Association of Town Finance Committees Annual Meeting

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Saturday, October 15th

Massachusetts Taxpayers Foundation

Overview

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V. Long-term challenges
   - Reserves
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   - Volatility of revenue base

About MTF

Founded in 1932, the Massachusetts Taxpayers Foundation is widely recognized as the state's premier public policy organization dealing with state and local fiscal, tax, and economic policies. The Foundation's record of **high quality research and non-partisan analysis** has earned the organization **broad credibility** on Beacon Hill and across the Commonwealth.

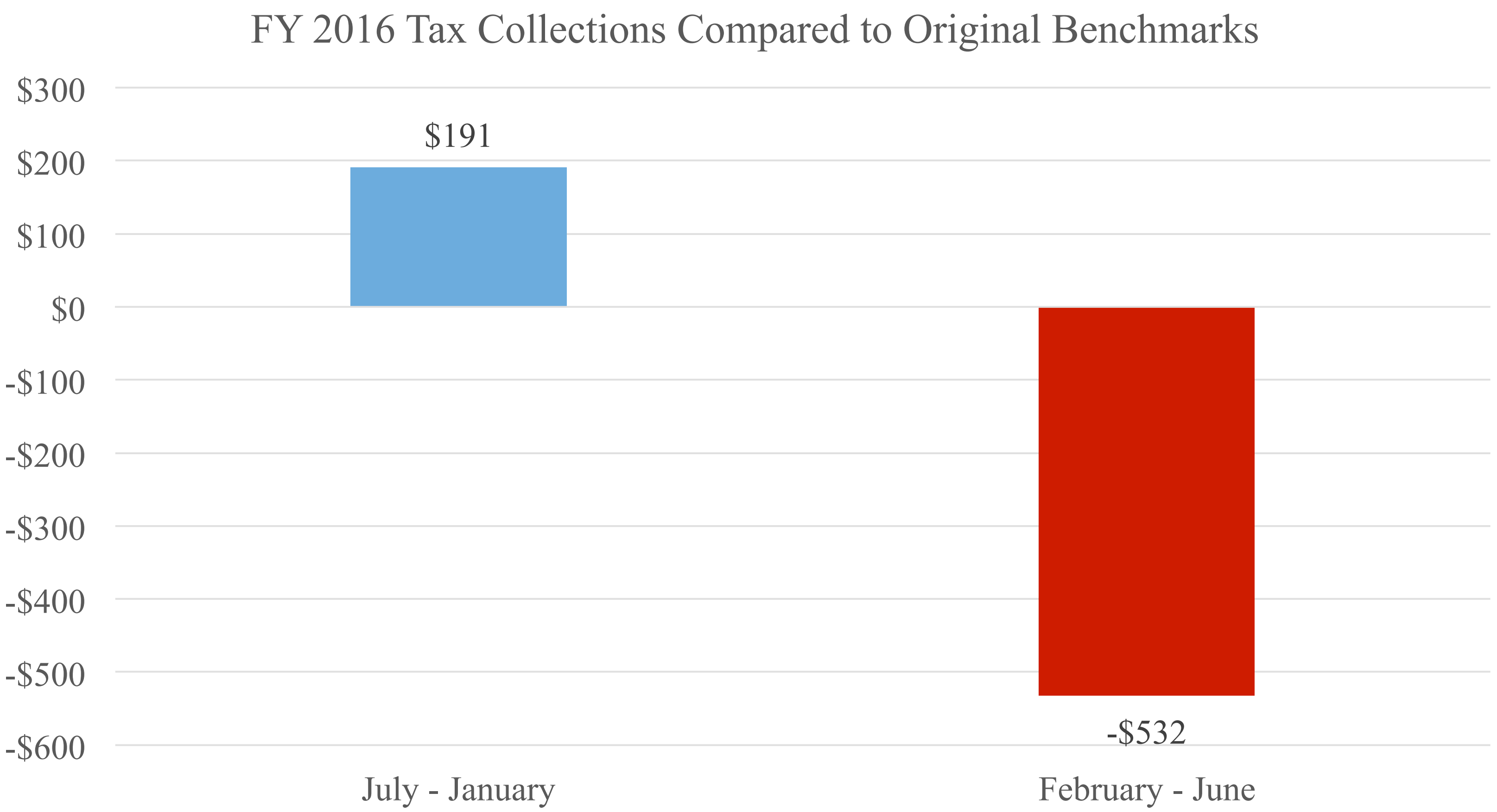
Our mission is to provide accurate, unbiased research with balanced, thoughtful recommendations that strengthen the state's finances and economy in order to foster the long-term well being of the Commonwealth.

Recent MTF work

- Budget updates
  - Over the course of the FY 2017 budget process, MTF released 15 budget briefs which provided analysis, recommendations and insight on the state's $40 billion budget
- Transportation
  - MTF has been a leader in shaping state transportation policy for years. In June, MTF hosted Governor Baker and others to discuss our most recent report on the future of transportation reform
- Long-term fiscal health
  - Improving the long-term fiscal health of the Commonwealth is a fundamental goal of MTF. Over the past year, MTF has put out papers highlighting the need to increase state reserves and analyzing the role of capital revenues on recent budget shortfalls
- Informing public discourse
  - MTF weighs in on tax and policy issues of relevance to the Commonwealth. Recently, the Foundation released a paper looking at how charter school funding fits into the state's school finance system

FY 2016 review

FY 2016 was a tale of two halves



The steep drop in tax revenues in the last 5 months created a $500M + budget gap

FY 2016 Budget Gap	
January budget gap	-494
January budget solutions	403
Gap remaining	***-91***
Tax revenue shortfall	-484
Final FY 2016 gap	***-575***

The Administration identified a number of solutions

Possible one time solutions	
Convention Center Trust	$60,000,000
Tax & legal settlements	$84,000,000
MBTA contribution	$31,000,000
Other trusts & contributions	$131,000,000
Total	$306,000,000
Other solutions	
Lottery & tobacco revenue	$34,000,000
Dedicated sales tax savings	$16,000,000
Elimination of outstanding appropriations	$22,000,000
Total proposed solutions	***$378,000,000***

These solutions combined with other efforts will close the gap

- The Administration has put forward through legislation and other public documents ~$400 million in possible solutions:
  - The good news: no draw from reserves
  - The bad news: these solutions are heavy on one-timers
    - Up to $190 million in trust fund sweeps
    - $80+ million in tax and legal settlement revenue
- The Administration expects non-tax revenue and line item savings (reversions) to close much of the gap. They will likely only rely upon the other possible solutions to the extent necessary.

With the final FY 2016 spending bill enacted last week, FY 2016 books will soon close

- On October 6th the Governor signed the close-out supplemental budget sent to him by the Legislature
  - Spends $187.5 million to cover deficits in budget accounts
    - Vast majority of this amount ($164 million) went to MassHealth
  - Adopts $91M of the $111M in budget gap solutions proposed by the Governor
    - Decrease of $20M likely means that spending controls and other measures have generated more in savings that anticipated

FY 2016 in review

- Tax revenues grew by just $490M (2.2%) over FY 2015
  - Final collections fell $484 million short of benchmark
- Non-discretionary spending grew by $1.2 billion (net of related revenues)
- In order to balance the budget, the state has:
  - Relied on one time resources and departmental revenues
  - Limited discretionary spending growth to $155 million
    - Local aid grew by $148.7 million

FY 2017 budget picture

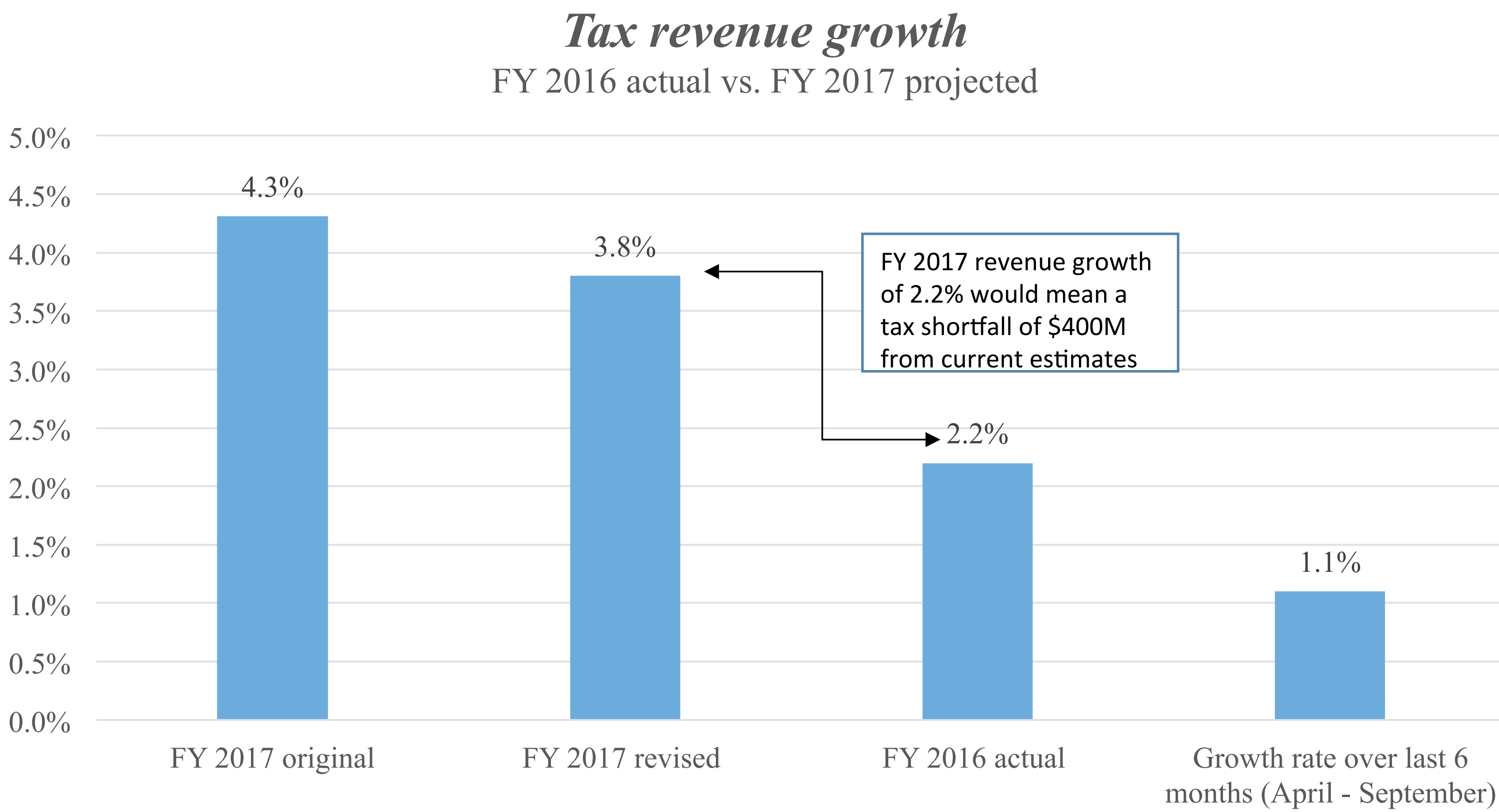
Tax shortfall in FY16 made for an unusual FY17 budget process

