
**Report on Revenue Volatility and
Approaches to Reduce Risk to
the State Budget**

**Department of Budget and Management
Comptroller of Maryland
Department of Legislative Services
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Report on Revenue Volatility and Approaches to Reduce Risk to the State Budget

Reasons for This Study

Due to the ups and downs of the business cycle, revenue volatility is unavoidable for State governments. States that rely heavily on highly volatile revenue sources like capital gains to fund ongoing spending are especially vulnerable to the vagaries of the economy. Minimizing reliance on unstable revenue sources can help states soften the impact of recessions and avoid building unsustainable ongoing spending into their budgets during economic booms. 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.

The 2016 *Joint Chairmen's Report* requires that the Department of Budget and Management (DBM), the Comptroller of Maryland, and the Department of Legislative Services (DLS) examine the volatility in Maryland's revenue structure and recommend an approach to reducing volatility.

Indications of Revenue Volatility

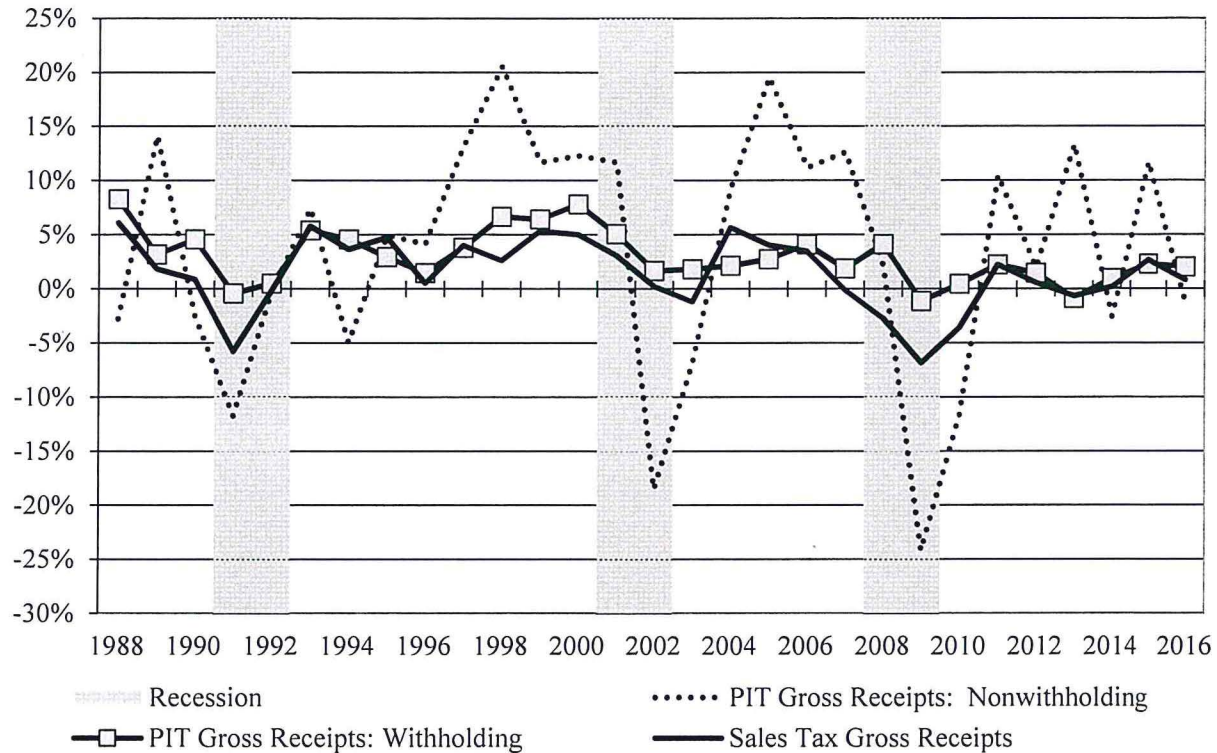
Revenue Volatility: Year-over-year Growth

General fund revenue growth varies considerably for a number of reasons. The two main revenue sources – personal income and sales tax – are largely driven by the economy; thus, growth moves up and down across the business cycle. Income and sales taxes account for 80% of general fund revenue.

General fund personal income tax receipts grew, on average, 4.8% over the period fiscal 1987 to 2016. Gross receipts for income tax can be broken down into two categories – payroll withholding and nonwithholding. Nonwithholding consists of quarterly estimated payments and final payments with returns from both individuals and fiduciaries. Withholding accounts for 78.0% of income tax gross receipts on average. Adjusted for major law changes, withholding and nonwithholding have similar average annual growth rates over the fiscal 1987 to 2016 period, 5.2% and 5.3%, respectively. Adjusted for inflation, withholding growth averaged 2.9%, and nonwithholding averaged 3.0%. Sales tax gross receipts (adjusted for major law changes) grew, on average, 3.7% over the period fiscal 1987 to 2016. Adjusted for inflation, growth averaged 1.4%.

Exhibit 1 shows the year-over-year percent change for the three revenue sources – sales tax gross receipts, income tax gross receipts from withholding, and income tax gross receipts from nonwithholding. The series have been adjusted for major law changes and inflation. The period fiscal 1987 to 2016 covers three recessions, which began in fiscal 1990, fiscal 2001, and the Great Recession starting in fiscal 2008.

Exhibit 1
Inflation-adjusted Year-over-year Percent Change
Fiscal 1987-2016



PIT: personal income tax

Note: Revenues have been adjusted for major law changes and inflation.

