

A Preview of the FY 2017 Budget

Ideally our state budget can be how we improve the education we provide for our children, how we maintain our roads, bridges, subways and other critical infrastructure, and how we protect and strengthen the economic security of all of our people. But in recent years we have struggled to make these investments because our budget is out of balance.

As the Fiscal Year (FY) 2017 budget season starts, the Commonwealth continues to face serious fiscal challenges. Our current FY 2016 budget relies significantly on temporary revenue sources and short-term savings. Ongoing costs for this year exceed ongoing revenue by about \$828 million. Looking forward to FY 2017, baseline revenue growth and baseline cost growth are expected to be roughly similar. Therefore this budget gap will not close itself and, with tax policy changes that would raise revenue unlikely, additional budget cuts will be more likely than new investments in the health of our communities.

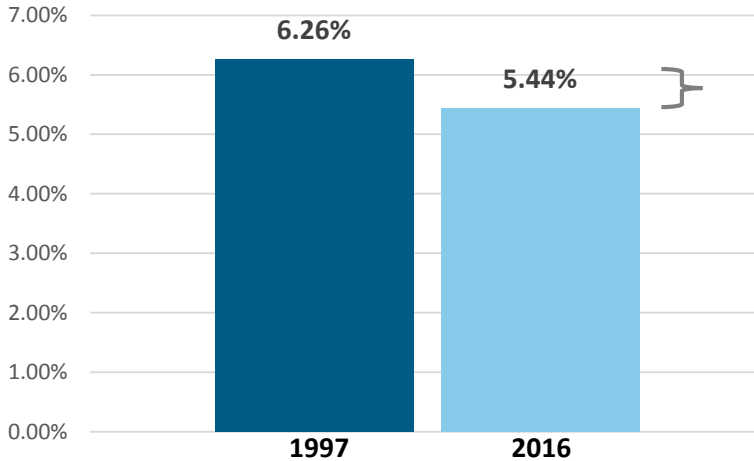
This year's budget challenges are part of a longer-term pattern that has plagued Massachusetts for more than a decade: deep cuts in recessions, barely balanced budgets in the best of times, and chronic structural budget gaps. Each of our last three Governors has taken office facing substantial budget gaps. And each has left office with substantial budget gaps. Why?

The data provides a very clear answer: the state cut taxes by over \$3 billion between 1998 and 2002 and has never been able fully to close the budget gap created by those tax cuts¹. The majority of the gap has been closed by annual budget cuts that have compounded over time: since FY 2001, unrestricted local aid has been cut by 43 percent, funding for higher education has been cut by 19 percent, support for environment and recreation accounts is down 28 percent, and there have been similar cuts throughout much of state government. There is also one area of state government where costs have grown significantly: health care. Health care cost growth has, of course, been a national trend, affecting both the public sector and the private sector.

Over the long term, a state budget will remain balanced if both spending and revenue grow at the same rate as the overall economy. If, for example, the economy is growing at 4 percent a year, then tax revenue will grow at 4 percent a year (if the overall rate of taxation remains stable), and spending growth of 4 percent will allow the budget to remain in balance. Therefore, when economists examine long-term budget trends they look at spending and revenue as a share of the economy. The Congressional Budget Office, for instance, describes their approach this way: "When analyzing changes in spending, revenues, deficits, and debt, CBO usually measures those amounts relative to economic output. That approach automatically incorporates inflation and growth in population, output, and income, providing context for understanding the size of the government's activities at different points in time and their effects on the sustainability of the budget."² For more detail see [Adjusting for Personal Income: When, Why, and How](#).³

Tax Cuts Have Reduced Revenue and Led to Budget Challenges

Massachusetts tax revenue as a share of the state economy



This 13.1% decline in tax revenue has led to deep budget cuts and ongoing budget challenges.

As we see above, tax revenue as a share of the economy has declined significantly over the past 20 years. This is primarily because of a series of income tax cuts adopted between 1998 and 2002 that reduced the overall tax rate, dramatically reduced the tax rate on dividend income, and raised the personal exemption. Over this timeframe net state spending as a share of the economy has not increased significantly, while total spending (which includes spending reimbursed by the federal government) has grown modestly. The reason net state spending has been stable while overall spending has grown modestly is that spending growth has been driven by healthcare costs and the federal government pays a large share of those costs. Most of the federal money that the state receives comes from the Medicaid program, which reimburses roughly half of state Medicaid spending. In addition, the Affordable Care Act provided increased federal reimbursements that included the federal government paying up to 90 percent of the costs of some of our Medicaid program. For more detail, see [New Federal Revenue Affects State Spending Trends](#).

