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MTF Bulletin

June 24, 2021

FY 2022 Budget Conference Committee Preview

House and Senate budget conferees are finalizing a fiscal year (FY) 2022 budget this month to send to Governor Baker for the start of the fiscal year on July 1st. As with any other year, budget negotiations will need to resolve hundreds of differences between the two proposals, but unlike most years, the most important issue facing conferees relates to resources and not to spending and policy. The House and Senate, working with the Administration, need to adjust assumed FY 2022 tax collections and determine how that adjustment will impact the budget and the state's fiscal health. This bulletin examines likely tax upgrade scenarios and the impact of those scenarios on the state's fiscal picture. It also provides an overview of major spending and policy differences to be resolved.

Background

Since March, MTF has highlighted three critical fiscal factors that would impact the FY 2022 budget:

1. The continuation of the federal Public Health Emergency Declaration, which provides enhanced federal Medicaid revenues, and the continued growth of MassHealth enrollment;
2. The passage of the American Rescue Plan (ARPA) and the billions in direct financial assistance it brings to Massachusetts; and
3. State tax collections that far exceed original projections.

The House and Senate budgets accounted for the first of these factors by increasing FY 2022 MassHealth spending by approximately $1.4 billion, offset by a similar amount of additional federal revenues. Both branches wisely elected to hold new federal ARPA resources aside from the traditional budget, opting instead, to expend Fiscal Recovery Funds through a separate process, subject to appropriation.

By the time House Ways and Means released its budget, it was apparent that the tax revenue estimates used to create the FY 2022 consensus revenue figure would require adjustment. Due to the pandemic-related delay in finalizing the FY 2021 budget, tax revenue benchmarks for that year were not put in place until January. Between January and the end of March, tax collections exceeded the benchmark by more than 20 percent or close to $1.5 billion over just three months.

Figure 1. FY 2021 Tax Revenue Picture at the Release of the House Ways and Means Budget

	Benchmark	Actual	$ Above	% Above
January	$2,918	$3,347	$429	14.7%
February	$1,502	$1,874	$372	24.8%
March	$2,413	$3,061	$648	26.9%
Total through March	$6,833	$8,282	$1,449	21.2%
$ in millions				

These strong revenue collections for the past several months posed an interesting dilemma for the House and Senate as they put forward their spending plans. Unilaterally upgrading revenues ran the risk of creating two budgets that used fundamentally different resource assumptions, both of which would have been developed prior to the delayed income tax deadline. Maintaining the consensus revenue figure, without additional resources, would result in a budget that required significant cuts. Instead of these two problematic options, both branches of the legislature adopted a bridge approach in which reliance on approximately $2 billion Stabilization and other one-time revenues supported spending growth while decisions on a tax revenue upgrade were deferred until conference committee.

This bridge approach results in two budgets with very similar spending totals and with resource assumptions that require significant adjustment.

Conference committee tax revenues

Fiscal year 2021 tax revenues now stand at $3.95 billion over the $29.090 billion benchmark established in January that was also used to develop the FY 2022 revenue estimate. It is likely that final June revenues will increase total collections to more than $33 billion. This surge in tax collections has two major impacts on the FY 2022 budget. First, it fundamentally alters the fiscal situation the state can expect heading into the new fiscal year in terms of reserve balances and potential surpluses. Second, it requires a major revision in the FY 2022 forecast.

Fiscal situation heading into FY 2022

Two key data points that will impact final FY 2021 finances are the final number for tax collections (which will be known in early July) and the amount of capital gains taxes collected (known by the end of July). The capital gains figure is important because collections above $1.312 billion are automatically deposited into state reserves, with 90 percent going to the Stabilization Fund.

It is likely that capital gains make up a large share of income tax growth in FY 2021. Through May, 78 percent of above benchmark income tax collections were due to non-withholding income taxes (which includes capital gains), while the remaining 22 percent came from withholding taxes. This share is notable because non-withholding income ordinarily comprises a relatively small share of total income taxes (less than one quarter through May). Historically, capital gains taxes make up just over 50 percent of non-withholding collections; in FY 2021 capital gains have comprised 53 percent of non-withholding collections through May.

