May 15, 2015

The Honorable Michael E. Busch
Speaker of the House
H-101 State House
Annapolis, MD 21401

Dear Mr. Speaker:

In accordance with Article II, Section 17, of the Maryland Constitution, I have today expressly disapproved and vetoed the following item in House Bill 71 – *Creation of a State Debt – Maryland Consolidated Capital Bond Loan of 2015,* et al.:

> Item ZA00 (I) appearing on page 29 of the enrolled bill, lines 27 through 33:
>
> "Maryland Hall for the Creative Arts. Provide a grant to the Board of Directors of Maryland Hall for the Creative Arts, Inc. to assist in funding the design, construction, and equipping of renovations to its facility to improve Maryland Hall for the Creative Arts gallery and theater spaces (Anne Arundel County)……….2,000,000."

I am allowing the remainder of House Bill 71 – *Creation of a State Debt – Maryland Consolidated Capital Bond Loan of 2015,* et al. (MCCBL), to become law without my signature even though I have strong reservations as expressed below about the General Assembly's amendments that expand the State's capital program.

Maryland's Rapidly Escalating Debt Levels

Most significantly, the Legislature's actions to increase state debt authorizations put Maryland's finances on an unsustainable path that is inconsistent with sound financial stewardship. In total, the Legislature added $50 million in general obligation bond authorizations above the $995 million capital budget that I proposed in the original bill.

If the General Assembly had remained within the prudent spending level that I proposed, it would have insured the financial stability of the State's capital program by reducing expenses well within the debt management ratios. Moreover, it would have reduced the explosion of general funds needed for debt service in future years and thus improved Maryland's fiscal position for out–year structural deficits.

The State has increased its own debt affordability levels in six of the last eight years. These levels of debt authorizations, if continued, would bring the State to the brink of breaching its established limits of debt service as a percent of revenues. There is virtually no margin of error to account for fluctuating economic conditions or unexpected capital expenses.

The increased debt authorizations necessarily result in higher expenses for debt repayment in the future. Maryland's state property tax revenues are legally dedicated to pay debt service on State bonds. As a result, the increase in debt service costs is now out–stripping the growth in property tax revenues. I have no intention of increasing property tax rates to fund this debt service shortfall incurred by the prior Administration.

Over the past several years, the General Assembly budget practices of using debt service to fund general operating expenses has unfortunately positioned Maryland to where the fastest growing part of the State's general fund budget is debt service. In the Fiscal Year 2016 budget submitted in January, general fund debt service costs increased by 96% from $140 million to $274 million. In Fiscal Year 2017, these costs will exceed $400 million and our debt service will cost more than the entire school construction program for Maryland.

By comparison, in Fiscal Year 2013, Maryland's general fund debt service cost was zero. Unfortunately, this rapidly escalating debt service will soon exceed $500 million and, when combined with increased pension costs, will account for over 10% of the operating fund budget within five years. We must act quickly to rein in these growing costs and keep them from crowding out our ability to fund new priorities for Maryland government instead of paying off the credit card of recent budgets approved by the General Assembly.

<u>Bond Premiums Should Be Used Exclusively to Pay Debt Service</u>

The Legislature ignored the sound advice of State Treasurer Nancy Kopp concerning the use of anticipated bond premiums over the next two fiscal years by appropriating over $48 million in bond premium revenues for Program Open Space, Rural Legacy, and Agricultural Land Preservation in Section 15 of the MCCBL. In testimony before the General Assembly budget committees, Treasurer Kopp advised:

> "Consistent with prior budget practices, the Governor's Budget estimates bond premium for the upcoming March sale. The March sale is completed before the

