



Analysis of state policy choices with particular attention to their impacts on low- and moderate-income Marylanders

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In this issue

- **Legislative Preview** - *See page 2*

Just When You Thought It Was Safe To Go Back To The Budget...

...Balancing the budget will require \$550 million of cuts. Reduced revenue numbers from the official estimating board and a tight Spending Affordability recommendation from the legislature, along with Senators' and Delegates' "fiscal fatigue" after the special session, will limit flexibility in the budget.

- **5 Surprising Facts About Maryland's Budget** - *See page 7*
- **State Scope – 24 States face Shortfalls – California Declares State of Emergency** - *See page 8*
- **Director's Corner** - *See page 10*

Legislative Preview

Just When You Thought It Was Safe to Go Back to the Budget...

The Maryland General Assembly convenes on January 9th for its annual 90-day legislative session. The 188 Senators and Delegates will be retuning to Annapolis just eight weeks after concluding their special session on the budget. The 2008 session will complete action on the budget and consider substantive legislation.

Fiscal Fatigue and the 550-million-dollar Question

The three-week special session in October and November required legislators to make stressful decisions on tax changes, spending cuts and gambling. They will be gun-shy about revisiting fiscal issues. But they will have to.

Enacting a budget for the state is the one task the General Assembly is required to complete each year. The action of the special session required \$550 million in budget cuts. Only \$349 million are specified in the legislation. The Governor must identify the remaining \$200 million when he submits his proposed budget on January 16. If he is going to fund the “Geographic Cost of Education Index,” as expected another \$38 million will need to be cut to offset that cost.

The reductions specified in special session legislation come mostly at the expense of local school funding.

Reductions Specified in Special Session Legislation	\$ millions
Reduce growth in “Thornton” school funding	192
Use fund balance for employee health insurance	77
Eliminate electric property tax grants	31
Use Open Space funds for park operations	17
Use special fund for court technology	11
Use sales tax funds for Med-Evac helicopters	11
Eliminate 500 vacant state positions	10
TOTAL	349

So, Where Will The Remaining Cuts Fall? The past few months have given us some clues. There have been four potential sets of budget cuts made public in the past few months. In June, the Department of Legislative Services published “Balancing the Budget without New Revenues,” known around Annapolis as “The Doomsday Budget.”¹ It provided a \$1.4 billion menu of budget cuts. In October, Governor O’Malley released his “Cost of Delay Budget Reductions” totaling \$1.7 billion. During the special session, DLS refined its list and presented a menu of \$800 million in reductions to the House Appropriations Committee. The House ultimately approved about \$460 million of this list before many of the specific cuts were eliminated in the State Senate.

These lists represent the best thinking of executive branch and legislative branch budget analysts. Most likely, they contain the reductions which will ultimately be worked into the Governor’s budget proposal. As you would expect, the four lists overlap considerably.

On the table?
Potential Budget reductions Suggested by DLS, Governor and House of Delegates
June – November, 2007 (\$ millions)
Net of Special Session Actions

Item	Doomsday DLS 27-Jun	Cost of Delay Governor 23-Oct	Potential Reductions DLS 1-Nov	House Action House 6-Nov
Teachers Retirement	324	63	30	
Medicaid Provider Rates	28	240	32	36
Retirees Health Liability	150	100		
Open Space To General Fund		141		
Employee Lay-Offs		137		
Public Higher Education	55	119	38	3
Private Higher Education	64	16	6	6
Employee COLA	62	62	62	
Special Education		50		
Community Provider Rates	16		47	
Local Police Aid	44	7		
Local Disparity Grants		42		
DDA Community Services		40		
Geographic Cost Of Education	20	38	20	
Employee Pay Steps		36		
Local Funding For Property Assessment		35		
Retirees Rx Coverage	34	34		
Non-Medicaid Mental Health Services		30		
Community College Grants	10	28	7	7
Foster Care		24		
Addiction Treatment		22		1
Mental Health "Grey Area" Services	10	20		
Medicaid Premium	19			
Medicaid Hospital Day Limits			19	
Community College Retirement	18			
Arts Council		16	1	1
Heritage Tax Credit	15	13	10	10
Medicaid Mental Health - Cover Under MCO's			13	3
W.P. Carter Center (Mental Health)	13		13	
Stem Cell Research	8	13	8	3
System Reform/Children's Cabinet Fund	12	5		
Aging Schools	11		0.3	0.3
Scholarships		11		
Medicaid Prescription Carve-Out	10		9	
Public Safety Communication System	10			3
Nursing Home Cost Shift	10			
Employee Deferred Comp		10		
Subtotal	943	1,351	313	72
Others	137	76	88	54
Total*	1,080	1,426	401	126

*Totals are less than the original proposals because actions taken at the special session have been netted out.

