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Curing Maryland's Structural Deficits: A Call for Mandate Reform

by

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In the past six months, the ongoing gap between the revenues collected by Maryland state government and the amount its laws require it to spend has grown appreciably worse. In October, as Free State Foundation Senior Fellow Cecilia Januszkiewicz noted in an FSF *Perspectives* paper, the Department of Legislative Services estimated that these structural deficits will continue until fiscal 2014. At that time, analysts expected ongoing expenses to exceed revenues by almost $1 billion in 2014.[1] In late March, these same General Assembly staff members told the House-Senate conference committee on the budget that these deficits will continue to grow every year, amounting cumulatively to almost $8 billion over the next five years, even when projected revenues from slot machines are included. Yet it is widely acknowledged that video lottery terminals (slots) cannot bring in as much money as originally estimated due to the reduced number of machines bidders have proposed to operate.

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[1] Cecilia Januszkiewicz, "Structural Solutions for Maryland's Structural Deficit: Pathways to Reform," *Perspectives from FSF Scholars,* Vol. 3, No. 20., Free State Foundation, p. 1. December 5, 2008. Department of Legislative Services, *Spending Affordability Briefing*, October 14, 2008, p.32.

Even more telling is a small chart done by legislative staff describing the growth of general fund revenues and spending from fiscal years 2006 to 2012. In those six years, state general fund revenues are projected to have grown about 17% while general fund spending is estimated to have risen 35%.[2] In other words, spending is growing twice as fast as revenues. Moreover, two-thirds of that spending is driven by mandates and entitlements, with that money mostly going to local governments or individuals. When all the general and special fund revenues coming directly from state taxpayers in the current year's budget (FY 2009) are included, 79% ($19.6 billion) is spent on a mandated amount or purpose, such as education, health or transportation.

These figures make clear that there is something seriously wrong with how Maryland budgets and spends, and those problems cannot be fixed without fundamental changes in the mandatory appropriations, funding formulas and entitlements that drive state spending inexorably upward.

This paper will explore how the state got into this fix and will suggest what might be done about it. It builds on the extensive work of Senior Fellow Cecilia Januszkiewicz, who detailed many of these problems in 2008 papers and op-ed pieces and proposed procedural solutions. This paper will take a complementary approach, looking at the operation and policy rationales relating to specific programs in greater detail.

There is no mystery in Annapolis about how structural deficits and the mandates that drive them are perpetuated, though there is some delusion that they will magically disappear when the economy improves. Before Januszkiewicz documented the history last year, the nonpartisan Department of Legislative Services over the last six years has issued numerous reports and studies on the state's budget process, spending mandates and formulas, and briefed the General Assembly leadership and fiscal committees on these regular reports. Yet the budget numbers continue to escalate, new programs are mandated, and new special funds are created.

Appropriators only fiddle with the mandates, funds and formulas to balance the budget in the current year, and make few permanent changes for future years. When the most realistic appropriators put aside wishful thinking about future revenues, they know they must change the underlying structure – and their ingrained spending addictions — before the structural deficits will go away.

I. Handcuffing the Legislature, then the Governor

Since 1918, when the state constitution was changed to correct problems of deficit spending, patronage and what we now call legislative "earmarks," Maryland's governor has had powerful control over what is termed an "executive

[2] Department of Legislative Services, informal Excel sheet, April 4, 2009

budget." Unlike legislatures in most states, the Maryland General Assembly can only cut the governor's proposal, not add to it or move money around in it.

About this, a 2003 DLS study on the budget process observed: "[I]t can be argued that the reformers overcorrected: in their effort to punish the legislative branch for its failure to maintain fiscal order, they at once overestimated the wisdom inherent in the executive function and underestimated the benefits of the legislative process for public decision making. Since 1918, the budgetary process in the State has evolved in ways that restore some measure of balance to the process, but at the price of making some unwholesome fiscal practices into budgetary norms."[3]

Having been handcuffed by the constitution, the lawmakers through negotiation and legislation have been able to handcuff the governor, requiring him to set money aside for a whole series of programs that only the legislature may change in subsequent years. "[A] collateral consequence is a budget structure and process that is more complex, more rigid, and oftentimes less efficient than would be possible if legislative authority could be exercised more directly," the 2003 study said.[4]

The study suggested some other changes in the budget process, such as giving the legislature more time to work on the budget. But little happened once the 2002 election produced new leadership in the House of Delegates and a new Republican governor. Faced with an executive from the minority party, the Democratic legislature did not reduce the mandated spending programs, but even added more restrictions in budget language (so-called "fencing"), spelling out the specific purposes for which money could be spent.

