Massachusetts Taxpayers Foundation

MTF

333 WASHINGTON STREET

BOSTON, MA 02108-5170

617-720-1000

October 1, 2019

Big Decisions Ahead for $767 Million Budget Surplus

MTF Recommends Steps to Close the Books on Fiscal 2019 in a Timely Fashion

Though the Commonwealth's fiscal year 2019 ended June 30th, decisionmakers must make several important decisions before the final accounting of the state's finances for the year can be completed. Most importantly, lawmakers will determine how to allocate the year-end budget surplus, which MTF calculates at approximately $767 million.

Governor Charlie Baker has offered a plan for allocating the surplus that includes pre-paying for tax cuts with a cost of $175 million over two years, depositing an estimated $168 million in the Commonwealth Stabilization Fund and investing $346 million in new spending initiatives in key policy areas such as transportation, education, and drinking water infrastructure.

This policy brief estimates the value of the budget surplus, summarizes the Governor's proposed approach to allocating the surplus, describes timing-related issues facing decisionmakers, and recommends steps to close the fiscal year in a timely fashion while strengthening the state's finances.

Key Takeaways

- MTF estimates the year-end budget surplus will total approximately $767 million, which policymakers must decide how to allocate in the coming weeks.
- The Governor's proposal would increase the "rainy day" fund balance to $3 billion and better prepare the Commonwealth for future fiscal crises.
- The Governor's plan misses an opportunity to do more regarding the Commonwealth's pension and OPEB unfunded liabilities.
- MTF suggests holding the portion of the surplus allocated to new initiatives, about $346 million, in a temporary reserve to allow for further deliberation while closing the books on fiscal 2019 in a timely fashion.

Budget Surplus

Projecting the FY19 Budget Surplus	
Budget Surplus	Amt
Tax Surplus	
Budgeted Tax Revenue above estimate	1,076.9
Excess Capital Gains Transfer above estimate	-359.2
Tax Surplus	717.6
All Other Non-Tax Revenue and Spending Change	48.8
Subtotal, Budget Surplus	**766.5**
Governor's Proposed Surplus Allocation	
Transfer to Reserves	
Pre-Pay for Tax Cut	175.0
Stabilization Fund Transfer	168.0
OPEB	47.3
Subtotal, Transfer to Reserves	390.3
New Spending	
Life Sciences and CPA	30.0
Proposed New Initiatives	
Education	104.9
Transportation	54.6
MBTA	50.0
Subtotal, Transportation & MBTA	104.6
Clean Water	55.0
Public Safety	24.9
Housing	20.4
Other HHS	16.3
Environment	12.1
Other	7.9
Subtotal, Proposed New Initiatives	346.1
Total Allocation	**766.5**
FY19 Surplus After Allocation	**0.0**

Figures in $ millions.

Figure 1: Fiscal 2019 Surplus Summary

Calculating the Budget Surplus

Though many steps of the budget process occur in public, the period preceding the final accounting of the state's finances, as marked by the publication of the Statutory Basis Financial Report (SBFR), occurs primarily inside state agencies and can be difficult to follow. Several important pieces are moving simultaneously. Certain non-tax revenue, such as federal reimbursements for MassHealth spending, are received after the fiscal year ends on June 30 but must be "booked back" later in the year. Agencies continue to spend against fiscal 2019 spending line items after June 30 during the Accounts Payable period. Other adjustments and corrections are also processed during this time.

Further, spending items such as MassHealth are required to meet their obligations under their partnership agreements with the federal government regardless of appropriation. As a result, MassHealth typically spends beyond the appropriation for the program and lawmakers must resolve any difference between appropriation and actual spending at the end of the fiscal year. The presence of these differences, known as "deficiencies", along with the presence of spending accounts for which unspent balances remain, or "reversions", as well as spending items for which authorization to extend the appropriation into the next fiscal year is requested, known as "Prior Appropriation Continued" (PAC), mean that it can be very difficult to understand what is really going on with the state's finances.

The Massachusetts Comptroller's office is responsible for tracking and calculating all these moving pieces. In the coming weeks, the Comptroller will communicate to executive and legislative decisionmakers the precise amount of the fiscal 2019 budget surplus (revenue in excess of expenses).

This analysis uses available public data from the supplemental appropriations requests filed by the Governor on June 27, 2019 and September 6, 2019, the Commonwealth of Massachusetts Information Statement dated April 10, 2019 (hereafter, "April CIS"), and the Commonwealth of Massachusetts Information Statement dated August 9, 2019 (hereafter, "August CIS").

