BUDGET QUESTIONS FOR THE MARYLAND ELECTION AND BEYOND

Roy T. Meyers[1]
Professor of Political Science
UMBC
meyers@umbc.edu
September 17, 2010

This report is available on the web at: http://userpages.umbc.edu/~meyers/mdbudgetqs.pdf

SUMMARY

Maryland is projected to face large budget deficits over the next few years. The current campaign debate for Governor has generally avoided how the state should deal with this problem. Instead, candidates have emphasized what they consider to be strong parts of their past budgetary records, and weak parts of their opponents' records. But while evidence from the past can provide some useful information about the candidates' preferences and likely behaviors, it does not directly address how the state should deal with its budgetary challenges. To help citizens understand those challenges and to better evaluate the candidates, this report suggests some important questions that could be asked of candidates regarding their budgetary plans. Each question is supported by background information and web links to selected reference sources. An appendix collates the suggested questions.

THE CANDIDATES' COMPETING CLAIMS AMID PROJECTIONS OF BUDGET DEFICITS

The ongoing gubernatorial election is featuring numerous claims about budgetary actions taken under the O'Malley and Ehrlich administrations. For example,

from the O'Malley campaign:

> *"Governor O'Malley cut state spending by $5.6 billion and reduced the size of government by 4,200 positions. . . Over his four year term, Bob Ehrlich increased state spending by more than any other Governor in Maryland history and increased General Fund spending by over $3 billion. Bob Ehrlich ignored Spending Affordability guidelines for three out of the four budgets he submitted, leaving Governor O'Malley with a $1.7 billion structural deficit."*[2]

---

[1] Neil Bergsman and Warren Deschenaux provided helpful comments on a draft. Mistakes and interpretations are my responsibility.

[2] http://www.martinomalley.com/issue/issue/fiscal_responsibility/, accessed August 5, 2010.

from the Ehrlich campaign:

> *"As Governor from 2003 to 2007, Ehrlich defeated or vetoed $7.5 billion in tax hikes proposed by the Maryland General Assembly. . . In the last three years, the O'Malley Administration has plunged Maryland into its largest budget deficits in history without offering any plan to balance the budget. In addition to this deficit, total state spending today is nearly $2 billion higher than it was when the O'Malley Administration took office."* [3]

Since many citizens assume that candidates will stretch the truth to advantage their campaigns, they might like to know which of these candidates' claims are accurate about Maryland's complicated finances. However, evaluating those claims is not the main purpose of this report. Instead, it responds to an observation made by long-time Maryland state government reporter Len Lazarick that the candidates' claims about the past are not that meaningful:

> *Perhaps the closeness of the contest has helped make it a battle about the past — about what Ehrlich and O'Malley have done as governors. The big-spender friend of special interests vs. the big-tax enemy of small business. How the two men performed in the past in the same job is certainly relevant to whether we should re-hire them in the future, but we need to know not just what they've done, but what they are going to do.*
>
> *The closeness of the contest may be constraining both of them from seriously confronting the budget problems that appear to be even more difficult to handle than the deficits they both dealt with in the past. Both men drained special funds to help balance operating budgets. Next year, there will be no more of these piggy banks to be raided, and Congress is unwilling to step up again and fill in the gap.*
>
> *There is likely no political advantage to describing the hard choices ahead. Layoffs, substantial program cuts, tax hikes. What are these candidates going to do?*[4]

I largely agree with Lazarick. And I would add that what he observes is not new. In July 2006, the year of the last election, the Department of Legislative Services estimated a General Fund positive ending balance (revenues over spending) of $1.3 billion for the 2006 fiscal year that had just ended on June 30. But by fiscal year 2008 the state was projected to start running structural deficits in the general fund of over $1 billion a year.[5] In their election campaigns, the two candidates rarely mentioned this projected structural deficit.

---

[3] http://www.bobehrlich.com/bob-on-the-issues/, accessed August 5, 2010.

[4] Len Lazarick, "Tight race for governor has too much focus on the past," *Maryland Reporter.com*, August, 3 2010; http://www.marylandreporter.com/page5403450.aspx.

[5] Department of Legislative Services, *Effect of the 2006 Legislative Program on the Financial Condition of the State*, July 2006, p. 18; http://mlis.state.md.us/2010rs/misc/fiscal-effects.pdf.

Looking back, Maryland's leaders would be happy if they only had to deal with the outyear deficits that were projected in 2006. After the legislature did not make significant changes to the state's budget during its regular 2007 session, the Governor called a special session for the fall, during which the legislature enacted significant tax increases. Yet not all of the projected higher revenues materialized, due to the dramatic deterioration in the national economy that started that winter. The Great Recession has been the most significant fiscal challenge faced by the states since the Great Depression; most have made large cuts in spending. Maryland was no exception: billions in spending were cut in the Governor's budget, by the legislature, and in eight separate meetings of the Board of Public Works. The remaining gap was filled by stimulus funding from the federal government.

However, federal assistance is now winding down, primarily due to political concerns about federal budget deficits. Economic growth, employment, and consumption in Maryland are not likely to increase enough to generate sufficient revenues to sustain projected expenditures. This is reflected in the Department of Legislative Services *Major Issues Review 2007-2010* projection of the general fund, which shows deficits of over $1.6 billion in each year until fiscal year 2015.

THE LIMITATIONS OF FOCUSING ON THE PAST

This gubernatorial election is unusual in that each candidate has a four-year record as governor. I will not argue that these records are irrelevant, but rather that there are some reasonable grounds for doubt about whether the candidates' claims about the budgetary past are definitive guides to their likely actions in the future.

