

# MARYLAND'S FISCAL SLIDE

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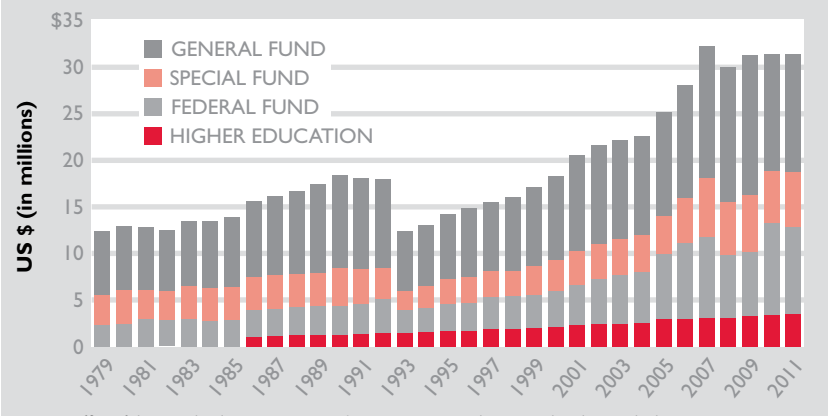
**EILEEN NORCROSS**

IN FY 2011 MARYLAND ENTERS ITS THIRD YEAR OF RECESSION and fifth year of structural deficit, with ongoing revenues insufficient to cover ongoing spending. To address this year's \$2 billion shortfall, the state cut spending by \$1 billion, and applied \$1.27 billion in federal stimulus funds, one-time revenue fixes of \$25 million, and \$800 million in fund transfers. Budgetary balance in the coming year hinges on anticipated revenues from video lotteries and the assumption that Congress will extend the stimulus's increased Medicaid matching provision to fill \$389 million of the budget gap.

These tactics are not part of a one-time strategy prompted by the recession. Maryland has struggled to balance its budget for much of the last decade. The state's structural deficit has continued to deepen since 2007, leading to the legalization of video lottery gaming to increase revenues. To date, these revenues have been insufficient to meet the gap. Budgetary balance has been achieved through fiscal maneuvers including fund sweeps, debt finance, federal aid, and the state's Rainy Day Fund. In spite of these maneuvers, by 2015 the structural deficit is projected to grow to \$1.65 billion.

Maryland's deepening fiscal problems suggest a paradox. In 1982, the state instituted a commission to limit spending growth. Maryland's constitutionally-defined balanced budget rule requires the Governor to present and the legislature to pass a balanced budget. On the surface these rules imply Maryland's budget is guided by principles of fiscal discipline.

**FIGURE 1 MARYLAND'S BUDGET BY FUND, 1979-2011**  
(REAL, 2008 DOLLARS)



Source: Office of the Maryland Treasurer, Annual Report, various editions; and authors' calculations.

Since the end of the recession of 1991–1992, Maryland’s budget has grown an average of 5 percent a year in real terms. Spending has doubled in real terms from \$15.2 billion to \$32 billion since 1998. The only year the budget decreased in real terms occurred in 2008. With federal stimulus funds, by 2009, spending was 11 percent higher than in 2006. (Figure 1)

Maryland’s budget rules were designed with the intent of restraining spending growth. They have instead produced sustained and growing deficits. The rapid growth in Maryland’s budget, as well as the increase in mandated spending are products of the state’s fiscal institutions—the legislative and constitutional rules under which the state budgets. These include the Executive Budget process, the Spending Affordability Commission, and the Debt Affordability Commission.

The evolution and interaction of these rules forms the state’s political-fiscal environment. This environment also includes the state’s fiscal relationship to the federal government. The effect of this relationship is seen clearly with the American Recovery and Reinvestment Act of 2009, the intent of which is to stabilize state budgets with bailout funds and stimulate economic growth through infrastructure spending.

The combined effect of these has been the subsidization of spending path that cannot be sustained absent significant increases in state taxation, or spending reduction and reform. This paper examines each of these institutions and their role in creating the present fiscal crisis.

