The Maryland Public Policy Institute

The Annapolis Report

A Review of the 2012 Legislative Session and Special Sessions

THE ANNAPOLIS REPORT

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BY GABRIEL J. MICHAEL

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INTRODUCTION

2012 was an unusual year in the Maryland General Assembly. In April, we witnessed a game of political brinksmanship end without passing major portions of the state's proposed budget, leaving the state to operate under the pejoratively termed "doomsday" budget. A month later, legislators returned to Annapolis for a special session and managed to pass a major income tax increase, as well as shift responsibility for funding public school teachers' pensions away from the state. In August, the General Assembly concluded a second special session focused on expanding gambling and associated tax revenue in the state.

This fourth annual edition of The Annapolis Report adopts a different approach from previous years. Because of legislative delays and additional special sessions, this year's report is heavily condensed, highlighting only the most important activity in each session. Weighting and scoring of legislation has also been omitted. Finally, this year's report reviews legislative activity in rough chronological order by session.

As always, the goal of The Annapolis Report is to provide a concise, plain-language guide to many of the major topics addressed in the General Assembly: the state's budget, taxes, education, health insurance, and more. The Annapolis Report differs from many other projects in not assessing the performance of individual legislators; rather, it focuses on the activity of the legislature as a whole. For this reason, we focus on analyzing, interpreting, and condensing that activity for our readers.

ANALYSIS

The Regular Session

The General Assembly's 2012 regular session spanned 90 days from January 11 to April 12. Nearly 2,600 bills were introduced, of which 794 passed in both houses, and 730 were signed into law. While a bitter debate over budget cuts and income tax increases overshadowed most of the session's activity, as well as the failure to pass major portions of the state's proposed budget, there were several other important issues addressed during the session and analyzed below.

The "Doomsday" Budget

In an unusual turn of events, the Democratically-controlled General Assembly managed to pass a fiscally conservative budget, balanced through reductions in spending and constraints in budgetary growth. Since 1992, Maryland's budget has typically been balanced by a combination of two pieces of legislation: the budget bill, which specifies the amount of money allocated to various activities, programs, and departments; and the Budget Reconciliation and Financing Act, or BRFA, which contains all the necessary actions for balancing the budget that require actual changes in law.[1] The BRFA often shifts money from special, dedicated funds to the state's general fund to cover shortfalls, and adjusts aid and budget growth formulas to constrain cost increases.

While the state's budget bill passed during the regular session, the General Assembly failed to pass the BRFA, as well as a hotly-debated income tax increase known as the State and Local Revenue and Financing Act, or SLRFA. Without the additional revenue from the tax increases and fund transfers contained in these two bills, automatic contingencies present in the original budget bill were activated to balance the budget through reductions in spending and constraints in budgetary growth.

Despite the dire predictions regarding the "doomsday" budget, much of the outcry was overstated. For example, Democratic legislators warned that without additional revenue, they would be forced to cut hundreds of millions of dollars in education spending, as well as terminate 500 state employees.[2] In reality, these cuts were actually reductions in planned increases. The net result, despite the rhetoric about hundreds of millions of dollars in cuts, was that state aid to public schools increased by $1.9 million thanks to the "doomsday" budget.[3] As for the idea that state employees would lose their livelihood, the budget called for eliminating 500 positions, not terminating 500 employees. As the state currently has several thousand vacant positions, 500 positions could easily have been eliminated without a single state employee losing his or her job.[4]

Indeed, the fiscally conservative budget that emerged from the chaos of the regular session would have had a number of positive effects, making it possible to eliminate ineffective tax credits, eliminate the patronage of delegate and senatorial scholarships, and require state employees to bear a larger portion of their increasing health insurance costs.[5] Overall, the "doomsday" budget actually resulted in an increase of nearly $700 million, or 2 percent, in spending over the fiscal year 2012 budget.[6]

Why exactly did the General Assembly fail to pass the BRFA and SLRFA? Immediately after the end of the regular session, finger-pointing abounded. For weeks, House and Senate Democrats failed to agree on the extent of the planned income tax increase. House Democrats favored an increase targeted squarely at high earners, while Senate Democrats envisioned an across-the-board increase that would have affected the majority of Marylanders who file tax returns. Combined with a protracted debate on expanding gambling in the state, the General Assembly failed to vote on the remainder of the budget bills up until midnight of the final day of the session.

