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A Closer Look at the FY 2018 Budget Challenge

For the second straight year, budget conferees are working to finalize a budget for July 1st while grappling with how best to adjust the fundamental tax revenue assumption used to balance the budget. This brief examines the challenges budget conferees and the Administration face and how these challenges differ from their experience finalizing the FY 2017 budget.

The Tax Revenue Picture

Lower than expected tax collections over the past 6 months have essentially invalidated the tax revenue assumption used in the FY 2018 budget. Each of this year’s budget proposals has been built on the assumption that the state would collect \$26.056 billion in taxes in FY 2017 and that those revenues would grow by 3.9 percent to \$27.072 billion in FY 2018. It is now clear that the estimate of FY 2017 collections is off by more than \$400 million. In addition, tax revenues are growing very slowly – just 1.2 percent growth to date in FY 2017 – making the 3.9 percent growth assumption used in this year’s budget unrealistic. Given these two factors, a downward revision to FY 2018 tax estimates is necessary to more accurately reflect the state’s expected revenue. The chart below demonstrates just how big of an impact this revision is likely to have on the budget.

Table 1. Likely FY 2018 Tax Revenue Shortfall

FY 2018 Growth Rate	FY 2017 Shortfall		
	-\$400	-\$450	-\$500
3.00%	\$646	\$698	\$749
2.75%	\$710	\$762	\$813
2.50%	\$775	\$826	\$877
2.25%	\$839	\$890	\$941
2.00%	\$903	\$954	\$1,005

The Process for Revising Tax Revenues in the Conference Committee

State finance law does not lay out a specific process for creating a Conference Committee budget that uses different tax revenue estimates than the one used by the House and Senate to craft their budgets. However, it is likely that that budget makers will follow a process similar to the one used last year when poor collections in FY 2016 led to a \$750 million downgrade in the FY 2017 tax assumption. The chairs of the House and Senate Committees on Ways and Means and the Secretary of Administration and Finance recently asked the Department of Revenue as well as other economists to reforecast FY 2018 tax revenues as they did last year when budget conferees and the Administration worked together to review those reforecasts and develop a new consensus tax number for the final budget.

State finance law does require the Administration to submit an amended budget plan to the Legislature if tax or other revenues have decreased since the Governor’s spending plan was originally filed, but is silent on whether the Legislature must act upon the Governor’s revised budget once filed.

Parallels to FY 2017

During last year’s Conference Committee, the Foundation noted that the situation faced by budget makers – the need to use a lower tax revenue figure than assumed in all previous budget proposals –was without precedent over the last 20 years. Faced with a very similar situation for FY2018, Conferees can at least look to FY 2017 to provide a template for how to approach the changing budget situation.

However, while there are similarities with the FY 2017 situation, there are many important differences, and these differences make the FY2018 challenge far more difficult.

Table 2. Comparison of Current Tax Collections with Last Year

	Tax revenues v. Benchmark	YTD Tax Revenue Growth (actual)	YTD Tax Revenue Growth (baseline)
May of 2016	-\$311	2.6%	3.4%
May of 2017	-\$439	1.2%	2.4%

First and foremost, the revenue picture is worse than it was a year ago. In 2016, the revenue situation led to a \$750 million downgrade of tax estimates that ultimately proved insufficient. This year’s larger shortfall and slower rate of growth mean that an even larger revenue downgrade is likely with fewer options for making up the gap.

One of the major solutions used to balance the Conference budget in FY 2017 – utilizing capital gains revenue for operating expenses – will have much less of an impact this year. In FY 2017, each of the original budget plans assumed \$356 million in capital gains revenue above the statutory threshold – revenues that should be deposited into the Rainy Day Fund and other reserves. Each budget diverted \$150 million of these revenues to the General Fund, with the \$206 million balance deposited to the Rainy Day Fund. When the Conference Committee revised tax revenue downward, capital gains tax revenue were no longer assumed to exceed the threshold, which meant that the \$206 million deposit to the Rainy Day Fund was no longer necessary. In effect, the \$206 million was freed up to be used for operating expenses thereby partially offsetting the \$750 million reduction. In FY 2018, the original tax revenue estimate assumed much lower capital gains collections and the House and Senate budgets only assume that \$51 million in above threshold revenues for the Rainy Day Fund. This means that when revenues are downgraded, no more than \$51 million of the reduction can be offset by a foregone Rainy Day deposit.

Table 3 summarizes how the combination of a larger potential revenue downgrade and a smaller capital gains offset – make balancing the FY 2018 budget much more difficult than the challenge faced in FY 2017. For the purposes of this example, a \$900 million tax revenue downgrade is assumed in FY 2018.

Table 3. Impact of FY 2017 Budget Solutions on FY 2018

	FY 2017	FY 2018
Tax Revenue		
Tax revenue downgrade	-\$750	-\$900
Tax offsets		
<i>Cap gains</i>	\$206	\$51
<i>SBA & MBTA</i>	\$60	\$42
<i>Income tax</i>	\$80	\$80
Net tax downgrade	-\$404	-\$727
Solutions		
Net spending cuts	\$197	\$197
Reversions	\$152	\$152
Non-tax upgrade	\$60	\$60
Solves	\$408	\$408
Remaining surplus/gap	\$4	-\$319

As the chart demonstrates, the same combination of solutions used to balance the budget in FY 2017 would leave a \$300 million gap for FY2018, an amount that far exceeds the total amount of net spending cuts that were necessary to balance last year’s budget.

