



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

# MARYLAND POLICY REPORTS

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# Budget Wrap-Up

## The Return of the Structural Deficit

When the Maryland General Assembly adjourned its special session last November, the members were under the impression they had solved the state's \$1.7 billion "structural deficit." This means that the state government was spending \$1.7 billion more, on an ongoing basis, than the ongoing revenues. Up to that time the difference had been made up by spending down fund balances and transferring money from dedicated funds into the general fund.

Since November, serious weakness in the national economy has become apparent. In addition, the legislature repealed an unpopular sales tax on computer services, and used temporary measures to replace the revenue. In addition, the Governor and legislature's long-term financial plan requires voter approval of slot machines in November.

As a result, there is a prospect of the return of the structural deficit.

### The Result

In its broad outlines, the final budget is not very different from what Governor O'Malley proposed in January. Overall growth is \$1.2 billion, which is only 4%. Increases are concentrated in health (principally Medicaid), K-12 education (about 1/2 the increase it would have received prior to special session formula adjustments) and transportation.

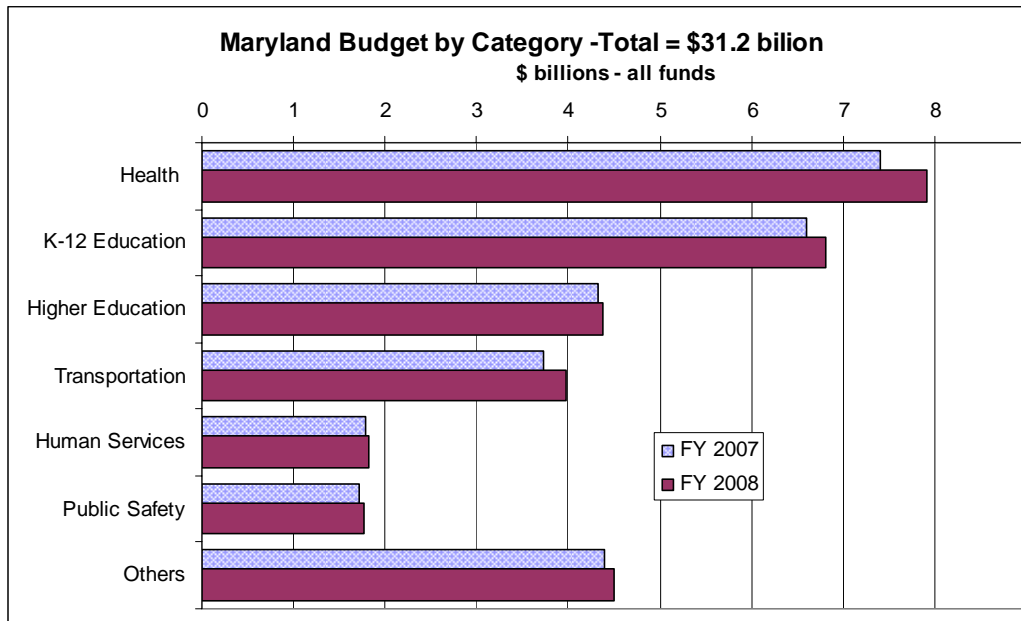
The budget is balanced through June 2009 – although it uses accumulated balances to finance \$351 million in ongoing spending. The Governor and legislature have shrunk a \$1.7 billion structural deficit by four-fifths, but have not eliminated it.

### Governor's Budget Followed Special Session Plan

#### *Projected Modest Deficits in Future Years*

After revenue estimates fell \$100 million per year in December, Governor O'Malley introduced a budget in January which followed the outlines of the plan crafted in the special session. The spending plan included cuts from the projected amounts for local education, Medicaid, other local aid programs, and developmental disability and mental health provider payments. For the most part, these were not outright cuts from current funding levels, but were reductions to the expected growth.

Figure 1



Because of a positive balance projected from the current year, this budget was balanced in fiscal year 2009 in spite of the reduced revenues. However, the budget forecast showed deficits of \$123 and \$140 million in fiscal years 2010 and 2011. (See Figure 2) The legislature's policy analysis director, Warren Deschenaux, characterized these projected shortfalls as within the capacity of the state to manage using regular budgetary practices. The forecast showed the budget returning to balance in 2012, based on the assumption that significant revenues would then be realized from slot machines.

