A Preview of the Fiscal Year 2014 Budget

The mid-year budget cuts announced by Governor Patrick in early December serve as a stark reminder that our state is still in a severe fiscal crisis. We are now five years into the worst national economic crisis since the Great Depression. Equally important, we are almost fifteen years into an ongoing fiscal crisis that started in the late 1990s.

Between 1998 and 2002, the Commonwealth implemented income tax cuts that cost us $2.5 billion a year in lost revenue.[1] As a result, even during the strongest years of economic growth our state was barely able to fund essential services, and in recessions we have had to cut deeply. When adjusted for inflation, since 2001 funding for local aid is down 45 percent, funding for higher education is down 31 percent, funding for public health is down 25 percent, and significant cuts have occurred across the rest of state and local government as well.

Also contributing to the pressures on the state budget is that the cost of health care increased significantly more rapidly than the rate of overall growth in the economy during much of the last decade. Without restoring revenue, and even with keeping health care cost growth in line with growth in the economy, we are likely to continue down a path of reduced support for transportation, local aid, education, and other essential public services.

This Fiscal Year 2014 budget preview examines the specific fiscal challenges facing the Commonwealth and projects a preliminary budget gap of at least $1.28 billion. We reach this estimate by reviewing the budget gap filled by temporary revenues and savings in FY 2013, the rate of revenue growth anticipated in FY 2014, and the projected cost growth for FY 2014 caused by inflation and caseload increases.

The Gap between Ongoing Revenues and Ongoing Costs in FY 2013

The primary source of the preliminary budget gap in FY 2014 is the gap between ongoing revenues and costs in FY 2013—that is the portion of the budget that is being financed by temporary revenues (mostly reserve funds from the state Stabilization or "Rainy Day" Fund) or temporary savings. This gap was fairly large in the initial FY 2013 budget, and it then grew as revenue growth was slower than anticipated during the first four months of the year and the new gap had to be filled partly by temporary revenues.

Using reserves to balance the budget during an economic downturn is not inappropriate—this is why reserves funds are created and maintained. The Administration's own long term fiscal plan calculates that the amount of Rainy Day Fund reserves used in FY 2013 is within the limits of what would be considered appropriate to use for balancing the budget at this point in the economic cycle.[2]

The problem, however, is that our reserve funds are limited. Even if in theory it would be appropriate to continue using reserve funds at current rates to balance the budget until the economy recovers, the reality is that we don't have adequate reserves to do so. Our Rainy Day Fund is currently projected to end FY 2013 with approximately $1.2 billion.

Use of Temporary Revenues and Savings in the Initial FY 2013 Budget

The enacted FY 2013 budget relied on $743 million in temporary revenues and savings. This included a withdrawal of $350 million (plus $9 million in interest) from the Rainy Day Fund, and about $90 million from other reserves. The budget also postponed a special corporate tax break saving close to $46 million, and counted on $10 million in one-time revenue from the disposition of abandoned property.

In addition, the FY 2013 budget relied on some savings strategies in the state Medicaid program. These strategies included cash management policies that shifted $256 million of costs into future years. Since half of Medicaid costs are reimbursed by the federal government, the net savings to the state in FY 2013 of this shift would be approximately $128 million.

The Commonwealth also relied on $110 million in temporary savings realized by cancelling a requirement to reserve a portion of the state's revenues in order to carry forward that amount into the next fiscal year. [3]

Subsequent Use of Temporary Revenues and Savings in the FY 2013 Budget

In early December, the Secretary of Administration and Finance announced a downward adjustment of $515 million in the revenue estimate for FY 2013. To keep the budget balanced, the Governor announced a series of emergency budget cuts, called for the Legislature to enact additional cuts, and proposed balancing the budget with the use of additional temporary revenues. These measures withdrew an additional $200 million from the Rainy Day Fund, counted on $60 million from other state reserves and temporary federal revenue sources, and $10 million in other one-time savings.[4]

Total Temporary Revenues and Savings in the FY 2013 Budget

Over the course of the fiscal year, the FY 2013 budget has been relying on a total of approximately $1.01 billion in temporary revenues and savings to achieve balance. This consists of the initial FY 2013 temporary revenue and savings of $743 million, and $270 million in additional revenues and savings announced in December (see chart).

