

## A Preview of the Fiscal Year 2018 Budget

(Revised, May 2017)

Our state budget is how our Commonwealth funds the things we do together to strengthen our communities, make life better for our people, and build a vibrant economy. The budget process works best when the choices are clear to everyone and made in as deliberate of a manner as possible, considering long-term issues as well as immediate challenges.

As budget writers prepare for Fiscal Year (FY) 2018, it appears that the Commonwealth again faces a significant gap between ongoing revenue sources and the cost of maintaining current services. This has been the case for many years in Massachusetts, with a series of budgets balanced using temporary revenue sources and savings initiatives that may prove to be temporary in nature (such as early retirement strategies that can lose their fiscal effectiveness if it turns out that the people who retired need to be replaced). Because the Commonwealth has been using temporary revenue to balance the budget during this period of economic expansion, we have not been able to build up the level of reserves to be prepared for the next recession.

We have also seen a pattern of instability, with mid-year budget cuts and, this year, major changes to the budget very late in the budget process. This pattern is caused partly by a lack of adequate transparency in the budget process.

Two steps by state government would allow for a significantly more transparent process and, likely, fewer unwanted budget surprises in the future:

**The public release of a *maintenance budget* that discloses the projected costs of maintaining current services from one fiscal year to the next.**<sup>1</sup> Nineteen other states publish such a document.<sup>2</sup> Massachusetts does not. One of the major issues that led to mid-year budget cuts and use of temporary revenue in FY 2017 was the Administration's determination that the Legislature had failed to provide needed funding for a number of accounts. There is not, however, any public document available at the beginning of the budget process that provides baseline information on the funding needed in each account to maintain current services. The Governor's budget proposal provides related information, but there is no systematic way to know whether those recommendations for each line item constitute a cut below the cost of current services, an increase above that cost, or are a continuation of funding at the "maintenance level." For instance, if the budget proposes a decrease in funding for a particular child care account, that could be because of a projected reduction in the number of people who will be eligible for the program or a decision to serve fewer of those who are eligible.

While the Administration likely provides some such data to the Legislature, it is not publicly available. If that information were disclosed publicly, it might decrease the likelihood of budgets being enacted that fail to provide needed funding that ultimately must be appropriated by supplemental budget later in the year. And while many accounts that are funded below maintenance levels do not require supplemental funding during the year – because in some cases a lower level of services can be provided to match the lower funding level – it would allow for greater public understanding of the

choices made during the budget process if there were a clear way to identify when funding levels require such service reductions.

**The public release of a baseline tax revenue growth estimate.** The initial tax revenue growth estimates for FY 2017 were unusually optimistic, but there was no easy way to see that because of the way the estimates were presented. In determining the tax revenue estimate for the next fiscal year, budget writers need to take two steps:

1. Determine how much new revenue (or less revenue) there will be due to economic growth (or, in a recession, economic decline). This is called baseline growth.
2. Determine how already-enacted tax policy changes will affect the amount of tax revenue available. Because several tax cuts were being phased in during FY 2017 (including an increase in the state Earned Income Tax Credit (EITC)), the revenue estimate derived from looking at growth in the state economy alone would need to be adjusted down to reflect the expected revenue loss from these policy changes.

Looking carefully at the projections made at the start of the FY 2017 budget process, we see that while the announced projection for actual tax revenue growth was a seemingly reasonable 4.3 percent, the baseline growth that would have been needed to achieve that amount of tax revenue growth was actually 5.55 percent (because some of the revenue growth would be used to pay for already enacted tax cuts and thus wouldn't be available to fund the budget). Further, the announced 4.3 percent revenue growth projection was a projection of growth above a newly increased FY 2016 projection. The decision to increase the FY 2016 revenue projection in January proved to be a mistake. While revenue growth was looking good in January of 2016, it could have been anticipated that the final FY 2016 collection numbers would not exceed the original estimates. Late in 2015 the stock market declined significantly. While this would not affect tax revenue growth immediately, it could have been anticipated that it would affect revenue collections come April of 2016 (when people would file their 2015 taxes), thus affecting FY 2016 collection totals. That's exactly what happened. In order to hit the announced 4.3 percent tax revenue growth rate, the baseline tax estimate would have needed to be 6.1 percent above the initial estimate upon which the FY 2016 budget was built – a very high growth rate and one that might have raised red flags with the public. Had that information been publicly available, it is likely that the fiscal problems that emerged towards the end of the FY 2017 budget process would have been recognized much earlier in the year.

