Massachusetts Taxpayers Foundation

MTF LEGISLATIVE SESSION PREVIEW

2025-2026

GENERAL BUDGET & FISCAL UPDATE

Each year, the Commonwealth of Massachusetts' annual budget allocates the resources necessary to support the operations of state government and maintain critical local services. In Massachusetts, the annual operating budget is developed and approved through a lengthy and involved legislative process that begins with the filing of the Governor's budget proposal and concludes with the submission of a final budget agreement between the House of Representatives and State Senate.

During the 2025 – 2026 legislative session, two operating budgets will ultimately be signed into law that will include approximately $60 billion of state investment in areas such as healthcare, education, transportation, and workforce development. Given the significance and scope of the annual operating budget, this preview offers an overview of the state budget process and the factors that have had the largest impacts on state spending decisions in recent years. It also identifies the key policy questions that policymakers will face in the upcoming legislative session related to the state's short and long-term fiscal outlook.

Background & Policy Context

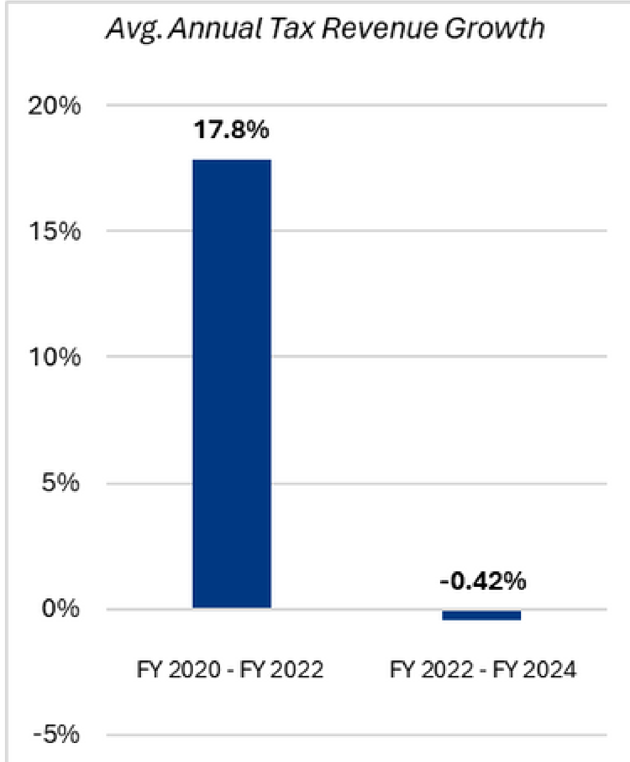
State Budget Process

The state budget in Massachusetts conforms to a fiscal year schedule, which runs from July 1st to June 30th. In order for the budget to be in place for the start of a new fiscal year, the budget development process generally takes place from January to July, beginning with the Consensus Revenue Agreement and ending with the enactment of the Final Budget. For more information, see MTF's State Budget Process 101 Primer.

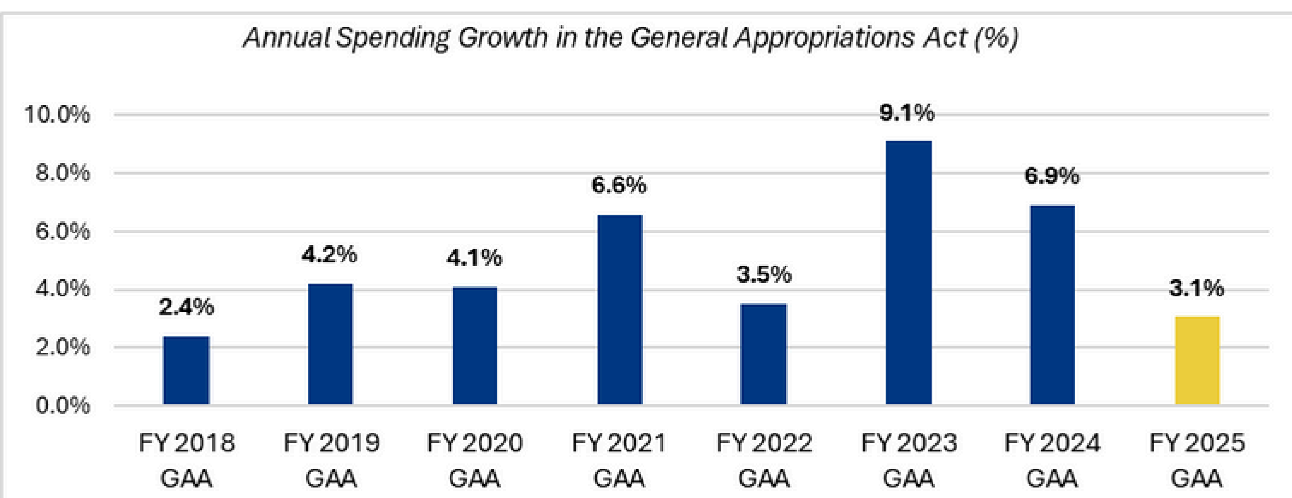
Recent Trends in State Revenue & Spending