> budget is finalized so that actual bond premium is known and adjustments can be made if there is a shortfall in the estimated amount. The enacted budget thus includes a combination of known revenues sufficient to fund the appropriation. This is done to reduce the risk to the State of relying on a volatile and difficult to predict revenue source to fund debt service. This assures both the rating agencies and bond investors that funds to pay debt service are actually there and that the State is not potentially underfunding the ABF [Annuity Bond Fund] if bond premium is overestimated. . . . If the anticipated premiums are not realized, a deficiency appropriation would be required from the General Fund. This volatility and uncertainty could be mitigated by maintaining a larger balance in the ABF, however you could avoid the volatility all together by simply maintaining the State's conservative budgeting practices in regards to bond premium". (Testimony of State Treasurer Nancy K. Kopp to Senate Budget and Taxation Committee, February 17, 2015)

I agree with Treasurer Kopp that the bond premium is a "volatile and difficult to predict revenue source" and that assuming future bond premium revenue is not a good financial management practice. Furthermore, the General Assembly's actions this year to use anticipated bond premiums to fund capital expenditures establishes a troubling precedent.

I urge the General Assembly to refrain from this practice in the future and to abide by Treasurer Kopp's admonition to adhere to "the State's conservative budgeting practices" that all premiums from the sale of State bonds be used exclusively to pay debt service on the State's general obligation bonds, pursuant to Section 8-132 of the State Finance and Procurement Article.

If the General Assembly had followed this time-honored practice, the bond premium revenue that we realize in Fiscal Year 2016 would be applied directly to reduce the Fiscal Year 2017 debt service shortfall currently estimated at $419 million (Appendix F-2, 2016 Budget Highlights).

Moreover, the Attorney General expressed a serious concern about the risks of violating federal law if the bond premiums as redirected by the General Assembly are not spent in a timely manner:

> "Section 15 of the bill provides that $48,393,337 in premiums from the sale of State bonds in fiscal years 2015 and 2016 shall remain in the State and Local Facilities Loan Fund or the Annuity Bond Fund and, with the approval of the Board of Public Works, may be expended for certain enumerated programs. In the recent past, pursuant to § 8-132 of the State Finance and Procurement

> Article, any premium from the sale of State bonds has been used exclusively to pay debt service on the State's general obligation bonds. By using bond premium for the payment of debt service, the State has been able to ensure that any bond premium is expended in sufficient time to meet certain tax–exempt bond requirements. We caution that the State could be required to rebate certain investment earnings to the Internal Revenue Service if the bond premium set–aside for the enumerated projects is not expended in time to meet the tax exempt bond requirements". (Letter to Governor Lawrence J. Hogan, Jr. on May 11, 2015)

In light of these warnings from the State Treasurer and the Attorney General, I urge the General Assembly to follow their advice and refrain from such risky practices in the future. Maryland taxpayers are best served by always following sound budget practices that protect the State's Triple–A bond rating.

Public School Construction Mandate

The Legislature added $20 million in Fiscal Year 2016 General Obligation bond funds for school construction in five jurisdictions with "Significant Enrollment Growth or Relocatable Classrooms": Anne Arundel, Baltimore, Howard, Montgomery and Prince George's counties. The funding is contingent on the enactment of Senate Bill 490. The bill purports to establish a $20 million mandate in the capital budget for the program in Fiscal Year 2016 and future years, to be "over and above" the appropriation for regular school construction.

This one item was a large part of the $50 million in general obligation bond authorizations added by the Legislature. I am quite concerned that the General Assembly is disregarding the extensive analysis and review process administered by the Interagency Committee on School Construction (IAC) to prioritize the funding of public school construction projects. If the existing process is inadequate, the General Assembly should engage the IAC to improve the program. We should not add to the capital budget to meet these needs in a piecemeal and undisciplined fashion, benefiting a few powerful jurisdictions. Despite these reservations, I signed the legislation because I recognize the need for additional school building projects in all regions of Maryland.

Future Budgets

In conclusion, as I have emphasized above, I am committed to getting Maryland on the path to structural balance and fiscal responsibility. By reducing the level of State borrowing, we will reduce future debt service requirements, and help resolve Maryland's ongoing structural deficit. Accordingly, please expect to see significantly smaller capital budgets and five–year Capital Improvement Programs in the future.

Sincerely,

Governor Lawrence J. Hogan, Jr.

cc: The Honorable Thomas V. Mike Miller, Jr.