FY 2016 BUDGET ISSUES

The FY 2016 budget is typical of budgets over the last fifteen years. We are now six years into a recovery, and yet when the budget was enacted, it relied on \$600 million of temporary revenue and short-term savings. Additionally, a number of accounts were underfunded by \$225 million, according to administration estimates. For example the accounts to pay for shelter for homeless families and for our Sheriff’s departments received significant less in funding than the expected costs. The budget also assumed \$145 million more in non-tax revenue than the state actually expects to receive this year. And it counted on \$63 million more in savings from an early retirement program than the state now expects to achieve.

Budget Challenges Coming out of FY 2016		(\$ in millions)
One-time resources used in FY 2016 GAA		
Divert excess capital gains revenue from Stabilization Fund		-\$300
Non-filer tax amnesty		-\$100
Delaying provider payments in MassHealth		-\$116
Other one-time revenue		-\$93
		-\$609
Other shortfalls		
Projected FY 2016 non-tax revenue shortfall		-\$145
Sales tax holiday		-\$26
Additional deficiencies		-\$225
Early retirement		-\$63
		-\$459
Mid-year adjustments that reduce the FY 2016 gap		
9C cuts		\$50
Newly identified federal revenue		\$50
Mid-year increase to FY 2016 tax revenue estimate		\$140
		\$240
TOTAL		-\$828

Additionally, the administration has made some mid-year adjustments that reduce the FY 2016 gap (final section of chart above). Specifically, the administration recently made \$50 million in FY 2016 spending reductions that will help close the structural gap very modestly. The Governor made these cuts using authority granted to him in section 9C of Chapter 29 of the state's General Laws, described in greater detail in [What is the Governor's 9C Authority?](#) The administration also identified an additional \$50 million in federal revenue that further reduces the gap. More significantly, the administration increased the FY 2016 tax revenue estimate by \$140 million. If this new revenue estimate proves to be accurate, the structural gap this year would be reduced by about \$240 million (or a little less if the new federal revenues are not from ongoing sources). Thus, the gap coming out of FY 2016 would be approximately \$828 million.

While there is a structural gap \$828 million in the current year budget, it is likely that the budget will meet the statutory definition of balance: there will likely be revenue to pay for all authorized spending. In addition to the \$609 million of temporary revenue relied on in the original budget, the state added \$113 million of new temporary revenue in a supplemental budget that shifted a one-time surplus in debt service accounts from 2015 to 2016. There will also likely be end-of-year surpluses in some accounts that can cover deficits in others.

THE FY 2017 BUDGET

Because revenue next year is expected to increase at close to the same rate as costs, much of the structural gap in the FY 2016 budget will likely carry forward to next year. Budget writers will be confronted with the choice of making potentially harmful cuts, raising revenue (which they have largely stated they don't plan to do), or using another round of temporary fixes that reduce the

Commonwealth's ability to build the reserves our Commonwealth will need in the next economic downturn.

Projecting future year costs is an essential part of sound budgeting practice (for more detail, see [Opening the Process: Releasing Maintenance Budgets to the Public](#)). In Massachusetts, state law dictates that each state agency should produce an estimate of cost of its programs for the coming year.⁴

The information in these required statements would provide the most accurate estimates of baseline cost increases and decreases. Public access to that data would allow for greater understanding of the budget process and more meaningful opportunities for public participation. Without such estimates it is hard for the public – and even legislators – to know for sure whether proposed funding levels represent a reduction or an increase from the funding level required to maintain current services. In Massachusetts, however, these statements have not been made public (by this administration or prior ones), nor is it clear that they are consistently completed in the manner described in state law. It would be a significant improvement in state budget transparency if these costs estimates were made public reasonably early in the budget process.

Without official baseline cost estimates being made public, the projections provided below are simply estimates.

FY 2017 COST GROWTH

Since detailed maintenance budget estimates of cost changes for each state agency are not publically available, this preview uses the overall inflation rate in most cases to generate rough estimates of cost growth for next year. In reality, some expenses will increase at more than the rate of inflation. For example, when the stock market crashed in 2007 our state pension fund suffered major losses and we have had to increase payments into the fund as a result. On the other hand, in good economic times some expenses will increase at less than the rate of inflation or will decline. For example, funding for transitional assistance has declined and that decline is likely to continue as the economy improves and more of the parents receiving this support find jobs. Overall it is likely that adjusting most of the budget just for inflation modestly understates the likely cost increases to provide the same level of services.

Health Care

One area of state government is large enough – and has particular cost trends – that it is important to examine it separately: health care. Health care costs (the net state costs of MassHealth and related health spending and the costs of state employee health insurance) account for 24 percent of the state budget and health care costs have consistently grown at more than the rate of inflation.

