

Maryland Policy Report

No 2010-2

March 25, 2010

A FIRST LOOK AT MARYLAND'S PROPOSED FY 2011 BUDGET

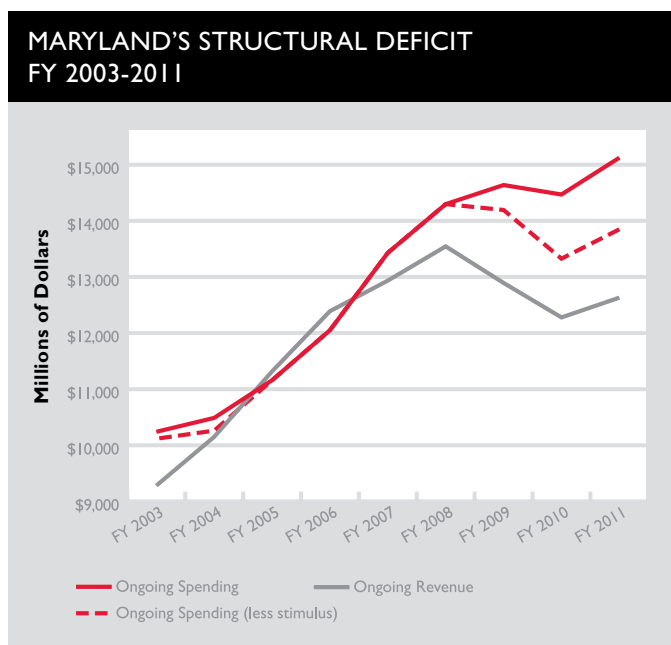
BY GABRIEL J. MICHAEL

INTRODUCTION

EACH NEW YEAR BRINGS ANOTHER LEGISLATIVE session, and with it, another budget proposal. Prospects for recovery from this recession are good, but slow. While Maryland's unemployment rate is lower than the national average, analysts believe the state cannot expect full recovery until 2012 at the earliest.¹ Yet the economic toll of the past year only reinforces the importance of ensuring that the state of Maryland is fiscally responsible, promoting tax policies that will encourage economic growth while cutting costs and increasing the efficiency of services.

Unfortunately, the O'Malley administration's proposed budget accomplishes none of these things. For the fifth year in a row, Maryland faces a massive and ever-increasing structural deficit, estimated to be \$2.5 billion in FY 2011.² Maryland simply does not generate enough tax revenue each year to meet its expenses. Indeed, in the past two years, tax revenues have actually declined as a result of the recession, and while they are expected to increase in the coming year, they will still not have caught up to pre-recession levels. Meanwhile, spending has increased almost without fail.

In recent years, Governor O'Malley has proposed a variety of ways to make up the difference: diverting tax revenues collected for special purposes into the general fund; borrowing from various accounts with the stated intent of repaying them; or issuing debt to pay for projects that were originally supposed to be funded in the current year. For the third year, the budget also relies heavily on federal stimulus funds. Despite the name, these funds have primarily been used to pay for normal annual expenses such as Medicaid and aid to local school systems. While these funds



have allowed Maryland to weather the recession without drastically cutting services, they have also generated an unhealthy reliance on federal monies; stimulus funds account for nearly \$1.3 billion of the proposed FY 2011 budget, making up over 8 percent of the state's spending.

Indeed, the state's latest fiscal briefing notes that when stimulus funds are excluded, the state's spending levels in FY 2011 will be below the levels in FY 2007.³ But in a year, stimulus funds will no longer be available, and the state will again face a \$1.5 billion to \$2 billion shortfall.⁴ Federal stimulus funds may have had the perverse effect of allowing

states to spend beyond their means throughout the recession, only to feel the pinch when the funds run out.

This paper reviews the primary measures taken to make up the deficit in the governor's current budget proposal as of March 2010. It then examines the main cost drivers behind the state's continually increasing structural deficit, and concludes with some basic options that may be taken to reduce this deficit. In order to speed recovery from the recession, encourage economic growth and attract new business and jobs to Maryland, the state must return to a sustainable level of spending.

OVERVIEW OF PROPOSED BUDGET'S MEASURES

In his proposed budget for FY 2011, Governor O'Malley has included a number of measures aimed at presenting a balanced budget to the General Assembly. About half of these are cost-cutting measures, while the other half is designed to increase general funds, mainly by transferring balances from special funds.⁵ However, only about a quarter of these adjustments affect the ongoing structural deficit. The rest are temporary actions that will only provide relief for one year. Some of the most drastic measures proposed are listed below.

