State Spending: Fiscal 2004 to 2013



Department of Legislative Services 2016

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Department of Legislative Services
Office of the Executive Director
Maryland General Assembly

Warren G. Deschenaux
Executive Director

July 2016

The Honorable Thomas V. Mike Miller, Jr., President of the Senate
The Honorable Michael E. Busch, Speaker of the House of Delegates
Members, Maryland General Assembly

Ladies and Gentlemen:

The Senate Budget and Taxation Committee requested that the Department of Legislative Services (DLS) examine spending changes of the last decade. In response, DLS has prepared this report, which examines spending changes from fiscal 2004 to 2013. The report provides a review of economic conditions that shaped State budgets. The report examines total per capita spending trends in conjunction with key indicators such as inflation. Key areas, including education aid, Medicaid, and personnel, are examined. The report also compares spending in major categories and examines trends. The report is accompanied by a technical supplement that reviews agency spending trends.

Patrick S. Frank, Scott P. Gates, Matthew B. Jackson, and Laura M. Vykol wrote the report, which was reviewed by Patrick Frank. Maureen R. Merzlak prepared the manuscript. Your questions and comments are welcomed.

Sincerely,

Warren G. Deschenaux
Executive Director

WGD/PSF/mrm

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Chapter 1. Economy

The State Constitution requires that the Administration's annual budget be balanced. This means that total revenues supporting spending are at least equal to spending. Before preparing a budget, revenues are estimated. In Maryland, the Board of Revenue Estimates estimates general fund revenues. To prepare this estimate, the board first examines the State economy. The revenue estimate is a reflection of the State's economy. Revenue estimates are prepared throughout the budget cycle, first in September (nine months before the new fiscal year), again in December (to be used by the Administration when preparing the budget), and finally in March (shortly before the legislature enacts the budget).

Two Recessions

The National Bureau of Economic Research (NBER) is a nonprofit organization that conducts research and disseminates research findings among academics, public policymakers, and business professionals. The organization also examines business cycles and identifies recessions. NBER has defined a recession as a "significant decline in activity spread across the economy, lasting more than a few months, visible in industrial production, employment, real income, and wholesale-retail trade." The recession begins in the month that economic activity peaks and ends in the month that economic activity reaches the trough. Recessions are a national period of diminishing economic activity. NBER uses a number of monthly indicators to determine when recessions begin and end. These include indicators that measure industrial production, sales volume, employment, and income.

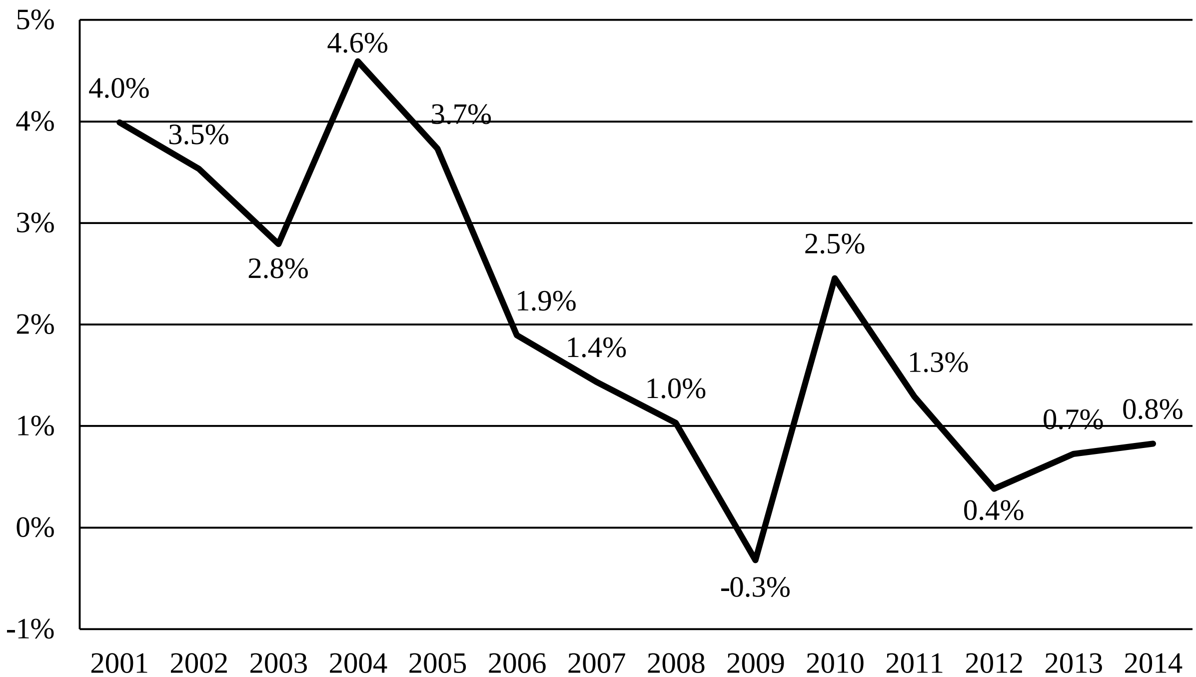
Since calendar 2000, the State has experienced two recessions. The first began in March 2001 and ended in November 2001. The 2001 recession was neither particularly long nor deep. For Maryland, the effects of the recession tended to be delayed, as revenues did not decline until fiscal 2002 and 2003. Although the recession was shallow, it was precipitated by a stock market crash, and the subsequent drop in capital gains income contributed to the decline in personal income tax revenues in fiscal 2002 and 2003.

