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FIXES FOR THE LONG HAUL

How Governor Hogan and the General Assembly Can Balance and Reform the Maryland Budget

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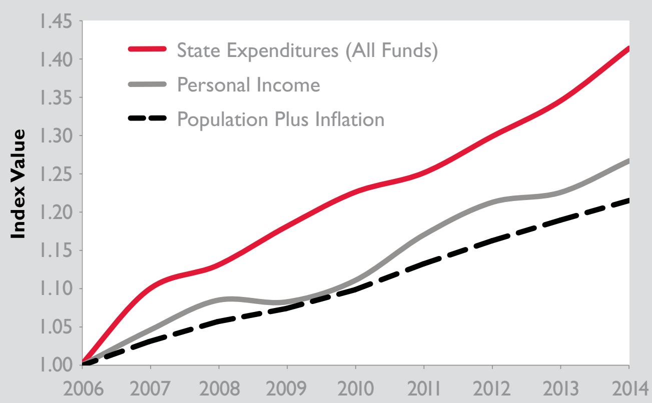
THE BUDGET SHORTFALLS THAT THE STATE OF MARYLAND has wrestled with for much of the last decade are structural in nature. They are not due simply to the unavoidable reality of business cycles, nor can they be explained away by the recession. Rather, they could have been substantially avoided if better budgetary restraint had been practiced by Maryland lawmakers.

An early warning sign should have been that government spending grew faster than the economy over the past decade. As shown in Figure 1, state spending (all funds) between 2006 and 2014 grew by 41 percent while personal income in Maryland grew by 26 percent.[1] If spending had grown only at the rate of personal income, Maryland's budget woes would not exist today and the state might even have a small surplus.

It's a classic case of government "overeating" during boom times—increasing spending and taking on commitments for future spending as if the good times will never end. But the business cycle has both an up and down period, and when the inevitable recession occurs, government finds it difficult and painful to tighten its belt. Thus, it's vitally important that budget fixes enacted over the next few years do more than correct Maryland's budget imbalances in the short term;

FIGURE 1 COMPARATIVE GROWTH INDICES 2006-2014



Source: Bureau of Economic Analysis, Census Bureau, Department of Legislative Services, and Maryland Public Policy Institute

they must make important structural reforms to the budget process so as to avoid imbalances over the long term. The reforms must restrain the governor and General Assembly from going on another spending and commitment bender in the next economic upcycle, only to be caught in more budget woes in the next down cycle.

FACING UP TO THE PROBLEM: SHIFTING PERSPECTIVE AND BALANCING THE BUDGET

In his budget for Fiscal Year (FY) 2016, new Gov. Larry Hogan has proposed budget cuts and caps on spending increases that are intended to permanently end the cycle of overspending. Despite the constitutional requirement to balance the state budget and Maryland's need for better fiscal responsibility, he is getting push-back on these proposals from state legislators.

A traditionally "blue state" like Maryland puts the burden of proof on policymakers who want to reduce (or at least slow the growth of) government spending. It is assumed, during the budget-writing process each year, that most programs will receive at least some increase in funding, regardless of program performance or importance. Some programs, like education, receive much larger, mandated annual spending increases. Those funding levels are known as the "current services baseline." Moving forward, the policy burden should be shifted so that lawmakers who want government to grow faster than the economy and the taxpayers' ability to sustain funding for essential services, no matter the economic conditions, would have the responsibility to demonstrate such spending increases are appropriate and fiscally wise.

One of the major political obstacles for the Hogan administration is a General Assembly that does not share Hogan's views on fiscal responsibility. While he could easily spend his entire term in office butting heads with the General Assembly leadership, Hogan should instead focus on giving local governments more control over their budgets, especially with how they spend the money handed to them by the state each year. Instead of allotting specific quantities of money for pre-selected projects, the governor could push to transform aid to local counties into "block grants." County officials would be given greater latitude to choose how to allocate those state-originated funds to best serve the needs of their local communities—shifting money to higher-priority programs. This would help counties deal with a constrained state budget and encourage them to end low-value programs. Proposing this shift would weaken the automatic, mandated spending increases that cause Maryland to run chronic deficits.

WHAT ABOUT CUTS AND QUICK FIXES?

As the Hogan administration's FY 2016 budget is debated, the factors that should be crucial to determining which short-term fixes to pursue are similar to the criteria that make a long-term fix desirable. The fixes should not only reduce the size of the budget relative to the projected baseline over the next few years, but also lower the overall trajectory of the trend line of future spending and make fundamental changes to the budget that will persist into the future.