Source: Comptroller of Maryland

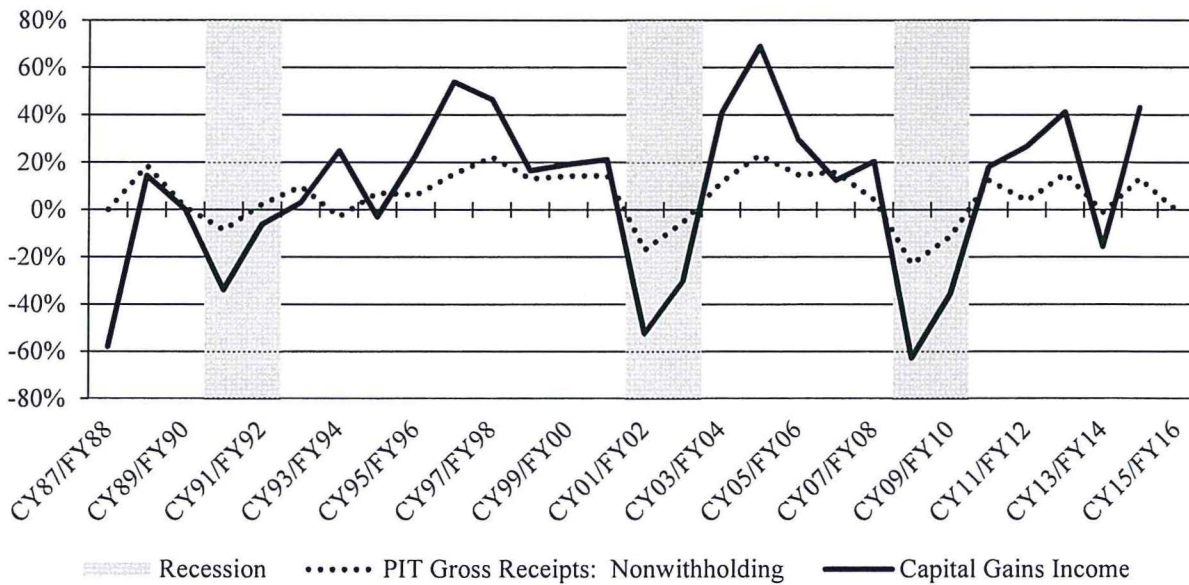
While all three revenue sources vary with the business cycle, nonwithholding is substantially more volatile than either withholding or sales tax. Withholding and sales tax, not surprisingly, tend to move together as they are both dependent on employment and wage growth. Sales tax, however, tends to weaken more than withholding during recessions. Income tax nonwithholding swings significantly with years of double-digit gains and double-digit declines. In addition, the volatility of nonwithholding has increased as the gyrations during the 2001 and 2008 recessions were considerably more pronounced than during the 1990 recession.

Capital Gains Income

The underlying variability in taxpayers’ 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. In 2014, capital gains income totaled \$9.5 billion for Maryland residents and generally accounts for 5% to 6% of net State income tax revenues.

Exhibit 2 graphs the year-over-year percent change in income tax nonwithholding (adjusted for major law changes) and capital gains income for Maryland residents. Note that capital gains income is only available on a calendar year basis, and the most recent data is 2014. Capital gains income swings sharply across the business cycle, dwarfing the volatility in nonwithholding payments. The performance of the stock market is also a key driver of capital gains income. In addition, the change from year to year tends to be significant even outside recessions as capital gains income has not increased or decreased by single digits since 1994.

Exhibit 2
Income Tax Nonwithholding and Capital Gains Income
 Year-over-year Percent Change



CY: calendar year
 FY: fiscal year
 PIT: personal income tax

Note: Nonwithholding has been adjusted for major law changes.

Source: Comptroller of Maryland; Internal Revenue Service

Taxpayer behavior can also contribute to the variability of capital gains income, and therefore, nonwithholding payments. Taxpayers generally control when they realize a capital gain by choosing when to sell an asset and will make that decision for a variety of reasons. A good example of this was in 2012 when Maryland capital gains income increased 41.0% over 2011 in a year when the stock market, as measured by the Standard & Poor's 500 index, was up 8.7%. The potential for federal tax increases in 2013 led taxpayers to accelerate capital gains realizations in 2012, substantially boosting taxable income.

Capital gains income is notable for being highly concentrated among high-income taxpayers. As a result, the behavior of a relatively small group of taxpayers can significantly impact the level of capital gains income in any given year. **Exhibit 3** shows the portion of capital gains income accounted for by each income class using data provided by the Comptroller of Maryland. The top 1.0% of Maryland tax returns generally account for around 70.0% to 75.0% of all capital gains income. The top 0.1% (around 2,600 returns) normally contributes close to 50.0% of capital gains. Tax year 2013 was an unusual year in that capital gains for the highest income taxpayers fell substantially while increasing for everyone else.

Exhibit 3
Maryland Taxable Capital Gains Income

<u>Income Class</u>	<u>Tax Year 2010</u>		<u>Tax Year 2011</u>		<u>Tax Year 2012</u>		<u>Tax Year 2013</u>	
	<u>Returns</u>	<u>Share of Capital Gains Income</u>	<u>Returns</u>	<u>Share of Capital Gains Income</u>	<u>Returns</u>	<u>Share of Capital Gains Income</u>	<u>Returns</u>	<u>Share of Capital Gains Income</u>
Top 0.1%	2,538	49.7%	2,577	54.0%	2,611	48.8%	2,690	35.7%
>0.1% and <=1%	22,851	23.3%	23,198	20.5%	23,501	23.5%	24,213	20.4%
>1% and <=5%	101,556	11.5%	103,102	10.5%	104,452	11.8%	107,615	16.1%
>5% and <=10%	126,945	4.0%	128,878	3.6%	130,564	3.9%	134,518	6.9%
>10% and <=25%	380,835	4.1%	386,632	4.0%	391,693	4.1%	403,554	8.0%
>25% and <=50%	634,725	2.1%	644,388	2.4%	652,821	2.5%	672,590	4.8%
>50% and <=75%	634,725	0.8%	644,387	1.1%	652,821	1.6%	672,590	2.9%
>75% and <=100%	634,726	4.5%	644,388	3.8%	652,821	3.9%	672,591	5.1%
	2,538,901	100.0%	2,577,550	100.0%	2,611,284	100.0%	2,690,361	100.0%
Top 1%		73.0%		74.5%		72.3%		56.1%

Note: Data includes full-year Maryland residents only. The income class is defined by net Maryland Income.