**THE EXECUTIVE BUDGET**

Ensuring fiscal restraint was at the center of Maryland’s 1915 gubernatorial election. The legislature appropriated \$1,500,000 more than revenues in 1914 adding

to charges of legislative irresponsibility.<sup>1</sup> Criticism focused on the appropriations process. Bills were passed, “in the last hours under the suspension of the rules, generally allowing each senator or delegate practically what he wanted for his own county or locality, regardless of the amount appropriated, and leaving it to the executive to do the paring.”<sup>2</sup> Based on the Goodnow Commission’s recommendations, in 1916 Maryland’s constitution was amended, introducing the first and strongest executive budget in the United States. Budgetary authority shifted towards the Governor. Several key features remain in place. Most important, the legislature may cut from, but not add to, the proposed operating budget. After the legislature passes the operating budget, the Governor cannot veto it. When the legislature adjourns, the Governor may cut appropriations up to 25 percent with approval from the Board of Public Works. Legislators may add to the capital budget and the Governor may veto these items.

The Goodnow Commission’s cure for legislative profligacy was an application of theories emerging from the new field of public administration.<sup>3</sup> It was thought that by concentrating power in the executive, the politics and administration of budgets could be kept separate, yielding a more rational and responsible budgetary process. This notion, as Meyers and Pilkerton note was deceptively, “simple, far simpler than the Madisonian system of separated institutions sharing powers,”<sup>4</sup> and thus simplistic.

A century later Maryland still adheres to the budget process put in place by the Goodnow Commission. Yet the problem identified by the Progressive-era reformers remains: appropriations are made without fiscal discipline. The constitutional fix of an executive budget to restrain the legislature’s power over spending gave rise instead to a number of strategies to influence spending by both “indirect and opaque means,”<sup>5</sup> and directly through subsequent constitutional amendment. Over time, a set of budget norms and rules have emerged, highlighting the gap between the intention of budgetary rules and their design and implementation.

The Goodnow Commission wanted to prevent deficits, but also preserve the right of the legislature to initiate appropriations. Maryland’s Constitution allows the legislature to pass supplementary appropriations bills to propose spending as long as a revenue source is also provided. Interestingly, outside of bond bills, the use of supplementary appropriations bills has been limited.<sup>6</sup> Appropriations bills, excluding bond bills, represent two percent of all legislation. In 2006, 823 laws were passed in the General Assembly. Of the 636 bills that became law, only 26 were appropriations bills, and 33 were bond bills. The cost of new legislation can be significant. In 2006, 161 enacted bills were estimated to have an impact on spending of \$1.75 billion by FY 2010. Only 16 of these were appropriations bills, with a total spending impact of \$270 million.<sup>7</sup>

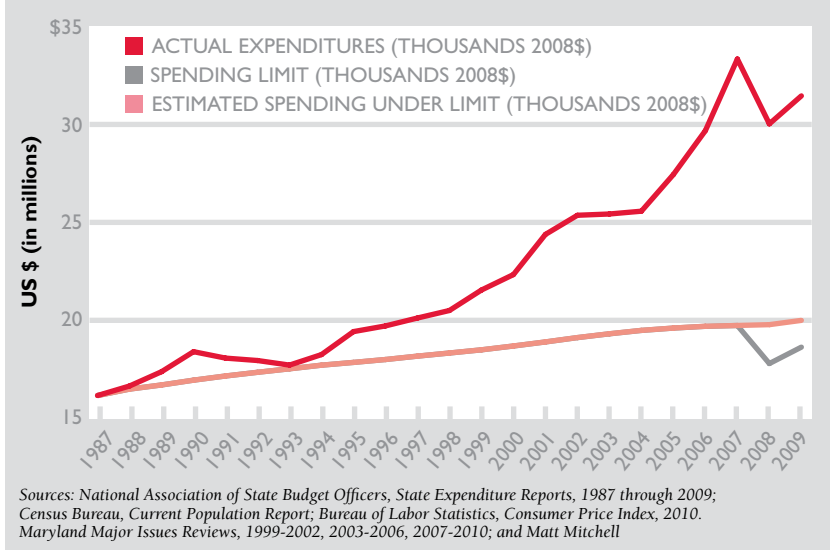
Instead of using the constitutionally-provided mechanism to appropriate spending, the legislature accomplishes its objectives by avoiding the provision altogether.

