MassBudget Information. Participation. Democracy.
Massachusetts Budget and Policy Center

BUDGET BRIEF **January 18, 2012**

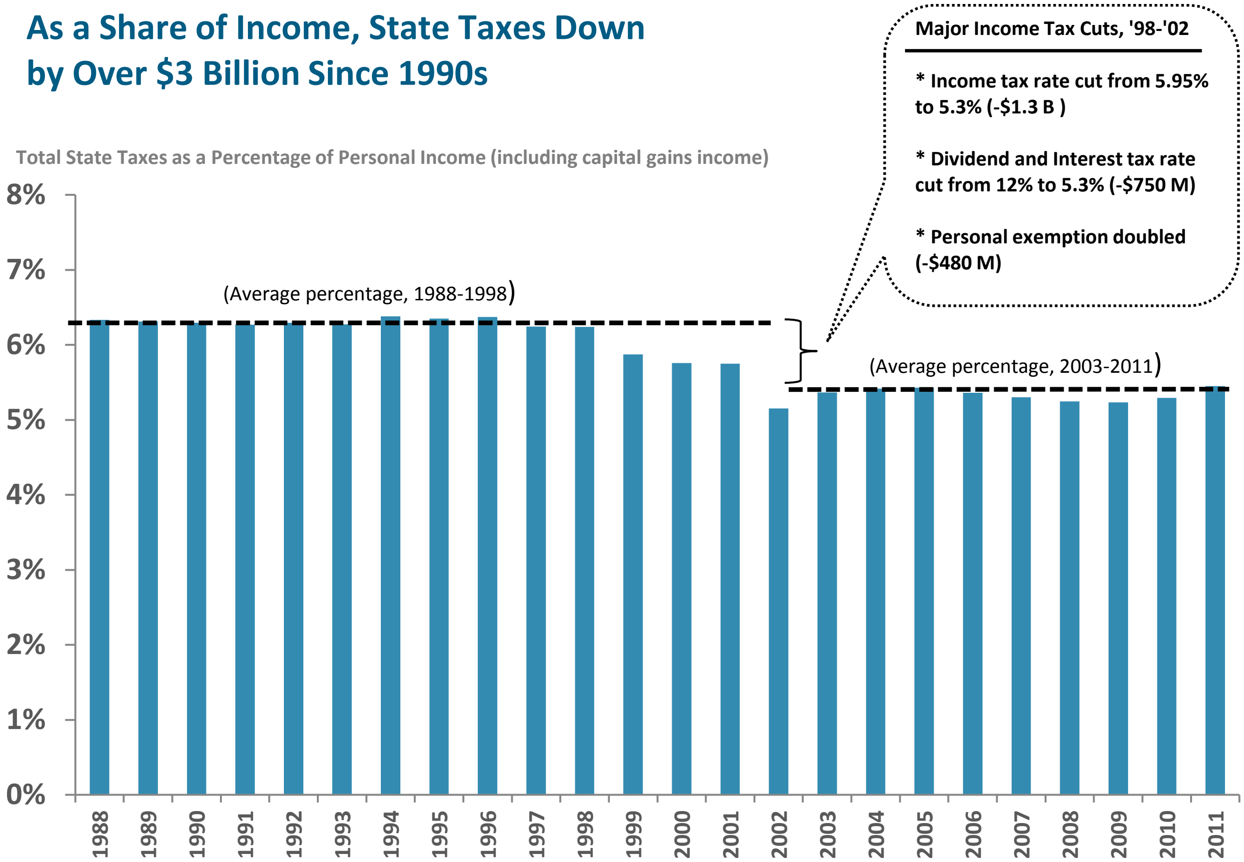
Fiscal Year 2013 Budget Preview

Governor Patrick is expected to file his Fiscal Year 2013 Budget proposal on January 25th. This budget preview examines the fiscal condition of the state and the challenges budget writers will face in crafting next year's state budget.

As a result of the national recession, tax revenues have declined dramatically since FY 2008. While revenues have begun to grow in the last couple of years, total tax revenues for FY 2013 still are projected to be more than $600 million below the total from FY 2008 (adjusted for inflation).[1] At the same time, real costs have increased, both because the need for safety net services increases during recessions and because the costs of some services – such as health care – have been growing more rapidly than inflation.