The second recession, referred to as the Great Recession, began in December 2007 and ended in June 2009. The Great Recession lasted for 18 months. It was the longest and deepest recession since World War II. The recovery after the Great Recession was also less robust than the recovery after the 2001 recession. There were also substantial stock market declines during calendar 2008 and 2009, which resulted in large drops in capital gains income that exacerbated declines in personal income.

One Mild and One Severe Recession

Exhibit 1.1 shows annual changes in gross State product (GSP). The exhibit shows that GSP slowed in fiscal 2002 and 2003 after the 2001 recession. The Great Recession was also more severe, with GSP declining in fiscal 2009. Also, the recovery after the 2001 recession was more robust than the recovery after the Great Recession.

Exhibit 1.1
Gross State Product
Year-over-year Percent Change
Fiscal 2001-2014

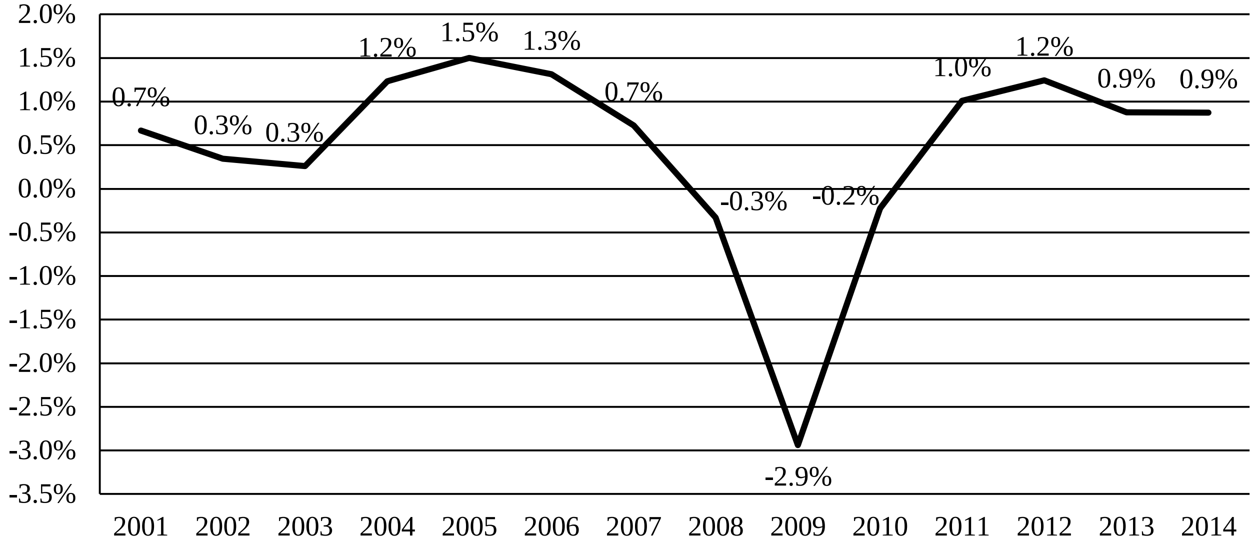


Note: Gross State product is adjusted for inflation.

Source: Bureau of Economic Analysis, U.S. Department of Commerce

Exhibit 1.2 shows that in calendar 2002 and 2003, employment growth slowed to only 0.3%. Once again, Maryland experienced the most significant slowdown after the 2001 recession. Similarly to GSP, the Great Recession was more severe than the 2001 recession. Employment actually declined in calendar 2008, 2009, and 2010.