It does so by simply passing regular legislation to create new programs, or enhance existing ones. Since these bills do not propose to spend immediately, a revenue source does not need to be identified.<sup>8</sup> In doing so, the legislature builds future spending commitments into the budget, placing the responsibility for identifying funding on the executive branch. The Governor may still veto any legislation. Yet, the strategy has enabled the legislature influence future appropriations while avoiding the constitutional mechanisms meant to control legislative spending. Under Maryland's "strong executive budget system," through the use of regular legislation, the General Assembly can exert some influence over future spending while still heeding the process required by the original constitutional amendment.

One reason for the reliance on regular legislation is that in addition to not needing to identify a revenue source, as the result of a 1978 amendment to the constitution, the legislature may initiate spending mandates and require the Governor to fund enacted programs. Since then, Maryland's budget has grown to consist almost entirely of mandated spending. The largest and most recent state mandate is the 2002 Thornton Bridge to Excellence Act, which requires the state to remedy the spending disparity in low-income schools in keeping with the state constitution's "thorough and efficient education" clause. Since 2003, K-12 spending has increased by 10 percent a year. To pay for the \$1.3 billion increase in aid to local government, the first year of funding was met with an increase in the cigarette tax.

The legislature's ability to successfully influence the executive budget points not only to the difficulty of creating binding rules on government spending—rules may be poorly designed, and well-designed rules may be amended, poorly enforced,<sup>9</sup> or evaded—it also underscores the Goodnow Commission's misdiagnosis of runaway spending. The legislative branch does not uniquely tend towards spending profligacy. The executive branch is not immune to politics nor does it tend to greater fiscal prudence. Budgetary decisions are not purely technical matters. If this were the case, then regular legislation representing a future obligation would be vetoed more often by the executive branch. Budgets reflect fiscal actions undertaken in a political realm. Maryland's executive budget, as with all budgets, has evolved to accommodate political bargaining among different branches of government to achieve a spending program that meets the incentives of politicians.

Maryland has operated under a unified Democratic government for all but two periods in the last 40 years. It may be that the legislature can achieve its spending goals through legislation because these goals are shared by the executive. During Maryland's most recent period of divided government between 2003 and 2007, Republican Governor Robert Ehrlich vetoed a record number of bills during the 2005 session, a total of 385. However in 2006, the Governor also allowed 161 bills to become law with a \$1.75 billion price tag. A second possibility is that in exchange for signing new legislation, the Governor may be attempting to gain favor with opponents in order to avoid legislative cuts to the Executive oper-

**FIGURE 2 MARYLAND'S ALTERNATIVE SPENDING PATH, 1995 BASE YEAR**

ating budget.<sup>10</sup> This strategy may pay off in particular if the price tag falls on a future administration.

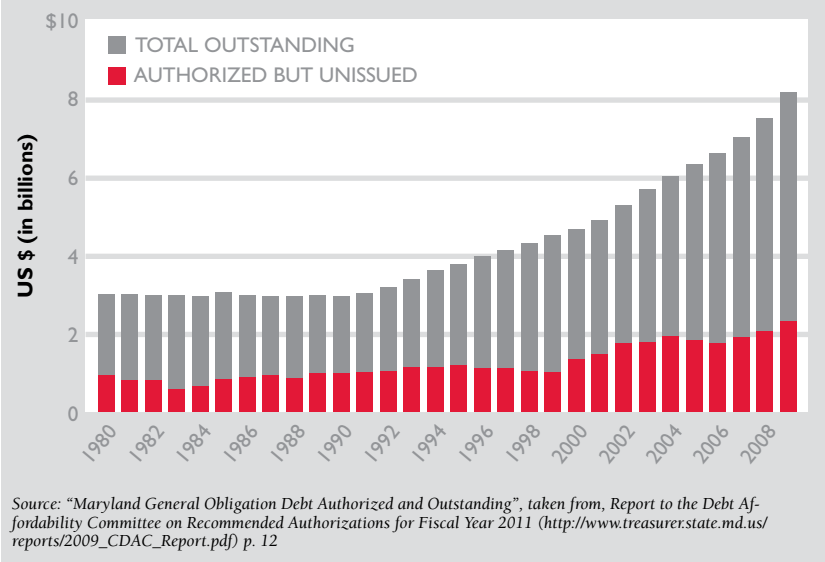
The legislature may use supplementary appropriations, or legislation to influence spending. And it may exercise its power to cut from the operating budget. When cuts are made, at the executive's disposal is the supplemental budget. Technically meant to permit for emergency spending, typically, the supplemental budget is instead used to reallocate funds cut by the General Assembly, "or to reward or punish legislators based on their levels of support for the Governor's agenda."<sup>11</sup>