Tax Surplus

The Commonwealth finished fiscal 2019 with tax collections available to budget of $27.8 billion, or approximately $1.1 billion over the revised tax benchmark of $26.8 billion. Of this excess amount, $359 million was transferred to the Commonwealth Stabilization Fund per statute. After accounting for this transfer, the tax surplus totals approximately $718 million.

All Other Non-Tax Revenue and Spending Changes

All other changes, including non-tax revenue (e.g. fines, fees, and penalties) and spending changes (unspent balances in spending accounts) is an estimate inferred from the changes between the April CIS and August CIS, and the amounts requested in the Governor's final supplemental appropriations bill filed on September 6, 2019. MTF estimates these changes add at least $49 million to the budget surplus and produce a total estimated budget surplus of approximately $767 million as depicted in Figure 1.

The $49 million estimate is likely to be a somewhat conservative estimate of the actual value of all other non-tax revenue and spending changes due to the type and nature of data that is publicly available currently.

The Comptroller's office supports a database offering daily comparisons of the budget to actual spending. Using this data, MTF calculates existing deficiencies of $351 million on a gross basis and $133 million net of offsetting revenue.[1] The fiscal impact of PACs is more ambiguous as it depends both on amounts assumed during the fiscal year and whether the PAC amount was assumed to be spending or a reversion.

Similarly, comparable information on non-tax revenue is not yet available. As a result, the extent to which non-tax revenue estimates were too conservative or too aggressive is not yet known publicly.

[1] Budget-to-Actual Spending in the Commonwealth's Budgeted Funds, Office of the Comptroller, Accessed September 24, 2019. This database was launched publicly on August 19, 2019.

Governor's Proposed Allocation

Transfers to Reserves: Pre-Pay for Tax Cuts

The Governor proposed three tax law changes, including:

- A reduction of the personal income tax rate to 5 percent beginning January 1, 2020;
- Increasing the personal income tax's dependent exemption from $1,000 to $2,000 beginning in tax year 2019; and,
- Changing the relationship between the federal corporate tax code and the state tax code related to certain business expenses.

Personal Income Tax Rate Reduction

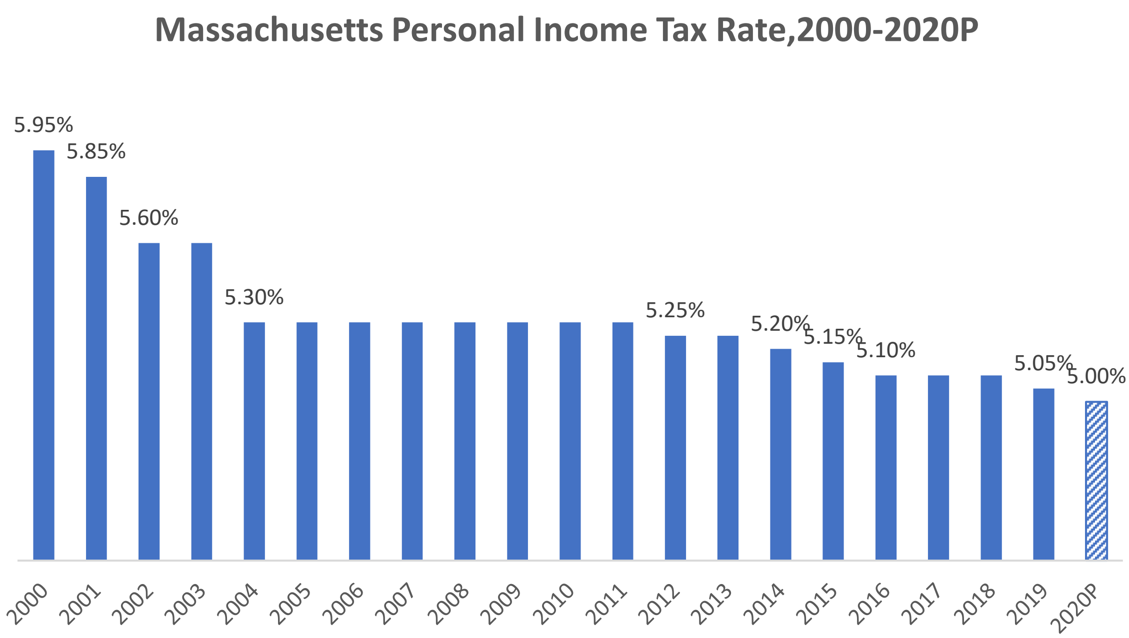

Figure 2: Massachusetts Personal Income Tax Rate, 2000-2020 Proposed. Data from the Tax Foundation.

