Ten Questions on the FY 2018 Budget

The Consensus Revenue Hearing, held on December 5th, kicked off the FY 2018 budget development process. The testimony at the hearing highlighted a number of fiscal challenges that the state can expect in the near future. The Foundation is providing a list of the top ten FY2018 budget questions, the answers to which will be very telling about the size and scope of these challenges and the strategies for addressing them.

1. ***What tax revenue growth can be expected in FY 2018?***

   The economists that presented at the Consensus hearing had widely different views about how much revenue will grow in FY 2018, with revenue forecasts varying by more than $1.1 billion. The Foundation was at the low end of the range, projecting growth of 2.65 percent, while other forecasts predicted growth as high as 5.17 percent. The five year average of the consensus growth rate is 4.5 percent. This consensus figure becomes very important because taxes make up two-thirds of all state revenue available for the budget.

	FY 2018 Projection	Assumed Growth
Economy.com (DOR Vendor)	$27,104	3.91%
Global Insight (DOR Vendor)	$26,810	3.20%
MTF	$26,640	2.65%
BHI	$27,771	5.17%
Alan Clayton Matthews	$27,267	3.69%

   There are two reasons to assume a lower rate of tax revenue growth will be agreed to in FY 2018. Overly optimistic forecasts in each of the past two years have led to substantial revenue downgrades later in the year and large budget gaps as a result. Given this recent history, it’s likely that a more conservative tax estimate will be used for FY 2018.

   In addition, there is no reason to believe that the disappointing revenue growth trend over the last year (a modest 1.4 percent) will change substantially in the months ahead. Adding to the case for caution is the heightened uncertainty related to the economic policies of the incoming Trump Administration. As the Foundation’s revenue estimate for FY 2018 highlights, the new Administration’s policies could have several possible revenue implications for the Commonwealth. While it’s possible that revenues will rebound in the months to come, continued modest growth or an economic downturn are equally plausible given the growing number of national and global economic uncertainties.

2. ***Will the income tax rate reduction be triggered for 2018?***

   The state income tax rate, currently 5.1 percent, is subject to an automatic reduction of 0.05 percentage points if annual revenue growth benchmarks are met. Due to faltering tax revenues in FY 2016, a rate reduction will not occur in January of 2017.

   Whether or not an automatic reduction for 2018 will be triggered depends on if:

   - FY 2017 baseline tax revenue exceed FY 2016 baseline tax revenue by 2.5 percentage points more than inflation; and

- The three month average tax revenue growth between August and November of 2017 exceeds baseline revenue for the same period in 2016 after adjusting for inflation.

Based on tax collections to date and the most recent inflation information, a rate reduction seems unlikely because the year-to-date baseline tax revenue growth stands at 3.4 percent as of the end of November while inflation is approximately 2 percent. However, the Department of Revenue forecasts that an income tax reduction will occur in FY 2018. If DOR is correct, the rate reduction would result in the loss of approximately $80 million in tax revenue.

3. *Will any tax changes be proposed?*

Major tax changes in FY 2017 were off the table after House Speaker Robert DeLeo announced in January that the House, where all tax bills must originate, would not consider new taxes or fees for the remainder of the legislative session. As of yet, neither the House nor the Senate has ruled out tax changes in time for the FY 2018 budget, and while the Governor has indicated he would not support broad-based new taxes, he has hinted that he would be amenable to closing loopholes.

While no tax changes were adopted last year, several of the proposals that were introduced and rejected may resurface in FY 2018. Revenue raisers may include repeal or reform to the state's film tax credit and the imposition of a new tax on short term apartment rentals, while proposals to increase the state's Earned Income Tax Credit or reintroduce a sales tax holiday would result in lost revenue.

If new taxes are part of the FY 2018 budget it will be imperative to understand whether the new revenues are used to reduce the state's structural deficit or to create new programs or expand existing ones.

4. *How heavily will the state rely on one-time solutions to address the structural deficit?*

For more than a decade, the state budget has operated with a structural deficit – where ongoing revenues are insufficient to meet expenses – and various one-time resources have been used to close the gap. Those one-time solutions range from withdrawals from the state's Rainy Day Fund, to temporary federal aid to sweeping trust fund balances, to the sale of state-owned property. Budget-makers have done a good job of reducing their reliance on non-recurring revenues in recent years, but they are still overly used to balance the budget.

