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FY 2019 Budget: Taking a Closer Look at Conference Committee

Fiscal year (FY) 2019 begins on July 1st and budget conferees in both the House and Senate are working to complete their compromise budget in time for the start of the year. This brief outlines several of the issues that are being negotiated and examines challenges that complicate resolution.

Comparing House and Senate – Revenue

The two budgets being reconciled are remarkably similar in their revenue assumptions, but this similarity belies a more complicated scenario for reaching compromise. On the one hand, this similarity makes it much easier to resolve differences and come up with a single revenue approach. On the other hand, lack of revenue differences provides little opportunity for one branch to accommodate the different initiatives of the other branch, a fact that is particularly noteworthy this budget cycle because there are significant spending discrepancies between the two budgets.

Figure 1. FY 2019 Revenue Differences

	House	Senate	Linked to Policy Change
Race Horse Development Fund	$0.0	$16.5	Y
Temporary accommodations	$0.0	$13.0	Y
Hotel room resellers	$0.0	$7.0	Y
Benefit reimbursements to the General Fund	$0.0	$10.0	N
Miscellaneous	$6.6	$0.0	N
Unique revenue related to policy		***$36.5***	
Unique revenue unrelated to policy		***$16.6***	

Numbers in millions

The chart above does not incorporate additional MassHealth revenue included in the House budget, because that revenue is dependent on spending levels. The House spends $96.6 million more on MassHealth and therefore their budget generates $49.1 million more in federal reimbursements.

Aside from MassHealth, there is approximately $50 million in revenue differences between the two budgets. More than half of these ($36.5 million) are related to two policy proposals included in the Senate budget:

- ***Race Horse Development Fund ($16.5 million)***
  For the second straight year, the Senate has proposed transferring the balance of the Race Horse Development Fund (established as part of gaming legislation) to the General Fund. The House rejected a similar proposal in last year's budget.
- ***Expansion of the lodging tax ($20M)***
  The Senate budget also relies on revenue from expanding the state's lodging tax to temporary accommodations (like Airbnb) and the resale of hotel rooms. The House has also passed legislation to tax temporary accommodations (though not room resale) but did not assume any FY 2019 revenue. There are major differences in the House and Senate approaches to this tax and so the timing of a policy compromise and the likely revenue from any compromise are far from certain.

If all new sources of revenue from both budgets were combined (excluding MassHealth), it would increase revenue by no more than $40 million – well short of the amount necessary to support all House and Senate spending priorities.

<u>Comparing House and Senate – Spending</u>

Each year, the budget reflects different spending priorities in the House and Senate budgets which total hundreds of millions of dollars.

Figure 2. FY 2019 Spending Differences

	House	Senate	Total
Earmarks	$62.3	$56.1	$118.4
MassHealth	$84.2	$3.6	$87.8
Education reimbursements	$0.0	$57.7	$57.7
Higher education	$21.6	$23.5	$45.1
Early Education	$30.2	$6.7	$36.9
DTA & DCF	$4.2	$28.2	$32.4
MBTA	$27.0	$0.0	$27.0
Chapter 70	$0.0	$23.5	$23.5
Other	$74.5	$82.8	$157.3
Total unique spending	***$304.0***	***$282.1***	***$586.1***

Numbers in Millions

This year, however, those spending differences are even more pronounced. Total spending in the two budgets differs by just $21.9 million, but this masks more than $500 million in spending differences.

Figure 3. House & Senate Unique Spending, FY 2017 – FY 2019

	Unique House	Unique Senate	Total
FY 2019	$304.0	$282.1	***$586.1***
FY 2018	$209.6	$227.5	***$437.1***
FY 2017	$186.0	$209.4	***$395.4***

Numbers in millions

Unique spending in the House and Senate budgets is up 34 percent over last year and almost 50 percent compared to FY 2016. The increase in unique spending, coupled with the relative lack of difference on revenues, means that that there is a significant delta between the sum total of spending in the two budgets and the amount of revenue available to support that spending.

Figure 4. Difference between Maximum Spending & Revenue

	House	Senate
Total spending	$41,515	$41,494
Spending in common	$41,211	
Unique spending	$304	$282
Maximum spending	$41,798	
Maximum revenues	$41,570	
Difference	***-$228***	

Numbers in millions

This disconnect between available resources and spending demands has three important implications:

- The new spending initiatives in the House and Senate budgets will have to be pared down substantially to fit within the revenue template used in the House and Senate budgets;
- It will be difficult to produce a conference committee budget that addresses approximately $200 million in underfunded accounts, the biggest fiscal risk in both the House and Senate spending plans, without further limiting new spending initiatives;
- Spending demands and existing revenue constraints may tempt budget makers to increase tax revenue estimates for FY19 in light of strong FY 2018 collections.

<u>Comparing House and Senate Proposed Policies</u>

The two budgets being negotiated each include a number of non-spending sections (185 in the Senate and 109 in the House) that cover a range of policy topics. As has been the case in recent years, the Senate budget includes significantly more policy provisions that the House. This mismatch in the number of sections can make it difficult to resolve policy differences in a way that is satisfactory for both branches.

