Department of Legislative Services

Maryland General Assembly
2017 Session

FISCAL AND POLICY NOTE
Third Reader - Revised

Senate Bill 371 (Senator Manno, *et al.*)

Budget and Taxation Appropriations

State Budget - Appropriations - Income Tax Revenue Estimate Cap and Revenue Stabilization Account

This bill requires the Bureau of Revenue Estimates (BRE) to calculate the share of general fund revenues represented by nonwithholding income tax revenues from the State individual income tax, beginning with the revenue estimate for fiscal 2020. At the end of fiscal 2020, and each fiscal year thereafter, if general fund revenues for the fiscal year are less than the Board of Revenue Estimates' March estimate, the amount of nonwithholding income tax revenues that exceeds a specified capped nonwithholding estimate must be applied to close the revenue gap, and any remainder must be deposited into the Revenue Stabilization Account (also known as the Rainy Day Fund) and/or the newly established Fiscal Responsibility Fund as specified in the bill. Revenues from the Fiscal Responsibility Fund are to be appropriated in the second following fiscal year to specified pay-as-you-go (PAYGO) capital projects. The bill also alters what constitutes the "unappropriated general fund surplus" and specifies it is the State's goal that 10.0% of estimated general fund revenues in each fiscal year be retained in the Revenue Stabilization Account.

The bill takes effect July 1, 2017.

Fiscal Summary

State Effect: In the short term, there is no fiscal effect. Special fund revenues for the Fiscal Responsibility Fund and the Rainy Day Fund may increase beginning in FY 2020; due to the volatility of nonwithholding income tax revenues, any such increase cannot be reliably estimated at this time. General fund revenues available for expenditures may decrease beginning with the FY 2020 budget bill. Beginning with the FY 2022 budget bill, special fund expenditures for PAYGO capital projects may increase. **This bill establishes mandated appropriations beginning in FY 2022.**

Local Effect: State support for public school construction and capital projects at public schools and community colleges may increase beginning with the FY 2022 budget bill.

Small Business Effect: None.

Analysis

Bill Summary:

Reporting Requirements and Methodology: The bill specifies reporting requirements relating to nonwithholding income taxes for BRE and the Board of Revenue Estimates. "Nonwithholding income tax revenues" is the State share of individual income tax quarterly estimated and final payments and does not include income tax withholding or specified payments and refunds. The board must approve a methodology for determining the State share of nonwithholding income tax revenues for each fiscal year; the Consensus Revenue Monitoring and Forecasting Group must develop and recommend to BRE a methodology for doing so. The group must study the methodology in the bill to determine whether improvements are recommended; as appropriate, the group must report to the General Assembly by January 1, 2018, on recommendations to improve the methodology.

Beginning with the revenue estimate for fiscal 2020, BRE must calculate the share of general fund revenues represented by nonwithholding income tax revenues. For each fiscal year, BRE must calculate the 10-year average share of general fund revenues represented by nonwithholding income tax revenues. The 10-year average is based on the 10 most recently completed fiscal years for which data is available when the estimate is prepared in the September before the beginning of the fiscal year, and the same 10-year average must be used in all subsequent revenue estimate revisions for that fiscal year. For each fiscal year, if BRE's estimate of the share of general fund revenues from nonwithholding income tax revenues is above the 10-year average share, BRE must adjust the revenue estimate by reducing general fund revenues from nonwithholding income tax revenues. Although the adjustment may not be more than 2.0% of total general fund revenues, it must be an amount sufficient to align the estimated share of general fund revenues from nonwithholding income tax revenues with the 10-year average share. This capped estimate must be incorporated in the revenue estimate that BRE reports to the Board of Revenue Estimates.

Use of Unappropriated General Fund Surplus: For purposes of the Revenue Stabilization Account, the unappropriated general fund surplus does not include the amount of nonwithholding income tax revenues that exceed the capped estimate of nonwithholding income.

