HB 430

Department of Legislative Services

Maryland General Assembly
2017 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 430 (The Speaker)(By Request - Administration)
Appropriations

Fiscal Responsibility Act of 2017

This Administration bill establishes a nonwithholding revenue limit that applies to the State individual income tax. If the Revenue Stabilization Account (also known as the Rainy Day Fund) balance is below 10% of the estimated general fund revenues for the fiscal year and the nonwithholding revenue limit for that fiscal year is a positive number, the Comptroller must distribute to the account the lesser of (1) the product of the nonwithholding revenue limit and the total general fund balance or (2) whatever amount is needed for the account balance to equal 10% of the estimated general fund revenues for that fiscal year. In any fiscal year when the nonwithholding limit is a positive number and the product of the nonwithholding revenue limit and the total general fund revenue is greater than the amount necessary to increase the Rainy Day Fund balance to 10% of the estimated general fund revenues, the Comptroller must distribute the amount that exceeds the 10% threshold to the newly established Fiscal Responsibility Fund to be used for specified purposes, unless doing so would result in the general fund being out of balance.

The bill takes effect June 1, 2017.

Fiscal Summary

State Effect: No effect in FY 2017 or 2018. However, Revenue Stabilization Account revenues may increase significantly beginning in FY 2019, and revenues to the Fiscal Responsibility Fund may increase beginning in FY 2019, but due to the volatility of nonwithholding revenues, any such increases cannot be reliably estimated at this time. To the extent that less general fund revenues are available in the budget as a result of the nonwithholding limit, the bill may result in lower general fund spending beginning in FY 2019. The Comptroller's Office can implement the bill with existing resources.

Local Effect: None.

Small Business Effect: The Administration has determined that this bill has minimal or no impact on small business (attached). The Department of Legislative Services concurs with this assessment.

Analysis

Bill Summary: "Nonwithholding revenue" is all State individual income tax revenues that are not withheld by an employer from an employee's compensation. As shown in **Exhibit 1**, the "nonwithholding revenue limit" is the estimated annual nonwithholding revenue share for the fiscal year following the fiscal year in which the estimate is made minus the average of actual annual nonwithholding revenue shares for the 10 fiscal years immediately preceding the current fiscal year. The "actual annual nonwithholding revenue share" is the percentage in each fiscal year (rounded to the fourth decimal place) that is calculated by dividing the nonwithholding revenue for that fiscal year by the total general fund revenue for that fiscal year.

Exhibit 1
Nonwithholding Revenue Formulas under the Bill

$$\text{Actual Annual Nonwithholding Revenue Share} = \frac{\text{Nonwithholding Revenue for that Fiscal Year}}{\text{Total General Fund Revenue for that Fiscal Year}}$$

$$\text{Nonwithholding Revenue Limit} = \frac{\text{Estimated Nonwithholding Revenue for the Next Fiscal Year}}{\text{Estimated Total General Fund Revenue for the Next Fiscal Year}} - \text{The Average of Actual Annual Nonwithholding Revenue Shares for the 10 Fiscal Years Preceding the Current Fiscal Year}$$

Source: Department of Legislative Services

The report that the Bureau of Revenue Estimates must submit to the Board of Revenue Estimates after the end of each fiscal year must contain a list of the actual annual nonwithholding revenue share for each of the 10 fiscal years immediately preceding the fiscal year covered by the report, and it must include an average of the actual annual nonwithholding revenue shares for those 10 fiscal years. The bureau must also include a statement of the nonwithholding revenue limit in its December, March, and September reports to the board. The budget books for a fiscal year must state the nonwithholding revenue limit.