- Each FY 2017 budget proposal (Governor, House & Senate) based on tax revenue assumption of $26.86 billion
  - Figure established in January and assumed FY 2016 taxes would be $484 million higher than turned out to be the case
- Experts convened by Administration in June to reassess likely FY 2017 tax revenues
- Following that discussion, budget conferees revised budget tax estimate downward by $750 million

Budget conferees' action was necessary, unusual and could prove insufficient

- FY 2017 is the first time in at least 15 years that the final budget used tax revenue estimate that was different than any prior budget proposal
  - Closest parallel is FY 2009 when revenue declines related to the Great Recession became apparent after the House budget debate
- Budget conferees acted quickly and decisively to reduce tax estimates and conclude the budget process on time
- Still, the tax revenue estimate used is likely too high and the spending reductions made in conference likely insufficient

FY 2017 tax growth assumptions remain optimistic



Budget conferees avoided major cuts when tax revenues were downgraded

Tax revenue reduction	-$750.0
Non-spending cut solutions	
Reduction of cp gains to Stabilization Fund	$206.0
Elimination of income tax rate reduction	$80.0
Other	$59.8
Assumed reversions and non-tax revenue changes	$211.4
Spending cuts	
Revised caseload assumptions (net)	$131.4
Other cuts	$65.3
Total solutions	$753.9

- Only 25% of the $750M tax revenue reduction was closed by spending cuts
  - 2/3 of spending cuts made in Conference were based on more optimistic caseload projections

In total, Conferee action reduced the budget's bottom line by ~ $450M

	H2	House	Senate	Conference
FY 2017 spending	$43,900.2	$43,892.2	$43,915.7	$43,596.4
Reversion assumption				-$151.6
Total	$43,900.2	$43,892.2	$43,915.7	$43,444.8

- The Governor vetoed a further $267.1M to account for ~$275M in necessary spending not included in the Conference budget
    - The Conference budget underfunded programs such as family homelessness prevention and indigent criminal defense
- However, the legislature overrode all but $35 million of these vetoes negating their impact

Despite action, FY 2017 is going to be a challenge

- Spending and revenue pressures are likely to combine to make for a difficult FY 2017:
  - Spending:
    - Close to $300 million in spending exposures unaccounted for in budget
    - Budget leaves no margin for error if MassHealth/other caseload accounts fail to meet target
  - Revenue:
    - Assumed tax revenue growth of 3.8% is not supported by recent collections
    - Limited options to close potential gap since a number of one-time revenue solutions had to be used to close FY 2016

FY 2017 tax revenues – a closer look

Continued concerns for FY 2017 revenues

- Year-over-year tax revenue growth for the past six months (April – September) is 1.1%; below Foundation's FY 2017 revised forecast of 2.8%
- Withholding taxes in September were strong, signaling a potential bounce back
- Other income taxes continue to decline, down 11% over the past six months
- After accounting for the sales tax holiday in FY 2016, sales tax revenue growth is below 1% for the past six months

MA State tax revenue growth has slowed considerably from FY15

	Withheld	Other Income	Sales	Corporate	Other	Total
FY 2015	5.3%	23.0%	5.1%	-3.6%	-0.6%	5.8%
FY 2016	3.3%	-10.5%	4.7%	4.6%	6.9%	2.2%
April - September 2016	4.4%	-11.4%	1.5%	6.4%	8.2%	1.1%

- Income and sales tax growth were down sharply in FY 2016 compared to FY 2015
- If you focus on the last 6 months (end of FY 2016 and start of FY 2017), numbers look even worse

Tax numbers difficult to reconcile with other economic indicators

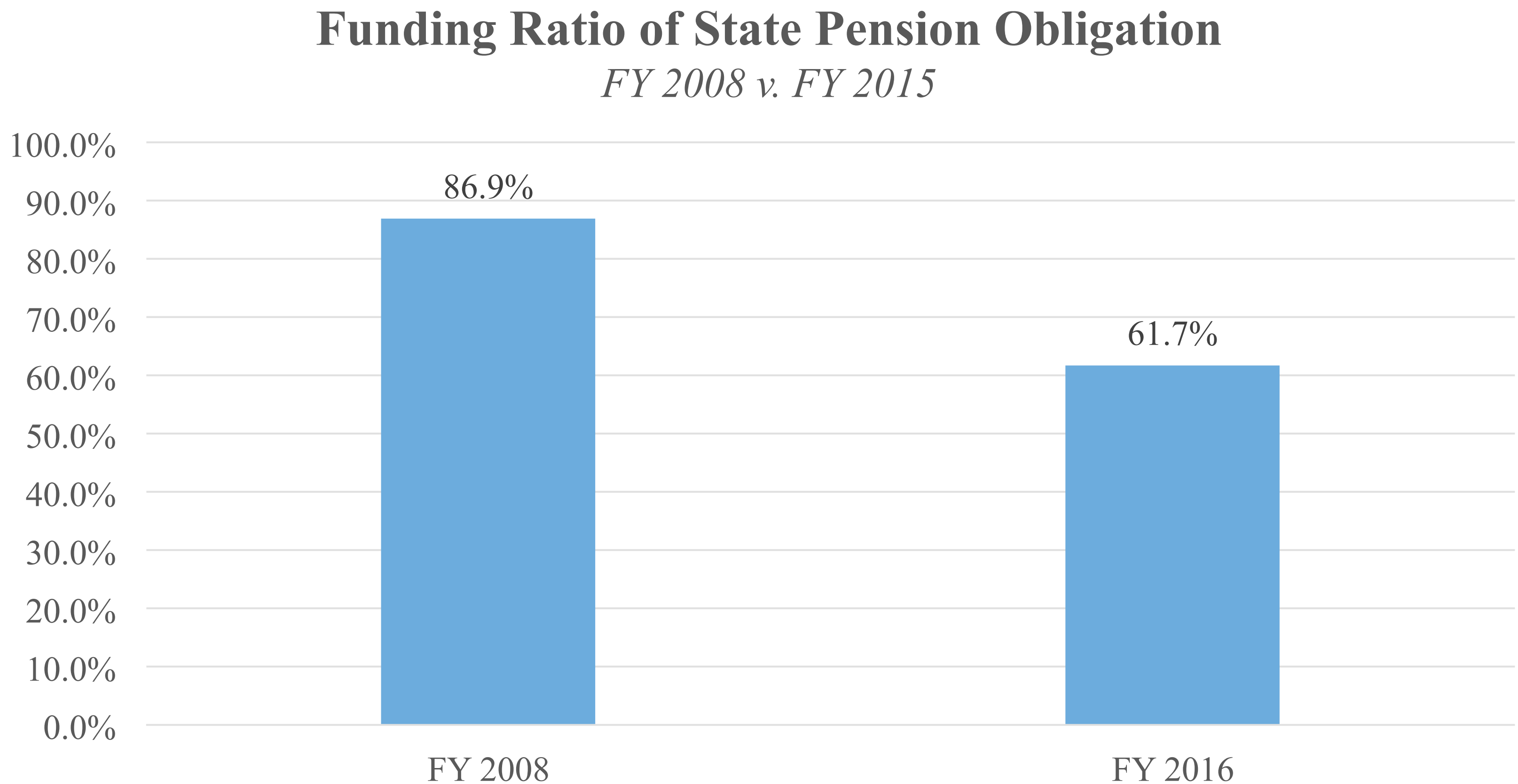
- State unemployment rate continues to fall
  - Current rate of 3.9% is lowest since 2002
- Massachusetts economy has added more than 100,000 new jobs since start of 2015
  - 70% of these are above average wage jobs
  - State's construction industry is booming
- Capital gains collections met expectations in FY 2016
  - Typically, volatile capital gains can cause unexpected revenue swings