## Soft Economy Knocks Revenue Estimates Down Again

The big hit to the budget came with a revision to the official revenue estimates in March. The Board of Revenue Estimates wrote off a combined \$333 million from the revenue estimates for fiscal years 2008 and 2009. They cited a slow-down in the state and national economies, which were evidenced in reductions in sales tax collections and in lower-than projected estimated tax payments.

## Cutting the Budget

The legislative action on the budget seemed to follow two tracks. The budget committees got to work reviewing the budget to make cuts. The rationale at first was to provide a cushion against further revenue write-downs and projected future shortfalls. Once the revised revenue estimates came out, the cuts were needed principally to offset the write-down.

The legislature cut \$440 million from the Governor's proposed budget.<sup>1</sup> General funds (state funds which the Governor and legislature may use for any purpose) account for \$227 million of this total. Only the general fund cuts help the state's bottom line.

In choosing where to cut, legislators seemed to be trying to avoid immediate harm to public services as much as they could. The largest cuts are detailed in Figure 3.

Figure 2

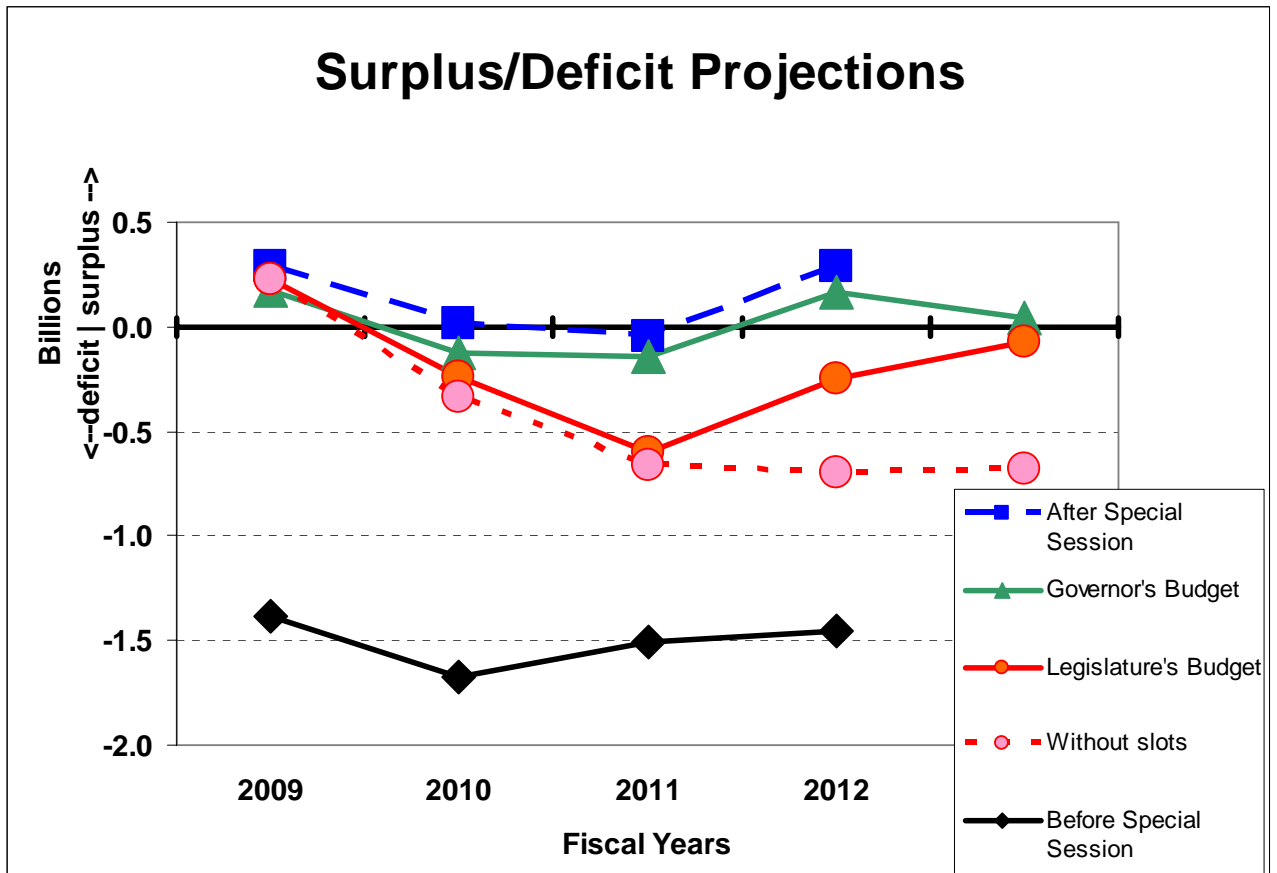


Figure 3

**Legislative Reductions to the Fiscal 2009 Budget  
(\$millions)**

<b>ITEM</b>	<b>General Fund</b>	<b>Other Funds</b>	<b>Total</b>
Retiree health liability	65	35	100
Transportation		60	60
Medicaid	41	20	61
State colleges & universities	42	9	51
Chesapeake Bay Trust Fund		25	25
Small business health insurance		20	20
Medical malpractice insurance subsidies		15	15
Children's services	9		9
Community colleges	8		8
Other judiciary	8		8
Other info. tech.	8		8
Court info. tech.-use special fund	7		7
RICA-Southern Md.	5		5
Housing - use special fund	5		5
Others	29	29	58
	<b>227</b>	<b>213</b>	<b>440</b>