THE FY 2013 BUDGET RELIES ON MORE THAN $1 BILLION IN TEMPORARY REVENUES AND SAVINGS (millions)	
Use of Temporary Revenues and Savings in the Initial FY 2013 Budget	
Tax Revenue	
Delay FAS 109 deductions	$46
Departmental Revenues	
Abandoned property revenues	$10
Other Sources of Funds	
Stabilization (“Rainy Day”) Fund withdrawal	$350
Stabilization (“Rainy Day”) Fund interest transfer	$9
Proceeds from various trusts	$6
Use of Group Insurance trust surplus	$40
Use of Commonwealth Care trust surplus	$44
One-Time Savings	
Forgone carry forward of consolidated net surplus	$110
Medicaid cost shift	$128
Sub-Total	**$743**
Subsequent Use of Temporary Revenues and Savings in FY 2013 Budget	
Additional withdrawal from Stabilization ("Rainy Day") Fund	$200
Other state reserves and federal revenues	$60
Additional one-time savings	$10
Sub-Total	**$270**
TOTAL	**$1,013**

The Gap between Ongoing Revenues and Ongoing Costs in FY 2014

In calculating the initial FY 2014 budget gap, we need to examine the difference between FY 2014 projected growth in revenue and the cost of providing current services, as well as accounting for the gap between ongoing revenues and ongoing costs in FY 2013. If revenues are projected to grow faster than costs, the gap for FY 2014 will be reduced. If costs are growing faster than revenues, the gap grows.

Projected Growth in Revenues in FY 2014

On January 14, the Administration announced its consensus revenue estimate, and determined that the FY 2014 budget would be developed assuming a 3.9 percent growth in tax revenues. This would amount to approximately $838 million in new tax revenues for FY 2014.[5]

Because of the difficultly in projecting changes in non-tax revenues, we assume that departmental fees and assessments will stay constant with FY 2013 levels.

Projected Growth in the Cost of Providing Current Services in FY 2014

To estimate the initial budget gap for FY 2014 we must also project the cost of providing current services in FY 2014. This is often called creating a "maintenance budget," as it describes the costs of maintaining current services, making adjustments for cost changes caused by inflation, caseload changes, and other factors.

A true maintenance budget examines each element of the current budget in detail: how much would costs increase for government services; how might caseloads change (for example, would economic conditions cause more people to become homeless and require emergency shelter); what other external factors might affect costs in the coming year. Unfortunately, the state does not publish a maintenance budget.

Without a published maintenance budget, we make rough estimates about the costs of providing current services into FY 2014. In most instances, we take current budget levels and increase them by an inflation rate of 2 percent. For costs associated with publicly-funded health insurance, we use a slightly higher inflation rate to better reflect health care cost growth. When we have specific details that allow us to more precisely estimate cost projections for other areas, we use those.

HEALTH CARE

Massachusetts will spend approximately $7.6 billion on publicly-funded health insurance in FY 2013. This consists of roughly $12.7 billion on MassHealth and other health reform programs, for which the federal government reimburses the state for approximately half of these costs, leaving the state with a net state cost of approximately $6.4 billion. The Commonwealth will also spend approximately $1.3 billion on health care for public employees.

Although it is difficult to project health care costs, we estimate that these costs will grow in line with the 3.6 percent growth rate identified in last year's health care cost containment law. At this growth rate, MassHealth and health reform programs would increase by $229 million, and state employee health insurance would increase by $46 million. We also assume a 3 percent growth in enrollment in MassHealth, which adds another $191 million.

With these estimates, we project health care spending growth would add approximately $466 million in new costs in FY 2014. This is in addition to the $128 million in FY 2013 costs shifted into FY 2014 (discussed above).

There are, however, a number of moving pieces that make a precise estimate for FY 2014 very difficult. Most importantly, the implementation of the federal Affordable Care Act will have a number of implications for health care financing in Massachusetts. In some ways, the law is likely to reduce costs for Massachusetts, largely because increased federal reimbursements will reduce net state costs for MassHealth.

For example, people currently covered by the Commonwealth Care program will now become eligible for Medicaid or for federal tax credits. While Massachusetts receives a 50 percent reimbursement from the federal government for Commonwealth Care, the state will receive a 75 percent federal reimbursement when those people move to the newly-expanded Medicaid program. In addition, the new federal health care tax credits, once they become available, will cover health care costs now being paid for with state dollars.

