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Massachusetts Budget and Policy Center

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Fiscal Year 2012 Budget Preview

This *Budget Brief* examines the fiscal condition of the state as the Fiscal Year 2012 (FY 2012) budget process begins. Specifically, it describes the preliminary budget gap the state faces in the budget year starting July 1, 2011. A state budget gap is the difference between the costs of providing the same level of services and the revenues expected to be available. It also accounts for tax or spending changes that are part of existing law (such as phased-in tax cuts or legally mandated spending increases).

To calculate the preliminary budget gap for next year (FY 2012), this brief uses a three-step process, which is outlined below and discussed in detail throughout the body of this brief. First, we determine the gap coming out of this fiscal year's budget, which ends on June 30, 2011. That shows us the current gap between ongoing spending and ongoing revenue. Then, to determine if that gap will be larger or smaller next year (and by how much), we examine likely revenue growth, tax policy changes, and spending growth. Finally, we add together the projected gaps (or surpluses) from steps 1 and 2. Through this process, we project a $1.78 billion gap for FY 2012.

Step 1: Calculate the gap coming out of FY 2011……………………-$1.68 billion

a) FY 2011 temporary revenue and savings…………………-$1.89 billion
b) FY 2011 projected adjustments……………………………+$207 million

Step 2: Project budget conditions for FY 2012………………………-$102 million

a) Baseline revenue growth…………………………………+$1.0 billion
b) Tax policy changes………………………………………-$132 million
c) Cost growth…………………………………………………-$970 million

STEP 3: TOTAL GAP {Step 1 (-$1.68 billion) plus Step 2 (- $102 million)} = -$1.78 BILLION

STEP 1: CALCULATE THE GAP COMING OUT OF FY 2011 (-$1.68 BILLION)

PART A: FY 2011 TEMPORARY REVENUE AND SAVINGS (-$1.89 BILLION)

The current FY 2011 budget relies on $1.56 billion in temporary revenue from the American Recovery and Reinvestment Act (ARRA) and related federal funding, and $328 million in other temporary revenue and savings. Since this amount represents temporary revenue and savings only available for the current fiscal year, this total will create a $1.89 billion gap between ongoing revenue and ongoing spending.

This federal revenue falls into the following categories:

- *$1.24 billion* in a temporary increase in the share of Medicaid costs paid by the federal government.
- *$296 million* in education funds.

- *$25 million* in other American Recovery and Reinvestment Act (ARRA) funds.

In providing this assistance, the federal government strengthened the overall national economy by protecting against state budget cuts that would have accelerated the downward spiral of layoffs, reduced demand, and further layoffs. Federal recovery assistance also helped states to avoid far deeper cuts in core public services like education, public safety, health care and other safety net programs. This assistance, however, is expected to end before Fiscal Year 2012.

Additional temporary revenue and savings include:

- *$160 million* in anticipated repayment from the federal Medicare program.
- *$100 million* in one-time debt savings in FY 2011.[1]
- *$68 million* in withdrawals from trust funds and other accounts.

PART B: FY 2011 PROJECTED ADJUSTMENTS (+$207 MILLION)

The budget, as it stands today, suggests a gap of $1.89 billion. Since it is likely that both revenue and expenses will exceed budgeted amounts, the size of the final budget gap will depend on what happens to tax revenue and spending during the rest of the fiscal year. For the reasons described below, we expect that mid-year revenue increases will modestly exceed cost increases. As a result, the final FY 2011 budget gap could come down to approximately $1.68 billion.

On the revenue side, the news is good. Tax receipts are exceeding projections. Currently, the Department of Revenue projects that tax receipts will exceed projections by $511 million to $603 million.[2] For this preview, we use the midpoint of $557 million.

This estimate assumes that tax revenue will grow roughly 6 percent between FY 2010 and FY 2011.[3] Tax revenue growth is difficult to project, particularly in times of economic uncertainty. It is important to remember that estimates are just that. For every percentage point that revenue growth exceeds current projections, the gap is reduced by a further $200 million (and, conversely, if it falls short of projections, the gap grows by $200 million per percentage point).

On the cost side, there are pressures that will likely add to costs. Safety net programs, particularly Medicaid, are experiencing increased demand. With persistently high unemployment, access to employer-provided health care has declined, causing more unemployed people to look to government to provide health care for them and their families. As a result of this increased demand, costs increase. Fortunately, as part of its recovery efforts the federal government is currently paying 62 percent of the costs of Medicaid in Massachusetts, which is above the usual 50 percent reimbursement rate. Nonetheless, increasing dependence

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[1] The state refinanced debt to save $300 million. That full $300 million could reasonably be counted as a one-time expense, but since there was also a one-time $200 million spike in debt service costs in FY 2011, we use the net savings of $100 million below the long term trend as the one-time savings amount.

[2] From page 6 in the Massachusetts DOR's FY2012 Consensus Revenue Estimate Hearing *Briefing Book*, December 12, 2010, available online at: http://www.mass.gov/Ador/docs/dor/Revenue_Outlook/FY12_Consensus.pdf

[3] This comparison looks at total FY 2010 tax revenue versus total FY 2011 revenue, even though both years' totals include some new revenue from tax policy changes. One could make a similar comparison by netting out the impact of tax changes for each year.

on safety net programs and growth in other costs will likely lead net expenses to exceed projections by about $350 million.[4]

STEP 2: PROJECT BUDGET CONDITIONS FOR FY 2012 (-$102 million)

PART A: BASELINE REVENUE GROWTH (+$1.0 BILLION)

Department of Revenue forecasts project baseline tax revenue growth from FY 2011 to FY 2012 of 4.1 percent to 5 percent. Since total tax revenue in FY 2011 is projected to be just under $20 billion, each percentage point of growth is worth about $200 million. Therefore, baseline tax revenue is expected to grow by about $800 million to $1 billion.