Program spending cuts are one way to do that. However, cuts that are politically palatable are likely to be very small in terms of the savings they would generate. This doesn't mean those cuts should not be pursued, but it's an indication of just how many of the cuts would be needed to return Maryland to fiscal sustainability.

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Cutting larger programs may help alleviate the deficit, but such cuts would be met with political opposition. Sustaining those cuts would likely require fundamental reforms that may take a while to enact and implement. We'll discuss such reforms below. But our initial discussion focuses on the short term and how to balance the FY 2016 and FY 2017 budgets. We believe the best course to achieve that is a broad spending freeze.

WHY A FREEZE IS JUSTIFIED

On the heels of large increases in Maryland spending over the past eight years, a broad categorical freeze is a robust way of both reducing the baseline spending for the next two fiscal years and preparing the way for a reorganization and reassessment of what state government should be doing with Marylanders' tax money.

Governor Hogan's proposed FY 2016 budget comes close to a freeze on spending, limiting spending growth to 1 percent. Still, spending in the Maryland budget for FY 2014 was 28 percent higher than it was just before the start of the recession (FY 2007), despite all the supposed "cuts" made to spending over the past few years.[2] Most of those cuts were really just smaller-than-planned increases—not really cuts at all.

Keeping general fund spending as close as possible to the level of the prior year—a level of spending that would hardly be considered a "cut" by taxpayers when compared to previous fiscal years—could eliminate Maryland's budget shortfall or at least come very close to doing so. Freezing spending at 2015 levels would keep intact the net 5 percent increase in spending from the prior fiscal year—a generous increase considering the economic circumstances.[3]

This budget freeze should include a state employee hiring freeze, which would save money relative to the projected spending baseline. This hiring freeze does not have to jeopardize legitimate government functions, as the freeze would mainly target positions that are currently unfilled. The Spending Affordability Committee, assembled by the Maryland General Assembly and comprised largely of state lawmakers, has recommended a hiring freeze, too, and the Committee notes that agencies can "make maximum use of existing vacant positions to address staffing needs."

The Committee adds:

The Governor should use the budget and his authority to abolish and create positions to reallocate personnel resources as necessary to address service needs. Layoffs should be avoided as sufficient opportunities for savings should exist within the existing State workforce authorization.[4]

RECOMMENDING REORGANIZATION

However, a spending and hiring freeze is only a stop-gap measure. It must be paired with long-term fiscal reform that would allow for more lasting reorganization of government. Just as the governor has authority to reallocate personnel resources, he should also ask for, and the legislature should grant, the power to reorganize agencies within the state executive branch while the spending freeze is in place.

This reorganization power could become a permanent budgetary power of the governor that is triggered in future recessions if the state faces budgeting shortfalls that eclipse a certain threshold. Considering that Maryland's "Rainy Day Fund" is currently required to retain a balance equal to 5 percent of general fund revenue, perhaps the governor's reorganization authority should kick in when there is a general fund shortfall in excess of the 5 percent mark.

This authority could do more than just precipitate long-needed reforms in some areas. It could also give the governor extra leverage in budget matters when a recession hits the state general fund. If, for example, an agency head is asked to find savings in his budget, that request would not be made in a vacuum. Instead, the governor may be able to trump the desires of the agency head by reorganizing the agency's structure, mission, and personnel if sufficient spending cuts and savings are not identified by the agency.

BALTIMORE'S "OUTCOME BUDGETING"

An example of successful government fiscal reform can be seen in Baltimore City, which long struggled with poor fiscal management until the current mayor and City Council decided such mismanagement could not continue. The city's "Outcome Budgeting" initiative is meant to help Baltimore close budget shortfalls and cut the city's infamously high property taxes over time.[5]

Freezing spending at 2015 levels would keep intact the net 5 percent increase in spending from the prior fiscal year.

The process basically requires city agency or department heads to prove they can make efficient use of the money that is budgeted to them. It does so by not using the prior year's funding as the baseline for the next budget year's request; instead, it allows the mayor to prioritize policy areas by which to allocate personnel and resources. Another basis for funding an agency or department in Baltimore's new budget environment is proof that the agency or department is meeting or exceeding pre-set performance standards. Agencies vie for funding based on a proven ability to deliver quality services or the creation of a workable action plan to use the budgeted money most efficiently.