Figure 2. Revenue Scenarios for FY 2021

	Scenario 1	Scenario 2	Scenario 3
Final tax collections	$33,401	$33,722	$34,029
Amount above benchmark	***$4,311***	***$4,632***	***$4,939***
Est. capital gains collections	$2,595	$2,725	$2,871
Capital gains threshold	*$1,312*	*$1,312*	*$1,312*
Automatic deposit to reserves	$1,283	$1,413	$1,559
Above benchmark collections remaining	***$3,028***	***$3,219***	***$3,380***
Esimated FY 2021 Closeout Obligations			
Offset to assumed Stabilization Fund draw	-$1,100	-$1,100	-$1,100
Amount necessary to cover remaining obligations and expected spending	-$800	-$800	-$800
Preliminary surplus estimate	***$1,128***	***$1,319***	***$1,480***

$ in millions

Figure 2 uses year-to-date data and historical trends to present three reasonable scenarios for final FY 2021 tax revenues and above benchmark capital gains. Under all three scenarios in which total revenues range from $33.4 to over $34 billion, the state will be able to forego a withdrawal from the Stabilization Fund in FY 2021 and instead further build the fund balance while still generating a budget surplus. This means that the FY 2022 fiscal year is likely to build on a revenue base that exceeds $33 billion and with a Stabilization Fund balance closer to $4.7 billion than the current $3.5 billion level. Even with this large Stabilization Fund deposit, a revenue of surplus of more than $1 billion is likely.

Revising tax revenue for FY 2022

The most reasonable approach for FY 2022 budget conferees is to assume that tax revenues grow by a modest rate over the final FY 2021 level. After revenues flattened in FY 2020, the historic revenue growth in FY 2021 is not likely to repeat. At the same time, with a reopening economy, revenues should continue to grow even as federal programs that have buoyed tax collections come to an end. Should strong collections continue in the coming fiscal year, it will likely be driven by additional capital gains collections, and this money should be set aside from the budget.

Figure 3. Possible Tax Revenue Revisions for FY 2022

		FY 2022 revenue growth		
		1.5%	2.5%	3.5%
FY 2021 revenue	Scenario 1 ($33.4 billion)	$33,902	$34,236	$34,570
	Scenario 2 ($33.7 billion)	$34,228	$34,566	$34,903
	Scenario 3 ($34 billion)	$34,539	$34,880	$35,220

$ in millions

Figure 3 provides a range of FY 2022 revenue estimates based on different FY 2021 total tax collection scenarios. At minimum, a revenue upgrade of $3.8 billion over the current $30.1 billion consensus revenue figure is appropriate. The magnitude of this upgrade will eliminate the need to budget on any Stabilization Fund withdrawal, support all House and Senate spending, augment reserves and leave a significant budget surplus.

Implications of raising FY 2022 tax estimates

The surge in FY 2021 tax collections is in sharp contrast to the initial projections of steep revenue drops due to the pandemic, and a nice problem to have, but its policy implications require careful consideration. MTF urges policymakers to adhere to some key principles as it charts our fiscal course:

- ***Achieve a Stabilization Fund balance of 10 percent of total spending by the end of FY 2022***
  Massachusetts is now in the position of not only avoiding drawing down our reserves during the pandemic but having the ability to augment our Stabilization Fund balance. Further, there is a statutory obligation to dedicate 90 percent of above benchmark capital gains to that fund, resulting in a significant deposit in FY 2021 and likely in FY 2022. The initial goal should be to increase our Stabilization Fund to 10 percent of our total spending, or approximately $5 billion. Achieving this standard would position Massachusetts well for future downturns and meet or exceed best practices set forth by national fiscal watchdogs and rating agencies.
- ***Minimize the level of the surplus built into the conference committee budget***
  The economic volatility of the last 15 months is unprecedented. It will take time to understand the extent to which baseline FY 2021 collections are sustainable going forward. The initial FY 2022 budget should retain a cautious approach to and avoid new spending that was not included in either the House or Senate versions.
- ***Coordinate the use of FY 2021 and FY 2022 surpluses with federal Fiscal Recovery Funds***
  Massachusetts is already wrestling with how to develop a thoughtful, equitable and effective approach for the use of $5.2 billion in Fiscal Recovery Funds (FRF), provided through ARPA. One of the chief challenges in those efforts is the criteria set forth by the federal government. The availability of significant revenue surpluses in FY 2021 and potentially FY 2022 presents the opportunity to coordinate the use of these resources in a manner that reduces or eliminates restrictions on how Massachusetts supports a strong pandemic recovery. One way to do this would be to dedicate a share of surplus revenues into a Commonwealth Investment Fund that can be used in conjunction with FRF resources. Dedicating funds in this way would also ensure that planning for the use of federal and state resources occurs as part of the same process.

We do not yet know where final FY 2021 tax revenues will land, nor how FY 2022 will build on recent revenue trends. It is apparent, however, that the revenues collected to date warrant a major upgrade in FY 2022 and a shift in the use of the Stabilization Fund from withdrawals to deposits. Past that, policymakers would be well served to coordinate additional state and federal resources in a way that maximizes the value of both for residents, employers, and communities.

Conference committee spending comparison

The House and Senate budgets are remarkably similar in major spending areas. The two branches differ by less than $20 million in their spending recommendations on the $19 billion MassHealth program, while Chapter 70 and unrestricted local aid spending is identical. In fact, $47.4 billion out of $48 billion in spending is common to both budgets.

Figure 4. FY 2022 House and Senate Spending Comparison

	House	Senate
Total spend	$47,706	$47,723
Total earmarks	$102	$117
Shared earmarks	$35	
Shared spend	$47,420	
Unique spend	$285	$303
All spending combined	***$48,001***	
$ in millions		

The House and Senate budgets each include about $300 million in unique spending which can be divided into two broad categories: earmarks and policy priorities. While the House and Senate align on many big ticket spending items, clear differences in policy prioritization are still apparent. These include:

- **Higher education** – the House budget provides approximately $20 million more than the Senate in direct aid to public campuses and scholarship support;
- **Mental health** – the Senate provides $22 million more than the House for mental health supports, including $10 million to recapitalize the Behavioral Health Promotion and Prevention trust fund;
- **Elder care aide rate add-on** – the House budget includes $27.9 to increase hourly rates for eligible home care and personal care workers;
- **MassHealth nursing home rates** – the Senate provides $15 million more for nursing home rates than the House budget;
- **Early educator rates** – the House invests $20 million in additional rate payments for early childcare workers; and
- **Local boards of public health** – the Senate budget includes $10 million in grants for local boards of public health.

The majority of funding earmarks are unique to one version of the budget and will also need to be resolved by the conference committee. Combined, the two budgets include $182.3 million in earmarks spending, of which just $35 million is shared. Approximately 1,000 unique earmarks make up the remaining earmark spending.

If all spending in the House and Senate budgets were approved in conference, it would result in a bottom line of just over $48 billion in line-item spending, about $300 million more than either legislative spending plan. Typically, balancing a budget inclusive of all spending would require budget conferees to include all or most revenue initiatives proposed in either budget and identify several new resources. However, the anticipated upgrade in FY 2022 tax revenue will enable budget makers to support all proposed spending without requiring the planned Stabilization Fund draw.

Conference committee policy comparison

The House and Senate budgets include 221 policy sections, of which 44 are common to both bills. This leaves more than 150 individual sections on a variety of policy topics to be negotiated. Like most years, the policy sections in the legislative budget proposals cover a wide range, however, tax policy provisions comprise the most notable policy differences to be resolved.