Given recent tax trends, a further revenue downgrade is necessary

- At recent economic summit, MTF presented the following FY 2017 tax revenue forecast:
  - $25.98 billion in state tax revenues
    - 2.8 percent growth over FY 2016
    - Recast is $250 million below FY 2017 benchmark of $26.23 billion
- Under state law, the Administration must certify or revise the current revenue estimate by today - October 15th

Long-term fiscal challenges – pension and retiree health

State pension has not recovered from the Great Recession



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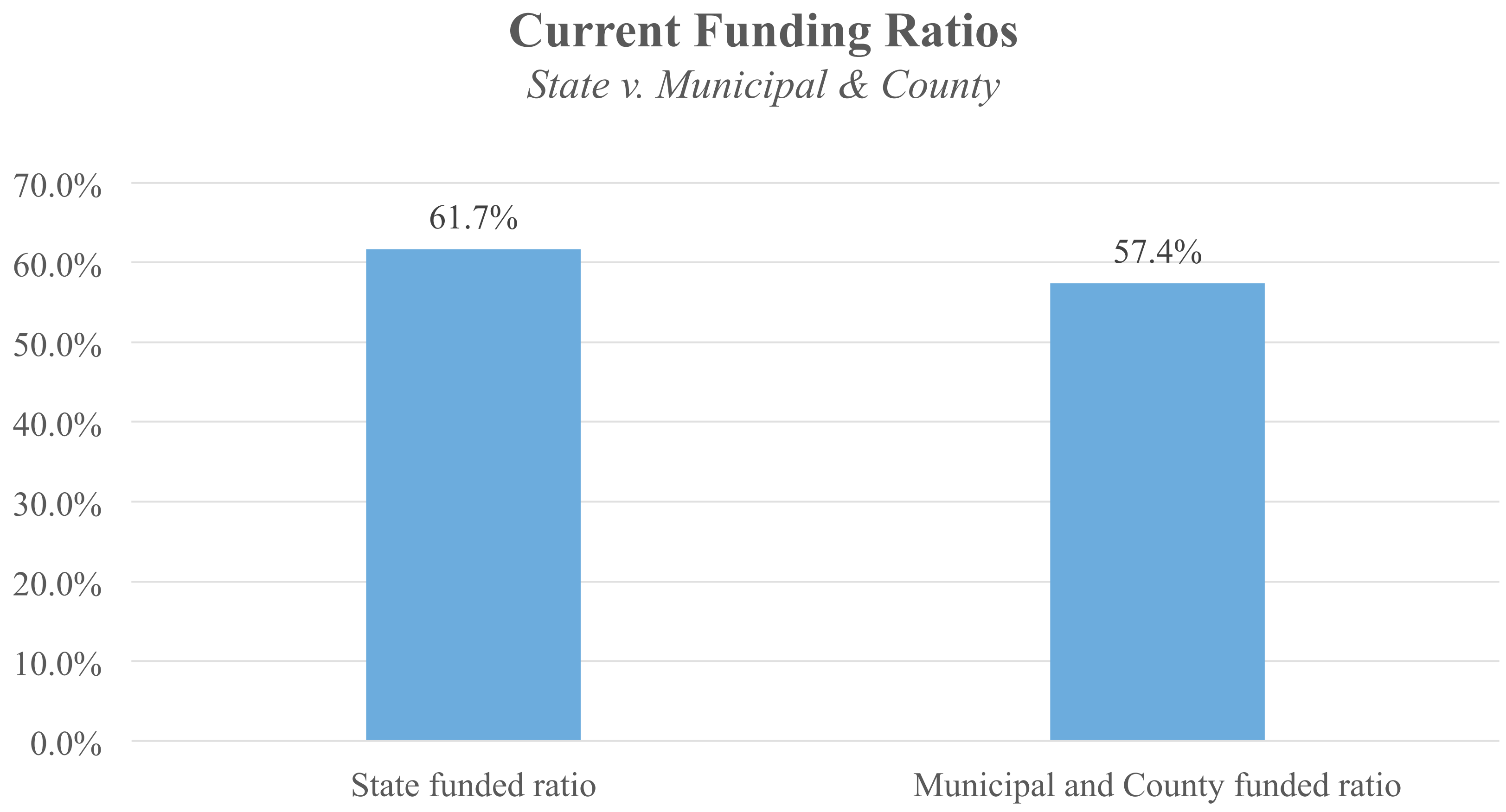
Some action on pension obligations taken, but not enough

- The Good news:
  - The state adopted pension reforms in 2012 which raised retirement age and reduced the generosity of benefits for new employees
  - The state has adopted more conservative methods for estimating the pension obligation, which is well-received by rating agencies and protects against risk
  - The state has increased it's annual contribution by 10% in each of the last 3 years
- The bad news:
  - 2012 reforms only impact new employees and so does little to reduce current liability
  - Pension investment returns remain far below previous levels
    - Between 1985 and 1999, the return averaged 13% annually
    - In 2015 returns were 1.1%
  - Major additional funding will be necessary in FY 2018 to meet FY 2037 full funding goal

In the aggregate, municipalities are in similar shape



However, among municipalities there is wide variance

Distribution of Pension Funding Ratio for Muni & County Systems	
Above 70%	27
Between 57.4% and 70%	32
Muni & County Total is 57.4% Funded	
Between 50% and 57.4%	20
Below 50%	22

- Chart above reflects local and county pension systems included in PERAC's annual report

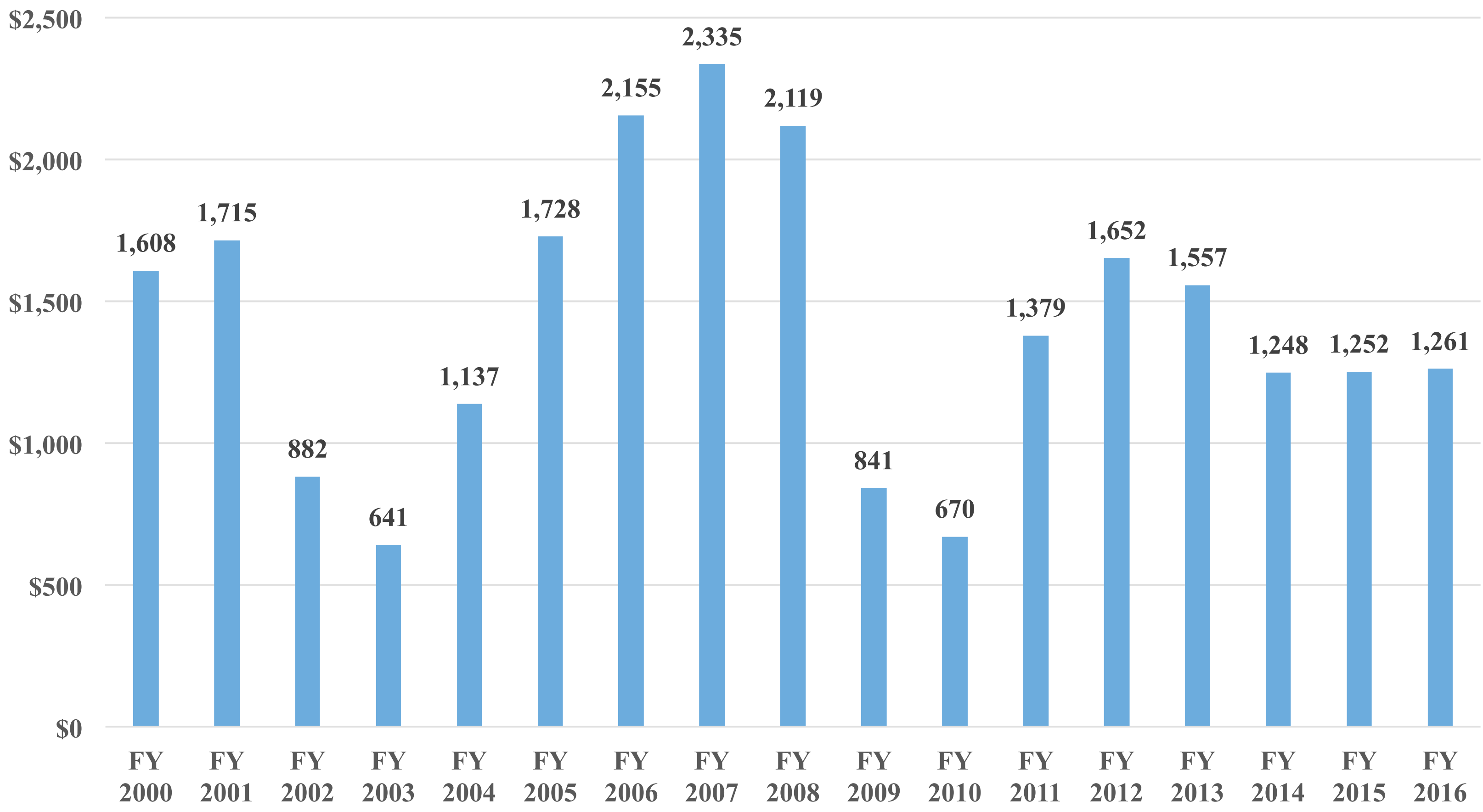
State & municipal OPEB liabilities are even more disturbing