Use of Nonwithholding Income Tax Revenues: At the end of fiscal 2020, and each fiscal year thereafter, if general fund revenues for the fiscal year are less than the Board of Revenue Estimates' March estimate, the amount of nonwithholding income tax revenues that exceeds the capped estimate must be applied to close the revenue gap for that fiscal year. If the available nonwithholding income tax revenues exceed the amount that is needed to close the gap and if the Rainy Day Fund balance is less than 6.0% of the estimated general fund revenues for that fiscal year, the Comptroller must distribute to the Revenue Stabilization Account the *lesser* of (1) the remaining balance of nonwithholding income tax revenues in excess of the capped estimate or (2) the amount required for the account balance to equal 6.0% of the estimated general fund revenues for that fiscal year. The Comptroller must distribute 50.0% of any remaining amount to the Revenue Stabilization Account, unless that account exceeds 10.0% of general fund revenues. Any remainder must be distributed to the Fiscal Responsibility Fund.

Establishment of the Fiscal Responsibility Fund: The bill establishes the Fiscal Responsibility Fund, which is meant to retain the amount of nonwithholding income tax revenues deposited to the fund in accordance with the bill until the revenues are appropriated in the State budget. 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 must be credited to the general fund. The fund may only be used to provide PAYGO capital funds for public school construction, public school capital improvement projects, capital projects at public community colleges, and capital projects at four-year public institutions of higher education. Expenditures from the fund may only be made in accordance with the State budget. The Governor must include in the budget bill for the second following fiscal year an appropriation equal to the amount in the fund for PAYGO capital projects. Money from the fund that goes to PAYGO capital projects is to be supplemental funding and is not intended to take the place of funding that otherwise would be appropriated for capital projects, including those funded with PAYGO funds and the proceeds from the sale of general obligation bonds. At the end of the fiscal year, the unspent balance of each appropriation that was made for that fiscal year from the fund reverts to the 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 fund 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.

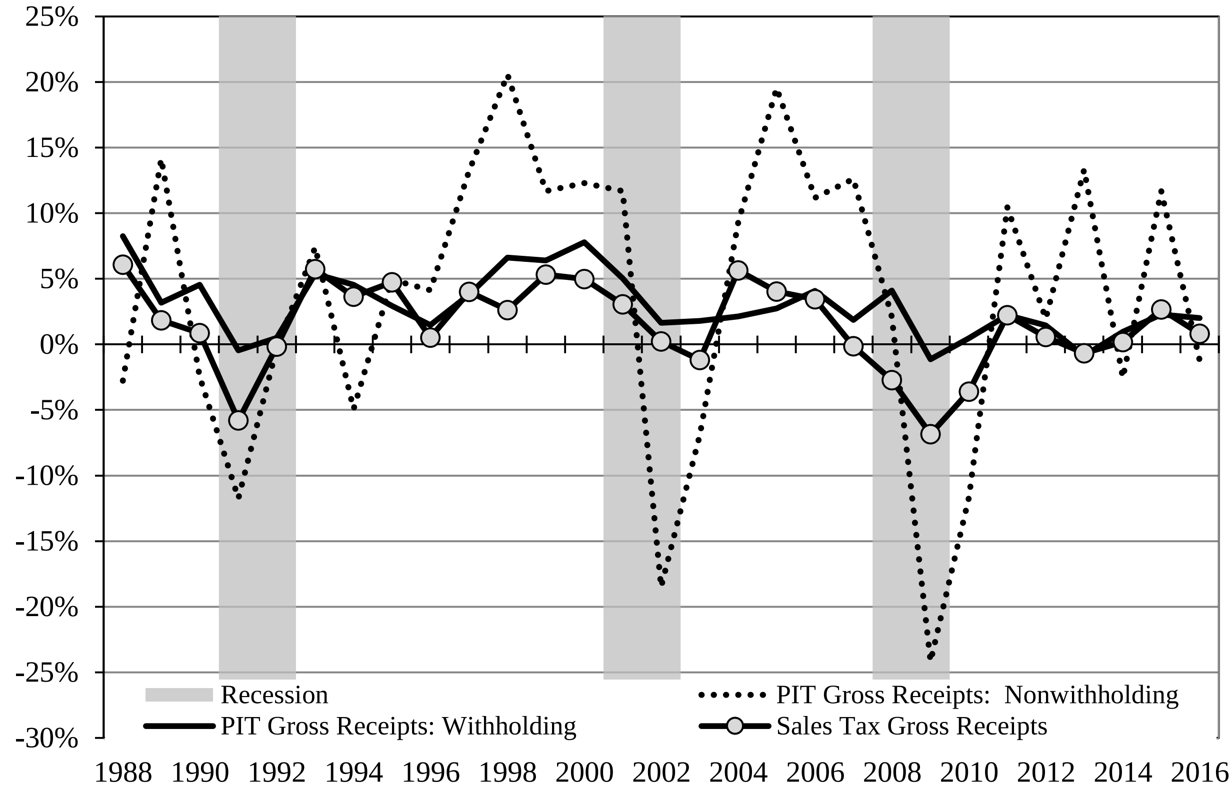
For fiscal 2017 through 2020, an amount equal to one-half of the unappropriated general fund surplus in excess of $10.0 million from the second prior fiscal year must be paid to the State Retirement and Pension System (SRPS) trust fund, up to a maximum of $50.0 million annually.

