MARYLAND GENERAL ASSEMBLY
SPENDING AFFORDABILITY COMMITTEE

December 19, 2007

The Honorable Martin J. O'Malley
Governor, State of Maryland
State House
Annapolis, Maryland 21401

Dear Governor O'Malley:

We are pleased to submit the fiscal policy recommendations of the Spending Affordability Committee made during the 2007 interim. The committee adopted these recommendations at its meeting on December 18, 2007. The committee reviewed data concerning the economic condition of the State, revenue and expenditure trends during the past several years, personnel data, and the results of the Capital Debt Affordability Committee report.

The committee made recommendations concerning the fiscal 2009 spending limit, general and reserve fund balances, capital debt, transportation debt, and State positions.

The Spending Affordability Committee has completed its assigned tasks. As required by law, the recommendations of the committee have been submitted to the Governor and the Legislative Policy Committee.

We are most appreciative of the time and effort expended by each member of the committee. A special note of thanks and appreciation is extended to the members of the Citizens Advisory Committee for their valuable assistance and input.

Sincerely,

Senator Ulysses Currie
Presiding Chairman

Delegate John L. Bohanan, Jr.
House Chairman

UC:JLB/ESS/msh

MARYLAND GENERAL ASSEMBLY
SPENDING AFFORDABILITY COMMITTEE

December 19, 2007

The Honorable Thomas V. Mike Miller, Jr., Co-Chairman
The Honorable Michael E. Busch, Co-Chairman
Members of the Legislative Policy Committee

Ladies and Gentlemen:

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Spending Affordability Committee

2007 Interim Report

Annapolis, Maryland
December 2007

2007 Spending Affordability Committee Report and Recommendations to the Governor and the Legislative Policy Committee

The Spending Affordability Committee was created in 1982 (Chapter 585 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 table on the following page.

The committee notes that operating spending in relation to the State's economy, as measured by the personal income statistic has fluctuated between 7.0 and 7.6 percent. Recent decisions, such as the unprecedented increases under the Bridge to Excellence in Public Schools Act, have raised spending to levels experienced in the mid-1980s. The chart on page 4 illustrates the historical pattern of spending versus personal income.

The committee notes that the State's budgetary outlook has changed considerably due to the actions taken during the 2007 special session. Whereas previous projections revealed an ending general fund cash deficit of $1.4 billion, actions were taken to increase revenues and curtail spending to close the budget gap. The estimated combined effects of the special session actions, taking into account the determinations of the Board of Revenue Estimates, result in projected cash balances of $88 million at the close of fiscal 2009.

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.

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
2004	4.37%	635.2	4.33%	629.0
2005***	6.70%	1,037.1	6.69%	1,036.3
2006***	9.60%	1,604.7	9.57%	1,599.0
2007	7.90%	1,450.0	7.51%	1,378.4

*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 percent.

**Data from the 2001 session and subsequent years reflect a revised methodology for calculating the spending affordability limitation.