Medicaid Match One of the most well-publicized revenue adjustment measures in the governor's budget is the assumption of \$389 million in federal funds that will be used to pay for Medicaid.⁶ Whether or not Maryland will receive these funds will depend on whether Congress decides to extend certain provisions of the American Recovery and Reinvestment Act for an additional six months. As of March 10, both the House and Senate have passed bills that include the extension, but the two chambers have yet to agree on the specifics. While the extension is strongly supported by organizations such as the National Conference of State Legislatures and the National Governor's Association, the more fundamental question is whether it makes sense to submit a budget premised on legislative action completely beyond both the governor's and the General Assembly's control. Views across the nation are split: 22 state governors chose not to rely on the funds in their proposed budgets, while 24 state governors did include the funds.⁷

Local Income Tax Reserve Account For the second year, the administration has proposed borrowing about \$350 million in funds from a little-known fund called the local income tax reserve account. According to Warren Deschenaux, Director of Maryland Department of Legislative Services Office of Policy Analysis, this tactic is designed to shift the state away from full accrual accounting (recognizing revenues when they are earned and expenses when they are incurred) and further toward cash accounting (recognizing revenues when they are received and expenses when they are paid) in this particular area.⁸ While this tactic offers the state some budgetary flexibility, it also indicates that the

state may be paying one year's expenses with the next year's revenues. If the state continues to find it necessary to use the local income tax reserve account in this way, it reflects poorly on the state's financial condition.

Issuing Debt to Increase General Fund Revenues The governor's budget proposal continues the troubling practice of issuing debt in the form of general obligation bonds to pay for capital projects originally slated to be paid in the current year. The capital budget calls for \$291 million of bonds to replace special funds from current and prior years, permitting \$291 million to be transferred to the general fund and spent on current expenses.⁹

Director Warren Deschenaux noted that while this practice is technically legitimate because the bonds are being used to purchase capital assets, this new debt is essentially being used as a method of refinancing current capital assets, instead of actually adding new capital assets.¹⁰ This year's proposed bond funding amount has increased over last year's figure of \$238 million, and includes part of the remaining \$157 million of funding for the InterCounty Connector (ICC).¹¹ Though hardly anyone remembers, back in 2003, the state moved \$315 million directly from the Transportation Trust Fund to the general fund, with a promise of repayment. Repayment eventually was changed to a promise to fund the ICC. Now, that promise too is being broken, and the state is simply issuing new debt to pay for the ICC.¹²

Another example of this practice is found in the proposed budget's request to transfer a total of \$200 million from the Bay Restoration Fund to the general fund during FY 2010 and FY 2011.¹³ The transferred funds would be replaced with general obligation bonds in the same amount. The Bay Restoration Fund's revenues come from taxes associated with wastewater treatment plants, and are collected for the purpose of upgrading the technology used in such plants, thereby improving bay water quality. This proposal completely dissociates the tax revenues from the purpose for which they were collected, and adds to the state's growing debt burden.

Balance Transfers While swaps, substitutions, and transfers are an ever-present feature of attempts to balance the budget, transfers that involve tax revenue originally collected for one purpose being spent on another, unrelated purpose constitute a breach of trust between the state and its citizens.

Take, for example, this year's budget's proposed diversion of over \$238 million in highway user revenues to the state's General Fund.¹⁴ These revenues are collected from sources such as vehicle titles and registrations and motor fuel taxes, and are designed to be distributed to localities to fund transportation-related expenses. This arrangement permits a logical connection between the taxes that are collected and the services that are provided. When the

revenues are diverted to balance the state's budget, this connection is severed, the state is left an easy out for its imbalanced budget, and localities are left in the lurch, unable to count on funds for their transportation and road services. With this year's record snowfall, the viability of this proposal may be in jeopardy, as many localities have already spent many times their budgeted amounts on snow removal.

The final list of transfers will differ from the governor's proposal, but aside from highway user revenues and the Bay Restoration Fund discussed in the previous section, other major items on the list include multi-million dollar transfers from Program Open Space, the University System of Maryland, and numerous other funds. A full list is available as part of Appendix B in the proposed budget's fiscal and policy note.¹⁵

The economic climate makes tax increases inappropriate and politically infeasible.

Cost Containment Measures The proposed budget contains some \$965 million in cost containment measures; in large part, this consists of a host of measures aimed at reducing the state's human resources costs, including salary furloughs and continued elimination of cost-of-living adjustments.¹⁶ A few state programs are targeted for reduced spending, including funding for mental hygiene and developmental disability services. There are also several smaller reductions in aid to local governments, such as cutting the amount of aid for school buses, community colleges, and local police and health groups.