One-timers in initial Budget	
Capital Gains Diversion	$150
Land Sales	$30
MassHealth One-time	$74
EOHHS Trust Sweep	$13
Midyear Gap Close One-timers	
Trust fund sweeps	$112
Legal settlements	$20
Total One-timers	***$399***

One-time solutions will be under consideration again in FY 2018, but there are fewer options and those remaining have downside risk. The Rainy Day Fund balance is still below pre-recession levels and withdrawals should be off limits as a short-term budget solution.

The recent practice of using capital gains revenue above the statutory threshold to balance the budget must also come to an end in order to rebuild reserves. This money is supposed to be deposited into the Rainy Day Fund and given its low balance and the concerns raised by rating agencies with this practice, budget-makers' willingness to divert from the Rainy Day Fund in FY 2018 will be a clear indication of the scope of the challenges they confront.

5. ***What will marijuana legalization mean for the FY 2018 budget?***

This will be the first budget development process that must account for marijuana legalization. Under the recently approved ballot initiative, revenue from applications and licensing fees from marijuana retailers, cultivators and manufacturers will be received in the first half of FY 2018 and tax revenue from sales will begin in the second half of FY 2018.

Licensing and application fee revenue is estimated between $3.5 and $5 million, but revenue from sales is far less certain.

FY 2018 Marijuana Tax Estimate	
Assumed Sales	
Marijuana sales in 2018	300 million
FY 2018 impact (first 6 months)	$150 miillion
FY 2018 tax revenue	
6.25% sales tax	$9.4 million
3.75% marijuana excise	$5.6 million
Estimated tax revenue	***$15 million***
Estimated General Fund Revenue	***$9.4 million***

Using a 2018 marijuana sales estimate of $300 million – which is consistent with a study published this spring by two investment firms in support of legalization – FY 2018 tax revenue would be in the $15 million range. However, whatever revenues are collected by the state from the licensing and application fees and the marijuana excise will be deposited into a dedicated fund to cover industry oversight expenses. It is unlikely that the marijuana sales tax revenue, which will be deposited into the General Fund, will have a meaningful budget impact.

A bigger question is whether the costs associated with creating the industry's regulatory infrastructure will exceed dedicated revenue and if so, where the Commonwealth will find the money to cover the costs.

6. ***What's the true level of FY 2017 spending?***

A key data point for building a budget is the total amount of expenditures in the prior fiscal year. Because numerous costs typically follow trends from previous months, it is impossible to have accurate spending assumptions for the upcoming year without a clear understanding of current spending.

FY 2018 poses two unique challenges that make such spending projections especially difficult. To balance the FY 2016 budget the Administration focused on maximizing the amount of appropriated funds that would remain unspent. These reversions decreased total spending by hundreds of millions of dollars in the aggregate, but it is not yet apparent which specific line-items were reduced. Therefore, some of the line-item assumptions used in the FY2017 budget are not based on actual spending amounts and could be

inaccurate. Compounding the challenge is the continued use of reversions in the FY 2017 budget. $200 million of appropriated funds are anticipated to remain unspent and revert to the General Fund to balance this year's budget. This approach will make it harder to estimate actual spending in FY 2017 in time for the FY 2018 budget process.

7. ***What will the next pension funding schedule look like?***

Budget-makers must determine a new three year pension funding schedule, which is typically done in conjunction with the Consensus Revenue agreement. The last schedule committed to three straight years of 10 percent annual increases in the state's contribution – the largest contribution increases in the state's history. These increases enabled the state to accelerate the date of full funding by four years from 2040 to 2036. Despite these additional contributions, low pension fund returns and reductions to the fund's assumed long-term rate of return have resulted in growth of the state's unfunded liability. The level of contributions over the next three years will likely have to increase by at least ten percent annually to stay on the 2036 schedule; this would cost an additional $220 million in FY 2018.