Exhibit 1.2
Maryland Employment
Year-over-year Percent Change
Calendar 2001-2014



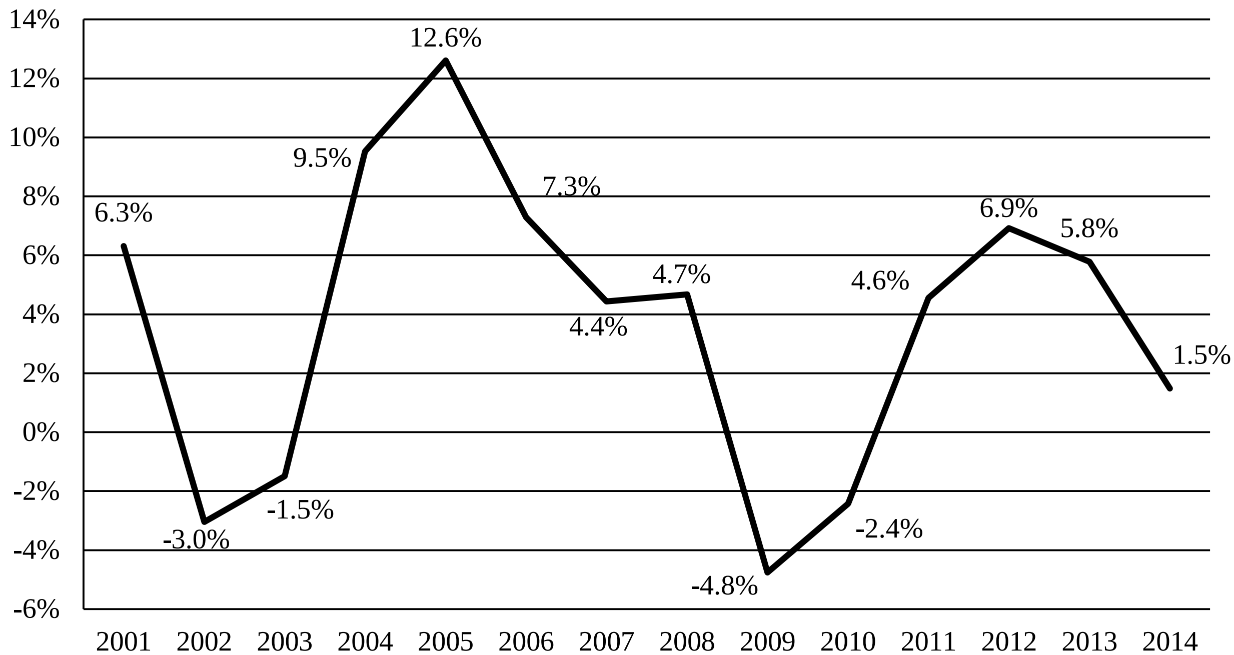
Source: Bureau of Labor Statistics, U.S. Department of Labor

The labor market's recovery after the 2001 recession was not particularly robust. Employment in the 2001 recession dropped 0.7% peak-to-trough over 9 months (almost 17,000 jobs). Despite the relatively small decline, it took until May 2003 (28 months) to match the peak level of employment when the recession began.

In the Great Recession, Maryland employment fell 5.7% (almost 149,000 jobs) peak-to-trough over 24 months (February 2008 to February 2010). This exaggerates the situation, however, because February 2010 included two large snowstorms, and there was a sharp drop in employment. If March 2010 is the trough, then the peak-to-trough decline was 4.4% (115,000 jobs). The recovery was very slow, and it took until May 2014 to reach the level of employment the State had in February 2008 (75 months).

As GSP slowed and employment declined, State general fund revenue shrank. **Exhibit 1.3** shows that after the milder 2001 recession, general fund revenue declined by 3.0% in fiscal 2002 and 1.5% in fiscal 2003. There was robust growth in fiscal 2004 and 2005. Once again, the declines during the Great Recession were substantial, as revenues declined by 4.8% in fiscal 2009 and 2.4% in fiscal 2010. Growth after the Great Recession was also more subdued.

Exhibit 1.3
General Fund Revenues
Year-over-year Percent Change
Fiscal 2001-2014



Source: Maryland State Comptroller's Office

These annual general fund revenue changes are not adjusted to reflect changes in tax rates or the tax base. Though there are a number of incidental changes in most years that do not have a noticeable effect on aggregate revenues, some years do have substantial law changes. Most significantly, the decline in fiscal 2009 and 2010 revenues would have been more severe without increasing the sales and income tax[1] rates during a special session in 2007. At the time, the sales tax rate increased from 5 cents to 6 cents, which added about $400 million to fiscal 2009 revenues. The State also increased corporate income and tobacco taxes, which added approximately $80 million and $150 million, respectively. Without these revenues, the decline in fiscal 2009 could have been as much as 9%.