PRIMARY COST DRIVERS

Why, for year after year, has Maryland faced an ongoing structural deficit? What are the primary cost drivers for the state?

Primary and Secondary Education The proposed budget allocates \$5.7 billion in state aid for public schools; this figure represents one of the largest components of state spending. This amount is \$190 million more than last year, but nearly half of the increase goes to pay for costs associated with currently retired teachers. In fact, as a whole, retirement costs will account for \$850 million—nearly 15 percent—of what is reported as education funding.¹⁷

Education costs have increased dramatically over the past years due to the Bridge to Excellence Program, also known as Thornton funding. Passed in 2002, the program's aim was to increase education spending by \$1.3 billion a year. Proponents of the Bridge to Excellence Program argue that increased spending has paid off handsomely; Education Week, a national publication covering K-12 education, recently ranked Maryland public schools first in the nation for the second year in a row.¹⁸ Critics point out that the rank-

ings do not assess more complex problems, such as gaps in achievement between low and high income students.

Regardless of one's political position on the Bridge to Excellence Program, the state faces consistent problems in providing the mandated level of funding. Since the original legislation was passed without identifying an associated revenue source, the state must scramble every year to come up with enough funds to meet its target allocations. Meanwhile, long-anticipated slots revenue destined for education funding has still not materialized.

Medicaid The proposed budget allocates \$6.1 billion in spending for Medicaid. Federal funds, including the potential \$389 million Medicaid match extensions discussed above, account for about \$3.8 billion of this, leaving approximately \$2.3 billion for the state to supply. This represents over 17 percent of the state's general fund expenditures, and is likely to be a record high share.¹⁹ Growing enrollment in Medicaid fueled by expansions to the program passed in 2007's special legislative session, and declining state revenues over the past few years have combined to make Medicaid spending one of the largest items in the state's budget.

Pensions State spending on pensions, which include both state employees and state contributions to local teachers, is expected to reach \$1.37 billion; over 9 percent of the state's spending. This makes for a \$183 million increase over FY 2010, in large part due to market losses.²⁰ That is, since markets performed poorly, the pensions funds did not generate as much interest as expected, and the general fund (read: the taxpayer) is required to make up the shortfall.

Also concerning is the fact that in FY 2011, we are using \$235 million in stimulus funds to pay for these pension benefits.²¹ Because of smoothing techniques, market losses due to the recession will be spread over several years, but federal stimulus funds will soon disappear. It will take heroic measures to make up this difference in next year's budget.

Health Insurance The state will spend \$897 million on health insurance in FY 2011; \$218 million of this sum is spent on health insurance for retired workers.²²

The state managed to constrain a projected 7 percent increase in costs to only 4.6 percent by taking such measures as encouraging the use of generic prescriptions. However, health insurance costs are only expected to increase in the coming years, meaning we can expect continuing pressure on the state's general fund. Expect a \$40 million increase in total health insurance costs in FY 2012, bringing the amount paid directly from the general fund to nearly \$600 million.

CONCLUSION

There are no quick fixes to Maryland's budgetary troubles. As long as state legislators are willing to mandate multi-year

increases in appropriations without identifying revenue sources to pay for them, we can expect to witness a yearly scramble in which the state diverts tax dollars from their designated purposes, empties accounts, and issues debt to cover its costs.

For example, if Thornton funding has been as effective as is claimed, then it makes sense to identify specific sources of revenue for the program. Such sources should be realistic, not simply anticipated; large amounts of slots revenue have long been anticipated in Maryland, but have not yet arrived.

State legislators must take a hard look at the cost of pensions and retiree health care benefits. Expansions in pensions were signed into law in 2006; in 2009, the market suffered major losses, and as a result, the state's pension funds taken together now stand at less than a dismal 65 percent funding level, the lowest in years.²³ Retiree health care benefits are essentially completely unfunded. These expenses place an enormous strain on the state's budget, forcing the state to directly cut services, or reduce aid to localities and force them to do the cutting. These expenses may also prompt resentment among Marylanders working in the private sector, whose retirement benefits are not guaranteed by anyone.

Unions and government agencies frequently cite the perceived importance of both generous pensions and retiree health care benefits to attracting and retaining quality employees. Yet the massive costs of these benefits have forced the state to take drastic cost containment measures in the present, such as discontinuing pay increases and COLAs, and implementing employee furloughs. The Department of Legislative Services notes that general salary increases were not awarded in 2003, 2004, or 2010, and this year's budget proposes to eliminate them for 2011 as well. Performance bonuses were eliminated in 2002 and have not been reinstated.²⁴ These kinds of severe cost containment measures seriously undermine the argument that generous retirement benefits are necessary to ensure quality human resources.