Funding Ratio of OPEB Liabilities	
State OPEB	3.7%
Municipal OPEB	Less than 1%

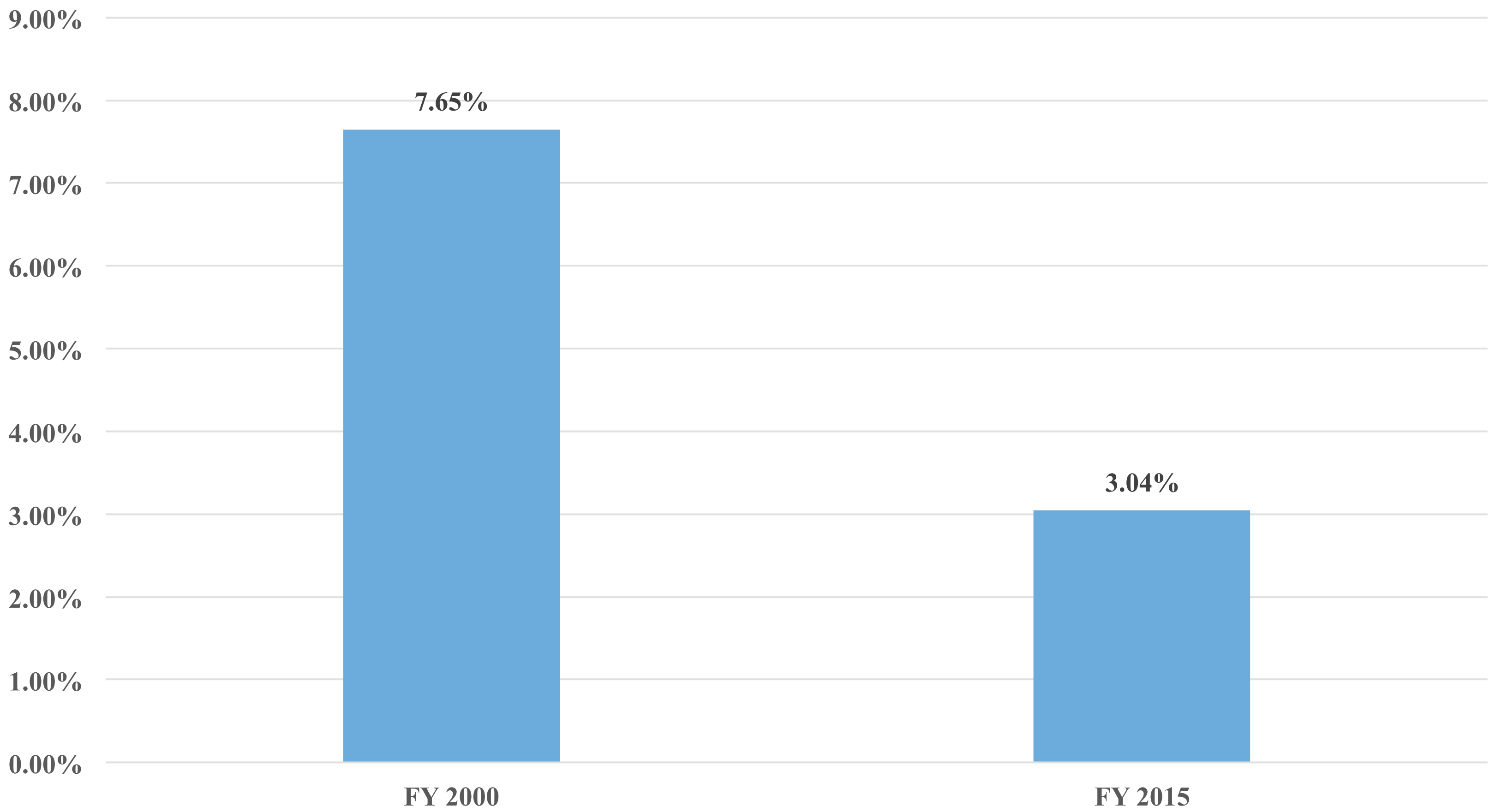
- Of 27 Gateway Cities, only 2 have set aside any funds for their long-term OPEB liability
- In 2013, legislation to reform retiree health benefits was filed
  - The bill was based on the recommendations of a special commission of which MMA and MTF were members
  - The legislation stalled and has yet to be revisited
- MTF believes that eligibility and benefit changes have to be a major part of the solution

Long-term Fiscal Challenges – Reserves

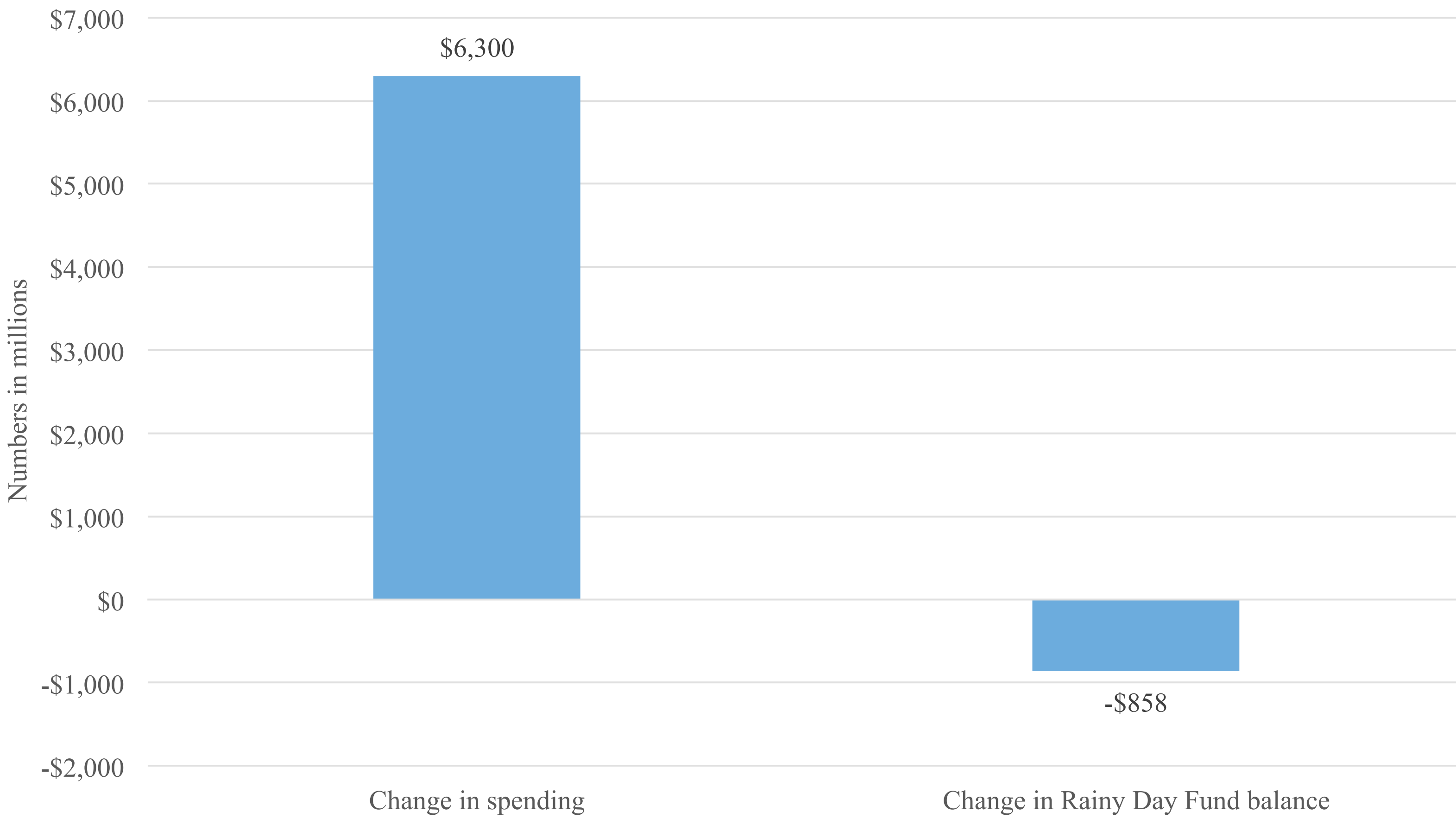
The Rainy Day Fund is $350M lower than it was 15 years ago and has barely grown over the last 3 years