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 1** 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 1
Inflation-adjusted Year-over-year Percent Change
Fiscal 1988–2016



PIT: personal income tax

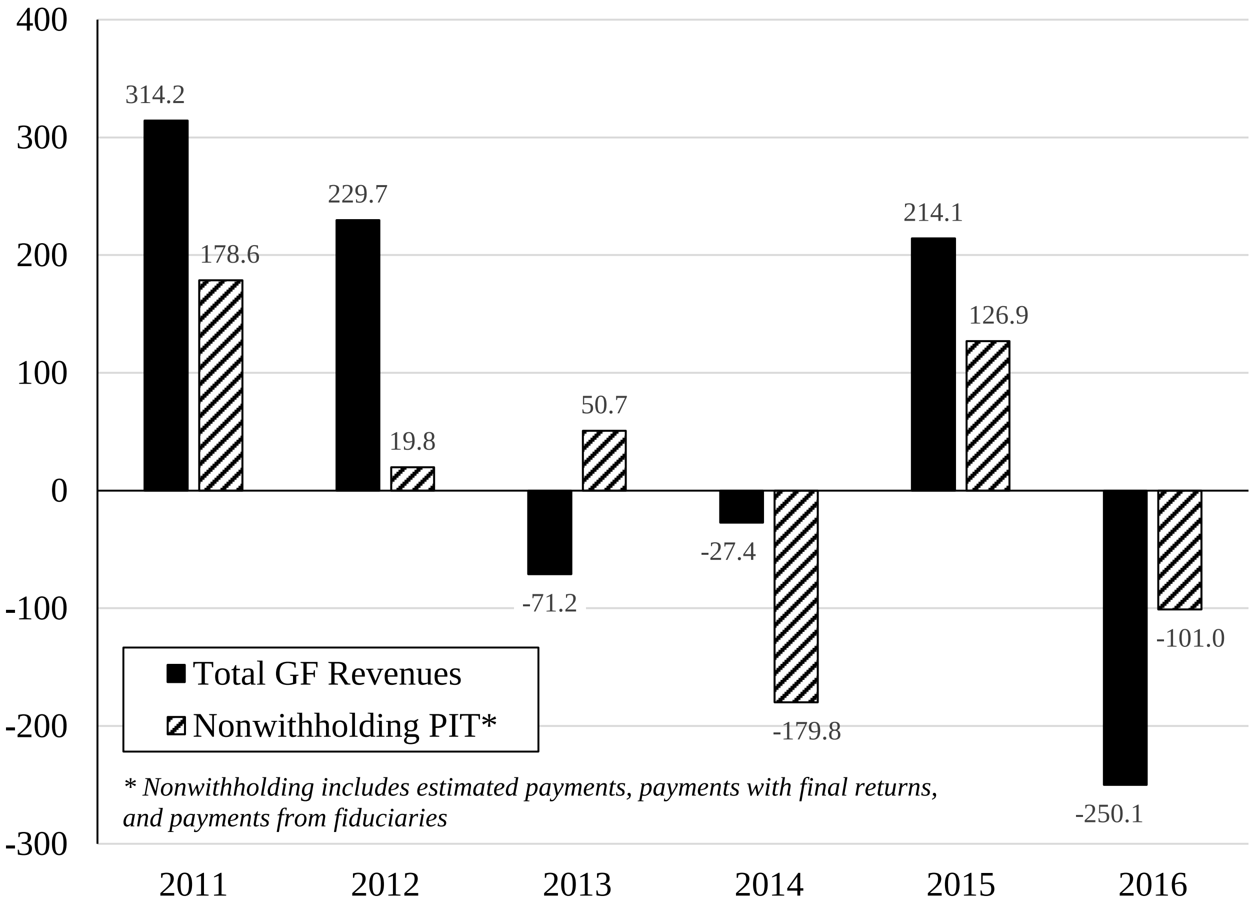
Note: Revenues have been adjusted for major law changes.