Finally, as long as Maryland relies on a spending affordability process that is inconsistent, opaque, and correlated with consistent structural deficits, it is hard to see how legislators have an incentive to keep costs under control. The process should do a better job of linking spending

affordability to growth (or decline, as has been the case in recent years) in revenue, rather than general growth in the state's economy.²⁵

Bringing the state's structural deficit under control must be a priority. The economic climate makes tax increases inappropriate and politically infeasible. The only remaining solution, then, is to cut back on excessive spending, if not by actual reductions, then at least by constraining spending growth. Maryland's challenges will only be greater in the next fiscal year, as over \$1 billion in federal stimulus funds will no longer be available to help shore up the state's finances. Candidates for the 2010 gubernatorial race should clearly communicate their plans for dealing with the state's fiscal condition; their policies will surely play a deciding role in the outcome of the election.

Gabriel J. Michael is a senior fellow at the Maryland Public Policy Institute.

1. Jay Hancock, "Rise in temp workers a sure, if slow, sign of recovery," *The Baltimore Sun*, February 10, 2010, http://articles.baltimoresun.com/2010-02-10/business/bal-bz.hancock10feb10_1_temp-agencies-economy-recovery; Aaron Davis, "O'Malley puts 'economic recovery' ahead of tax increases," *The Washington Post*, January 22, 2010, <http://www.washingtonpost.com/wp-dyn/content/article/2010/01/21/AR2010012104724.html>.
2. Department of Legislative Services, *Fiscal Briefing*, January 2010, p. 26, http://mlis.state.md.us/2010rs/budget_docs/all/Operating/Fiscal_Briefing.pdf.
3. *Ibid.*, p. 27.
4. *Ibid.*, p. 3.
5. *Ibid.*, p. 6.
6. *Ibid.*, p. 2.
7. Jennifer Burnett and Debra Miller, "States Bet Budgets on Medicaid Match Extension," March 9, 2010, <http://www.csg.org/about/pressreleases/Governor-CountonMedicaidMatchExtension.aspx>.
8. Warren Deschenaux, personal communication.
9. Department of Legislative Services, *Fiscal Briefing*, p. 3.
10. Warren Deschenaux, personal communication.
11. Spending Affordability Committee, *2009 Interim Report* (Annapolis, MD, December 2009), p. 61.
12. Gabriel J. Michael, *The Annapolis Report: A Review of the 2009 Legislative Session* (Rockville, MD: The Maryland Public Policy Institute, 2009), p. 9.
13. Department of Legislative Services, *HB 151 Fiscal & Policy Note*, March 4, 2010, p. 11, <http://mlis.state.md.us/2010rs/billfile/HB0151.htm>.
14. Department of Legislative Services, *Fiscal Briefing*, p. 61.
15. Department of Legislative Services, *HB 151 Fiscal & Policy Note*, p. 101.
16. Department of Legislative Services, *Fiscal Briefing*, p. 2.
17. *Ibid.*, p. 38.
18. Liz Bowie, "Education magazine ranks Md. No. 1," *The Baltimore Sun*, January 14, 2010, <http://www.baltimoresun.com/news/education/bal-md.edweek-14jan14.0.6809007.story>.
19. Marc Kilmer, *A Growing Fiscal Concern: Medicaid Spending in Maryland*, Maryland Policy Report (Rockville, MD: The Maryland Public Policy Institute, January 9, 2008), p. 3.
20. Department of Legislative Services, *Fiscal Briefing*, p. 33.
21. *Ibid.*
22. *Ibid.*
23. Comptroller of Maryland, *Comprehensive Annual Financial Report* (State of Maryland, 2009), p. 103.
24. Department of Legislative Services, *HB 151 Fiscal & Policy Note*, p. 97.
25. Cecilia Januszkiewicz, "Structural Solutions for Maryland Structural Deficit," *Perspectives from Free State Foundation Scholars*, p. 3, no. 20 (December 5, 2008).

ABOUT THE MARYLAND PUBLIC POLICY INSTITUTE

Founded in 2001, the Maryland Public Policy Institute is a nonpartisan public policy research and education organization that focuses on state policy issues. Our goal is to provide accurate and timely research analysis of Maryland policy issues and market these findings to key primary audiences.

The mission of the Maryland Public Policy Institute is to formulate and promote public policies at all levels of government based on principles of free enterprise, limited government, and civil society.

In order to maintain objectivity and independence, the Institute accepts no government funding and does not perform contract research. The Maryland Public Policy Institute is recognized as a 501 (C) (3) research and education organization under the Internal Revenue Code.