With a new Democratic governor, a November 2007 special session of the Assembly raised an estimated $1.3 billion in sales, cigarette, income and corporate taxes. The legislature ordered its fiscal staff to look at the budget process especially in comparison to other states. That 2008 study summarized the much more extensive 2003 work, and closed with a single paragraph that suggested "the time may be ripe" to modify the budget process, giving "the legislature greater authority to reallocate funds while reducing its authority to mandate future funding."[5] Because of the dire revenue projections that came out the following month, there was little momentum to change the process this year.

More significantly, the 2008 DLS study on the budget process did summarize the benefits and problems with the mandates, entitlements and special funds. Among the advantages of mandates and entitlements are that they give the legislature more power, protect priority programs during bad fiscal

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[3] Department of Legislative Services, *Assessment of the Maryland Budget Process*, 2003, p. 31. [Link http://dlslibrary.state.md.us/publications/OPA/I/AMBP_2003.pdf]

[4] ibid., p. 33

[5] Department of Legislative Services, *Maryland's Budget Structure and Process*, November 2008, p. 15. [Link http://mlis.state.md.us/other/spending_affordability/2008InterimReport.pdf]

times, and deter annual fights over funding for protected agencies or interest groups. Disadvantages include reduced flexibility in dealing with falling revenues, reduced competition for scarce state resources, reduced transparency in how funds are allocated, and the potential to cause structural budget problems.

A brief of survey of other comparable states by staff of the National Conference of State Legislatures found that "other states do not make use of spending mandates to the extent Maryland does because of their greater flexibility in making appropriations."[6]

It is important to note that mandates and entitlements are not the only things driving budget growth and deficits. There is also spending largely authored by the governor to create or expand programs without identifying a funding source. In this year's budget as passed, mandated spending went up about 3%, while the smaller portion of the budget that was not mandated went up 9%, but that rise was reduced by mid-year budget cuts.[7] Among the non-mandated programs were funding for stem cell research, biotechnology research and other bioscience initiatives, and money to support a continuing freeze on state college tuitions.

II. Examining Specific Spending Mandates

In the $13.8 billion general fund budget, where the components of the structural deficit are primarily found, mandates and entitlements consume about two-thirds of the money. More than half the mandates are for local aid, primarily education, libraries and community colleges, and another third for entitlements, primarily Medicaid, the health insurance for low income and disabled people.[8] In October 2007, a DLS report identified 128 different funding mandates or entitlements – including 45 to fund education, 20 for health care and 10 in transportation.[9]

1. Public School Aid and Medical Assistance

The poster child for the advantages and disadvantages of mandatory appropriations is the Thornton education aid, also known as the Bridge to Excellence program, passed with bipartisan majorities in the 2002 election year without a dedicated funding source. Until slots revenue kicks in a few years, it still has no dedicated funding source, but continues to have widespread support.

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[6] ibid., p. 7

[7] Department of Legislative Services, *Mandated Appropriations in the Maryland State Budget*, September 2008, [Link http://mlis.state.md.us/2008RS/misc/MandatesInBudget.pdf]

[8] DLS, Maryland's Budget Structure and Process, op. cit., p. 5

[9] Department of Legislative Services, *Fiscal 2008 Mandates and Entitlements*, October 2007. [Link http://mlis.state.md.us/Other/Fiscal_Briefings_and_Reports/102607_Mandated_Appropriations_and_Entitlements.pdf]

Education aid is the mandate of all mandates in Maryland because public schools are the only program in the state budget that the constitution says the state must create and fund. It says the General Assembly "shall by Law establish throughout the state a thorough and efficient System of Free Public Schools; and shall provide by taxation, or otherwise, for their maintenance." On top of that, the "School Fund shall be inviolate and appropriated only to the purposes of education."[10] The requirement to fund at some level could not be more clear. Yet the level of state funding required for the state to comply with the constitutional mandate is obviously much less clear, and by its very nature subject to considerable leeway.