Over the last two years, the Commonwealth has been navigating a time of fiscal transition. During the pandemic (FY 2020 to FY 2022), state tax revenue collections grew at an average annual rate of 17.8 percent. This exponential revenue growth during the pandemic was fueled by a strong stock market and pandemic-recovery spending, and it led to large tax revenue surpluses and increased supplemental spending. It also led to significant increases in the amount of spending included in the annual operating budget. In the FY 2023 state budget, spending grew over the prior year by 9.1 percent. In the five prior years (FY 2018 to FY 2022), spending had grown by an average of 4.2 percent each year.

Since FY 2022, trends in state tax revenue collections have shifted dramatically, with revenue growth between FY 2022 and FY 2024 actually decreasing by an average annual rate of 0.42 percent. The vast majority of this loss has been seen in the non-withheld income tax category, and specifically, in capital gains collections. Between FY 2022 and FY 2024, capital gains collections decreased by $1.8 billion (47 percent). It's worth noting that this revenue decline has taken place despite the passage of the four percent income surtax on income over $1 million; which went into effect in January 2023 and resulted in $2.46 billion in new revenue in FY 2024.



Throughout the budget development process in FY 2025, a main priority of the Healey administration and the State Legislature was to realign spending growth with revenue expectations. The FY 2025 consensus revenue estimate assumed that non-surtax state tax revenues would increase by 3.5 percent over FY 2024. Ultimately, the budget that was signed into law by Governor Healey reflected spending growth of 3.1 percent. This represented a large decrease in year over year spending growth compared to recent years, which was a necessary fiscal decision given continued downside revenue risks in FY 2025 and beyond. Moving forward, it will be imperative for state budget writers to continue to limit year over year spending growth, or they risk creating an ever increasing structurally imbalanced budget.



Income Surtax Implementation

In November 2022, Massachusetts voters approved a ballot measure that instituted a new four percent income surtax on individuals whose income is over $1 million. The surtax went into effect in January 2023, and during the 2023 – 2024 legislative session policymakers were tasked with creating a process to collect, track, and spend these resources that conformed to the requirements of the new law. Specifically, lawmakers were constitutionally obligated to ensure that all new revenues collected through the surtax are dedicated towards investments in education and transportation.

As part of the FY 2024 state budget, the administration and Legislature developed and approved the following multi-step process for surtax revenues:

1. All revenues related to the income surtax are certified by the Department of Revenue (DOR), deducted from total tax collections, and transferred to a new Education and Transportation Trust Fund.

2. Surtax revenues up to a specific threshold, known as the "surtax spending cap," are appropriated and spent on education and transportation-related initiatives, approved as part of the annual operating budget.

3. Surtax revenues collected in excess of the surtax spending cap are transferred from the Education and Transportation Trust Fund to two other trust funds: 85 percent to the Education and Transportation Innovation and Capital Fund, and 15 percent to the Education and Transportation Reserve Fund (the balance of which cannot exceed one-third of that year's surtax spending cap).

Through this process, as part of the FY 2024 and FY 2025 state budgets, $2.3 billion in income surtax revenue has been cumulatively appropriated towards education and transportation investments. As described in the following section, important discussions took place throughout the legislative session regarding how surtax resources should be distributed across the education and transportation sectors, as well as how the surtax can be used to most effectively support the short and long-term investment priorities of the Commonwealth.