When it became clear that the budget would be balanced without the passage of an income tax increase or the usual fund transfers and shifts, Republicans argued that a special session would be unnecessary, and that the state could afford to live with a 2 percent increase in overall spending for the coming year. A month later, however, Governor Martin O'Malley convened the first special session of the calendar year with the explicit goal of undoing the contingency actions of the original budget bill. This report contains the details of that session and its effect on the state's operating budget below.

Healthcare and Health Insurance

HB 443 continues the implementation of Maryland's Health Benefit Exchange. Maryland's early efforts in establishing the exchange, which is required as a part of federal healthcare reform, appear to have paid off in the wake of the Supreme Court's June decision to uphold the Patient Protection and Affordable Care Act. The exchanges are designed to help individuals and small businesses compare and purchase health insurance plans. These efforts already brought the state $34 million in federal funds to help set up the exchange, and qualified Maryland to receive an additional $123 million. However, federal funding for the exchange is only available through 2014, after which Maryland must cover the estimated $40 million in annual costs associated with the exchange. In an interview with *Bloomberg Businessweek*, Lieutenant Governor Anthony Brown suggested that additional taxes could cover the costs.[8]

Bay Restoration Fund/Flush Tax

HB 446 doubled the Bay Restoration Fee, colloquially known as the "flush tax," from $30 to $60. The Bay Restoration Fund is used to upgrade wastewater treatment plants throughout the state, and faces a $380 million shortfall in funds; even after doubling the flush tax, a $75 million shortfall will remain because the state is too close to its self-imposed debt ceiling to use the additional tax revenue to back new bond issues.[9] Meanwhile, a total of $290 million has been transferred from the Bay Restoration Fund to cover General Fund deficits; bonds have replaced the transferred funds, driving the state closer to its debt ceiling and incurring additional debt service costs. Such transfers prompted Moody's, a bond rating agency, to downgrade the bonds issued by Bay Restoration Fund.[10] While legislative proposals were introduced this session to protect the Bay Restoration Fund from further transfers, none passed.

Education

SB 848 makes important changes to the state's maintenance of effort (MOE) requirements. In general, MOE requires county governments to fund their school systems with at least as much money per student as provided in the prior year. Failure to do so can result in loss of scheduled increases in state education aid for the county. The new legislation codifies certain standards for granting waivers to MOE, including whether a county has historically funded its school system beyond requirements. This change alters the ratchet-like mechanism that requires ever-increasing spending each year. The bill applies any MOE penalties to the county, rather than to the school board, by allowing the state to divert local income tax revenue from the county to the school board. Opponents of the changes argue that the bill grants too much power to the state and emphasizes education spending above all other priorities.[11] The bill also grants counties the ability to raise local property taxes above any caps established in the county.

SB 362 increased the minimum age through which children are required to attend school from 15 to 17, a measure that has the effect of ensuring most children cannot drop out of school prior to turning 18. Various estimates place the societal cost of each dropout in lost tax revenues, social assistance, and incarceration at around $200,000 to $300,000.[12] While the legislation will increase education spending in order to pay for several thousand additional students to attend school, if a portion of those students ends up receiving a high school diploma as a result, the net fiscal effect of the legislation may be positive.

Workers' Compensation

In a move designed to prevent the state from transferring additional funds from its surplus, the General Assembly passed HB 1017/SB 745, which converts the state-run Injured Workers' Insurance Fund (IWIF) to a private, non-profit corporation. IWIF serves as the insurer of last resort for workers' compensation insurance, and is the largest insurer of its kind, serving a quarter of the market in Maryland.