The Fiscal Responsibility Fund's purpose is to mitigate fiscal risks to the State associated with certain potential liabilities. The Comptroller must administer the fund, which is a special, nonlapsing fund, and account for the fund. The State Treasurer must hold the fund separately and invest the money in the same manner as other State money may be invested. Any interest earnings of the fund are credited to the general fund. The fund consists of money distributed to the fund in accordance with the bill, money appropriated in the State budget to the fund, and money received from any public or private source for the benefit of the fund. Expenditures from the Fiscal Responsibility Fund may be made by an appropriation in the annual State budget or by budget amendment and may only be used to help pay for the following types of potential State liabilities:

- pay-as-you-go (PAYGO) capital projects;
- the Postretirement Health Benefits Trust Fund;
- the accumulation funds (trust fund) of the State Retirement and Pension System (SRPS); or
- the Workers' Compensation Fund.

Current Law: The Revenue Stabilization Account was established in 1986 to retain State revenues to meet future needs and to reduce the need for future tax increases by moderating revenue growth. The account consists of direct appropriations in the budget bill and interest earned from all State Reserve Fund accounts.

If the account's balance is between 3.0% and 7.5% of projected general fund revenues, the Governor must include in the budget bill the lesser of $50.0 million or whatever amount is required for the account balance to exceed 7.5% of estimated general fund revenues for that year. If the account's balance is below 3.0% of the estimated general fund revenues for that fiscal year, the Governor must appropriate in the budget bill at least $100.0 million to the account.

If the account's balance exceeds 7.5% of projected general fund revenues, the Governor is not required to include additional funds for the account in the budget bill.

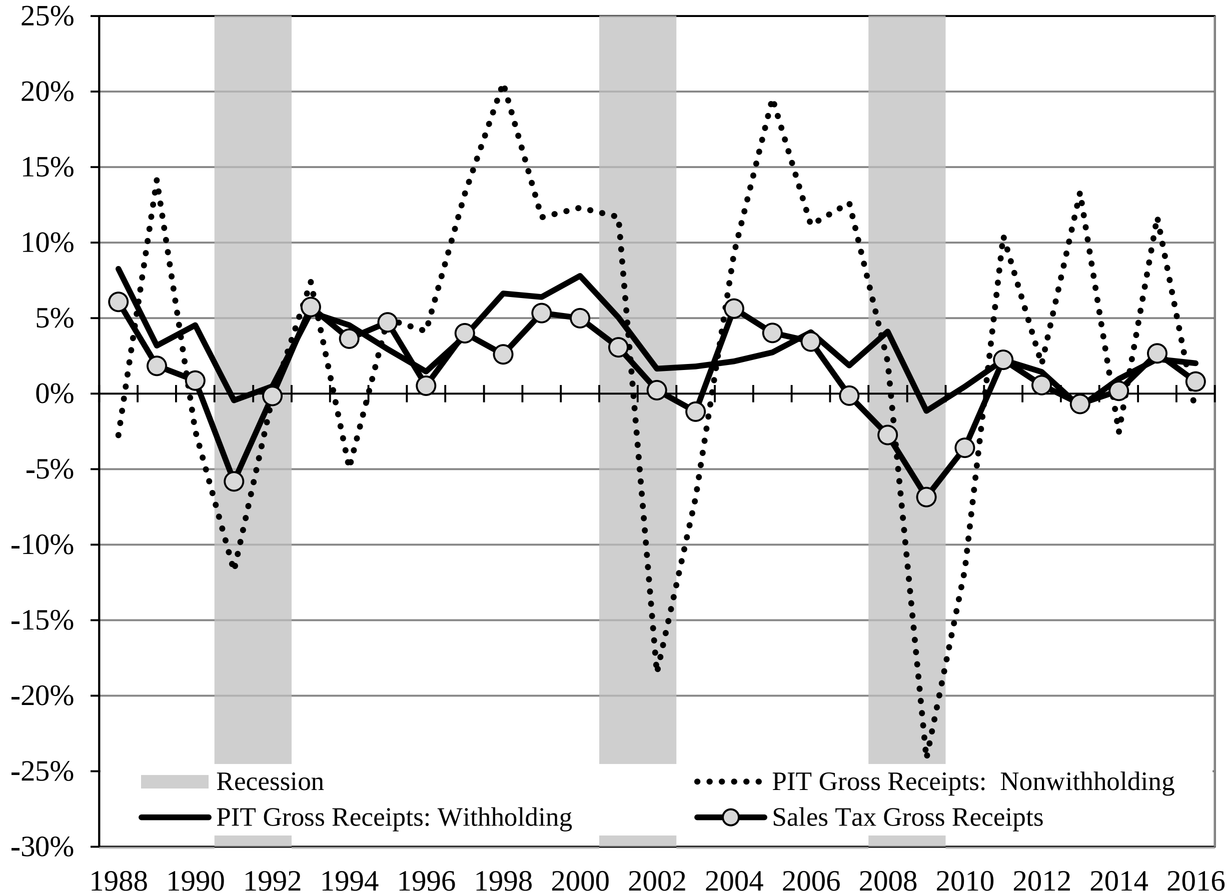
The Governor may transfer funds from the account to the general fund as necessary to support the operation of State government on a temporary basis, if the transfer (1) does not result in an account balance below 5.0% of the estimated general fund revenues for the fiscal year in which the transfer is made and (2) is authorized by either an Act of the General Assembly or the State budget bill as enacted. However, if the transfer would result in an account balance below 5.0% of the estimated general fund revenues for the fiscal year in which the transfer is made, the Governor may transfer funds only if the transfer is authorized by an Act of the General Assembly other than the State budget bill.