- The largest cut, \$100 million to retiree health liability will result in a miniscule increase in the large problem of financing health care for state employees. This cut means the amount we are putting aside towards this liability next year will be the same as this year's amount. The overall liability, estimated at \$15 billion, is so large that neither the reduced amount nor the original \$200 million would make much of a dent. In separate action, the legislature extended the deadline for a Blue-Ribbon-Commission report on how to handle this liability to 2009.<sup>2</sup>

- The next-largest item cut is dedicated funds available for Department of Transportation operations and projects. The largest share of this cut is related to the legislative staff's lower estimate of the cash-flow needs of transit construction projects.
- \$40 million of the \$61 million cut in Medicaid is based on a different estimate of hospital utilization in fee-for-service programs. It is not supposed to reduce eligibility or the services available. This cut is probably unwise, because medical assistance needs can be expected to increase in a weak economy. Medicaid is an entitlement program. If these costs outstrip the revised estimates, it will be a problem in next year's budget session. The remaining \$21 million reflects the use of special funds for Medicaid expansion and enhanced dental coverage.
- A \$51 million cut to higher education funding will have a real effect on operations, but it preserves a 4% increase in state-support on a per-pupil basis. It will also require some facility improvement projects to be funded by university borrowing rather than state revenues.
- A \$25 million cut in the Chesapeake Bay Trust Fund cuts in half the amount authorized during the November special session for this new environmental program.

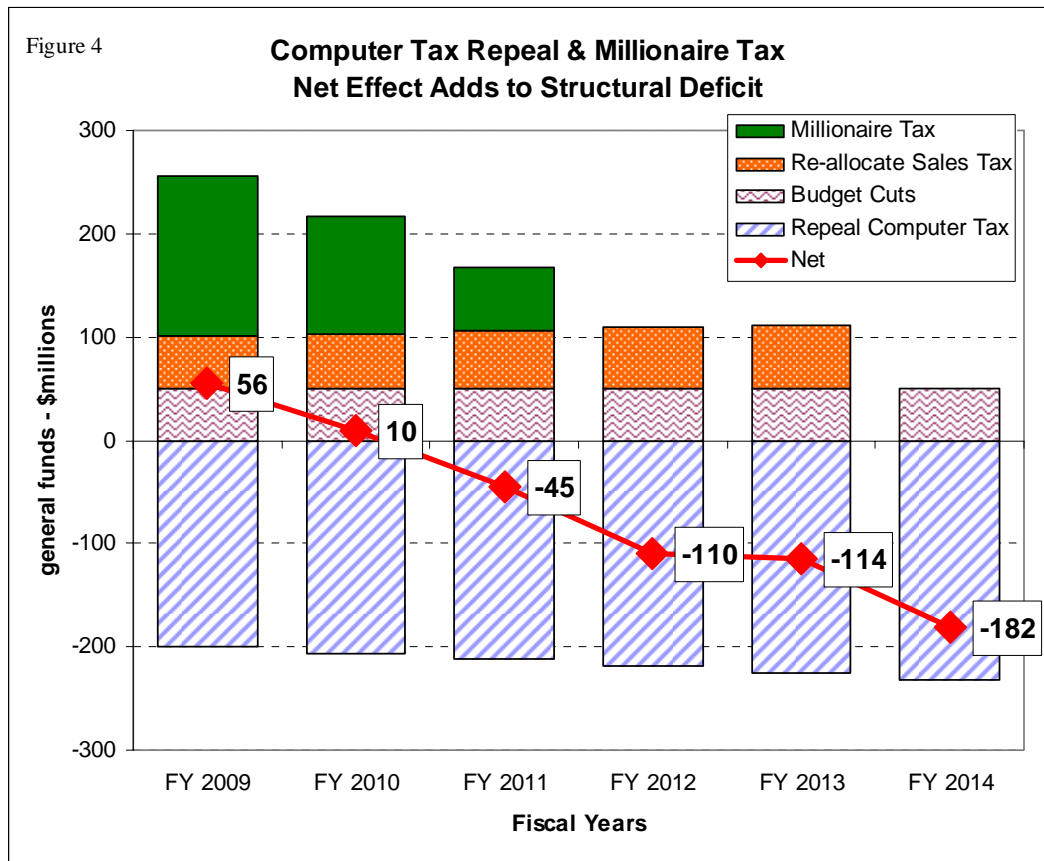
The final budget calls for three state residential institutions to cease operations in fiscal year 2008:

- Rosewood Center, a 225-bed center for developmentally disabled adults in Baltimore County;
- The Regional Institute for Children and Adolescents (RICA) – Southern Maryland, a treatment center in Prince George's County for emotionally disturbed boys treating 29 residents and 65 day patients; and
- The Maryland Youth Residence Center, a 20-bed shelter in Baltimore City that served as an alternative to juvenile detention (the facility was closed in 2007 to make building repairs).

## **Tech Tax Out – Millionaire Tax In**

In the special session of November 2007, the legislature approved an expansion of the sales tax to computer services. This expansion of the sales tax, although supported by the Maryland Budget and Tax Policy Institute, turned out to be enormously unpopular. Opponents' concerns included substantive, procedural and symbolic issues. Opponents held that the tax would put Maryland's information technology sector at a competitive disadvantage, that it was enacted without proper notice, opportunity for public scrutiny, and deliberation, and that it indicated a lack of support by state government for the technology sector. The computer services industry did a highly effective job of organizing

opposition to the tax, and generated massive pressure for repeal.



To repeal the tax, the legislature needed to come up with \$200 million in offsetting budget actions. It approved a proposal to repeal the computer services tax, and replace the revenue with<sup>3</sup>:

- \$100 million from a surtax of 0.75% on taxable income over one million dollars, which would be in effect for three years;
- \$50 million to be re-directed from the transportation fund to the general fund for five years; and
- \$50 million in general budget cuts, to be decided by the Governor by July 1.

The result is the replacement an ongoing revenue source with a series of temporary measures. Figure 4 shows the net effect.

**Millionaire Tax** - The millionaire-tax revenue averages about \$100 million a year for three fiscal years. The timing of the revenue is un-even because of the way tax filing seasons fall into state fiscal years. The state gets 18 months worth of revenue in fiscal year 2009, and only six months worth in fiscal year 2011.

After the end of the three-years, without further legislative action, this revenue source would lapse.

**Sales tax and transportation revenues** - The next provision of the bill gets a little convoluted. In the special session, the legislature wanted to bolster the state's transportation fund, but did not have majority support for increasing traditional transportation revenues, such as the gas tax. Instead, the legislature allocated a \$400 million share of the sales tax to the transportation fund.

When they repealed the computer services tax, the legislature temporarily reduced the share of sales tax directed to the transportation fund by about \$50 million of the \$400 million. Thus the transportation fund still gets a \$350 million annual infusion from the sales tax.

The \$50 million reallocation-of-the-reallocation lasts for five years. Beginning in fiscal year 2014 the amount is added back to the transportation fund.

**\$50 million in budget cuts** - Finally, the legislature called on the Governor to identify another \$50 million in spending cuts to complete the package. He will need to bring the cuts to the state Board of Public Works for approval before July 1. The process for deciding on the cuts is likely to have very little opportunity for public input. The \$50 million target amounts to 3/10 of 1% of all general fund spending, or 8/10 of 1% of "discretionary" state operations (excluding local aid formulas and entitlement programs).

