Assessing Affordability II:
Analysis of Maryland's Spending Affordability Process in Response to *The Appearance of Fiscal Prudence*

by

Eileen Norcross and Benjamin J. VanMetre

Department of Legislative Services
Office of Policy Analysis
Annapolis, Maryland

July 2012

Executive Summary

The publication *The Appearance of Fiscal Prudence: Maryland's Spending Affordability Committee* from the George Mason University Mercatus Center claims that Maryland's spending affordability process was ineffective in limiting spending given the State's experience with structural deficits over the past decade. Authors Eileen Norcross and Benjamin J. VanMetre also believe that there are design flaws in the establishment of the annual spending base, that the basis for change should be tied to spending instead of revenues, and suggest that the Spending Affordability Committee (SAC) has never recommended a reduction in the base budget. They conclude by recommending that Maryland adopt a strict spending rule, similar to the state of Colorado, which limits growth to a formula based on population and inflation.

Norcross and VanMetre's work is fundamentally flawed:

- It reflects a lack of understanding of the spending affordability process, as several statements from prior SAC reports are taken out of context or misinterpreted.

- Despite publication in April 2012, they omit references to the 2010 and 2011 SAC reports which recommended actions to reduce the State's structural general fund deficit.

- The authors incorrectly infer that the adoption of tax and expenditure limits will obviate structural deficits. After the 2008 recession nearly all states reported budget gaps to the National Conference of State Legislatures. Nothing in the record of academic literature suggests a connection between tax and expenditure limitations and the avoidance of structural deficits. Shortfalls related to the last two recessions were a result of declines in revenue and an increase in entitlement caseloads.

- The tax and expenditure limit experience in Colorado, their "model" for adoption in Maryland, resulted in a loss of service quality, the rise of special taxing districts, changes in fiscal management, and the exclusion of fee-based enterprise activities (similar to special funded agencies in Maryland). Since adoption in 1992, voters have opted to mandate increased education spending and to adopt Referendum C to counteract the "ratchet down" effect of that limit. The Colorado Supreme Court also ruled in favor of the state to permit the repeal of sales tax exemptions, income tax credits, and income tax deductions without the need for voter approval.

- Efforts by the authors to portray strict spending rules based on population and inflation as a more effective limitation are not even supported by the working paper that they cite from fellow Mercatus Center research.

This analysis by the Department of Legislative Services demonstrates that after an initial decline State spending as a share of personal income (a metric used in the academic literature) has been remarkably consistent since the beginning of the SAC process. SAC has also evolved over time to address not only

spending limits but also other elements of State fiscal management. This has included, for example, recommendations pertaining to the size of the State workforce, the size and use of reserves, general obligation bond and consolidated transportation bond debt issuance levels, and actions to reduce the structural general fund deficit.

Assessing Affordability II: Analysis of Maryland's Spending Affordability Process in Response to *The Appearance of Fiscal Prudence* by Eileen Norcross and Benjamin J. VanMetre

Background

The Appearance of Fiscal Prudence

In April 2012, Eileen Norcross and Benjamin J. VanMetre of George Mason University's Mercatus Center published *The Appearance of Fiscal Prudence: Maryland's Spending Affordability Committee*. This work questioned the success of the Spending Affordability Committee (SAC), which was enacted in the early 1980s, at limiting growth in the State budget to affordable levels. The report includes specific claims pertaining to perceived flaws in the process and closes by recommending the adoption of a strict spending rule to limit annual growth to increases in population and inflation. The adoption of such spending rules would presumably have circumvented the structural general fund deficits experienced by the State during much of the last decade.

Specifically, the authors state the following with respect to the SAC process:

- design flaws exist including failure to apply the SAC limit to the entire State budget; subjective exclusions vary from year to year; and the process is subject to gaming to understate the base in order to recommend spending and revenue increases;

- SAC ties spending growth to revenue growth. The report suggests that limits tied to spending growth are more effective; and

- SAC functions as a spending target, ignoring guidelines to limit growth in personal income and misinterpreting economic data to justify spending levels. Recommendations are also thought to be inconsistent by recommending spending growth during periods of structural deficits. It is also claimed that the committee has never recommended reducing the size of the State budget.

History of Tax and Expenditure Limits

Tax and expenditure limits date to the nineteenth century, chiefly applied to the property tax, but rose to national prominence when Proposition 13 was adopted by voters in California in 1978. Twenty-three states adopted tax and expenditure limits soon after the passage of Proposition 13, and 43 states adopted a limit just on property taxes between 1978 and 1980.

In 2008, the National Conference of State Legislatures (NCSL) prepared an update indicating that 31 states had adopted tax and expenditure limits. This data is provided in **Appendix 1**. As seen, 10 states have adopted limits based on spending rules such as growth tied to increases in inflation and population. Another 17 states limit spending to varying measures of personal income, which serves as a proxy for economic activity. Finally, 4 states limit growth to some percentage of revenues (*e.g.*, spending cannot exceed 98% of revenue in 3 of those states).

Maryland's Spending Affordability Process

Following the adoption of Proposition 13 in California, Maryland was one of many states that considered legislation to impose automatic spending caps. At the 1979 session, 22 bills to limit spending were considered, including 16 proposed constitutional amendments. Instead, a Special Joint Committee on Tax and Spending Limitations was created to review the issue. A report was issued in 1979, and further debate of the issues occurred at the 1980 and 1981 sessions. Legislation creating SAC was enacted in 1982 and codified as Title 2, Subtitle 10 of the State Government Article. The statute sets a goal for the process to limit the rate of growth in State spending "so that the level of state spending is consistent with the economic growth of the state."

Sections 2-1001 through 2-1008 of the State Government Article outline the composition and duties of the joint committee. It must include an equal number of Senators and Delegates and may include public members. The committee meets annually in the fall, typically holding three public meetings to consider projections of revenues and expenditures. On or before December 1, the committee is charged with making recommendations to the Legislative Policy Committee (LPC) and the Governor regarding a nonbinding recommended level of operating budget growth, new debt authorization, State personnel, a recommended use of any anticipated surplus, and other appropriate findings and recommendations.

In formulating its recommendations, the committee is directed by statute to "consider economic indicators such as personal income, gross State product, or other data." In setting a limit on growth in State spending, the committee reviews total appropriations approved at the prior legislative session (including the most recently enacted budget and prior year deficiency appropriations) against projected appropriations for the upcoming budget year and deficiencies for the current fiscal year. In other words, total spending approved at each session regardless of the specific fiscal year is used as the basic unit of measurement.

Appropriations that are subject to the limit include all those of an ongoing nature funded from State-sourced revenues. This includes general funds, which are comprised of all tax and fee revenues that are not earmarked for specific purposes; special funds, which are those revenues dedicated by statute to specific purposes; and current unrestricted funds, which are higher education revenues from student tuition, fees, and other income. Excluded from the calculation are items which represent spending from non-State-sourced revenues; the pass-through of non-State-sourced backed appropriations to local governments or other entities;

spending for one-time purposes; technical double-counting of appropriations; self-supporting enterprise activities; transfers; and the incorporation of new revenues into the base.

- ***Non-State-sourced Revenues*** – Spending that is backed by federal funds and higher education current restricted funds (largely spending for contracts paid by federal and private sources) is excluded. These fund sources do not represent State-sourced revenues over which the State has control.

- ***Non-State-sourced Pass-through*** – Pass-through funding represents monies that are collected from local governments or the private sector, that are then appropriated through a State agency for distribution back to the local government level or other private entities. For example, the locally imposed 9-1-1 emergency number system fee is appropriated through the budget of the Maryland Department of Public Safety and Correctional Services. Other examples include hospital uncompensated care revenue, which flows through the Maryland Department of Health and Mental Hygiene and debt service for Certificates of Participation paid by non-State entities in the Maryland Department of Transportation.