## THE FY 2018 BUDGET

To determine the challenges budget writers will need to address in FY 2018, we need to examine three sets of issues: the use of temporary revenue and the underfunding of accounts in the FY 2017 budget; the likely changes in the cost of providing current services in FY 2018; and the likely growth in tax revenue in FY 2018.

### *Temporary Revenue and Underfunded Accounts in the FY 2017 Budget*

Because budget writers will need to find different sources of revenue (or new savings) in FY 2018 to fund the portion of the budget funded with temporary solutions in FY 2017, it is important to

determine the total amount of temporary solutions in the FY 2017 budget. The chart below provides a list, totaling \$679.2 million. The following are among the largest:

- Using capital gains tax revenue to fund the operating budget, instead of dedicating it the State Stabilization Fund (otherwise known as the Rainy Day Fund) as provided by law. Because capital gains tax revenue is highly volatile, Massachusetts has a law dictating that when the state expects to receive more of this type of revenue than roughly the long-term average, the excess amount is supposed to be deposited into the state Stabilization Fund. This ensures that we don't budget based on temporarily elevated levels of capital gains tax revenue, and it also helps to build our Stabilization Fund, which is our reserve account to help the state weather the next recession. In the FY 2017 budget, the state relied on \$150 million of such one-time revenue.
- Use of revenue in trust funds. The state has a number of trust funds in which money has been set aside for specific purposes. In some cases, those funds had more than the Governor's office stated was needed. The state took \$145.6 million from these trust funds to help balance the current year's FY 2017 budget.
- Use of end-of-year account balances. The FY 2017 budget assumed that there will be \$200 million in unspent appropriations (otherwise known as reversions) available to fund operating costs elsewhere in the budget. The Administration has undertaken a number of initiatives, such as hiring freezes, to achieve these savings. It is hard to know for sure what the long-term effects of these strategies will be. But to the extent that agencies are delaying hiring or other expenditures that ultimately will be necessary, these savings will only be temporary. Absent a clear public description of where and how these savings can be sustained over the long term, it is prudent to treat them as temporary savings.
- Underfunded accounts and 9C (mid-year) budget cuts. In the enacted FY 2017 budget, there were a number of accounts that were underfunded. (These include Emergency Shelter Assistance for Families in Need, MassHealth, Private Counsel Compensation, Snow and Ice Removal, and various Sherriff's accounts.) Recognizing that additional revenue would be required mid-year to fully fund these accounts during FY 2017, in October of 2016 the Administration identified additional federal revenue as well as excess revenue in a number of state trust funds, sufficient to fully fund several of these accounts. In December of 2016, the Administration identified additional underfunded accounts and made mid-year cuts to free up revenue to fund these accounts. (These mid-year funding reductions are called "9C cuts" after the section in Massachusetts General Law that gives the Governor the power to make such unilateral cuts in order to keep the budget in balance.)