In addition to the cyclical decline in revenue caused by the recession, the Commonwealth's budget is also under pressure from long term policy choices. The state has cut taxes aggressively – particularly in the late 1990s – and as a result now has significantly less revenue available to pay for core services like education, transportation, local aid, public safety, and preservation of the safety net. Throughout most of the 1980s and 1990s, total state tax revenue (the sum of income, sales, corporate, and other taxes) was a bit above six percent of the private sector economy (see chart, below). In the late 1990s the state began cutting income taxes aggressively. As indicated in the chart below, cuts to the general income tax rate, the rate on dividend income, and an increase in the personal deduction reduced annual income tax revenue by a total of about $2.5 billion.

Primarily as a result of these tax cuts, state taxes as a share of income have been significantly lower in the past decade than they had been previously. Taxes are now a bit above five percent of state personal income, a decline of about one percentage point from the average rate from 1988-1998. In the coming fiscal year, that nearly one percentage point decline will translate into a loss of more than $3 billion in annual revenue for the state.[2]



Thus the Commonwealth faces FY 2013 while coping with both the lasting effects of the recent deep recession and the ongoing fiscal effects of previous policy choices to cut taxes deeply. This Budget Preview describes the immediate challenges the Commonwealth faces as a result of these short and long term pressures.

To estimate the budget gap facing the Commonwealth in FY 2013 we follow a two-step process:

1. Determine how much of the 2012 budget will be funded with temporary revenues.

2. Determine the gap between the growth in available revenue and the growth in costs.

USE OF ONE TIME REVENUE IN FY 2012

The first step in calculating the preliminary budget gap for FY 2013 is to determine the gap between ongoing spending and ongoing revenue in FY 2012. During times of fiscal crisis, states use reserves to close the gap between ongoing costs and ongoing revenues. The amount of reserves and other temporary revenue used in one year is the starting point for calculating the next year's budget gap – because the state will need to replace that revenue (or implement cuts) in the next year.

Initial FY 2012 Budget

The FY 2012 budget relies on about $550 million in temporary revenues (see table below). This includes money from the state Stabilization Fund (the "Rainy Day" fund), from other trust funds, and from the sale of abandoned property. It also includes money that had gone unspent in FY 2011 and was then used as a revenue source in FY 2012 (through a process called "prior appropriations continued" or PACs).

FY 2012 REVENUE INITIATIVES	Temporary or One-Time
Disposal of Abandoned Property	85,000,000
Sale of Underutilized State Land	12,000,000
Stabilization ("Rainy Day") Fund Withdrawal	185,000,000
Stabilization ("Rainy Day") Fund Interest	9,000,000
Proceeds from Various Trusts	57,400,000
FY 2011 Revenue to fund prior appropriations continued	202,000,000
Total	**550,400,000**

Revenue and Cost Changes Since Enactment of the FY 2012 Budget

Changes in spending and revenue that occur in the course of the fiscal year – after enactment of the budget – can also affect the size of the current year gap. While tax revenues are exceeding original projections, some costs are as well. Though it is difficult to project mid-year changes in revenue and spending, as of now it appears that those sets of changes may balance each other out.
On the revenue side, the state increased its estimate of likely tax revenue by $395 million. Of this amount, however, $163 million was one-time revenue that cannot be used for current expenses (and will be deposited into the Stabilization Fund)[3] and another $26 million will offset projected declines in non-tax revenue. As a result, total available revenue will increase by significantly less than $395 million.

The state has enacted supplemental budgets that have increased funding for homeless services by about $40 million (essentially restoring funding that had been cut as part of a reform effort), and provided $10 million in funding for salary adjustments for low-paid human service workers.
It is very likely that there will be additional supplemental budgets, or the use of one-time savings or revenue, to address several additional issues in the FY 2012 budget.

