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Avoiding Structural Deficits in Maryland: Recommendations for Reform

by

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I. Maryland's Structural Deficit

Maryland has serious ongoing fiscal problems that can only be remedied with significant reforms to the legislative and budgetary processes. In the face of projected budget deficits far into the future, meaningful reforms are necessary in order to instill a greater sense of fiscal discipline in the state's elected officials. The reforms recommended in this paper are principally directed to requiring legislators to identify a specific revenue source for each new or expanded program, to improving the spending affordability process and to providing Maryland's elected officials and its citizens, with greater access, in a timely fashion, to fiscal information. Adoption of the recommended changes will raise

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the awareness of the costs of new programs and the limited resources that are available, without massive tax hikes or gambling revenues, to pay for such programs.

Despite recent proclamations that Maryland has conquered its structural budget deficit, the deficit is projected to continue until at least Fiscal Year 2013. [1]This optimistic projection includes significant revenues from slot machines, which have not yet been authorized pending a statewide referendum in November 2008. And it does not account for the cost of any of the new programs enacted in 2008 or the cost of new programs promised by elected officials for future years.

As required under the Maryland Constitution, balanced budgets have been submitted by the Governor and adopted by the General Assembly for each year since the 1916 adoption of the current Maryland budget system.[2] Yet, for most of the 21st century, Maryland has endured a chronic structural deficit[3] in which ongoing spending commitments exceed ongoing estimated revenues.[4]

To provide the context for understanding the need for budgetary reforms recommended in this study, it is useful to review the following summary of the state's recent fiscal history and current budget projections. In December 2006, the state's Spending Affordability Committee, comprised exclusively of legislators who are advised by a citizen's advisory committee, forecast structural imbalances of $1.5 billion for FY 2009 through 2012. This forecast remained unchanged after the 2007 legislative session and the enactment of the FY 2008 budget.[5] Since the FY 2008 budget depleted most reserves and state revenues were unlikely to increase by $1.5 billion based on then current law, future balanced budgets would require reductions in spending of $1.5 billion.[6] To avoid reductions of this magnitude, Governor O'Malley called the General Assembly into Special Session in October 2007.

The Governor's plan, most of which was adopted by the General Assembly, increased the personal income tax, the sales tax, the corporate tax, the tobacco tax and the vehicle excise tax. The Governor also proposed significant new revenues from the legalization of slot machines. The only program curtailment

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[1] 90 Day Report 2008, p. A-18.

[2] Sometimes, as with the FY 2002 Budget that had been adopted in the 2001 General Assembly Session, the balancing was achieved by underestimating ongoing costs and overestimating revenues. 2001 Spending Affordability Report, p.8.

[3] A chronic structural deficit is like a chronic disease, symptoms may be temporarily alleviated but without aggressive treatment, the condition persists.

[4] In FY 2005 and FY 2006, there was a structural surplus. 2006 Spending Affordability Report, p.37.

[5] 90 Day Report 2007, p. A-14.

[6] The FY 2008 budget was balanced through the transfer of almost $1 billion of reserves from the State's Rainy Day Fund and $100 million from the Dedicated Purpose Account and a cash surplus from FY 2007 of $284 million. Fiscal Digest for FY 2009, p. A-1. The transfers to balance the FY 2008 budget essentially depleted the Rainy Day Fund balance to the statutory minimum of 5% of general fund revenues. 2007 Spending Affordability Report , p.77

proposed by the Governor was a slower rate of growth in the funding for K-12 education and the repeal of the utility property tax grant to certain Maryland counties. At the same time that significant tax increases were proposed to meet existing obligations, the Governor proposed additional spending to expand Medicaid eligibility, to provide a State subsidy for small businesses to offer health care to their employees and to increase funding for higher education. The General Assembly adopted most of the Governor's proposals, which entailed estimated total increases in State tax revenues of more than $1.5 billion, slot machine revenues of an additional $600 million and additional State spending of more than $500 million.[7]

As a result of the increase in the sales tax from 5% to 6% on January 1, 2008 approved during the 2007 Special Session, the State received approximately $350 million in revenue not originally anticipated in FY 2008. Even with this new revenue, the Spending Affordability Committee projected that the structural deficit in FY 2008 would be $674 million.[8] Similarly, despite the significant tax increases during the Special Session, in its December 2007 report, the Committee projected that the structural deficit would continue until FY 2012, at which time the budget would be just within structural balance due to the first receipts from slots.