Table 1

<b>ISSUES FROM FY 2017 BUDGET CONTRIBUTING TO FY 2018 BUDGET GAP (Temporary Revenues and Underfunded Accounts) \$ millions</b>	
<b>TEMPORARY REVENUES</b>	
<b>One-Time or Temporary Tax Revenues</b>	
Cap on the Life Sciences tax credit	5.0
Portion of capital gains revenue diverted from Stabilization Fund	150.0
<b>SUBTOTAL</b>	<b>155.0</b>
<b>One-Time or Temporary Non-Tax Revenues</b>	
Civil litigation (Volkswagen)	20.0
Court house sale	30.0
<b>SUBTOTAL</b>	<b>50.0</b>
<b>Transfers from Trusts</b>	
Mass. Water Resources Authority debt service reimbursement	32.8
Build America Bonds subsidy trust sweep	8.2
Dept. of Developmental Services Commissioner's trust	7.0
Boston Edison settlement	6.5
Dept. of Mental Health trusts	7.7
MassDevelopment expendable trust	6.0
Housing Preservation and Stabilization Trust	4.0
Delivery System Reform trust transfer	73.5
<b>SUBTOTAL</b>	<b>145.6</b>
<b>Use of Reversions From FY 2017 Funding</b>	
Using debt reversions to fund the State Retiree Benefits Trust	25.8
Using reversions to fund other budget costs	200.0
<b>SUBTOTAL</b>	<b>225.8</b>
<b>UNDERFUNDED ACCOUNTS AND REVENUE SHORTFALLS</b>	
<b>Underfunded Accounts</b>	
Underfunding of county sheriffs	25.0
Underfunding of MassHealth	20.0
Underfunding of Dept. of Mental Health	5.0
Underfunding of Ch. 257 human services rate obligations	14.7
Underfunding of collective bargaining obligations	8.0
Underfunding of Dept. of Corrections	15.0
Underfunding required deposit to the State Retiree Benefits Trust	103.0
<b>SUBTOTAL</b>	<b>190.7</b>
<b>Revenue Shortfall</b>	
MassHealth pharmacy revenue shortfall	10.0
<b>SUBTOTAL</b>	<b>10.0</b>
<b>PRELIMINARY TOTAL</b>	<b>777.1</b>
<b>9C (mid-year) cuts to various accounts*</b>	<b>(97.9)</b>
<b>TOTAL</b>	<b>679.2</b>
*These mid-year budget cuts free up funds that could be directed to underfunded accounts.	

### *FY 2018 Cost of Providing Current Services*

Only the Administration has access to the data needed to provide a reasonably precise estimate of FY 2018 costs to maintain current services. Such an estimate requires examining likely caseload levels for programs (particularly those where all who are eligible have a legal right to the services); projected needs in specific areas (like child protective services); and inflation rates for different types of costs (health care inflation, for example, has been higher than overall inflation rates).

In some cases, that analysis will identify costs growing rapidly, and in other cases it will show maintenance costs declining (for example, in a strong economy when more people can find work, costs for some income support programs decline).

Because such detailed data isn't publicly available, this budget brief uses broad estimates. We assume that most costs will grow at the rate of inflation. While costs in some areas will grow at a higher rate and others at a lower rate (with the exception of health care costs), there is not a more reliable way to adjust overall costs. While there are some specific costs that we could project with more certainty (and those are likely to grow at more than the rate of inflation) there are others that are not easy to project accurately, yet are likely to grow at less than the rate of inflation or decline. Thus it is likely more accurate to use one general adjustment for most of state government. The one exception we make is health care. Health care costs are a very large share of the budget and have a clear pattern of growing at a significantly higher rate than overall inflation. Our projections assume that the cost of most of state government (everything other than health care) will grow at the projected rate of inflation: 2 percent. Since state spending other than health care totals \$24.8 billion, two percent growth represents \$496.2 million in new costs in FY 2018.

Because of health care cost growth and increasing enrolment in MassHealth, healthcare spending in the state budget has grown faster than the rate of inflation and there is every reason to believe that trend will continue. It would allow for a more transparent and orderly budget process if the Administration were to publish a projection of costs for maintaining our current health care programs and policies after accounting for projected caseload and cost changes. Absent such an estimate, this brief assumes that health care costs in the state budget will grow at the rate the state has adopted as a target for overall health care cost growth: 3.6 percent.<sup>3</sup> Since state health care spending (net of reimbursements from the federal government) is \$9.4 billion, 3.6 percent growth will mean \$339.2 million in new health care costs in FY 2018.