***The committee initially approved a limit of 5.70 percent for 2005 and 8.90 percent for 2006.

Economy

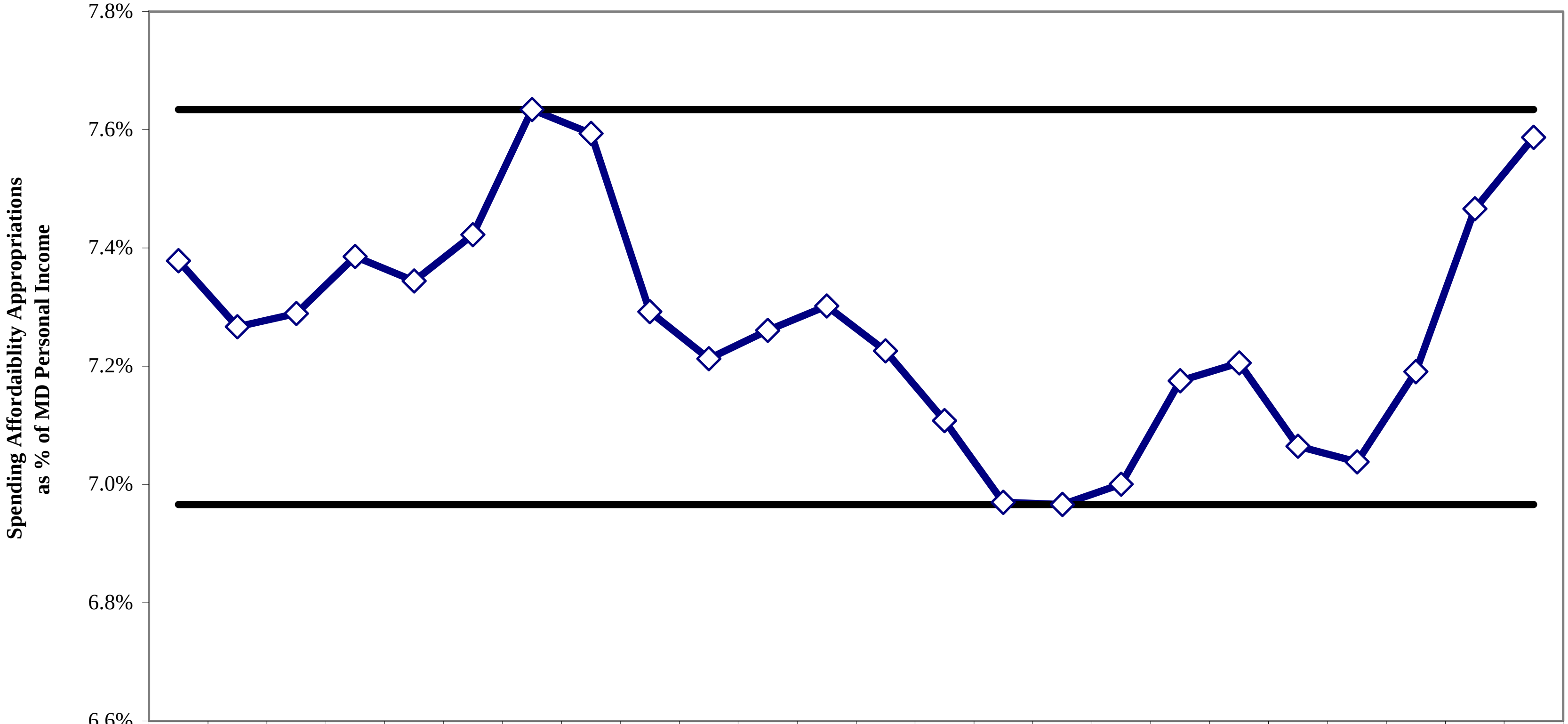
The Maryland economy marked its third year in a row of healthy growth in 2006. Total personal income grew 5.7 percent in 2006, the same as in 2005. Employment rose by 1.2 percent, slowing from the 1.5 percent pace in 2005. Industries related to the housing market such as real estate agents and certain finance companies experienced job losses especially in the second half of 2006. The retail trade sector also posted a year-over-year drop in employment in the second half of 2006. The data available for 2007 presents a somewhat mixed picture of the Maryland economy. Through November, employment is up 1.1 percent. Total personal income grew 5.8 percent in the first half of 2007. Wage and salary income is up 5.7 percent compared to growth of 5.4 percent in 2006. The Maryland housing market continues to contract sharply. According to data from the Maryland Association of Realtors, sales in 2007 have fallen 22.0 percent through November on top of a 21.0 percent decline in 2006.

The economic outlook is for slower growth compared to the forecast from December 2006 that was the basis of the revenue projections from the Board of Revenue Estimates. Part of this is due to the weaker employment growth in 2006 and year-to-date in 2007 than was previously estimated. The continuing contraction in the residential housing market will weigh on the economy, resulting in projected employment growth of less than 1 percent in 2008. Economic growth should rebound in 2009 in response to interest rate cuts from the Federal Reserve and a bottoming out of the housing market. The impact of the U.S. Department of Defense’s Base Realignment and Closure process will begin to be felt in 2010.