On the other hand, health care benefits that will be available under the federal law may be less than those currently provided in Massachusetts. To maintain current benefit levels, Massachusetts would need to spend state dollars to maintain coverage. Moreover, the federal law includes cuts to funding for hospitals that serve a large share of uninsured patients, but it is unclear exactly how those cuts will affect Massachusetts.

Because there are not clear answers to exactly how all of these factors will play out in Massachusetts, we do not include estimates for the budgetary impacts of all of these changes in our FY 2014 maintenance budget. These issues will, however, likely play a significant role in the overall budget debates in FY 2014.

EDUCATION

The Chapter 70 formula for determining state education aid serves as a detailed maintenance budget, reflecting the changing costs year-to-year of providing an adequate education for all students. (The formula's underlying cost allocations, however, have not been fundamentally reevaluated or updated since the formula's creation in 1993.) A maintenance budget for Chapter 70 aid will likely require a modest increase over FY 2013 levels due to what is known at this point about each of the following primary factors used in calculating aid:

- **Inflation.** The inflation rate used for adjusting the foundation budget (the total amount districts are required to spend from state and local sources combined) will be a low 1.55 percent, based on the inflation factor identified in state law.

- **Enrollment.** The Department of Elementary and Secondary Education (DESE) has projected that FY 2013 enrollment (which is used for determining FY 2014 aid) will show a very slight increase (about 0.2 percent) over FY 2012. While statewide growth is likely to be very low, the overall effect on the foundation budget could be somewhat larger due to the formula's hold-harmless provision, which stops any district from receiving a cut even if its enrollment declines.

- **Required Local Contribution.** The state education funding formula requires greater state funding when local revenue capacity is growing slowly, and less when local revenue capacity is growing rapidly. Local revenue raising capacity has suffered during the economic crisis as there has been less new construction that would expand the local tax base. If this trend continues, the state will have to contribute a larger share of revenue towards district foundation budgets.

In addition, the state has been phasing in reforms to the Chapter 70 formula. While maintenance estimates should generally include costs associated with funding commitments that have been made and are being phased in, there is not clear statutory guidance on the phase-in rate for the Chapter 70 reforms. Overall, while a precise estimate of maintenance for Chapter 70 is difficult, we estimate 4 percent cost growth, which translates to $167 million.

DEBT SERVICE

To project debt service costs for FY 2014, we assume a continuation of the annual average growth rate for debt service spending for the past five years. Since FY 2008, the state budget for debt service has increased approximately 3.4 percent on average annually. Projecting this increase into FY 2014, we estimate an increase in debt service of approximately $82 million.

CHAPTER 257

In FY 2014, there will be costs associated with implementing a standardization and adjustment for rates to contracted human and social service providers, as mandated by Chapter 257 of the Acts of 2008. Although we do not know exactly how much this will cost, it is anticipated that implementation of this initiative will have an additional net state cost of $100 million or more in FY 2014. As a precise estimate is not available we use an estimate of $100 million.[6]

OTHER BUDGET AREAS

While specific cost increases very across different areas of government, we assume 2 percent inflation in all areas other than those discussed specifically above. While this may be less than cost increases actually anticipated in many programs, and therefore the low end of likely cost growth for maintaining current services, it approximates the generally projected appropriate inflation rate.
For all budget areas other than health care, Chapter 70, and debt service, the current FY 2013 budget is approximately $14.68 billion. A 2 percent increase on that amount would be an estimated $294 million cost increase for FY 2014.

Gap between Estimated Cost Growth and Revenue Growth

The projected growth in the cost of providing current services in FY 2014 totals approximately $1.1 billion (see chart). The estimated tax revenue growth in FY 2014 is approximately $838 million. Accordingly, the gap between revenue growth and anticipated cost growth for FY 2014 is $270 million.

FY 2014 ESTIMATED ADDITIONAL COSTS TO MAINTAIN CURRENT SERVICES AND REVENUE GROWTH (millions)	
Projected Growth in the Cost of Providing Current Services	
Health Care	
MassHealth and Health Reform (3.6% inflation)	$229
MassHealth and Health Reform (3% enrollment growth)	$191
State Employee Health Insurance (3.6% inflation)	$46
Education	
Chapter 70 (4% growth)	$167
Debt Service	
Debt Service (3.4% growth)	$82
Human Services (Chapter 257)	
Implementation of human service rate adjustments	$100
Other Budget Areas	
Other budget areas (2% inflation)	$294
Total Cost Growth	**$1,109**
Projected Growth in Revenues	
Estimated tax revenue growth	$838
Total Revenue Growth	**$838**
Gap Between Cost Growth and Revenue Growth	**$270**

Program Budgeting

Last year, Governor Patrick promulgated an executive order to change, among other things, the presentation of the state budget.[7] As part of a broader initiative to improve strategic planning across government, the state budget will be presented not just in traditional line-item format but also as a "program budget." Readers of the budget will be able to see funding organized not just by line item, but also organized and clearly described as sets of programs. The budget would also explain how each of these programs fit within broader strategic plans.

