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Ten Questions about the FY 2019 Budget: UPDATE

Two months ago, MTF identified ten key questions that will shape the FY 2019 budget. Now it is time to revisit those questions in the context of Governor Baker's budget recommendations and the latest revenue and policy developments. For each of the questions first posed in January, this brief provides an abbreviated version of our original commentary (in italics), updated information and a revised outlook for how these issues will impact the budget in the months ahead.

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

MTF's Original Assessment was that revenue growth between 3.3 and 4 percent was likely:

It is possible that, in light of FY 2018 revenue collections to date which are $728 million above benchmark, the Consensus Revenue agreement will upgrade expected revenues this year thereby reducing the assumed rate of growth for FY 2019.

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 2018 above- benchmark tax revenues and 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.

New Information:

On January 12th, budget makers agreed on an FY 2019 tax revenue estimate of $27.594 billion. This agreement also upgraded the FY 2018 tax revenue assumption by $157 million to $26.661 billion (for FY 2019 revenue growth of 3.5 percent) in light of strong December collections.

January tax revenues exceeded the revised monthly benchmark by $158 million. In February, tax revenues fell $78 million short of expectations, but collections currently exceed the benchmark by $725 million.

Revised Outlook

The House and Senate, like the Governor, are required to use $27.594 billion in tax revenue as the starting point for their budget, but nothing precludes them from increasing or reducing tax estimates based on policy proposals or new information. In fact, there are several reasons why tax collections trends will bear close watching in the months ahead:

- *Poor revenue growth* – in each of the last two years budget makers have had to significantly downgrade the consensus revenue estimate in the weeks prior to the start of the new fiscal year. In both cases, it was apparent that the initial revenue estimate used to build the House, Senate and Administration budgets was far too optimistic. Historically speaking, the need to reduce revenue assumptions by more than $500M prior to the start of a fiscal year is extremely rare, but given that it has now occurred two years in a row it is something to keep in mind for FY 2019.

- *Revenue volatility* – it is not yet clear what the strong revenue collections of December and January mean going forward. While it is possible that large revenue gains persist, it is equally possible that this revenue represents early collection of estimated tax payments that will come at the expense of future collections. Should big revenue swings – either positive or negative – occur heading into July, it will heighten fiscal uncertainty for FY 2019.
- *End of year surplus* – it is also possible that the state will maintain a significant revenue surplus in FY 2018 due to above-benchmark tax collections. If that's the case, there will be pressure to use some of that surplus to support spending priorities. However, given the possibility that strong FY 2018 collections will negatively impact growth in FY 2019, coupled with the uncertainty surrounding tax ballot questions and the low level of state reserves, it is imperative that any surplus be dedicated to the Stabilization Fund.

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

<u>MTF's Original Assessment</u> pointed out the challenge of accounting for two ballot initiatives with sizable revenue implications in FY 2019:

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.

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

<u>New Information:</u>

Governor Baker's FY 2019 budget proposal does not include any specific provisions to account for potential revenue impacts from ballot outcomes. His budget does assume that the balance of the state's Stabilization Fund will grow by $152 million through the end of next fiscal year as the state adheres to policies to deposit excess capital gains and other revenue to state reserves.

Revised Outlook:

A reduction in sales tax revenue, without an offsetting income tax increase, remains a plausible scenario in FY 2019. The Supreme Judicial Court's decision on the validity of the income tax surcharge is expected in late spring and will provide much-needed clarity on the decisions voters will make in the fall. Discussions on removing the sales tax question from the ballot are ongoing, but it would be a mistake for the House and Senate to await further developments to start preparing possible contingency plans. The first step in any contingency plan must be to devote any FY 2018 revenue surplus to state reserves and reduce the structural deficit.

3. ***How will federal tax legislation impact the budget?***

MTF's Original Assessment projected a short-term spike in corporate tax collections due to federal repatriation of foreign asset provisions as well as a possible surge in capital gains*:*

- *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.*
- *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.*

New Information:

The Governor's budget assumes that the state will receive $65 million in FY 2019 revenue due to the repatriation of corporate profits. No legislative language is required to collect this revenue and to date no proposals have been put forth to amend state tax laws to reflect federal changes.

With respect to capital gains, nearly three quarters of above-benchmark tax collections in recent months has been due to non-withholding income tax revenue, likely reflecting taxpayers' response to the federal tax changes as predicted.