The Maryland Budget and Tax Policy Institute has tabulated the proposals on each of these lists, set aside the items actually included in the special session legislation, and sorted the remaining items into six categories. This gives us a listing of potential budget actions that remain “on the table” for consideration. The larger items on list are shown on the table on page 3. The totals are less than the original amounts, because the actions already taken at the special session have been netted out. Excluding duplications, these options total over \$2.1 billion. So the Governor will need to select only a portion of the list to get to his \$238 million.

The budget cuts will have significant effects in health care, higher education, and other human services.

Local Government and Schools The largest category relates to local government, with the state payments for teachers retirement leading the list. Governor O’Malley has indicated he intends to avoid further cuts affecting local governments beyond those legislated in the special session. So, these options may be off the table.

Medicaid and Human Services Human services are the second largest category. Many of these proposals affect Medicaid. For example, proposals involve reducing provider

rates (or failing to increase them to cover inflation), re-engineering pharmacy and mental health benefits, and instituting premiums. Of course, the state just committed to expand Medicaid to cover 100,000 un-insured Marylanders. It seems odd to expand Medicaid in the special session and then cut it in the regular session.

Other possibilities in the human services area include reductions in rates paid to service providers by the departments of Human Resources, Education, Health and Mental Hygiene and Juvenile Services; reductions in addiction treatment or mental health services; or the closure of residential institutions.

Employee Compensation and Benefits The next largest category of proposed cuts affects state employees and retirees. Proposals include across-the-board lay-offs, reduction or elimination of an employee cost-of-living adjustment, the elimination of regular pay steps for the year, reducing the payments for future retiree health insurance, and the elimination of prescription drug coverage for retirees eligible for Medicare prescription benefits.

Higher Education Fourth largest is higher education, with items on the menu affecting the University of Maryland, the state’s other public colleges and universities, private higher education, and scholarship aid.

Other A category for “other” includes a list from arts and museum funding, stem cell research, and lottery agent commissions. Business development and environmental programs are also prominent on this list.

Fund Transfers Finally, there is the possibility of transferring amounts from dedicated funds, such as Program Open Space, into the General Fund.

Many of the more likely possibilities involve forgoing inflationary increases or planned expansions of services, rather than outright cuts from current service levels. Others might involve saving

general funds by funding certain programs from other sources – for example using state bonds to fund housing and business development programs. Even so, it seems clear that it will be difficult-to-impossible to add to the baseline budget.

Revenue - \$100 million lower per year

In December, the Board of Revenue Estimates issued the official revenue estimates for the upcoming budget. The Board consists of the Comptroller, the Treasurer and the Secretary of Budget and Management, and it is supported by a small professional staff, economists and financial professionals in various state agencies, and an Economic Advisory Panel of volunteer private-sector experts. In Maryland we have a tradition of professional and fair-minded revenue estimating. If there is any bias, it is towards more conservative (i.e. safer) estimates. Unlike some states, Maryland has not had a problem with political manipulation of the revenue estimates.

Maryland relies on income and sales taxes for most of its revenue. Since these sources are quite sensitive to economic conditions, forecasts of the national and state economies are central to projecting revenues. The Board projects a slowing economy in 2008, followed by renewed growth. They are not projecting an actual recession. They identify the possibility of a downward spiral in the housing market as the most significant risk to the economy (and, therefore, the state's revenues).

The Board estimated revenue increases of 5.3% for the current year and 8.1% for the upcoming fiscal year. These estimates include the effects of revenue increases enacted by the special session. Subtracting these legislated increases, baseline growth would have been 2.2% this year and 5% next year.

Although the members of the Board all characterized these estimates as “on track”, they are in fact about \$100 million lower in each year than the estimates used by the legislature during its special session.

The Department of Legislative Services projects that the upcoming budget will be balanced on a knife's edge, with an ending general fund balance of only \$1 million and a reserve fund balance only 6/10 of 1% above the 5% statutory target.