The legislature's financial analysis assumes all of these reductions will continue into the future. Typically, around half of budget reductions are one-time measures which do not reduce expenditure needs in the next year.

The net effect is to add over \$180 million to the state's projected deficit after five years (even accepting the assumption that the \$50 million spending cuts will be ongoing).

## **The Trend: Revenue Woes and Computer Tax Regret Lead to Retrenchment of Special Session Actions**

The changes have been made at the margins. One theme is that many of the initiatives approved in the special session were trimmed or delayed to balance the budget in the regular session. Transportation, environment, and higher education are examples.

In the special session, the legislature also established a plan to expand Medicaid coverage for uninsured adults. This is one area where the legislature did not materially retreat from its special session action. This

seems to signal that health coverage remains a particularly strong priority for the legislative leaders.

## Reasons to be Nervous

The state's budget is now balanced through June 30, 2009. The state's reserve fund contains the 5% cushion recommended by credit analysts (\$737 million) and another \$228 million in reserves and projected general fund balance. This puts Maryland in better shape than the majority of US states.

However, there are plenty of things to be nervous about.

- The budget still spends more than it takes in. The rest is financed by spending down the fund balance. The Department of Legislative Services estimates the “structural deficit” – the gap between ongoing revenues and ongoing spending - is \$351 million.
- If the economy worsens more than estimators have projected, revenues will drop further and expenditure needs for medical assistance, foster care, and other programs for the needy will escalate.
- Even accounting for the fund balance, projections show deficits in the next two fiscal years. Shortfalls are estimated at \$243 million in fiscal 2010 and \$596 million in fiscal 2011. The conventional wisdom around Annapolis is that more revenue measures are not likely to gain any legislative support. The expectation is that budgets will be balanced by spending cuts.
- After 2011, the state's financial plan depends on revenue from slot machines. If the voters defeat slot machines at referendum in November, the projected deficit remains in the range of \$600 million annually.

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**Impact on the typical millionaire**

The surtax on incomes over \$1 million affects an estimated 6,300 taxpayers. The new income tax rate increases the tax payments of the "typical millionaire" by just 3/10 of 1%. Although the top rate increases by 3/4%, the overall effect is much less for three reasons.

1. High-income taxpayers generally have a lot of exemptions and deductions: property tax, mortgage interest, business expenses and charitable contributions, for example. These are taken off your income before you even start applying any tax rates. On average, the taxpayers in the million-dollar bracket have about \$200,000 in exemptions and deductions.
2. The new tax rate (like all income tax rates) is a "marginal" rate. It only applies to income earned above \$1 million. The taxes on your first \$1 million of taxable income don't change at all. For every \$100 you earn over and above the \$1 million threshold, your state taxes go up 75 cents. So, for the taxpayer who just barely clears a million dollars, the "millionaire's tax" has no effect at all.
3. You can probably deduct your state tax on your federal return. If you are in the 33% federal tax bracket, so your federal taxes will go down about 1/3 of the amount that your state taxes go up.

**Maryland State Tax Calculation**

Gross Income	\$3,100,000	no change
Exemptions & deductions	\$200,000	no change
Taxable Income	<u>\$2,900,000</u>	
Tax on first \$1 million	\$52,572.50	no change
Tax on income over \$1 million	<del>\$104,500.00</del>	\$118,750.00
TOTAL	<del>\$157,072.50</del>	\$171,322.50
Increased Maryland Tax		\$14,250.00
Reduced federal tax (because state tax is deductible)		<u>-\$4,702.50</u>
Net Increase		\$9,547.50
 % of income		<u>3/10 of 1%</u>

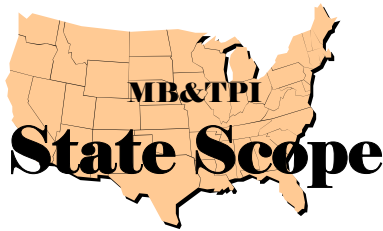
According to legislative fiscal staff, the average taxpayer in the million-plus bracket makes \$3.1 million in gross income (technically "Maryland Adjusted Gross Income"). This "typical" millionaire will pay about \$10,000 in additional tax: an extra 3/10 of 1% of income.

