2003 Spending Affordability Committee Report and Recommendations to the Governor and the Legislative Policy Committee

The Spending Affordability Committee was created in 1982 (Chapter 585, Acts of 1982). The committee is composed of 20 legislative members including the presiding officers, the majority and minority leaders, the chairmen of the fiscal committees (or their designees), and other members appointed by the presiding officers. A four-member citizen advisory committee assists the committee.

The committee's primary responsibility is to recommend to the Governor and the General Assembly a level of spending for the State operating budget that is reflective of the current and prospective condition of the State's economy. Consideration is given to constraining disproportionate growth in State-funded expenditures in any fiscal year which might necessitate or "build in" unsupportable levels of spending in future years.

The committee's prior recommendations and legislative action on the operating budget are reflected in the following table:

Spending Affordability Committee's Prior Recommendations and Legislative Action on the Operating Budget
($ in Millions)

	Committee Recommendation		Legislative Action	
Session Year	**Growth Rate**	**Amount**	**Growth Rate**	**Amount**
1983	9.00%	$428.0	5.70%	$269.8
1984	6.15%	326.7	8.38%	402.0
1985	8.00%	407.2	7.93%	404.6
1986	7.70%	421.5	7.31%	402.2
1987	7.28%	430.2	7.27%	429.9
1988	8.58%	557.5	8.54%	552.9
1989	8.79%	618.9	8.78%	618.2
1990	9.00%	691.6	8.98%	689.7
1991	5.14%	421.8	5.00%	410.0
1992	No recommendation		10.00%	823.3
1993	2.50%	216.7	2.48%	215.0
1994	5.00%	443.2	5.00%	443.2
1995	4.50%	420.1	4.50%	420.0
1996	4.25%	415.0	3.82%	372.8
1997	4.15%	419.6	4.00%	404.6
1998	4.90%	514.9	4.82%	506.6
1999	5.90%	648.8	5.82%	640.6
2000*	6.90%	803.0	6.87%	800.0
2001**	6.95%	885.3	6.94%	884.6
2002	3.95%	543.2	3.40%	468.1
2003	2.50%	358.2	0.94%	134.1

*2000 legislative action does not reflect $266 million of Cigarette Restitution Fund (CRF) appropriations. CRF dollars were excluded because they had not previously been available to the State. The 2000 growth rate including CRF dollars was 9.16%.

**Data from the 2001 session and subsequent years reflect a revised methodology for calculating the spending affordability limit; data from the earlier years reflect the older methodology.

The committee notes that operating spending in relation to the State's economy, as measured by the personal income statistic, is lower now than when the spending affordability process began in 1982. As illustrated in the chart on the next page, throughout much of the 1980s, the ratio remained relatively stable. During the 1990 and 1991 sessions, the combination of increased spending demands and economic slowdown caused the spending ratio to increase. Following the recession, however, operating spending in relation to personal income fell acutely. With the onset of another recession in calendar 2001, spending in relation to personal income rose again. Regardless, personal income in calendar 2004 and 2005 is projected to be below the high of 7.6% reached during the early 1990s.

The committee's statutory responsibility is to consider spending growth in relation to growth anticipated in the State's economy. In its review of the State's economy, the committee considered both income and wealth factors in developing a broad understanding of Maryland's economic position. In determining the spending limit, the committee has considered economic performance, revenue estimates, and budget requirements.