Focusing on the past is actually a routine strategy by campaigns, because many citizens think more about the past than about the future when they vote. There are several explanations for such "retrospective voting," all of which relate to the way the practice helps voters choose between competing candidates when it is difficult to find accurate and relevant information. For example, if a voter especially prefers low taxes, and hears Ehrlich say that he did not raise taxes when he was previously in office, and knows that O'Malley did raise taxes, the voter can make a simple choice: vote for Ehrlich, assuming that the ex-Governor's past behavior will predict his future behavior should he win the office for a second time.

However, there are several limitations to this approach. Since candidates sometimes oversimplify their records, voters who rely on their claims may jump to unjustified conclusions. For example, while it is true that Ehrlich did prevent increases in "broad-based" income and sales taxes, he successfully proposed increases in property taxes and tax-like "fees," a point that O'Malley has made repeatedly. But rather than work through the pros and cons of relying on one tax base rather than another, voters who are partisans listen mostly to and readily accept the positions of their parties' favorites.

Voters may also be confused by the candidates' contrasting claim about their spending records: O'Malley says that he cut the general fund by billions, while Ehrlich says O'Malley increased total spending by billions. Both can be true simultaneously when the federal government provided substantial increases in funding to the state. But understanding the distinction can be difficult because discussions of the state budget almost always emphasize the general fund, which is only about half of the state's total spending. Interpreting the Ehrlich criticism is also complicated by the fact that O'Malley's acceptance of federal funds allowed the state to maintain some services without having to raise taxes; Ehrlich has not supported his criticism by suggesting which spending should have been cut had federal funds not been available.

Understandably wanting to ignore such complexities, some retrospective voters simply penalize incumbents for conditions that upset them, such as the high current unemployment rate. Incumbent governors are especially susceptible to such voting decisions, even though some conditions are largely out of the incumbents' control. O'Malley has responded by emphasizing his efforts to create jobs in the face of three years of a very tough national economy. But he has also tried to claim credit for having cut the number of government jobs, in order to refute the traditional criticism of Democrats as supporters of "big government spending."

O'Malley's strategy of "if life gives you only lemons, make lemonade" extends to blaming Ehrlich for having supported spending increases during a period when the economy was much stronger than it is now. Yet had the Great Recession not happened, more revenues would have been available to finance the spending increases proposed by O'Malley during his first campaign. Similarly, had Ehrlich faced as difficult an economy as has O'Malley, Ehrlich would have had to accept some increases in broad-based taxes, or failing that, would have had to make much larger cuts in spending than did O'Malley.

It is common in American politics for candidates to expect that voters will punish them for supporting specific spending cuts and tax increases, so candidates are usually vague about how they will actually reduce deficits. Voters in the U.S. often accept this as a routine aspect of American politics. However, in some other countries, candidates are expected to present voters with realistic options for the government's finances during the campaign. For example, in both Australia and the Netherlands, detailed party platforms regarding the government's budgets are to be announced before elections and evaluated for their technical feasibility by independent government experts. This practice is welcomed by citizens in these countries because it gives them a better opportunity to evaluate the candidates' budget promises.[6]

Consider, in contrast, how citizens might try to evaluate the contents of Ehrlich's just released "Road Map to 2020," available at: http://www.bobehrlich.com/road-map-2020/. This

[6] For Australia, see: http://www.finance.gov.au/publications/charter-of-budget-honesty/index.html. The Liberal-National Coalition's refusal to comply with this policy in the most recent election was controversial. See: http://www.theaustralian.com.au/national-affairs/coalition-tackled-on-377m-budget-gap/story-fn59niix-1225907030460. For the Netherlands, see: http://www.cpb.nl/eng/pub/cpbreeksen/document/139/doc139.pdf.

document lists numerous proposals in job creation, education, transportation, environment, energy, crime, health, and agriculture. It also includes sections on taxes and the budget. Among the tax proposals are full repeal of the 2007 sales tax increase, but the plan does not mention that this would increase deficits by over $600 million a year. Ehrlich also supports new or expanded tax credits and implies a reduction in corporate taxes that would further increase the deficit. If these tax proposals were adopted, then annual deficits would be above $2 billion a year. On the spending side, he proposes to evaluate agency missions, study pension solvency, review mandates, and streamline state purchasing; he provides one specific case of likely savings--for agency public relations activities. Other sections of the plan include a mix of proposals that could increase or decrease spending, but the plan provides no specifics about likely budget impacts. Absent specifics, one has to take on faith that the combined effects of Ehrlich's spending proposals would save over $2 billion a year, or the budget would not be balanced.

If and when O'Malley releases a similar list of proposals, I will revise this report to compare it to Ehrlich's regarding how specific it is about future budget effects.

BUDGET QUESTIONS FOR THE FUTURE

The remainder of this report thus presents some basic budget questions that citizens and reporters might ask the candidates. Each question is supported with a mini-primer on the topic, including links to available documents and occasional suggestions for how these documents could be made more useful for citizens.

For a lengthier general introduction to the Maryland budget, see in particular Volume IV of the Legislative Handbook: http://mlis.state.md.us/2006rs/misc/Legislative_Handbooks/Volume_IV.pdf (this will be updated after the general election). Detailed analyses of Maryland's finances may be found at: http://mlis.state.md.us/Other/Fiscal_Briefings_and_Reports/Fiscal_Br_Rep_Ana_Index.htm. Another useful source for Maryland is the Maryland Budget and Tax Policy Institute, at: http://www.marylandpolicy.org/, including its report: http://www.marylandpolicy.org/documents/RegularPersonsGuide2010-Final.pdf. A national source on different approaches to reducing state budget deficits is http://www.cbpp.org/files/2-16-10sfp.pdf.