- ***One-time Spending*** – Spending for one-time purposes is excluded since it does not contribute to the base budget nor require ongoing support. An example of large one-time spending was for appropriations made in the late 1990s to address the Year 2000 computer issue. Pay-as-you-go (PAYGO) capital is also excluded from the limit because it is for one-time purposes, there are large variations in annual project cash flow needs, and it is good policy to encourage use of cash for capital purposes in lieu of debt.

- ***Technical*** – Technical adjustments are made to ensure that State spending is not double counted in the affordability calculation. State support for higher education, for example, is budgeted both as general funds and within higher education institution budgets, as current unrestricted funds. The budget of the Maryland Correctional Enterprises is similarly excluded, since its goods and services are mostly purchased by State agencies.

- ***Enterprise Activities*** – Business-like entities such as the Maryland Port Administration and the Maryland Aviation Administration began to be excluded at the 2002 session, since their operations were funded by airlines and shipping lines, only up to the amount covered by revenue. Spending above revenues is not excluded from the SAC calculation. The justification for excluding enterprise activities is that if business activity falls, which would occur during a recession, spending is adjusted downward to reflect lower revenue. Similarly, the State Lottery Agency was also excluded, since its revenues from lottery sales support its operating expenses.

- ***Transfers*** – Appropriations that are credited to other accounts that may be spent later in the State budget or which are used to address long-term liabilities are also excluded because of their one-time nature and for policy considerations. Appropriations to the

Rainy Day Fund are not counted as State spending but are reflected as spending when withdrawn in support of operations. The State also has appropriated funds in the past toward long-term workers' compensation and retiree health care liabilities.

- ***New Revenue*** – One-time exclusions have also been made to incorporate large increases supported by new State-sourced revenues. This was the case at the 2000 session, when settlement revenues were received from the tobacco companies for the first time.

After the committee issues its recommendation in December, the Governor submits the proposed budget to the General Assembly on the third Wednesday of January. If the proposed budget exceeds the spending affordability recommendations, State law requires the Governor to include in supporting budget materials, the degree to which the proposed budget and recommendations differ and to set forth the reasons for exceeding the recommendations.

After completing action on the budget, each chamber passes its own version of the operating bill. When reporting to the floor of their respective chambers, the budget committees must report a budget that complies with the spending affordability recommendations, or if the amended budget exceeds the recommendations, they must explain the rationale for doing so. On or before June 1 of each year, the Department of Legislative Services must report to LPC on the extent to which final action on the State budget conformed with the spending affordability recommendations.

Issues

The work put forth by Norcross and VanMetre raises a number of issues, in part because many of the statements they draw from prior SAC reports are taken out of context, data reported for the entire State budget and SAC-eligible spending is incorrect in numerous instances, incorrect statements are made, and recommendations from the 2010 and 2011 SAC reports are omitted in order to allege that SAC has never recommended reducing base spending. **Appendix 2** provides a detailed listing of the errors and omissions found within their report. At the macro level, the authors fail to fully understand the SAC process, the relationship of the business cycle to structural deficits, and the deficiencies in the strict spending rules that they recommend.

This section includes responses to the allegations raised in the report and provides clarifications where necessary.

Design Flaws (Subjective Exclusions/Games the Process to Recommend Spending and Revenue Increases)

Amount of the Budget Subject to Limitation

A number of studies note that state level tax and expenditure limitations do not cover the entire budget, but instead exempt portions. For example, it is noted that several states exclude

certain categories of spending (*e.g.*, debt service); a number of others exclude certain classes of revenue such as federal sourced revenue, or conversely apply their limit only to state-sourced tax revenue (for example, Tennessee). Merriman cites New Jersey, which had a limitation in place from 1976 to 1983 that excluded portions of the budget related to pensions, as well as spending tied to revenue that came from fees or the sale of capital assets.[1] In 1989, Howard listed the percent of the budget that was exempt from tax and expenditure limitations in 19 states. As seen in **Exhibit 1**, this ranged from 22% exempt in Massachusetts to 71% exempt in Oregon.[2] **Maryland's SAC process exempted 30% of the budget in 1989, placing it among the top states in terms of the amount of the budget subject to limitation.**

Exhibit 1

Percent of Selected Budgets Exempt from Tax and Expenditure Limits[3]

Reported as of 1989

Massachusetts	22
Michigan	25
Arizona	25
Montana	29
Alaska	29
Maryland	**30**
Tennessee	40
Hawaii	43
South Carolina	44
Missouri	44
Texas	45
Washington	48
New Mexico	50
Louisiana	57
California	57
Idaho	60
Colorado	60
Oregon	71

Note: Maryland is added for comparative purposes and was not included in the original list of states in the 1989 Howard article.

[1] Merriman, David. 1986. The Distributional Effects of New Jersey's Tax and Expenditure Limitation. *Land Economics* 62, no. 4 (November): 353-361.

[2] Howard, Marcia. 1989. State Tax and Expenditure Limitations: There Is No Story. *Public Budgeting and Finance* 9, no. 2 (Summer): 83-90.

[3] Howard, Marcia. 1989. State Tax and Expenditure Limitations: There Is No Story. *Public Budgeting and Finance* 9, no. 2 (Summer): 83-90.

Subjective Exclusions

The report alleges that exclusions from SAC are determined subjectively and change from year to year. The categories of exclusions, including non-State revenues, pass-through spending, PAYGO capital expenses, enterprise agencies, transfers, and technical double counts remain the same each year. Since the budget changes over time, adjustments are made to accommodate specific items in the budget that should be excluded in order to arrive at a more precise estimate of ongoing spending.

SAC Recommendations Tied to Revenue Growth

While the committee considers projected revenues and economic activity, the SAC recommendation is developed using the prior session's total eligible spending as the base. The suggestion that SAC recommendations are tied to revenue growth is erroneous.

SAC Functions as a Spending Target and Includes Inconsistent Recommendations

Spending limits recommended by SAC are not targets. Legislators and citizen members weigh projected economic activity, revenues, and baseline spending needs when determining the maximum level at which spending should increase. The 1990 SAC report, for example, specifically noted that:

> "This [recommendation] shall be regarded as an upper limit in spending and not a spending target. The extent to which the limit exceeds estimates of revenues from current sources should not be construed as support for additional taxes…"

The authors also suggest that SAC has never recommended reductions in spending. They do this by omitting the 2010 and 2011 SAC reports from their data, where recommendations were made to reduce the general fund structural deficit by 33.33% (2010) and 50.0% (2011). Moreover, the 1990 SAC report also recommended that:

> "The structural imbalance which has developed between general fund spending and revenues should be addressed principally by reduced spending."

Replace SAC with a Spending Rule Tied to Inflation and Population Growth

Norcross and VanMetre suggest that the spending affordability process be replaced by a strict spending rule to limit annual growth to a formula tied to inflation and population growth, which they claim is more effective. This section looks at the academic literature on the effectiveness of tax and expenditure limits, identifies some of the problems associated with this

type of limit, and focuses on the experience in Colorado which Norcross suggested is a model which could work in Maryland.[4]

Do Tax and Expenditure Limits Work?

A number of academic studies have generally concluded that tax and expenditure limits have had limited success at limiting growth in spending.[5] Norcross and VanMetre make extensive reference to a working paper by Mercatus Center Research Fellow Matthew Mitchell, in support of their assertion that an inflation and population based spending rule is more effective. However, Mitchell's paper specifically notes that "Those TELS [tax and expenditure limitations] that restrict budget growth to inflation plus population growth seem not to have a statistically significant impact on state expenditures as a share of income."