Economy

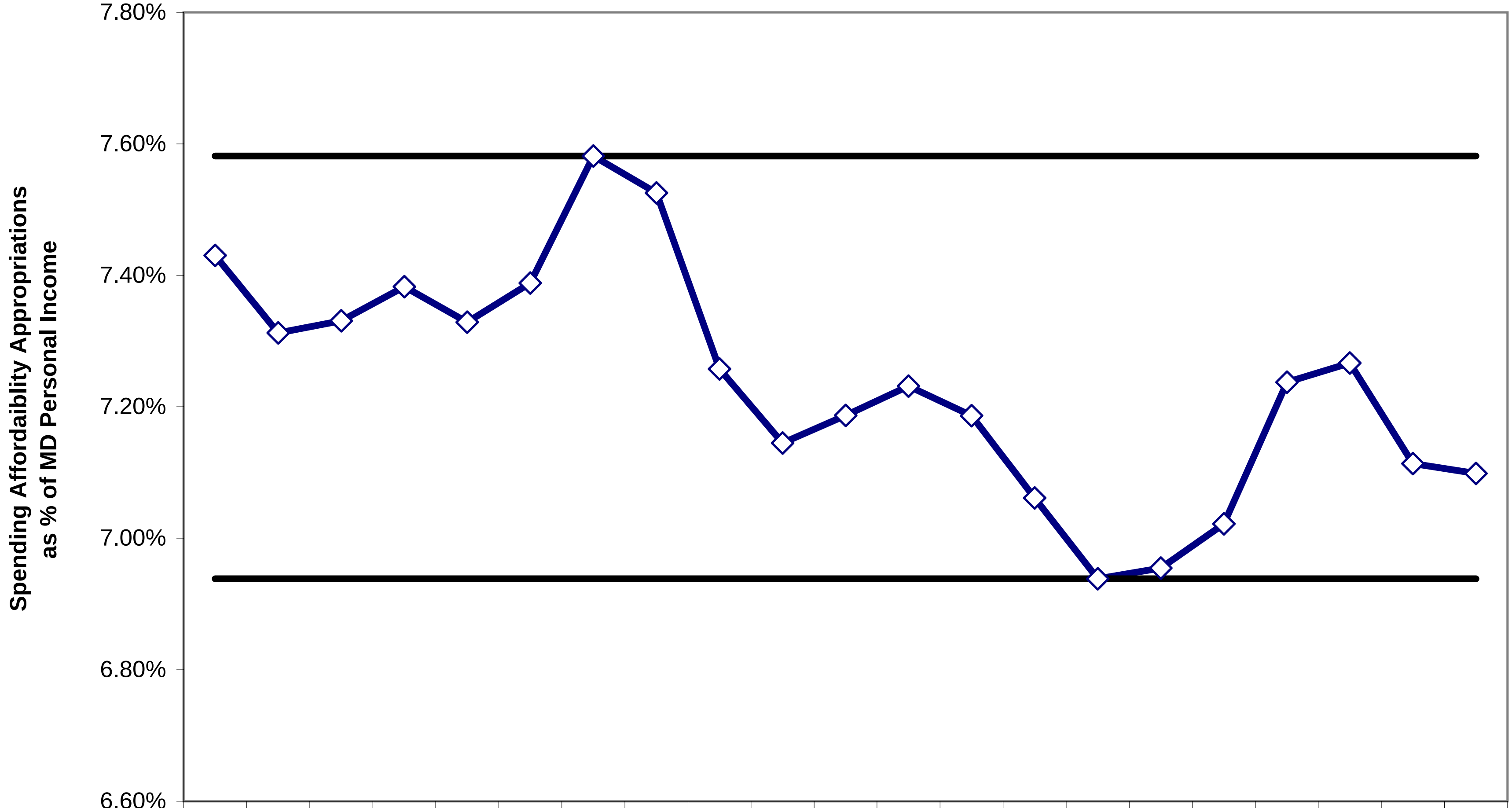
The year 2001 marked the end of the longest economic expansion in U.S. history. Officially, the recession began in March 2001 and ended in November 2001. The recession in Maryland was much less severe than for the nation as a whole. While the U.S. economy has lost 2% of its job base, around 2.7 million jobs, Maryland never lost jobs on an annual basis. For several months in late 2001, the Maryland economy lost jobs on a year-over-year basis. However, in both 2001 and 2002, Maryland added a modest number of jobs (17,000 in 2001 and 5,400 in 2002). This is in striking contrast to the last recession in the early 1990s when the Maryland economy lost 5% of its job base and lost jobs in two consecutive years (1991 and 1992).

Despite the relatively good economic news for Maryland, the economic outlook today is slightly weaker than the forecast from December 2002 that was the basis of the Board of Revenue Estimates revenue projections. This is due largely to weakness in the Maryland economy in early 2003. Maryland experienced three consecutive months of year-over-year job loss at the beginning of the year. This results in a downward revision for total employment and personal income growth for all of calendar 2003. Similarly, the outlook for 2004 is slightly weaker as the economy gradually steps up to something approaching long-term trend growth in 2005 and 2006.

Revenues

The weak economic outlook has impacted the revenue outlook for the State. Fiscal 2003 ended $34 million above the estimate and fell 1.0% from fiscal 2002. However, there were a number of one-time or temporary items in both years. Adjusting for those items, ongoing general fund revenues were below the estimate by $11 million and down from 2002 by 0.4%. The largest revenue source, the personal income tax, exceeded the estimate in 2003 but was down 1.4% from 2002. This is the second year in a row that personal income tax revenue fell, although the decline this year was much less than the 7.1% drop in fiscal 2002.