Accuracy of deficit projections

Current budget projections show large budget deficits in the next several years. Do you think these projections are too pessimistic? If "yes," why are you more optimistic?

Background: Revenue forecasts are formally issued three times a year in a report in December and revisions in March and September. Forecasts by the Board of Revenue Estimates may be found at: http://www.marylandtaxes.com/finances/revenue/bdrevenueestimates.asp. Budget projections are issued by the Department of Budget and Management in the Governor's budget request (http://dbm.maryland.gov/agencies/operbudget/Pages/OperatingBudget.aspx). These projections modify the "baseline" projection--an estimate of the budget under the law as it stands--for the effects of the Governor's proposals, assuming they are adopted by the legislature. Legislative baseline projections and estimates of the budgetary effects of legislative actions are issued periodically by the Department of Legislative Services (DLS) (http://mlis.state.md.us/Other/Fiscal_Briefings_and_Reports/Fiscal_Br_Rep_Ana_Index.htm).

Baseline revenue projections are based on economic forecasts. While such forecasts are based on the best judgments of professionals, they are inevitably going to be wrong--the only questions are: "by how much?;" and, "in which direction?" The last few years have shown how errors can be particularly large when recessions greatly reduce revenues from expected levels.

A common problem in state budgeting is to forecast the likely course of the economy, and then base budget projections on this point forecast without thinking much about the likely range around this point. Doing otherwise illustrates the sensitivity of budget projections to the economic forecast; for example, the Congressional Budget Office typically reports its "rules of thumb" of the budgetary effects from different economic conditions than those in the forecast: http://www.cbo.gov/ftpdocs/108xx/doc10871/AppendixC.shtml.

It is possible that the relatively slow growth in the Maryland economy now forecasted for the next several years could be exceeded in practice; this would make the budget situation less challenging, and could partially justify the campaigns' relative inattention to projected budget deficits. On the other hand, should we experience the second part of a "double-dip" recession, projected deficits would be even larger. The state's budget experts have not released formal estimates of such effects.

Budget projections also rely on a large number of "technical" assumptions about the likely path of spending. Budget analysts, often following estimating conventions, base their projections on guesses about the caseloads for benefit programs, inflation, and employee compensation, among other "drivers" of higher spending. Information about these assumptions used by the General Assembly can be found in this DLS report: http://mlis.state.md.us/Other/spending_affordability/Technical_Supplement_2009.pdf. Modifications to these assumptions can change projections of budget deficits. These assumptions are particularly important for "mandatory" spending, for which existing laws require additional spending each year based on specific drivers. Underestimates of mandatory spending require the next budget to make up the funding deficiencies.

In January 2009, DLS released an analysis of spending from mandates (http://mlis.state.md.us/2009RS/misc/MandateReform.pdf); the legislature adopted "budget reconciliation" legislation in 2009 and 2010 that reduced spending growth driven by some mandates. However, some of those savings are written into the law for only several years, and it is uncertain whether the Governor and legislature will allow those savings to expire, continue them at current levels, or make further cuts.

Beyond the general fund

The state's budget process now concentrates on balancing the state's "general fund," with less emphasis given to "special funds" such as the Transportation Trust Fund and Program Open Space. Will you continue this concentration on the general fund, or will you broaden the budget debate by including these special funds?

Background: The general fund excludes those programs that are financed by legally-dedicated revenues; many of these are instead labeled "special funds." The largest special fund is the Transportation Trust Fund (TTF). The TTF combines operating and capital spending for all modes of transportation, and is financed by a mix of transportation taxes, fees, tolls, federal grants, and revenue bonds. DLS has suggested that anticipated revenues for this fund may be insufficient to fund planned spending. (http://mlis.state.md.us/2010rs/budget_docs/all/Operating/J00_-_Maryland_Department_of_Transportation_Overview.pdf) Another major special fund is Program Open Space, which uses proceeds from real estate transfer taxes to finance state and local government acquisition of environmentally-sensitive and recreational lands. The state's expansion of Medicaid in 2007 also relied on moneys from special funds.

During both the Ehrlich and O'Malley administrations, revenues that had been dedicated to special funds were transferred to the general fund. For fiscal years 2009 and 2010, each year over $1 billion was transferred into the general fund. In some cases, the financing lost by the special funds was replaced by other sources, including receipts from borrowing; in other cases, program activities in the special funds declined. The latter approach was sometimes characterized as a "raid" on the special funds. A neutral rather than pejorative description was that the state decided to rearrange its priorities and not insulate these programs from making comparable sacrifices just because they are not included in the general fund.

Revenues can be dedicated for different reasons--to make it more likely that the beneficiaries of spending bear the costs, to force the Governor to accept legislative priorities that were not included in the proposed budget, or to show an especially strong commitment to the special funds' purposes. In the latter case, advocates sometimes say that after dedication, these funds "can never be touched." That is false, as shown by the treatment of recently-created special funds for higher education and environmental protection, from which moneys were transferred to the general fund during the Great Recession.

In fact, as shown by the laws that mandate spending in the general fund, many of the general fund's expenditures are at least as politically difficult to "touch" as are special funds. DLS reports that "approximately two-thirds of the general fund budget consists of statutorily mandated entitlements and formula-based funding."[7] Because the mandated growth in these programs makes up a large part of projected deficits, reconsidering the benefits and costs of entitlements and formula funding is an inevitable part of reducing deficits. See: http://www.freestatefoundation.org/images/Curing_Maryland_s_Structural_Deficits.pdf

Federal funds

Grant funds from the federal government may help finance additional services for Maryland's citizens. Will your administration seek to maximize receipt of these funds? How much of the medium-term deficit can realistically be plugged with federal assistance? Do you believe that by accepting federal funds the state risks having to comply with burdensome federal requirements?