The Commonwealth's personal income tax rate is currently subject to adjustment annually based on a statutory "trigger" that reduces the rate when certain economic thresholds are met.[2] Most recently, the rate was reduced from 5.1 percent to 5.05 percent on January 1, 2019 based on this provision.

[2] M.G.L. ch.62 §4

Governor Baker proposes to waive the “trigger” requirement and reduce the income tax rate from 5.05 percent to 5 percent effective January 1, 2020.

The approved fiscal 2020 budget already assumes the tax rate will decrease to this lower rate and reduce income tax revenue by $88 million, thus the Governor’s proposal has no budgetary impact. This move would complete the process of reducing the state’s personal income tax rate to the target rate of 5 percent, as depicted in Figure 2.

Importantly, current law also requires the restoration of the charitable deduction in the year after the 5 percent rate is reached.[3] The Massachusetts Department of Revenue (DOR) estimates this change would reduce income tax revenue by $64 million in fiscal 2021 and $257 million in fiscal 2022.

Dependent Exemption

The Governor proposed to increase the income tax exemption for dependents from $1,000 to $2,000 a change that would impact more than one million taxpayers and reduce income tax collections by $87 million annually.[4] The Governor proposed to set aside $175 million of the one-time fiscal 2019 surplus to support this ongoing change for fiscal 2020 and fiscal 2021.

Combined with the impact of charitable deduction noted above, fiscal 2022 tax revenue could be reduced by approximately $344 million as a result of these two changes. This amount would be higher than the impact of tax law changes in previous fiscal years. For example, tax law changes were estimated to reduce collections by $219 million in fiscal 2019 and $255 million in fiscal 2020.[5]

Decoupling from IRS 163(J)

The Governor’s proposal includes three policy sections that decouple the Massachusetts tax code from the federal tax code for purposes of the interest deduction limitation. This change will restore the tax treatment of interest expenses that existed in Massachusetts prior to the enactment of the Tax Cuts and Jobs Act (TCJA). According to DOR, this

[3] Commonwealth of Massachusetts Information Statement August 9, 2019. Pg A-12.
[4] H.4067 Filing Letter dated September 6, 2019
[5] *DOR Briefing Book FY2019 Consensus Revenue Estimate,* Pg. 7, MA Department of Revenue, December 7, 2017, and *DOR Briefing Book FY2020 Consensus Revenue Estimate*, Pg. 7, MA Department of Revenue, December 5, 2018.

change is estimated to reduce tax collections by approximately $37 million in fiscal 2020. MTF has advocated for this change with executive and legislative policymakers in order to provide clarification and retain competitiveness for capital investment among peer states.