At enactment, the budget assumed around $760 million in savings in the state MassHealth (Medicaid) program. While it appears the administration will be successful in realizing a reasonable portion of those savings, several initiatives are not likely to achieve the savings projected in FY 2012. Most significantly, the FY2012 budget had assumed $210 million in savings from procurement reforms

within the PCC (Primary Care Clinician) program. It now appears unlikely those savings will be achieved in FY 2012. The state also assumed $50 million in savings from reforms in the provision of services to people dually eligible for Medicaid and Medicare. This initiative required approval from the federal government, which has not approved the changes that would be needed in order to realize the projected savings this year. Finally, $35 million in cuts to funding for adult day health programs that were assumed in the budget are no longer expected to be implemented. Together, these items amount to some $295 million in projected savings that now appear unlikely to materialize in FY2012.

It is unclear whether these additional MassHealth costs will be covered through supplemental appropriations or by cash management techniques that would shift costs into future years. But in either case, for purposes of estimating the gap between ongoing costs and ongoing revenue in FY 2012 we need to adjust for these issues. While the gross cost of these issues is approximately $300 million, the federal government reimburses half of the state cost of most of MassHealth. As a result, the net cost of these items will be about $150 million.

In addition, there are a number of other accounts for which the state likely will provide additional funding during the year, including various sherriffs' departments and the low-income heating assistance account. With the additional costs described above likely offsetting the projected increase in available revenue (though there could be further changes on the revenue and spending sides in the second half of the fiscal year), it now appears that the approximately $550 million gap between permanent spending and permanent revenue in the enacted FY 2012 budget is a good estimate of the gap in the current FY2012 budget.

REVENUE AND COST PROJECTIONS FOR FY 2013

As the analysis above indicates, the gap between ongoing spending and ongoing revenue in FY 2012 is likely to be approximately $550 million. The second step in projecting the preliminary budget gap for FY 2013 is to project revenue growth and cost growth. Generally, revenues grow faster than spending in times of strong economic growth and less rapidly than spending during times of economic crisis (when incomes are stagnant and more people need basic safety net protections). Our national economy is still not growing robustly, and we see the results in our state budget.

Projected Revenue Growth

The Executive Office of Administration and Finance and the House and Senate Ways and Means Committees have adopted a consensus tax revenue estimate (CRE) of $21.950 billion for FY 2013, which reflects a baseline estimate of $22.136 billion (the CRE includes a downward adjustment of $186 million, discussed below). This is in line with the projections of a number of outside experts, but is significantly above the midpoint of estimates generated by the state Department of Revenue (DOR). DOR's midpoint estimate for baseline tax revenue in FY 2013 is $21.874 billion (which, like the CRE, then was adjusted downward by $186 million).[4] The DOR midpoint baseline estimate would be $864 million more than the current estimate of tax revenue for FY 2012 ($21.010 billion), while the CRE baseline would be $1.126 billion higher. The CRE baseline estimate thus is $262 million higher than the midpoint DOR baseline estimate.

These baseline revenue amounts are $186 million larger than the final projections because of existing laws that will reduce revenue below the baseline amount in FY 2013. Most significantly, there are a number of previously enacted tax cuts scheduled to be phased in with a cost of about $120 million in

FY 2013 (see table below).[5] As a result of these tax cuts and other adjustments, DOR lists a net adjustment to the baseline revenue estimate of minus $186 million.[6]

Tax law changes	Incremental Revenue impacts in FY2013 ($ Mil.)
Corporate/Financial Institution Tax Rate Cut	(15)
FAS109 Deduction (a tax reduction for certain corporations)	(46)
Income Tax Rate Reduction to 5.25%	(60)
TOTAL	**(121)**

In addition to this $186 million downward adjustment to the estimates of available revenues, a further downward adjustment must be made to account for a new state law governing the use of revenues from capital gains taxes. State law now dictates that any time the state receives more than $1 billion in revenues from capital gains taxes, the amount in excess of $1 billion must be deposited in the state Stabilization Fund. The DOR estimate includes a projection that the Commonwealth will collect $1.412 in capital gains revenue in FY 2013. As a result, $412 million would have to be deposited in the Stabilization Fund. The CRE, by contrast, assumes only $1.1 billion in capital gains taxes, an amount that would require only a $100 million deposit into the Stabilization Fund.