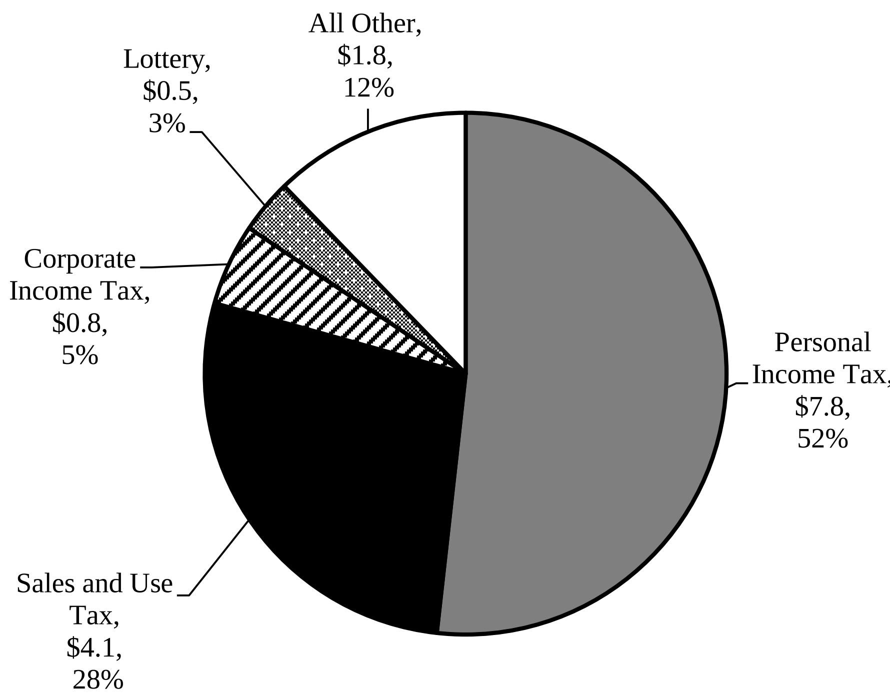
There were also increases to the personal income tax in the 2012 first special session. Tax rates for single taxpayers earning over $100,000 and joint taxpayers earning over $150,000 per

[1] Because of an increase in personal exemptions, most taxpayers actually paid less in income taxes after the 2007 tax increase.

year increased. The maximum rate increased from 5.5% to 5.75%. This was expected to increase revenues almost $200 million annually.

Key general fund revenues are income taxes and sales taxes. **Exhibit 1.4** shows that personal income taxes were 52% of general fund revenues, and sales taxes were 28% of general fund revenues in fiscal 2014. The remaining revenues, such as corporate income, lottery, and business franchise taxes, account for less than a quarter of general fund revenues.

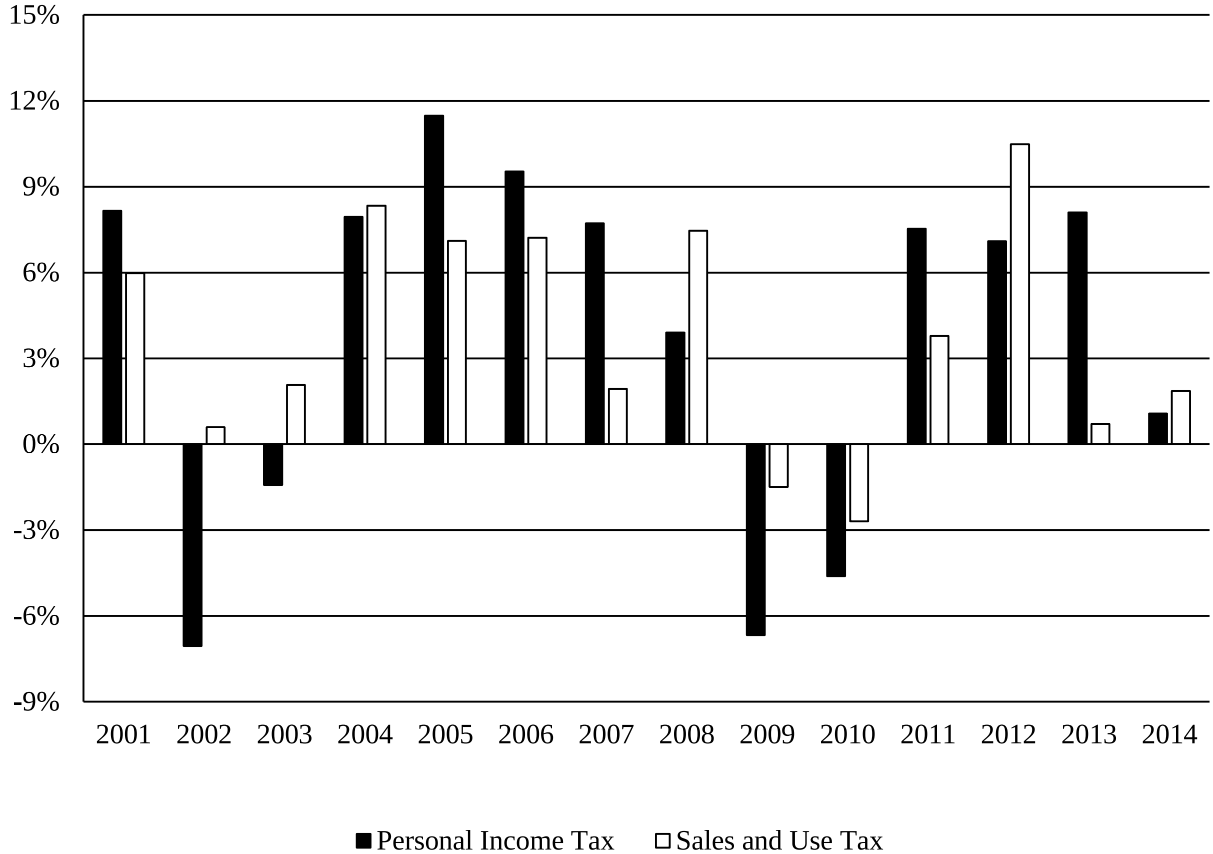
Exhibit 1.4
Fiscal 2014 General Fund Revenues
($ in Billions)