Revised Outlook:

The impacts of federal tax changes are still not fully known, making it difficult to draw too many conclusions from strong tax collections over the past few months. As a result, the Foundation continues to suggest that budget makers should assume the above-benchmark revenues related to capital gains will be non-recurring and are therefore not sustainable. It is less clear whether or not some of the federal changes will have a more permanent impact on state revenues.

The Administration's revenue estimate related to repatriated corporate profits aligns with the lower range of the Foundation's initial estimates using national data and information provided by other states. By using a relatively conservative estimate of $65 million, there is limited negative budget risk and some potential for a more positive result.

Unlike a number of other states, Massachusetts has not published an assessment of the likely impact of the federal tax bill on state revenues and taxpayers. Such an assessment would be a very useful tool in developing the FY 2019 and FY 2020 budget.

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

MTF's Original Assessment highlighted the possible impacts of federal tax reform on the revenue experience of Massachusetts:

Tax collections in Massachusetts have been below historic norms in this recovery period. This trend is not limited to Massachusetts (as) 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.

New Information:

Recent revenue collections have rebounded, more closely tracking economic performance. Following strong December revenue collections, budget makers upgraded FY 2018 revenue estimates by $157 million. Through February, revenues stand $725 over this revised benchmark. However, for the reasons already mentioned, this may reflect a one-time blip rather than a more permanent alignment.

On the national level, a variety of policy debates and decisions has heightened economic uncertainty as evidenced by the recent volatility in the stock market. While few, if any, economists are predicting a recession in the next 12 months, there are signs of softening that should be monitored. The state's economy as measured by employment levels as well as business and consumer confidence continues to outperform the national economy but it would be impacted by national headwinds.

Revised Outlook:

Tax collections are well above benchmark for now, but those gains may be given back in the coming months and may not be indicative of revenue performance in FY 2019. Recent news only underscores the danger that revenue uncertainty poses for FY 2019.

5. Will MassHealth reforms be included in the budget?

MTF's Original Assessment made the case for why MassHealth reforms must be a FY19 budget priority:

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 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.

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.

New Information:

The Governor's FY 2019 budget proposes transitioning 140,000 non-disabled adults currently on MassHealth to products subsidized through the Connector. In response to criticisms of the original version introduced last year, the Administration's revised plan protects those impacted by the change from a reduction in benefits or increases in cost. The proposal is estimated to save the state $120 million per year when fully implemented.

Largely due to this proposal, the Governor's budget projects the lowest level of program growth since FY 2012 (when the program was 35 percent smaller) with an increase of slightly more than $200 million over FY 2019.

Revised Outlook:

Controlling MassHealth costs remains the key to managing the state budget and investing in other spending priorities. The proposal put forth by the Administration provides an excellent opportunity for policymakers to create a template for how assess and implement program reforms going forward. As with any initiative of this scope, a number of logistical and policy questions need to be fully understood to ensure successful implementation. It is important that the Administration continue to work with the House and Senate to develop a process to move forward with this reform proposal while fully assessing these questions of feasibility.

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

MTF's Original Assessment was that, given the drawbacks to the proposal, the state should not pursue this policy in FY 2019:

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.

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.

New Information:

The FY 2019 Consensus Revenue agreement assumes that the state will collect a full 12 months of sales tax revenue, but is silent as to how to accomplish this. The Governor's budget proposes continuing to move $125 million in tax revenue forward for each of the next three budget cycles while developing regulations to implement the real time sales tax collection for debit and credit card purchases originally proposed last year. Essentially, the Administration believes that with more time, the cost, compliance and technology concerns that have been raised with this proposal could be addressed.

Revised Outlook:

The final budget needs to fill the $125 million tax revenue gap created by last year's proposal. There are a host of ways to do this by midyear 2021, as proposed in the Governor's budget, that do not entail implementing a costly and ill-conceived real time collection model.

The Legislature should address this budget issue separately from the proposed changes to the sales tax. Any initiative to modernize sales tax collections should be done in conjunction with impacted retailers, banks and credit card companies and the process should consider all of the potential options rather than just the one method proposed.

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

MTF's Original Assessment was that FY 2019 will be a test of budget makers' commitment to rebuild state reserves:

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.

<u>New Information:</u>

Governor Baker's budget takes two important steps to replenish the Stabilization Fund. It devotes expected above-benchmark capital gains and abandoned property revenue to state reserves in adherence with one of the fiscal best practices the state adopted in FY 2011. It also assumes that all but $20 million in any FY 2018 end of year surplus will be deposited into the state's Rainy Day Fund.