As the bill's fiscal and policy note suggests, protecting the fund's surplus could result in lower premiums and increased dividends for policyholders, and thus benefit Maryland businesses. Further, by protecting the fund's assets from transfers to cover other state expenses, the bill may partially force more responsible budgeting practices at the Governor's office. In a final cash grab, the first special session's Budget Reconciliation and Financing Act transferred $50 million from IWIF to pay for other state expenses; when IWIF becomes a private corporation, this kind of transfer will no longer be possible.

Tax Credit Evaluation Act

HB 764/SB 739 passed in a substantially neutered form. As originally proposed, the bill would have required periodic evaluation and reconfirmation of various tax credits by the General Assembly. However, due to strong opposition from a variety of special interest groups across the political spectrum, the bill was amended to include only the evaluation procedures, making it likely that ineffective tax credits will remain on the books even after receiving a negative evaluation.

Collective Bargaining

Maryland continued its trend of expanding public employee unions by making four additional agencies eligible to participate in collective bargaining agreements. Such expansions may increase personnel costs, as well as reduce the ability of the affected agencies to effectively manage their workforces.[13] The four affected agencies are the Office of the Comptroller, the Maryland Transportation Authority, the State Retirement Agency, and the State Department of Education.

Privacy

In 2010 and 2011, the State's Department of Public Safety and Correctional Services, as part of its background check process, required job applicants to divulge social media login information such as Facebook usernames and passwords. After one individual refused, the story became public, and the department discontinued the practice after receiving a complaint from the ACLU.[14] HB 433/SB 971 explicitly prohibit any employer, public or private, from requesting or requiring such information from prospective employees.

Ethics

SB 920 requires certain ethics disclosure forms completed by legislators and related to recusals and conflicts of interest to be posted online.

First Special Session

The first special session ran from May 14 to May 16. The session's primary purpose was to pass both the income tax increase (SLRFA) and the additional budget bill (BRFA) that had failed during the initial session.

Budget Reconciliation and Financing Act

Fiscal year 2013's operating budget totals over $35.5 billion, about $938 million more than the 2012 budget, for an overall budgetary growth of 2.7 percent.[15] The BRFA both increased revenues, primarily through the income tax increase discussed below, and reduced expenditures, primarily through cost shifting of teacher pensions to localities, also discussed below. Additional revenue was obtained by transfers from special funds to the general fund; the two largest transfers came from Program Open Space ($96.9 million), the state's land conservation program, and the Injured Workers' Insurance Fund ($50 million).[16] As a result of actions taken in the BRFA, the state is projected to end FY 2013 with an estimated general fund balance of $204 million, and a rainy day fund balance of $721 million.[17]

Expenditures eliminated as part of the "doomsday" budget but restored under the BRFA include a 2 percent cost-of-living increase for state employees ($34 million), as well as rejecting increased employee responsibility for health insurance costs ($15 million).[18] FY 2013 costs for employee retirement amount to $1.5 billion, a 6.4 percent increase over FY 2012, while costs for employee and retiree health insurance amount to $993 million, a 6.2 percent increase over FY 2012.[19]