Source: Maryland State Comptroller's Office

Personal income taxes tend to be more volatile than sales taxes, so the recessions affected income taxes more than sales taxes. **Exhibit 1.5** shows that income taxes declined at much as 7% in fiscal 2003, while sales taxes increased by under 1%. In fiscal 2005, when the State realized the largest increase in general fund revenues, income taxes increased by 11%, while sales taxes increased by 7%. During the Great Recession, there were substantial declines in both income and sales taxes, but the income tax did decline more.

Exhibit 1.5
Personal Income and Sales Tax Revenues
Year-over-year Percent Change
Fiscal 2001-2014



Source: Maryland State Comptroller's Office

After the 2001 recession, general fund revenue peaked at $13.5 billion in fiscal 2008 and then declined to $12.6 billion in fiscal 2010, a 7.3% total decline. Revenues did not reach fiscal 2008 levels again until fiscal 2012, four years later. After the 2001 recession, revenue peaked at $9.8 billion in fiscal 2001 and declined to $9.3 billion in fiscal 2003, a 5.0% total decline. By fiscal 2004, revenues exceeded the prerecession peak. Not only was the Great Recession deeper, the recovery was also slower.

Chapter 2. Overview of State Budget Actions

During the 10-year period from fiscal 2004 through 2013, the State grappled with two significant budget challenges. The period began with the State struggling to complete implementation of the Bridge to Excellence in Education Act, while simultaneously dealing with the after effects of the 2001 recession. The Bridge to Excellence in Education enacted in 2002 incrementally increased aid to education over the 5-year period from fiscal 2004 through 2008. State spending on education aid grew by about $2 billion from fiscal 2003 through 2008 due primarily to the Act and escalating teacher retirement costs. This rapid spending growth contributed to periodic structural budget gaps during fiscal 2004 through 2007 and was not sustainable in the long term without adjustments to ongoing revenues and/or reduced spending for other programs.

The State initially managed the structural budget gap through a combination of fund transfers, temporary spending reductions, and modest revenue enhancements. In fall 2007, with an ongoing structural gap forecast at more than $1 billion, Governor Martin J. O'Malley called a special session, and the General Assembly enacted a package of cost containment actions, revenue enhancements, and new spending designed to eliminate the State's structural deficit.

The most notable actions from the special session were significant changes to the State's revenue structure including:

- authorizing video lottery gaming at five locations in the State contingent on the voters approving a constitutional amendment. The public ultimately approved the constitutional amendment in November 2008. Much of the revenue generated was earmarked for K-12 education;

- raising the sales tax from 5.0% to 6.0% and the corporate income tax from 7.0% to 8.25%;

- increasing the State tobacco tax by $1; and

- making the income tax more progressive.

The special session actions were expected to increase State revenues by $541 million in fiscal 2008, $1.4 billion in fiscal 2009, $1.5 billion in fiscal 2010 and 2011, and more than $1.9 billion in fiscal 2012. More than $400 million of additional annual revenue was dedicated to the Transportation Trust Fund (TTF) beginning in fiscal 2009. Legislative actions also created modest dedicated revenue streams for higher education and programs to improve the health of the Chesapeake Bay.

Adjustments to spending included cost containment measures designed to reduce State spending by about $483 million in fiscal 2009 and new spending to expand Medicaid benefits to low-income adults with incomes below 116% of the federal poverty level. Cost saving actions included temporarily freezing inflationary increases for education aid, deferring scheduled enhancements to formula funding for various programs (including community colleges, private higher education institutions, and libraries) and eliminating a $30 million Electric Utility Generating Property Tax Grant for local governments.