Major Senate Policies

- ***Community Preservation Trust funding***
  The Senate budget proposes increasing deeds surcharges to generate approximately $36 million in annual revenue to dedicate to the Community Preservation Trust Fund.
- ***Employer Medical Assistance Contribution (EMAC) surcharge changes***
  The Senate adopted two amendments to mitigate the impact of the EMAC surcharge levied on employers in last year's budget. One provision would prevent businesses from being hit with both a state and federal penalty in the same year. The Senate also empowers the Administration to create a hardship waiver for businesses that meet certain criteria.
- ***Charter school approval***
  The Senate budget would prohibit the state from approving new charter school applications in any year in which the legislature does not fully fund district charter school reimbursements.
- ***Higher education campus notification***
  An amendment to the Senate budget requires any higher education campus planning a merger, closure, acquisition of another school or opening of a new campus to notify the Board of Higher Education at least 120 days prior to action.
- ***MassHealth pharmacy rebates***
  The Senate budget relies on $40 million (net of federal revenues) in FY 2019 savings from a section that enables the state to negotiate supplemental pharmacy rebates for the MassHealth program.
- ***Law enforcement and immigration***
  The Senate adopted an amendment related to state and local law enforcement and immigration policy. Among other things, the amendment prohibits state and local law enforcement from asking about a person's immigration status unless otherwise required to by state or federal law.

Major House Policies

- ***Increases to the dairy farmer and conservation tax credits***
  The House budget increases the cap on these two tax credits by two and three million dollars respectively.
- ***State Police audit and hiring practices***
  Under the House budget, a new independent audit unit, overseen by the Inspector General, would be placed within the State Police. In addition, the House creates a commission to examine hiring and promotion practices at the State Police.

Tax Revenue Context

The state will end FY 2018 with hundreds of millions more in tax revenue than originally anticipated.

Figure 5. FY 2018 Tax Collections v. FY 2019 Tax Assumption

FY 2018 collections to date	$24,639
June benchmark	$2,902
Estimated FY 2018 total	$27,541
FY 2019 assumption	$27,594
$ growth	$53
% growth	0.19%

Numbers in millions

If June collections meet benchmark, the state will end FY 2018 with $879 million more tax revenue than expected and total tax collections will be just $53 million less than the tax assumption used in both the House and Senate's FY 2019 budgets. These strong tax collections and the resource challenges outlined above could prompt budget makers to increase the tax revenue assumption in FY 2019.

The revenue landscape has changed since the budget's original tax projection was made in January and some adjustment may be warranted. However, as the Foundation pointed out in our analysis of FY 2018, much of the tax growth is related to the sale of capital assets and the impact of federal tax changes; both leading to a temporary spike in non-withholding income that is unlikely to persist and therefore must not be built into next year's budget.

Given these facts, any adjustment to FY 2019 revenue figures should follow the following principles:

- ***Do not use anticipated FY 2018 surplus revenue to pay for FY 2019 spending***
  Rather than increase revenue assumptions for FY 2019, budget makers could instead use FY 2018 resources to support next year's spending. This would be a major mistake. Paying for FY 2019 programs with prior year revenue increases the structural deficit going forward and reduces the Stabilization Fund deposit at the end of the current year. In a recession, the structural deficit balloons and reserve funds are the primary tool to avoid painful cuts. Taking steps to increase the structural deficit and limit reserve deposits during good fiscal times is imprudent.
- ***Do not assume savings from unexpended appropriations***
  In recent years, the conference budget assumed that a certain amount of appropriated funds would go unspent (otherwise known as reversions). The state budget does revert money each year, but baking that into the original budget limits the tools the state has to deal with midyear fiscal problems. Using reversions while also upgrading tax assumptions significantly increases the fiscal risk in the budget by relying on best case scenarios to balance the budget.
- ***Do not adjust original assumptions for non-withholding income tax revenue***
  Non-withholding income (which includes capital gains) is the most volatile source of tax revenue and the most difficult to project. Through May, $642 million (73 percent) of above benchmark tax revenue is due to non-withholding income. Not only is this revenue

volatile, and unlikely to recur, but it is subject to automatic deposit in the Stabilization Fund if it exceeds a certain threshold. There is strong reason to believe that the FY 2018 spike in this type of income is temporary and will decline next year. The FY 2019 budget should not alter its original assumption for non-withholding tax revenue.

- ***The Conference budget must not underfund accounts to balance the budget***
  The House and Senate budgets underfund several major accounts by more than $200 million, making it the biggest fiscal risk in each spending plan. Upgrading FY 2019 tax assumptions without appropriately funding these programs exacerbates the fiscal risk in two ways. First, it makes it more likely that the state will fall short of revenue assumptions. Second, it adds additional spending obligations to a budget that already has a $200 to $300 million exposure from underfunding. Last year, budget conferees added a $104 million reserve to pay for underfunded accounts. This year, conferees should fully fund the accounts at the start of the fiscal year.

Bottom line

Conference committee negotiations to finalize the FY 2019 budget are complicated by the fact that the combined demand for new spending in the House and Senate budget outpaces revenue assumptions. Budget makers may be tempted to address this challenge by enhancing tax revenue assumptions in light of strong FY 2018 collections. A case can be made for some adjustment, but only if it does not add to the structural deficit, impact deposits to the Stabilization Fund and results in a balanced FY 2019 budget.