If done properly, program budgeting could be an important reform, allowing everyone to look at our Commonwealth's budget to better see how we are doing in our efforts to improve education, provide health care, keep our communities safe, provide child care or housing, and keep our air and water clean. The program budgeting initiative should allow for greater clarity in describing the goals of our state's budget, and make it easier to develop systems for measuring the effectiveness of public programs.

With the release of the FY 2014 budget, the Administration is expected to present both a "program budget" and a traditional "line item budget." Using both systems in parallel will allow for the reforms associated with program budgeting, while also allowing readers of the budget to compare current proposed funding to historic funding.

Conclusion

As the state begins the FY 2014 budget process, we face a budget gap of at least $1.28 billion (see chart). This gap largely reflects the reliance on temporary revenue and savings in the FY 2013 budget. In addition the continuing weakness of the national economy is projected to lead to slow revenue growth in FY 2014, adding to the state's fiscal challenges. It is important to note that the projected FY 2014 budget gap does not reflect separate gaps and additional funding needs in transportation, education, local aid, and other areas of the budget that have been cut severely over the past decade.

FY 2014 Budget Gap (millions)	
FY 2013 Temporary Revenue and Savings	
Initial temporary revenues and savings	$743
Additional temporary revenues and savings	$270
FY 2014 Cost Growth	
Estimated cost growth	$1,109
FY 2014 Revenue Growth	
Estimated tax revenue growth	($838)
TOTAL	**$1,283**

Our state, like our nation, has yet to climb out of the economic downturn that began in 2007.[8] But our state's budget problems also reflect longer term policy choices—such as deep cuts to the income tax enacted between 1998 and 2002—that have reduced our capacity to fund much of what it is important that we do through government: educate our children; maintain a transportation infrastructure that works; keep our communities safe; provide a basic safety net; and provide work supports for working parents seeking to climb into the middle class.

As policy makers seek to balance this year's budget, they face the difficult challenge of finding not just temporary fixes but lasting solutions that would address the state's structural budget problems and allow for investments in transportation, education, and other public systems. These investments are important both because we count on them now, and because they can serve as the foundation for strong and long term economic growth.

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[1] See MassBudget's " Income Tax Cuts and the Budget Deficit in Massachusetts", January 9, 2013, available at http://www.massbudget.org/report_window.php?loc=tax_cuts_factsheet.html.
[2] See "Commonwealth of Massachusetts Long-Term Fiscal Policy Framework", May 2012, available at http://www.mass.gov/anf/docs/anf/long-term-policy-framework.pdf.
[3] See Mass. Budget and Policy Center, "Budget Monitor: The Legislature's Budget for FY 2013," July 3, 2012, available at http://massbudget.org/reports/includes/832/revenue.pdf.
[4] See Governor's announcement and related materials on "Closing the Budget Gap," December 4, 2012, available at http://www.mass.gov/governor/pressoffice/fy13-budget.html.

[5] Approximately $37 million of this total will not be available for use in the state budget, as state law requires that capital gains tax revenues above $1.023 billion in FY 2014 be directed to the Rainy Day Fund. The Department of Revenue currently estimates that $1.060 billion of the state's FY 2014 tax revenues will come from capital gains tax revenue.
[6] For information on the implementation of Chapter 257, see http://www.mass.gov/eohhs/provider/contracting/chap257/.
[7] See Gov. Deval Patrick, Executive Order No. 540, "Improving the Performance of State Government by Implementing a Comprehensive Strategic Planning and Performance Management Framework in the Executive Departments," available at http://www.mass.gov/governor/legislationeexecorder/executiveorder/executive-order-no-540.html.
[8] See Mass. Budget and Policy Center, "The State of Working Massachusetts 2012", January 1, 2013, available at http://www.massbudget.org/report_window.php?loc=swma_2013.html.