8. ***How will enrollment and federal policy changes impact MassHealth?***

MassHealth consumes a growing portion of the state budget and this growth is driven by increasing enrollment in the program. When enrollment grows faster than expected, it can quickly create major budget problems. The FY 2017 budget assumed MassHealth enrollment of 1.889 million members – growth of 1.4 percent over final FY 2016 enrollment. Actual enrollment through November for the fiscal year has exceeded projections by 17,000 members, a growth rate of 2.3 percent. This has led to an FY 2017 budget gap of more than $100 million and portends additional spending on the MassHealth program in FY 2018.

	FY 2010 - FY 2013 Average	FY 2016	FY 2017 Initial	FY 2017 Updated
MassHealth Caseload Growth	3.9%	-2.3%	*1.4%*	*2.3%*

Between FY 2010 and FY 2013, MassHealth enrollment grew at an annual rate of 3.9 percent. MassHealth enrollment spiked during implementation of the Affordable Care Act, but flattened for a brief period before creeping up in recent months. The question for FY 2018 is whether or not it's possible to hold enrollment flat once again.

In addition to MassHealth enrollment trends, the status of the state's recently approved Medicaid waiver could have ramifications on FY 2018. The waiver governs the financial and policy framework for MassHealth over the next five years. Should the Republican-controlled Congress act on proposals to fundamentally alter the Affordable Care Act (ACA) or Medicaid, the state's waiver would be affected. While many of the proposed changes would take years to implement, others, such as repeal of the ACA's Medicaid expansion provisions, could jeopardize federal reimbursements in FY 2018.

What's less clear is whether or not a Trump administration would renegotiate or eliminate some of the waiver terms because it deems them no longer in the public interest or promoting the objectives of Medicaid. There is little precedent for such action, but previous practice may not govern the Trump Administration.

9. How will other non-discretionary spending change?

Every year the Commonwealth must pay certain obligations such as debt service, public employee health insurance and retiree health care. In FY 2017, these non-discretionary costs are estimated to cost $4.5 billion – an increase of over $200 million from the prior year budget. Because these nondiscretionary spending categories must be paid first, money available for important discretionary programs, such as early education, substance abuse and child welfare, will depend on how much these non-discretionary costs grow.

Debt service costs will depend on how much new debt is issued, the timing of issuance and the Treasurer's efforts to refinance existing debt. If recent trends continue, it's likely that debt service costs will increase by approximately $50 million.

State employee and retiree health care costs are a function of enrollment, utilization and the cost of provided services. Total enrollment and utilization has been stable – even declining slightly in recent years – but an expected uptick in the cost of the state-offered health insurance plans could require a sizable increase in state funding.

10. How will local aid funding change?

The two major sources of local aid to cities and towns are Chapter 70 education aid and Unrestricted General Government Aid (UGGA). In FY 2017, funding for these two accounts increased by $158.3 million over FY 2016 spending.

	FY 2016	FY 2017	Increase	% Increase
Chapter 70	$4,511,882,199	$4,628,013,618	$116,131,419	2.6%
UGGA	$979,797,001	$1,021,928,272	$42,131,271	4.3%
Total	***$5,491,679,200***	***$5,649,941,890***	***$158,262,690***	***2.9%***

The 4.3 percent increase to UGGA in FY 2017 reflects a commitment made by Governor Baker to increase funding by the same percentage as projected revenue growth. The FY 2018 increase will likely be smaller to reflect more conservative tax revenue growth assumptions. In FY 2018, each percentage point of projected tax growth represents an additional $10.2 million for UGGA.

Chapter 70 funding has two primary components: a minimum amount required to ensure each school district meets minimum required spending levels and additional amounts provided to improve the fairness or adequacy of state funding. In FY 2017, approximately $34.5 million was needed to meet the minimum requirements of the formula, while $81.6 million was used to improve formula fairness and adequacy.

In recent years, calls to overhaul the Chapter 70 formula have increased and earlier this year the Senate adopted major reforms that would substantially increase state aid. Even without such reforms, it's likely that local aid funding in these two accounts increases by $100 - $150 million in FY 2018.

Over the next six months, the Governor, House and Senate will each have to answer the questions posed above. How they do so will have immediate consequences for the rest of the budget because the combination of slowing tax revenue growth and growing non-discretionary obligations leaves very little fiscal flexibility in FY2018