Source: Comptroller of Maryland

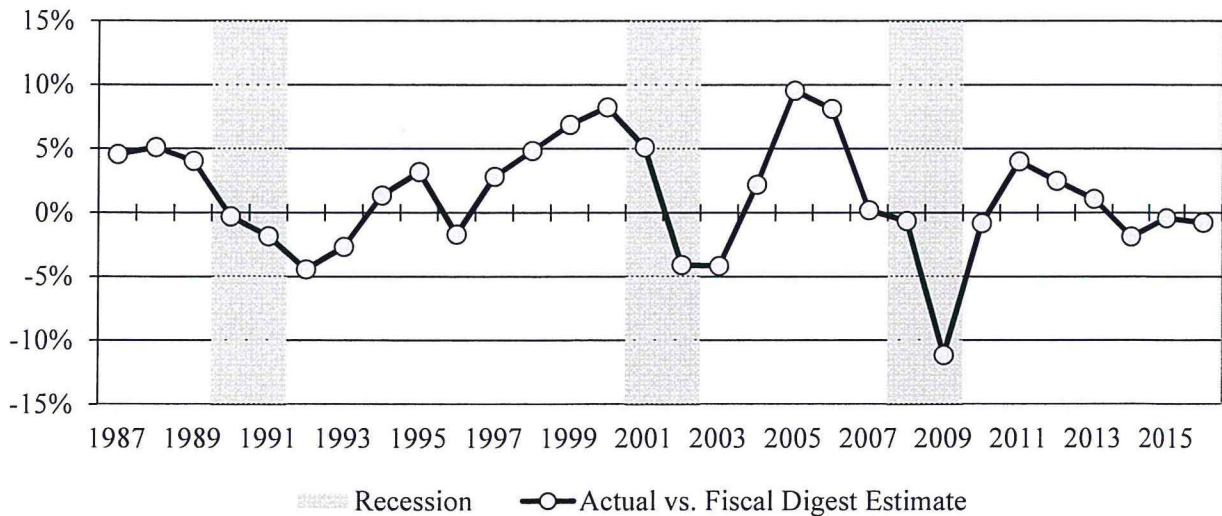
Revenue Volatility: Comparison to Estimate

Variance from estimate is the type of volatility that is perhaps most relevant to the budget. The year-over-year change in revenues would be more manageable if it were accurately anticipated. The Board of Revenue Estimates (BRE) is responsible for the official revenue forecasts used in budgeting. For any given fiscal year, the BRE will do multiple estimates starting before the year begins and continuing until shortly before it ends.

Perhaps most relevant is the estimate of revenues at the time the budget for the fiscal year was adopted. The BRE issues a revenue forecast each December, and this estimate is used by the Governor when submitting a budget in the subsequent session. The BRE may revise that estimate in March, and legislation enacted into law during the session may alter the expected revenue. DBM publishes the *Fiscal Digest* in June for the fiscal year that begins in July. The revenue estimate in the *Fiscal Digest* reflects the BRE’s December estimate along with any revision in March and the impact of any law changes.

Exhibit 4 graphs the percent difference between the actual general fund revenues and the estimate from the *Fiscal Digest* for fiscal 1987 to 2016. The volatility across the business cycle is easy to see as revenues come in well above estimate at the peak of the cycle then substantially underperform during recessions.

Exhibit 4
Total General Fund Revenues
Percent Difference Actual vs. Estimate
Fiscal 1987-2015



Source: Comptroller of Maryland; Department of Budget and Management

It is, of course, difficult to predict recessions, and even when they are clearly underway, it has often been hard to calibrate the revenue estimate to the true weakness in collections. Thus, it can be the case that revenues significantly underperform the estimate for several years. This happened during the recessions in the early 1990s and the early 2000s but less so in the Great Recession. The inverse is true during the expansion part of the business cycle, as the revenue estimate will often be consistently below the true revenues by a considerable amount for several years. This can be clearly seen in the late 1990s when actual revenues exceeded the *Fiscal Digest* estimate by 5% or more for four straight years.

The other noteworthy point about **Exhibit 5** is that revenue volatility relative to the estimate has gotten smaller. Despite the extremely large miss in fiscal 2009, the period of the Great Recession and beyond has seen smaller variances from the estimate than during the previous 20 years. As seen in Exhibit 5, the absolute average gap between the actual general fund revenues and the estimate from the *Fiscal Digest* was 2.3%, below the previous two decades, for the period fiscal 2007 to 2016. This is partly due to the lack of the strong recovery in revenue growth seen after the previous two recessions. Over the 10-year period from fiscal 2007 to 2016, actual revenues exceeded the *Fiscal Digest* estimate only four times. In contrast, overattainments and underattainments were evenly split during the fiscal 1987 to 1996 period, and from fiscal 1997 to 2006, there were only 2 years where revenues came in below the *Fiscal Digest* estimate. Increasing total revenues has made even small revenue underattainment difficult to manage in the budget. As the general fund budget increases to \$17 billion, underattaining by 1% results in a \$170 million shortfall.