The literature also notes other unintended consequences of strict spending limits. This includes:

- **Service Quality:** Documented effects on the quality of services in states with tax and expenditure limitations have included lower teacher quality, per pupil spending, higher class sizes, and lower teacher salaries.[6]

---

[4] See http://www.wbaltv.com/news/politics/Maryland-s-budget-process-is-flawed-economist-says/-/9379266/12553380/-/1kp0th/-/index.html.

[5] See Kenyon, Daphne A., and Karen M. Benker. 1984. Fiscal Discipline: Lessons from the State Experience. *National Tax Journal* 37, no. 3 (September): 433-446; Howard, Marcia. 1989. State Tax and Expenditure Limitations: There Is No Story. *Public Budgeting and Finance* 9, no. 2 (Summer): 83-90; Cox, James, and David Lowery. 1990. The Impact of the Tax Revolt Era State Fiscal Caps. *Social Science Quarterly* 71, no. 3 (January/February): 492-509; King-Meadows, Tyson, and David Lowery. 1996. The Impact of Tax Revolt Era State Fiscal Caps: A Research Update. *Public Budgeting and Finance* 16, no. 1 (Spring): 102-112; Mullins, Daniel R., and Philip G. Joyce. 1996. Tax and Expenditure Limitations and State and Local Fiscal Structure: An Empirical Assessment. *Public Budgeting and Finance* 16, no. 1 (Spring): 75-101; and Shadbegian, Ronald J. 1996. Do Tax and Expenditure Limitations Affect the Size and Growth of State Government? *Contemporary Economic Policy* 14, no. 1: 22-35.

[6] See Rueben, Kim S. 1997. The Effect of Tax and Expenditure Limits on State and Local Governments. PhD diss., Massachusetts Institute of Technology; Martell, Christine R. 2007. Debt Burdens of Overlapping Jurisdictions. *Municipal Finance Journal* 28, no. 2 (Summer): 1-23; and Thompson, Fred, and Mark T. Green. 2004. Vox Populi? Oregon Tax and Expenditure Limitation Initiatives. *Public Budgeting and Finance* 24, no. 4 (Winter): 73-87.

- **Changes in Intergovernmental Relationships:** Horizontal shifts in responsibility occur, for example, by the creation of additional service-providing governmental entities. States with tax and expenditure limits have created additional special taxing districts as a means of circumventing State level limits.[7]

- **Distributional Impacts Found in the Shift from Broad-based Taxes to User Charges and Fees:**[8] The disadvantaged populations who are the main recipients of public sector services may be disproportionately affected as they must pay taxes and additionally pay more regressive fees. This saps a larger share of their net income.

Other Issues Related to Strict Spending Rules

Strict spending rules also can create other problems with implementation. Some examples include:

- **Loss of Flexibility for Elected Officials to Weigh Growth in the Budget to Address Spending Needs Against Revenues:** In considering such measures in Maryland at the 1980 session, Governor Harry R. Hughes noted that "Such an arbitrary limit would have undoubtedly limited the state's ability to respond to crises, changing times and the inevitable fluctuations of the state and national economy."[9]

---

[7] See Mullins, Daniel R. 2004. Tax and Expenditure Limitations and the Fiscal Response of Local Government: Asymmetric Intra-Local Fiscal Effects. *Public Budgeting and Finance* 24, no. 4 (Winter): 111-147; Martell, Christine R. 2004. Special Districts and the Public Purse. Paper presented at the annual meeting of the Western Social Science Association, Salt Lake City, UT; and Advisory Commission on Intergovernmental Relations. 1977. *State Limitations on Local Taxes and Expenditures.* Report A-64. Washington, DC: U.S. Government Printing Office.

[8] See Mullins, Daniel R., and Philip G. Joyce. 1996. Tax and Expenditure Limitations and State and Local Fiscal Structure: An Empirical Assessment. *Public Budgeting and Finance* 16, no. 1 (Spring): 75-101; Advisory Commission on Intergovernmental Relations. 1995. *Tax and Expenditure Limits on Local Governments*. Report M-194. Washington, DC: U.S. Government Printing Office; Danziger, James N. 1980. California's Proposition 13 and the Fiscal Limitations Movement in the United States. *Political Studies* 28, no. 4 (December): 997-612; Sherwood-Call, Carolyn. 1987. Tax Revolt or Tax Reform? The effects of local government limitation measures in California. *Economic Review-Federal Reserve Bank of San Francisco* 2 (Spring): 57-67; Hoene, Christopher. 2004. Fiscal Structure and the Post-Proposition 13 Fiscal Regime in California's Cities. *Public Budgeting and Finance* 24, no. 4 (Winter): 51-72; Reid, Gary J. 1988. How Cities in California have Responded to Fiscal Pressures Since Proposition 13. *Public Budgeting and Finance* 8, no. 1 (Spring): 20-37; Thompson, Fred, and Mark T. Green. 2004. Vox Populi? Oregon Tax and Expenditure Limitation Initiatives. *Public Budgeting and Finance* 24, no. 4 (Winter): 73-87; and Mullins, Daniel R., and Philip G. Joyce. 1991. The Changing Fiscal Structure of the State and Local Public Sector: The Impact of Tax and Expenditure Limitation. *Public Administration Review* 51, no. 3 (May/June): 240-253.

[9] Hughes, Governor Harry Roe, with John W. Frece. 2006. *My Unexpected Journey: The Autobiography of Governor Harry Roe Hughes*. 1st ed. Charleston, SC. The History Press.

- **Assumptions That the Base Budget Is Funded Properly:** If areas of the budget are underfunded when a limit is adopted, it becomes more difficult to fund those areas adequately after a limit is adopted. Examples include unfunded liabilities, education adequacy, etc..

- **Inability to Address Areas That Grow Faster Than Inflation and Population:** Items that grow faster than inflation can include entitlement caseloads (*e.g.*, Medicaid or Temporary Cash Assistance (TCA) which grow faster during times of economic distress), unexpected crises (*e.g.*, natural disasters), and personnel compensation (*e.g.*, health insurance inflation or the need to maintain competitive salaries for the workforce such as information technology professionals).

The Colorado Experience with the Taxpayer Bill of Rights

The Colorado Experience with the Taxpayer Bill of Rights (TABOR) passed in 1992 to limit revenues to the amount attained in the prior year plus growth for population and inflation. It also requires surplus revenues to be returned to taxpayers and stipulates that tax increases require voter approval. A unique feature of this limit became known as the "ratchet-down" effect. If revenue fell below the spending limit, the following year's limit was reduced to the level of reduced revenue plus inflation and population growth. This had occurred in the 2001-2003 period during the economic recession. It is useful to evaluate the effects of this limit, as well as the changes made to modify it, since Norcross and VanMetre hold this up as a model for replacing Maryland's SAC process.

Effects of the TABOR

Erosion of Voter Support: In 2000, approximately 30% of voters surveyed said that they would vote to repeal the TABOR. However, by 2003, support for the measure had decreased to 50%, and about 67% thought that the TABOR should be modified to allow government services to return to levels prior to the 2001 recession.[10]

Creation of Special Taxing Districts: The literature indicates that there has been a proliferation of special districts with the capability of issuing debt, as an apparent circumvention of limits imposed by the TABOR.[11]

---

[10] See James, Franklin J., and Allan Wallis. 2004. Tax and Spending Limits in Colorado. *Public Budgeting and Finance* 24, no. 4 (Winter): 16-33.