### **GIVING THE APPEARANCE OF FISCAL PRUDENCE: THE SPENDING AFFORDABILITY COMMISSION**

In 1982, to avoid implementing a Tax and Expenditure Limit (TEL) that many states were adopting in during the tax revolts of the 1970s and 1980s, Maryland established the Spending Affordability Commission (SAC), comprised of fiscal committee leaders in the General Assembly and an advisory committee of citizens. The SAC makes an annual recommendation for state spending growth to guide appropriations.

The annual recommendation of a spending limit suggests fiscal restraint. Due to its design the cap has failed to limit spending. By tying an annual spending limit to income growth, a ratchet-like effect in spending occurs. Each new level of spending sets a new higher baseline. New spending may be used to expand initiatives and programs that become embedded in the budget, creating new constituency demands. When revenue downturns occur, equivalent reductions in spending

**FIGURE 3 MARYLAND GENERAL OBLIGATION DEBT AUTHORIZED AND OUTSTANDING**



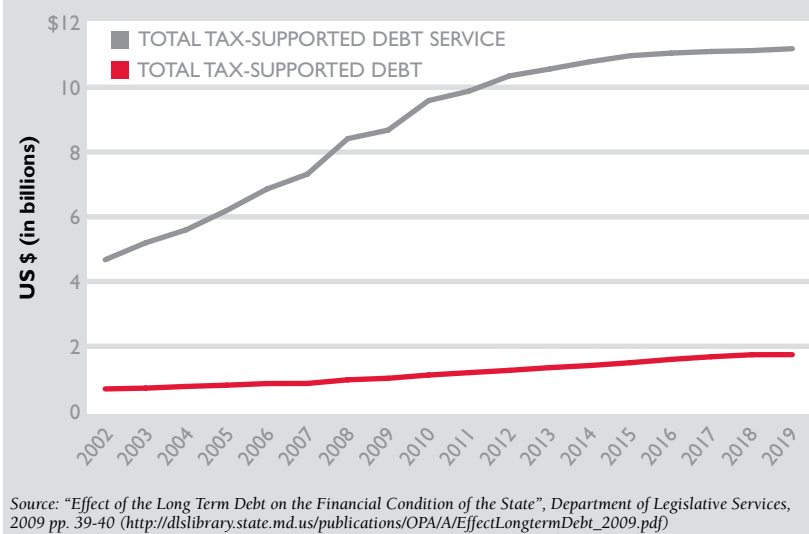
have not followed, as the last two recessions show, though spending reductions in the general fund did result after the 1990-1991 recession. This inconsistent policy response during recessionary periods calls into question the methodology used to recommend annual spending limits.

The calculation for the spending limit has varied in different years, by including, or excluding, different funds.<sup>12</sup> Far from being a technical calculation, the SAC's methods may instead "obscure private bargains between the branches."<sup>13</sup> Arriving at a spending ceiling is not a matter of mathematical formula, but rather part of a larger negotiation between the legislative leadership and the executive to develop a rule to assist both parties in navigating which portions of the budget should be protected from the Governor's veto, or the legislature's cuts.<sup>14</sup>

Maryland's SAC process, in both design and implementation, has not only failed to limit spending, but has instead built in a bias toward greater annual spending. As a comparison, if Maryland had adopted a strict and transparent rule to limit spending, such as limiting spending growth to the annual combined increase in population and inflation, state spending would have followed a much slower growth path,<sup>15</sup> as Figure 2 shows.