During periods of economic recovery, revenue projections generally underestimate revenue growth, sometimes significantly. For a historical comparison of projections to actual collections, please see page 26 of the Department of Revenue's Briefing Book available at http://www.mass.gov/Ador/docs/dor/Revenue_Outlook/FY12_Consensus.pdf. For this reason, we assume the high end of the forecasters' estimates, representing baseline growth of about 5 percent, or $1 billion.[5]

Again, it is important to recognize that this seemingly precise number is based on an estimate. If baseline tax revenue were to grow instead by 6 or 7 percent, the gap would be $200 million or $400 million smaller. Conversely, if baseline tax revenue grows only by 3 percent or 4 percent, the gap would be $400 million or $200 million larger.

PART B: TAX POLICY CHANGES (-$132 MILLION)

Baseline growth is the growth in revenue before adjusting for tax law changes, so we also need to adjust projected revenues for these changes. Adjustments to tax policy will cost roughly $132 million in FY 2012, as reflected in the chart below. Since the sales tax on alcoholic beverages was reversed by voter referendum, the $64 million gained from this source in FY 2011 will no longer be available beginning January 2011. A phased-in cut to the corporate income tax will cost the state $37 million in FY 2012. An additional special corporate tax cut relating to the Statement of Financial Standards (FAS) No. 109 will cost $46 million in FY 2012.[6] Life science incentives were reduced in FY 2011 and will return to previous levels in FY 2012. Finally, a net increase of $20 million would result from abandoning the sales tax holiday; the Legislature has not yet approved a sales tax holiday for FY 2012.

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[4] Factored into this $350 million is a supplemental budget sitting on the Governor's desk that appropriates $330 million. The net cost to the state will be $172 million, since the federal government will reimburse $157 million of this as its share of Medicaid spending.

[5] We project this as growth over actual projected FY 2011 revenue and do not make certain adjustments that DOR makes to account for one time payments made in FY 2011 relating to judgments and settlements on back taxes (because while those specific one-time payments will not be made in FY 2012, each year there are new such judgments and settlements).

[6] For more information on this corporate tax cut, please see: http://massbudget.org/doc/694 or http://www.boston.com/news/local/massachusetts/articles/2009/10/13/mass_stands_to_lose_535m_in_business_tax_revenue/

Tax Policy	FY 2011 Impact	FY 2012 Impact	Net Change for FY 2012
Elimination of Alcohol Sales Tax Exemption	$64 million	$0	-$64 million
Corporate Tax Rate Cut	-$149 million	-$185 million	-$37 million
FAS109 Deduction	n/a	-$45.9 million	-$45.9 million
Life Sciences Tax Incentives	-$20 million	-$25 million	-$5 million
Sales Tax Holiday	-$20 million	$0	+$20 million
TOTAL			**-$131.9 million**

PART C: COST GROWTH (-$970 MILLION)

The cost of providing the same level of services typically grows from year to year and the size of this growth varies based upon sector-specific circumstances within the broader economy. The ideal way to determine a maintenance budget is to calculate the specific inflation and caseload pressures on each item in the state budget. Since this information is not currently available, we use estimates based upon inflation. In some areas these estimates are likely to overstate actual costs and in others they are likely to understate. Ultimately, we project that overall costs will grow by $970 million from FY 2011 to FY 2012. This total cost growth projection includes:

- *$611 million* in increased health care costs. Health care costs grow faster than the rest of the economy. For this projection, we assume 8 percent cost growth in most health care accounts, and net out the federal reimbursement of Medicaid costs. Cost trends in state health care accounts are driven both by overall health care inflation and by caseload changes.

- *$58 million* increase in Chapter 70 education aid to local and regional school districts. This projection is based upon a set of assumptions outlined in a companion paper entitled *Fiscal Year 2012 Chapter 70 Education Aid Preview* available at http://massbudget.org/doc/770. As the paper explains, there is a range of reasonable estimates that could be made for calculating maintenance costs for Chapter 70.

- *$301 million* increase in other spending. As inflation has been relatively low during the ongoing fiscal crisis, we use a 2 percent inflation factor for projecting other cost increases within the state budget.[7]

STEP 3: TOTAL GAP {Step 1 (-$1.68 billion) plus Step 2 (- $102 million)} = -$1.78 BILLION

Finally, by adding together the projected gaps from steps 1 and 2 described above, we project a gap of $1.78 billion for FY 2012.

Step 1: Calculate the gap coming out of FY 2011……………………-$1.68 billion

[7] Due to the market crash during the recent fiscal crisis, the state's required appropriation for pensions in order to meet the unfunded liability by 2020 would be very high. I t is likely that the contribution amount will be lowered by extending the amortization period for the pension funds. Our estimate does not include a spike in payments into the pension fund.

Step 2: Project budget conditions for FY 2012.........................-$102 million

Step 3: Sum of Steps 1 and 2 (-$1.68 billion + -$102 million).........-$1.78 billion

In conclusion, the Commonwealth – along with virtually every state in the nation – faces yet another extremely difficult budget year. In order to support informed participation in the public debate over our shared priorities, this brief provides a snapshot of the specific challenges we are likely to face in the coming year. Previous *MassBudget* research has examined some of the longer-term causes of our fiscal crisis and that work provides a useful context for the circumstances leading up to fiscal year 2012.[8]

[8] To access this research, please go to: http://massbudget.org/doc/638/656