The Maryland Public Policy Institute

THE MARYLAND STATE BUDGET AND MANDATORY SPENDING

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STATE OF THE STATE

The State of Maryland is suffering from long-run and short-run fiscal problems. A recent comprehensive financial analysis of all 50 U.S. states ranked the Old Line State 41st in fiscal health.[1]

This study assesses the Maryland budget with a focus on mandatory spending and how the office of Gov. Larry Hogan struggles to balance the budget as a result, in part, of rigid revenue earmarks and mandatory spending requirements. Entering this year's budget cycle, 82.2 percent of expenditures were predetermined because of existing state laws and regulations.

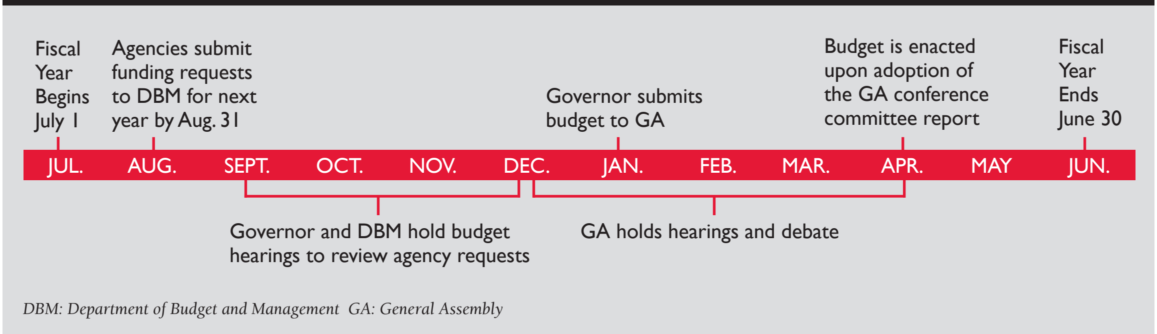
The state budget is extremely important to the state's economic health. Maryland risks drastic economic changes if it does not address its long-run fiscal problems soon. Despite a balanced budget provision in the state constitution, the state government has accumulated $17.21 billion in debt—about $2,880 per capita, 30.4 percent higher than the U.S. state average.

Worse, Maryland's unfunded pension liabilities are alarming. The state's ability to pay 143,000 retired teachers, state police, judges, and other former employees is in jeopardy.[2] Maryland has a $45.5 billion investment portfolio to provide monthly benefits to retired state employees. Unfortunately, the $45.5 billion is short of the anticipated payout necessary to fulfill the state's retirement promises.

If the state's investment portfolio earns its target return of 7.55 percent, Maryland would be short about $20 billion—39.0 percent—for its current long-term liabilities. For the fiscal year ending June 2016, Maryland's retirement portfolio earned a meager 1.16 percent after fees.[3] The portfolio returned 2.68 percent for fiscal 2015.

Using a less-optimistic 'risk-free' assumption indexed to the 3.2 percent yield on 15-year Treasury bonds, Maryland's unfunded pension liabilities total $74.7 billion, meaning the account is nearly 63.0 percent *underfunded*. Other post-employment benefits (OPEB) promised by the state, consisting primar-

FIGURE 1. MARYLAND'S BUDGET PROCESS



ily of health care and prescription drug coverage, are estimated to cost nearly $9.0 billion. Maryland's OPEBs are 97 percent *underfunded*.

The Governor's Office recognizes the problem with growing unfunded liabilities. In 2015, Robert Neall, fiscal advisor to Governor Hogan, acknowledged the state would need to permanently increase its contributions to the pension fund.[4]

Maryland is not in a fiscal situation where it can easily afford to increase its pension contributions and cut its debt, perhaps by tapping into a significant budget surplus each year. The short-run budget is just as ugly as the long-run outlook.

In September, the Maryland Board of Revenue announced updates regarding state revenue collection. The Board decreased its revenue estimates for the current fiscal year by $365 million, and decreased its estimates for the budget committee planning next year's budget by $417 million. Combined with a $250 million revenue shortfall in 2015, the current budget committee needs to find a way to close a more than $1 billion budget gap just to balance the immediate budget.[5]

THE MARYLAND BUDGET

The budget process begins with a review of the previous year's budget, including revenue and expenditure estimates. Maryland has a balanced budget constitutional provision, mandating that each year, total revenues must equal or exceed total expenditures. Any budget shortfall must be corrected, and both revenue and expenditure estimates need to be updated for the following year.

