MassBudget Brief: Fiscal Year 2011 Budget Preview

In crafting the Fiscal Year 2010 (FY 2010) budget, the state faced a gap of approximately $5 billion.[1] To close the gap, the state relied on three sets of strategies (approximate amount in parentheses after each item):

1. Savings from budget cuts and other spending reductions ($2.22 billion).
2. Increased fees and taxes ($795 million).
3. The use of federal and state temporary revenue sources ($1.95 billion).

With the recently announced further declines in tax revenue for FY 2010 indicating that the Commonwealth is currently $212 million below benchmark for the first quarter of FY 2010,[2] it is likely that additional cuts, revenues, or reserves will be required to keep the budget balanced throughout FY 2010.[3]

The picture for FY 2011 is just as challenging. While the state made some very difficult choices to impose deep cuts and raise new revenue, these strategies account for about 60 percent of the budget gap. The rest of the gap – $1.95 billion – was closed using temporary revenue sources. This *Brief* examines the FY 2011 budget gap and the challenges the state will face in filling that gap.

It is important to note, as difficult as these challenges are, the state's fiscal situation would be far worse if the federal government were not providing $1.62 billion in stimulus funding this year and up to $812 million in FY 2011. While this temporary assistance doesn't solve the state's long-term structural problems, it did reduce by more than a billion and a half dollars in FY 2010 (and about half that in FY 2011) the amount that the state would have been forced to raise in taxes or cut in spending during the recession. Without the federal assistance in FY 2010 the state either would have had to cut hundreds of million dollars more from local aid, education, health care, human services, and the other major areas of the state budget, or would have had to raise taxes by more than twice as much as the increase that was enacted – or both.

THE PRELIMINARY FY 2011 BUDGET GAP

Calculating the FY 2011 budget gap will require looking at: how much in temporary revenues were used to fill the FY 2010 budget gap; maintenance cost increases associated with existing state services; and how much revenues will change due to changes to state tax laws and economic growth. These are discussed in detail below.

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[1] See the Overview in MassBudget's *Budget Monitor: The Legislature's Fiscal Year 2010 Budget with the Governor's Vetoes and Amendments* for a discussion of the $5 billion deficit projected for FY 2010, available at: http://massbudget.org/doc/681.

[2] Massachusetts Department of Revenue announcement on revenue collections, available at: http://www.mass.gov/?pageID=dorterminal&L=5&L0=Home&L1=Tax+Professionals&L2=News+and+Reports&L3=DOR+Press+Releases&L4=2009+Press+Releases&sid=Ador&b=terminalcontent&f=dor_news_pressreleases_2009_Sept09_revenues&csid=Ador.

[3] On Oct. 15, 2009, the state will announce the final revenue shortfall for FY 2010 and within the following two weeks the Governor will use his 9C authority to announce the cuts necessary to balance the budget.

FY 2010 Temporary Revenue

Most of the state budget is financed with ongoing revenues, such as taxes, fees and federal aid. During a recession, as revenues fall because of decreased economic activity, states also rely on the use of reserve funds and temporary federal revenue, such as that provided in the stimulus law, which is officially known as the American Recovery and Reinvestment Act (ARRA). In calculating the budget deficit for FY 2011, the first step is to identify how much of this year's budget is being paid for by such temporary sources. That total is approximately $1.95 billion. The following items are the major temporary revenue sources relied on in FY 2010:

- $1.262 billion in increased Medicaid reimbursements provided in ARRA.
- $323 million in ARRA funds for education (called "Fiscal Stabilization").
- $34 million in other ARRA funding that supports the state budget.
- $327 million from state reserve accounts (primarily the state's Stabilization Fund).

FY 2011 Maintenance Cost Changes

Because of inflation, changes in caseloads, one-time cost savings that can't be repeated in future years and other factors, the cost of existing government programs changes from year to year. As it is too early to make precise estimates of costs for the budget year ending in June 2011, this *Brief* provides rough estimates of potential cost changes. Over the next six months the state will be developing more precise estimates. These estimates will project both changes in costs due to inflation and changes in the demand for services related to stress in the overall economy. These "maintenance estimates" have historically not been released publicly. Particularly as the state faces unusually difficult choices, it would be beneficial for state budget writers to release program-by-program maintenance estimates as soon as such estimates are available. While even official estimates would likely have to be revised as new information becomes available, releasing information based on the best data available would be an improvement in the transparency of the budget process.

This *Brief* provides an overall maintenance cost increase estimate by applying one rate of growth to health care spending and another rate to other spending:

- Health Care Spending: 8 percent. Because of the trends in health care costs and the likely increase in enrollment in Medicaid due to the weak national economy, health care costs will likely increase by approximately 8 percent.[4]
- Non-Health Spending: 2 percent. Overall inflation in the economy is likely to be lower than this, but demand for services will likely continue to increase as the economy remains weak and unemployment is projected to increase modestly. In reality, inflation and enrollment patterns affect each state program differently, but there are not yet enough data to make detailed projections.