The Commonwealth currently spends \$17.9 billion on health care. But a large share of those costs are reimbursed by the federal government through the Medicaid program. The net state cost is \$10.2 billion. If we assume that health care costs (including inflation and enrollment affects) will grow at 5%, roughly the rate of growth in recent years, then net health care costs will grow by \$490 million in FY 2017.

State Budget Other Than Health Care

If we assume that most of the state budget (other than health care) will grow at the expected rate of inflation, that will lead to \$538 million in new costs in FY 2017 (\$23 billion x 2.2 percent).

After Health Care the next largest expenditure item is education. The K-12 education funding context this year is somewhat complicated. Baseline funding for local aid for education is determined by a formula in state law (Chapter 70). The Chapter 70 formula identifies the amount that should be spent in each community to provide a quality education (called the Foundation Budget), identifies how much should be contributed by the local community based on capacity, and then sets the state contribution to allow for each district to spend the Foundation Budget amount (for a full explanation see [Demystifying the Chapter 70 Formula](#)). In the long term there are issues with this formula that will likely need to be addressed (see report of the [Foundation Budget Review Commission](#)). In this year's budget there is likely to be an odd outcome from the formula. It uses a specific inflation factor that is different from the standard Consumer Price Index, and rather than projecting forward it uses historic data (so that there is reliable data rather than projections). The measure of inflation it uses, in the time period measured, shows negative inflation. This means that when the formula generates state aid numbers for next year those numbers will not fund cost increases due to inflation between FY 2016 and 2017. In previous years when the formula calculation produced a higher inflation number than policy makers were willing to fund, they adjusted the rate down by choosing a different time period to measure. During this year's budget debate, some adjustment to Chapter 70 funding will likely need to be made to account for the formula not providing an increase to cover inflation. A number of strategies are possible: the state could now reverse the reduction in aid implemented when the inflation rate seemed too high (more details in inflation section [HERE](#)), further implement reforms begun in 2007 (more detail [HERE](#)), or start to phase in reforms recommended by the Foundation Budget Review Commission. There is also a technical issue that will need to be resolved that relates to how the Commonwealth counts the number of low-income students (for more detail see [FAQ: Expanding School Meals and Implications for School Funding Formulas](#)).

FY 2017 REVENUE GROWTH

Baseline Tax Growth & Cost of Tax Cuts

Currently, baseline tax revenue growth in FY 2017 is projected to be \$1.430 billion.⁵ When adjusted for various anticipated tax law and administrative changes that will impact tax collections, actual FY 2017 growth is expected to be \$1.209 billion.⁶ Included in this downward adjustment of \$221 million is the recent personal income tax rate reduction from 5.15 percent to 5.10 percent (which occurred on January 1st, 2016) and an anticipated further reduction of the PIT rate to 5.05 percent come January 1st, 2017.⁷ The changes also include an increase in the state Earned Income Tax Credit and other smaller changes.⁸

Two further adjustments are required. First and most importantly, the \$1.209 billion figure includes a major source of revenue that is *not* directly available for budgetary purposes in FY 2017: capital gains income that exceeds a statutorily determined threshold. State law directs any capital gains tax revenue exceeding this threshold (which is set at \$1.128 billion for FY 2017) to be deposited into the state's Stabilization Fund ("Rainy Day" fund), rather than be used for current year expenditures.⁹ Current estimates are that this excess in FY 2017 will total some \$356 million.¹⁰ As MassBudget has effectively accounted for \$300 million of this in our estimate of challenges carried over into FY 2017 from FY 2016

(the FY 2016 budget was balanced using a one-time draw of \$300 million in excess capital gains revenues), we must here account only for the additional \$56 million of excess capital gains tax growth expected in FY 2017. This adjustment reduces our expected FY 2017 revenue growth total from \$1.209 to \$1.153 million.

The second and last adjustment is for an expected increase in lottery revenues in FY 2017, adding \$19 million to the total. With this additional revenue factored in, we arrive at a final estimate of FY 2017 tax revenue growth of \$1.172 million.

FY 2017 Spending and Revenue Growth		(\$ in millions)
FY 2017 Cost Growth		
Health care		-\$490
All Other		-\$538
		-\$1,028
FY 2017 Revenue Growth		
Baseline FY 2017 revenue growth estimate		\$1,430
Adjustment for tax law and administrative changes (detail below)		-\$221
	<i>Income tax rate reduction from 5.15 to 5.10%</i>	-\$78
	<i>Income tax rate reduction from 5.10 to 5.05%</i>	-\$79
	<i>EITC increase</i>	-\$74
	<i>Net other changes</i>	\$10
Adjustment for FY 2017 growth in excess capital gains		-\$56
Lottery		\$19
		\$1,172
TOTAL		\$144

Note: We do not adjust down the FY 2017 revenue estimate to account for the \$100 million FY 2016 tax amnesty revenue because we treat that as a FY 2016 one-time revenue source in our discussion of FY 2016.