Figure 1 illustrates the budget process. The government fiscal year runs July 1 through June 30 of the following calendar year. Almost immediately after the start of the fiscal year, agencies begin preparing their requests for the next budget cycle. Agencies submit their requests to the Department of Budget and Management (DBM) for the next year by August 31.

The Governor's Office spends the rest of the calendar year reviewing agency proposals, then submits a full budget to the legislative General Assembly (GA). The GA then holds committee meetings on the budget proposal into April until a final budget is ratified.

Budget Flexibility

In 2016, the state planned $40.4 billion in expenditures.[6] About $11.6 billion of those state expenditures were directly funded from the federal government. Major recipients were health services, $6.8 billion; human resources, $1.9 billion; public education, $1.0 billion; and the Maryland Department of Transportation, $1.0 billion. The state has virtually no control over the spending of federal funds. The remaining $29.0 billion of the 2016 state budget is funded from the state's own-source taxes and fees and is under Maryland's budgetary control.

Those $29.0 billion in revenue enter one of two funds for budgetary use: the General Fund (GF) or the special and higher education fund (SF). The 2016 SF funded $12.5 billion of the state's expenditures and the GF funded $16.6 billion.

All of the $12.5 billion revenue entering the SF are earmarked for a dedicated purpose: $4.1 billion from higher education revenue, including tuition, and $3.8 billion from transportation revenue, including fuel taxes, titling tax, vehicle registration, and aviation charges. Tuition revenue mostly remains at the institution generating the tuition; fuel taxes go to state highway construction and maintenance.

FIGURE 2. (IN)FLEXIBILITY OF MARYLAND BUDGET EXPENDITURES

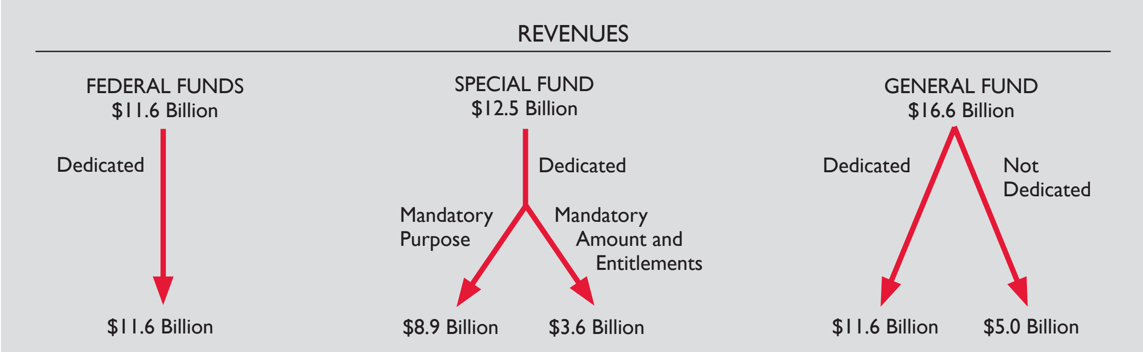


TABLE 1. MARYLAND STATE SPENDING FROM OWN-SOURCE REVENUES ($ IN MILLIONS)

	General Fund	Special and Higher Ed Funds	Total Funds
Mandated Amount	$7,927.5	$2,561.4	$10,488.9
Entitlement	$3,692.3	$982.2	$4,674.5
Mandated Purpose	0.0	$8,935.8	$8,935.8
Nonmandated	$4,963.1	$0.00	$4,963.1
Total Allocation	**$16,582.9**	**$12,479.4**	**$29,062.3**

Most of the $16.6 billion revenue entering the GF (largely from income and sales taxes) also has a dedicated purpose. For example, $11.6 billion (69.9 percent) of GF expenditures are predetermined prior to any annual budget process as either state-mandated expenditures or entitlement expenditures.[7] The remaining $5.0 billion are non-mandated funds and can be allocated at the discretion of the governor and state legislature.

In total, 82.8 percent of Maryland's own-source revenue is predestined for an expenditure program before any budget planning begins. Figure 1 illustrates the budgeting path from revenues to expenditures in Maryland.

Budget Flexibility

Table 1 details the flexibility of Maryland's budget by fund. Of the $16.6 billion GF, $7.9 billion (47.6 percent) are mandated expenditures, $3.7 billion (22.3 percent) are entitlement expenditures, and $5.0 billion (30.1 percent) are non-mandated. The SF has no non-mandated expenditures. The $12.5 billion in the SF is divided among expenditures with mandated amounts $2.6 billion, entitlements $1.0 billion, and mandated purpose $8.9 billion.