[4] Based on recent projections by the U.S. Centers on Medicare and Medicaid Services, which estimate Medicaid expenditures growing 7.8 percent between 2010 and 2011. Because of the worsening economy and expected caseload changes, we have rounded this figure to 8 percent. See http://www.cms.hhs.gov/NationalHealthExpendData/downloads/proj2008.pdf.

We apply these rates of cost increases to the state-funded portion of state spending (we do not include, for example, the portion of Medicaid spending that is reimbursed by the federal government). This calculation shows a net state increase of $528 million for health care and of $401 million for the rest of the state budget, leading to a total maintenance increase of $929 million. In addition to changes in maintenance costs, there was also approximately $200 million in one-time savings in the state's FY 2010 budget that will not be available in FY 2011. This includes $150 million from using funds already in the School Building Assistance Trust Fund to offset costs for that program and certain "pay for performance" initiatives in Medicaid that have the effect of shifting costs into future years. Altogether these maintenance estimates total $1.13 billion.

Changes in State Revenue Collections

There are two major sources of state revenue, and several smaller sources. The major sources are taxes (estimated at $19 billion in FY 2010), and revenue provided by the federal government (estimated at $8.4 billion in FY 2010, including temporary increases associated with ARRA). The other sources include the state Lottery, fees, fines, payments from the tobacco settlement agreement, money from the state's Stabilization Fund, and other sources (estimated at $4.6 billion overall in FY 2010).

The major changes that need to be estimated for the purpose of calculating future budget gaps are changes in the amount of tax revenue. Federal revenue is primarily a function of state spending on Medicaid, and the calculations in the section of this *Brief* estimating cost changes already include an adjustment to reflect changes in federal revenue. The remaining state revenue sources such as fees and fines are smaller and the baseline growth from these sources does not change dramatically from year to year. As there generally are not official estimates available, we do not make any assumptions about changes in the amount from these other revenue sources in this preview.

There generally are two ways that tax revenue changes from one year to the next. First, changes in tax law will alter how much revenue the state collects. Second, changes in the state's economic growth will affect revenue collections. In determining the state's projected budget gap for FY 2011, we look at both.

A. FY 2011 Revenue Changes due to Previously Enacted Tax Law Changes

There are two significant recent tax law changes that need to be considered in examining the FY 2011 budget gap. Together they will lead to a projected increase in revenue of $79 million.

- The sales tax increase enacted in 2009, because of the timing of implementation, is only expected to generate 10 months of income in FY 2010. In FY 2011 it will generate a full 12 months of revenue. This is estimated to increase state revenue by $130 million.

- The legislation enacted in FY 2008 to reduce corporate tax avoidance also included a phased-in reduction of the corporate tax rate. This reduction is estimated to reduce state revenue by $51 million in FY 2011.

B. Changes in Revenue due to Economic Growth

Tax revenue is notoriously difficult to estimate, particularly in times of economic crisis. If the economy does not begin to recover, tax revenue could decline further. The revenue data so far this year indicate that the current estimate for FY 2010 may be overly optimistic. If, however, there is a strong national recovery, tax revenue could increase significantly in FY 2011. In past recoveries, baseline tax revenue has increased at rates up to 10 percent a year, and sometimes more. Current projections indicate that the economy will be recovering at a modest pace in FY 2011, and therefore we project a 4 percent growth rate in tax revenue. This rate is lower than we have seen in previous recoveries, but given the risk that the FY 2010 base may be lower than officially projected and that the recovery is likely to be slow, it would be unwise to assume a higher rate of growth. Given this assumption, we project that a 4 percent increase will bring $760 million more in revenue for FY 2011. It is possible, however, that tax revenue growth could be significantly stronger or weaker than this projection.

The FY 2011 Initial Budget Gap

To calculate the initial budget gap for FY 2011, we need to account for each of the issues discussed above. We add together the costs that were covered by temporary revenue in FY 2010, the projected increases in maintenance costs, and then subtract from that the new tax revenue expected in FY 2011.

Use of temporary revenue in FY 2010	$1.95 billion
Maintenance Cost Increases	$1.13 billion
Net Legislated Revenue Increases	-$79 million
Revenue Increases from Economic Growth	-$760 million
Total Initial Gap:	$2.24 billion

This total initial gap is very close to the amount of temporary revenue ($1.95 billion) used to balance the FY 2010 budget. This is not surprising, as in normal economic times baseline spending growth and baseline revenue growth are generally comparable. When the economy is very strong, baseline revenue growth will generally exceed baseline spending growth, and in recessions the opposite occurs. Because baseline revenue growth is not likely to exceed baseline cost growth in the long term, states must be careful not to adopt spending or tax cut policies in strong economies that will not be sustainable when economies grow weaker during a recession. It is important to consider, however, that this initial gap could increase to the extent that revenue declines beyond expectations this year or that programs costs exceed the amount budgeted because of increased need due to the weak economy or other factors.