Over the decades, the funding level was the subject of several lawsuits by Baltimore City, claiming the state was not living up to its funding obligations. A judge agreed that the city was being shortchanged, and in 1999, in order to avoid more such suits, the legislature created a commission chaired by Alvin Thornton, head of the political science department at Howard University. It also included the chief fiscal leaders of the legislature. The commission hired consultants to determine the basic cost of education in Maryland schools and completed it work in 2002. It recommended a broad $1.3 billion increase in education funding to local school systems over the next six years and said the money should be in the form of block grants that replaced a number of narrower school aid programs that required funds to be spent in specific ways. Since 2002, the state increased its spending on K-12 education by more than $2 billion a year, and for fiscal 2010 the total state funding for all school programs stands at $5.5 billion. Local school systems have increased their own spending by $1.3 billion in that period.

A three-year study by an outside consultant determined that more than half the increased spending (52.8%) was spent on increased salaries and benefits for teachers, and concluded that the spending did improve student performance and reduce the gaps in that performance between rich schools and poor.[11] Following the release of that three-volume consultant's report in December 2008, Education Week issued its own report card on the states, and for the first time Maryland ranked #1 in the country. (It should be noted that the publication gave Maryland only a grade of B with a score of 84.7, edging out Massachusetts by one-tenth of a point. Despite the teacher raises, Maryland rated only a C- under Education Week's teaching profession category because of its lack of teacher accountability standards and lack of incentives for targeted schools.)

Maryland public schools enroll 843,000 students — 15% of the state population. Thornton aid was already popular with local school boards, teachers and their unions. Armed with these external validations of its success by the consultant and the education journal, the governor and politicians at all levels tout the merits of Thornton aid. While other mandated funding has been cut for

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[10] Maryland Constitution, Article VIII, §1, 3.

[11] MGT of America, *An Evaluation of the Effect of Increased State Aid to Local School Systems Through the Bridge to Excellence Act*, December 2008. [Link http://docushare.msde.state.md.us/docushare/dsweb/View/Collection-18046]

the fiscal 2010 budget, the Bridge to Excellence is fully funded. But that amount is frozen for fiscal 2011 – a good first step in getting it under control. Its inflation adjuster had already been permanently reduced in 2007, and will be fixed at 1% in 2012.

As the largest single mandated program in the state budget, some appropriators argue that Thornton alone is the largest single cause of structural deficits, which are about the same size as the Thornton aid. The increased spending on salaries by local school boards, over whose contracts the state has no control, also drives up the cost of teacher pensions, where the state had long paid the entire contribution to the pension system, a topic we'll revisit shortly.

Medical assistance for the poor and disabled is the single biggest entitlement program in the state budget, $2.5 billion. Anyone who qualifies by income or disability may receive benefits, and more than 15% of the Maryland population is enrolled. The number of enrollees began rising last year, as the state relaxed the income levels to qualify to 116% of the federal poverty level ($10,400 for a single person, $21,200 for a family of four), using a doubling of the cigarette tax to pay for it. Maryland was already more generous than most states in enrolling infants, children and pregnant women. Further expansions are envisioned over the next four years, but the cost of these programs are masked by a temporary increase in the federal matching contribution under the stimulus program.

2. Other Mandates and Formulas

The range of mandates is illustrated by the fact that the final version of the fiscal 2009 and 2010 budgets have over 30 items of "mandate relief" that are contained in the Budget Reconciliation and Financing Act (BRFA — pronounced *birfa*). Without that 58-page bill, introduced by Gov. Martin O'Malley and heavily amended by legislators, it would be impossible to balance the budget each year. For instance, for fiscal 2010, it changes the per-capita funding for county and regional library aid. It alters the Cade Formula for Community Colleges and reduces the amount of Sellinger Aid to Private Colleges and Universities. Both these college programs are tied to the amount of funding per student at public universities.

There are formulas as well for the Maryland State Arts Council, which absorbs a $3 million cut and will only get to distribute $13.5 million to local arts councils, symphonies and theaters next year. The program for prevention and cessation of tobacco is gutted, losing two-thirds of its $21 million. Other changed mandates reduce funding to house long-term inmates at local jails; this coming year, mandates for increments (step increases) and merit pay for state employees are out the door, as is their deferred compensation match. Rates for group homes and nonpublic special education placements are reduced, and there are many transfers of special funds into the general fund.