Background: Over the fiscal year 2009-2011 budgets, federal stimulus funds replaced state general funds by a bit less than $1 billion a year, on average. Over the same period, the state also spent about $1.5 billion of federal funds a year, on average, for activities that had not been in the state's budget.[8] Information about the allocation of these funds can be found at: http://statestat.maryland.gov/recovery.asp. Federal assistance of this large magnitude is unlikely to be maintained over the next few years, even if the economy weakens again.

The state has a good record of replacing state funds with federal funds, an approach called "fund swaps." It also recently won a four-year federal grant of $250 million in the "Race to the Top" for education reform. While federal funds can either substitute for or supplement state funds, they are not always "free," since they may require the state to spend more of its own money over time, or to meet federal expectations (also known as "strings") that Maryland might otherwise prefer to ignore.

The largest federal impact on the state budget over the next few years will be the implementation of health care reform. This law will substantially broaden access to health care for the now under- and uninsured, replacing some recent state initiatives in this area. However, implementing the law will be extraordinarily complicated and take quite a while, so there is still much uncertainty about its likely effects. A state commission recently projected that the reform will enable the state to save roughly $600 million to $1 billion over the next 10 years. See: http://www.healthreform.maryland.gov/documents/100726interimreport.pdf Over the long-run, health care reform must reduce the rate of growth of health care spending across both the public and private sectors. This is particularly important for the state because Medicaid spending is projected to continue to grow at a pace far exceeding state revenue growth.

---

[7] Major Issues Review 2007-2010, p. A-4.

[8] DLS, Major Issues Review 2007-2010, p. A-5.

Rainy day fund

When the economy improves, how much should Maryland save for the next economic downturn by putting money aside in the "rainy day fund?" And under what circumstances should the state draw down these savings?

Background: Maryland's rainy day fund, formally the Revenue Stabilization Account, is by law intended to save 7.5% of projected general fund revenues. When balances in the fund are below that target, the Governor is required to propose in the budget an appropriation into the fund of at least $50 million. In addition, when the general fund for a previous year has an unappropriated balance above $10 million, in a subsequent year that surplus must be appropriated into the fund. However, the Governor may also transfer moneys out of the rainy day fund to support state operations as long as the resulting balance in the fund doesn't fall below 5% of projected general fund revenues.

Both the 7.5% target and the 5% floor are "rule of thumb" targets--they are not based on statistical modeling of the volatility of state revenues and expenditures. Since even mild recessions cause the state's financial position to worsen more than the amount typically saved in the rainy day fund, relying on just that fund to smooth out the budgetary effects of the business cycle has been insufficient. The state has also been reluctant to draw down its rainy day fund below the 5% level during recessions, as a precaution against the possible financial effects of large disasters, such as a pandemic. The state's officials believe that this practice helps maintain Maryland's AAA bond rating.

Maryland has instead responded to large budgetary downturns by drawing much more on other sources, and particularly by transferring balances from non-general funds into the general fund. For example, each year public universities save a portion of tuition and fees to finance the rehabilitation of buildings, but in the past two years the universities were required to transfer some of these funds to the state's treasury. Those funds will eventually have to be replaced, presumably when the economy improves. The universities preferred this approach to the possible alternative of having to layoff personnel when demand for higher education had increased. For a summary of such transfers for the past year, see: http://www.marylandtaxes.com/finances/FY2010_closeout.pdf.

A decade ago, the country was nearing the end of the "dot.com" period of abnormally high economic growth, which had produced large increases in government revenues. It was during this period that the state enacted the "Bridge to Excellence" law that required a large increase in aid to localities for elementary and secondary education, and also implemented the last stage of a scheduled cut in income taxes. Maryland also spent some of its above-average revenues on "one-time" purchases, particularly of capital assets like school buildings. Governor Glendening argued then that the latter approach was fiscally responsible because it did not put additional spending into the budget base.

An alternative would have been to save more in the rainy day fund during the good years. This would have made less money available for program expansion and/or for one-time spending and might have prevented the scheduled tax cut. However, had Maryland saved more funds, withdrawals from a larger rainy day fund could have taken the place of some of the cuts made in recent years. Those "procyclical" cuts have worsened the effects of the recession (as has been the case in most other states) because they withdrew income from the state's citizens. These cuts in state employee pay and in payments to program beneficiaries and providers have partially counteracted the federal stimulus and slowed the recovery of the state's economy. This economic drag could have been even worse had the state not creatively used the panoply of one-time savings to maintain basic services.

A counterargument regarding this approach is that the failure to save sufficiently for bad times creates political conditions that make it easier for elected officials to permanently eliminate government inefficiencies. But even if this is partially true, it is still not the best approach for producing this result.

State government workforce

Over the last four years, the state government workforce, excluding higher education, was reduced by over 2000 positions. Over the past three years, the pay of state employees was temporarily reduced by about 2% a year on average through mandatory furloughs. Will your administration seek additional savings in this area, or do you expect to increase spending on employee pay?

Background: Salaries and wages for the government workforce are about one-fifth the state's total spending. Detailed information about state employees may be found at: http://dbm.maryland.gov/employees/Pages/employeesHome.aspx.

