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Ten Questions about the FY 2019 Budget

The fiscal year (FY) 2019 budget process is officially underway, commencing last month with the annual Consensus Revenue Hearing. The testimony provided at the hearing touched on a number of issues – including slow revenue growth, insufficient reserves and growing non-discretionary costs – that have contributed to the budget challenges of recent years. The testimony also highlighted several potential policy changes at both the state and national level that will make developing the FY 2019 budget particularly difficult. This brief poses ten major questions that budget makers will face in the coming months.

What is a reasonable tax revenue figure to expect for FY 2019?

The tax estimate agreed to as part of the consensus revenue process is the foundation upon which the budget is built. Getting that estimate wrong – especially overestimating likely revenues – destabilizes the entire budget. The budgets of the last year three years demonstrate the problems that revenue overestimation creates: drastic last minute adjustments to revenue and spending prior to finalizing the spending plan; reliance on one time resources; failure to replenish the state's reserves; and midyear budget cuts to name a few.

	Consensus Estimate	Actual Revenues	Difference
FY 2016	$25,479	$25,270	-$209
FY 2017	$26,860	$25,604	-$1,256
FY 2018	$27,072	$26,504	-$568

Numbers in millions. Note: Actual revenues do not include tax settlements. The FY 2018 actual revenue figure is the current estimate.

To avoid a repeat of these recent problems, the Executive Office for Administration and Finance (ANF), House Ways and Means and Senate Ways and Means should be conservative in their revenue projections, in spite of the strong revenue collections enjoyed over the first six months of the current year. The estimates presented at the recent hearing all forecast relatively strong revenue growth (compared to recent years) over the current FY 2018 estimate. This is largely due to anticipated short-term impacts of federal tax legislation, making a growth estimate of between 3.3 and 4 percent likely.

	FY 2019	% Growth over Current
DOR (Economy.com)	$27,582	4.1%
DOR (Global Insight)	$27,374	3.3%
DOR (Current/Hybrid)	$27,392	3.4%
MTF	$27,586	4.1%
Beacon Hill Institute	$27,581	4.1%
Alan Clayton Matthews	$28,697	8.3%

A sound approach for budget makers would be to limit the danger of overestimating revenues by assuming that capital gains revenues will comprise a sizable portion of FY 2019 revenue growth and adhering to the state law that requires all capital gains revenues in excess of a certain threshold be deposited in to the Stabilization Fund. Dedicating much of the FY 2019 expected revenue growth to the Stabilization Fund provides a cushion should revenue collections disappoint again this year and begins to replenish state reserves if revenue targets are met.

How will the FY 2019 budget account for looming tax revenue ballot questions?

In addition, to the ordinary challenges of forecasting revenues 18 months into the future, this year has the added challenge of accounting for the impact of two 2018 ballot initiatives that could have sizable revenue implications in FY 2019.

A proposal to amend the state's Constitution to impose a four percentage point income tax surcharge for earnings over $1 million would likely generate an additional $800 – $950 million in the last six months of FY 2019, assuming that it withstands a legal challenge. On an annualized basis, the surcharge could generate approximately $2 billion according to a 2015 DOR estimate, but not all of that money may materialize given the major negative consequences for the state economy and budget. For now, lawmakers will be closely monitoring proceedings at the state's Supreme Judicial Court as the case makes its way through the court.

Voters are also scheduled to decide whether or not to roll back the state's sales tax rate (from 6.25 to 5 percent) and create an annual no-sales tax weekend. This change would reduce FY 2019 tax collections from one of the more stable sources of tax revenue by $600 – $650 million and make the state even more reliant on income tax revenues, which are subject to bigger year to year swings.

The revenue challenges of these ballot questions are compounded by problematic timing. The fact that these questions will not be voted on until November – more than four months after the FY 2019 budget is finalized, makes planning for them especially difficult. The table below shows the wide disparity in tax revenue outcomes depending on what happens with these questions:

Outcome	FY 2019 Revenue	Impact
Median Consensus Revenue Forecast	$27,582	$0
Income tax surcharge only	$28,482	$900
Income tax surcharge and sales tax cut	$27,852	$270
Sales tax cut only	$26,952	-$630

The most disruptive ballot outcome for FY 2019 would be if the sales tax cut is successful while the income tax surcharge is either invalidated or defeated. Given the potential size of the revenue swing, the only prudent way to prepare for this possibility would be to set aside above-benchmark FY 2018 tax revenue and commit to a sizable Stabilization Fund deposit in FY 2019.

How will federal tax legislation impact the budget?