**HIDDEN IN PLAIN SIGHT: THE GROWTH OF MARYLAND'S DEBT**

Maryland's Capital budget process differs from the operating budget process. Because the capital budget is financed partly through bonds, the General Assembly may add spending through bond bills, which are considered supplementary appro-

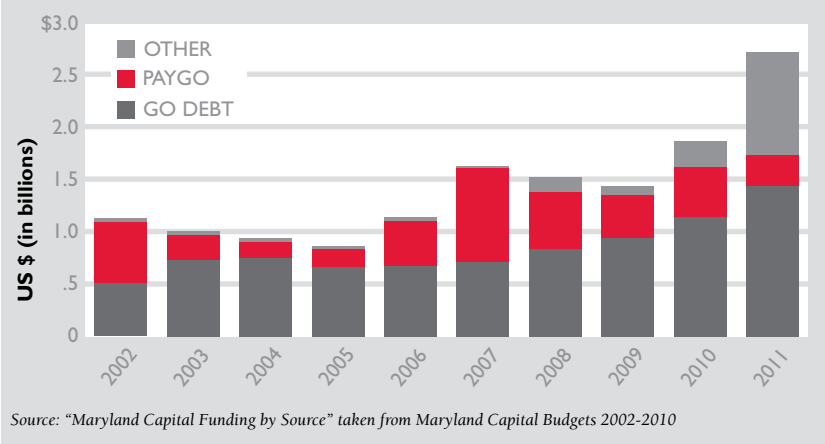
**FIGURE 4 MARYLAND TAX-SUPPORTED DEBT PAST & PROJECTED 2002-2019**

priations. After spending requests are submitted by state agencies, the Debt Affordability Committee evaluates the state's indebtedness and recommends a maximum general obligation debt limit. The Governor proposes the capital budget and the General Assembly may modify or cut from it.

Maryland's debt limit appears to have encouraged fiscal prudence at first glance. The state has retained the highest ratings from bond agencies. During the last decade, total debt outstanding was limited to less than 3.2 percent of total state income and debt service limited to less than 8 percent of revenues. However, several signs point to Maryland's growing reliance on debt to finance state spending as well as balance its budget. Since 1991, the level of new issuances has grown steadily by an average of 5 percent a year in nominal terms. In part this growth has been fueled by historically low interest rates. (Figure 3)

Since 2002, total tax-supported debt grew from \$4.6 billion to \$9.8 billion in nominal terms. In this period the Debt Affordability Commission increased the debt limit to 4 percent of total state income. By issuing more debt, the cost of servicing Maryland's debt has become an increasing drain on the state's general fund. In 2011, debt service rose to \$1.17 billion, or 7.3 percent of revenues. General fund revenues and a constitutionally-dedicated property tax are used to pay for debt service. The tax rate is determined by the Board of Public Works to ensure it is set at a level sufficient to pay for state debt service. In recent years, the tax rate has remained constant, leading the state to draw more on general funds into order to service the debt,<sup>16</sup> and leaving less to balance the state's budget.

**FIGURE 5 MARYLAND CAPITAL FUNDING BY SOURCE**



The Debt Affordability Commission recommends that debt authorizations grow at 3 percent annually through 2019, while recognizing the need that this may need to be re-adjusted since, “the risks of exceeding the affordability criteria are probably greater than at any other time in the last 20 years.”<sup>17</sup> (Figure 4)

In addition to the overall growth in debt, Maryland’s use of debt underscores growing fiscal instability. Debt is being issued to pay for increased spending and indirectly balance the budget. Maryland’s capital budget is funded through a combination of bonds, tax revenues, and dedicated fees, known as PAYGO, as well as other sources including federal grants and auxiliary bonds issued by state agencies. The amount of PAYGO funds in the capital budget varies from year to year. As a result of the recession and decrease in tax revenues the capital budget is currently more reliant on bonds, and other sources to fund capital spending. PAYGO funds have also been transferred from the capital budget to fill the operating budget gap. Transfers from special funds and the capital fund to balance the operating budget have been in some cases replaced with new debt. (Figure 5)

Between 2007 and 2010, \$889.1 million was transferred from special funds and capital funds to balance Maryland’s budget. The Budget Reconciliation Act of 2010 replaced these depleted funds with new bond issues. The manipulation of Maryland’s capital budget and special funds to achieve operating budget balance highlights the tentative nature of Maryland’s budgetary balance. The state’s fiscal crisis, the result of two decades of mandated spending growth is being sustained by one-shot revenues and special fund transfers that are replaced with debt.