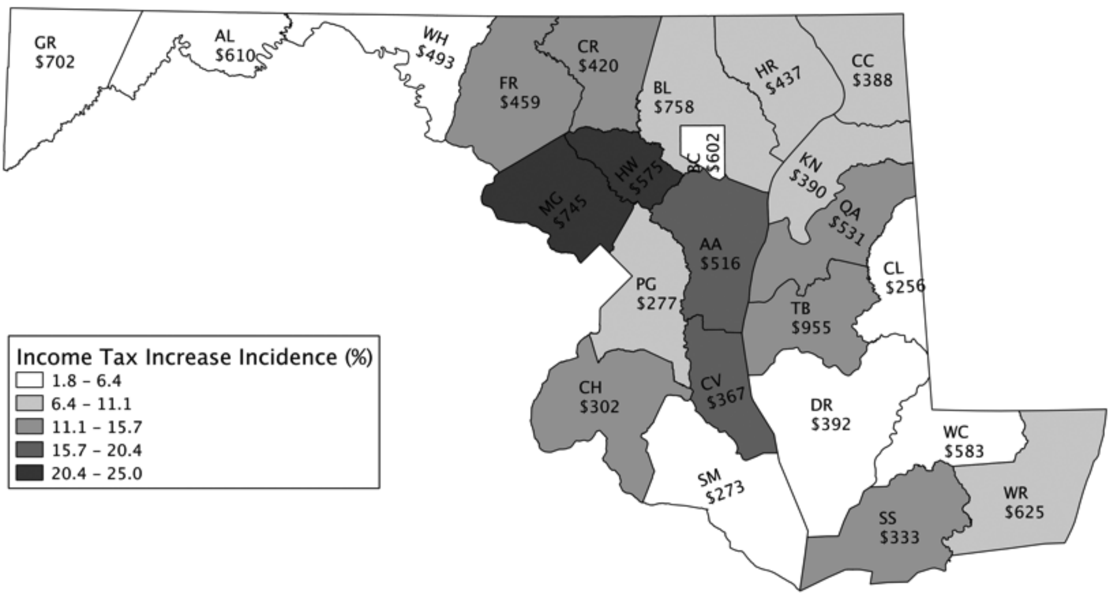
For the second year in a row, significant progress was made at reducing Maryland's structural deficit. In December 2011, the gap between the state's ongoing revenues and ongoing expenditures was estimated to be $1.1 billion; after the tax increases and cost shifting of the BRFA, the gap is now estimated to be $548 million.[20] Projections indicate that the structural deficit will fluctuate between $400 million and $600 million in the coming years—certainly better than in recent prior years, although much of the low-hanging fruit has been picked, leaving many observers wondering how the state will tackle the remaining deficit.

One of the regular session's most hotly debated topics, eventually acted upon during the special session, was the state's proposal to reduce its pension costs by shifting a portion of those costs to localities. This proposal is discussed in its own section below.

Teacher Pension Cost Shift

Shifting the cost of teacher pensions away from the state has been on the legislative agenda since 2010, with discussions about such a shift go-

FIGURE 1 AVERAGE EFFECTS OF INCOME TAX INCREASES BY COUNTY



ing back even further. Until this year, the state paid the full cost of employer contributions for teachers' pensions, even though local governments employ teachers and set the compensation that determines pension benefits. On the other hand, the state legislature is responsible for defining pension benefits, and school boards make personnel decisions rather than county governments.

From the state's perspective, shifting the cost of teacher pensions to the counties saves the state millions of dollars: the general fund nets an additional $109 million in FY 2013, increasing to approximately $154 million in FY 2017.[21] Of course, these funds must still come from somewhere; under the new policy, counties will responsible for the difference.

After considering a number of different proposals for implementing the cost shift, the legislature eventually settled on holding school boards responsible for a phase-in of pension "normal costs." Normal costs are the costs associated with the benefits earned during the current year. Over the coming years, school boards will be responsible for an increasing amount of normal costs, starting at 50 percent in FY 2013, and increasing to 100 percent by FY 2016. School boards will not be responsible for the current $11 billion unfunded liability for teacher pensions that has accrued since 2000.

While technically the school boards are responsible for the difference attributable to the cost shift, in reality the county government is responsible, since the state's maintenance of effort requirement increases each county's required education funding by an amount equal to the cost shift. A number of counties are held harmless or even experience net gains as a result of the shift due to a variety of measures designed to mute the impact of the cost shift, and increased revenue primarily attributable to a large income tax increase.