[11] See Martell, Christine R. 2007. Debt Burdens of Overlapping Jurisdictions. *Municipal Finance Journal* 28, no. 2 (Summer): 1-23; Martell, Christine R. 2004. Special Districts and the Public Purse. Paper presented at the annual meeting of the Western Social Science Association, Salt Lake City, Utah; and Martell, Christine R., and Paul Teske. 2007. Fiscal Management Implications of the TABOR Bind. *Public Administration Review* 67, no. 4 (July/August): 673-687.

Changes in Fiscal Management: This has included increased earmarking of new revenues for specific purposes, mandatory spending, and accounting gimmicks (*e.g.*, involving Medicaid accruals, sweeping balances into the general fund, and changing the date of employee pay to get a one-time savings).[12]

Shifts to Enterprise Activities: Enterprises that receive less than 10% of their revenue from government sources are not counted in the TABOR limit. Currently, this includes higher education auxiliary facilities, the State Lottery, College Assist and CollegeInvest, correctional industries, the State nursing home system, the Unemployment Insurance Program, the State Fair Authority, the Student Obligation Bond Authority, the Division of Wildlife, and the Colorado Tolling Enterprise. Many of these entities are similar to special fund agencies in Maryland. Although Norcross and VanMetre raise the issue that not all of Maryland's budget is covered by SAC, fee-supported agencies in Colorado are similarly exempt from the TABOR limit.

Erosion of Service Quality: In Colorado, child immunization, pre-natal services, state support for higher education, and transportation highway maintenance had all fallen to the bottom in U.S. rankings. As a percent of the general fund budget, higher education spending decreased from 19 to 10%. There were also reductions in capital maintenance, and the number of children without health insurance nearly doubled. Inflation-adjusted spending for primary and secondary education fell to fortieth in the United States, from a ranking of twenty-fifth.[13]

Changes to the TABOR

Several changes have been made in the TABOR since its adoption including a recent court case that resulted in a revised interpretation relating to tax changes.

- Amendment 23 was passed in 2000 to require that schools get funding equal to 1% over inflation for a 10-year period. The latter initiative was put into place to address the fact that education spending had fallen to nearly the bottom of the rankings in the United States.

- Referendum C, passed in 2005, was a voter-approved revenue change that allowed the state to retain and spend all excess TABOR revenues for a 5-year period from fiscal 2006 through 2010. After 2010, Colorado is able to retain a portion of excess revenues up to a cap.

---

[12] Martell, Christine R., and Paul Teske. 2007. Fiscal Management Implications of the TABOR Bind. *Public Administration Review* 67, no. 4 (July/August): 673-687.

[13] See Martell, Christine R., and Paul Teske. 2007. Fiscal Management Implications of the TABOR Bind. *Public Administration Review* 67, no. 4 (July/August): 673-687.

- In 2009, the Colorado Supreme Court ruled in favor of the state in the case of *Mesa County Commissioners vs. the State of Colorado*. As a result, a series of bills were passed to permanently or temporarily repeal sales and use tax exemptions, income tax credits, and income tax deductions. Prior to this decision any tax law changes were interpreted to be unconstitutional without a vote by the people.

Spending Rules Do Not Prevent Structural Deficits

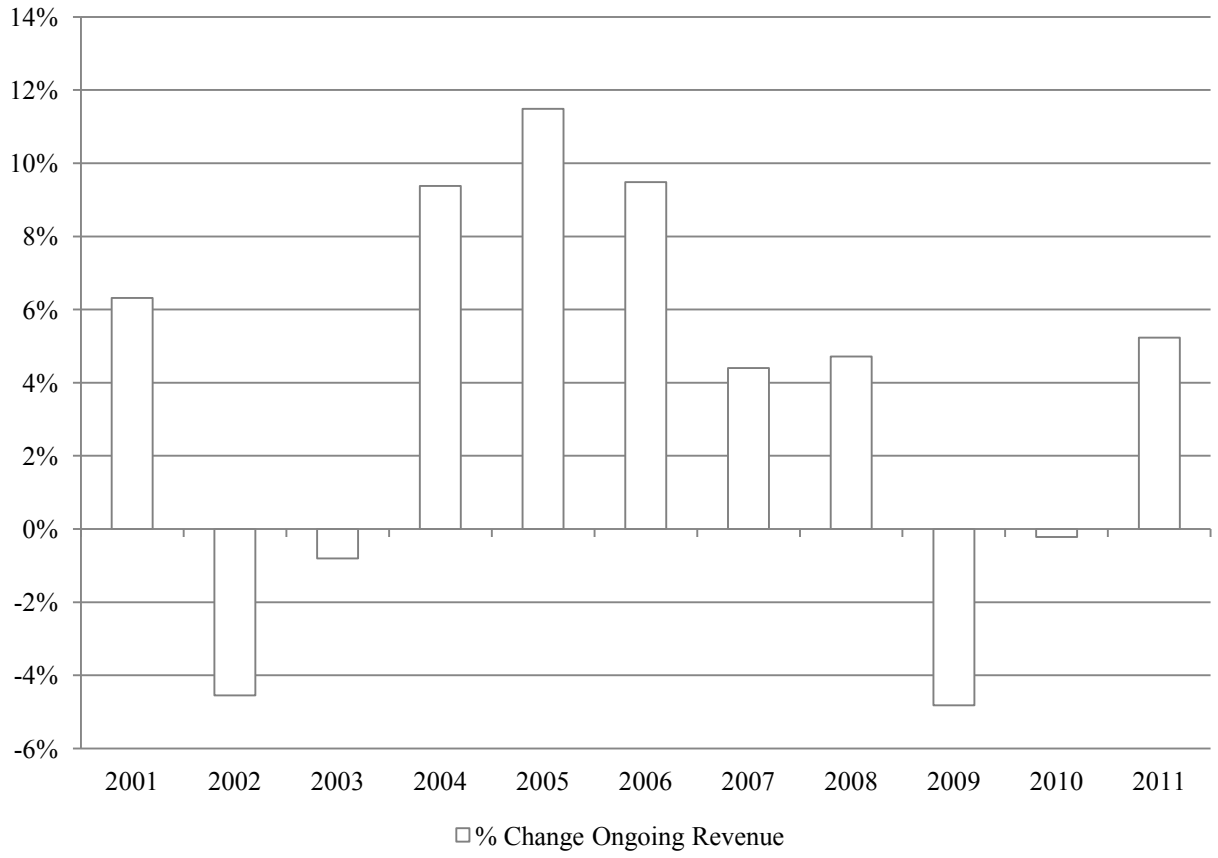
One of the criticisms in the report by Norcross and VanMetre is that the design and implementation of SAC has had the reverse effect of building in unsupportable levels of spending. They note that the State has seen nearly 10 years of structural deficits. There are two major deficiencies in this line of thinking:

- There is no connection between tax and expenditure limits and structural deficits. Nothing in the academic literature suggests a connection between spending limits and avoiding the effects of downturns in the business cycle on State revenues.

- Limits tied to population and inflation are subject to the same budgetary dynamics caused by the business cycle. Typically, strict mathematical spending limits are accompanied by other measures designed to reduce tax revenue or to further scale back spending. Examples include requirements to rebate surplus revenue to taxpayers, the original feature of the TABOR that ratcheted down spending to the lower of prior year spending or revenues, and voter approval of revenue increases. In their report, the authors model annual spending growth under a scenario where increases are limited to population and inflation. In every year of their model, there is a spending increase. However, as outlined below, the effects of business cycles render this proposed limit unworkable.

Periodic business cycles impact the State budget in two ways. Revenues decrease and spending demands grow as more citizens become eligible for entitlement programs such as Medicaid, Food Stamps, and TCA. **Exhibit 2** illustrates how Maryland's general fund revenues fell after the recessions of 2001 and 2008. In both cases, revenues fell about 5% in the first year and declined slightly more in the subsequent year.