# StateScope

## Council of State Legislatures Survey: 23 States' Budgets in the Soup

The National Conference of State Legislatures recently released its latest State Budget Update.<sup>4</sup> Based on reports from legislative fiscal directors in April, it found 16 states with shortfalls in the current year and 23 projecting fiscal year 2009 shortfalls. The projected shortfalls total over \$11 billion in the current year and \$26 billion for 2009. NCSL Fiscal Affairs Director Corina Eckl stated that the total will be closer to \$28 billion when anticipated shortfalls are added from Illinois and other states which did not initially report numbers.

Eckl found that in most states “Revenue growth has fallen way below what states had anticipated .... It’s declining much more rapidly and dramatically than what they had expected.”<sup>5</sup> The study finds the biggest problems in states that have been hit



hardest by the collapse of the real estate bubble (California, Florida, Nevada and Arizona, for example) and in New York where the financial services industry is such a major share of the economy.

Legislatures in at least 16 states are looking at spending cuts, at least six are tapping rainy Day Funds, and at least eight considering tax increases, with the cigarette tax under consideration in a number of them.<sup>6</sup>

Energy-producing states, such as Louisiana, North Dakota, and Alaska are doing well. Alaska sports an \$8 billion surplus – nearly twice its general fund amount.

Eckl made the point that many states are using reserves and can manage through 2009. Her real concern is that if the nation experiences a severe and prolonged recession, the 2010 budgets will be much worse.

### Florida – Ain’t No Sunshine

Florida is one of the states hit hardest by the mortgage crisis. According to Eckl, Florida faces an “unprecedented” 3-year decline in revenues. The Florida legislature cut \$1 billion in a special session in October, only to have revenue estimates fall further.<sup>7</sup>

The Florida legislature recently wrapped up its budget work for fiscal 2009.<sup>8</sup> Budgeteers omitted funding for Everglades restoration. State funding for schools will not keep up with enrollment increases. Reimbursement rates for nursing homes are in for a \$164 million cut. University and community college students face 6% tuition increases. “Hundreds” of state jobs will be cut, including 199 probation officers. The number of lay-offs is unknown. State employees will get no raises, except for the Florida Highway patrol. To show a spirit of common sacrifice, the part-time legislators cut their own salaries by 5%.

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## ***Director's Corner***

### ***Headline News – Government Programs Work Well***

To hear folks talk, you would think government programs can do nothing right. In fact, most government programs work. They help people on a daily basis. That does not generate big news.

One example is the Food Stamps program. The program, in its current form, turned 30 last year. View the video "*Making America Stronger: U.S. Food Stamp Program*" at [www.cbpp.org/foodstamp-video.htm](http://www.cbpp.org/foodstamp-video.htm). The video features former US Senators George McGovern and Robert Dole, the sponsors of the 1977 Food Stamp Reform Act. It shows how an effective program addressing a clear problem can draw support across the political spectrum. It also shows some of the real-world citizens who are able to make ends meet because of this program.

Because of Food Stamps, severe hunger and malnutrition have been almost eliminated in the US. Food stamps serve nearly two times the number of low-income Americans as welfare payments, with a 98% accurate rate for eligibility. In January 2008, there were 26 million food stamp recipients in the US, 349,000 in Maryland. The biggest problem now is the low benefit rate – about one dollar per person per meal. To read blogs of activists and other regular Marylanders who took the Maryland Center for Hunger Solutions challenge to eat for one week on this dollar amount, see [www.mdhungersolutions.org](http://www.mdhungersolutions.org).

Another example is the State Children's Health Insurance Program. The federal-state program provides health coverage to children and pregnant and post-partum mothers from poor and moderate-income families. This program has demonstrably reduced the number of children with un-met health needs.<sup>9</sup> It is also improving the kids' actual health conditions. For example, research indicates kids covered by S-CHIP suffer fewer asthma attacks.<sup>10</sup> As of June, 2007 4.4 million children were enrolled in CHIP, 105,000 of them in Maryland.

These are not isolated examples: there are many government programs which work to improve people's lives. Can government programs perform better? Of course. We need to focus on understanding problems and improving operations so that programs can be as effective as possible. We should challenge the incorrect belief that Governments do nothing right.

*-Neil Bergsman*

## About the Maryland Budget & Tax Policy Institute

The Maryland Budget and 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 low-income Marylanders and other vulnerable populations and the important community programs that serve them. For additional information, to be added to our e-mail list, or to make a tax-deductible contribution, please visit our website at [www.marylandpolicy.org](http://www.marylandpolicy.org).

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