This method of budgeting opens up options for executive branch officials to explore alternative means to offer essential government services, such as contracting-out some functions to nonprofit or even for-profit firms. When the budget process is not beholden to the inertia of the prior year's budget, but instead to a more sensible metric of performance and efficiency, taxpayers are likely to be much better off in the long run.

STOP ISSUING NEW DEBT

A complimentary short-term measure that Maryland should adopt is a moratorium on new capital projects and new debt issuance. Doing this would immediately reduce the projected debt service and overall debt load of the state. Debt service was the second fastest growing line-item in the budget, estimated to grow at a rate of nearly 92 percent between FY 2015 and 2016.[6]

This is an important concern for cash-flow reasons. Interest costs on state debt are estimated to grow $140 million to $274 million in FY 2016.[7] That number would be zero if there were enough statewide property tax revenue to fund the spending. But there isn't (suggesting that all those debt-financed projects have not improved the quality of life in Maryland to the degree that the the projects' proponents claimed) and so money must be borrowed to fund the projects and future general fund revenue has to be devoted to debt service. Statewide property tax revenues in Maryland have plateaued in the $720–$730 million range in the past few years, but bond service payments (interest plus principle) have grown to over a billion dollars.[8]

Debt service levels in excess of property tax revenues that persist over time, especially in a period of economic distress, can put pressure on policymakers to increase the statewide property tax—a most unwelcome policy in a recession. As it is, that debt already puts pressure on the budget situation by forcing lawmakers to fund an unavoidable cost.

The only way to end Maryland's debt woes is to place a moratorium on issuing new debt and suspend projects that are to be funded with new debt issues. This "time out" from borrowing would allow lawmakers to explore other financing options, such as public-private partnerships for services and projects that are deemed essential. This review could be part of the results-based analysis contained in the freeze-and-review spending proposal we described above.

DO A REAL COST-BENEFIT ANALYSIS

The moratorium would also give Maryland policymakers time to consider whether the current funding sources for various capital projects are appropriate. For instance, is general fuel tax revenue—best viewed as a user fee for drivers using state highways—the appropriate source for subsidizing mass transit programs, given that most auto drivers rarely (if ever) use transit? A user fee approach to capital projects—and the issuance of revenue bonds (which are repaid only from revenues from a specific, revenue-generating entity) instead of general obligation bonds (which must be paid with tax dollars if revenues don't meet promised returns) to pay for the projects—would serve state taxpayers better than the highly politicized funding that exists today, both because the beneficiaries of those projects would bear the projects' cost and bondbuyers would offer their judgment of whether the capital projects will be successful.

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The review and reform of all transportation programs and the tax sources that fund them are essential for a successful capital project moratorium. It is likely that a serious review of these projects would result in the termination of many highly expensive but dubious proposed projects, like the Purple and Red line Metro expansions in the Maryland suburbs of Washington, D.C.

TIE THE DEBT LIMIT TO PROPERTY VALUES, NOT REVENUE

A debt moratorium would also give lawmakers an opportunity to consider stricter permanent limits on the issuance of future state debt of all types. An effective debt limit should protect taxpayers from excessive government debt loads created by policymakers but for which taxpayers are ultimately liable. Such a limit should be stronger than mere statute; it should be enshrined in the State Constitution, making it hard for the governor and General Assembly to circumvent or the Capital Affordability Committee to ignore.

Since general obligation bonds are tied directly to property tax burdens, an effective limit would be to require debt service to remain at or below a certain percentage of property tax revenues—a limit that should be far below the more-than-100 percent that is in effect now. A better limit would be to cap the amount of general obligation debt outstanding as a specific proportion of the net taxable property valuations in the state. That would create a "circuit breaker" for state debt: when property values drop, new debt issuance would cease until property valuations rise again.

If, instead, debt capacity is tied to revenue generated by property taxes, that would pressure legislators to increase property tax rates in order to increase revenue and also the debt capacity cap. That would be detrimental to taxpayers. It is better to use something that lawmakers have no direct control over—like property valuations—as a basis for the debt limit.