The new federal tax law includes major changes to federal income and corporate taxes. While all of the impacts of the legislation are unknown, there are several ways the changes are likely to impact the state budget:

- Short-term revenue impact on corporate taxes – it is possible that Massachusetts could see a spike in corporate tax collections due to federal changes. One benefit could come from the federal transition tax that will lead companies to "repatriate" foreign assets. Massachusetts should receive a boost from companies that are subject to the state's corporate tax that are repatriating assets. This benefit is likely to be temporary and to occur between FY 2018 and FY 2019.

  In addition, Massachusetts collections would benefit from federal efforts to limit corporate interest deductions. Under the federal plan, the limit of the interest deduction would offset the "full business expensing" change. However, Massachusetts already disallows the accelerated depreciation provisions, meaning that, unless the Massachusetts statute is changed, it will see a revenue increase for the business interest limitation, but will not see the accompanying revenue loss from accelerated depreciation.

- Short-term revenue impact on capital gains – conventional wisdom holds that many tax filers have delayed capital asset sales recently while waiting for certainty (and beneficial treatment) in federal tax policy. Federal tax reform is likely to generate an uptick in capital gains tax revenue in FY 2018 or FY2019, as the holders of capital assets react to the more favorable tax treatment. The timing of this likely revenue windfall is uncertain but it is important to note that these expected revenue gains do not represent new sources of ongoing tax revenue, but rather tax revenue that would otherwise have already been received or would come to the state in the future.

- Long-term impacts on the state economy – while federal tax change could bring short-term revenue benefits to the state and increased economic activity, the long-term revenue impact is largely negative. The capping of the State and Local Tax deduction (SALT) at $10,000 will make Massachusetts state tax burden much less competitive compared to many other states. Under the uncapped SALT, Massachusetts residents were able to deduct $19 billion from their gross income before federal taxes in 2015. Limitations on that deduction will mean that the income and property tax burden in Massachusetts got much more expensive relative to lower-tax jurisdictions and could make Massachusetts a less attractive place to work and live. The plan will also negatively impact many institutions of higher learning as the federal plan would tax many college endowments which will increase costs for one of the largest sectors of the state economy.

- Long-term impact on the state budget – finally, the cost of the federal tax plan increases the likelihood of spending cuts to programs that either directly or indirectly help the state budget. The Children's Health Insurance Program (CHIP) provides a clear example of a direct impact: should the federal government limit or eliminate CHIP payments to the states, it will cost Massachusetts between $50 and $250 million on an annual basis. Indirect impacts could be just as profound. In federal fiscal year (FFY) 2018, low-income Massachusetts residents are scheduled to receive $122.9 million in federal funds for heating assistance through the Low Income Home Energy Assistance Program (LIHEAP). While these funds are expended outside of the state's budget, there would be great pressure on the state to backfill any reduction should the federal program be cut.

Will the (relatively) strong economy continue and will state tax revenues finally catch-up?

The current period of economic expansion is already one of the longest in the nation's history and many economists are predicting continued growth in the US economy through next year, driven in part by lower corporate taxes in the federal reform law. At the recent Consensus Revenue hearing, each of the FY 2019 tax revenue forecasts assumed economic growth throughout the upcoming fiscal year for Massachusetts as well.

Despite this growing economy, the FY2019 budget promises to be quite challenging. Tax collections in Massachusetts have been below historic norms in this recovery period. The state is in the midst of a third straight year with tax revenue growth of less than three percent in spite of very low unemployment and other signs of a strong state economy. This trend is not limited to Massachusetts – 28 states saw revenue reductions between the 2nd quarters of 2015 and 2016 and a further 11 saw declines in the same quarter between 2016 and 2017.Sluggish tax collections across the states has made identifying ways to address this problem more difficult because it suggests causes of this phenomenon are more macro-economic in nature than Massachusetts-specific. The question Massachusetts, and other states, now face is whether the experience of the last few years is an anomaly or if it represents a structural disconnect between our tax code and the underlying economy. Federal tax reform could lead to an uptick in state capital gains

collections, but this is likely to be non-recurring and therefore will not reduce the state's long-term structural deficit.

Will MassHealth reforms be included in the budget?