Compounding the growing reliance on debt finance is the federal stimulus’s Build America Bonds (BABs) Program intended to incentivize states to issue federally-subsidized bonds to finance capital projects, aimed at sparking economic recovery.



**FIGURE 6** FY 2011 BUDGET

	<b>TOTAL CUTS TO MARYLAND'S BUDGET</b>	<b>TOTAL STIMULUS</b>
FY 2008	\$196,000,000	-
FY 2009	\$506,000,000	\$545,000,000
FY 2010	\$956,000,000	\$2,353,300,000
<b>TOTAL</b>	<b>\$1,658,900,000</b>	<b>\$2,898,400,000</b>

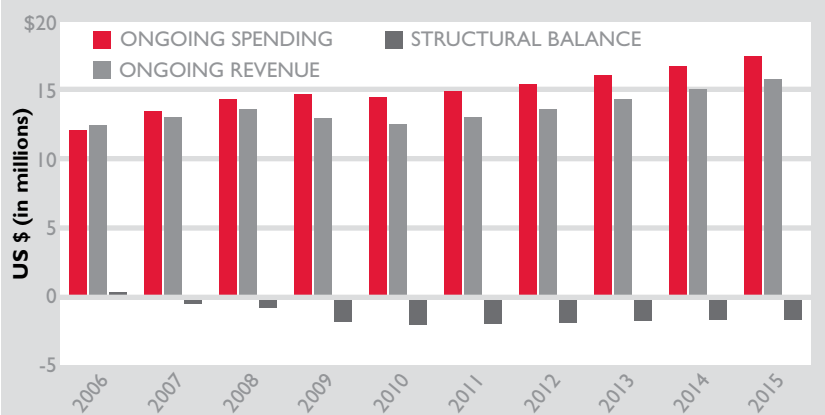
The Debt Affordability Commission suggested in their September 2009 report that future General Obligation (GO) debt issues may be restrained, or authorizations abandoned due several factors, including the decline in state income and revenues, excessive GO debt authorizations in 2009, the general increase in GO debt, and the likelihood of future higher interest rates.<sup>18</sup> This cautious assessment did not prevent the state from issuing more debt due to the low-interest rate incentives offered through stimulus. In February 2010 Maryland issued the largest BABs offering by the states up to that point, with \$400 million in new GO debt to provide funding for state facilities construction, acquisition, and other capital projects. The federal inducement for states to issue debt highlights the profound effect that federal policies have on state fiscal practices and institution. These policies: the tax-favored treatment of municipal debt and the increase in federal grants to the states have served to further weaken state institutions aimed at encouraging fiscal prudence.

### **FEDERAL GRANTS: FISCAL ILLUSION AND THE HARD BUDGET CONSTRAINT**

Since 1979, in real terms, federal funds in Maryland's budget increased from \$2.3 billion to \$6.7 billion in 2008. The largest area of growth in federal funds is for the Medicaid program, which must be matched by state funds. Over the period, federal funds remained a relatively constant portion of Maryland's total budget, averaging 21 percent of all spending. As a result of the federal stimulus, between 2007 and 2010, federal grants compose 29 percent of the state's budget, totaling \$9.3 billion in FY 2010, as the general fund declined from 49 percent to 40 percent of total spending.

Federal grants are intended to support states in meeting policy goals established by the federal government. As intergovernmental aid, federal grants to the states influence fiscal behavior in several ways. First, the transfer of federal funds to state budgets creates "fiscal illusion."<sup>19</sup> By distributing the cost of spending across all federal taxpayers, federal grants dilute the perceived cost of spending to state beneficiaries, since they do not bear the full cost of spending upfront. Thus, recipients may demand more spending than they otherwise would.<sup>20</sup> In essence the source of taxation (federal revenues) and the place of spending (state and local government) are separated, leading to "grant illusion."<sup>21</sup>

**FIGURE 7 MARYLAND'S PROJECTED STRUCTURAL DEFICIT**



Source: "Maryland's Projected Structural Deficit", taken from *Major Issues and Review, 2007-2010*, Department of Legislative Services, Maryland General Assembly p. A-17.

