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FY 2021 BUDGET PREVIEW: Revenue Expectations for the FY 2021 State Budget

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Note: This is part of a MassBudget series looking ahead at some major stories to watch for in the Fiscal Year (FY) 2021 budget debate. Check back for additional briefs and for a summary.

What to watch for in the Fiscal Year (FY) 2021 budget debate

Budget writers are expecting modest revenue growth in the coming fiscal year, some $862 million more than is expected in the current fiscal year (FY 2020). At the same time, however, recent and scheduled tax and non-tax revenue decreases will take a big bite out of state revenues, some $650 million or more. While these losses already are factored into FY 2021 revenue estimates, these changes reduce the amount lawmakers otherwise would have available to work with as they craft the FY 2021 budget (see further discussion, below). With a new commitment to increasing state K-12 education funding and the ever more obvious need to repair and upgrade our transportation systems, will lawmakers have the revenue to make the necessary investments in these and other budget priorities?

Introduction

When most of us think about a budget, we typically think about how much will be spent on each item in a list. This is especially true when talking about government budgets: we tend to focus on the amounts provided to our priority spending areas. Will the schools get an increase? Will the library accounts be fully funded? Will the MBTA and regional transit authorities get enough to maintain services or will they need to cut routes or raise fares?

While most of the discussion around the annual state budget process focuses heavily on the spending side of the ledger, every dollar allocated through the budget ultimately depends on the state's ability to generate the necessary revenue. This preview looks at the revenue side of the ledger: How much revenue do budget writers expect there will be as they craft a budget for the coming fiscal year? Do they expect more or less than the year before? Do they expect the Commonwealth will have the revenue to support new initiatives? Do they expect they will need to cut funding if legislators don't approve new sources of revenue?

The first major step in the annual state budget process is for the Governor and Legislature to agree on the amount of revenue they expect the Commonwealth to collect in the coming fiscal year. The deadline for this decision is January 15th, just before the Governor releases his budget proposal. This agreed-upon amount of anticipated revenue is called the **Consensus Revenue Estimate** or "CRE." The CRE provides a common starting point as the Governor, the House, and the Senate each develop their respective spending proposals for the coming fiscal year.[i]

(Throughout this brief, you will see words in bold. These terms are defined in a glossary at the end of the report.)

How Much Revenue Are Budget Writers Expecting in FY 2021?

The Governor, House and Senate have agreed to a CRE amount of $31.151 billion for FY 2021. This total represents expected **actual growth** of $862 million (or 2.8 percent) over the current FY 2020 **benchmark estimate** of $30.289 billion.[ii] This level of growth is substantially below the 4.7 percent growth seen over the first half of the current fiscal year (FY 2020) and is far below the rates of growth seen in FY 2019 (6.9 percent) and FY 2018 (8.5 percent). The growth rate upon which the FY 2021 CRE amount is based, however, sits toward the upper end of the Department of Revenue's estimated growth range for the coming fiscal year. As part of the CRE briefing process back in December (a day of testimony before the Joint Committee on Revenue by economists and other experts, that helps inform budget writers as they prepare to set the CRE), the Department of Revenue (DOR) had estimated actual revenue growth in FY 2021 would be between 1.7 percent and 3.0 percent.

Built into the FY 2021 CRE is an expectation that $1.590 billion of the total will come from taxes on **capital gains**. By law, a portion of such revenues must be transferred to the state's Stabilization Fund and thus is not available to be spent as part of the standard budget process. The FY 2021 CRE expects that $250 million of these capital gains taxes will be transferred to the **Stabilization Fund** and another $28 million will be transferred (also by law) to the state pension fund.

What Is Driving the Estimate for FY 2021?

The FY 2021 revenue forecast – and hence the CRE - is based on two core assumptions. The first is an expectation that economic growth will slow considerably in FY 2021 relative to the strong growth rates seen over the last several years. The second is that the U.S. and Massachusetts economies will not fall into recession in 2020 or 2021.

Together, these assumptions push DOR, and other revenue watchers, toward an expectation of growth, but *modest* growth, of revenue throughout FY 2021. This expectation is reflected in the FY 2021 CRE amount.