For agencies other than the state's universities, the Governor and the General Assembly set ceilings for employment and require agencies to receive permission to create and then fill each position. Yet some agencies have been unable to fill all approved positions because their budgets are too tight. While their budgets show funds that could be used to pay newly-hired personnel, agencies leave these positions vacant because they must pay for other operating expenses that are higher priorities than new staff. Then when budget cutbacks eliminate these vacant positions, this effectively requires agencies to cut back on other operating expenses--since a non-existent employee cannot be compensated, eliminating that position does not generate any current personnel savings.

Over the past several decades, reductions in personnel across the states have been generated mostly by contracting out. For example, closing large mental health institutions, highly desirable on policy grounds given the failures of these "warehouses," led to more funding of for-profit and non-profit service providers in mental health. Another area--corrections--has seen growth in government employment, due to higher rates of incarceration, but contracting out has moderated this growth (though Maryland has not relied as heavily on contracting). For operations such as corrections, where essential personnel must be in place 24-7, low numbers of employees and poor management can lead to excessive overtime costs. Controlling that risk has been an emphasis of the O'Malley administration.

In contrast to a public perception that Maryland state government is overstaffed, there have been long-standing vacancies in selected agencies such as Juvenile Services and Human Resources. These vacancies can be explained by the relatively low pay, even after recent state efforts to increase that pay, in comparison to the difficult working conditions these employees often face. Staff shortages have sometimes led to major problems at juvenile facilities. The deterioration of those who are under the law due services from the state can eventually force the state to bear higher costs, such as for out-of-state placements.

National studies often show that state employee compensation is lower than that offered by the private sector or by the federal government, after adjusting for the different education levels held by employees. A 2008 consultant's study for Maryland, mandated by the state legislature, found a similar gap.[9]

Historically, the relatively low pay of state government employees was offset by higher job stability and more generous retirement benefits. The former is no longer true; the latter is covered in the next section.

Pensions and retiree health benefits

Long-run projections of what the state owes its employees for pensions and health insurance show large unfunded liabilities. How will your administration deal with this challenge?

Background: Until recently, the long-run costs of state retirement benefits were not fully transparent. However, guidelines from the Governmental Accounting Standards Board (GASB) now require states to report these likely costs. Failure to set enough money aside over time to pay for these obligations will place a state's credit rating at risk.

Estimating the likely amount of defined benefit pension and other retirement benefit obligations is highly complicated, and quite sensitive to assumptions such as the rate of return on the state's investments. Of course, these investments have taken big hits in recent years, far larger than last year's rally in the market. Consequently, only about 65% of likely future

---

[9] Maryland Department of Budget and Management, 2008. *State of Maryland Salary and Benefits Comparative Study*, submitted by CPR Human Resource Services, pursuant to 2006 Joint Chairmen's Report; available from Maryland State Archives.

payments by Maryland's largest employee pension fund are funded now with savings. More information on the state's retirement systems can be found at: http://www.sra.state.md.us/ and http://www.msrp.state.md.us/ (the latter covers teachers employed by county school boards; their pensions are funded by the state). For retiree health benefits (known as "OPEB," or Other Post-Employment Benefits, following GASB's terminology), the state has received two actuarial studies, the latter of which showed total unfunded liabilities of about $15 billion. The "annual required contribution" to prefund these liabilities would be over $1 billion a year.

States normally repair such insufficiencies over a number of years. This can take the form of amortization payments and/or it can take the form of benefit cuts which reduce the unfunded liabilities. The latter approach would be viewed by state retirees as a promise broken by the state. The General Assembly has created the Public Employees' and Retirees' Benefit Sustainability Commission, which is supposed to provide its initial recommendations this December and issue its final report in December 2011. The state's Blue Ribbon Commission to Study Retiree Health Care Funding Options health benefits, after a recent extension, now has a similar schedule for its reports. It has the difficult task of projecting how implementation of the federal Affordable Care Act will affect the state's likely costs.

Other spending efficiencies

Some citizens argue that the state has not done enough to reduce "fraud, waste, and abuse." What strategies will your administration use to discover and implement efficiencies in how the state operates, besides reviewing the size and compensation of the workforce?

Background: In the summer of 2009, Governor O'Malley asked citizens for their suggestions about how to improve government efficiency. The voluminous responses can be found here: http://www.governor.maryland.gov/documents/budget_feedback.pdf. Many of the suggestions were not limited to what budget experts would define as efficiencies, and some in fact asked for deficit-increasing actions, such as tax cuts or more spending on selected programs. Other suggested options fit the efficiency definition: reducing non-personnel operating expenses, cutting overhead, selling unused assets, replacing obsolete information technology, contracting out more, and preventing improper payments.

Rooting out corruption and inefficiency has a long and distinguished history in the United States; in fact, the Progressives of a century ago helped create the modern system of government budgeting to foster better government. That existing budget process often produces efficiency savings, either by limiting spending on specific activities, or by requiring managers to flexibly adjust their spending to comply with tight spending ceilings.

The common assumption of those who oversee budgets is that there will always be opportunities to save money by improving government efficiency. But it is also possible to overestimate the potential extent of such savings. For a notable example in the federal government, see http://www.nationalaffairs.com/doclib/20060406_issue_078_article_5.pdf. Maryland has periodically relied on efficiency commissions to identify savings. The last one was during the Ehrlich administration, and is generally viewed as having produced some worthwhile recommendations that nonetheless did not sum to significant budget savings. See: http://www.msa.md.gov/megafile/msa/speccol/sc5300/sc5339/000113/000000/000142/unrestricted/20040000.pdf.