Revenues

Fiscal 2007 general fund revenues exceeded the estimate by $75.0 million, or 0.6 percent. General fund revenues totaled $12.9 billion in fiscal 2007, an increase of 4.4 percent over 2006. Excluding one-time revenues, ongoing revenues grew 4.6 percent in 2007. For fiscal 2008, total general fund revenues through November are up 3.2 percent over the same period in 2007. However, a number of things are distorting the year-over-year comparison. Fiscal 2007 reflects the impact of the tax-free week for back-to-school items. There was no tax-free week in fiscal 2008. Fiscal 2007 also reflects extraordinarily large estate tax payments from a small number of estates. In fiscal 2008, the corporate income tax includes the payment of a large one-time refund. The year-to-date growth in general fund revenues is about 4.9 percent after adjusting for these items. Given the significant under-attainment in the sales tax in fiscal 2007 and the expectation of slowing economic growth, the Department of Legislative Services projects general fund baseline growth of 3.3 percent in fiscal 2008 and 4.9 percent in 2009.

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	2005	2006	2007
SA as % of PI	7.38%	7.27%	7.29%	7.39%	7.34%	7.42%	7.63%	7.59%	7.29%	7.21%	7.26%	7.30%	7.23%	7.11%	6.97%	6.97%	7.00%	7.18%	7.21%	7.06%	7.04%	7.19%	7.47%	7.59%
24-year high	7.63%	7.63%	7.63%	7.63%	7.63%	7.63%	7.63%	7.63%	7.63%	7.63%	7.63%	7.63%	7.63%	7.63%	7.63%	7.63%	7.63%	7.63%	7.63%	7.63%	7.63%	7.63%	7.63%	7.63%
24-year low	6.97%	6.97%	6.97%	6.97%	6.97%	6.97%	6.97%	6.97%	6.97%	6.97%	6.97%	6.97%	6.97%	6.97%	6.97%	6.97%	6.97%	6.97%	6.97%	6.97%	6.97%	6.97%	6.97%	6.97%

Legislation passed at the 2007 special session made numerous changes to the State's revenue structure. In total, general fund revenues are projected to be higher by $367 million in fiscal 2008 as result of legislation passed at the special session. In fiscal 2009, the additional revenue totals an estimated $837 million reflecting a full year impact. These changes raise the expected growth in general fund revenues to 6.1 percent in fiscal 2008 and 8.2 percent in 2009.

Budget Requirements

Prior to the actions taken during the special session, the committee was projecting a general fund balance of $145 million at the close of fiscal 2008. The positive balance is attributable to continued adherence to spending limits supplemented by one-time transfers and the carry-forward of the fund balance from the prior year. These actions are partially offset by potential deficiencies of $68 million to address specific anticipated spending shortfalls during fiscal 2008. Areas projected to require deficiency funding include per diem placements; the reopening of the Victor Cullen Academy; payment of prior year bills in the Department of Juvenile Services; medical assistance payments for higher than anticipated inpatient costs; and the energy assistance program.

Legislatively mandated increases in education aid – despite achieving the full phase-in of the Bridge to Excellence funding – and escalating Medicaid expenses were behind a 7.4 percent increase in operating spending forecast for 2009. The forecast also assumes significant increases in State agency costs, including a 2.0 percent general salary increase and full budgeting for employee and retiree health insurance costs.

This increase in spending has been moderated by actions taken by the General Assembly in House Bill 1 (Chapter 2 of the 2007 special session). In a combination of specific actions and expression of legislative intent, spending is to be reduced by $550 million as compared to the earlier baseline projections. The specific actions total $337 million and include:

- reducing the growth in aid to local school systems by $190 million;
- eliminating the State grant to local governments for electric generating property;
- using special funds in lieu of general funds in several instances, including to fund employee health insurance, operate State parks, and undertake information technology projects in the Judiciary; and
- eliminating 500 vacant positions from Executive Branch agencies.

The General Assembly expressed its intent that the Governor identifies the balance of the recommended savings with the development of the fiscal 2009 allowance.