Exhibit 5
Actual General Funds Revenues Compared to *Fiscal Digest* Estimate

	Absolute Average Difference: <u>Actual vs. Estimate</u>	Number of <u>Years</u>	Number of Years Actual Revenues <u>Underattained</u>	Number of Years Actual Revenues <u>Overattained</u>
Fiscal 1987 to 1996	2.9%	10	5	5
Fiscal 1997 to 2006	5.6%	10	2	8
Fiscal 2007 to 2016	2.3%	10	6	4

Source: Department of Legislative Services

Revenue Volatility Approaches in Other States

States have taken a variety of approaches to help insulate their budgets from the volatility of revenues. Many states limit how much spending can grow, often tied to growth in population,

inflation, personal income, or some combination of these. In Maryland, the Spending Affordability Committee recommends a limit on spending growth, although it is not binding to the Governor. While the committee has made many different types of recommendations, in most years, spending has been tied to growth in personal income.

Another approach on the spending side is to limit the budget to a certain percentage of the revenues. In Delaware, for example, the general fund budget is limited to 98% of available revenues (including fund balance). Iowa, Mississippi, Oklahoma, and Rhode Island have similar requirements ranging from 95% to 99% of estimated revenues.

A few states apply a limit to the revenue estimate itself. In Michigan and Missouri, revenues are limited to a certain percentage of the prior year's state personal income. Florida revenue growth is limited to the average growth in state personal income over the previous five years. In Colorado, revenue growth is tied to an index of population and inflation growth relative to a base year.

Recently, some states have focused specifically on the most volatile aspects of personal income tax. While not altering the revenue forecast itself, California and Massachusetts have sweeper¹ provisions in statute tied to tax revenue from capital gains income.

By statute, Massachusetts provides for the transfer to the Commonwealth Stabilization Fund (CSF) tax revenue from capital gains income in excess of \$1.0 billion in a fiscal year. Of the amount transferred to the CSF, 5% goes to the State Retiree Benefits Trust Fund, and 5% goes to the Pension Liability Fund. The threshold rises each year by the growth in U.S. gross domestic product over the preceding five years. For fiscal 2015, the threshold was \$1.048 billion, and capital gains taxes were estimated to have totaled \$1.68 billion. But in each of the last three fiscal years (fiscal 2015 to 2017), the transfer was suspended and the money was retained in the General Fund.

California recently adopted a system that also sets aside excess revenue from capital gains income in a reserve fund. In 2014, California voters adopted Proposition 2, which included a sweeper provision that consists of a base amount equal to 1.5% of general fund revenues. Income tax revenue from capital gains income over 8.0% of general fund taxes is added to the base amount. General fund taxes are a subset of revenues excluding fees and penalties. There is then a deduction related to Proposition 98, California's education funding law, resulting in the net amount. Half of the total Proposition 2 amount goes into the Budget Stabilization Account, and

¹ In many states, statutes require that unappropriated revenues are appropriated into a Rainy Day Fund. In Maryland, State law requires that the Administration appropriate an amount equal to any unassigned general fund balance at closeout in excess of \$10.0 million into the Rainy Day Fund. This appropriation is made to the budget two years after the unassigned general fund surplus is realized. For example, fiscal 2008 closed with an unassigned surplus totaling \$185.7 million, thus the Administration's fiscal 2010 allowance included a \$175.7 million appropriation to the Rainy Day Fund. This appropriation to the Rainy Day Fund is referred to as the "sweeper."

the other half goes toward debt payments. The first budget under the Proposition 2 provisions was fiscal 2016.

The difficulty with focusing on revenue from capital gains income is that the tax is paid on a tax, not fiscal, year basis, and information is only available once taxpayers file returns. Thus, fiscal year figures for capital gains tax revenue will always be estimates. California built in a three-year process to true up their fiscal year transfer as data from tax returns become available.

Virginia has taken a different approach, focusing on nonwithholding income tax revenue rather than capital gains specifically. Rather than a sweeper provision, Virginia puts a cap on their estimate of nonwithholding income tax revenues, referred to as a collar, beginning with the fiscal 2015 budget. The cap involves limiting the estimated nonwithholding income tax revenue to a certain share of estimated total general fund revenues. The share is determined by the average percent of general fund revenues comprised by nonwithholding income tax revenue over the prior 10-year period. In fiscal 2016, for example, the prior 10-year average was 16.1%. If the forecasted nonwithholding revenue is above that share, the general fund revenue estimate used for the budget would be reduced by the amount by which it is over.

The point of the collar is to dampen/lower the revenue estimate, potentially increasing the likelihood that the revenue estimate will be exceeded (or miss will be smaller) and at the same time, lowering allowable (ongoing) spending. This helps reduce the potential or magnitude of budgetary shortfalls.

The revenue forecasting body (Governor's Advisory Council on Revenue Estimates) continues to forecast nonwithholding income tax revenues as it always has, which produces the baseline estimate. The cap, or collar, is then an adjustment to the revenue estimate in the Governor's budget submission. There is no statutory basis for the collar. In the fiscal 2016 budget and the biennium budget for fiscal 2017 to 2018, Virginia limited the reduction from applying the cap to not more than 1% of total general fund revenues.