After the adjustments to baseline and the capital gains deposit (which, for the DOR midpoint estimate, amounts to a combined $598 million downward adjustment), the amount of additional revenue available in FY 2013 under the DOR midpoint estimate would be $266 million above the amount available in FY 2012. The consensus revenue estimate begins with a figure that is $262 million *higher* than the DOR midpoint estimate and assumes that $312 million *less* of the revenue will come from capital gains taxes. Therefore, the CRE results in a projection of new FY 2013 revenue that is $574 million *higher* than the new revenues ($266 million) projected under the DOR midpoint estimate. The CRE thus projects a total of $840 million in new FY 2013 revenue, compared to the $266 million under DOR's midpoint estimate.

There are also two other major sources of revenue: federal revenue and non-tax state revenue. Non-tax state revenue is the smallest source and generally does not fluctuate dramatically. Federal revenue is a large source, but is usually driven primarily by state Medicaid spending. The state essentially receives from the federal government a reimbursement for half of the amount it spends on the Medicaid program. For purposes of this budget preview we account for changes in federal Medicaid reimbursements in our projections of Medicaid spending by focusing only on the net state costs of the Medicaid program and not counting the federal share on the spending or revenue side. While in recent years there were also significant increases in federal revenue for Medicaid and other programs as a result of enhanced state fiscal relief in response to the recession, very little of that money was available after FY 2011. To the degree that some of that revenue was still being used in FY 2012, replacing it will place additional pressures on the state budget.

Projected Cost Growth

Only the state government has the capacity to project costs in a detailed fashion. In 21 other states the administration makes such estimates and releases them publically.[7] Massachusetts does not. Therefore, this budget preview relies primarily on projections based on estimates of inflation. Specifically, we assume that most costs will grow at roughly the rate of inflation in the overall economy and that health care costs will grow at a higher rate, in line with national trends. We do not make adjustments for caseload growth, because the necessary data is not publically available.

The FY 2012 state budget (the General Appropriations Act) is approximately $33.4 billion.[8] Of this, $13.25 billion is for the costs of MassHealth, health reform programs, and state employee health insurance that, as noted, we adjust using a healthcare-specific inflation factor. Subtracting the healthcare costs from the FY 2012 total leaves $20.2 million in other costs. If we assume these costs will grow at an inflation rate of two percent (the projected rate of inflation as measured by the Consumer Price Index), there will be $400 million in new costs in FY 2013 due to inflation outside of healthcare. That is likely a low estimate of overall cost growth as it does not account for population growth, caseload growth, or costs that increase at more than two percent a year.

Of the $13.25 billion for health care costs, the net cost to the state (after accounting for federal revenue) in FY 2012 is expected to be about $7.31 billion.[9] Adding the state share of additional spending required to make up for unrealized MassHealth savings discussed above adds about $148 million, for total net spending of $7.46 billion. National projections for growth in health costs show expected growth rates of around 6.7 percent for Medicaid and just below 4 percent for state and local government employee health costs. Applying these growth rates to the two components of health care spending, MassHealth and GIC produces a total net spending projection of $7.92 billion for FY 2013, which would require about $463 million in new state dollars.[10]

In addition, the Massachusetts Supreme Judicial Court recently ruled that the state's failure to include certain legal immigrants in the Commonwealth Care program violates the equal protection clause of the state constitution. As a result, the state will be required to allow these residents to participate in the Commonwealth Care program. The cost to the state is estimated to be approximately $150 million in FY 2013.

Together, then, we estimate that growth in state costs for the overall budget will amount to at least $1.01 billion. For the Medicaid program, this estimate includes only the costs of the state share of spending. Under our assumptions, the Federal share of Medicaid will grow by just over $400 million as well – meaning that the gross cost increase for FY 2013 would be approximately $1.4 billion. The Office of Administration and Finance (ANF) has indicated that it is projecting gross baseline cost growth of

$1.6 billion for fixed costs in major areas. Adjusting this number to reflect inflationary and other baseline cost increases in other areas of the budget, which add to the total, and then netting out increased federal revenue associated with the increased Medicaid costs, likely results in net cost growth of $1.4 billion. As the administration's estimate would reflect caseload and other fixed costs in addition to inflation, it is likely that this higher estimate is more precise.