In April 2008, just after the 2008 Session of the General Assembly and after the enactment of more than $1.5 billion in tax increases in November 2007, the Department of Legislative Services (the "Department") projected that the structural deficit would continue until FY 2013.[9] The Department warned that: "While an upturn in projected economic activity will serve to mitigate these projected shortfalls, both the Administration and the legislature will need to consider some magnitude of spending reductions, revenue enhancements or use of reserves in order to resolve the projected gap between revenues and spending."[10]

On July 10, 2008, the Department of Legislative Services warned that State revenues were falling short of the estimates used for the FY 2009 budget that began on July 1, 2008. The Department estimated that general fund revenues could fall short of estimates by $200 million.[11] Neither the April or July 2008 analysis includes the cost of new programs adopted during the 2008 session or commitments made by the Governor that have yet to be incorporated in legislation or the budget, such as the Maryland Bio 2020 initiative that promises $1.1 billion in State funds for biotechnology companies over the next ten years or the plan for statewide communications interoperability with an

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[7] The Constitutional Amendment authorizing slot machines will be submitted to the voters for approval in November 2008.
[8] 2007 Spending Affordability Report, p.38.
[9] 90 Day Report -2008, p. A-18. This projection does not take into account additional spending commitments as a result of legislation passed during the 2008 session.
[10] Ibid., p. A-17.
[11] Washington Post, July 9, 2008, p. B-08.

unknown but likely significant cost or the State's commitment to provide $75 million over 5 years beginning in FY 2011 to Prince George's Hospital.[12]

If elected officials continue to make promises without a plan for paying for the promises, Maryland will be permanently trapped in a cycle of chronic structural deficits in which ongoing spending commitments will exceed ongoing revenues.

How can Maryland break the cycle of structural deficits that have plagued it since the beginning of the 21st Century? A moratorium on the adoption of new or enhanced programs would stop the cycle. Despite the common sense appeal of such a moratorium, the political process and human nature makes this a somewhat unlikely solution. The best alternative solutions are reforms that will enhance accountability and transparency in the legislative and budgetary processes.

The following recommendations provide some suggestions for providing more information in a more timely fashion to both elected officials and Maryland citizens in order to raise the awareness of the costs of new programs and the limited resources that are available.

II. Recommendations

1. Each proposed law should identify the source of funds to support the spending required by it.

In 1915, the Democratic party, as part of its platform for the gubernatorial election, created a commission to review the State's budgetary system and recommend reforms that would prevent future State deficits. The Chairman of the Commission was Dr. Frank J. Goodnow, the President of the Johns Hopkins University. The recommendations of the Goodnow Commission for creating a new budget system for Maryland were submitted as a constitutional amendment to the Maryland General Assembly in 1916. The General Assembly approved the amendment and the voters approved in November 1916.

Under the budget system proposed by the Goodnow Commission that remains in effect today, the General Assembly can reduce or eliminate appropriations but cannot increase appropriations (other than its own appropriations or that of the Judiciary) beyond the level proposed by the Governor. This restriction prevents the General Assembly from redirecting to other purposes the amounts of any reductions it makes to the appropriations proposed by the Governor.

[12] Governor's Press Releases, June 16, 2008, July 10, 2008 and July 25, 2008.

Despite the restrictions imposed on the General Assembly's powers, the Goodnow Commission believed that it was important to preserve the legislative power to initiate appropriations. At the same time, the Commission wanted to assure that deficits would not occur. To accomplish both of these goals, the Commission recommended that the General Assembly be required to provide a new revenue source for each appropriation that it initiates. These bills are known as supplementary appropriation bills.

If the General Assembly wishes to provide funding in the same fiscal year as the budget it is considering for a purpose not provided by the Governor or to increase funding from the level proposed by the Governor, it can pass a supplementary appropriation bill authorizing the new spending. But – and this is key -- it must identify a new revenue source to pay for the proposed spending. It cannot rely on funds that the Governor did not allocate in the budget and that remain as surplus for succeeding years. The Goodnow Commission believed that requiring the General Assembly to create a new revenue source for programs not contained in the Governor's budget would prevent deficits because spending would be matched with revenues.

This constitutional provision has not been effective in preventing structural deficits. This is because the requirement that the General Assembly specify the revenue source that will fund the spending applies only when the General Assembly proposes to authorize immediate funding, not when it adopts general legislation that creates new programs or enhances existing programs that commit the State to spending millions of dollars in future years. More than 2000 pieces of legislation are introduced each year and 600 are signed by the Governor. Few, if any, of these bills include a funding source.

The current legislative process is based on an unrealistic assumption that inflationary increases in State revenues will pay for new programs. The State's chronic structural deficit contradicts this assumption.