There has been a recent trend in the news media to refer to the General Fund Budget as "the operating budget" or simply as "the budget." But this $13.8 billion "general fund" budget is less than half of the $32.3 billion Maryland government is planning to spend in FY 2010. Average taxpayers likely do not much care which pocket of which pants the money is coming from. It might strike them as strange that this alleged "operating budget" does not include the money spent on highways or mass transit because they are paid for with "special funds," such as the gasoline tax, the vehicle titling tax and registration and license fees. It also does not include federal matching funds for Medicaid, which make up about half the medical assistance budget, more with an influx of stimulus federal dollars.

3. Special or Dedicated Funds

The existence of "special" or "dedicated" funds is another way legislators have tried to permanently direct how money is spent. Frequently a certain kind of tax or fee associated with a program is "dedicated" to fund the program. In the fiscal 2009 budget, there are 361 special funds, and 119 of them, amounting to $1.1 billion did not exist 10 years ago.[12] These newer funds include the Cigarette Restitution Fund ($171 million); the Chesapeake Bay Restoration Fund ($96 million funded by the "flush tax" on sewer and septic users); the Higher Education Investment Fund ($54 million from the corporate income tax); and the Chesapeake Bay 2010 Trust Fund (funded at the 2007 special session with gas and car rental taxes).

In tough times, as we're experiencing now and as we do about every five years, the "special funds" turn out to be not so special and subject to raiding by the governor or the legislature to shore up the structural deficit in the General Fund. To do this, the legislature must change mandated uses in the BRFA, something the governor cannot do on his own. Over $1 billion from 29 special funds are thrown into the General Fund to balance the budget for this year and next. These include $162 million in local highway user revenues in fiscal 2010 generated by the various "special fund" transportation taxes that counties will not receive to help them build and maintain local roads.

Legislators are again taking Program Open Space money that is generated by the real estate transfer tax – an ideal example of a program that was passed with a dedicated funding source in 1969. O'Malley said he would only use Open Space money for purchasing or developing parks and recreation projects, and not raid it to balance the budget as his predecessor had done. The legislature had other things in mind, and POS represents a $180 million pot of money in the budget for this year and next, but $140 million will be replaced with bond funding, replacing dedicated cash with future debt – hardly a prudent practice.

Cecilia Januszkiewicz has repeatedly recommended that "mandated appropriations laws should be required to identify a revenue source" to support

[12] *Maryland's Budget Structure and Process*, op. cit., p. 7

the program and grow.[13] But such safeguards mean little when the legislature can redirect "dedicated" revenues to other purposes. Yet, it is hard to imagine restricting the legislature's authority to do so, though requiring they be passed with super majorities might prevent some of the moves.

4. Pension and Health Benefits

Pensions and other post-employment benefits (OPEB, largely health insurance) are just another form of mandated entitlements. Unlike other entitlements and mandates, they also represent ongoing liabilities to the state that must be funded in advance, according to rules set down by the national Governmental Accounting Standards Board (GASB). In addition, unlike the salaries paid to state employees and teachers, or reimbursement of providers giving health care to Medicaid recipients, pensions and OPEB do not provide direct services to citizens. Teacher and public employee unions argue that defined-benefit pensions attract teachers and state workers to their jobs and help retain some of them, but they have become increasingly rare in the private sector. Maryland pensions are available to anyone with 30 years service, regardless of age.

The cost of these pensions and health benefits are escalating faster than the rest of the state budget, especially after an unfunded enhancement in benefits made by the legislature and signed by a Republican governor in the 2006 election year. To make matters worse, while all retirement funds have suffered significant losses in the past year, investment losses by Maryland's system "are larger than the majority of peer pension plans of similar asset size," a recent legislative analysis said.[14] Even before the significant losses in the last eight months, for the first time in five years, the system failed to reach its targeted rate of return at 7.75% in fiscal 2008.