For fiscal 2017 through 2020, an amount equal to one-half of the unappropriated general fund surplus in excess of $10.0 million from the second prior fiscal year must be paid to the SRPS trust fund, up to a maximum of $50.0 million annually. Any unappropriated general fund balance in excess of $10.0 million that is not otherwise paid to the SRPS trust fund is paid to the account.

Background: The Department of Budget and Management, the Comptroller, and the Department of Legislative Services issued a report in November 2016 on the volatility of Maryland's revenues and recommended an approach to reducing volatility. They recommended that the State consider limiting estimated revenues from nonwithholding income tax revenues by placing a cap on the amount of nonwithholding revenues assumed during the budget process.

Due to the ups and downs of the business cycle, revenue volatility is unavoidable for state governments. The underlying variability in taxpayer incomes is what drives the volatility of the income tax. Nonwithholding payments are generally related to income other than wages, and this income is often quite volatile, especially capital gains. **Exhibit 2** shows the year-over-year percent change for three revenue sources: sales tax gross receipts, income tax gross receipts from withholding, and income tax gross receipts from nonwithholding. Nonwithholding consists of quarterly estimated payments and final payments with returns from both individuals and fiduciaries.

Exhibit 2
Inflation-adjusted Year-over-year Percent Change
Fiscal 1988-2016



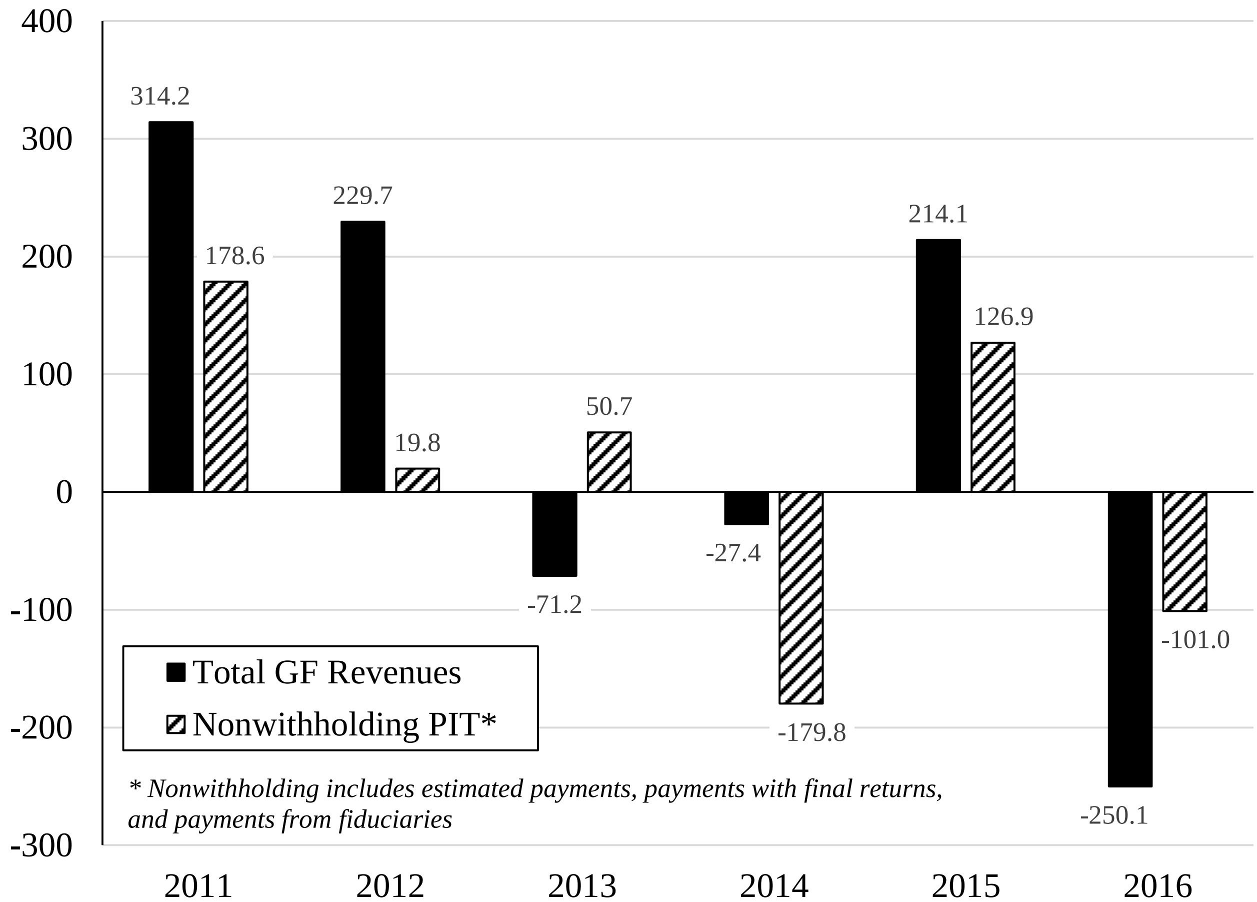
PIT = personal income tax