In most years, the spending required by legislation signed by the Governor has a full implementation cost that is significant. For example, during the 2002 and 2006 legislative sessions, the General Assembly adopted and the Governor approved legislation having a full implementation net **annual** general fund cost of $731million and $372 million, respectively. In just these two years, the General Assembly adopted legislation that required more than $1 billion of new annual State spending and did not identify revenue sources or spending reductions to pay for the new spending. Normal growth in state revenue cannot match this level of increased spending commitment.

To assure that the State does not commit more funds to programs than it expects to receive, each bill should be required to identify how the new spending required under the bill will be funded. [13] The funds could be a new source of

[13] The requirement to identify the means to pay for proposed legislation can be imposed by regular statute or by an amendment to the Maryland Constitution. Imposing the requirement by

revenue or specifically identified savings from reducing or eliminating specifically identified programs. Such a requirement would also alert legislators and Governors to the fiscal consequences of whatever new programs they propose and would educate the public that new or expanded programs are not free.

A cumulative listing of the proposed sources of revenue or spending reductions should be combined with the cumulative listing of costs of each bill (recommended below). This would foster a better understanding of choices that must be made with limited resources or the new burdens to be imposed upon the State's residents by reason of new revenue sources.

To the extent that the Governor's proposals are not reflected in legislation, the Governor too should be required to identify how new programs or enhancements will be funded. Press releases announcing each new program or program enhancement should identify the source of the funding as announcements are made.

2. ***Fiscal estimates for each proposed law should be available to the public at least two days before the first hearing on the legislation.***

While much of the attention in resolving budget deficits is focused on the budget process, as noted above, the cumulative impact of general legislation enacted each year has a significant impact on the State's financial condition. Lack of attention to the cumulative costs fosters the chronic fiscal distress that the State has experienced and expects to continue experiencing over the coming years.

The General Assembly currently receives a fiscal note for each proposed law. Fiscal notes, prepared by the Department of Legislative Services, provide an estimate of the costs to the State for a five year period of the new spending required and any new revenues that will be generated. Too often, the fiscal note is not available until the day of the hearing and sometimes not until after the hearing. When the fiscal estimates are not available until the date of the bill hearing, legislators and citizens do not have the tools to make appropriate inquiries about cost estimates.

Fiscal notes can be very useful tools in educating the public and legislators about the costs of new programs, a critical step to averting structural deficits. In order to maximize the usefulness of fiscal notes, they should be issued at least two days in advance of the hearing to allow both citizens and legislators the opportunity to review and question the costs.

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constitutional amendment has the appeal of making it more difficult to change the requirement. The Goodnow Commission, for example, recommended a constitutional amendment to implement the new budget system on the belief that "A mere statutory provision... cannot, in our judgment, produce the reform in State finance which is demanded by the people and voiced in the Democratic platform." Goodnow Report, p.8 (1916).

Fiscal notes sometimes assert that the costs of implementation are minimal and can be absorbed within existing resources. While this might be true if only one or two bills were enacted each year, the aggregate costs of 600 separate pieces of legislation each year belie a conclusion that no added revenues sources will be necessary to implement legislation.

Fiscal notes should specify the new spending that will be required no matter how minor they seem. Understanding all of the potential costs for all proposed legislation is critical to avoiding structural deficits.

3. ***During the legislative session, the Department of Legislative Services should maintain on its website a cumulative list that reflects the estimated full implementation costs of each proposed law.***

After the Governor has finished signing bills, the Department of Legislative Services prepares a report that estimates the impact of adopted legislation on the State's financial condition. This report is very useful because it indicates how much additional revenue will be necessary to fund the new spending required under all of the bills that have been adopted. Unfortunately, the information comes after the legislative process is over and, thus, does not have a meaningful impact on decisions concerning enactment.

Looking at each individual fiscal note does not provide the same view as looking at the cumulative costs of all proposed legislation. Maintaining such a cumulative list during the session would provide both legislators and citizens with information about the costs to State taxpayers of implementation of all of the proposals under consideration. Such a list would provide a sobering picture of the costs of expanding and enacting new programs.

The Governor too should notify the public about the amount of spending required as a result of the new bills that are to be signed. When the Governor's Office announces what bills the Governor will sign, the announcement should include an estimate, based on the fiscal notes, of the spending required by the legislation to be signed. The estimate should include a cumulative total for each bill signing event. This would enhance public awareness of the costs to the taxpayers of the legislation adopted each year by their elected officials.

4. ***The methodology for determining "spending affordability" should be re-examined.***

The spending affordability process was created in 1981 by the General Assembly's Legislative Policy Committee "to limit the growth of State spending to a level that does not exceed the rate of growth of the State's economy."[14] In light

[14] State Government Article sec. 2-1002.

of the persistent structural deficit, it is time to re-examine whether "affordability" should continue to be measured in terms of growth in the Maryland economy.