CALCULATING THE FY 2013 PRELIMINARY GAP

If we use the lower DOR revenue estimates (which would lead to only $266 million in new tax revenue being available) and the $1.01 billion net spending increase estimate, then the preliminary budget gap in FY 2013 is projected to be about $745 million larger than the current FY 2012 gap between ongoing costs and ongoing revenue. When we add these two together – the $745 million gap between new FY 2013 costs and new FY 2013 revenues, and the approximately $550 million current FY 2012 gap (which carries forward into the next fiscal year) – the preliminary gap for FY 2013 would be projected to be about $1.3 billion.

If, instead, we use the higher joint revenue estimate (which projects $840 million in new available revenue), and the higher ANF estimate of spending growth ($1.4 billion), then the gap between new FY 2013 spending and new available FY 2013 revenue would be about $560 million. Adding this figure to the current FY 2012 gap of some $550 million (which, again, would carry over into the next fiscal year), would produce an FY 2013 gap estimate of $1.110 billion.

In the end, even though the two estimates may be different, they both point towards a deficit well above $1 billion.

The FY13 Deficit: A Rough Calculation

550 Million	−	266 Million	+	1.01 Billion	=	1.29 Billion
gap from FY12		in new revenue		cost growth (primarily inflation)		Projected Deficit in FY13
550 Million	−	840 Million	+	1.4 Billion	=	1.11 Billion
gap from FY12		in new revenue		cost growth (primarily inflation)		Projected Deficit in FY13

* Estimate 1 uses the Department of Revenue numbers for revenue and our own estimate of spending.
* Estimate 2 uses the Joint Revenue Estimate of revenue and a spending figure that incorporates additional information from the Office of Administration and Finance.

[1] Collections for budgeted tax revenues totaled $20.879 billion in FY 2008 (DOR communication to MassBudget). Adjusted for inflation to 2012 dollars (using CPI-U), this amount is equal to $22.299 billion. The midpoint Consensus Revenue Estimate of budgeted tax revenues for FY 2013 is $21.687 billion (DOR FY 2013 CRE Briefing Book). The inflation-adjusted FY 2008 collection total therefore exceeds the FY 2013 estimate by $612 million.

[2] During the period 1988-1998, state taxes as a share of total state personal income averaged 6.307 percent in Massachusetts. (This figure includes taxes from capital gains, and is adjusted to include income from both taxed and untaxed capital gains. The figure also includes taxes from people who work in Massachusetts but live in another state, and is adjusted to include the Massachusetts income earned by these out-of-state residents). From 1998-2002, the state enacted a series of tax reductions, particularly affecting personal income taxes. These included a reduction in the tax rate on wage and salary income from 5.95 percent to 5.3 percent, a reduction in the tax rate on dividend and interest income from 12 percent to 5.3 percent, and a doubling of the personal exemption amount. In addition, sales tax collections fell by some $1 billion as a share of personal income over the decade between 1998 and 2008, due largely to increased internet sales (where sales taxes often go uncollected) and a continuing shift in consumer purchasing patterns away from goods and toward services (which are largely untaxed in Massachusetts). The recent sales tax rate increase has largely restored this particular source of revenue loss though likely only for the time being as internet sales and the shift toward services

continue. In the period following these tax cuts, the years 2003-2011, state taxes as a share of total state personal income averaged 5.345 percent, a decline of 0.962 percentage points. Total state personal income (including capital gains income) in Massachusetts topped $381 billion in 2011. Had the Commonwealth collected another 0.962 percent of this personal income (as was done in the 1988-1998 period) this would have provided the state with an additional $3.66 billion in revenues in FY 2011. [For a more complete discussion of the general sales tax in Massachusetts and revenue losses related to the growth of internet sales, please see the relevant chapter in the MassBudget *Tax Primer*: http://www.massbudget.org/report_window.php?loc=Tax_Primer_83110.html]