Reserves as a share of spending has declined by more than half



Since the Great Recession began, spending has grown while reserves have declined



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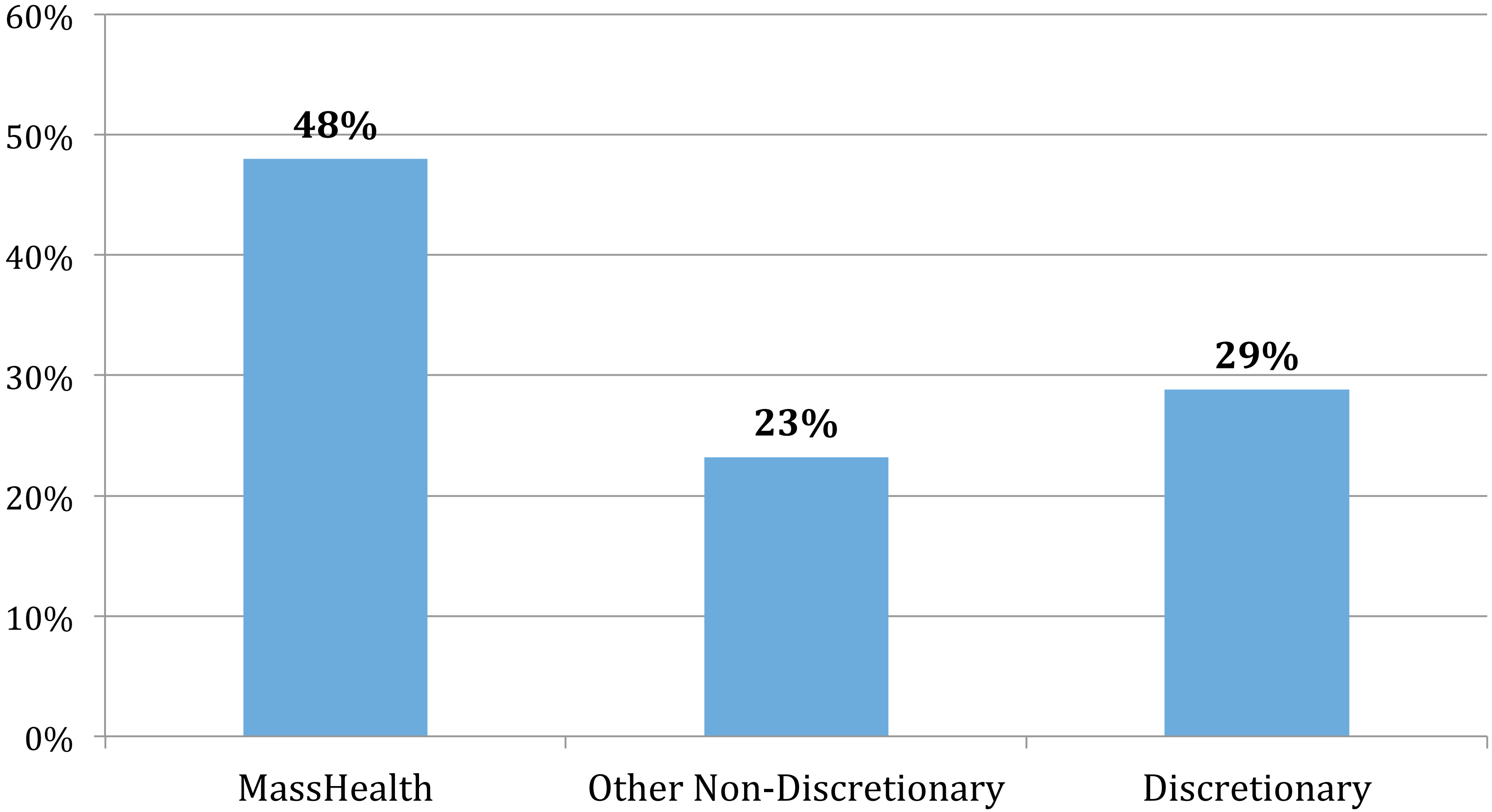
Long-term Fiscal Challenges – MassHealth

Since FY 2001, MassHealth has accounted for half of spending growth



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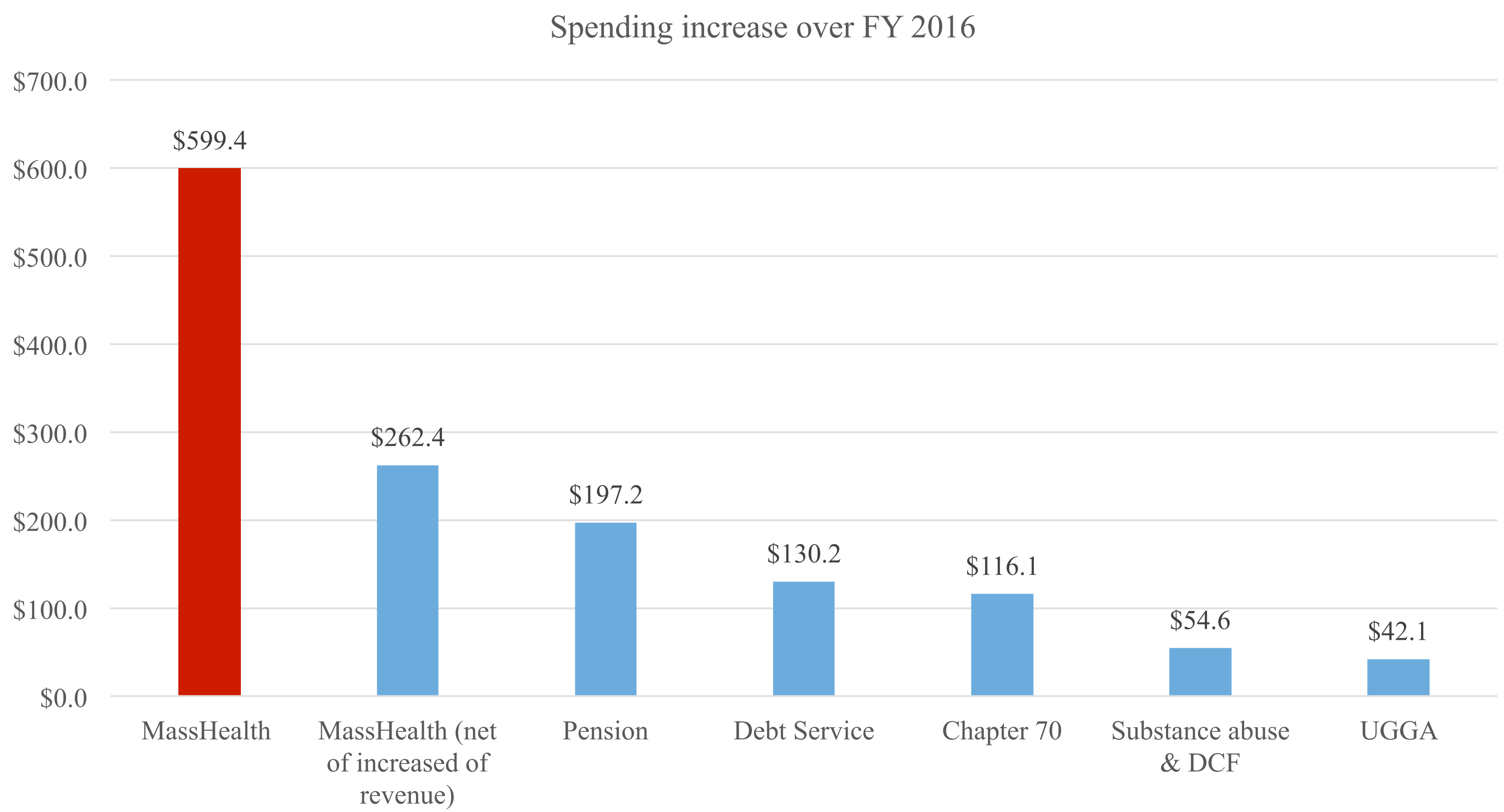
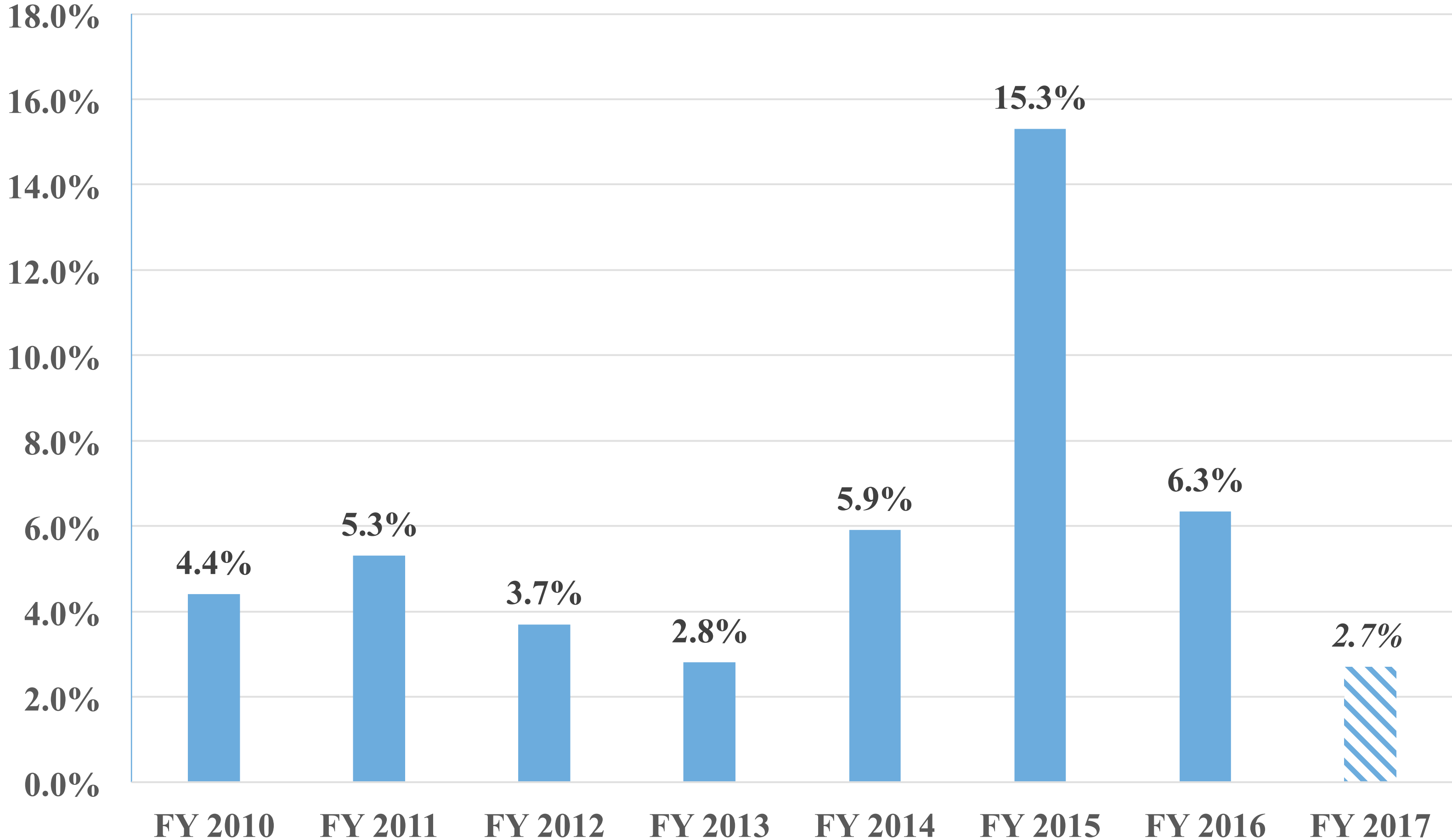
FY 2017 provides an example of how MassHealth growth dwarfs other spending areas