In every year since the spending affordability process was adopted, the Spending Affordability Committee has proposed increases in total State spending.[15] Yet, it is clear that increases in general fund spending have not been affordable in many of those years because general fund spending has exceeded general fund revenues necessitating transfers from reserves or special funds or increases in taxes and fees in order to balance the State budget.

The Committee's emphasis on the growth in the economy has led to spending increases that reflect projections of a growing economy. But these economic growth projections are disconnected from the growth in State revenues. While a review of economic growth is useful in assessing the accuracy of estimates in revenue growth, growth in either personal income or the State economy is not identical to the growth in general fund revenues. As a result, the spending affordability limit often exceeds estimated increases in State general fund revenues, allowing spending to grow faster than general fund revenues.

For example, the aggregate spending limit established by the Spending Affordability Committee for FY 2008 was 7.9%. The actual increase in general fund appropriations after legislative action on the budget was 8.13%. [16] The Board of Revenue Estimates estimated that general fund revenues for FY 2008 would increase by 4.5%.[17] At the time the spending limit was adopted, ongoing spending was projected to exceed ongoing revenues by $1.3 billion. With spending already vastly exceeding estimated revenues and with general fund revenues estimated to increase by only 4.5%, it is difficult to understand how an 8.13% increase in general fund spending could be deemed "affordable." Limiting general fund spending to a level no greater than the estimated increase in general fund revenues would make structural deficits less likely.

Another problem with the spending affordability process arises because the spending limit is an aggregate limit for general, special and higher education funds. The structural deficit is, however, a general fund problem. Consideration should be given to establishing separate spending limits for each type of fund. In this manner, spending and the revenues on which it depends could be more closely monitored and aligned. Such a change would also make the spending affordability process more transparent.

The spending affordability process is also manipulated by certain budget reductions made by the General Assembly. The General Assembly reduces

[15] The Committee did not issue a recommendation for Fiscal Year 1993 but the budget passed by the General Assembly limited the increase in State spending to 10%.
[16] The 8.13% growth does not include $82 million in the State Employee's Health Insurance Fund that was used to support the State's share of premiums for retirees and employees.
[17] The Board of Revenue Estimates is comprised of the Comptroller, the Treasurer and the Secretary of Budget and Management. The Board provides the revenue estimates that are generally used by the Governor to prepare the State budget.

special fund appropriations but authorizes an increase in the appropriation (and thus spending) during the fiscal year through the use of budget amendments. The General Assembly also reduces general funds and authorizes the use of special funds in lieu of the general funds through budget amendments. These maneuvers have the effect of reducing the amount of appropriations for purposes of meeting the spending affordability limit but allowing actual spending to grow more than the limit because the amounts authorized to be appropriated by budget amendment are not included in calculating how much budget growth there has been for purposes of the spending affordability limit. The amounts specifically authorized to be expended by budget amendment when an appropriation is reduced should be included in the calculation of whether the spending affordability limit has been met.

5. ***At the outset of its deliberations, the Spending Affordability Committee should publicly disclose the methodology for the determination of what spending is affordable.***

While the Committee does a good job of articulating the rationale for its recommendations, there are many exclusions from the spending affordability formula that are not publicly disseminated. For example, the recommendation for FY 2009 issued in December 2007 makes a recommendation that "Appropriations subject to the spending affordability limit shall be limited to growth no greater than 4.27% over those approved in the 2007 session." Yet, nowhere in the report can one find exactly what appropriations are subject to spending affordability. Some of the answers can be found by searching through previous Spending Affordability reports. Some of the answers can be found in Appendix G of the Budget Highlights Book that summarizes the Governor's Budget. But the Budget Highlights Book is not issued until a month after the Committee issues its recommendations.

In the early years of the process, the Committee's Report included a description of how spending affordability was determined and what appropriations were subject to the spending limit. A return to this practice would make the often byzantine spending affordability process more transparent to legislators and citizens alike.

6. ***The Spending Affordability Committee should hold at least one hearing, after preliminary recommendations are made, to allow public testimony.***

Currently, the Spending Affordability Committee holds three public hearings at which the Department of Legislative Services provide information to Committee members and the public. There are no public hearings at which members of the public can comment on the recommendation. The Committee should hold at least one hearing at which the public may testify. To be most useful, this hearing should be provided after preliminary recommendations are made but before final recommendations are adopted by the Committee.

7. Changes to the spending affordability limit adopted by the Spending Affordability Committee in December should only be made during a public meeting after adequate public notice.