[3] The state has a new law that dictates that revenue from one-time tax judgments and settlements in excess of $10 million must be deposited into the state Stabilization Fund. These are generally revenues that result when major tax payers are audited and there is a dispute with the Department of Revenue over the amount the taxpayer owes. If the taxpayer settles with the department or there is a court judgment ordering the taxpayer to pay additional taxes and/or fees, the one-time payment the taxpayer must make now will be deposited in the Stabilization Fund rather than treated as general revenue for the budget. Settlements that are dedicated to specific purposes (such as settlements by the Attorney General reimbursing consumers for fraud or deceptive practices) are not subject to this law and are not deposited to the Stabilization Fund. See Massachusetts General Laws, Chapter 29, section 2H (final paragraph): http://www.malegislature.gov/Laws/GeneralLaws/PartI/TitleIII/Chapter29/Section2H

[4] Department of Revenue (DOR), Consensus Revenue Estimate Hearing Briefing Book for FY 2013, midpoint of p. 7 estimates. The $21.874 billion figure presented here includes $186 million in revenues (added back to DOR's midpoint estimate by MassBudget to arrive at a "baseline" figure) that DOR already has deducted from their pg.7 estimates. DOR makes this $186 million downward adjustment based on anticipated FY 2013 impacts from a number of tax law and revenue initiative changes specified under current law. We address those adjustments separately in the discussion of changes in FY 2013.

[5] For further discussion of the Life Sciences and FAS 109 tax changes, please see the "Revenues" section of the MassBudget *Budget Monitor,* examining the FY 2012 General Appropriations Act:
http://www.massbudget.org/report_window.php?loc=FY12_GAA.html
For further discussion of the Corporate/Financial Institution rate cuts, please see the DOR weblog posting:
http://revenue.blog.state.ma.us/blog/2011/12/corporate-tax-rate-drops-to-80-percent-effective-january-1.html
For further discussion of the Income Tax rate cut, please see the DOR weblog posting:
http://revenue.blog.state.ma.us/blog/2011/12/personal-income-tax-rate-resumes-march-downward.html

[6] Other than the tax cuts listed in the table on page 3, the major adjustments are a possible loss of $5 million if the state removes an administrative $20 million cap on the cost of the Life Science Tax credit, a loss of $82 million from reduced enforcement, and an increase of $21 million in revenue if, as is current law, the state does not repeat the sales tax holiday that it has approved each of the last several summers. The loss of $82 million would occur only if the state fails to authorize $1.2 million for enhanced enforcement efforts in FY 2013 (it did authorize that amount in FY 2012). The $21 million increase would occur only if the state fails to enact a sales tax holiday in FY 2013 (it has authorized such a tax holiday in recent years). [Estimates provided to MassBudget by DOR, January 2012. See also the "Revenue" section in the MassBudget *Budget Monitor* for the FY 2012 GAA: http://www.massbudget.org/report_window.php?loc=FY12_GAA.html]

[7] Center on Budget and Policy Priorities, *The Current Services Baseline*, October 21, 2011*:*
http://www.cbpp.org/cms/?fa=view&id=3602

[8] This total includes both line-item spending and spending done by "transfers" in the budget or as the result of existing laws. For details on Massachusetts budget totals, see: http://browser.massbudget.org and for an explanation of spending by "transfers" see "What the Budget Includes" at http://browser.massbudget.org/AboutBudgetBrowser.aspx.

[9] This amount is the sum of the state share of MassHealth and Health Reform spending ($5.94 billion) and spending for state employee health insurance ($1.37 billion).

[10] Projected growth rates come from the National Health Expenditure Projections for 2010-2020 issued by CMS at the start of 2011; these projections are provided on a calendar year basis and we average 2012 and 2013 rates to produce a projected rate for FY 2013. Net state MassHealth and Health Reform spending as calculated by MassBudget for FY 2012 is $ $6.089 ($5.94 billion plus $148 million for new FY 2012 costs); we multiply this total by the expected growth rate of 6.75 percent, for an increase of $410.8 million. We multiply FY 2012 GAA spending for state employee health costs by the projected growth rate for state and local government spending (3.8 percent) to arrive at an expected increase of $52 million. The total increase is about $463 million.