Finally, the budget solutions available to Conferees are limited by the fact that this is the fourth straight year of budget deficits. A number of the available options – including trust fund and legal settlement revenues – have been used to address budget problems in FY 2016 and FY 2017. Therefore, the stock of short-term budget fixes is depleted and those that remain may not be palatable to lawmakers.

Possible Solutions

Spending

Once the revised revenue growth number is determined, Budget Conferees will likely look for ways that House and Senate budget spending can be reduced without cuts to services. This exercise typically involves picking the lowest appropriation of the House, Senate or administration budget proposals. The Foundation estimates that this approach would generate \$280 million in net savings compared to the Governor’s original spending plan.

However, it’s unlikely that the final budget will adopt this low number approach across the board for two reasons. First, it is probable that the final budget will retain higher spending levels for priorities such as Chapter 70 or local earmarks, necessitating cuts in other areas. Second, several spending areas, such as indigent defense, family homelessness and winter road cleanup, would be underfunded by more than \$100 million if the low appropriations were chosen. Accounting for spending priorities and underfunded accounts will reduce the total savings from the low number approach.

Another way spending was reduced in FY 2017 was to assume appropriated funds would go unspent. The final FY2017 budget sent to the Governor presumed \$151 million in reversions and the Governor relied on an additional \$50 million in reversions to balance the budget during the veto process. In essence, reversions allow the budget to assume spending cuts without having to identify where those cuts will ultimately come from, a practice very likely to be used again in the FY 2018 budget.

Ultimately, without the use of major revenues not included in either the House or Senate budgets, spending reductions will almost certainly be required. This fact and the possibility that those cuts will entail the elimination or reduction of existing programs— something that was largely avoided in FY 2017 – highlight the possible benefit to the legislature of Governor Baker filing amendments to his initial budget proposal. Those amendments would provide Conferees with the Administration’s roadmap for balancing spending needs with reduced tax revenue.

Revenue

Additional budget revenue that can be used to close the gap may come from several sources. First, a tax downgrade could free up some revenue by eliminating the transfer of excess capital gains revenues that would otherwise go to the Rainy Day Fund. Similarly, reducing sales tax estimates will reduce spending obligations to the School Building Authority and MBTA, which receive a percentage of total sales tax revenues. Finally, it is now unlikely that the revenue growth triggers necessary to reduce the state’s income tax rate will be met for 2018. Holding the rate steady will provide an additional \$80 million in budget revenue.

House and Senate conferees will carefully consider revenue differences between the two budgets as a source of additional funds. Unfortunately, while there are some notable differences, they are unlikely to play a big part of the budget solution because the total revenue generated is relatively small and several of the proposals, such as film tax credit restrictions, have not gained traction in the past. The chart below highlights notable revenue differences:

Table 4. Revenue Differences between House and Senate Budgets

	House	Senate
Temporary Accommodations	\$0	\$18
Hotel Reseller	\$0	\$7
Film Tax Restriction	\$0	\$14
Trust Fund Sweep	\$15	\$0
Race Horse Development Fund	\$0	\$15
Unique Revenues	\$69	

The Senate budget also increases the state’s deeds excise tax as well as the tax on flavored tobacco products, but the revenue generated from these proposals is earmarked for trust funds outside of the budget.

Trust fund balances and other one-time resources may provide additional monies that can be diverted to the state budget. About \$200 million in trust fund sweeps were used to closeout FY 2016 and will likely be part of the approach to end FY 2017 in balance; however, because trust revenues have been relied upon so heavily in recent years it means that fewer are available for use in FY 2018.

S&P’s recent downgrade of the state’s bond rating due to failure to rebuild reserves means another common revenue source – a draw from the Rainy Day Fund – is off limits. Other one-time solutions can include the sale of state assets, unexpected legal settlements and moving payment obligations – often related to MassHealth – from one fiscal year into the next.

Finally, new, ongoing taxes or fees could be considered given the magnitude of cuts that may otherwise be necessary but introducing new revenues at this stage is controversial and typically employed only as a last resort. Given the sizeable new employer health care assessment already contained in the budget and several other smaller

tax increases, it is more likely that program redesigns or other novel proposals to close the budget gap will be considered instead.

Conclusion

Recent tax collection data clearly indicate that a downgrade to the tax revenue assumption used in the FY 2018 budget is necessary. This means that for the second straight year the process of reconciling the House and Senate budgets will be made even more difficult because of the reduced available resources upon which to draw. Legislators' experience from FY 2017 will provide some guidance on how to move forward, but this year's challenges are far greater because of the scope of the problem and the more limited options available.

The employer assessment/Medicaid reform package released today by the Administration shows that major policy proposals not previously considered may ultimately form a large part of the solution to the FY 2018 budget, but with only ten days until the start of the fiscal year, the time for determining the least painful way to balance the budget is growing short.