One of the most important facts to realize about the possible magnitude of efficiency savings is that many of the services provided by government are not delivered by government employees, but rather are delivered indirectly by contractors and grantees. Generating efficiencies for these activities thus requires careful management of relationships with the government's partners. And since governments rely increasingly on information technology to conduct operations, skillful design and management of information systems is required. Often an up-front investment is needed to save money over the long-run. Finally, many of the perceived inefficiencies in government processes, popularly known as "red tape," were put in place to promote fairness and accountability.

Consequently, generating efficiency savings requires an administration to mount a sustained management effort. The popular press and academic experts have both given the O'Malley administration very high marks in this area, particularly for its Statestat approach. See, for example, http://www.governing.com/poy/Martin-OMalley.html, and http://www.hks.harvard.edu/var/ezp_site/storage/fckeditor/file/pdfs/centers-programs/centers/taubman/policybriefs/performancestat.pdf.

Program priorities and spending cuts

Many budget experts suspect that potential efficiency savings will not be sufficient to close the state's projected budget deficit. Leaving aside new revenues for the moment, how will you set priorities when deciding how to cut spending? Which areas of the budget would you be least likely to cut? And where would you start to look for savings?

Background: A budget should be just a means to an end; the end should be improving the quality of life in the state. Improving the quality of life requires the government to effectively provide services to its citizens, such as education, public safety, health protection, and environmental conservation. In our democratic system, we expect citizens, candidates, and elected officials to differ about which services government should provide, and about what levels of services should be provided at what costs. The budget is supposed to resolve this dispute each year by allocating the state's limited financial resources to the priorities decided by elected officials.

Once efficiency savings are exhausted, budget deficits require elected officials to be more selective about the services they can afford to provide. Yet at times, the process they use to make budget cutbacks can seem unconnected to any reasonable process of setting priorities. A popular approach across the states is to simply target areas of the budget that have recently grown at a rapid rate. However, it could be that recent spending growth reflects a strong preference to deal with a significant problem. For example, higher funding to restore the Chesapeake Bay to health may reflect a recognition that this will be possible only with a sustained increase in spending from recent levels.

Maryland's process for priority-setting has long depended on executive leadership. O'Malley has listed 15 very detailed strategic goals, at: http://www.statestat.maryland.gov/gdu.asp. During his administration, Ehrlich proposed what he called "the five pillars" of his administration's policy; his was a much less detailed approach than O'Malley's. (Unfortunately, available archived web sites do not provide full versions of the Ehrlich approach.) In a previous policy brief (http://userpages.umbc.edu/%7Emeyers/policy_brief_5.pdf), I suggested that Maryland could build on the Governor-dependent approach by adopting a strategic planning process like that used by some other states. In this kind of strategic planning, the legislature also participates in identifying priorities, and the state reports periodically through accessible web pages on the state's progress.

An example of how this approach might be used is suggested by a recent issue brief from Advocates for Children and Youth. They recently reported that though Maryland's citizens have the highest income in the nation, Maryland's children rank only 25th in well-being, as measured by some standard indicators. Of the 50 states, only Alaska has a greater gap between its citizens' incomes and its children's quality of life. http://www.acy.org/upimages/Kids_Count_2010.pdf.

Of course, there is no "silver bullet" approach to improving the quality of child well-being. Doing so instead requires careful evaluation of alternative approaches and quality implementation of promising alternatives. If a strategic planning approach identified child well-being, then the budget could help support a focus on it. That would require the state to improve its process of performance budgeting, another suggestion in my previous policy brief. Agencies are now required to submit "Managing for Results" (or MFR) data with their budget requests to the Governor; these data are included in the detailed budget request to the General Assembly. However, these data are often very difficult to interpret by the public and the legislature, particularly if one is searching for low-performing programs. See http://www.ola.state.md.us/top_pgs/Publications/pubs_managing%20for%20results.html.

Finally, a significant reality regarding setting priorities is that the state's budget is heavily dominated by just four areas: health, education, public safety, and transportation. They constitute approximately 80% of the state's total operating spending and 70% of the state's capital spending. Setting priorities will inevitably require greater selectivity within these areas. Should the public prefer to not dramatically reduce Maryland's activities in these areas, more revenues will be needed to eliminate the budget deficit.

Tax expenditures

Maryland's tax law allows many individuals and businesses to reduce what they owe by taking advantage of special preferences. The lost revenues from these preferences are called "tax expenditures." Though these expenditures are often similar in their effect to spending programs, tax preferences are far less visible and receive less scrutiny in the budget process. Will your administration systematically review tax expenditures to see if eliminating some of them will help reduce the budget deficit?

Background: Maryland's income tax is "piggybacked" on the federal law, requiring citizens to calculate their adjusted gross income using the many federal exclusions, exemptions, and deductions that are included in the federal law. The state "decouples" from--that is, doesn't allow--a few of these preferences. Maryland also allows additional reductions in tax liability for taxpayers who engage in certain activities. For example, public service companies who purchase Maryland-mined coal are eligible for a credit against the franchise tax.

Unfortunately, tax preferences are often not compared during the budget process to spending programs that are similar in stated purpose. Multimillion-dollar tax provisions get less scrutiny than expenditure items only one percent of that size. But state law does require the executive branch to report every two years to the General Assembly on these tax breaks. The most recent report is for fiscal year 2010, and is available at: http://dbm.maryland.gov/agencies/operbudget/Documents/2010TaxExpendReport.pdf. The state failed to produce such a report for fiscal year 2008. Maryland's analysis of and reporting on tax preferences lags behind other states; see: http://www.cbpp.org/files/4-9-09sfp.pdf and http://onlinelibrary.wiley.com/doi/10.1111/1540-5850.00088/abstract.