With the actions taken during the special session, the committee projects the State will close fiscal 2008 with cash reserves (from the general fund balance and the Rainy Day Fund) of $1.1 billion, or 8.1 percent, of general fund revenues.

Recommendations

In light of the considerations discussed above, the committee proposes the following recommendations for the 2008 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 4.27 percent over those approved at the 2007 session. This limit would provide for an $847 million increase in appropriations at the 2008 session, allowing for total expenditures subject to spending affordability of $20,675 million.

This spending limit reflects the actions taken during the 2007 special session to increase revenues, slow the rate of budget growth, and fund several key new initiatives. The committee recognizes the possibility of continued softening of the economy and the State's revenues and expects that the General Assembly will respond with appropriate fiscal discipline and prudence in the enactment of the fiscal 2009 budget.

B. Calculation Adjustment

The General Assembly added language to the fiscal 2007 budget bill directing the Department of Budget and Management (DBM) to establish policies and procedures to minimize reliance on budget amendments for appropriations that could be included in the budget bill as a deficiency appropriation. To encourage compliance with the new policy, the committee excluded from the calculation of the 2007 session spending limit, any deficiency appropriations that could otherwise be submitted as budget amendments. **Consistent with the 2006 committee recommendation, the committee recommends that 2007 session deficiency appropriations for items that could be added to the budget as budget amendments be included in the affordability limit.**

2. Rainy Day Fund

In addition to its general fund recommendations, the committee also continues to recommend a prudent use of the Revenue Stabilization Account ("Rainy Day" Fund) to address general fund needs. The committee projects a Rainy Day Fund balance at the beginning of fiscal 2009 of about $680.0 million, which meets the statutory requirement for a balance of at least 5 percent of estimated general fund revenues. The Governor will be required to include

$146.5 million for the Rainy Day Fund in the fiscal 2009 allowance, based on the unappropriated general fund surplus above $10.0 million from the fiscal 2007 closeout.

The committee supports maintaining a minimum 5.0 percent balance in the Rainy Day Fund but also recognizes that declining revenue estimates may necessitate use of the portion of the fund balance above 5.0 percent to ensure fiscal equilibrium in fiscal 2009. The committee also supports the goal of achieving a 7.5 percent balance in the Rainy Day Fund in the long-term, consistent with the provisions of the State Finance and Procurement Article.

3. Capital Budget

A. General Obligation (GO) Debt

The committee concurs with the recommendation of the Capital Debt Affordability Committee (CDAC) that a maximum of $935 million in general obligation bonds may be authorized at the 2008 session. This level allows for a $125 million increase in spending over the 2007 session authorization and includes $3 million for the Tobacco Transition Program.

The recommendation to increase the authorization by $125 million in the 2008 session reflects a change in the CDAC's authorization policy. In response to high demand for capital spending, the committee increased authorizations by $100 million more than previously planned. This increase is affordable within the CDAC's framework, which requires that State debt outstanding not exceed 3.2 percent of State personal income and that State debt service not exceed 8.0 percent of State revenues supporting debt service.

The committee concurs in the recommendation of the Capital Debt Affordability Committee that up to $935 million in new general obligation bonds may be authorized at the 2008 session.

B. Higher Education Debt

For fiscal 2009 the University System of Maryland intends to issue up to $67 million in auxiliary debt and $33 million in academic debt. This level of issuance will result in a debt service ratio within the 5.5 percent of current unrestricted funds and mandatory transfers criterion recommended by the system's financial advisers. Morgan State University, St. Mary's College of Maryland, and Baltimore City Community College do not plan on issuing any debt in fiscal 2009. **The committee concurs in the recommendation of CDAC that $33 million in new academic revenue bonds may be authorized for the University System of Maryland in the 2008 session.**

C. Transportation Debt

Maryland's debt policies have earned the State AAA bond ratings from all three major rating agencies. Rating agencies have commented that one of Maryland's strengths is setting and abiding by debt affordability limits. CDAC is charged with recommending debt limits. Included in its calculation of State debt are bonds issued by the Maryland Department of Transportation. As such, these bonds compete with other State capital projects within debt affordability limits.