Looking ahead to the 2025 - 2026 legislative session, the surtax will undoubtedly continue to play a major role in state financial decisions. After the first full year of surtax implementation, policymakers may also have an opportunity to adjust the process currently in place to ensure that it reflects the will of the voters while at the same time strengthening the state's financial position.

Key Actions in the 2023-2024 Legislative Session

Governor Healey's Inaugural Budget Proposal – The FY 2024 state budget represented the first spending proposal of the Healey-Driscoll administration, and in many ways that spending plan highlighted the policy priorities of Governor Healey for the 2023 – 2024 legislative session. The Governor's budget reflected a nearly $1 billion tax relief proposal, included $1 billion in new spending supported by the income surtax for education and transportation, and maintained investments in key pandemic-era programs related to childcare, housing, and food security. Each of these issues played a major role in the spending and policy deliberations that took place between the House and Senate in 2024, with action eventually taken on each one. A compromise tax relief package was signed into law in October 2023; the FY 2024 final budget reflected the new process to collect, track, and spend surtax revenues; and the Legislature agreed to continue investments in critical programs like C3 Childcare Operational Grants and Universal School Meals.

Implementation & Investment of the Income Surtax – As noted above, the FY 2024 budget established the process to collect, track, and spend surtax revenues; and the FY 2025 budget conformed to that process as well. Collectively, $2.3 billion of income surtax revenue has been appropriated in support of education and transportation initiatives in FY 2024 and FY 2025. To date, surtax investments in the operating budget have been more heavily concentrated in the education sector, as shown in the table below.

Income Surtax Investments in FY 2024 & FY 2025

	FY 2024 GAA	% of Total Investment	FY 2025 GAA	% of Total Investment
Education	**$524**	**52%**	**$762**	**59%**
Early Education	$71	7%	$278	21%
K-12 Education	$224	22%	$245	19%
Higher Education	$229	23%	$239	18%
Transportation	**$477**	**48%**	**$539**	**41%**
MBTA	$206	21%	$261	20%
MassDOT	$75	8%	$123	9%
RTAs	$90	9%	$110	8%
Local/Pilot Program	$106	11%	$45	3%
Total Investments	**$1,000**		**$1,300**	

$ in millions

The breakdown of income surtax spending over the last two years has also established several guidelines for the types of investments that lawmakers believe are consistent with the new law. For example, the FY 2024 and FY 2025 budgets have set precedents for using the surtax to support investments dedicated to early education, additional Chapter 70 state aid for public schools, and expanding the state's borrowing capacity for transportation-related capital projects. For additional detail on surtax spending in FY 2025, check out MTF's budget deep dive on surtax spending.

Tax Relief Legislation – In October 2023, the Governor signed into law a nearly $1 billion tax relief package that included a total of 17 different tax relief provisions targeting issues of cost and competitiveness. Due to the phasing in of several major provisions, including an increased child and dependent tax credit and a reduced short term capital gains rate, the package carried an FY 2024 cost of $571 million. Tax relief came on the heels of more than $10 billion in tax revenue growth over a two year period, as well as the agreement among key policymakers that tax relief would improve Massachusetts' position as a place that retains and attracts people, jobs, and investment.

Status of Major Tax Policies	
Policy	**MTF Annualized Cost**
EITC	*$91*
Circuit Breaker	*$60*
Rental Deduction	*$40*
CDTC	*$300*
Estate Tax	*$213*
Short Term Cap Gains	*$65*
Single Sales	*$79*
LIHTC	*$55*
HDIP*	*$20*
Minor Provisions	*$28*
Total Fiscal Impact	**$951**
Total Impact Net to Budget	**$886**

In addition to increasing the child and dependent tax credit and reducing the short-term capital gains rate, the legislation increased the senior circuit breaker tax credit, the rent deduction, and the earned income tax credit. It also increased the state's estate tax cap from $1 million to $2 million and proposed implementing mandatory single sales factor apportionment for corporate taxation. MTF's complete summary of the tax relief bill can be found here.