Legislators have been reluctant to consider serious reforms to the MassHealth problem to date, but growing budgetary pressures and cutbacks in federal funding may force changes to the state's Medicaid program. In June, the Baker Administration proposed the most sweeping set of MassHealth program reforms in more than a decade. The reforms, which the Administration estimated would save approximately $200 million (net) by FY 2019, involved moving approximately 370,000 MassHealth members to either other programs within MassHealth or other forms of subsidized care. In addition, it incented MassHealth members to take affordable employer sponsored insurance when offered. The proposal was largely rejected by the legislature over concerns with process, timing and policy implications. Both House and Senate leaders announced intentions for the legislature to craft its own set of health reforms later in this legislative session, but it is far from certain that their proposals will tackle MassHealth. The Senate's Health reform bill, enacted in November, does not include any new proposals designed to reduce MassHealth costs and includes language that could result in a major expansion of the program.

The underlying need for MassHealth reform remains. Its unabated growth prevents investments in other policy areas and is a leading contributor to the recent trend of difficult budgets during times of economic growth. Together with pension and debt service costs, these non-discretionary spending areas comprise 70 percent of tax revenues, compared to just over 60 percent in FY 2008.

The likelihood of federal health care funding limitations for states makes the necessity of reforms more pressing. Already in FY 2018 the state has had to tap into its own resources to replace Cost Sharing Reduction subsidies to insurance carriers that were eliminated by the Trump Administration. This unbudgeted expense pales in comparison to the costs to maintain the CHIP program without federal reauthorization. If Congress fails to act, the state will be forced to reduce benefits or backfill more than $250 million in lost funds in FY 2019. A proactive approach to adjusting the MassHealth program to reduce costs while maintaining strong benefits will put the state in a better position to adapt to the changing nature of the state/federal funding partnership for many health programs. Without such an approach in the FY 2019 budget, policy makers will have less time and fewer options should federal funds continue to decline.

Will the state revisit the Administration's FY 2018 accelerated sales tax proposal?

The testimony received by the Department of Revenue (DOR) when assessing the feasibility of implementing accelerated sales tax collections in FY 2018 was overwhelmingly in opposition due to prohibitive timing, cost and compliance hurdles it created for affected parties. Given this, implementation of a similar plan by the end of FY 2019 is doubtful, however the Administration is likely to pursue an accelerated payment policy in some form going forward.

Last year, the Administration proposed requiring daily remittance of sales tax on debit and credit card purchases to the Department of Revenue (DOR).[1] They estimated that the change would bring in $125 million in one-time revenue to the state in FY 2018 as some sales taxes that would normally be credited to the state in July of 2018 would come in a month earlier. The proposal was criticized by a wide range of businesses – from retailers to credit card processors to banks to credit card companies – due to the cost, extremely aggressive timeline, as well as compliance and security concerns. The Conference Committee budget required that prior to going through with the policy proposal, DOR certify that the change was feasible in FY 2018. In November DOR announced that the change was not feasible in FY 2018 and it has not moved forward with the original proposal. However there will be pressure to revisit this issue since the state is counting $125 million in FY 2019 sales tax revenue toward FY 2018 and that means that in FY 2019, the state will need to replace that $125 million in sales tax revenue.

While the Administration has indicated an interest in adopting accelerated sales tax remittance on a more reasonable timeline, budget makers should examine other, less onerous, alternatives to address the short-term $125 million issue. One such option would be for the state to implement a sales tax prepayment system, where sellers pay estimated tax obligations in advance. Similar systems are used in a number of other states making it far less disruptive.

How will the budget balance short-term challenges with the need for long-term fiscal improvements?

During the Great Recession the state unveiled several financial reforms designed to reduce the structural deficit, limit the impact of revenue volatility on the budget, rebuild spending reserves and address long-term financial commitments. Specifically, the state passed statutes that:

- Required capital gains revenues above a sustainable threshold be held aside from the operating budget and dedicated to the Stabilization Fund and other long term liabilities;
- Dedicated unpredictable settlement and judgment revenues in excess of $10 million to the Stabilization Fund;
- Created a schedule for, over time, dedicating the state's annual revenues from tobacco company settlements to the State Retiree Benefit Trust Fund (SRBTF); and
- Shortened the payment schedule for fully funding the state's pension obligations from 2040 to 2036.

Partially due to the enactment of these reforms, the state's bond rating was upgraded in 2011 to its highest ever levels. In recent years, however, the state has undone or failed to adhere to these reforms consistently (the state has maintained the 2036 pension funding schedule). Short-term budget problems have led to diversion of excess capital gains or settlement tax revenue from state reserves to the General Fund to balance the budget. The state has also failed to follow the

[1] Currently, sales tax revenues are remitted to DOR by sellers on a monthly basis. The current system does not differentiate between cash, check, debit or credit card sales for the purpose of sales tax remittance.

schedule for devoting tobacco settlement revenues to the SRBTF. For example, in FY 2018, the transfer will fall $125 million short of the amount called for in the original funding schedule.