Table 2 details the expenditure category of Maryland's non-mandated funds. Public safety and higher education combine for nearly half of the non-mandated budget expenditures, at $1.3 billion and $1.1 billion respectively. Health and hospitals account for $0.7 billion, and the state spent an additional $0.4 billion on human resources. Maryland also contributed $0.1 billion to a reserve fund in case of a future fiscal emergency.

TABLE 2. DETAILED NON-MANDATED BUDGET EXPENDITURES ($ IN MILLIONS)

State Program	Expenditures
Public Safety	$1,289.4
Higher Education	$1,146.4
Health and Hospitals	$693.0
Human Resources	$414.5
Executive, Financial, and Information Technology Administration	$394.2
Public Education	$295.6
Juvenile Services	$265.9
Reserve Fund	$100.0
Other	$364.0
Total	**$4,963.1**

Mandated appropriations and entitlements are detailed in Table 3. Education, Medicaid, and compensatory education comprise more than half

TABLE 3 PROGRAMS WITH STATUTORILY MANDATED APPROPRIATIONS OR ENTITLEMENTS

General Fund Program	Expenditure ($ in Millions)	Percent of Funds
Education	2,543.0	21.9
Medicaid	2,481.0	21.4
Compensatory Education	1,287.3	11.1
Aid for Local Employees Fringe Benefits	787.2	6.8
State Retirement Contribution	541.1	4.7
Developmental Disabilities Administration Medical Assistance	534.1	4.6
Judiciary	478.6	4.1
Community Behavioral Health Services	360.3	3.1
Debt Service	274.0	2.4
Students with Disabilities	272.2	2.3
Student Transportation	241.4	2.1
Community Colleges	229.4	2.0
Limited English Proficiency Grant	214.3	1.8
Foster Care	148.6	1.3
Disparity Grants	127.7	1.1
Students with Disabilities	120.9	1.0
Other	978.6	8.4
Total General Funds	**11,619.8**	**100.0**
SPECIAL FUND PROGRAM		
Medicaid	965.3	27.2
Debt Service	845.4	23.9
Education	397.9	11.2
Washington Metropolitan Area Transit Authority (WMATA) Operating Subsidy	320.4	9.0
Transportation Debt Service	282.7	8.0
State Retirement Contribution	170.6	4.8
Local Highway User Revenue Grants	169.3	4.8
WMATA – Capital/Debt Service Subsidy	132.1	3.7
Other	260.0	7.3
Total Special Funds	**3,543.6**	**100.0**

of GF-mandated appropriations and entitlement expenditures. Aid for local employees' fringe benefits, state retirement contributions, and Developmental Disabilities Administration medical assistance also totaled more than $0.5 billion.

The largest mandated appropriations and entitlement expenditures from the SF were Medicaid, $0.9 billion; debt service, $0.8 billion; and education, $0.4 billion. The Washington Metropolitan Area Transit Authority required a $0.3 billion operating subsidy and $0.1 billion debt service subsidy from the SF.

A BRIEF HISTORY OF MARYLAND BUDGET MANDATES

Maryland's executive (governor) dominates the budget process. The Governor's Office proposes an annual budget, and Maryland's legislature may only reduce funding levels from the initial proposal.

This was not the case before 1916, when each of Maryland's executive branch agencies submitted a separate funding request directly to the legislature. The legislature reviewed and approved each funding request via separate appropriation bills, and the executive role was limited to a line-item veto.

This legislature-centric model of budgeting was problematic. The state lacked a unified budget and adequate oversight. Agencies did a poor job of self-budgeting, often exhausting their appropriations in less than a full year, or over-requesting and then not remitting additional funds. In 1915, budget inadequacies produced a general fund budget deficit of nearly 40 percent.[8]

In response to these issues, the executive-dominated budget model was implemented in 1916 and remains mostly the same to this day. The new model removed the governor's line item veto power and established a formal schedule for enacting and submitting a budget: The governor would initiate a budget, then the legislature would review it and approve the final budget. The legislature only had power to reduce expenditures, limiting political pressures on General Assembly members.

Since the 1916 budget process was implemented, only five major changes have been made. In 1920, a merit-based civil service system was established for the state's workforce. In 1939, the Department of Budget and Procurement was created to assist in development of the budget. In 1945, the Board of Revenue Estimates was established to create an independent estimate of state revenues. In 1952, executive agencies were asked to move to a programmatic budget, rather than a line-item budget, to better assess outcomes and improve accountability. Finally, in 1978, a constitutional amendment gave the General Assembly power to implement mandatory spending requirements for programs in future governor-initiated budgets.