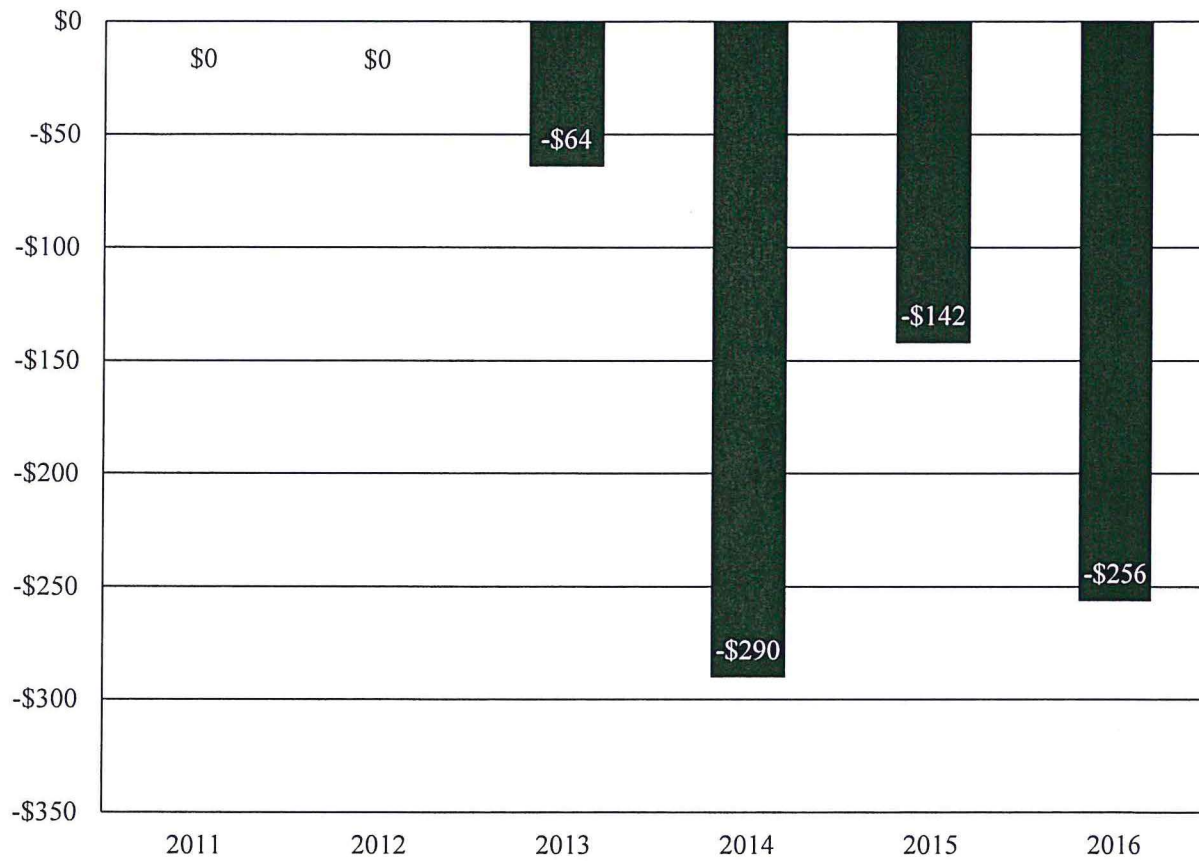
Suggested Approach for Maryland

Having reviewed practices in other states, DBM, the Comptroller of Maryland, and DLS recommend that the State consider reducing revenue volatility by limiting increases to nonwithholding income tax revenues. This should be done by placing a cap, or collar, on the amount of nonwithholding revenues. To estimate the cap, the State should determine the average share on nonwithholding revenues to total general fund revenues. If nonwithholding revenues exceed this collar, amounts in excess will not be appropriated in the upcoming budget. The collar should be estimated each time that BRE prepares a revenue estimate. Since this amount can become rather substantial, the State may consider placing a limit on how large the collar can become. For instance, the collar may be limited to 1% of revenues. This approach has the following advantages:

- **Encourages Savings at Height of Business Cycle:** In years that revenues are increasing at unsustainable levels, the collar reduces the available revenues and spending while creating additional reserves. In years that revenues are growing at sustainable levels, revenues and spending are unaffected.
- **Promotes Structural Balance:** By constraining the amount of unsustainable capital gains revenues built into the State's revenue forecast, the collar will encourage the funding of ongoing spending with more stable sources of revenue. A sluggish or recessionary economy will still produce structural deficits, but the collar should mitigate the magnitude of such deficits.
- **Relies on Real-time Data to Calculate Collar:** The State collects nonwithholding data during the fiscal year. As such, calculations made during the year are based on current revenue collections. This contrasts with capital gains specific data that does not become available until well after the close of the fiscal year. The availability of data during the year makes it easier to prepare reliable estimates. It should be noted, however, that since the State collects both the State and local income taxes, payments from taxpayers are always a mix of the two. Therefore, general fund nonwithholding receipts will have to be estimated using an estimate of the State share of total State and local collections.
- **Collar Is Self-adjusting:** If the State adopts an approach that uses a 10-year rolling average to compute the collar, the collar estimate will be adjusted each year to reflect the most recent actual data. As the economy changes, the collar changes with it.