CHALLENGES IN CLOSING THE FY 2011 BUDGET GAP

The state will have limited resources available to it as it crafts the FY 2011 budget. One option is to continue to dip into the temporary sources that will still be available in FY 2011; a second is that Congress passes another fiscal relief bill; and the third is to lower spending, or raise taxes, or both.

Federal Temporary Revenue

- The state will have available approximately $635 million in Enhanced Medicaid Reimbursements and Temporary Assistance to Needy Families (TANF) Emergency funds from ARRA. This is about half of the amount the state is anticipating in FY 2010 (this ARRA funding expires half way through FY 2011).

- The state will have available up to $177 million in Federal Fiscal Stabilization Funds from ARRA (this is funding targeted primarily at education). Massachusetts spent $411 from this source in FY 2009, and has budgeted to spend $323 million in FY 2010. If tax revenue fails to meet projections for FY 2010, it is likely that some or all of the remaining $177 million will be spent this year.

State Reserves

- At the end of FY 2010, the balance in the state Stabilization Fund will be approximately $561 million, unless there are withdrawals or deposits other than those currently anticipated. There are no other significant state reserves.

Together these temporary sources could provide up to $1.37 billion. It would be risky, however, to assume that the FY 2011 budget will be able to spend that much from these temporary sources. Some of these funds could be depleted in FY 2010. Moreover, even with strong economic growth in FY 2012, the state will still face a budget gap in that year and may need funds from the state's reserves to help fill that gap.

Additional Federal Relief

The challenges facing Massachusetts are fairly typical of state budget problems across the country.[5] To avoid a new round of severe budget cuts and significant tax increases, the federal government could provide additional state fiscal relief. This would help protect the national recovery by reducing the need for states to pursue fiscal policies that would harm the economy by reducing individual or public spending (as a result of tax increases and budget cuts). It would also allow states to protect vulnerable populations at a time when unemployment may be peaking.

Spending Cuts and Tax Increases

The FY 2011 budget process will force the state to make additional difficult choices. It is unlikely that economic growth or the ability to use reserve funds will allow the state to balance the FY 2011 budget without reducing spending or identifying new revenue sources, or both. Budget writers will need to examine every area of state spending, including appropriations in the budget and the money the state spends on tax expenditures.[6] Readers interested in examining current spending and trends over the past ten years in each category and subcategory of the budget can do so using MassBudget's on-line Budget Browser at http://browser.massbudget.org/. Information about taxes can be found on the Browser website at http://browser.massbudget.org/BrowserRevenuePage.aspx or on MassBudget's web site at MassBudget publications on taxes (at http://www.massbudget.org/topic/tax).

Projections for FY 2012

It is impossible to make accurate projections two years into the future. If the economic recovery is weak or the nation falls back into recession, the fiscal condition in FY 2012 would be dire. Even in the best of circumstances, however, the state will face significant challenges in balancing its FY 2012 budget. If, as may be necessary, the state relies on a billion dollars or more of federal ARRA revenue and its own reserves, in FY 2011, then FY2012 could be even more challenging as both of those sources would likely be almost entirely exhausted. As many other states will likely be in similar conditions, Congress could act to provide additional fiscal relief, otherwise the stat e will face very difficult choices.

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[5] See "New Fiscal Year Brings No Relief From Unprecedented State Budget Problems," http://www.cbpp.org/cms/index.cfm?fa=view&id=711, Sept. 3, 2009.

[6] Tax expenditure is the cost to the state of creating credits or exemptions or other special rules within the tax code. Massachusetts' Tax Expenditure budgets are available at: http://www.mass.gov/?pageID=dorsubtopic&L=5&L0=Home&L1=Tax+Professionals&L2=News+and+Reports&L3=State+Budget+Documents&L4=Tax+Expenditure+Budget&sid=Ador.

As the Commonwealth continues to face severe long-term fiscal challenges as a result of the large tax cuts of the late 1990s,[7] ultimately the state will need to examine in a comprehensive manner the quality of services residents want their government to provide and the fairest way to fund needed services.

[7] See MassBudget's *Substantial Surpluses to Dangerous Deficits: A Look at State Fiscal Policies from 1998 to 2008*: http://www.massbudget.org/documentsearch/findDocument?doc_id=638#, January 14, 2009