Note: Revenues have been adjusted for major law changes.

Source: Comptroller's Office

Exhibit 3 shows that nonwithholding revenues fell far short of their estimates in fiscal 2014 and 2016. As a result, general fund revenues were $27.4 million below the estimate in fiscal 2014 and $250.1 million below the estimate in fiscal 2016. Much of the shortfall can be attributed to nonwithholding revenues.

Exhibit 3
General Fund Close-out: Actual Revenues vs. Final Estimate
Fiscal 2011-2016
($ in Millions)



GF: general fund
PIT: personal income tax

Source: Comptroller's Office; Department of Legislative Services

States that rely heavily on highly volatile revenue sources like income tax revenues from capital gains to fund ongoing spending are especially vulnerable to the vagaries of the economy. In recent years, a number of states have adopted or considered changes to their revenue forecasting and budgetary practices to reduce their vulnerability to revenue volatility.

Many states, including Maryland, limit how much spending can grow, often tied to growth in population, inflation, personal income, or some combination of these. A few states, including Colorado, Florida, Michigan, and Missouri, apply a limit to revenue estimates. Recently, some states have focused specifically on the most volatile aspects of the personal income tax. While not altering the revenue forecast itself, California and Massachusetts have sweeper provisions tied to tax revenue from capital gains income. Meanwhile, Virginia puts a cap on nonwithholding income tax revenues, which involves limiting the estimated nonwithholding income tax revenue to a certain share of estimated total general fund revenues.