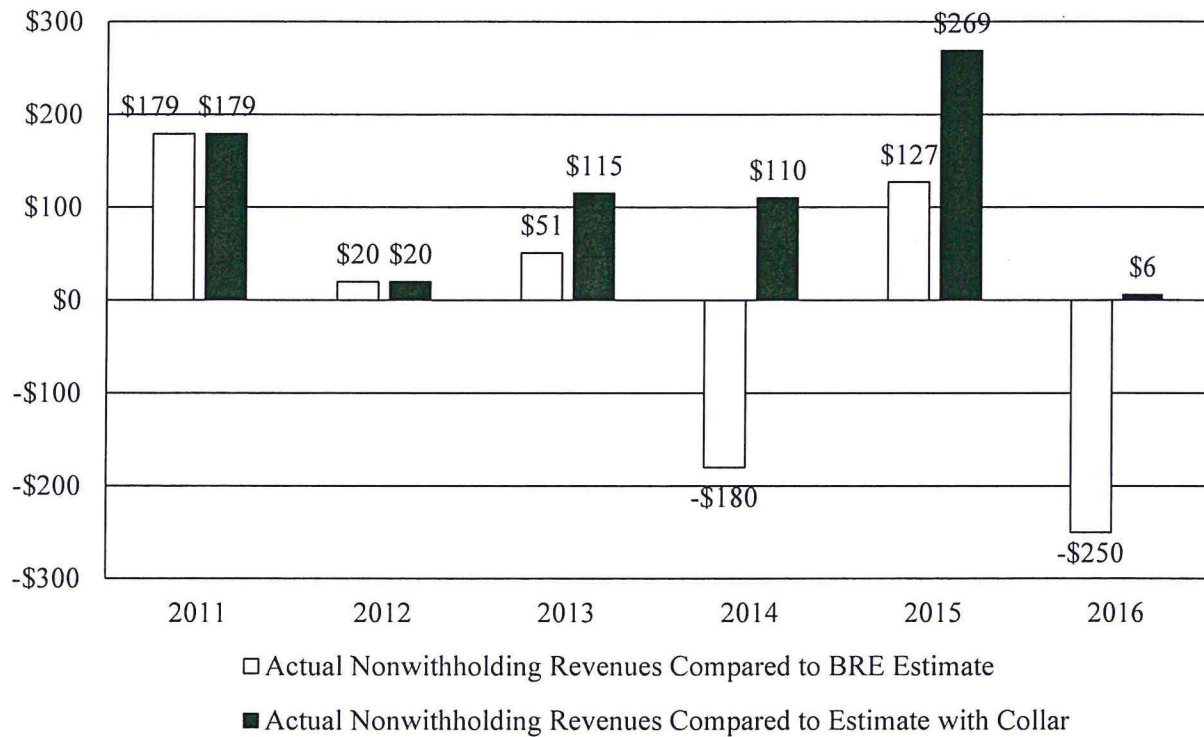
Exhibit 6 shows that in four of the last six fiscal years, the collar would have reduced the revenue forecast leaving less money available for appropriation. Consistent with the intent of the collar, no revenues would have been withheld during the recession (fiscal 2011 and 2012), and only minimal revenues would have been captured by the collar as the economic recovery began in fiscal 2013. While the collar would have captured substantial sums in each of the last three years, **Exhibit 7** demonstrates that the estimates of nonwithholding revenues fell far short of the estimates in two of those years. Had the collar been in place in fiscal 2016, the State would have closed the year with nonwithholding revenues \$6 million in excess of expectations rather than \$250 million below the estimate.

Exhibit 6
Effect of Collar on Revenues Available for Appropriation
Fiscal 2011-2016
(\$ in Millions)



Source: Department of Legislative Services

Exhibit 7
Impact of Collar on Closeout General Fund Revenues
Fiscal 2011-2016
(\$ in Millions)



BRE: Board of Revenue Estimates

Source: Department of Legislative Services

The experience over the last six years illustrates that the collar buttresses the State’s well-regarded approach to financial management. The fiscal discipline required by the collar reduces the budgetary stress created when nonwithholding income tax revenues fall short of expectations and discourages funding ongoing spending commitments with historically unsustainable revenues.

Use of Extraordinary Nonwithholding Revenues

If adopted, the collar approach will periodically generate surpluses of nonwithholding personal income tax revenue. In rare cases, nonwithholding income tax revenues may overperform expectations while the remainder of general fund revenues close the year short of the estimate. The workgroup recommends applying extraordinary nonwithholding revenues against the shortfall in other general fund revenues to avoid closing a fiscal year with a deficit.

After addressing any shortfalls at closeout, most of the extraordinary revenues captured by the collar should flow to the Rainy Day Fund until the balance in the fund reaches 10% of general fund revenues. A Rainy Day Fund balance of 10% will provide adequate cash resources to help mitigate the impact of revenue volatility during a recession. A detailed analysis of the appropriate balance to target for the Rainy Day Fund is presented later in this document.

Once the target balance for the Rainy Day Fund is realized, revenues captured by the collar should be dedicated to one or more of the following activities:

- **PAYGO Capital:** Use of one-time or temporary revenues to either expand the capital program or substitute for projects that would otherwise be funded with debt is a fiscally prudent approach to meeting the State's facility needs while minimizing debt service costs.
- **Unfunded Retiree Health Insurance Liability:** The State has an unfunded liability of about \$9.4 billion at the beginning of fiscal 2016. Funding reserved to address the liability represents only about 2.9% of the liability.
- **Unfunded State Employee Workers' Compensation Liability:** The State has a liability of \$418 million. The account has \$5 million for the liability, so the unfunded liability is \$413 million. The State has not appropriated any funds to reduce the unfunded liability since fiscal 2003.
- **Accelerating the State Retirement Systems Return to Full Funding:** The State is presently 70% funded, as of the beginning of fiscal 2017. The State's annual contribution already exceeds the actuarially required contribution. Since a long-term strategy to restore the system to financial health is already in place, this is a lesser priority for funding than the retiree health and workers' compensation liability for which no long-term funding plan exists.

The workgroup recommends enactment of legislation requiring the appropriation of nonwithholding revenue set-aside by the collar methodology to:

- **Offset any general fund revenue shortfall at closeout caused by other general fund revenues falling short of the March estimate.**

- **Increase the balance in the Rainy Day Fund to 10% of general fund revenues.**
- **Once the balance in the Rainy Day Fund reaches 10%, one or more of the following: PAYGO Capital and unfunded workers' compensation and retiree health liabilities. The General Assembly may wish to specify a specific allocation for each activity (up to the first \$100 million for PAYGO, the next \$50 million for retiree health, etc.) or give the Governor the authority to allocate funds in the budget among a set of approved activities.**

Rainy Day Fund – How Much Is Enough?