The resolution of the structural deficit was short lived as the onset of the recession in fiscal 2008 produced structural deficits in excess of $1 billion beginning in fiscal 2009 and precipitated an ongoing budget crisis that extended from fiscal 2008 through 2013. The State responded to this challenge by maintaining spending on top priorities including education and health care for the indigent and developmentally disabled, further adjusting revenues, scaling back spending on selected programs, deferring planned spending increases for a variety of programs, and temporarily redirecting dedicated revenues.

This decade of fiscal stress forced the State to reexamine spending priorities, permanently expand its revenue sources, increase a number of existing taxes, and temporarily repurpose existing dedicated revenue streams to the general fund. The State's efforts to achieve financial stability without deep cuts to high priority programs were aided at various times in the period by temporary increases in federal aid for health care and education programs. Notable changes in priorities are summarized below. A detailed analysis of expenditure trends is provided in the chapters that follow.

Tax Rates Raised and New Revenue Sources Identified

As noted above, significant revenue changes were adopted at the 2007 special session, most notably, the authorization for electronic gaming at selected locations in the State and the increase in the sales tax rate. Legalized gaming was authorized to expand further in 2012 to encompass table games, more video lottery machines, and a sixth geographic location. By fiscal 2013, gross annual revenues from legalized gambling exceeded $600 million with almost $300 million dedicated to K-12 education aid.

Other ongoing dedicated revenue sources tapped by the State in subsequent years included:

- an assessment on hospitals that was gradually expanded until it generated about $390 million per year in special fund revenues dedicated to the Medicaid program;

- a nursing home quality assessment that generated more than $130 million of special fund revenue for the Medicaid program in fiscal 2013; and

- a phased-in sales tax on motor vehicle fuel sales with the revenue dedicated to the TTF. While this change was enacted at the 2012 legislative session, new revenues were not realized until fiscal 2014.

These new special fund revenue sources produced about $820 million of revenue in fiscal 2013 to support ongoing Medicaid and K-12 education expenses. When fully phased in, the sales tax on motor vehicle fuel will generate more than $300 million for the TTF.

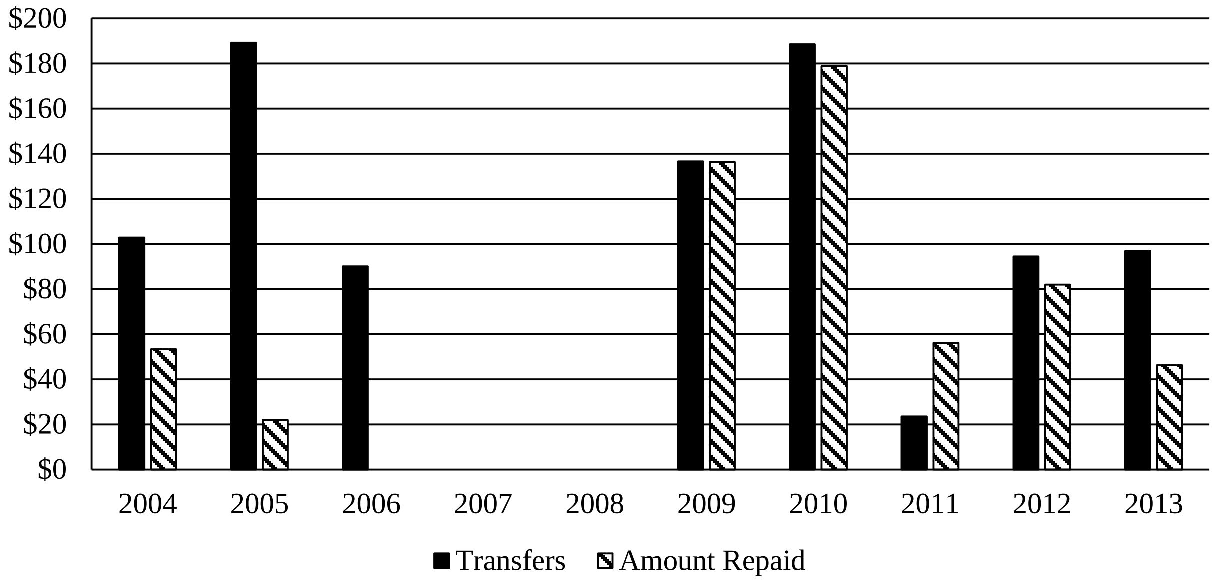
New dedicated revenue streams were supplemented by increases in various existing taxes. Over the 10-year period, sales, corporate income, personal income, tobacco tax, and motor fuel taxes were all increased to support ongoing State spending.