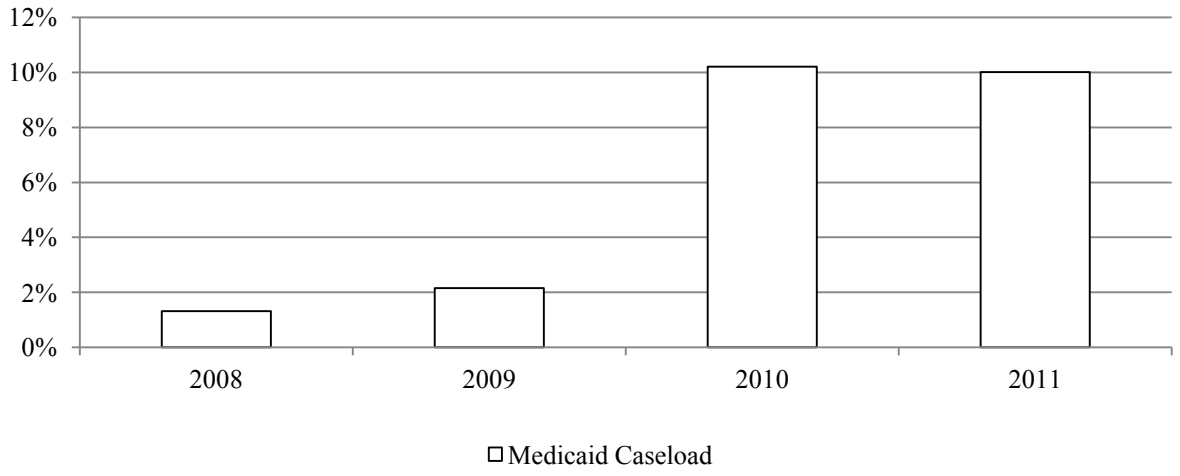
Exhibit 2
Annual Percent Change in Ongoing General Fund Revenues in Maryland
Fiscal 2001-2011
($ in Millions)



Source: Department of Legislative Services

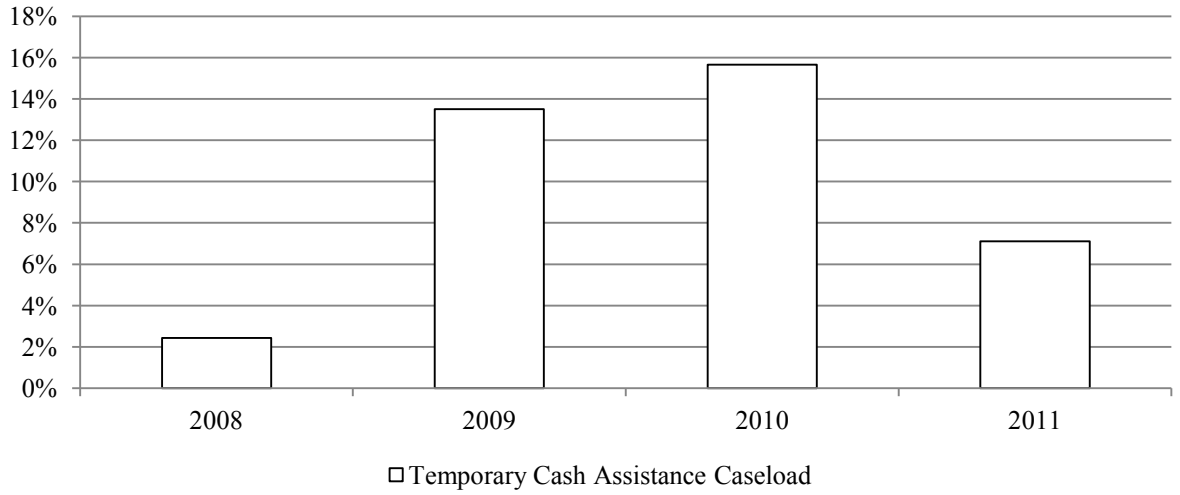
Exhibits 3 and **4** illustrate the large increases in Medicaid and TCA programs following both recessions (Food Stamp caseloads are not shown since they are 100% federally funded).

Exhibit 3
Annual Percent Change in Maryland's Medicaid Caseload
Fiscal 2008-2011



Source: Department of Health and Mental Hygiene

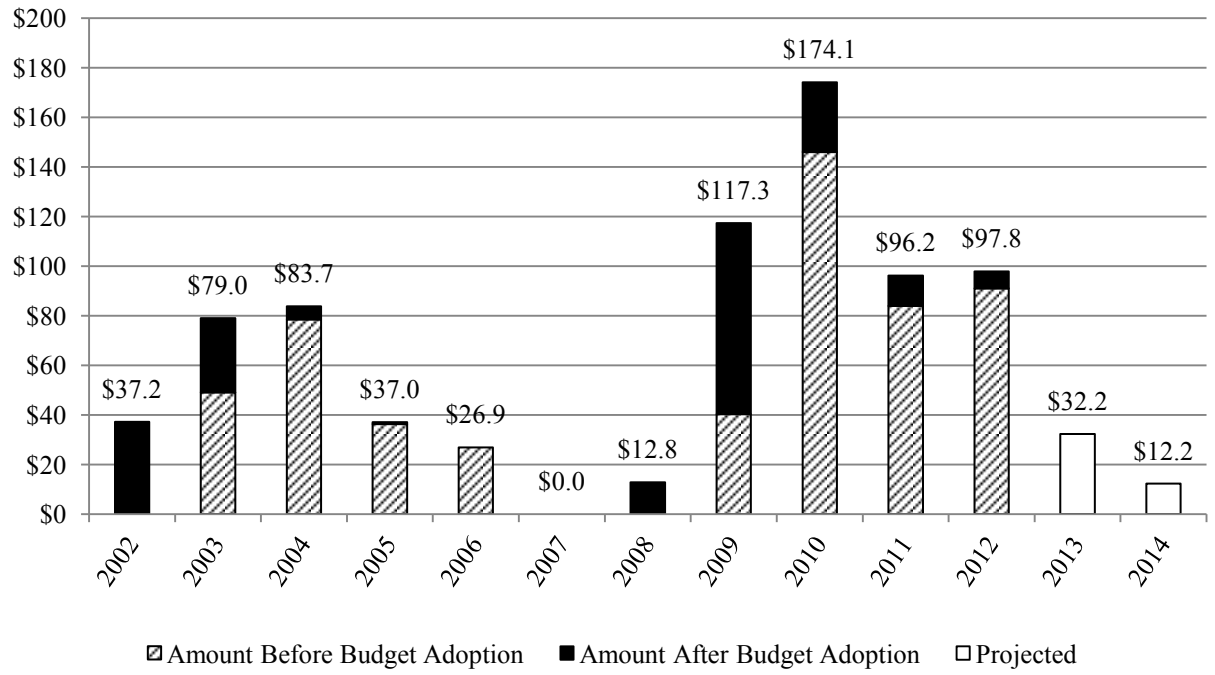
Exhibit 4
Annual Percent Change in Maryland's Temporary Cash Assistance Caseload
Fiscal 2008-2011



Source: Department of Human Resources

Nationally, budget gaps following the 2001 recession were about $84 billion and reached $174 billion after the 2008 recession. This resulted in budget gaps that needed to be addressed through some combination of spending cuts, new taxes or fees, and use of one-time actions such as fund balance, reserves, and transfers from dedicated fund balances. This phenomenon is not unique to Maryland. **Exhibit 5** compiled by NCSL aggregates budget gaps reported by the states following both of the last two recessions.