Failure to abide by these fiscal reforms led to S&P's decision to downgrade Massachusetts' bond rating in June of 2017. In its downgrade, S&P specifically cited, "…the commonwealth's failure to follow through on rebuilding reserves as stipulated through its own fiscal policies aimed at mitigating the state's propensity for revenue volatility." This action serves as an important reminder as to the consequences of insufficient attention to long-term fiscal challenges particularly during an economic recovery.

FY 2019 could serve as a turning point and a return to fiscal discipline if the state responds to the concerns highlighted by S&P by making replenishment of the Stabilization Fund a top priority and following through on the fiscal policies put forth in 2011. The impact of the S&P downgrade has not yet manifested – the state has done an excellent job of marketing its bond offerings and the downgrade has yet to be seen in pricing – but lawmakers must heed S&P's warning sign. The state budget is twice the size it was fifteen years ago, while the Stabilization Fund balance is $400 million lower. Without a behavior change, the next fiscal downturn will be disastrous.

Will the FY 2019 continue to make progress on chronically underfunded accounts?

For years, the annual budget passed by the Legislature has underfunded several major spending areas at the outset with the expectation that unexpected revenues or other savings could be used to supplement these accounts later in the year. In FY 2018, budget makers created a new $104.1 million reserve to address these unaccounted for costs. While the amount of this reserve is too low to adequately cover foreseeable spending needs, it is a step in the right direction for handling this issue going forward. A similar reserve of $200 million in next year's budget would decrease the likelihood of midyear budget challenges in FY 2019.

What will the opening of two resort casinos mean for the budget?

Two resort casinos (MGM Springfield and Wynn Boston Harbor in Everett) are scheduled to open in FY 2019 and provide new revenue to the state. Under the state's gaming law, the state will receive 25 percent of gross gaming revenue at both facilities, which is ultimately projected to generate between $200 and $300 million on an annual basis. The Springfield casino is scheduled to open in September of 2018, while the Everett casino is on track for a June of 2019 opening. Based on past revenue projections, the state will likely receive $50 to $70 million in FY 2019 tax revenue.

A portion of tax revenues from the two resort casinos does not go to the General Fund, but instead is distributed among twelve separate funds designated for a variety of purposes. However, approximately half of the tax revenues will be subject to appropriation by the legislature and therefore can be used to balance the FY 2019 budget. The chart below outlines the funds that will receive gaming receipt tax revenue.

Fund	Percentage	Subject to Appropriation	Share of $60M
Gaming Local Aid Fund	20.0%	Yes	$12.0
Transportation Infrastructure & Development	15.0%	No	$9.0
Education Fund	14.0%	Yes	$8.4
Stabilization Fund	10.0%	No	$6.0
Debt Reduction	10.0%	No	$6.0
Gaming Economic Development Fund	9.5%	Yes	$5.7
Community Mitigation Fund	6.5%	No	$3.9
Public Health Trust Fund	5.0%	No	$3.0
Local Capital Projects Fund	4.5%	Yes	$2.7
Race Horse Development Fund	2.5%	No	$1.5
Mass. Cultural Council	2.0%	No	$1.2
Tourism Fund	1.0%	No	$0.6

What will recreation marijuana sales mean for the budget?

The Cannabis Control Commission can begin granting licenses for the sale of marijuana beginning on June 1st of 2018. Marijuana will be subject to the state sales tax, a separate excise tax and a local option tax, but what the size of this nascent industry will be in FY 2019 is a big unknown, as is the amount of tax revenue that it will generate. Prior to the passage of the ballot question, a report from a marijuana investment research firm estimated that Massachusetts would have a $1.07 billion marijuana industry by 2020. Given the time it is likely to take the industry to fully develop, a range of $300 to $500 million in FY 2019 sales is a reasonable expectation.

	Rate	Share of $300M	Share of $500M
Sales Tax	6.25%	$18.8	$31.3
Excise Tax	10.75%	$32.3	$53.8

Marijuana sales will be subject to the state's sales tax, which will support the General Fund, but the majority of revenue generated by marijuana sales – the 10.75 percent excise tax – is intended to cover the cost to regulate the marijuana industry, support related public health needs and provide funds for public safety. While excise tax revenues are dedicated to a separate Marijuana Regulation Fund, the fund is subject to appropriation by the Legislature. This means that the Fund can be used to support the larger budget, provided expenditures are consistent with its intended use.