Temporary Repurposing of Dedicated Revenues

While significant structural changes to the State's revenues and spending were adopted from fiscal 2004 to 2013, the State also relied heavily on one-time transfers of special fund balances to the General Fund and temporary redirections of dedicated revenues to the General Fund. Transfer tax revenues, which are normally dedicated to land preservation and open space activities, were a frequent source of redirection with a total of $922 million redirected over the 10 years. A significant portion of the money redirected over the 10 years (almost $500 million) was replaced within the period by general obligation (GO) bonds. The bond replacement was made possible in part by an increase in debt authorizations. The net impact of the transfers and bond replacement was a reduction to the planned funding for land preservation and open space programs. **Exhibit 2.1** shows that in every year except fiscal 2007 and 2008, transfer tax revenues were moved into the General Fund. Additional bond authorizations were authorized after fiscal 2013 to reimburse funds transferred from fiscal 2009 to 2013.

Other notable revenue diversions over the period include $155 million from the TTF, $517 million diverted from local highway user revenues (HUR), and $917 million from the Local Income Tax Reserve Account. The transportation revenue diversions had a significant impact on local transportation aid as discussed further in this chapter.

Exhibit 2.1
Transfer Tax Revenues Diverted to the General Fund
Fiscal 2004-2013
($ in Millions)



Source: Department of Budget and Management and Department of Legislative Services

Increased Capital Spending and Debt Service Costs

The General Assembly authorizes GO bonds to support the State's capital program. The capital program supports construction projects – such as prisons – and also provides grants, the most substantial of which are the local school construction grants. Between fiscal 2004 and 2013, the program expanded. Prior to fiscal 2001, State policy was to increase authorizations by $15 million each year. This policy was changed in fiscal 2002 when the State increased the planned authorization from $460 million to $490 million. Specific increased authorizations between fiscal 2004 and 2013 are:

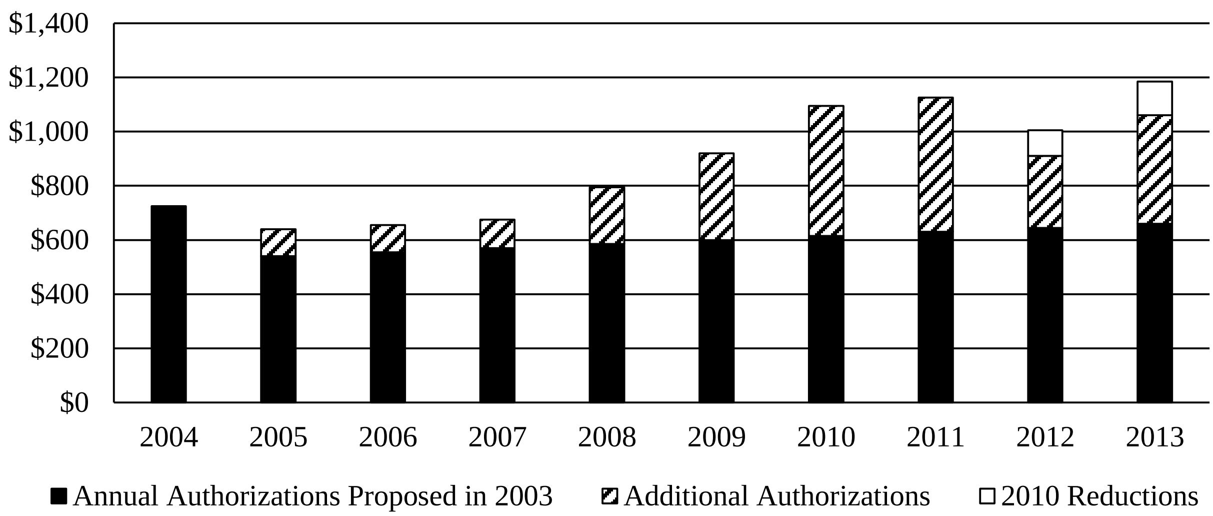
- adding $100 million a year for five years beginning in fiscal 2005;
- changing the annual increase from $15 million per year to 3% per year beginning in fiscal 2007;
- permanently increasing authorizations by $100 million per year in fiscal 2008;

- permanently increasing authorizations by $100 million per year after fiscal 2009[1], and

- providing for a one-time $150 million supplemental authorization in fiscal 2010 and 2012.

As with the operating budget, capital spending was also affected by the Great Recession. In December 2009, debt ratios exceed the limits set by the Capital Debt Affordability Committee (CDAC). The committee limits debt outstanding to 4% of personal income and debt service to 8% of revenues supporting debt service. In December 2009, the Board of Revenue Estimates reduced general fund revenue projections. As a result, debt service exceeded 8% of revenues. To reduce debt service, CDAC reduced GO bond authorizations by $810 million. This was done by increasing fiscal 2011 authorizations by $150 million and reducing fiscal 2012 by $95 million, fiscal 2013 by $125 million, and fiscal 2014 to 2017 by $740 million. **Exhibit 2.2** shows GO bond authorizations from fiscal 2004 to 2013.