Ongoing Spending in Relation to Personal Income
Under Spending Affordability Concept



	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
SA as % of PI	7.43	7.31	7.33	7.38	7.33	7.39	7.58	7.53	7.26	7.14	7.19	7.23	7.19	7.06	6.94	6.95	7.02	7.24	7.27	7.11	7.10
20-year high	7.58	7.58	7.58	7.58	7.58	7.58	7.58	7.58	7.58	7.58	7.58	7.58	7.58	7.58	7.58	7.58	7.58	7.58	7.58	7.58	7.58
20-year low	6.94	6.94	6.94	6.94	6.94	6.94	6.94	6.94	6.94	6.94	6.94	6.94	6.94	6.94	6.94	6.94	6.94	6.94	6.94	6.94	6.94

The slight underattainment in fiscal 2003 and the somewhat weaker economic forecast alter the outlook for near-term revenue growth. In October 2003, the Department of Legislative Services (DLS) projected that general fund revenue for fiscal 2004 will be $65 million less than the estimate upon which the current budget was based. This estimate represents an increase of 6.7 % over ongoing revenues in fiscal 2003. Compared to total revenues in fiscal 2003, which includes transfers and federal aid, fiscal 2004 revenues are projected to rise 6.5 %. In fiscal 2005, DLS projected total general fund revenue growth of 3.0 %. In all three years there are a number of unusual items, such as fund swaps and law changes, which distort the year-over-year growth rates. Adjusting for these items shows that the forecasted underlying growth rate is about 3.8 % in fiscal 2004 and 4.6 % in fiscal 2005.

Budget Requirements

The committee is projecting a general fund balance of $188 million in fiscal 2004. The expectation of a positive balance is attributable to one-time transfers, temporary federal aid of $244 million, and cost containment actions announced by the Governor in July 2003 that reduced fiscal 2004 spending by approximately $204 million. These actions are partially offset by expected deficiency appropriations of about $215.8 million to address specific anticipated spending shortfalls during fiscal 2004. Areas projected to require deficiency funding include Medicaid program activities, mental health services, foster care placement costs, and expenses related to inmates confined to local jails.

Legislatively mandated increases in education aid and escalating Medicaid and mental health expenses underpin the 7.2% increase in operating spending forecast for fiscal 2005. While the forecast does not anticipate a general salary increase for State employees, employment related costs increase significantly as most employees are expected to qualify for increments and pay-for-performance bonuses. Annualized general fund savings from the abolition of almost 1,700 positions in fiscal 2004 are expected to total almost $40.6 million in fiscal 2005.

If no actions are taken to decrease expenditures or generate additional revenue, fiscal 2005 expenditures could exceed revenues by $738 million. Factors contributing to the potential shortfall include the use of $831 million of one-time transfers and temporary revenues to support fiscal 2004 spending, mandated increases in education aid, and continued growth in Medicaid spending. With general fund revenues forecast to grow slower than operating expenditures in fiscal 2005, the fiscal 2005 estimate brings the imbalance between ongoing revenues and ongoing operating costs to more than $1.0 billion. The outlook for future years is no better as spending pressure will exceed the normal growth of revenues through fiscal 2008 under current law.

Recommendations

In light of the considerations discussed above, the committee proposes the following recommendations for the 2004 session:

1. Operating Budget

A. Spending Limit and Sustainability

Appropriations subject to the spending affordability limit shall be limited to growth of no greater than 4.37 % over those approved at the 2003 session. This limit would provide for a $632 million increase in appropriations at the 2004 session, allowing for total expenditures subject to spending affordability of $15.095 million.

In recognition of the continued structural imbalance in State finances, the recommended limit constrains spending growth to a level below that forecasted for the State's economy overall. This limit will require reductions in spending to levels below that estimated to be required to support current services in order to address part of the State's structural budget problem. Budget reductions cannot comprise the whole solution to the State's structural problem, however. Even as we limit spending growth to "affordable" levels in economic terms, the committee notes that the existing revenue base of the State is insufficient to support the remaining programs.

The committee, therefore, calls on the Governor and the General Assembly to take the actions necessary to find the revenues required to pay for the cost of government services provided and promised in the future. **Accordingly, the committee recommends that future sustainability be a primary consideration in the development of the fiscal 2005 general fund budget and that the imbalance between revenues and expenditures be erased entirely by fiscal 2006.**

2. State Reserve Fund

In addition to its general fund recommendations, the committee also recommends a prudent use of the Revenue Stabilization Account ("Rainy Day Fund") to address general fund needs. Section 7-311 of the State Finance and Procurement Article establishes the Rainy Day Fund to retain revenues for future needs and guard against future tax increases. The section requires that the fund have at least 5% of the estimated general fund revenues. The statute allows for the withdrawal of funds. When the fund balance falls below 5%, the statute requires that $50 million be appropriated into the fund annually until the 5% balance is restored. When the balance falls below 3% of general fund revenues, the statute requires that $100 million be appropriated.

