0%
Economic Development	**$419.7**	**$401.1**	**$450.8**	**$401.4**	**-$18.3**	**-4.4%**	**$31.1**	**7.4%**
Business and Labor	191.1	167.9	214.7	174.4	-16.7	-8.7%	23.6	12.3%
Environment	228.7	233.2	236.1	227.0	-1.7	-0.7%	7.4	3.2%
Central Costs	**$4,584.5**	**$4,739.5**	**$4,820.3**	**$4,804.3**	**$219.8**	**4.8%**	**$235.8**	**5.1%**
Employee Benefits [3]	2,608.7	2,732.6	2,795.0	2,797.7	189.0	7.2%	186.3	7.1%
Debt Service	1,975.8	2,006.9	2,025.3	2,006.6	30.8	1.6%	49.5	2.5%
Other	**$1,006.0**	**$1,057.5**	**$1,044.5**	**$1,029.1**	**$23.1**	**2.3%**	**$38.5**	**3.8%**
Total	**$30,219.1**	**$31,629.2**	**$31,769.3**	**$31,637.0**	**$1,417.9**	**4.7%**	**$1,550.2**	**5.1%**

[1] Amounts are adjusted to include certain "off-budget" authorizations, primarily for health care and pensions, and to exclude MBTA, school building assistance, convention center, mosquito control and certain other expenditures moved off-budget over the previous several years.

[2] Combines MassHealth accounts with related "off-budget" funds, such as the Commonwealth Care Trust Fund (including the Health Safety Net Trust Fund) and the Essential Community Provider Trust.

[3] Does not include workers' compensation and unemployment insurance which are budgeted in agency accounts.