Exhibit 5
Cumulative State Budget Gaps
Fiscal 2002-2014
($ in Billions)



Source: National Conference of State Legislatures

Looking at the peak year of fiscal 2010, NCSL collected the size of budget gaps reported by individual state. About two-thirds of the states with tax and expenditure limits listed in Appendix 1 reported budget gaps. The budget gaps reported by Maryland as a percent of total general fund spending compared to the model state of Colorado is shown in **Exhibit 6**. Colorado reported a budget gap that was about 3 percentage points higher than the gap reported in Maryland. **The data demonstrates that a strict spending limit bears no relationship to structural deficits induced by revenue decreases brought on by business cycles.**

Exhibit 6
Reported General Fund Budget Gaps in Fiscal 2010

State	Fiscal 2010 Gap as a Percent of Budget
Colorado	8.0%
Maryland	5.1%

Source: National Conference of State Legislatures, *State Budget Update: November 2009*

Evaluating Maryland's Spending Affordability Process

Most state tax and expenditure limits are designed to constrain growth relative to personal income; a proxy for government spending as a share of the economy. Thus it is appropriate to examine state government spending trends as a share of personal income. Howard notes that:

> "…the TELS [Tax and Expenditure Limitations] movement is perhaps best viewed as a movement to prevent state government from increasing its share of state personal income….If the proportion of personal income dedicated to state government remains constant from the date of TELS enactment forward, the limitation is judged to have provided a true constraint to the growth of government. If the proportion increases, the TEL is ineffective because it had failed to constrain the growth of government." (Howard 1989, 85)

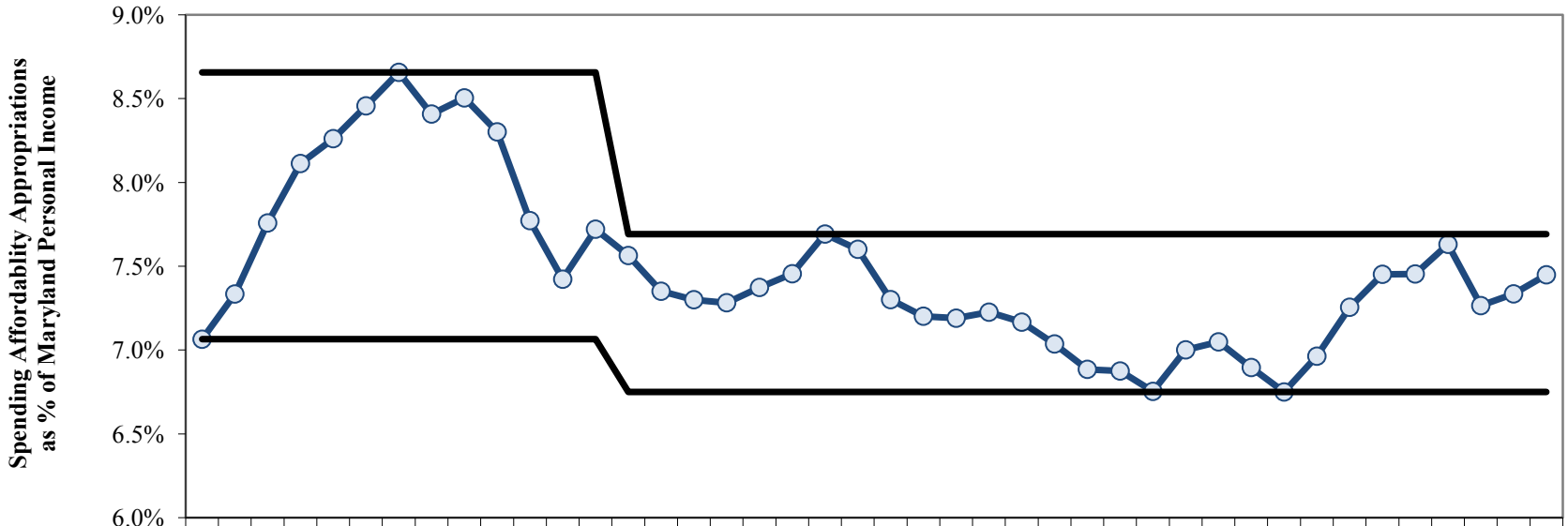
Osborne and Hutchinson suggest that there is a zone of fiscal tolerance as a share of personal income. They suggest that this range is between 35.0 cents and 37.0 cents of each dollar of personal income for all levels of governments; 20.0 cents to 22.0 cents on the dollar at the federal level; ***7.3 cents to 8.3 cents at the state level***; [emphasis added] and 6.0 cents to 6.6 cents at the local level (Osborne and Hutchinson 2004, 44).

Exhibit 7 illustrates spending in Maryland as defined under the spending affordability concept since fiscal 1971. As shown, State government spending grew rapidly in the 1970s. Prior to the implementation of the spending affordability process, Maryland budgets ranged from a low of 7.1% of personal income to a high of 8.7% in fiscal 1977. This high is above the level of taxpayer tolerance suggested by Osborne and Hutchinson. Following adoption of spending affordability, the share of State spending relative to personal income has fallen within a range of 6.7 to 7.7% of personal income. Spikes in spending are clustered around downturns in the economy, attributable to decreases in personal income. **Maryland's spending affordability process has successfully worked to decrease government spending as a share of the economy and maintained that lower share over a nearly 30-year period.**

Exhibit 7

Ongoing Spending in Relation to Personal Income under the Spending Affordability Concept

Fiscal 1971-2012



	71	72	73	74	75	76	77	78	79	80	81	82	83	84	85	86	87	88	89	90	91	92	93	94	95	96	97	98	99	00	01	02	03	04	05	06	07	08	09	10	11	12
SA as % of PI	7.1	7.3	7.8	8.1	8.3	8.5	8.7	8.4	8.5	8.3	7.8	7.4	7.7	7.6	7.4	7.3	7.3	7.4	7.5	7.7	7.6	7.3	7.2	7.2	7.2	7.2	7.0	6.9	6.9	6.8	7.0	7.0	6.9	6.7	7.0	7.3	7.5	7.5	7.6	7.3	7.3	7.4
28-year high	8.7	8.7	8.7	8.7	8.7	8.7	8.7	8.7	8.7	8.7	8.7	8.7	8.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7	7.7
28-year low	7.1	7.1	7.1	7.1	7.1	7.1	7.1	7.1	7.1	7.1	7.1	7.1	7.1	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7

PI: personal income
SA: spending affordability

Source: Department of Legislative Services

SAC's Evolution and Refinement of Fiscal Management

The spending affordability process in Maryland goes beyond simply setting an annual advisory growth limit to the Governor. The process includes a number of macro level elements that aid the legislature in setting statewide fiscal policy. Some of these elements include:

- an advisory growth limit on ongoing operating spending;
- the level of regular positions to be maintained by the State;
- general obligation bond issuance limits;
- Consolidated Transportation Bond debt issuance levels;
- recommendations in response to federal budget/policy changes;
- the level and use of State reserves; and
- policy recommendations to address specific issues, such as structural deficits, expansion of the Earned Income Tax Credit, limits on budget amendments and the creation of separate programs for PAYGO to better reflect base spending, etc.

SAC evolved as budgetary conditions changed. This has included the addition of recommendations on debt policy, the incorporation of new revenues into the base, and the reflection of federal American Recovery and Reinvestment Act of 2009 revenues that supplanted general funds into the base.

Conclusion and Recommendations

Norcross and VanMetre's assessment of Maryland's spending affordability process is fundamentally flawed. A combination of incorrect data, statements taken out of context from prior reports by SAC, and the omission of recommendations to address the structural deficit made since 2009 render their analysis moot. The experience of tax and expenditure limits in Colorado suggests that it is not a model of implementation for Maryland or any other state.