Insofar as the Rainy Day Fund balance is a conspicuous feature of State finance and is relied upon by bond rating agencies and others as a measure of State financial health and management, the committee expects that the fund be managed prudently. The rating agencies advise that use of the Rainy Day Fund during an economic downturn will not impact the State's AAA bond rating. However, they will look closely at the State's plan to restore structural balance between revenues and spending.

The committee recommends the State reduce the Rainy Day Fund balance below 5% only if all other available cash balances are exhausted and other options have been

fully explored. The committee also recommends that the General Assembly reject any proposal to reduce the Rainy Day Fund balance below 5% to support the fiscal 2005 budget that is not accompanied by a realistic plan for achieving a structural balance between operating spending and ongoing revenues by fiscal 2006.

3. Capital Budget

A. General Obligation Debt

The committee concurs with the provisional recommendation of the Capital Debt Affordability Committee (CDAC) that $655 million in general obligation bonds may be authorized at the 2004 session. The final recommendation of CDAC will occur following a review of the official December revenue estimates. The provisional recommendation is $90 million less than the fiscal 2004 authorization but $100 million more than was anticipated by CDAC one year ago. The $655 million debt limit provides $650 million for capital projects and $5 million in funding for tobacco buyout. The bond funding may include the issuance of both taxable and tax-exempt debt.

Accordingly, the committee concurs in the provisional recommendation of the Capital Debt Affordability Committee that $655 million in new general obligation bonds may be authorized at the 2004 session. This limit allows for the use of taxable and tax-exempt bonds and gives the Governor and the legislature considerable flexibility to structure capital financing in the context of the total budget needs of the State.

B. Bond Sale Premiums

For the period fiscal 2001 through 2004, the State has received $197 million in bond sale premiums, because the coupon rate (interest rate paid on bonds) has been greater than the market interest rate. Bond sales in fiscal 2004 and 2005 are expected to continue to generate premiums. However, the State does not project bond sale premiums when preparing the Annuity Bond Fund forecast and debt service expenditure forecast.

The committee recommends that the State begin to estimate bond sale premiums when preparing the Annuity Bond Fund and debt service forecasts.

Legislation enacted in 2003 allows the State to use bond sale premiums to support the capital program. In fiscal 2004, revenues generated from bond sale premiums support debt service reducing the need to fund debt service through property taxes and general funds. However, given the expected future decline in bond sale premiums, these premiums should not be relied upon as a permanent revenue source.

The committee does not support the use of bond sale premiums to expand the capital program. The use of bond sale premiums should be limited to supporting debt service payments or reducing general obligation bond issuances. The first priority for any bond sale premium revenues should be stabilizing the property tax rate and minimizing general fund spending on debt service in fiscal 2005 or future years.

C. Non-tax Supported Debt

State agencies and independent authorities have over $10 billion in debt outstanding. This debt, which has grown over 50% in five years, is not directly supported with general funds or transportation revenues and is not considered to be State debt. **The committee notes that this was the first year the CDAC examined non-tax supported debt in the course of its work and recommends that the process be formalized and made more rigorous in the future.**

D. Higher Education Debt

1. 2004 Session Higher Education Debt Authorization

For fiscal 2005, the University System of Maryland (USM) intends to issue up to $18 million in auxiliary debt and $33.1 million in academic debt. This level of issuance will result in a debt service ratio below the 5.5% of current unrestricted funds and mandatory transfers recommended by the system's financial advisers. Morgan State University, St. Mary's College, and Baltimore City Community College do not plan on issuing any debt in fiscal 2005.

The committee concurs in the recommendation of the Capital Debt Affordability Committee that $33.1 million in new academic revenue bonds may be authorized for the University System of Maryland at the 2004 session.

2. Debt Affordability Criteria

Currently CDAC's criterion for measuring higher education debt affordability is to compare debt service to unrestricted current fund expenditures and mandatory transfers. USM also evaluates debt affordability by comparing unrestricted net assets to debt outstanding. The ratio of unrestricted net assets to debt outstanding has declined to 53% at the end of fiscal 2003. This brings the ratio close to the 50% threshold recommended by USM's financial advisors. CDAC does not use this ratio to monitor USM debt outstanding.