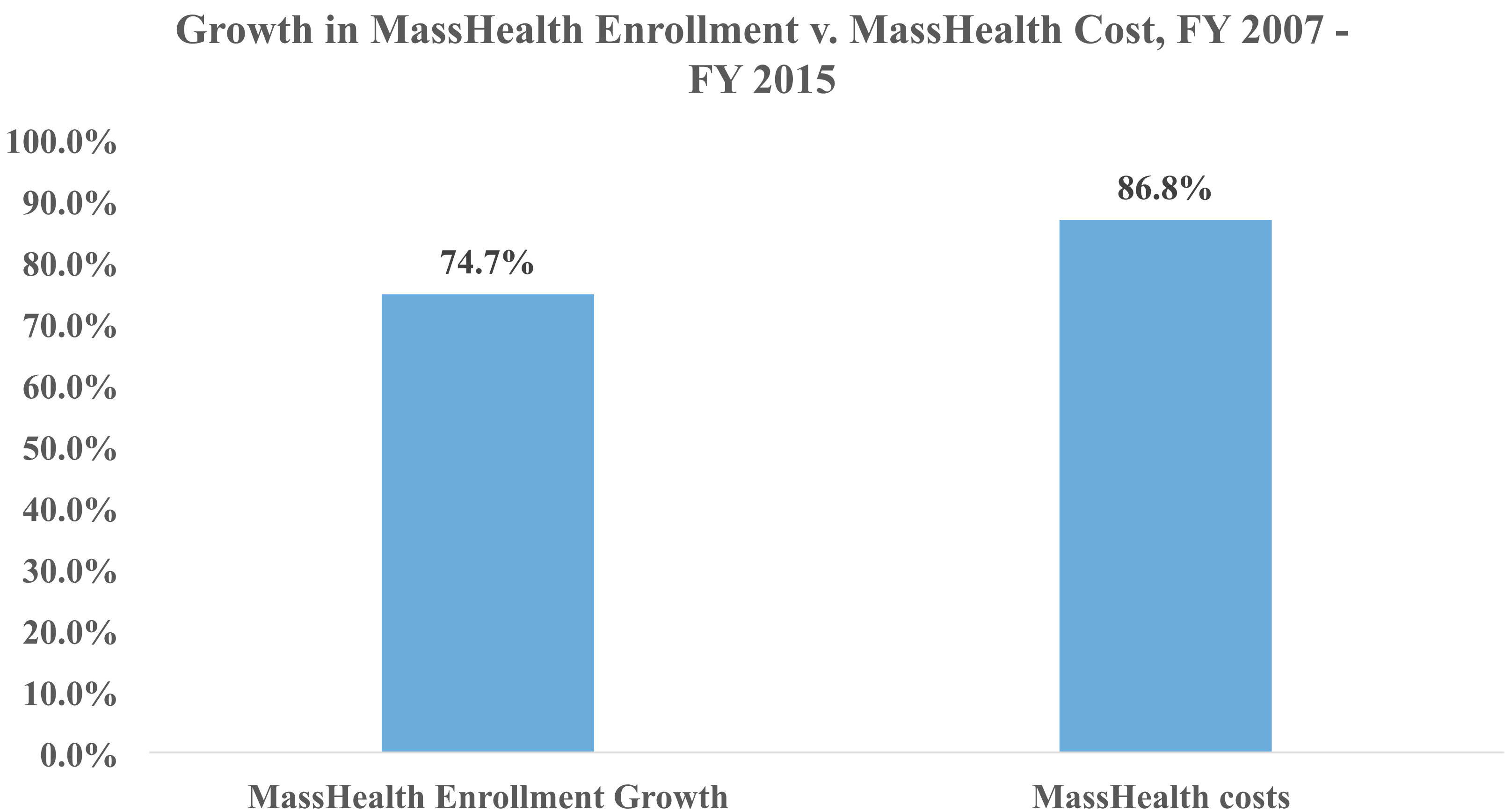


This MassHealth spending increase is in spite of modest enrollment growth projections*



*ACA implementation began in FY 2014. Enrollment growth does not include temporary coverage

Controlling MassHealth enrollment growth is essential



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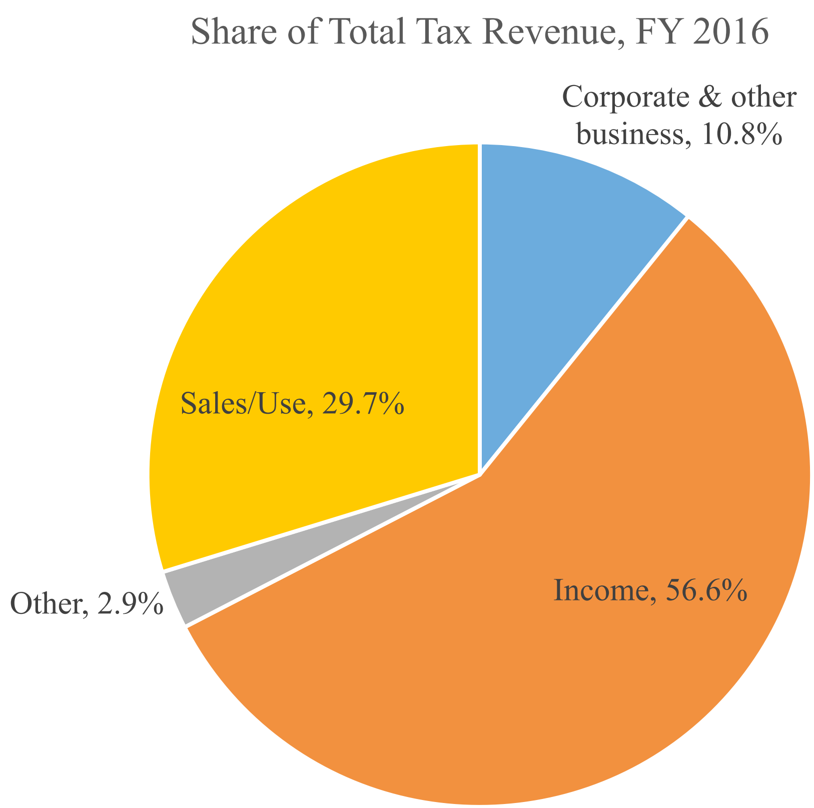
Volatility of revenue sources