The gross numbers are staggering, though we've become numbed to huge stock market losses recently. In October 2007, the assets in the state retirement system reached an all-time high of $40.9 billion. Eight months later, in June 2008, the assets were down to $36.6 billion, and seven months after that, at the end of January this year, they were estimated at $26.3 billion, a 35% decline in 15 months.[15] This is particularly harmful to a system where payouts are based not on investment performance, but on promised benefits based on life-time earnings. The funds in the pension system are now below 80% of future liabilities, the level considered a responsible funding of a defined-benefit program.

The situation has been made even worse by two other events. An actuarial accounting error last year miscalculated the state's pension contribution by $87.6

[13] CJ, Structural Solutions, v. 3, n. 20, 2008, p.12.
[14] Department of Legislative Services, *State Retirement Agency Analysis*, p.3 [Link http://mlis.state.md.us/2009RS/budget_docs/All/Operating/G20J01_-_State_Retirement_Agency.pdf]
[15] ibid., p. 17

million this year, an amount that will now be amortized with interest over the next 25 years. The hole grew even deeper following the legislature's enhancement of retirement benefits in 2006 – a year with both a flush budget and an election. In FY 2006, the state's contribution to the pension fund for its active and retired employees was $275 million. For the coming fiscal year, that has jumped nearly 80% to $495 million.

The increases are even more dramatic for teachers and librarians – pension benefits for local employees totally paid by the state. There are now more teachers than state employees covered under the state plan, and the teachers make 21% more per year in average salary ($56,607 compared to $46,465). For teachers already retired, their retirement benefits are 63% higher than state workers ($16,632 compared to $10,188), further driving up required pension contributions.[16] In fiscal 2006, the state contributed $415 million to the pensions of local school and library employees. In fiscal 2010, that contribution is $774 million, an 86% hike in four years, and $140 million more than the current year (up 22%).

All this money comes out of the general fund, representing another unfunded mandate directly tied to education that continues to drive the structural deficit.

The story is even worse on OPEB. Currently, the state funds retiree benefits – but only for its own, not county employees — on a pay-as-you-go basis, about $314 million per year. But GASB says states and localities must now advance fund these liabilities. In Maryland's case, those liabilities are estimated to be $15.2 billion, requiring a total annual contribution of $1.2 billion, about $900 million more than the state is now putting in. When times looked fairly good last year, Governor O'Malley put $210 million in the fiscal 2009 budget for the OPEB trust fund. The legislature cut that in half, and then, as part of cost containment measures to balance this year's budget in October, the Board of Public Works cut the remaining $46 million that hadn't already been put in the OPEB trust fund. In this year's budget, there is no contribution to OPEB at all. Last October, the trust fund held $148 million, less than 1% of its future liabilities.[17] "We've given up on OPEB," said the legislature's chief fiscal analyst, Warren Deschenaux.[18] GASB has no authority to enforce its standards, but failing to fund OPEB could affect the state's almost sacrosanct AAA bond rating. However, the three rating agencies are giving states and municipalities several years to come up with a plan for funding the liabilities.

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[16] ibid., Appendix 7, p. 30
[17] Blue Ribbon Commission to Study Retiree Health Care Funding Options, *2008 Interim Report*, December 2008., link [http://dlslibrary.state.md.us/publications/OPA/TF/BRCSRHCFO_2008.pdf]Cecelia Januszkiewiz complained about the lack of availability of these reports in March 2008 op-ed [Link http://freestatefoundation.org/images/Dealing_With_Health_Care_Costs.pdf], but they are now online. Her comments about the lack of action and the year delay in the commission final report still stand.
[18] Interview, March 13, 2009.

A DLS study for the OPEB commission compared Maryland's health insurance benefits with those of nine other states that also hold AAA bond ratings. "Maryland offers among the most generous package of health benefits to its retirees compared to the benefits offered" by the other states, DLS found. "Maryland offers the shortest vesting period, the lowest prescription drug co-payments, the second most plan options, and the second highest premium subsidy. As a result, Maryland has the highest retiree health liability per covered retiree and spouse among these 10 states."[19]

The commission also heard from a consultant comparing retirement benefits in large private sector companies. Only about a third now offer health benefits, compared to 90% of state governments, and half of the private sector employers cap their share of the cost of these benefits.

Clearly, the liabilities of health insurance benefits for Maryland retirees is another unfunded entitlement that helps drive the state's structural deficit in the general fund – especially if they were being advanced funded, as GASB requires.