At times, the Spending Affordability Committee adopts a recommended spending level only to revise it upward after the Governor submits the State budget. When the Committee has done so, there has generally been little or no public notice of the meeting at which the upward revision will be approved and little or no public discussion as to why an increase is proposed or warranted.

While the spending affordability limit is not binding on either the Governor or the General Assembly, the General Assembly has traditionally held spending increases to the level recommended by the Committee. Thus, if the Governor has submitted a budget that exceeds the recommended limit, increasing the spending limit means that the General Assembly needs to reduce less spending from the Governor's budget in order to ensure compliance with the recommended spending level.

To ensure the integrity and transparency of the spending affordability process, the Committee should be required to hold a public hearing at which the Committee explains the reasons for any revision and allows the public an opportunity to comment. Advance notice of the hearing to the public should also be required.

8. Upward adjustments in revenue by the Board of Revenue Estimates in March should not be used to fund additional appropriations.

The Board of Revenue Estimates issues its report on estimated revenues in December of each year and reviews the recommendation in March. Frequently, the revenue estimates are increased based on trends from December through February. Governors often use these additional revenues to provide for spending not included in the budget submitted in January.

In the early years of the Spending Affordability process, the Committee recommended that "Additional appropriations should not be added to the operating budget as a result of increased revenues, if any, from the March report of the Board of Revenue Estimates. If the March estimates project increased revenues, the additional amounts shall be transferred to the Loan Fund to be used in lieu of previously authorized bonds or transferred to the pension funds to reduce future State contributions."[18] Returning to this practice would be a small step in averting structural deficits.

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[18] Spending Affordability Committee Report to the 1982 General Assembly, p. 1.

9. Budget Conference Committee meetings should be held in a public place and with adequate public notice.

After the budget is passed by each House of the legislature, a Conference Committee consisting of representatives from each House is appointed to resolve the differences between the Senate and House action on the budget. The decisions made by the Conference Committee are in effect the final decisions on the State's $31 billion budget because changes almost never occur on the floor of either House during final consideration of the budget and the Governor has no veto authority over the budget bill once it is enacted.

The meetings of the Conference Committee are held in a room on the second floor of the legislative services building. The meetings are often held with only a few hours notice to legislators and to the Governor's representatives. The meetings are not reflected in the legislative schedule and are not announced to the public, although a few members of the press may be in attendance.

The public should be able to witness these discussions on the final decisions on spending their money. In order to ensure more accountability, the Conference Committee meetings should be held in a public place with adequate public notice. Additionally, the Conference Committee should be restricted from considering any proposals that had not previously been discussed at public hearings.

10. All reports that are submitted by State agencies to the General Assembly should be available in a timely manner on the General Assembly's web site.

Many statutes require regular reports from State agencies to the General Assembly. In addition, each year the budget bill imposes reporting requirements on many State agencies. These reports would be useful to Maryland citizens in assessing programs and the delivery of services by state agencies. Yet, most of these reports are largely unavailable to the public because the public does not know they exist. In fact, no cumulative list of all the reports required to be submitted by State agencies is available to the public.

Since taxpayer funds are used to produce these reports, taxpayers are entitled to know the reports exist and to obtain copies. In light of significant technological advances, there should be no barrier to publication of all of the reports on the Internet.

The availability of these reports to the general public would be a significant step toward assuring transparency in government spending and would enhance accountability of governmental agencies and elected officials.

11. Each State Task Force should be required to identify the source of funding for each recommendation.

Each year, the General Assembly by law and the Governor by Executive Order create many new Task Forces and Commissions. These groups examine a specific issue and make recommendations. The narrow focus of each of these Task Forces and Commissions often results in recommendations that have significant costs, particularly because the members are focused on addressing the specific issue rather than the costs of any proposed solution and how those costs will be funded. The recommendations often result in great expectations among the prospective beneficiaries that cannot be fulfilled without substantial reductions in existing programs or without substantial new revenue.

As with each proposed new law, Task Forces and Commissions should be required to estimate the costs for each recommendation and to specify how the additional spending would be funded. This would assure that both public officials and the public understand how each new recommendation would impact the State's financial condition as well as existing programs.

III. Conclusion

Raising the awareness of elected officials and taxpayers concerning the cumulative costs of new programs and new laws is fundamental to preventing structural budget deficits. Adoption of the foregoing recommendations to reform the state's budget process would enhance such awareness in a way that is likely to instill greater fiscal discipline in the budget process. In turn, such discipline will restore the state's fiscal health so that Maryland's taxpayers will not be called upon to produce ever greater amounts of revenue to fill the state's coffers.