DLS projects shortfalls in the \$230 million to \$260 million range for the next two years before achieving balance in fiscal 2011. Legislative Services' Director of Policy Analysis, Warren Deschenaux, asserts that these deficits “can be managed within the normal budgetary process.”²

Spending Affordability

The Spending Affordability Committee also issued its annual report in December. It recommended that growth in state spending be limited to 4.27% in the upcoming budget. The “Spending Affordability” process may be one of the most complicated and misrepresented aspects of Maryland's budget process. Here are some of the things that make spending affordability confusing:

- **The calculation of growth under spending affordability is unlike any other way of totaling the budget.** Normally, we total all of the spending taking place in a year. Spending

Affordability is concerned with the spending authorized by a particular session of the general assembly. So it will combine the fiscal 2009 budget with deficiency funding for the current year of fiscal 2008, and compare that with the original 2008 budget added to the 2007 deficiency appropriations.

Next, spending affordability focuses on on-going expenses. So it subtracts “PAYGO” funding for things like water treatment, housing, economic development and land acquisition programs, payments to reserve funds, and other large, one-time expenditures.

Spending affordability tries to look at expenditures of state tax revenues and close substitutes for tax revenues, so it includes spending from the state general fund, transportation, higher education and other special funds, but not federal funds and “enterprise” revenues.

It will be difficult-to-impossible to add to the baseline budget.

The committee may include or exclude certain expenditures for policy reasons. For example, spending on deferred maintenance above \$2 million is excluded from the growth calculation in order to encourage the Governor to provide more funds for building upkeep.

The result is that the percent increase calculated for spending affordability purposes can be wildly different from other calculations of budget growth. For example, when the legislature enacted the fiscal 2008 budget last year, the total year-over-year budget growth was 1.9%. The general fund increase was 2.6%. On a spending affordability basis, the increase was 7.5%.³

- **The recommendation is not binding.** The Governor may exceed the spending affordability limit in his proposed budget, and has done so more often than not. He is required to issues a statement as to the reasons for exceeding the recommendation. The limit is not binding on the legislature in enacting the budget, either. However, the legislature’s fiscal leadership generally uses the recommendation as a guide in its budget action. In 20 of the last 23 years the legislature has passed budget under the originally recommended limit.⁴ In 13 of the 23 years, the enacted budget was within \$10 million of the limit, suggesting that the spending affordability recommendation was a deciding factor in setting those budgets.

The 4.27% recommendation is designed to accommodate the initiatives funded by the special session legislation – and no more. With the reduced revenue estimates and two years of projected deficits before achieving balance, this means that spending initiatives other than Medicaid expansion, higher education, transportation, and environment programs will be largely off the table in the upcoming session.

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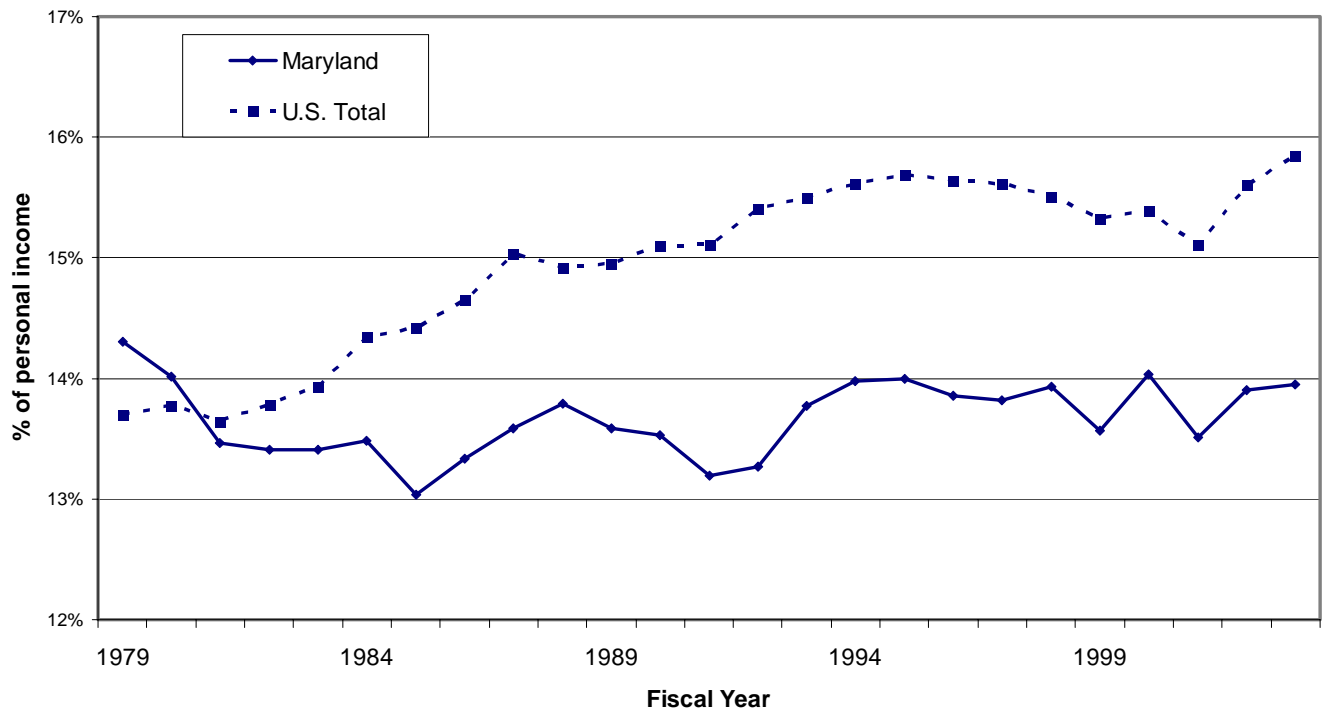
Five Surprising Facts about Maryland's Budget