As seen in this analysis, Maryland's spending affordability process has been effective in initially reducing and then maintaining spending as a share of personal income for almost 30 years. SAC has also evolved during its 30-year existence to address fiscal management more globally and to react to changing budgetary conditions. The SAC process has been a component of Maryland's fiscal management which has been recognized by the bond rating agencies when assigning Maryland a triple A bond rating. Perhaps the authors' real concerns are that

Maryland's policymakers have chosen to close structural deficits resulting from economic downturns through a combination of spending cuts and additional revenues. The SAC process can help guide that policy choice but ultimately the policymakers, and not the process, should be held accountable.

Appendix 1
State-by-state Tax and Expenditure Limits as of 2008

State	Year Adopted	Constitution or Statute	Type of Limit	Main Feature
Alaska	1982	Constitution	Spending	A cap on appropriations grows yearly by the increase in population and inflation.
Arizona	1978	Constitution	Spending	Appropriations cannot be more than 7.41% of total state personal income.
California	1979	Constitution	Spending	Annual appropriations growth linked to population growth and per capita personal income growth.
Colorado	1991	Statute	Spending	General fund appropriations limited to the lesser of (a) 5.0% of total state personal income or (b) 6.0% over the previous year's appropriation.
	1992	Constitution	Revenue and Spending	Most revenues limited to population growth plus inflation. Changes to spending limits or tax increases must receive voter approval.
	2005	Referendum	Revenue and Spending	Revenue limit suspended by voters until 2011, when the new base will be established.
Connecticut	1991	Statute	Spending	Spending limited to average of growth in personal income for previous 5 years or previous year's increase in inflation, whichever is greater.
	1992	Constitution	Spending	Voters approved a limit similar to the statutory one in 1992, but it has not received the three-fifths vote in the legislature needed to take full effect.
Delaware	1978	Constitution	Appropriations to Revenue Estimate	Appropriations limited to 98.0% of revenue estimate.
Florida	1994	Constitution	Revenue	Revenue limited to the average growth rate in state personal income for the previous 5 years.

State	Year Adopted	Constitution or Statute	Type of Limit	Main Feature
Hawaii	1978	Constitution	Spending	General fund spending must be less than the average growth in personal income in the previous 3 years.
Idaho	1980	Statute	Spending	General fund appropriations cannot exceed 5.33% of total state personal income, as estimated by the state Tax Commission. One-time expenditures are exempt.
Indiana	2002	Statute	Spending	State spending cap per fiscal year with growth set according to the formula for each biennial period.
Iowa	1992	Statute	Appropriations	Appropriations limited to 99.0% of the adjusted revenue estimate.
Louisiana	1993	Constitution	Spending	Expenditures limited to 1992 appropriations plus annual growth in state per capita personal income.
Maine	2005	Statute	Spending	Expenditure growth limited to a 10-year average of personal income growth, or maximum of 2.75%. Formulas are based on the state's tax burden ranking.
Massachusetts	1986	Statute	Revenue	Revenue cannot exceed the 3-year average growth in state wages and salaries. The limit was amended in 2002 adding definitions for a limit that would be tied to inflation in government purchasing plus 2.0%.
Michigan	1978	Constitution	Revenue	Revenue limited to 1.0% over 9.49% of the previous year's state personal income.
Mississippi	1982	Statute	Appropriations	Appropriations limited to 98.0% of projected revenue. The statutory limit can be amended by majority vote of the legislature.
Missouri	1980	Constitution	Revenue	Revenue limited to 5.64% of previous year's total state personal income.

State	Year Adopted	Constitution or Statute	Type of Limit	Main Feature
	1996	Constitution	Revenue	Voter approval required for tax hikes over approximately $77 million or 1.0% of state revenues, whichever is less.
Montana	1981	Statute	Spending	Spending is limited to a growth index based on state personal income. In 2005, the Attorney General invalidated the statute, and it is not in force at this time.
Nevada	1979	Statute	Spending	Proposed expenditures are limited to the biennial percentage growth in state population and inflation.
New Jersey	1990	Statute	Spending	Expenditures are limited to the growth in state personal income.
North Carolina	1991	Statute	Spending	Spending is limited to 7.0% or less of total state personal income.
Ohio	2006	Statute	Spending	Appropriations are limited to the greater of either 3.5% or population plus inflation growth. To override, two-thirds supermajority is needed, or a gubernatorial emergency declaration.
Oklahoma	1985	Constitution	Spending	Expenditures are limited to 12.0% annual growth adjusted for inflation.
	1985	Constitution	Appropriations	Appropriations are limited to 95.0% of certified revenue.
Oregon	2000	Constitution	Revenue	Any general fund revenue in excess of 2.0% of the revenue estimate must be refunded to taxpayers.
	2001	Statute	Spending	Appropriations growth is limited to 8.0% of projected personal income for biennium.
Rhode Island	1992	Constitution	Appropriations	Appropriations are limited to 98.0% of projected revenue (becomes 97.0% July 1, 2012).

State	Year Adopted	Constitution or Statute	Type of Limit	Main Feature
South Carolina	1980 1984	Constitution	Spending	Spending growth is limited by either the average growth in personal income or 9.5% of total state personal income for the previous year, whichever is greater. The number of state employees is limited to a ratio of the state population.
Tennessee	1978	Constitution	Spending	Appropriations are limited to the growth in state personal income.
Texas	1978	Constitution	Spending	Biennial appropriations are limited to the growth in state personal income.
Utah	1989	Statute	Spending	Spending growth is limited by formula that includes growth in population and inflation.
Washington	1993	Statute	Spending	Spending limited to average of inflation for previous 3 years plus population growth.
Wisconsin	2001	Statute	Spending	Spending limit on qualified appropriations (some exclusions) is limited to personal income growth rate.

Note: The National Conference of State Legislatures does not classify Maryland as a state with a tax and expenditure limitation, due to the nonbinding design which does not feature a statutory or constitutional formula.

Source: Waisanen, Bert. 2008. State Tax and Expenditure Limits – 2008. National Conference of State Legislatures: Denver, Colorado

Appendix 2
Errors, Statements Taken Out of Context and Misinterpretations Found in *The Appearance of Fiscal Prudence*

Report's Claim	Response
Page 7: The report suggests the Spending Affordability Committee (SAC) questioned its 30-year record on limiting State spending. "*Recent years have sorely tested the budgetary concepts customarily employed to account for spending for spending affordability purposes. The combination of huge mid-year spending reductions, massive federal assistance and extensive reliance on one-time supports makes it impossible to clearly establish a basis for calculating a limit without arbitrary judgments about what should be in or out.*"	Taken from the 2010 report, this statement pertains to calculation of the base for the 2011 session only and does not imply a judgment about the 30-year record of spending affordability to constrain growth in State spending. The traditional methodology compared all session spending each year, but in 2010, this was complicated by mid-year spending cuts lowering the base as well as federal aid which supplanted general fund spending.
Page 8: The report alleges that the design and implementation of SAC has failed in limiting growth to supportable levels, resulting in "close to a decade of structural deficits."	SAC reduced spending as a share of personal income. No academic literature suggests a link between tax and expenditure limits and the avoidance of structural deficits caused by revenue losses related to business cycles.
Page 8: The report alleges that "recommendations are formulated subjectively and recommended spending levels are justified according to a shifting set of economic, fiscal, and policy criteria."	The SAC methodology has been consistently applied over the past 30 years. Adjustments have been made as fiscal and budgetary conditions have evolved. The committee has consistently examined personal income, unemployment, and general fund spending and revenue trends. Limits are set based on judgments about spending needs and the direction of the economy.
Page 9: The report suggests that one design flaw in SAC pertains to the exclusion of federal funds and capital projects.	The SAC methodology includes State-sourced spending supported by general, special, and current unrestricted funds. Federal revenues and current restricted funds (largely federal higher education grants and contracts) are outside of the State's control. Pay-as-you-go (PAYGO) capital spending is excluded so that limits are applied to ongoing spending only and are not skewed by the peaks and valleys of capital project cash flows. Moreover, SAC includes about 70.0% of the budget in its calculations, which is more than most states with tax and expenditure limits.