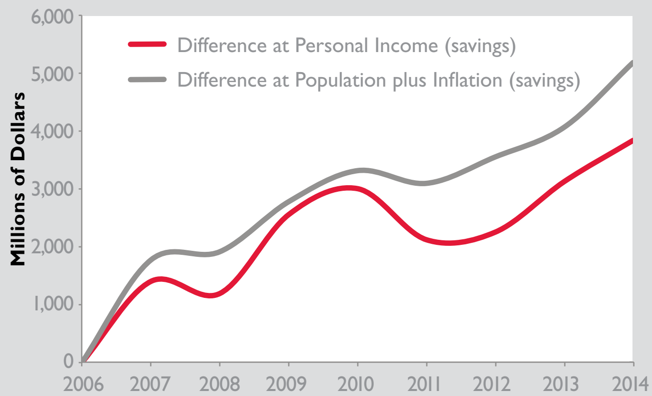
LONG-TERM REFORM TO THE BUDGET PROCESS: A STRONG SPENDING CAP

Once the shortfall is addressed in the current budget, a long-term reassessment of what government funds and how it budgets should be undertaken. Part of this can be done in the context of the executive branch reorganization trigger proposed earlier in this paper.

Until there is a compelling reason for policymakers to abandon the current-services baseline approach to budgeting, that approach will remain intact and, with it, the ever-present compulsion for lawmakers to spend. A better system would be one that is governed by a limit on spending growth. The "autopilot" nature of the current services baseline budgeting system stacks the deck against lawmakers who want a sustainable state fiscal policy and want to protect taxpayers.

The best sorts of spending limits are based on factors that are beyond the direct control of lawmakers and political inertia. They usually are based on population growth plus inflation, meaning that "real" (inflation-adjusted) state spending per resident would be fixed. These types of limits dictate that government cannot grow faster than that unless there is an emergency or voters allow a temporary exemption from the limit.

FIGURE 2 ESTIMATED BUDGET SAVINGS UNDER DIFFERENT SPENDING LIMITS 2006-2014



Source: Bureau of Economic Analysis, Census Bureau, Department of Legislative Services, and Maryland Public Policy Institute

As shown in Figure 2, had a "population plus inflation" spending limit been put in place in 2006, then state spending would have been nearly $5.2 billion lower in 2014—$31.8 billion versus $36.9 billion.

Such limits require lawmakers to make tradeoffs in the budget process. For instance, if the lawmakers believe that Program A should be expanded, then they must cut from Program B in order to free up funds for A. Such tradeoffs—which are both common and highly important in private life—are not encouraged by the current system.

HOW TO PHASE IN A SPENDING CAP

If a move to a population plus inflation spending cap seems too radical at this time, a potential transitional step for Maryland would be to cap spending over the next few years to a rate based on personal income growth in the state or the growth of gross state product (GSP). That would be a more generous limit than population plus inflation, because personal income and GSP have historically grown at a faster rate than population plus inflation.

But this transitional cap would still limit state spending growth to a lower rate than what has occurred in Maryland over the last decade. This transitional cap would institute a "speed limit" on government spending that would be self-regulating: when personal income begins to slow, it's an indication of a slowing economy and should, by definition, require a slowing of state spending to avoid a large budget shortfall.

As also shown in Figure 2, had a personal income spending limit been put in place in 2006, then state spending would have been $3.8 billion lower in 2014—$33.1 billion versus $36.9 billion.

One of the main benefits of a spending cap should be that it keeps spending relatively tame during economic booms to avoid high budget levels that have to be cut in recessions. Put another way, one year of exceptional growth shouldn't lead to a large jump in state spending that would then be painful to curtail if the economy slows or contracts. An easy way to dampen such variation would be to base the cap on an average of the prior three years' personal income growth or GSP growth.

Better than that would be a hybrid limit set at the lesser of either personal income growth or population plus inflation growth, but with the provision that a net decline in personal income or population would only result in a state spending freeze instead of a contraction. Under such a limit, an economic boom wouldn't encourage high rates of budget growth; it would smooth out the spending patterns and could actually—when paired with withdrawals from the rainy day fund—help the state government to weather a recession without spending cuts or tax increases.

CONCLUSION

The Hogan administration's proposed FY 2016 budget represents only the beginning of a long-needed conversation on how Maryland budgets are created and balanced. It is not enough for Hogan and state lawmakers to make one-time cuts or reduce mandatory spending increases, however substantial they may be. If lawmakers really want to solve the structural deficit long-term, they will need to change the default attitude in Annapolis from "Why cut spending?" to "Why spend?" If they can achieve that paradigm shift, they will benefit the state for generations to come.

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