State Fiscal Effect: If the Rainy Day Fund balance is below 10% of the estimated general fund revenues for the fiscal year and the nonwithholding revenue limit for that fiscal year is a positive number, the Comptroller must distribute to the Rainy Day Fund the product of the nonwithholding revenue limit and the total general fund balance, up to the amount that is needed for the Rainy Day Fund balance to equal 10% of the estimated general fund revenues for that fiscal year.

The Rainy Day Fund balance is currently estimated to be $860.3 million, which is approximately 5% of estimated general fund revenues for fiscal 2018. Any funds in the Rainy Day Fund in excess of 5% of the State's estimated general fund revenues are available to be transferred to the general fund for budget relief; the State is projected to have a structural deficit of over $1.0 billion by fiscal 2022. Thus, assuming the general fund is not out of balance, the Department of Legislative Services assumes that any money from the nonwithholding revenue limit is distributed to the Rainy Day Fund, with the majority of revenues exceeding the 5% threshold being transferred to the general fund for budget relief.

Once the Rainy Day Fund balance reaches 10% of the estimated general fund revenues, any excess amount derived from the nonwithholding revenue limit must be distributed to the Fiscal Responsibility Fund, which is used for PAYGO capital projects, the Postretirement Health Benefits Trust Fund, the SRPS trust fund, or the Workers' Compensation Fund. Thus, to the extent that the nonwithholding revenue limit surpasses the 10% Rainy Day Fund balance threshold, revenues to the Fiscal Responsibility Fund may increase significantly. Funds within that account may only be used to pay for specific State liabilities, so PAYGO general fund expenditures and distributions to the Postretirement Health Benefits Trust Fund, SRPS trust fund, and Workers' Compensation Fund may increase significantly.

As shown in **Exhibit 4**, the State's share of nonwithholding revenue from individual income tax returns has varied over the years. Therefore, since nonwithholding revenue is difficult to estimate, any such increase cannot be reliably estimated at this time.

The Comptroller's Office advises that the fiscal impact of the bill depends on the methodology used for establishing nonwithholding limits. If the bill had applied to the fiscal 2018 revenue estimate, the nonwithholding revenue limit would have required $112.3 million to be set aside and distributed to the Rainy Day Fund in fiscal 2018.

Exhibit 4
State Share of Nonwithholding Individual Income Tax Revenues
($ in Millions)

Fiscal Year	Nonwithholding
2011	$1,639
2012	1,736
2013	2,104
2014	2,085
2015	2,345
2016	2,363
2017 (est.)	2,422
2018 (est.)	2,519

Source: Board of Revenue Estimates

To the extent that less general fund revenues are available to be budgeted as a result of the nonwithholding revenue limit, the bill may result in lower general fund spending beginning in fiscal 2019.

Additional Information

Prior Introductions: None.

Cross File: SB 306 (The President)(By Request - Administration) - Budget and Taxation.

Information Source(s): Comptroller's Office; Department of Budget and Management; State Retirement Agency; Department of Legislative Services

Fiscal Note History: First Reader - February 14, 2017
md/mcr

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ANALYSIS OF ECONOMIC IMPACT ON SMALL BUSINESSES

TITLE OF BILL: Fiscal Responsibility Act of 2017

BILL NUMBER: SB306/HB430

PREPARED BY: Governor's Legislative Office
(Dept./Agency/GLO)

PART A. ECONOMIC IMPACT RATING

This agency estimates that the proposed bill:

X WILL HAVE MINIMAL OR NO ECONOMIC IMPACT ON MARYLAND SMALL BUSINESSES

OR

_____ WILL HAVE MEANINGFUL ECONOMIC IMPACT ON MARYLAND SMALL BUSINESSES

PART B. ECONOMIC IMPACT ANALYSIS