House 2 continues the practice of diverting some tobacco settlement revenue from the State Retiree Benefit Trust Fund to help balance the budget, but otherwise limits the use of one-time resources to $65 million from repatriation-related corporate revenue and the continued transfer of tax revenue related to the real time sales tax proposal.

Both branches of the Legislature are building their budgets against what appears to be a different revenue backdrop than Governor Baker. The perception of an FY 2018 surplus provides a true test of fiscal discipline for the Legislature and how they respond to it has major consequences for FY 2019 and beyond.

<u>Revised Outlook:</u>

The FY 2019 budget must limit use of one-time resources and adhere to statutory requirements to deposit volatile revenue streams to state reserves in order to put the state on a path to fiscal sustainability. In both regards, the Governor's budget provides a prudent template for the House and Senate to follow. Following this template will be insufficient, however, if budget-makers predicate spending on the hope of an FY 2018 budget surplus.

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

<u>MTF's Original Assessment</u> credited budget makers for taking a step in the right direction in FY2018:

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.

<u>New Information:</u>

The Governor's budget opts to fund these types of accounts directly as the chart below shows – as opposed to the reserve approach adopted by the Legislature.

	FY 2018 GAA	FY 2019 GOV
Indigent legal defense	$172,754,716	$236,938,646
Family homelessness	$186,026,253	$190,763,011
Sheriffs	$566,380,254	$626,715,238
MassDOT (snow and ice)	$303,341,772	$367,679,448
Caseload Reserve	$104,100,000	$0
Total	**$1,332,602,995**	**$1,422,096,343**

The Governor's budget is not without some risk of underfunding because family shelter costs have been creeping up again and the Administration's estimates for cash assistance for low-income families is possibly too low; however, in general, it presents a strong plan for avoiding future budget deficiencies.

Revised Assessment:

The Legislature should build on last year's work to enable better budget planning and reduce the need for future supplemental spending for routine expenses. The House and Senate may use different methods for determining appropriate funding levels for programs like indigent legal defense or county sheriffs, but total funding should approximate the amounts included in the Governor's budget.

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

MTF's Original Assessment was that the state would likely receive $50 to $70 million in new revenue in FY 2019 from new casino:

MGM Springfield and Wynn Boston Harbor in Everett are scheduled to open in FY 2019 and will 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.

Updated Information:

The Administration's budget assumes $60 million in FY 2019 revenue related to resort casinos to be distributed as follows:

Fund	Percentage	Subject to Approp	Gov Budget
Gaming Local Aid Fund	20.0%	Yes	$12.0
Transportation Infrastructure & Development	15.0%	Yes	$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
Total	***100.0%***		***$60.0***

The Governor's budget does propose amending the state's gaming law so that resort casino funds dedicated to transportation would be credited to the state's Commonwealth Transportation Fund and be subject to appropriation.

Revised Assessment:

It is likely that the House and Senate will assume approximately $60 million in resort casino revenue like the Governor's budget, but how they choose to distribute the funds could differ significantly. By dividing limited resort casino revenues into twelve different uses and setting approximately half of those revenues outside of the budget process, the impact of this new revenue source is severely limited. Reassessing this distribution with a more targeted focus might be appealing to Legislators.

10. What will recreation marijuana sales mean for the budget?

MTF's Original Assessment estimated marijuana revenues at between $50 and $80 million:

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. 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

Updated Information:

The Governor's budget assumes $63.26 million in state sales and excise tax revenues related to recreational marijuana, which implies $372 million in marijuana sales during FY 2019. Revenue related to the 10.75 percent marijuana excise ($40 million) is distributed as follows:

- $7.6 million for the operation of the Cannabis Control Commission
- $1.2 million for agricultural oversight of cannabis and hemp
- $31.2 million to support the Bureau of Substance Addiction Services

The funds directed to the Bureau of Substance Addiction Services are used to support existing state programming.

The speed with which recreational marijuana sales will get off the ground is still unclear, though the CCC promulgated final regulations earlier in March.

Revised Assessment:

MTF's original estimate of marijuana sales aligns with the amount included in the Governor's budget. We expect that the House and Senate are likely to closely match to this marijuana revenue estimate, but may use the revenues for different purposes. The state's marijuana law provides for several allowable uses for these funds, in addition to the operation of the CCC and oversight of the industry.