Realignment of Spending & Revenue Expectations in FY 2025 – The FY 2025 budget development process was unique compared to recent years due to its focus on reigning in spending increases to align with expected revenue growth. Each of the budget proposals originally put forward by the Governor, House, and Senate reflected spending growth over FY 2024 of approximately 3.6 percent; consistent with the estimated non-surtax revenue growth rate of 3.5 percent and significantly lower than the spending increases seen in FY 2023 and FY 2024 (9.1 percent and 6.9 percent, respectively). However, as actual revenue collections throughout FY 2024 continued to fall below expectations, there was a recognition that an even more conservative spending increase would be necessary in FY 2025 to ensure that the state was on solid financial footing.[1] Ultimately, the final budget reflected spending growth of 3.1 percent; but that was only possible after Governor Healey vetoed $317 million in gross spending from the conference report enacted by the Legislature. Looking ahead to FY 2026, maintaining modest rates of spending growth should be a priority for policymakers, particularly as they face both known and unknown cost exposures outside of the annual operating budget, including the Emergency Assistance shelter system and the Steward hospital crisis.

[1] In January 2024, Governor Healey also announced $545 million in gross spending vetoes ($375 million net). These spending cuts took place after December revenues were released, showing FY 2024 year to date collections falling behind benchmark by $769 million. For additional information on the Governor's FY 2024 spending vetoes, read the MTF Analysis of FY 2024 Tax Revenue Shortfall & 9C Cuts.

Key Policy Questions for the 2025-2026 Legislative Session

As policymakers, advocates, and other interested stakeholders prepare for the new legislative session and the upcoming FY 2026 budget development process, MTF highlights the following key policy questions:

How will state budget writers maintain new program investments while confronting slow and declining revenue growth?

Over the last few years, a wide array of new state programs and investments have been incorporated into the operating budget, including implementation of the Student Opportunity Act (SOA), full-year funding of C3 Childcare Operational Grants, Universal School Meals, and Free Community College. At the same time, the state has also continued funding for certain programs at pandemic-era highs, like rental assistance, shelter services, and food insecurity infrastructure grants. In combination with standard cost increases for other state-funded programs and services, these investments will be challenging to sustain during a time of limited revenue growth. In FY 2026, as in FY 2025, budget writers may be forced to build their budget proposals with fewer consensus tax revenues available to support budgeted spending than the year before. While a range of solves will be necessary to craft a balanced budget, there are at least two strategies that policymakers could consider using to cover certain cost increases. First, a number of these programs have been partially supported by income surtax revenue in the last two years and moving forward, that share could grow and account for any new spending requirements. This would be possible because the surtax spending cap will incrementally increase each year; but, it would also limit the resources available to support entirely new programs. Second, costs related to SOA implementation and childcare operational grants could be partially covered using existing trust fund resources. However, trust fund resources are one-time in nature, so for this to be an ongoing solution the fund balances must be maintained or replenished when possible. Ultimately, the maintenance of these significant programs may come at the expense of new investments as the state enters a period of limited revenue growth.

After the first full year of income surtax implementation, what changes could policymakers consider making to the process put in place in FY 2024 to collect, track, and spend these revenues?

The process created by policymakers in FY 2024 to collect, track, and spend surtax revenues is clear and transparent; and it has directed billions of dollars in new revenues towards the education and transportation sectors. However, after reflecting on the first full year of surtax revenue implementation, there are several policy changes and improvements worth consideration.

- **Improve surtax revenue reporting** – Two years after the income surtax went into effect, there remains limited reporting on actual surtax revenue collections throughout the fiscal year. Surtax revenues are included within the broader income tax category that is reported on monthly by the Department of Revenue, but collections directly related to the surtax are not segregated out from all other income tax collections. The lack of in-time reporting on the surtax creates challenges when it comes to comparing non-surtax revenue collections to benchmark, and comparing surtax collections to the surtax spending cap applied to the operating budget.

- **Differentiate between the surtax spending cap & surtax revenue projections** – The surtax spending cap is a limit on the amount of surtax revenue that can be incorporated into the operating budget each year. This cap is purposefully set at a level lower than projected collections to ensure that the amount of surtax spending in the budget is sustainable over the long-term. The relationship between the spending cap and revenue projections becomes confusing, however, because it is the spending cap that is currently incorporated into the tax revenue benchmarks for the fiscal year. Because the spending cap is purposefully lower than expected collections, this practice perpetually underestimates the amount of surtax revenues that will be collected during the fiscal year. Moving forward, policymakers may consider incorporating surtax projections into the tax revenue benchmarks, instead of the spending cap.