Income Tax Increase

The centerpiece of the State and Local Financing and Revenue Act (SLRFA) was an income tax increase projected to raise $196 million in FY 2013, for a total of $850 million over the next five years. Reductions and limitations to the state's personal income tax exemptions are projected to raise an additional $52 million in FY 2013, for a total of $197 million over the next five years. When these two tax increases are added to several smaller measures contained in the SLRFA, the total revenues are projected to be $264 million in FY 2013, for a total of $1.164 billion over the next five years.[22]

The income tax increase was accomplished by increasing several of the rates and by reducing the tax bracket thresholds so that more

TABLE 1 PREDICTED VS. ACTUAL EDUCATION TRUST FUND TAX REVENUES (MILLIONS)	FY 2011	FY 2012	FY 2013
PREDICTED (2007)[26]	$76	$494	$1,362
ACTUAL (2012)	$50[27]	$94[28]	$66[29] (YEAR TO DATE)

taxpayers fall into higher-taxed brackets. As a result, taxpayers filing singly with a Maryland taxable income exceeding $100,000, or jointly with income exceeding $150,000, will face higher rates. They will also face reduced, and in some cases eliminated, personal tax exemptions.

How will these tax increases affect you? More than 300,000 tax returns, or about 14 percent of all returns filed, will face a higher tax bill. If you are one of the affected taxpayers, you can expect to pay an average state and local tax bill that is $579 higher.

Unsurprisingly, the bulk of the burden falls on residents in wealthier counties. In Anne Arundel County, about 17 percent of returns will see tax increases; in Howard County, 25 percent; and in Montgomery County, 23 percent. Affected filers can expect to pay an average state and local tax bill that is $516, $575, or $745 higher, respectively.

Figure 1 is a map showing the percent of returns filed in each county affected by the two tax increases discussed above. The map also reports the average increase per affected filer.

Second Special Session

The second special session ran from August 9 to August 15. The primary focus of the session was to consider the expansion of gambling in the state; legislation proposing increased liability for owners of pit bulls and their landlords was considered, but ultimately failed due to differences between the House and Senate versions. The Senate's version of the bill would have expanded liability to all dog breeds and lowered the threshold of liability, whereas the House version was less expansive.[23]

Gambling

The General Assembly adopted several changes to state gambling law, the most important of which are reviewed here.

Several changes will require voter approval in a referendum this November. These include:

- Increasing the total limit on slot machines from the current maximum of 15,000 to a new maximum of 16,500
- Increasing the maximum number of casinos in the state from five to six
- Authorizing a new casino (the sixth) in Prince George's County, likely to be located at either National Harbor in Oxon Hill, or Rosecroft Raceway in Fort Washington
- Authorizing all current and future casino operators to offer table games in addition to slot machines

Other important changes include increasing the percentage of slot machine revenues designated for casino operators (i.e., a tax cut for casino operators), and shifting the ownership and leasing of slot machines from the state to casino operators.

The expansion of gambling in Maryland is being billed by supporters as a way to increase state tax revenues, particularly for education, while at the same time creating construction and service industry jobs, and ensuring that revenue currently flowing to surrounding states remains within Maryland. However, opponents have raised a number of concerns about how the revenues are actually being spent and whether the economic boost provided by another casino will be enough to offset the negative business and social effects associated with increased gambling.

While both the current and new law dedicate a significant portion of slot machine tax revenue to the state's Education Trust Fund, a large portion of that revenue simply displaces General Fund expenditures on education. Furthermore, the new law retains subsidies for the horse racing industry amounting to $378 million over the next five years.[24] The state's revenue estimates are highly uncertain, as they depend on a number of unpredictable factors; however, historical estimates have consistently overestimated the tax revenue eventually gained from slot machines.[25]

TABLE 2 VLT LOCATIONS AND COST TO STATE				
CASINO	**LOCATION**	**VLTS**	**TOTAL COST**	**COST/VLT**
HOLLYWOOD CASINO	PERRYVILLE	1,500	$65 MILLION	$43,333
OCEAN DOWNS	BERLIN	800	$34 MILLION	$42,500
MARYLAND LIVE!	HANOVER	4,719	$168 MILLION	$35,601
TOTAL		**7,019**	**$267 MILLION**	**$38,040**

Table 1 reports the amount of tax revenue from slot machines dedicated to the Education Trust Fund as predicted in 2007, when slot machines were originally approved by the General Assembly, versus the amount of tax revenue actually collected thus far.