There are 14 unique tax proposals in the two budgets, but three stand out in complexity and importance:

- **Film tax credit** – the state's film tax credit is scheduled to sunset at the start of 2023. House and Senate budgets both extend that date, but do so in very different ways. The House budget would make the existing tax credit permanent. The Senate proposes extending the credit's sunset to 2027 while also changing major aspects of how the credit works. The Senate would institute a $1 million cap on salary costs that can be applied to the credit and eliminate the ability for recipients to sell the credit to those with a Massachusetts tax liability. Finally, the Senate would increase the percentage of production days or production costs that need to occur in Massachusetts (from the current 50 percent to 75 percent).
- **Pass-through entity taxation** – the Senate includes a proposal, modeled on language included in the Governor's budget, which would provide taxpayers at partnerships or S-corporations with the option of paying tax on related income at the entity, and not personal income tax, level. Impacted filers would then receive a state personal income tax credit to avoid double taxation. This option would reduce the tax liability for some filers because it would lessen the income subject to the federal income tax. The Governor put forward a version of the plan that was revenue neutral for the state, whereas the Senate limits the state personal income tax credit, thereby generating an estimated $80 million in additional tax revenue. Because the proposal is optional, filers would theoretically only use the Senate option if federal tax savings exceeded any increased state taxes.
- **Childcare tax credit** – the Senate uses $16 million in revenue from their pass-through entity proposal to offset the conversion of the state's existing child care tax deduction to a refundable credit. The change would enable low-income families to benefit from the provision, providing up to $480 per year to families with more than one child.

In addition to each of the proposals listed above which have a significant fiscal impact and major effect on a subset of tax filers, there are also a number of smaller tax differences in the two bills:

Figure 5. Tax Policy Proposals to be Resolved

	House	Senate
Rural growth tax credit	✓	✗
Disabled employee tax credit	✓	✗
Conservation land tax credit increase	✓	✗
Historic rehab credit extension	✓	✗
Increased TNC fees	✗	✓
Cranberry Bog Credit	✗	✓
Elimination of transferable medical device credit	✗	✓
Elimination of energy patent deduction	✗	✓
Elimination of harbor tax credit	✗	✓

The conference committee will negotiate these policy differences at a time when state tax collections are quite strong. Still, it is vital that tax policy decisions adhere to sound fiscal principles. For example, tax credits designed to spur economic development should include clear policy goals for the behavior they are trying to incent and metrics by which to measure their impact. Similarly, the fiscal impact of a tax policy decision should be known prior to action. Budget conferees should ensure that the tax changes included in the final budget have a predictable impact on revenues and behavior, facilitate ongoing assessment and provide future policymakers with opportunities to reevaluate.

Many of the remaining non-tax sections deal with smaller issues, like the creation of legislative commissions or the extension of prior funding items, but there are more notable policy differences as well. These include:

- Expanded supplemental rebate authority for MassHealth (Senate section 50);
- Salary increases for sheriffs and court clerks (House sections 8A, 15A-15E, 16A & 16B);
- Limitations on penalties that can be applied to employers of commissioned workers who, in good faith, followed state guidance that was subsequently overruled by the Supreme Judicial Court (Senate sections 101, 102 & 141); and
- Creation of a Wind Energy Career Training program and trust fund, capitalized with $10 million. (House sections 5 & 33).

Bottom Line

Tax policy issues dominate the challenges faced by FY 2022 budget conferees at a time when tax revenues are far exceeding expectations and unprecedented federal assistance is available. The conference committee will have to decide how to resolve these tax policy issues and adjust expected FY 2022 tax revenues. After employing a bridge approach to balance the House and Senate budgets, the conference committee report must now eliminate use of one-time resources and instead prioritize replenishment of the Stabilization Fund balance to prepare for future challenges.

As the state considers potential tax revenue surpluses, it is important that those considerations occur as part of more extensive discussions on the use of federal ARPA funding and the need to create a sustainable and equitable pandemic recovery for all. A deliberate and thoughtful approach to the fiscal uncertainties of the last year has served the Commonwealth well; policymakers should maintain that approach as they finalize next year’s budget.