Second, intergovernmental grants, whether designed to augment or supplant state revenues, may stimulate state spending beyond the amount of the grant. Federal grants may lead states to expand spending, necessitating an increase in taxation or debt to support the program initiated by the grant. When the federal grant is eliminated or reduced, the state is left with the option of raising taxes, or cutting the program.<sup>22</sup>

The American Recovery and Reinvestment Act of 2009 (ARRA) awarded \$4.5 billion between FY 2009 and FY 2011 to Maryland to be used to help fill the state's budget gap, provide assistance to the needy, and stimulate the economy through public sector spending on infrastructure. The stimulus is an infusion of federal transfers through the existing intergovernmental aid apparatus that was first expanded during the 1960s with the Johnson Administration's War on Poverty and Great Society initiatives. Over the ensuing period, this domestic spending agenda has been altered, with programs eliminated and added and programmatic regulations and formulas changed, but the basic structure remains in place. Intergovernmental aid has changed the composition of Maryland's budget, as well as the state's fiscal incentives.

As general fund spending decreased by 7.5 percent between FY 2007 and FY 2011, this decrease was replaced, and then surpassed, by an 18 percent increase in federal funds between FY 2008 and FY 2010. The stimulus has replaced state spending, and in some cases expanded commitments in effect deepening the state's budget gap with spending that will either need to be sustained through own-source revenue, or cut after funds are expended in the FY 2011 budget. (Figures 6 and 7)

An explicit intent of the stimulus is to bailout the states by helping to fill budgetary shortfalls. When the national level bails out the lower level, the hard budget

constraint facing state and local governments necessary to ensuring a market-preserving federalist system is weakened.<sup>23</sup> Bailouts dull the consequences of the state's fiscal choices, thereby lessening the incentive for the state to address the causes of budgetary imbalance, while increasing the likelihood that the state will seek future bailouts.

In Maryland these effects are apparent. The stimulus has been applied to support the education spending increases in Maryland's budget resulting from the Bridge to Excellence Act, increases which are in part responsible for the state's structural deficit. The Fiscal Stabilization Fund (FSF) portion of the stimulus was awarded to states under a restriction requiring states to apply 81.8 percent of the FSF, roughly \$719.7 million in the case of Maryland, to restore budget cuts made to education spending. Due to Maryland's increase in education over the last decade, this provision did not apply. Instead, Maryland applied FSF funds to "support elementary and secondary school increases" including \$228.1 million in local employee fringe benefits. The stimulus, as bailout, has also altered expectations. In anticipation of the continuing revenue shortfall in the general fund to support Medicaid, Governor Martin O'Malley joined 28 other states and presented a balanced budget based on the expectation that Congress would extend the increase in the Medicaid federal match, and award Maryland an additional \$389 million.

Maryland's fiscal slide offers an interesting case of not only how spending restraints may be evaded but also of how restraints and budget rules only superficially suggest fiscal discipline, and may in fact give cover to fiscal profligacy. Institutions meant to constrain spending have evolved according to a political logic sustained by gamesmanship. The result is that Maryland has grown its budget beyond what the state can support without more drastic reductions in spending or significant tax increases. The effect of the federal stimulus has magnified the causes of Maryland's growing fiscal stress by building future spending into the state's budget while weakening the incentive for the state to undertake meaningful budgetary reforms.

The indication for now is that the state will continue its present course by repeating past tactics: increasing debt, relying on intergovernmental aid, and funding transfers well into this decade to finance growing spending. Maryland's policymakers operate under a perceptual gap. Institutions meant to constrain spending, such as the Spending Affordability Committee's recommendations, are poorly designed, yet are assumed to encourage fiscal discipline. Federal stimulus funds are perceived as a cost-less budgetary remedy in the midst of an historic revenue downturn. Yet, the effect of the stimulus is to expand spending, thus pushing the state into deeper fiscal distress. Maryland's dilemma presents both lessons and challenges to reformers seeking to institute effective rules to constrain state spending.

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