Report's Claim	Response
Page 9: The report states that due to exclusions the amount outside of SAC's purview, such as the Transportation Trust Fund (TTF), experienced rapid growth, necessitating a recommendation to increase TTF revenues.	Ongoing spending in the TTF is counted as part of the SAC limit. The transportation capital program is excluded because of the unpredictability of PAYGO cash flows. The citation from the 1990 SAC report references a period during an economic downturn when dedicated special fund revenues fell significantly and impeded the completion of ongoing capital projects. Since it is not common practice for the general fund to bail out the TTF, the options for this dedicated special fund was to either shut down ongoing capital projects or to increase dedicated revenues to the TTF (which was the SAC recommendation).
Page 9: The report further cites the rapid growth in PAYGO as the basis for SAC providing guidance on transportation debt and capital spending levels as well as federal policy impacts and long-term budget forecasts.	Instead of being a criticism of the process this highlights the continued evolution of the SAC process to look beyond ongoing base spending growth and to also make recommendations in areas that affect State fiscal policy. This includes annual recommendations on the level of Consolidated Transportation Bonds to be issued and review of long-term spending trends.
Page 9: The report charges SAC with building the base subjectively, with exclusions changing from year to year.	Most exclusions are the same every year (*e.g.*, PAYGO capital, higher education double-counts, non-State funded items, large one-time items, and reserve fund transfers). Additional exclusions get added from time to time based on changes in the budget. For example, debt service on Certificates of Participation are excluded because the debt service is paid by non-State sources.
Page 9: As part of its allegation of subjective base building, the report continues by citing a 1990 SAC report that notes that "determining what constitutes a capital project in some instances will involve a judgment decision."	In 1990, PAYGO capital projects were not identified in separate program and thus it was difficult to determine what was ongoing spending for maintenance and what was a one-time peak or valley in a capital project cash flow. Requirements to separately identify PAYGO programs to better reflect actual ongoing spending was included in budget bill language in fiscal 1996 and later codified at the 2002 session.

Report's Claim	Response
Page 10: Table 1 reports appropriations limited by SAC and the total State budget, from which is derived the percent of the budget that is limited.	Most of the reported data for SAC appropriations is incorrect. There was no recommendation for fiscal 1993. Actual State budget data is incorrect for fiscal 1985 and fiscal 2002 through 2009 inclusive. Correct data is reported in **Appendix 3.**
Pages 10-11: The report attempts to illustrate the subjective nature of building the base. As an example, SAC noted in its November 1990 report that the 1990 base needed to be adjusted to reflect mid-year budget cuts of $119 million. A recommendation of 5.1% was made from the revised base to accommodate baseline spending growth. The report suggests that allowing this level of growth while encouraging a search for revenue enhancements shows how the base is subject to "gaming".	The economic downturn of the early 1990s required the Governor to reduce fiscal 1991 spending by $119 million. SAC recognized that (1) the 1990 session base would be too high and needed to be adjusted; and (2) that the structural deficit caused by a drop in revenues required spending adjustments. The 5.1% growth level was made to account for baseline spending needs but it was noted in the report that this was an upper limit and not a spending target. In 1990, SAC also recommended that the deficit be "addressed by reduced spending" and "taxes should be considered as a last resort."
Page 11: Additional "gaming" by SAC is suggested to occur by cutting general fund spending and authorizing mid-year special fund budget amendments.	Any general fund reductions which are intended to be replaced by special fund budget amendments are not counted as SAC-eligible cuts (*i.e.*, the general fund cuts are considered to be offset by the special fund increase; therefore, such cuts are not counted as reductions for purposes of calculating the SAC limit for the next year. This unsupported allegation is repeated from a prior report by Cecilia Januszkiewicz that similarly provides no evidence to support this claim. A related issue pertained to appropriation increases during the year for special and current unrestricted revenues but was addressed by the 2005 SAC report which called for the Executive Branch to limit use of budget amendments in order to accurately reflect base spending in the allowance. Annual budget bill language to this effect has been included in each budget since fiscal 2007.
Page 11: The report suggests that SAC violated a rule to limit growth to personal income, which had been followed in the first 10 years of the process.	In the first 12 years after adoption, SAC did limit growth relative to personal income, though in 6 of those years the limit was set below the rate of personal income growth. Regardless, § 2-1004(b) of the State Government Article states that "In evaluating state expenditures, the Committee (SAC) shall consider economic indicators such as personal income, gross state product, or other

Report's Claim	Response
	data." SAC is not limited to one specific rule. Instead, elected officials have the flexibility to assess spending needs relative to revenues and economic activity when making a recommendation on spending.
Page 11: The report alleges excessive spending growth was allowed for fiscal 1986 when an 8.0% growth rate was recommended. The report suggests this level was 20.0% higher than personal income.	The justification is taken out of context. Along with the 8.0% growth recommendation for fiscal 1986, SAC notes that this was 20.0% higher than the growth rate in personal income for the 1982 to 1983 period (3 years earlier) during a depressed economy. The recommendation was made based on improved economic activity. In addition, as noted in the previous comment, there were several years in the 1980s when the growth rate was set at a rate less than the growth in personal income.
Page 13: The report alleges that "after 28 years of proposing annual increases in spending averaging 5 percent, on the heels of the Great Recession, for FY 2010 and FY 2011 the Committee scaled back the recommended growth rate in spending to 0.7% and 0.0%....[which] is not negative growth and…does not imply budget cuts."	Although published in April 2012, Norcross and VanMetre omit data from the 2010 and 2011 SAC reports, which recommended general fund reductions to address the structural deficit that arose after the Great Recession. In December 2010, SAC recommended reducing the deficit by 33.33% for fiscal 2012 exclusively through budget cuts, as part of a 3-year plan to eliminate the shortfall. In December 2011, SAC recommended cutting the remaining deficit by 50.0%, through either cuts or revenues.

Appendix 3
Percent of the Maryland Budget Limited by Spending Affordability
Fiscal 1983-2009
($ in Millions)

Fiscal Year	State Budget	SAC Appropriations	Percent Limited
1983	$6,224.6	$4756.0	76%
1984	6,465.4	5,184.0	80%
1985	6,998.5	5,073.5	72%
1986	7,942.1	5,493.7	69%
1987	8,526.0	5,873.8	69%
1988	9,132.7	6,339.4	69%
1989	10,002.8	7,029.8	70%
1990	11,162.5	7,659.2	69%
1991	11,432.4	8,373.8	73%
1992	11,695.1	8,614.1	74%
1993	11,879.0	No recommendation	n/a
1994	12,549.8	8,882.0	71%
1995	13,746.4	9,310.7	68%
1996	14,366.8	9,752.0	68%
1997	14,982.6	10,144.0	68%
1998	15,515.5	10,524.0	68%
1999	16,673.2	11,016.0	66%
2000	17,866.2	11,638.1	65%
2001	20,064.8	12,438.1	62%
2002	21,443.4	13,622.9	64%
2003	22,454.1	14,295.6	64%
2004	22,547.2	14,460.9	64%
2005	24,045.1	15,163.5	63%
2006	26,174.2	16,513.6	63%
2007	28,756.5	18,314.6	64%
2008	29,523.5	19,732.4	67%
2009	30,870.5	20,701.7	67%

SAC: Spending Affordability Committee