### *FY 2018 Revenue Growth*

The state Department of Revenue (DOR) has projected baseline revenue growth of 4.2 percent during FY 2018.<sup>4</sup> While some have projected slower revenue growth and others higher, we use the baseline revenue growth rate projected by DOR. Because some of that potential new revenue will be offset by previously enacted tax cuts, 4.2 percent baseline revenue growth would result in 3.5 percent *actual* revenue growth.<sup>5</sup> That would generate \$898.9 million in new revenue for the FY 2018 budget, beyond the amount projected to be available in FY 2017.<sup>6</sup>

Other state revenue sources are not likely to grow significantly or are already accounted for in our projections. While the state receives significant revenues from fees, that revenue is not projected to increase substantially. Revenue from the lottery is also not projected to grow – and may decline. Federal Medicaid reimbursements are likely to grow significantly, but we already account for that in

our calculation of health care costs. We count health care cost growth as only the cost growth on the portion of health care spending ultimately paid by the state (that is total *state* spending, net of federal revenue). We treat the cost growth on the federal share as essentially cancelled out by the corresponding increased federal reimbursement.

Looking only at the changes in spending and revenue that are projected to occur *during* FY 2018 (see discussions, above), MassBudget calculates a negative net total of \$63.5 million, meaning that revenues are expected to grow slightly faster in FY 2018 than expenses, thus slightly reducing the gap carried over from FY 2017. This net total combines our estimates of expected cost growth in FY 2018 with the DOR estimate of projected actual revenue growth in FY 2018 (see table, below).

*Table 2*

<b>FY 2018 ESTIMATED COST AND REVENUE GROWTH</b>	
<b>\$ millions</b>	
<b>FY 2018 COST GROWTH</b>	
Estimated health care cost growth	339.2
All other estimated cost growth	496.2
<b>SUBTOTAL</b>	<b>835.4</b>
<b>FY 2018 REVENUE GROWTH</b>	
Dept. of Revenue estimated growth in actual tax calculations	898.9
<b>SUBTOTAL</b>	<b>898.9</b>
<b>ESTIMATED COST GROWTH LESS REVENUE GROWTH</b>	<b>(63.5)</b>

*The Initial FY 2018 Budget Gap*

As the FY 2018 budget process begins, the state likely will face an initial gap of approximately \$615.7 million. This is composed of: 1) the gap carried over from FY 2017 because of the use of temporary solutions in that budget, and 2) the difference between projected cost growth and projected revenue growth in FY 2018 (see table, below). This gap will need to be filled by some combination of temporary revenue and savings, permanent cuts, ongoing savings, and new revenues.

Table 3

<b>THE FY 2018 INITIAL BUDGET GAP</b>	
<b>\$ millions</b>	
Issues from FY 2017 budget contributing to FY 2018 budget gap	<b>679.2</b>
FY 2018 estimated cost and revenue growth	<b>-63.5</b>
<b>ESTIMATED FY 2018 INITIAL BUDGET GAP</b>	<b>615.7</b>

<sup>1</sup> Such a process is described in Section 3 of Chapter 29 of the General Laws.

<sup>2</sup> “Better State Budget Planning Can Help Build Healthier Economies,” Center on Budget and Policy Priorities (2015), Figure 5, page 12. See <http://www.cbpp.org/sites/default/files/atoms/files/10-15-15sfpllookingahead.pdf>.

<sup>3</sup> The anticipated health care cost growth rate is based on the benchmark set in Chapter 224 of the Acts of 2012, using the rate of growth of total health care expenditures. For 2013-2017, the rate is 3.6 percent, the growth rate of the potential gross state product. See <http://www.mass.gov/anf/budget-taxes-and-procurement/oversight-agencies/health-policy-commission/>.

<sup>4</sup> Mid-point estimate for baseline growth over updated FY 2017 forecast. Department of Revenue, *Briefing Book FY2018 Consensus Revenue Estimate Hearing* (see page 7): <http://www.mass.gov/dor/tax-professionals/news-and-reports/state-budget-documents/briefing-book/>

<sup>5</sup> Mid-point estimate for actual growth over updated FY 2017 forecast. Department of Revenue, *Briefing Book FY2018 Consensus Revenue Estimate Hearing* (see page 7): <http://www.mass.gov/dor/tax-professionals/news-and-reports/state-budget-documents/briefing-book/>

<sup>6</sup> Range of estimates for actual growth = 2.9 percent to 4.0 percent. Midpoint = 3.45 percent  
 Current estimated FY 2017 benchmark collections = \$26.056 billion (See DOR FY 2018 Briefing Book, pg. 7)  
 $\$26.056 \text{ billion} * 0.0345 = \$899 \text{ million}$