Stabilization Fund

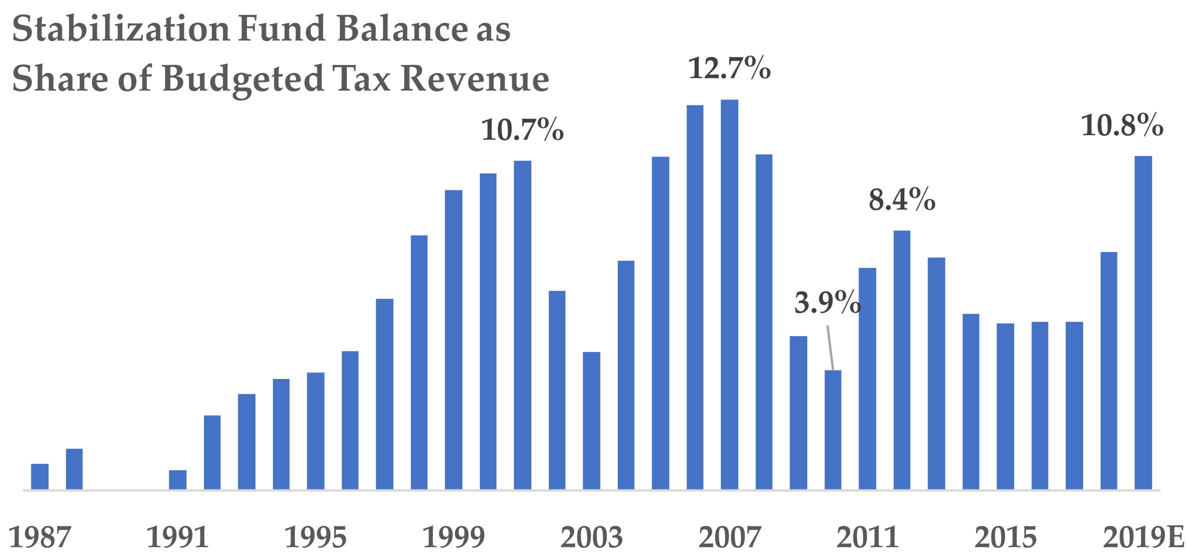

Figure 3: Stabilization Fund Balance as Share of Budgeted Tax Revenue, FY87-FY19Est

The Governor proposed to allocate such funds as required to bring the Stabilization Fund balance to $3 billion, estimated at $168 million.[6] A $3 billion balance in the Stabilization Fund would represent the largest nominal fund balance in state history.[7]

Adjusted for the growth of the state budget over time as measured by budgeted tax revenue (BTR), a balance of $3 billion would be able to replace about 11 percent of BTR and essentially return the Commonwealth's "rainy day" fund to its level at the start of the Great Recession in fiscal 2008. Given the volatility of state tax revenues in recent years, however, strengthening the Stabilization Fund should remain a high priority for policymakers.

[6] H.4067 Filing Letter dated September 6, 2019.
[7] For more on the Stabilization Fund, please see *The $3 Billion Stabilization Fund*, Massachusetts Taxpayers Foundation, August 8, 2019.

Unfunded Liabilities: Pensions and Other Post-Employment Benefits (OPEB)

The Commonwealth is anticipated to need more money than is currently saved to fund pension benefits for state employees and public-school teachers and, to a lesser extent, other-postemployment benefits (OPEB) such as retiree health care, for retired state employees. State financial reports calculate net unfunded liabilities of $36.7 billion for pensions and $15.3 billion for OPEB.[8]

Recent evaluations of the Commonwealth's creditworthiness by Standard & Poors (S&P) highlight unfunded pension liabilities as critical to improving the state's credit rating:

> *"Should the Commonwealth strengthen its pension funding discipline based on a prudent actuarial basis and retain material budget reserves during periods of economic growth as a matter of budgetary policy, with the aim of sustainably achieving what we view as strong reserve levels, we could raise the rating or revise the outlook."*[9]

On January 13, 2017, executive and legislative decisionmakers adopted a pension funding schedule that fully amortized the unfunded pension liability by fiscal 2037 and have adhered to the plan's nearly 9 percent annual increase to the pension payment, which will total $2.8 billion in fiscal 2020. Since that time, however, actuarial assumption changes and other technical adjustments have increased the unfunded liability. The pension funding schedule is due to be reviewed and revised during the development of the fiscal 2021 Governor's Budget Recommendation in December 2019-January 2020.

As part of initial analysis of the fiscal 2019 budget surplus in June 2019, MTF recommended policymakers use a portion of any such surplus to pay down unfunded liabilities associated with pensions and OPEB.[10] Despite this recommendation and the noted guidance from credit rating agencies, the Governor's plan does not allocate additional resources to the Commonwealth's unfunded pension obligations. This represents a missed opportunity to address these real costs while leveraging returns on

[8] *FY2018 Comprehensive Annual Financial Report*, Pg 3, Massachusetts Comptroller, January 18, 2018.

[9] *Massachusetts Appropriations; General Obligation; General Obligation Equivalent Security*, Pg 6, S&P Global Ratings, August 23, 2019.

[10] *FY19 Surplus: A $500 Million Question*, Massachusetts Taxpayers Foundation, June 27, 2019.

investment from a health stock market and taking advantage of the value of compounding.

Regarding OPEB, policymakers adopted a plan to dedicate proceeds from the legal settlement with tobacco companies (*Commonwealth of Massachusetts v. Philip Morris, Inc. et.al.* Middlesex Superior Court No. 95-7378, also known as the Master Settlement Agreement or MSA*)* to pay down the OPEB unfunded liability, starting with 10 percent of such revenue in fiscal 2013 and increasing 10 percent annually until the entire amount of the payment was so allocated as reflected in Figure 4.[11] Policymakers have not adhered to this policy since fiscal 2016.

The Governor proposed to allocate $71 million for OPEB in fiscal 2019, or 30 percent of the MSA amount, an increase of 47 million over the planned 10 percent contribution, but still far short of the scheduled payment of $166 million. Despite these efforts, the OPEB unfunded liability remains a significant long-term fiscal challenge that policymakers have not yet confronted in a meaningful way.