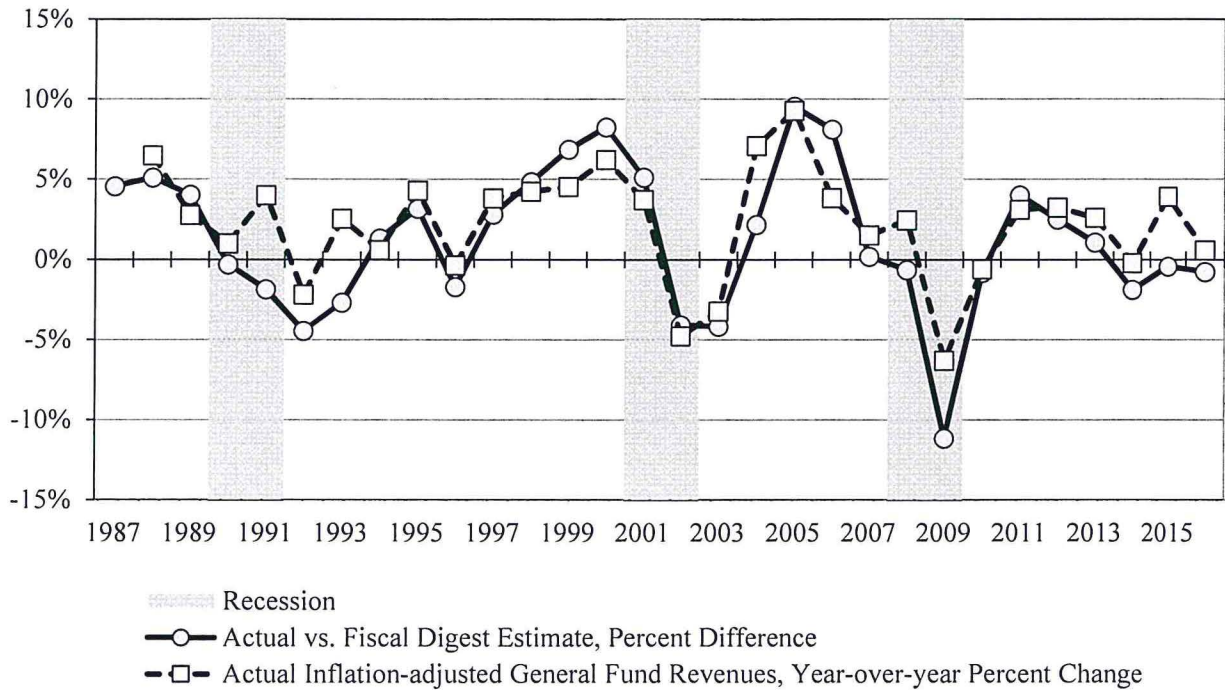
The appropriate level of funding to allocate to the Rainy Day Fund depends on the planned uses of the fund. Since the mid-1990s, Maryland has maintained a balance equivalent to at least 5% of general fund revenues. During the Great Recession, State leaders elected not to draw the balance in the fund below 5% despite unprecedented revenue write-downs (actual fiscal 2009 general fund revenues were 11% below the revenues anticipated at the beginning of the fiscal year).

Resistance to drawing the Rainy Day Fund balance below 5% reflected the perception that maintaining a 5% Rainy Day Fund balance would help the State preserve its AAA bond rating from all three rating agencies and demonstrate that the State was responding to the recession in a fiscally prudent manner. The temporary diversion of ongoing revenues from various dedicated funds and the transfer of fund balances from special fund accounts served as an alternative short-term revenue source further relieving pressure to drawdown the Rainy Day Fund balance.

The precedent of having maintained a Rainy Day Fund balance in excess of 5% during a historic recession may deter the State from drawing the Rainy Day Fund down during less severe recessions in the future. Therefore, any decisions about the appropriate balance to hold in the Rainy Day Fund to mitigate future downturns should be calibrated assuming there will be great reluctance to go below 5%.

The experience from the last three recessions (early 1990s, early 2000s, and 2008 to 2009) is helpful in evaluating the level of reserves that should be retained in the Rainy Day Fund. As shown in **Exhibit 8**, actual general fund revenues underperformed projections (the revenue estimate prepared at the beginning of the fiscal year) by about 4% in the first year of the recession in both the early 1990s and the early 2000s. The deep recession in 2008 led to revenues falling more than 11% below the forecast. The experience in subsequent years varies with a quick, albeit modest, recovery in the early 1990s leading to positive growth in the second year on an inflation adjusted basis while inflation adjusted revenues declined for a second consecutive year during both the recessions in the 2000s.

Exhibit 8
Total General Fund Revenues
Fiscal 1987-2015



Source: Comptroller of Maryland; Department of Budget and Management

DLS modeled three recession scenarios to examine the impact on revenues of recessions with different durations and recovery rates. The scenarios are:

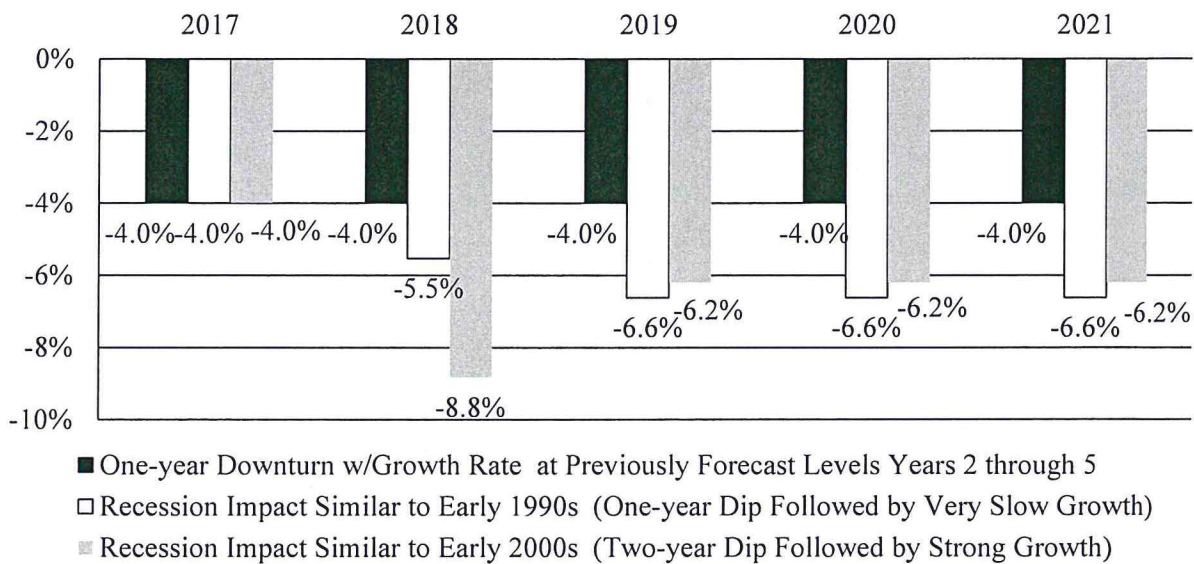
- Early 1990s-like recession with revenues falling short of the estimate in Year 1 by 4 percentage points and growing at a well below average rate in the next two years.
- Early 2000s-like recession with consecutive years of negative growth followed by well above average revenue growth in Year 3.
- A one-year dip with revenues falling 4% below estimate followed by normal rates of revenue growth.

DLS applied each of the three scenarios to its five-year forecast prepared at the beginning of fiscal 2017. All three scenarios assume a recession begins in fiscal 2017 and reduces forecast revenues for the year by 4.0% (consistent with the experience at the beginning of both the early 1990s recession and the early 2000s recession). In all three scenarios, revenue growth rates for

fiscal 2020 and 2021 (Years 4 and 5 of the forecast period) reflect the 3.9% growth anticipated in the State’s current five-year forecast for those years.

The results of the analysis are presented in **Exhibit 9** below with modeled revenues compared to the current forecast for the five-year period.

Exhibit 9
Impact of Recession on Fiscal 2017 Five-year Revenue Forecast
Percent Ongoing Revenues Fall Below Baseline Forecast
Fiscal 2017-2021



Source: Department of Legislative Services

Salient lessons include:

- No matter how brief the downturn and how quick the recovery – a recession will significantly lower the ongoing revenue base requiring long-term adjustments to planned spending or enhancements to ongoing revenues. Under any of the scenarios, the hangover from a fiscal 2017 recession will linger into fiscal 2021 with revenues anywhere from 4.0% to 6.6% below current revenue forecast for fiscal 2021.
- A healthy Rainy Day Fund balance can ease the initial strain of the recession, providing State leaders with time to thoughtfully adjust out-year budget plans.

- Given the State's reluctance to draw the Rainy Day Fund balance below 5.0%, the current Rainy Day Fund balance of about 6.0% of revenues is inadequate to respond to even the first year of a modest downturn.
- Actions taken during and after the Great Recession have depleted many special fund balances and impeded future efforts to temporarily divert ongoing special fund revenues to the General Fund. These new limitations on the use of special funds leave the State with fewer options for responding to future recessions. A Constitutional Amendment approved by the voters in 2014 prohibits diversion of revenues from the Transportation Trust Fund unless the Governor declares a financial emergency, and the General Assembly, by a three-fifths majority of both houses, approves the transfer. Similarly, Chapter 10 of 2016 requires reimbursement of future diversion of transfer tax revenues over the three successive years following the transfer.
- Raising the Rainy Day Fund balance to 10.0% of general fund revenues would provide adequate fund balance to offset about half of the lost revenue over the first two years of a recession while still maintaining a minimum fund balance of 5.0%.
- Use of the Rainy Day Fund balance even at the beginning of a recession should be accompanied by spending reductions that generate ongoing savings.
- Limiting the State's initial response to a recession to use of the Rainy Day Fund will delay difficult decisions, and to the extent the recession continues for multiple years, greatly increase the magnitude of spending reductions and revenue enhancements required in subsequent years. For example, using the Rainy Day Fund to cover the entire fiscal 2017 shortfall in each of the scenarios would mean that the Rainy Day Fund would be largely exhausted at the end of the year, and reductions of anywhere from 4.0% to 9.0% of planned spending would be required in fiscal 2018.

A recession will also impact general fund spending. During each of the last three recessions, enrollment in entitlement programs surged. Based on prior experience, a mild recession will cause general fund spending to grow by about 0.5% (\$75 million) faster than forecast in Year 1 and 1.0% (\$150 million) faster than forecast in Year 2 due to increased participation in Medicaid and Temporary Cash Assistance. Other spending pressures may ease during a recession. Planned cost-of-living adjustments for employees and service providers, for example, may moderate as the recession slows wage growth.

Recommendations

DBM, the Comptroller of Maryland, and DLS recommend that the State:

- Raise the Rainy Day Fund target to 10.0% of general fund revenues. A balance of 10.0% will provide adequate reserves to mitigate the immediate impact of a recession while still retaining a balance of 5.0% of revenues.
- Consider capping the amount that can be withdrawn from the Rainy Day Fund during a fiscal year. A cap will discourage an overreliance on the Rainy Fund at the beginning of a recession and preserve cash to assist with the multi-year challenges presented by a recession.
- Consider prohibiting withdrawals if fund balance is below 7.5% without passage of legislation by the General Assembly. The fund is frequently drawn down to 5.0% in good times to address ongoing structural budget shortfalls. This practice depletes cash resources in the absence of an economic downturn leaving minimal reserves in excess of 5.0% in the fund when they are most needed.