Outside observers and current casino operators question whether Maryland can support a sixth casino, to be located in Prince George's County. Two of the state's five current casino licenses remain unused, so the state's current three casinos may face additional competition from three new facilities in the coming years. Meanwhile, one of the state's first two casinos to open, Hollywood Casino in Perryville, has experienced a significant decline in business since the opening of Maryland Live! in Hanover; in fact, Hollywood Casino recently requested that the state remove up to 500 of the 1,500 slot machines located at the facility.[30]

In addition to the tax cuts provided to casino operators in exchange for the phase-out of state-subsidized slot machines (discussed below), the gambling legislation provided significant additional tax cuts to casino operators. Currently, casino operators receive 33 percent of the revenues earned from their state-financed slot machines. In exchange for modest upkeep requirements, the casino in Berlin and any future casino at Rocky Gap are eligible to receive 43 percent of slot machine revenue earned at these facilities. Both casinos have the option to continue using state-financed slot machines indefinitely; however, if either opts to handle machine procurement itself, it would be eligible to receive 49 percent of revenue earned at its facility.[31] When considered with other provisions from the bill, the tax cuts for casino operators are expected to total $378 million over the next five years. Additional revenues to the Education Trust Fund total only $63 million over the same time period.[32]

In an interesting about-face, the General Assembly ended the state's current policy of purchasing, leasing, and maintaining slot machines, turning this responsibility over to casino operators. Ever since the state's first purchase of slot machines in June 2010, debate over the policy has abounded. Critics, including Comptroller Peter Franchot, argue that the state is wasting money by purchasing or leasing the machines as well as subsidizing the casino business.[33] In an editorial commenting on the special session's changes to gambling policy, the *Baltimore Sun* said shifting responsibility for the machines to casino operators was a "no-brainer."[34]

Table 2 reports the number of VLTs purchased, leased, or authorized at the state's three operating casinos, along with the total expenditures approved by the Board of Public Works, and the average cost per slot machine.

Operators of newly opened casinos will be responsible for purchasing or leasing slot machines. For currently operating casinos, the rules vary: the casino in Berlin is allowed to apply for ownership or leasing of the state's slot machines at the casino (it is unclear what amount, if any, the casino will pay to acquire the machines), while the casinos in Perryville and Hanover are required to manage slot machine procurement after the state's current contract expires in 2015. In exchange for the phasing out of this state subsidy, the casinos in Perryville and Hanover will receive an additional 6 percent of slot machine revenue. This tax cut will also apply to potential future casino operators in Prince George's County or Baltimore City.[35]

The state's heaving reliance on future gambling revenues is ill-advised given the historical tendency to overestimate such revenues, as well as the fact that gambling is clearly associated with other negative business and social effects. These negative effects are more difficult to quantify than revenues, but are no less real. While casino construction and operation may be responsible for some temporary construction jobs, the vast majority of permanent service sector jobs created are low-wage positions paying between $25,000 and $32,000 annually.[36]

CONCLUSION

As a result of a telling showdown between House and Senate Democrats, who could not agree on the appropriate extent of an income tax increase, the General Assembly accidentally passed a relatively fiscally conservative operating budget. Democratic legislators worked quickly to label the budget as disastrous, although it actually represented a 2 percent increase in spending over the prior year.

While the first special session did take significant steps to further reduce the state's structural deficit, the strategy of increasing taxes combined with shifting costs to other units of government and transferring special funds to cover budget shortfalls is not sustainable. Such fund transfers frequently call for replacing funds with general obligation bonds, thereby increasing debt service costs and bringing the state ever closer to its debt ceiling.

The second special session's significant changes to state gambling law provide hundreds of millions of dollars in tax cuts to casino operators and subsidies to the horse racing industry, whereas three months earlier the General Assembly passed a major income tax increase affecting 14 percent of state residents filing tax returns.

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