One notable source of potential uncertainty in FY 2021 - and hence an item to watch during the budget debate — is revenue from the new tax on recreational marijuana sales. DOR estimates the Commonwealth will collect $132.5 million from recreational marijuana in FY 2020 and $145.7 million in FY 2021. The nascent market for recreational marijuana, however, is still growing: the state collected only $22 million from these sales in FY 2019. It remains to be seen whether the market will develop as quickly as expected and whether FY 2020 and FY 2021 collections from this source match – or possibly exceed - current estimates.

Expected revenue losses in FY 2021

While revenues overall are expected to grow during FY 2021, the state also can expect to see substantial losses of revenue from a number of policy changes occurring during this coming fiscal year and beyond. Because these losses are anticipated, they have been factored fully into the FY 2021 CRE and therefore will not create surprise gaps in the state budget. Nevertheless, the loss of these revenues does mean there will be fewer dollars available to support the many programs and services funded through the state budget. Major anticipated losses include the following:

- The strong economy and robust revenue collections of the last several years have activated (twice) a previously established "trigger" in our state tax code, automatically decreasing the personal income tax rate in two separate steps. On Jan. 1, 2019, the rate dropped from 5.1 percent to 5.05 percent and on Jan. 1, 2020, the rate dropped again, to 5.00 percent.

  DOR estimates that these two rate decreases will reduce state tax collections by $263 million in FY 2020 (the second rate decrease will have only a partial-year impact in FY 2020).[iii] The second rate decrease will be in effect throughout FY 2021 and will have a full-year effect of $185 million in revenue loss in that year.

  Combined, the rate drop from 5.10 percent to 5.00 thus will result in the loss of approximately $360 million in revenue in FY 2021 and in future years. These lost tax dollars are **recurring revenues** that otherwise could pay, year after year, for teachers, caseworkers, health care, and other public services.[iv]

- As part of the same, previously established set of tax triggers, the drop to a 5.00 percent income tax rate automatically activates the introduction of a new state tax deduction for charitable donations, one similar to the federal version. This state-level deduction is set to go into effect Jan. 1, 2021. DOR estimates this new tax break will cost the Commonwealth $64 million in lost revenue in FY 2021 as it comes online, and $300 million in FY 2022 and annually thereafter.

  Not only is this an expensive tax break, it is one that will heavily favor high-income filers: households that earn over $1 million claim almost half of the total federal charitable deductions claimed by all Massachusetts tax filers, while households earning less than $200,000 claim only 29 percent of the Massachusetts total. This lopsided distribution of benefits will be more or less mirrored in the new state deduction when it goes into effect.

- Finally, the state is slated to see a sizeable loss in *non-tax* revenue collections from one particular source. A temporary health care-related assessment that had been levied on some businesses expired at the end of 2019, meaning this source will deliver no revenue in FY 2021. This assessment was designed to raise about $230 million per year to help pay for the subsidized, state health care costs resulting from employers that use either MassHealth or the subsidized state Connector Care to cover their employees. The Legislature created this assessment in 2017 as a temporary, two-year supplement to the Employer Medical Assistance Contribution (EMAC).

  The Boston Globe recently reported that the assessment raised substantially more than expected, something closer to $640 million total over the two-year period. While the now-expired assessment may have raised more than expected (and possibly more than designers had thought necessary), it is not clear that the problem the assessment was meant to address no longer exists. Neither the Governor nor Legislature has proposed a plan to provide new revenue over the long-term to address, in particular, the state health care costs previously paid for with the supplemental EMAC assessment revenue.

Taken together, these recent changes are expected to reduce annual state revenues by some $650 million or more in tax and non-tax collections in FY 2021.[v] When the charitable deduction reaches its full-year impact in FY 2022, this total will be some $900 million or more in lost tax and non-tax collections.[vi] Again, while these reductions in recurring revenues already are factored into the CRE – and thus will not create an unexpected hole in the state budget - their loss nevertheless means the Commonwealth will be able to invest that much less each year in communities across the state than it otherwise could have.

Where in the Budget Process Does the Revenue Action Happen?