THE ECONOMICS OF EARMARKS AND MANDATORY FUNDING

The goal of using earmarks and mandates is straightforward. By linking a revenue source to an expenditure or assigning a legal requirement that the state increase an expenditure by a predetermined formula—such as increasing an expenditure annually by the rate of inflation—the legislature retains a stronger role in priority setting and is able to protect selected agencies and programs from budget cuts.

Mandatory Versus Discretionary Spending

Economics research is extensive on the effects of earmarks and mandatory spending. T. Renee Bowen and co-authors examined the effects of mandatory versus discretionary spending.[9] They found that mandatory and discretionary spending protocols produce different spending amounts.

If a state allocates all expenditures using discretionary public spending—no mandated expenditures—the party in power tends to spend less overall and implements more short-term focused policies to its benefit. This outcome occurs because there is no dynamic link between expenditures set in the current year and expenditures set in future years because all expenditures are discretionary and can be substantially changed each year, and the minority party has no bargaining power. Sizable literature supports the finding that many politicians have a strong preference for short-term benefits and are willing to pay for those using long-run costs, as those costs often accrue when the current politician is no longer in office.

If a state uses a mandatory expenditure protocol, expenditures will exceed discretionary spending levels in most cases.

If a state uses a mandatory expenditure protocol, expenditures will exceed discretionary spending levels in most cases. How much mandatory expenditures will exceed discretionary spending varies depending on the degree of party polarization.

If the parties are not very polarized, both parties tend to choose about the same level of expenditure, even if they place a very different value on most expenditures. This occurs because mandatory spending requirements provide "expenditure insurance" against power fluctuations—they raise the bargaining power of the minority party.

In the high-polarization case, the insurance effect from mandatory programs can lead the party that places the greater value on public spending programs to propose a level of public good spending above the efficient level, creating temporary "over-provision." This is only temporary because of power fluctuations—once the other party comes to power, it lowers the level of spending to the efficient level and provides other incentives for the party with the greater value to cooperate.

The conclusion is that mandatory spending requirements work exactly as designed by insuring spending levels against regime change. Mandatory spending requirements also make it more difficult for the ruling party to use the state budget for short-term political gains by spending on "pork-barrel" programs.

The problem with mandatory spending requirements is that initial spending levels and expenditure growth must be set efficiently and strategically when spending requirements are initially implemented. If the initial level is too great or too small and if growth exceeds or lags revenue growth, the beneficial components of spending requirements can be lost.

Maryland's existing model is unsustainable, with growth in mandated expenditures exceeding revenue growth for multiple years. Programs have become more and more difficult to sustain, and the Governor's Office has reached a point where creating a balanced budget is nearly impossible without new taxes or high-impact expenditure cuts.

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Earmarks

The practice of dedicating a portion of tax revenue to a specific expenditure category is a popular fiscal tool for state governments. Proponents of earmarks usually suggest that by earmarking a revenue source to an expenditure, e.g., lottery revenues to education, the expenditure program will grow as the revenue source grows.

However, in a seminal paper on the topic, James Buchanan noted that if any of the expenditure programs receive funding from the GF, the fund's revenues can be substituted or swept away as revenues from the earmarked source grow. In other words, earmarked revenues are fungible.

An example will help clarify this theory. Maryland spends $1.1 billion of its non-mandated GF on higher education. Suppose the legislature is able to pass a new special sales tax on the basis of its revenue being earmarked for higher education spending. Further, suppose this new tax brings in $500 million in revenue. Although it may seem natural to assume education spending will increase by $500 million as a result of the earmarked revenue (to $1.6 billion), policymakers actually have the option to decrease spending on education out of the GF.

Even if the $500 million earmarked to education spending is actually spent on education, total education expenditures may remain unchanged if the legislature decides to decrease general fund spending from $1.1 billion to $600 million. This allows policymakers to spend $500 million of revenue previously dedicated to education elsewhere, and the earmark is functionally equivalent to a $500 million increase in unspecified general fund revenue.

Adam Hoffer and George Crowley recently surveyed academic literature that attempts to quantify how much earmarked revenue adheres to its intended target—known as the "flypaper" effect. The authors also conducted an empirical analysis of earmarks across U.S. states,[10] with findings that could assist Maryland policymakers as they consider new ways of balancing the budget without over-burdening taxpayers.