- 1. Maryland state and local governments revenue, as a percent of the citizens' income, is less than 46 other states.⁵** State and local government own-source revenue (subtracting federal aid) is about 14% of Marylanders' total incomes. The national average is 15.8%. State and local revenues are combined to account for the variation in state's financial systems (for example, in many states the sales tax is an important local revenue, in Maryland it is almost entirely state revenue). 2004-2005 data is the most recent available on a national basis.

Even if we add \$1.5 billion of special-session revenue to Maryland's total, Maryland's percentage only goes up to 14.6% and our ranking among states goes up to 40th.

- 2. Government revenue, as a share of personal income, has grown less in Maryland than in other states.** Nationally, state and local revenue growth has out-paced income growth over the past 25 years. In Maryland, it has roughly kept pace.

Maryland & U.S., "Own Source General Revenue"



- 3. Maryland has fewer state and local government employees than other states.** Maryland has about 5.0 state and local employees for every 100 residents.⁶ The US average is 5.4. 42 states have higher percentages than Maryland's.

Only about 28% of these employees are state employees. Some of the biggest state job categories are prison staff, faculty and staff at the University of Maryland, and transit workers.⁷

- 4. 26 states provide more aid per pupil to local public schools.** On average, states provided \$5164 per pupil to local schools. In the 2005-06 school year Maryland ranked 27th with \$4841.⁸

- 5. 33 states have higher business taxes than Maryland (as a share of the private economy). The biggest tax on business is – by far – the property tax.** A study published by Ernst & Young LLP estimated the tax burden on businesses in each of the 50 states in fiscal year 2006.⁹ Maryland's taxes on businesses amounted to 4.6% of the state economy (gross state product). The national average was 5.1%, and Maryland ranked 34th among states.

Nationally businesses contribute 45% to state and local taxes. In Maryland it's 36%.

Nationally and in Maryland the property tax – primarily a local source of revenue – is the largest tax paid by businesses. The study found that the property tax comprised 37% of state and local taxes paid by businesses.

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State-Scope 24 States Face Shortfalls

State-Scope is a regular feature of Maryland Policy Reports which provides brief reports of interesting budget news from other US states.

The Center for Budget and Policy Priorities reports that at least 13 states need to overcome budget shortfalls in the upcoming year.¹⁰ Another 11 states, including Maryland, have projected budget problems in 2009 or 2010, for a total of 24 states. The projected shortfalls range from under 2% in Maine to potentially double digit figures in Arizona, California, New Jersey and Rhode Island. Analysts from the Center attribute the shortfalls to a combination of a slowing economy – especially in the housing sector – and the present costs of past policy decisions such as tax cuts and spending commitments. The remaining 26 states either have stronger finances, or have not updated their forecasts. See www.cbpp.org for the full report.

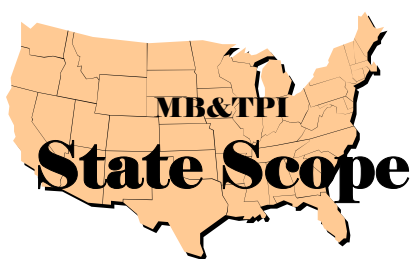
California Emergency

In California, Gov. Schwarzenegger is projecting a \$14 billion budget shortfall.¹¹ That's right: California's shortfall is almost as large as Maryland's whole general fund budget. The action-movie-hero-turned Governor has announced his intention to declare a "state of emergency" over the budget. California's projected shortfall, at 12% of the total budget, is roughly proportional in size to Maryland's.