IV. What to Do: Recommendations For Action

In the final days of the hectic 2007 special session that raised taxes and created new mandates and entitlements, there was a little noticed hearing in the House Appropriations Committee with a DLS presentation called "Considering Mandate Reform."[20] Together with the work by FSF Senior Fellow Januszkiewicz, it suggested a number of steps that must be taken to get the structural deficit under control, as politically unpalatable as they may be for many. Underlying these recommendations is the presumption that there will no tax increases through 2010, and there may not be the political will to raise taxes after that, even though some conservative legislators say the current course of the structural deficits makes further tax hikes inevitable.

In March, the Senate president and House speaker announced their intention to set up a work group of key legislators to address these funding formulas after this year's General Assembly session is over. The group has yet to be named, but here are actions they should consider.

► Require that new programs cannot be enacted without an identified funding source, such as a cut in a mandated spending program or a new tax – preferably the cut. This has largely happened in this budget cycle out of pure necessity and because of a commitment by the House leadership to review every single piece of legislation that would cost additional money. However, bad habits persist.

[19] Blue Ribbon Commission, *2008 Interim Report*, pp. 4-5.
[20] Department of Legislative Services, *Considering Mandate Reform*, Nov. 2, 2007, [Link: http://mlis.state.md.us/Other/Fiscal_Briefings_and_Reports/110207_Considering_Mandate_Reform.pdf]

For instance, the Commission to Develop the Maryland Model for Funding Higher Education in December 2008 did not develop a model for paying for colleges and universities; it came up with ways to spend as much as $700 million per year more on them without identifying a new funding source.[21] Yet, budget language added by the Senate says the legislature intends to adopt the recommendations of the commission "when fiscally prudent to do so."[22]

►Enact no new mandatory appropriations or entitlements, and include a sunset provision in all mandates so that they can be periodically reviewed before they are reauthorized. This especially applies to Medicaid. The need for health insurance is great, but the state is simply unequipped to continue to expand coverage the way it did in 2007.

►Implement a firm cap in Thornton education aid at current levels. Legislators on the budget conference committee actually did that for key elements of Thornton aid, but only for the out-year of fiscal 2011. For the coming year's budget, they raised K-12 education funding $131 million, an increase of 2.5%, and restored its inflation adjustment in 2012. This year's funding was only possible because of federal stimulus dollars for education.

►Closely examine all existing mandates other than Thornton. Repeal any with an absolute dollar amount. Remove or defer automatic increases, as legislators have done for some of the smaller mandates in this year's budget. While legislators have cut the inflation adjusters for numerous mandates in fiscal 2010, many of these have been restored in future budget years, in the hopes of improved revenue numbers. According to DLS, there is no reason to believe the revenue picture will improve substantially to overcome the structural deficit driven by the mandates and entitlements.

►Review interdependent formulas, such as the various forms of higher education aid, to insure that the intended policy objectives are being met. For instance, community colleges are permanently relegated to get a lower subsidy than four-year institutions, but some economic studies suggest that spending on community colleges produces a greater return on investment. The membership of the commission to study higher education funding was heavily weighted to favor universities and research institutions, and they will get the bulk of the new aid under the proposed spending model.

►Create a new system of reduced pension benefits for state employees and teachers so that new workers receive reduced benefits, contribute more to their pensions and/or wait longer for benefits.

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[21] Commission to Develop the Maryland Model for Funding Higher Education, *Final Report*, December 2008.

[22] Maryland General Assembly, *Report of the Conference Committee on the Budget*, April 11, 2009, p. 24

►Freeze the state contribution to pensions for teachers and librarians at the current levels. This will increase costs for local jurisdictions, but it will also discourage them from increasing the salaries that drive up pension contributions.

► The Blue Ribbon Commission on retiree health benefits (OPEB) needs to take some of the actions recommended by DLS analysts in January: raising health insurance costs to current workers and retirees by increasing the premiums and co-pays; and reducing the benefits or some combination of these steps.

Some of these moves, particularly on pensions and OPEB, may only slow the growth of the structural deficit. But without them, the notion of a "balanced" Maryland budget will continue to be a shell game featuring fund raids and short term fixes, with no permanent structural solution in sight.