Standard and Poor's has recently downgraded the USM credit outlook from stable to negative. This could lead to higher interest rates and debt service costs if USM academic and auxiliary revenue bonds credit ratings' are in fact downgraded. The committee is concerned that the CDAC process does not adequately reexamine higher education debt. **To improve the CDAC review of USM debt, the committee recommends that, in addition to evaluating debt service, CDAC also evaluate USM debt outstanding. It is suggested that CDAC use the criteria currently used by USM: maintaining a ratio of unrestricted net assets to debt outstanding of at least 50%.**

E. Transportation Debt

The Maryland Department of Transportation (MDOT) competes with other State capital projects within debt affordability limits. Transportation debt capacity is limited by the constraints on debt outstanding, debt service coverage, the cash flow needs for projects in the capital program, and overall State debt affordability limits. **The committee recommends that**

the General Assembly continue to set an annual limit on the level of State transportation debt so as to maintain debt outstanding within the 3.2% of personal income debt affordability criterion and debt service within the 8.0% of revenues debt affordability criterion.

4. Transportation

A. Traditional Debt: Consolidated Transportation Bonds

The 2004 draft *Consolidated Transportation Program* anticipates the issuance of new debt by MDOT through fiscal 2009 totaling $985 million. Debt outstanding will approach the statutory ceiling beginning in fiscal 2006 and by fiscal 2009 debt outstanding will be $86 million below the ceiling. These plans follow a period of relatively low debt issuance; MDOT issued just $225 million in new debt from fiscal 1998 through 2002. However, in fiscal 2003 MDOT issued $345 million in bonds and plans to issue $385 million in fiscal 2004.

To the extent transportation revenues exceed those projected by MDOT, the committee finds that the additional funds should be used to reduce the amount of bonds sold.

B. Nontraditional Debt: Revenue Bonds, Certificates of Participation

The usage of nontraditional debt, which includes debt sold by the Maryland Transportation Authority, the Maryland Economic Development Corporation, and Certificates of Participation and is backed by specific revenues, has increased substantially since fiscal 1992 and will continue to do so over the next six years. The department has released nine separate issuances of nontraditional debt. As of June 30 2003, nontraditional debt outstanding totaled $699 million. Currently, few constraints, aside from market conditions, exist on MDOT's issuance of nontraditional debt. Annual budget bill language limits only the issuance of Certificates of Participation to the amount anticipated in the annual budget. The committee is concerned that the increase in nontraditional debt could result in the department overextending its future revenue obligations.

While the committee appreciates the creative financing approach taken by the Department of Transportation to fulfill capital infrastructure requirements, the budget committees should give serious consideration to imposing limits on the issuance of nontraditional debt, especially as in the case of grant anticipation revenue vehicles (GARVEEs), where repayment of the debt will reduce future cash flows of the department.

5. State Employment

A. Hiring Freeze and Position Ceiling

Given current financial conditions, the prudent allocation of personnel resources is critical. Personnel costs comprise approximately a quarter of the State operating budget, and any effort to permanently reduce personnel spending through position ceilings or other means will help resolve the structural budget gap. Position ceilings imposed by the General Assembly for fiscal 2003 and 2004 have resulted in a decline in the size of the State regular workforce from 82,087 full-time equivalent positions in fiscal 2002 to 78,087 in fiscal 2004. The committee recognizes the continuing necessity of limiting the addition of nonessential positions.

The committee recommends that the Executive Branch position ceiling of 74,100 positions, established in Section 41 of the 2003 budget bill (Chapter 202, Acts of 2003), continue through fiscal 2005. Section 41 required that the Governor reduce the total number of Executive Branch positions to 74,100 for fiscal 2004.

B. Limit on Positions Created

To further constrain the growth in State spending, the committee recommends that the addition of new positions in fiscal 2005 should be limited to:

- **critical public safety and homeland security needs;**
- **facilities scheduled to open in fiscal 2005; and**
- **addressing workload increases and essential services at 24-hour facilities.**

If the Governor finds it necessary to add positions, these additions should be offset with abolitions elsewhere in the State budget. There are currently 3,881 positions vacant in the Executive Branch.

C. Areas of Concern

The recommended position limit should be regarded as a ceiling and not a goal. We expect the Governor and the budget committees to undertake as part of their normal process a critical examination of the necessity of each position to the mission of their agencies and of State Government. In particular, we request that special attention be paid to the adequacy or excess of positions allocated to particular agencies, and, within agencies, to the proper relationship of positions allocated to overhead and central office functions as opposed to those providing direct services to citizens.