Assembly leaders are divided whether to address the shortfall through program reductions alone, or by a combination of budget cuts and revenue increases. Program cuts could hit public schools, health care and poverty programs. Revenue increases could include Internet and vehicle taxes.

The emergency declaration is an interesting process. It was created through a voter ballot measure in 2004, and this would be its first road test. The declaration by the Governor, expected in January, would call the legislature into special session and require it to act in 45 days.

Maryland is similar to California in trying to expand health care coverage and improve public education while managing a tight budget situation. California's population is six times Maryland's, and its state budget is seven times Maryland's. California's "fiscal emergency declaration" is a bit different from anything we have in Maryland. Here, the legislature must complete action on the



budget before the end of the regular 90-day legislative session (early April), or else all other legislation is put on hold, and they go into an "extended session" until they complete work on the budget. As a practice, the Maryland legislature has completed its budget work on time, or occasionally within a day or two of the deadline.

This year, the Governor called the Maryland legislature into special session to take early action on revenues for budget-balancing. Constitutionally, the special session could have gone on for up to 30 days. Some officials and commentators in Maryland deemed the special session unnecessary. Some policy experts in California also are arguing that Schwarzenegger's emergency declaration is "just for show" and that precipitous action is not needed.

Maryland, California, and Michigan (which we profiled last month) are three examples of states' struggles to come to terms with the need to finance public services. In state after state, as finances get tight, elected officials face the choice of cutting services or raising revenues. The bulk of all states' budgets are devoted to education, health and public safety. It is almost certain that any significant budget cuts will hit those areas. That's what's happening in California and in Maryland.

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Work at the Institute!

The Maryland Budget and Tax Policy Institute is seeking a policy analyst and outreach specialist. See the announcement at www.marylandpolicy.org. Resumes and cover letters may be sent to Neil Bergsman at MB&TPI by mail or by e-mail to nbergsman@mdnonprofit.org. Help us provide accurate, timely and credible budget and policy information for the community.

Director's Corner

By Neil Bergsman

Happy New Year.

It's my job to complain and to criticize. The Governor and legislature have left me plenty of material for doing that. Keep reading. Overall, however, their efforts in the special session did more good than harm. They went a long way towards restoring balance. They made very serious efforts to spare those with the least means – especially by expanding the Earned Income Tax Credit. They provided a very significant prospect of health coverage for 100,000 uninsured citizens. That was all good work.

In our lead article this month, we point to the possibility of “fiscal fatigue” among Maryland’s lawmakers. Amazingly, some people do not want to spend all their time dealing with taxes and spending. I believe that the 2008 General Assembly session will seek to avoid tax and budget issues, and will be pre-occupied with issues such as mortgage foreclosure, death penalty, marriage, and energy costs – to say nothing of national politics.

I understand all that. At the same time, I see several important dollars-and-cents issues we should be looking at. First of all, we need to scrutinize the \$550 million in cuts that were part of the special session plan. A large number of them will be identified by Governor O’Malley in his proposed budget. It will be almost impossible to avoid cuts to education, health care, and programs that help low-income citizens. They are too big a share of the budget to avoid the knife entirely. We need to try and assure that the reductions are implemented in the least damaging ways possible.

Secondly, we should try to address the impact of the special session taxes on the poorest Marylanders. There is not a lot of maneuvering room financially. If there is an opportunity to provide a refundable credit for to offset sales tax increases for low-income households, or to expand the owners’ and renters’ property tax circuit-breakers for those families, that would be a big help.

Third, the slow-down of Thornton funding for local schools is a big setback. School Boards, superintendents and principals will need to be creative and resourceful to keep up the momentum with fewer dollars than they were led to expect, to say the least.

We may be in for a fairly quiet session on the budget front. If so, the calm exterior will conceal a lot of pressure building on the inside.

* * *

By the way, we went to a one-column format this issue to make it easier for those of you who read our Reports on your screen rather than printing them out. I hope this helps. See ‘ya next month.

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About the Maryland Budget & Tax Policy Institute

The Maryland Budget & Tax Policy Institute is a nonpartisan research organization that provides timely, accurate, and accessible analysis of state budget and tax issues. In addition to general budget and tax research and analysis, the Institute examines issues affecting vulnerable populations and the important community programs that serve them. For additional information on the Institute, to be added to our e-mail list, or to make a tax-deductible donation, please visit our website at www.marylandpolicy.org.

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