Eliminating selected tax preferences is known as "base broadening." The additional revenues received through this approach could be dedicated to deficit reduction and/or allow the reduction of tax rates.

Tax bases and rates

When states face large deficits such as those faced by Maryland, they often end up having to raise taxes even after making significant cuts to spending. If Maryland finds it needs more revenues, which tax bases should the state rely upon to generate these funds? How much higher would tax rates have to be on these bases to close the budget gap?

Background: Prior to the 2007 special session which led to significant tax increases, the DLS presented the General Assembly with what was informally named the "doomsday" analysis--an estimate of options for balancing the budget without new revenues. http://mlis.state.md.us/2007RS/misc/2007_Fiscal_Briefing/June_27_balancing.pdf. The magnitude of required spending cuts convinced the legislature to adopt higher tax rates. A painful irony of this experience is that the depth of the Great Recession still forced the General Assembly to adopt many of the spending cuts they were trying to avoid by raising new revenues.

Compared to other states, the overall level of taxation by Maryland state and local governments is high. However, once tax receipts are compared to the different levels of income in the states, Maryland's tax burden is relatively low. That is, since Maryland citizens are on average among the richest in the nation, they pay a smaller percentage of their income in taxes to to state and local governments than do citizens in most other states. See: http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=531.

Compared to other states, Maryland relies more on the personal income tax than it does on sales and property taxes. This makes Maryland's tax system less regressive than the systems in most other states. This means that the percentage of income paid as tax by most people is roughly the same; in many other states, those with higher incomes pay substantially smaller percentages in taxes than do those in the middle and lower parts of the income distribution.

Different taxes have different effects on the competitiveness of a state's businesses, of revenue yield over time, and fairness. Choices about which activities to tax (so-called "tax bases") and how high to set tax rates are inherently complicated and controversial. For example, it has been argued that the increase in Maryland's income tax rate caused high-income taxpayers to flee the state. However, there appears to be little evidence to support this claim; the reduced number of returns showing high incomes is more likely due to the effects of the recession and stock market decline, particularly on capital gains income.

While Maryland has a strong record in revenue forecasting, it has not devoted as much effort to public analysis of the overall tax system. The last comprehensive analysis of the state's tax system (the "Linowes report") was completed in 1990. A new study would help policy-makers decide which tax increases could be adopted with least harm.

Many tax experts believe that state governments must inevitably broaden their sales tax bases. The trend in purchasing is away from storefronts towards the internet, but federal law unfortunately limits the ability of the states to tax internet sales. Repeal of this unfunded prohibition would help repair the finances of most states, and treat local businesses more fairly. Similarly, consumption patterns have shifted from goods to services; since state sales taxes tend to tax goods more than they do services, states have seen lower yields from the sales tax. Though some of these additional service purchases are for medical treatments, an area that is unlikely to be taxed, expanding the sales tax base to include other services could still produce additional revenues. In 2007, the state broadened its sales tax to apply to only one additional service, for computer assistance. This targeting of part of one industry understandably led to its repeal in the next legislative session. A broader reform that was perceived as being fairer could be more sustainable, particularly if a broader base enabled a small reduction in the sales tax rate.

Another potential tax increase that has received increased attention in Maryland is a tax on alcohol. Maryland's rate is low compared to most other states; by raising it, the state could reduce alcohol consumption. Additional funds generated by the tax could either support additional services (such as mental health and substance abuse treatments) or reduce the deficit.

A useful analysis of tax increases that could be considered in the future is at: http://www.marylandpolicy.org/html/research/marylandtaxesmain.asp.

Capital budget and debt affordability

Maryland spends about $3 billion a year buying capital assets, about half on transportation, and much of the remaining for school buildings and water quality facilities. About $1.5 billion a year is borrowed to finance these projects; remaining costs are financed with current revenues and federal grants. If Maryland is to stay within its capital affordability guidelines, it may have to reduce capital borrowing in the future. What will be your policies for the capital budget and debt affordability?

Background: State governments borrow to purchase expensive assets that should provide services for a long time. Most borrowing is through the sale of bonds to investors. Payments of interest and principal to these bond investors over time spreads the cost of buying these assets. Those who benefit from these assets' services over the years help bear the cost of providing them. For example, gas taxes are used for years after a road's opening to redeem bonds sold to finance construction of these very expensive projects.

Maryland finances its capital assets by selling "general obligation" bonds, for which the full taxing power of the state is pledged to guarantee repayment, and "revenue" bonds, which are backed primarily by specific revenues (such as tolls to cross a bridge). The state also sells more complicated bonds--for example, "grant anticipation revenue vehicles," or GARVEEs, which have dedicated future federal grants for transportation to the financing of the Inter County Connector. Other complicated capital financing mechanisms include leases, public authorities, and public-private partnerships. These arrangements can often be tremendously complicated, and though they may mobilize private capital for public purposes, may also be costly compared to general obligation bonds. Finally, Maryland provides many grants for capital projects to local governments and non-profit organizations. A small subset of these grants are initiated by the legislature; they resemble the earmarks that have proved controversial in the federal government.