When we look at projected cost growth and revenue growth together we see that they are roughly of the same size. Estimates in table above show that revenue may grow about \$144 million more than costs. The actual gap may be smaller than that as there are some new spending commitments that have already been made, such as hiring additional social workers at the Department of Children and Families to better protect children at risk of abuse and neglect. In addition the official revenue estimate assumes strong revenue growth and may prove to be overly optimistic. In any case baseline revenue growth and cost growth will be reasonably close and most of the existing structural gap will carry forward and confront budget writers as the budget process begins.

While our Commonwealth faces difficult budget challenges, we will likely muddle through again this year as we have year after year since the early 2000's. Budget writers will probably cobble together more temporary solutions, some painful budget cuts, maybe some innovative savings, and perhaps some modest new revenues – likely from sources other than broad based taxes. What will likely be most significant in this budget year will not be what is done, but rather what doesn't happen. It is very unlikely that we will see a budget that is structurally balanced and that strengthens our capacity to weather the next recession. It is even more unlikely that we will see a budget that will raise new

revenue to fund investments in the future of our Commonwealth: like making higher education affordable again and modernizing our roads and bridges and public transportation systems.

The FY 2017 Deficit: A Rough Calculation

$$\begin{array}{rclcl}
 \text{\textbf{-\$828 million}} & + & \text{\textbf{\$144 million}} & = & \text{\textbf{-\$684 million}} \\
 \text{gap from FY16} & & \text{effects of FY17 tax and} & & \text{Projected deficit in FY17} \\
 & & \text{spending growth} & &
 \end{array}$$

¹ See MassBudget's "[Income Tax Cuts and the Budget Deficit in Massachusetts](#)", January 21, 2015

² See footnote 1 from Congressional Budget Office, [The 2015 Long-Term Budget Outlook](#), June 16, 2015

³ There are different ways to measure the size of the economy when using that as a benchmark against which to measure state spending. Our analysis uses a measure recommended by analysts at the New England Public Policy Center of the Federal Reserve Bank of Boston: "Given various challenges such as comprehensiveness, feasibility as a revenue source, availability, and transparency, adjusted personal income appears to be the most appropriate measure" <http://www.bostonfed.org/economic/neppc/memos/2008/weinerpopov073008.pdf>

⁴ "Every officer having charge of any state agency which receives a periodic appropriation from the commonwealth...shall annually, on or before a date set by the secretary of administration and finance submit to the budget director statements (1) showing in detail the amounts appropriated for the preceding and the current fiscal years...(4) estimates of the amounts required for the operations of state agencies and programs for the ensuing fiscal year, with an explanation of any increased appropriations recommended and with citations of the statutes relating thereto, a statement indicating the priorities assigned to each program by said officer." [Chap 29 sec 3]

⁵ Currently, FY 2016 tax revenues are projected to be \$25.751 billion, while the total for FY 2017 is projected to be \$27.181 billion. Baseline growth (i.e., growth prior to factoring in various tax law and administrative changes) therefore will total \$1.430 billion in FY 2017. Consensus Revenue Estimate press release (from 1-14-2016).

⁶ There also is a \$100 million incremental FY 2017 impact from the 2016 tax amnesty program, not included in this figure. MassBudget accounts for this drop in available FY 2017 revenues within the challenges carried over from FY 2016 into FY 2017.

⁷ Discussions with DOR, 1-15-2015.

⁸ Discussions with DOR, 1-15-2015.

See also MassBudget's, "Analyzing the State Budget for FY 2016", August 2015 (see Revenue section):

http://www.massbudget.org/report_window.php?loc=Analyzing_the_State_Budget_for_FY2016.html

⁹ See also MassBudget's, "Analyzing the State Budget for FY 2016", August 2015 (see Revenue section and specifically the Stabilization Fund subsection):

http://www.massbudget.org/report_window.php?loc=Analyzing_the_State_Budget_for_FY2016.html

¹⁰ Consensus Revenue Estimate press release (from 1-14-2016): FY 2017 capital gains revenue estimate is \$1.484 B. This leaves \$356 million in anticipated capital gains revenues above the \$1.128 B Stabilization Fund threshold for FY 2017.