Massachusetts is heavily reliant on income taxes

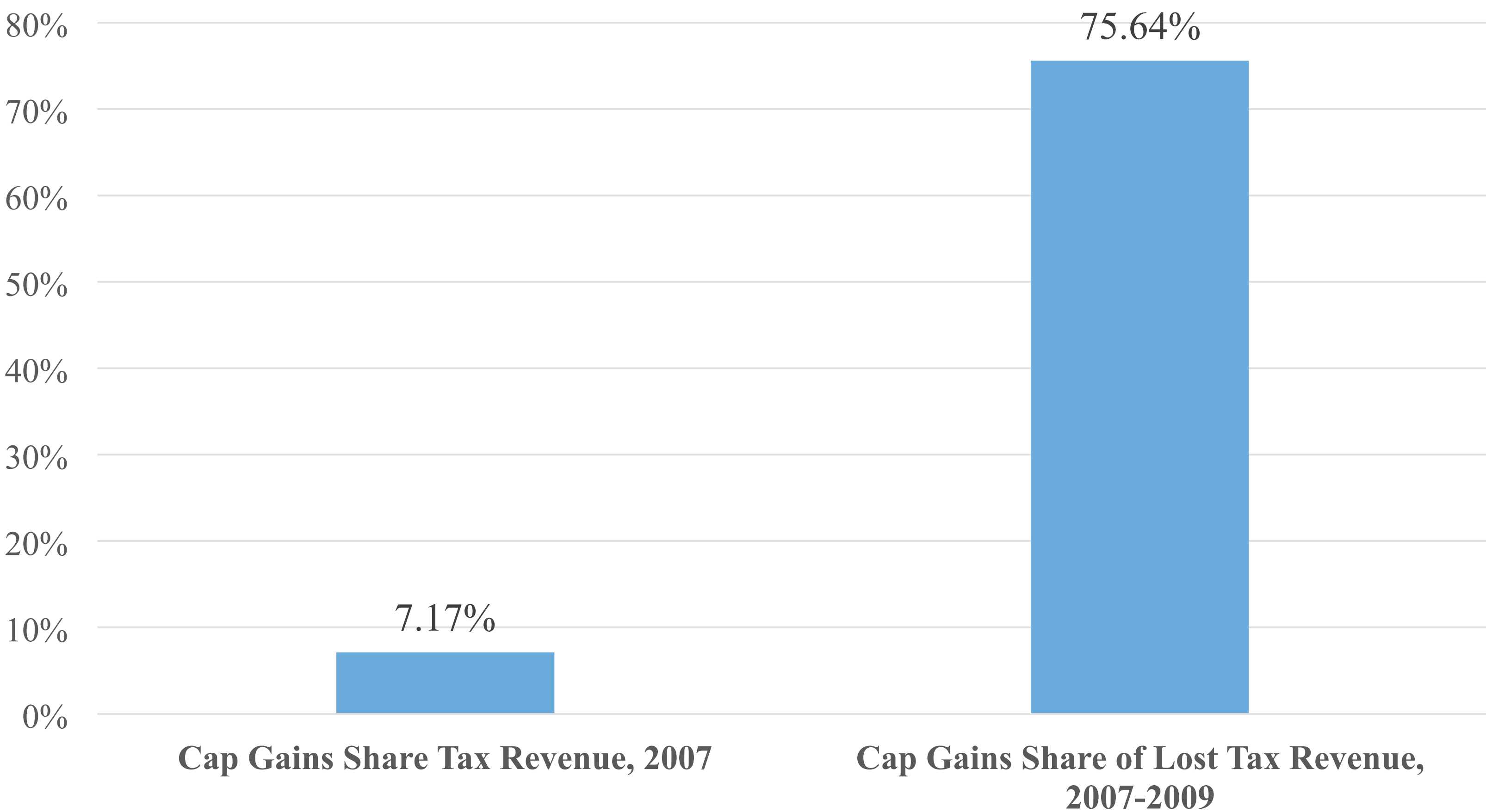


Income tax reliance creates challenges during tough times

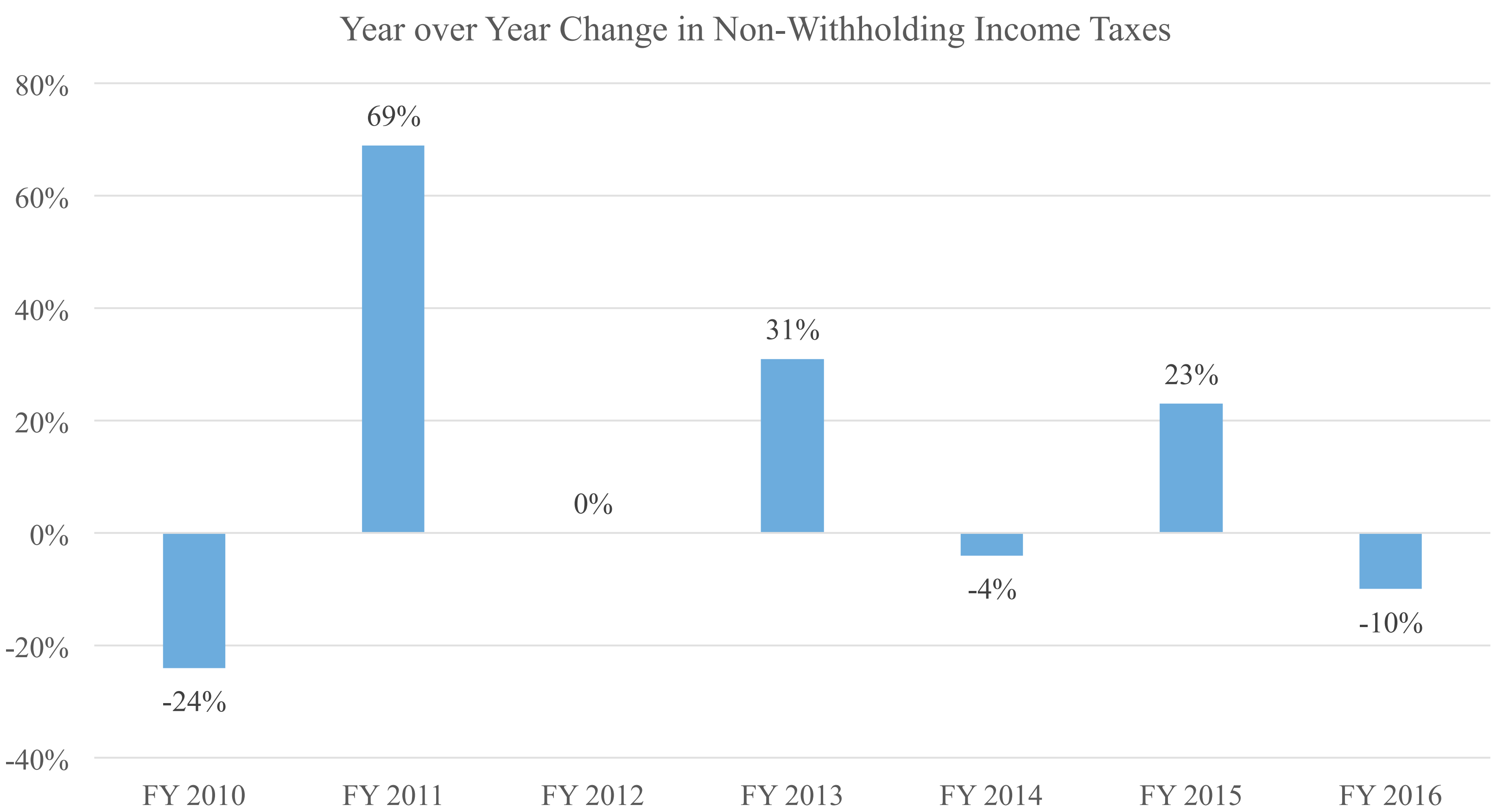
Decline in Tax Revenue Sources, FY 2008 to FY 2009		
	% Change	$ Change
Income	-15.2%	-$1,936
Sales	-4.1%	-$214

- Income was much more sensitive to the effects of the Great Recession than sales, falling more than 3 times faster and resulting in $1.9 billion in lost revenue

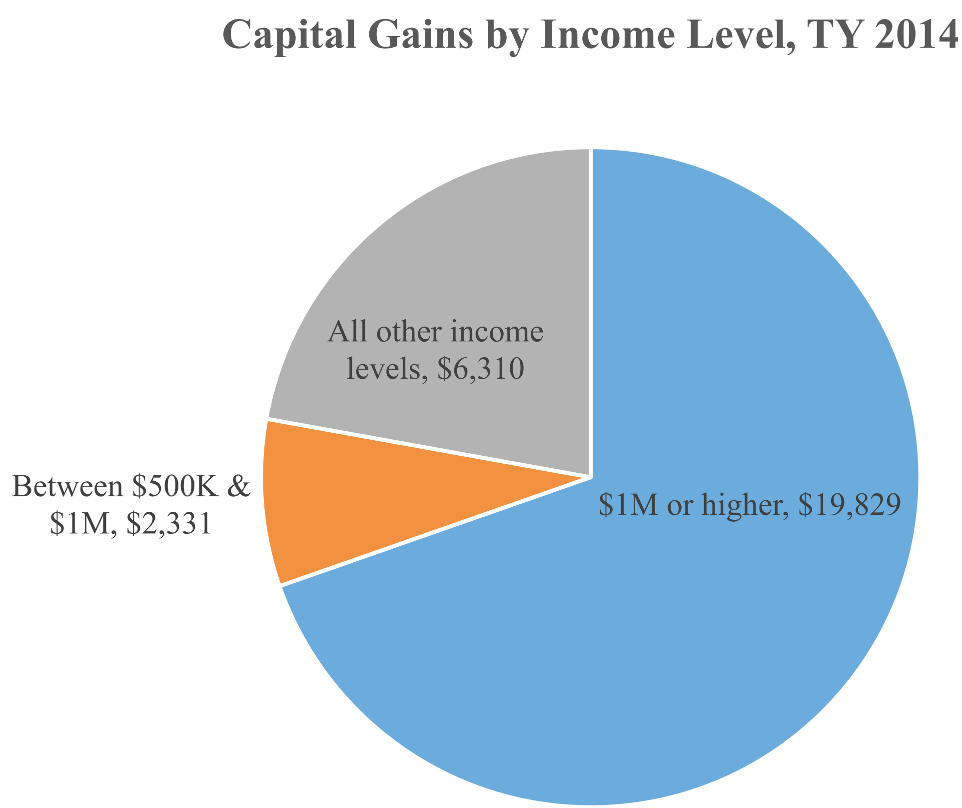
Income tax from capital gains is particularly subject to feast and famine