Maryland uses multiyear planning processes and detailed reviews of most capital projects to avoid problems. It also sets limits on how much the state should borrow (no more than 8% debt service to revenues and 4% debt outstanding to personal income). Bond authorizations have been increased in recent years to enable more borrowing, particularly for expanded construction of elementary and secondary schools. Also, the "PAYGO" practice of using some current revenues for capital purchases was reduced by relying instead on more borrowed funds. The recently expanded borrowing has led to lowered projections of bond authorizations for future years, which would reduce the state's future ability to purchase new capital assets. If, instead, the debt affordability ceilings were to be raised, some experts believe that this would risk Maryland's AAA credit rating. A rating downgrade would cause the state to pay slightly higher interest rates on its borrowing.

Materials from the Capital Debt Affordability Committee may be found here: http://www.treasurer.state.md.us/Debtmgmt_popup/CDAC_POPUP.htm.

Legislative and citizen involvement in the budget process

Maryland's governor is the most powerful in the nation when it comes to exercising budgetary power. The legislature is constitutionally prohibited from adding funds to the governor's operating budget. The Board of Public Works, on which the Governor sits with the state's Comptroller and Treasurer, can cut spending without having to publicize cuts before it meets. Do you believe that the Governor should retain these powers, or should the budget process be made more inclusive and transparent?

Background: Maryland's constitution was amended in 1916 to give the Governor extraordinary budget powers, in response to the perception that the legislature was corrupt and irresponsible. The theory was that by clearly identifying who should be largely responsible for the condition of the state, voters would have an easier time keeping that person accountable. However, the logic of this theory did not anticipate the professionalization of the General Assembly. Nor did it foresee the desire of many citizens to have more opportunities to affect budget priorities than is afforded by the chance to petition the Governor prior to his budget request. One response to these realities has been that the legislature has mandated spending in future budgets, which reduces the budget's flexibility from year-to-year.

The budget receives heavy media coverage just prior to and during the General Assembly session, and then only intermittent coverage during the rest of the year. The major exception is when the Board of Public Works announces budget cuts--but those cuts are revealed only at the last minute. Bills were introduced this year that would have required the opportunity for advance comment on proposed cuts, but they did not pass.

Other states rely less on their Governors to make budget decisions. Some involve citizens in town meetings and other forms of participatory budgeting, with the goal of helping citizens better understand the state's budgetary position and offer their suggestions for improving it. For more information on the governor's budgetary powers, see: http://userpages.umbc.edu/%7Emeyers/improveMD.pdf and http://www.marylandpolicy.org/documents/junereport060608.pdf.

Another view on transparency can be found at: http://www.freestatefoundation.org/images/Structural_Solutions_for_Maryland_s_Structural_Deficit.pdf. Finally, for an effort to expand the public's understanding of Maryland's budget through a computer game developed at the University of Baltimore, see: http://iat.ubalt.edu/MDBudgetGame/.

APPENDIX: BUDGET QUESTIONS FOR THE CANDIDATES

Current budget projections show large budget deficits in the next several years. Do you think these projections are too pessimistic? If "yes," why are you more optimistic?

The state's budget process now concentrates on balancing the state's "general fund," with less emphasis given to "special funds" such as the Transportation Trust Fund and Program Open Space. Will you continue this concentration on the general fund, or will you broaden the budget debate by including these special funds?

Grant funds from the federal government may help finance additional services for Maryland's citizens. Will your administration seek to maximize receipt of these funds? How much of the medium-term deficit can realistically be plugged with federal assistance? Do you believe that by accepting federal funds the state risks having to comply with burdensome federal requirements?

When the economy improves, how much should Maryland save for the next economic downturn by putting money aside in the "rainy day fund?" And under what circumstances should the state draw down these savings?

Over the last four years, the state government workforce, excluding higher education, was reduced by over 2000 positions. Over the past three years, the pay of state employees was temporarily reduced by about 2% a year on average through mandatory furloughs. Will your administration seek additional savings in this area, or do you expect to increase spending on employee pay?

Long-run projections of what the state owes its employees for pensions and health insurance show large unfunded liabilities. How will your administration deal with this challenge?

Some citizens argue that the state has not done enough to reduce "fraud, waste, and abuse." What strategies will your administration use to discover and implement efficiencies in how the state operates, besides reviewing the size and compensation of the workforce?

Many budget experts suspect that potential efficiency savings will not be sufficient to close the state's projected budget deficit. Leaving aside new revenues for the moment, how will you set priorities when deciding how to cut spending? Which areas of the budget would you be least likely to cut? And where would you start to look for savings?

Maryland's tax law allows many individuals and businesses to reduce what they owe by taking advantage of special preferences. The lost revenues from these preferences are called "tax expenditures." Though these expenditures are often similar in their effect to spending programs, tax preferences are far less visible and receive less scrutiny in the budget process. Will your administration systematically review tax expenditures to see if eliminating some of them will help reduce the budget deficit?

When states face large deficits such as those faced by Maryland, they often end up having to raise taxes even after making significant cuts to spending. If Maryland finds it needs more revenues, which tax bases should the state rely upon to generate these funds? How much higher would tax rates have to be on these bases to close the budget gap?

Maryland spends about $3 billion a year buying capital assets, about half on transportation, and much of the remaining for school buildings and water quality facilities. About $1.5 billion a year is borrowed to finance these projects; remaining costs are financed with current revenues and federal grants. If Maryland is to stay within its capital affordability guidelines, it may have to reduce capital borrowing in the future. What will be your policies for the capital budget and debt affordability?

Maryland's governor is the most powerful in the nation when it comes to exercising budgetary power. The legislature is constitutionally prohibited from adding funds to the governor's operating budget. The Board of Public Works, on which the Governor sits with the state's Comptroller and Treasurer, can cut spending without having to publicize cuts before it meets. Do you believe that the Governor should retain these powers, or should the budget process be made more inclusive and transparent?