Among the most commonly earmarked funds are inter-government grants. This is true in Maryland, as the state has little to no control over federal grants to be spent on state programs. Various estimates exist, but generally, flypaper estimates tend to range from 0.30 to 0.70, with a median of around 0.45. This suggests that an extra dollar in federal grants to a state will result in increased spending of about 45 cents and a tax reduction of approximately 55 cents.

The degree to which own-source revenue increases an earmarked expenditure varies by program. Between 60 and 80 cents on the dollar sticks to education from earmarked lottery revenues, whereas nearly every gas tax dollar earmarked to highway expenditures sticks.

One of the explanations for this finding is that revenue sources earmarked to related programs, e.g., gas taxes to roads, may act similarly to a user fee and may signal to budget makers where to direct funding. Earmarked revenue with little to no link to an intended expenditure provides no added information to budget makers and is certainly not a user fee.

Among the most commonly earmarked funds are intergovernment grants. This is true in Maryland, as the state has little to no control over federal grants to be spent on state programs.

In summary, earmarks mandate that certain revenue sources be spent on targeted expenditures. If those same expenditures are also partially funded by the GF, budget makers have the option of substituting GF expenditures as SF revenues grow.

MOVING FORWARD

Maryland needs to balance its budget and address its long-run fiscal problems. There is no magic solution that will satisfy all taxpayers or elected officials in the state. Most solutions we propose are politically unattractive in some form, but medicine is not known for its taste.

OUR RECOMMENDATIONS:

1. Adjust mandatory expenditure growth to align with state revenue growth. The state's budget has grown unsustainably largely because of mandatory expenditure growth exceeding revenue growth. The growth problem can be solved rather simply: change the growth rate in mandatory expenditures to be equal to the growth in total revenues. If total revenues only grow by 2 percent, mandatory expenditures and entitlements only grow by 2 percent.

2. Treat federal grants as a partial substitution for own-source revenue where possible. Federal grants can provide a substitute for own-source revenues. The extent of the substitution would certainly vary by agency and grant. Jason Sorens provides an excellent summary of public finance theory on the effects of intergovernmental transfers in recipient governments.[11]

3. Freeze the quantity or percentage of mandatory expenditures. The Governor's Office proposed a policy in which any new mandatory expenditure must be countered with a repeal or reduction of existing mandates.

4. Prioritize paying down debt. Paying down debt is particularly difficult when the state cannot balance its budget each year. It is even more problematic when the state faces a massive deficit in funding its pensions. However, budget woes diminish as debt interest payments shrink.

The recent proposal to increase state debt by more than $1 billion (including exemptions) is exactly the wrong approach.[12] Maryland bonds carry a AAA credit rating,[13] but even at a 5 percent interest rate, the new debt adds $50 million per year in interest payments alone. The state cannot balance its budget as it is. Adding $50 million in additional debt repayment only exacerbates the problem.

5. Enact structural tax reform. Maryland can reform its regulation and tax structure to increase revenues without dramatically increasing the burden to its citizens. These options include broadening the state's tax base to become more business friendly, eliminating targeted tax incentives that fail to deliver economic development, and legalizing and taxing consumption no longer considered to be illegal.

Business Climate

The Tax Foundation ranks Maryland 42nd in business climate.[14] Northrup Grumman's 2010 move from Maryland to northern Virginia in pursuit of a more business-friendly environment remains a crystal illustration of the costs of a poor business climate. Governor Hogan took a good first step by establishing his Regulatory Reform Commission, tasked with creating recommendations for making the state more effective and efficient for businesses and citizens.

Targeted Incentives

The Governor's FY 2017 budget proposes $11.5 million for the Film Production Activity Tax Credit. Economics research reveals film subsidies create little to no positive economic effect for a state.[15] Targeted incentives are typically captured by the most wealthy and are broadly considered to be inefficient and inequitable.

6. Tax and regulate In 2014, Maryland passed a bill to replace criminal penalties for the possession of small amounts of marijuana with a civil fine. In 2015, the General Assembly expanded the reform by decriminalizing the possession of marijuana paraphernalia. One step further would be to follow Colorado by legalizing cannabis and taxing its consumption.

The legal cannabis market in Colorado generated nearly $1 billion in total sales and $135 million in tax revenue for the state.[16] Tax collections in Maryland could easily equal or exceed those in Colorado.

As Maryland spends less and less of its $348 million state police budget on policing cannabis and other illegal drugs, funding can be redirected toward protecting Maryland citizens from violent crime.

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