Capital gains volatility has continued to wreak havoc in the recovery

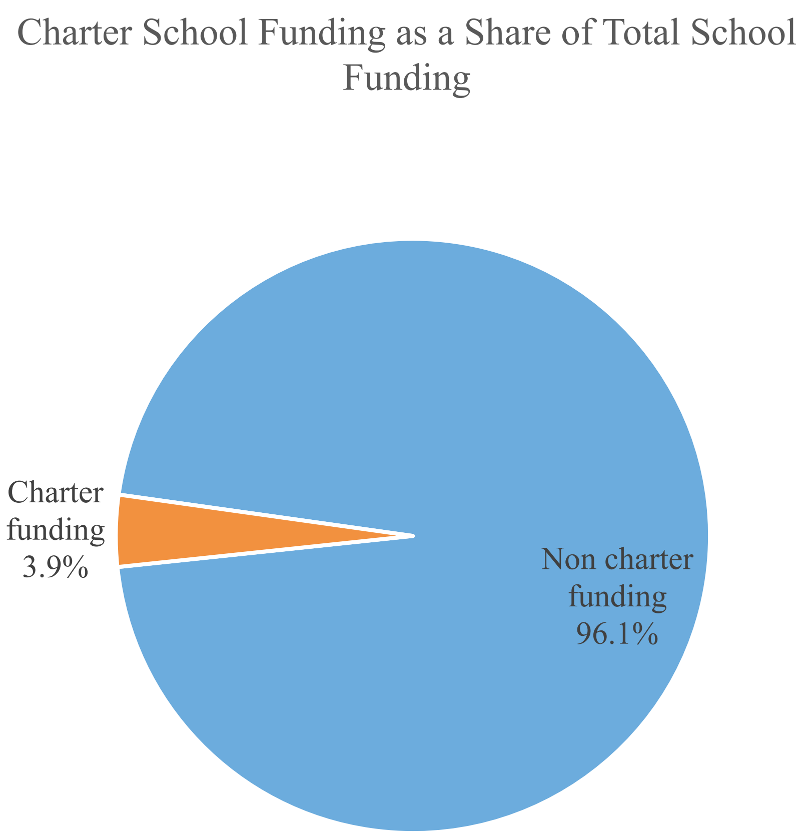


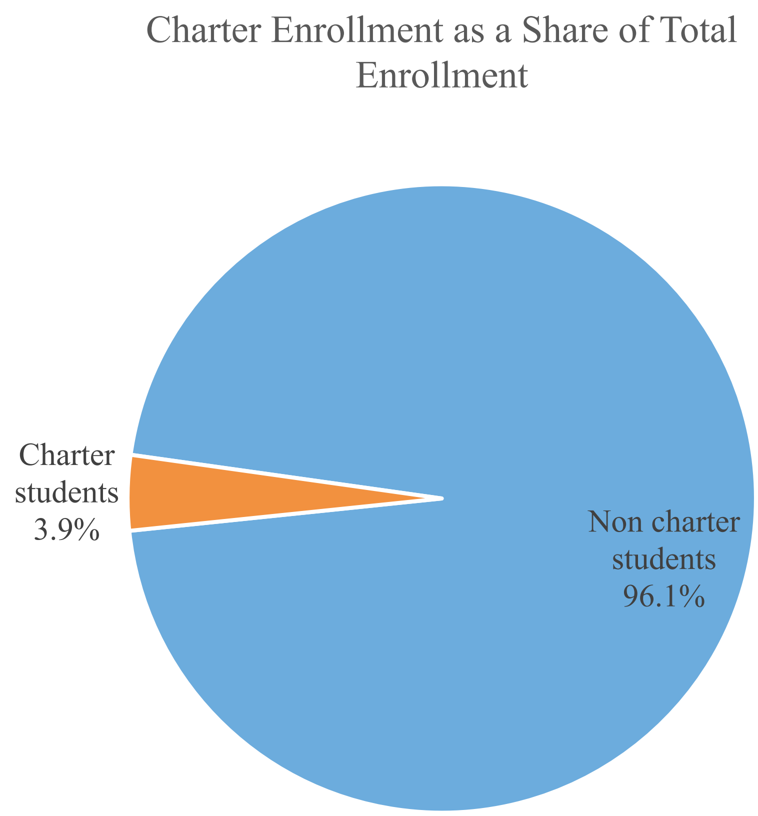
Increasing taxes on high earners will increase revenue volatility



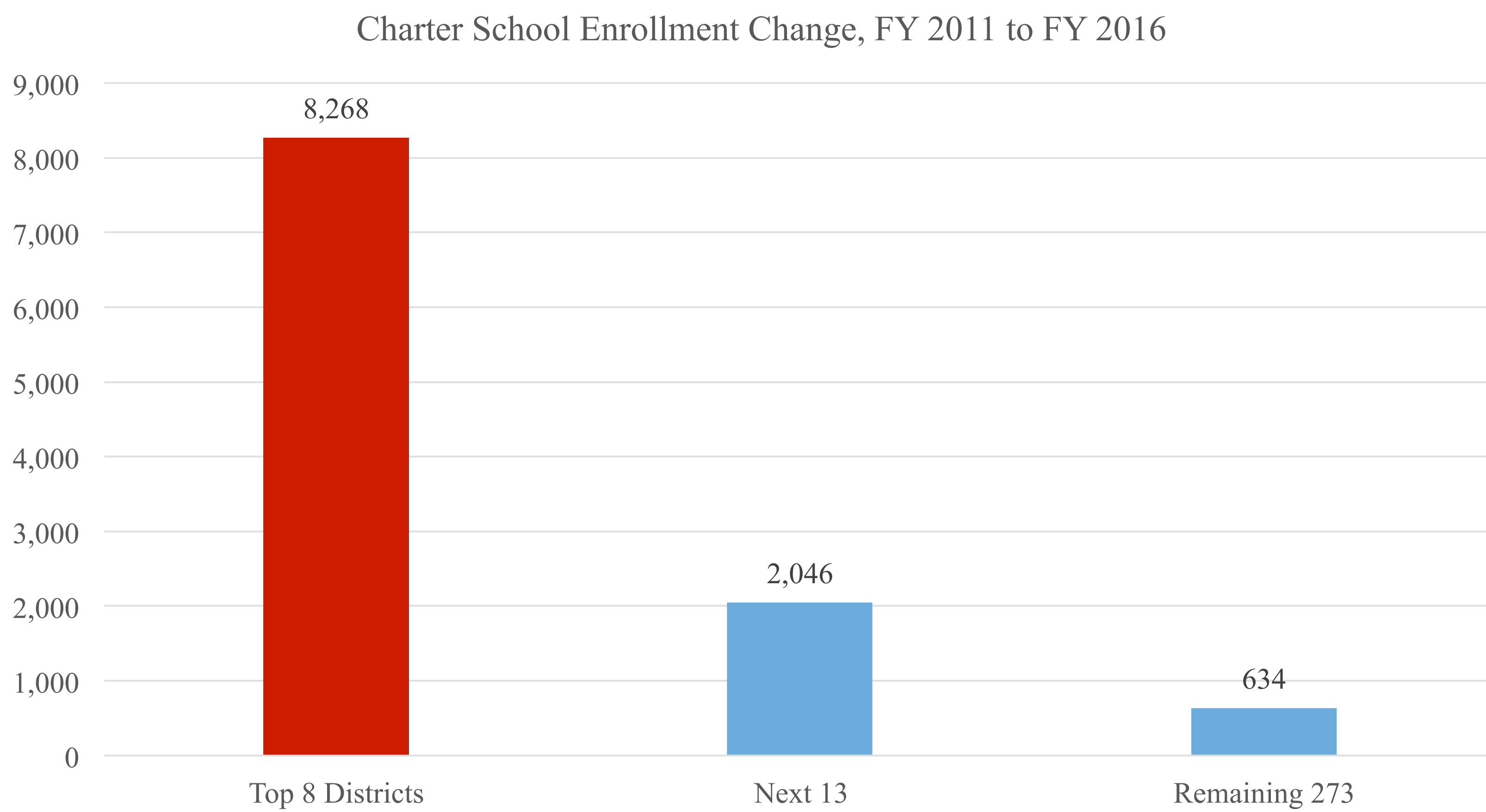
Appendix

Putting charter school funding in context





Looking at the impact of charter school enrollment



Purpose and conclusion

- The purpose of the report is to:
  - Put charter school funding in the context of the larger education finance system
  - Look at the impact of charter school enrollment on districts with largest recent charter enrollment changes
  - The report does not examine municipal budgeting tradeoffs in individual towns
- The report concludes that there is no discernable pattern between increasing charter enrollment and non-charter education spending in a district

Millionaires tax on schedule for 2018 ballot

To provide the resources for quality public education and affordable public colleges and universities, and for the repair and maintenance of roads, bridges and public transportation, all revenues received in accordance with this paragraph shall be expended, subject to appropriation, only for these purposes.

In addition to the taxes on income otherwise authorized under this Article, there shall be an additional tax of 4 percent on that portion of annual taxable income in excess of $1,000,000 (one million dollars) reported on any return related to those taxes. To ensure that this additional tax continues to apply only to the commonwealth's highest income residents, this $1,000,000 (one million dollar) income level shall be adjusted annually to reflect any increases in the cost of living by the same method used for federal income tax brackets.

This paragraph shall apply to all tax years beginning on or after January 1, 2019.

Timeline

- May 18th – 135 members of the Legislature vote to move the ballot question to the next Constitutional Convention
- Between January and June of 2017 – Legislature can advance question to 2018 ballot if 50 members vote in support
- November 2018 – Ballot question before voters

Fiscal concerns

1. Places a large revenue bet on a very small (<20,000) and mobile population
2. Income over $1 million is unpredictable
   - Between 2012 and 2013, millionaire revenue declined, in spite of an improving economy, due to federal tax changes. All other sources of tax revenue increased.
3. Doubles down on the state's reliance on volatile capital gains revenues – the revenue source that declined the most in the last 2 recessions

Governance concerns

1. Massachusetts would join Alabama as the only other state with a permanent tax rate in the state's Constitution
   - California has a tax surcharge which expires in 2017
2. There is no guarantee that the funds would go to improve stated purpose
   - State spending in education and transportation exceeds the revenue raised by the tax
3. There are Constitutional concerns with the question as drafted