Source: Comptroller's Office

Exhibit 2 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.

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.

Exhibit 2
General Fund Close-out: Actual Revenues vs. Final Estimate
Fiscal 2011-2016
($ in Millions)



Source: Comptroller's Office; Department of Legislative Services

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: A capped estimate of the nonwithholding income tax revenues must be incorporated in the BRE's revenue estimate in specified reports beginning with the revenue estimate for fiscal 2020. Therefore, to the extent that less general fund revenues are available to be budgeted as a result of the nonwithholding income cap, the bill may result in lower general fund spending beginning with the fiscal 2020 budget bill.

At the end of fiscal 2020, and each year thereafter, nonwithholding income tax revenues above the cap must be applied to close any general fund revenue shortfall, and any remaining amount must be deposited into the Rainy Day Fund up to the amount required for the account balance to equal 6.0% of the estimated general fund revenues for that fiscal year. Any remaining amount must be equally distributed to the Rainy Day Fund and the Fiscal Responsibility Fund. Once the Rainy Day Fund balance exceeds 10.0% of the estimated general fund revenues, any remainder goes to the Fiscal Responsibility Fund.

Thus, as a result of the nonwithholding income tax cap, revenues to the Rainy Day Fund and the Fiscal Responsibility Fund may increase significantly beginning in fiscal 2020. Money within the Fiscal Responsibility Fund may only be used to pay for specific PAYGO capital projects, so PAYGO special fund expenditures may increase significantly beginning as early as fiscal 2021 (if incorporated in the fiscal 2022 budget bill as a deficiency appropriation for the prior year).

As shown in **Exhibit 3**, 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.

Exhibit 3
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: Comptroller's Office

The Comptroller's Office advises that the bill has no fiscal impact because the Comptroller does not know what nonwithholding revenues will be in fiscal 2020. If the cap were applied to the fiscal 2018 revenue estimate, the revenue estimate would be reduced by $112.3 million. At the end of fiscal 2018, the capped estimate of $112.3 million would be applied to close the gap in revenues, if any. For fiscal 2018, the Rainy Day Fund balance is estimated to be $860.3 million, which is approximately 5.0% of estimated general fund revenues, so the remainder of the $112.3 million would likely be distributed to the Revenue Stabilization Account since it is likely less than the amount required for the Revenue Stabilization Account to equal 6.0% of the estimated general fund revenues.

Local Fiscal Effect: State support for public school construction and capital projects at public schools and community colleges may increase beginning with the fiscal 2022 budget bill. Any such increase cannot be reliably estimated at this time and will depend on the amount distributed into the Fiscal Responsibility Fund.

Additional Information

Prior Introductions: None.

Cross File: HB 503 (Delegate McIntosh) - Appropriations.

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

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Analysis by: Heather N. Ruby

Direct Inquiries to:
(410) 946-5510
(301) 970-5510