Use of Tobacco Settlement Revenue for OPEB, FY13-FY22E

FY	MSA Amt	S.152 Dedication	S.152 Amt	Actual Amt	Actual Dedication	Actual vs S.152
2013	253.5	10%	25.3	25.3	10%	0.0
2014	282.0	20%	56.4	56.4	20%	0.0
2015	245.8	30%	73.8	73.8	30%	0.0
2016	257.6	40%	103.0	77.3	30%	-25.8
2017	254.5	50%	127.2	25.4	10%	-101.8
2018	243.3	60%	146.0	73.0	30%	-73.0
2019	236.6	70%	165.6	71.0	30%	-94.7
2020E	236.6	80%	189.3	23.7	10%	-165.6
2021E	236.6	90%	213.0			
2022E	236.6	100%	236.6			

Figures in $ millions unless otherwise noted.

Figure 4: Use of Tobacco Settlement Proceeds for OPEB Unfunded Liability, FY13-FY22E

[11] Section 152 of Chapter 68 of the Acts of 2011

New Spending Requests

The Governor's plan allocates $346 million of the budget surplus to various items, including $105 million for education, $105 million for transportation, $55 million for clean water efforts, $25 million for public safety initiatives, $20 million for housing initiatives, and $36 million for other items.[12]

The Governor's proposals regarding education and transportation investments are largely consistent with MTF's recommendations for the FY19 surplus.[13]

Spending items with a total value of approximately $254 million are structured as one-time transfers to non-budgeted spending accounts controlled by public or quasi-public agencies, such as the proposed $50 million appropriation to the MBTA. In this way, the spending items are technically non-recurring in nature, though as agencies "spend down" balances in such accounts, the initiatives may require additional support in the future either on an *ad hoc* basis or as an ongoing commitment in the annual budget.

MTF Recommendation: A Cautious Approach to the Budget Surplus

MTF recommends policymakers adopt a cautious approach to the fiscal 2019 budget surplus.

This approach should include the following actions:

- Enact tax law changes to return a portion of surplus revenue to working families and businesses in the Commonwealth
- Make deposits in Stabilization Fund and pay down unfunded liabilities for OPEB
- Approve appropriations as necessary to address existing deficiencies and extend existing appropriations into fiscal 2020 to support ongoing programs and projects
- Consider placing the remaining budget surplus in a transitional escrow trust to support non-recurring investments in education and transportation initiatives

[12] Note that these figures include a $50 million request for additional funding for the MBTA noted by the Governor in the filing letter accompanying his proposed final supplemental appropriations bill (H.4067), though this appropriation request was filed on June 27, 2019 in H.3934.

[13] *FY19 Surplus: A $500 Million Question*, Massachusetts Taxpayers Foundation, June 27, 2019.

MTF recommends policymakers act on these items as quickly as possible in order to close the books on fiscal 2019 and support publication of the SBFR by the statutorily required deadline of October 31.

MTF suggests depositing any remaining budget surplus into a transitional escrow trust to support non-recurring investments in education and transportation initiatives. This approach has been pursued in the past. In 2005, for example, lawmakers deposited a budget surplus of $305 million into a transitional escrow trust and made spending decisions later in the year.[14] This approach allows for a more deliberative process for allocating the budget surplus while still adhering to the narrow statutory timeframe for closing the books.

Conclusion

Fiscal 2019 has been a particularly strong year for the Commonwealth's fiscal health. Above-expectation tax collections, moderate growth in spending, and careful financial management provide policymakers with the opportunity to prepare for future fiscal downturns, pay down unfunded liabilities, invest in key priorities, and improve economic competitiveness by reducing taxes.

The Governor's proposed budget surplus allocation pursues many of these objectives, though his plan misses an opportunity to do more on pension and OPEB unfunded liabilities. Given that credit rating agencies have identified these obligations as a key obstacle to improving the Commonwealth's creditworthiness and that the Commonwealth's debt-financed needs are increasing, paying down unfunded pension and OPEB liabilities should be a high priority for policymakers.

With an ambitious legislative agenda planned for the coming weeks and months that may require additional spending, policymakers should pursue the cautious approach outlined here to allow the Commonwealth to close the books on fiscal 2019 in a timely fashion while responsibly managing the state's finances.

[14] *FY2005 Statutory Basis Financial Report* Pg 2, MA Comptroller, October 28, 2005.