- **Incorporate more flexibility into the surtax spending cap** – Establishing a surtax spending cap for the fiscal year as part of the budget development process provides clarity and structure for state budget writers, and should remain an important part of the surtax process. However, it may also be appropriate to develop a structure to adjust the surtax spending cap at the end of the fiscal year, based on actual revenue collections. The surtax spending cap for the fiscal year is set 18 months prior to actual surtax revenue collections being known, and revenue projections can change dramatically over that time period. Creating a process that acknowledges fluctuations in revenue collections would allow administrative and legislative budget writers to more effectively manage surtax revenues as part of the operating budget.

What will be the strategy for investing income surtax revenue in FY 2026 and beyond?

Heading into the 2025 – 2026 legislative session, policymakers will need to address two primary questions related to income surtax investments. First, how will new income surtax revenue be distributed across the education and transportation sectors in the operating budget? And second, how will excess surtax revenues currently held in the Education and Transportation Innovation and Capital Fund be appropriated for one-time and capital-related projects?

To the first question, a portion of new income surtax revenues will likely be required to maintain large new programs that have been incorporated into the operating budget, including programs like Universal School Meals and C3 Childcare Operational Grants. To the extent that there are revenues available to support new investments, opportunities that maximize the long-term impact of a dedicated revenue stream should be prioritized. For example, in the FY 2025 GAA, policymakers approved a $250 million annual transfer of surtax revenue to the Commonwealth Transportation Fund, which unlocks more than $1 billion in additional borrowing capacity for transportation-related capital projects.

To the second question, a supplemental spending bill to appropriate surtax revenues in the Education and Transportation Innovation and Capital Fund is likely to be considered early in the new session. As policymakers consider how to spend these one-time resources, at least 50 percent should be dedicated towards transportation. In particular, as MTF previously reported, funds from the Innovation & Capital Fund, in conjunction with surtax operating resources, can be a crucial tool in helping to address MBTA operating gaps in FY 2026 and FY 2027.

What known and unknown cost exposures will impact state spending throughout the rest of FY 2025 and into FY 2026, and what resources exist to address these costs?

As state budget writers worked to close the books on FY 2024, a major area of discussion was how to appropriately prepare for the known and unknown cost exposures that the state is likely to face throughout FY 2025 and FY 2026. These costs include the Emergency Assistance (EA) shelter system, the Steward hospital crisis, and increasing demands on caseload-driven programs like MassHealth and Child Care Financial Assistance (CCFA).

These spending needs will be in addition to the standard increases required in FY 2026 to maintain a consistent level of service across all other state departments and agencies. Over the past few years, the state has had access to several reserve funds to help cover these costs and relieve pressure on the operating budget, including the Transitional Escrow Fund, the

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Student Opportunity Act Investment Fund, and a High Quality Early Education and Care Affordability Fund. However, the balances of these funds are dwindling and could be depleted over the next couple fiscal years. In order for reserve funds to remain a critical tool for budget writers, these funds must be bolstered when possible.

In addition, a major unknown impacting the state's fiscal future beginning in 2025 is the impact of federal action on the state's economy and budget. Policy proposals from the Trump administration could have profound and immediate impacts on the Commonwealth. For example, the extension and potential expansion of the Tax Cuts and Jobs Act of 2017 could boost state tax revenue collections in the short-term, but could come at the expense of major cuts to domestic programs, like Medicaid and funding for public schools. Each year, Massachusetts receives more than $10 billion in federal reimbursement for state Medicaid spending; and even a partial loss of that funding would be disastrous for the state budget and the state's healthcare system. During the 2025 – 2026 legislative session, policymakers must be aware that policy changes at the federal level could occur with limited notice, and they must be prepared to respond.

Related Research from the Massachusetts Taxpayers Foundation

State Budget Process

- Governor Healey's Fiscal Year 2025 Budget
- House Ways & Means Fiscal Year 2025 Budget
- Senate Ways & Means Fiscal Year 2025 Budget
- FY 2025 Conference Committee Report

Fiscal Updates

- FY 2024 Tax Revenue Shortfall & 9C Cuts (January)
- FY 2024 Fiscal Update (April)
- FY 2024 Fiscal Update & Closeout Supplemental Budget (October)
- FY 2025 Fiscal Update & FY 2026 Consensus Revenue Hearing (December)