In its October report, CDAC recommended increasing GO bond authorizations. The basis for this recommendation is that the debt was affordable under current guidelines. Since the CDAC report was released, the Administration proposed increasing State transportation capital spending and the General Assembly adopted legislation increasing State transportation revenues to support a larger transportation capital program. If transportation debt outstanding is expanded to the extent allowed by the legislation, State debt outstanding is projected to exceed 3.2 percent of State personal income by 2012. **It is recommended that CDAC consider the effect of increasing the State's transportation program as it reviews the State's affordability criteria.**

4. Operating Maintenance Exclusion

For the last seven years, operating spending by the Department of General Services (DGS) on facilities maintenance projects above a base funding level of $2 million has been excluded from the spending affordability calculation. The exclusion was initially authorized in the committees December 2000 report, which noted a backlog of operating maintenance projects at State facilities in the magnitude of $47 million. Left unaddressed, the committee recognized that this could lead to further deterioration of the State's infrastructure and to higher costs in the long run.

Despite the exclusion, DGS reports that it currently has a $35.0 million backlog of deferred maintenance and repair work, $22.4 million of which is rated as either high or medium priority (posing a high economic risk). In an October 2007 report to the budget committees, DGS estimated that the backlog could eventually be eliminated by fiscal 2021 with an annual deferred maintenance appropriation of $5.0 million. These projections assume that new projects accumulate at the historical annual average of $2.5 million a year. The DGS report indicated that current staffing levels would have to be increased in order to manage projects above a $5.0 million funding level. **In an effort to reduce the backlog, the committee continues to support the exclusion from the spending affordability calculation of operating maintenance spending by DGS above the historical spending level of $2.0 million. The committee also supports excluding the costs associated with either hiring additional staff or reclassifying current department vacancies dedicated to deferred maintenance projects.**

5. State Employment

Personnel costs comprise approximately one fourth of the State operating budget; the use of position ceilings and other controls in recent years has resulted in a decline in the size of the State's regular workforce from 82,089 in fiscal 2002 to 81,225 in fiscal 2008. Declines have been even sharper in Executive Branch agencies, dropping from 56,963 in 2002 to 53,733 in 2008. The fiscal 2008 totals recognize the July 2007 action by the Board of Public Works to eliminate 147 positions.

Despite the decline in the number of authorized positions, the committee notes that, exclusive of higher education, there are currently more than 4,500 vacant Executive Branch positions, approximately 1,728 of which are funded, in the 2008 budget. The high number of funded vacant positions suggests that many additional workforce needs may be addressed through full utilization and reallocation of existing resources.

As part of the overall approach to close the structural budget gap, the General Assembly has specified that the number of authorized positions in Executive Branch agencies be reduced by 500 by January 30, 2008. Chapter 2 of the 2007 special session (Budget Reconciliation Act) directs the Governor to submit an allocation schedule to the Board of Public Works to reflect the reduction.

The committee recommends that the actions taken to reduce the size of the State workforce as specified in the Budget Reconciliation Act be continued into fiscal 2009. The committee also recommends that the Governor exercise prudent discipline in the creation of additional positions in the fiscal 2009 budget. DBM should verify that reasonable efforts are made to fill existing vacancies and fully utilize authorized resources before adding new positions.

6. Study of Maryland's Budgetary Structure and Process

Chapter 2 of the 2007 special session includes a provision calling for the Spending Affordability Committee, in cooperation with DBM, to undertake a study of Maryland's budgetary structure and process. Specifically, the study is to "address how current laws and practices relate to national norms and best practices with respect to budget formulation, review, management, and oversight by the Executive and Legislative branches."

The statute establishes a report deadline of December 15, 2008, so that any appropriate legislation could be considered in the 2009 session. **The committee will undertake this study with all deliberate speed during the 2008 interim. The committee looks forward to working closely with the Executive Branch and anticipates the full cooperation of DBM.**