For those paying attention to revenue, the House's budget proposal is particularly important to watch (typically released mid-April). The Governor, who kicks off the budget process in January, can suggest new taxes or fees to the Legislature via his budget proposal, but the Massachusetts Constitution requires all "**money bills**" to originate in the House. If the House does not propose tax or fee changes, the Senate cannot either.

If any new or increased revenues *are* proposed, it will be important to consider whether the proposals make the state's tax system more or less fair. Massachusetts' state and local tax system currently is "regressive," meaning people with low or modest incomes pay a larger percentage of their income in those taxes than people with higher incomes do. "Progressive" tax systems have the opposite effect: people with more income pay a larger percentage of their income in taxes. Some types of new taxes or fees would make the system more regressive while others would help balance the system by requiring those with high incomes to pay a share of that income that's more in line with the share everyone else pays. Notably, all of the automatic tax changes discussed above are regressive; they will make the system less rather than more fair.

Glossary

- **Consensus Revenue Estimate (CRE):** The amount of tax revenue available to fund the annual state budget, as anticipated and mutually agreed on by the Governor, the House, and the Senate. The CRE typically is agreed to in late December or early January, prior to the beginning of the annual state budget process. The Governor, House, and Senate use the CRE to determine how much revenue they have to fund budget items.

- **Actual Revenue Growth:** The change in inflation-adjusted revenue collections during a given period — in this case, over the course of a single state fiscal year.

- **Benchmark Estimate:** This term is used to refer to updated projections of total annual state tax collections. Based on the CRE, these updates can be made by the Governor at various points throughout the year, providing more current — and hopefully, therefore, more accurate — estimates of likely collection totals in the current fiscal year.

- **Capital Gains:** The profit made by selling assets (stocks and bonds, houses, art, etc.) for more than the owner paid for the assets. In Massachusetts, most such profits are taxed at the same rate as other forms of personal income.

- **Stabilization Fund:** Also called the "Rainy Day Fund". A state fund into which a portion of current year revenues are placed in anticipation of the need to draw on these dollars in years when revenue collections fall short of expectations.

- **Recurring Revenue:** Revenue derived from a recurring source. These revenues can be replenished from this source in the future. Personal income taxes and sales taxes are examples of recurring revenues, as revenue from these sources is available on an ongoing basis. Revenue from the sale of a particular state property, however, is an example of non-recurring, one-time revenue: it is available only once, at the time of sale.

- **Money Bill:** An informal term used to describe bills originating in the House that include language directly altering the amount of taxes or fees collected by the Commonwealth. If the House does *not* include such language in a bill — in other words, if the bill is not a "money bill" — then the Senate version of the same bill likewise cannot include changes to state taxes or fees.

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[i] State Fiscal Years begin on July 1st, by which time, the Governor, House and Senate are supposed to have agreed upon a budget for the coming year. Periodically, however, the budget process extends into July or beyond.

[ii] The 2020 benchmark amount includes a $190 million increase over the prior benchmark amount of $30.099 billion. This upgrade, made by the Governor's Executive Office of Administration and Finance, was announced along with the FY 2021 CRE.

[iii] The rate drop from 5.05 percent to 5.00 percent occurs mid-year in FY 2020 and thus has only a partial-year impact in FY 2020. The full year impact of the 5.10 percent to 5.05 percent rate drop is estimated by DOR to be $175 million in FY 2020. The full year impact of the rate drop from 5.05 percent to 5.00 percent is estimated by DOR to be $185 million in FY 2021. Together, the combined drop from 5.10 percent to 5.00 percent will reduce personal income tax collections by some $360 million annually.

[iv] Because these losses are baked already into DOR's estimates, they do not, technically, create a hole in the FY 2021 budget. The budget will be built off the CRE, which takes these losses into account. These personal income tax losses, however, do reduce the amount of revenue that otherwise would have been available to budget writers.

[v] This total includes $360 million from the personal income tax rate drop, $64 million from the introduction of the charitable deduction tax break, and $230 million from the EMAC supplemental assessment.

[vi] This total includes the additional $236 million loss ($300 million - $64 million = $236 million) in FY 2022 and beyond, once the charitable deduction reaches its estimated full-year impact of $300 million.