Exhibit 2.2
General Obligation Bond Authorizations
Fiscal 2004-2013



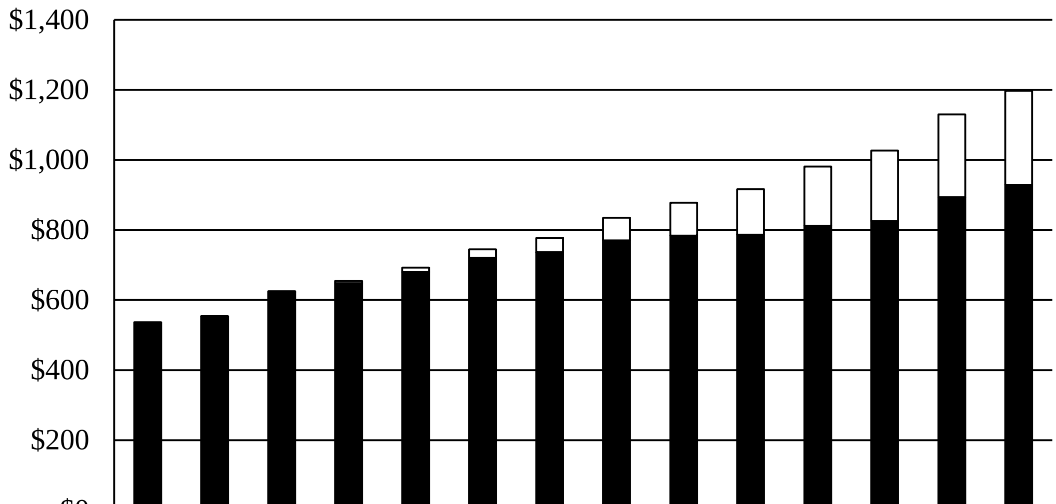
Note: In December 2009, the Capital Debt Affordability Committee reduced fiscal 2012 authorizations by $95 million and fiscal 2013 authorizations by $125 million, resulting in authorizations totaling $910 million and $1,060 million, respectively.

Source: Department of Legislative Services

[1] Though this did not have an effect on spending until fiscal 2010, this was adopted by CDAC in fiscal 2005 to avoid a decline in spending after fiscal 2009.

Increased authorizations led to increasing debt service costs. Initially, debt service cost increases were moderate. This is because the State generally only issues approximately 30% of debt within a year after it is authorized and because the State does not begin to make principal payments until the third year. The delay in authorizations is because capital projects take years to complete, so all the funds are not needed in the first year. The State issues debt on a cash-flow basis, so most of the debt is issued more than a year after it is authorized. **Exhibit 2.3** shows that, even in fiscal 2013, the effect of authorizing an additional $2.5 billion is $129 million.

Exhibit 2.3
General Obligation Bond Debt Service Costs
Fiscal 2004-2017



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
□ Additional Costs	$0	$1	$3	$6	$13	$24	$41	$65	$94	$129	$168	$201	$236	$268
■ Projected Costs	537	553	622	648	679	721	737	770	784	787	812	826	893	929

Source: Department of Legislative Services

Spending Priorities

As discussed Chapter 4 and the technical supplement, the State constrained spending growth in many areas, and in some cases, deeply reduced spending on targeted programs. At the same time, funding for certain priorities continued to grow. Spending from all revenue sources grew at an average annual rate of 8.4% from fiscal 2004 to 2007 but slowed to 3.4% from fiscal 2007 to 2013. State general fund spending was especially constrained in the later period growing 0.7% from fiscal 2007 to 2013 after growing more than 11.0% annually from fiscal 2004 to 2007.

Some Programs Received Less Funding than in Prior Years

Actual reductions in year-over-year funding impacted a number of programs and activities, particularly noneducation aid to local governments. Programs and activities experiencing real declines in funding during at least part of the 10-year period include:

- **Transportation Aid for Local Governments:** Allocations of HURs to local governments rose from fiscal 2004 to 2007 peaking at $562.0 million in fiscal 2007. The impact of the recession and the State's decision to divert HURs to the General Fund led to a steep decline in subsequent years with annual allocations to local governments falling below $200.0 million in fiscal 2010 through 2013.

- **Local Health Grants:** Direct grants to local health departments fell from $60.4 million in fiscal 2004 to $37.3 million in fiscal 2010 and remained at $37.3 million through fiscal 2013.

- **State Aid for Police Protection:** Like local health grants, the aid dropped precipitously in fiscal 2010 falling from $66.0 million to $45.0 million and remained at this level through fiscal 2013.

- **Electric Utility Generating Property Tax Grant:** Funding for these grants to counties was eliminated beginning in fiscal 2009.

- **State Employment:** Excluding higher education institutions, the number of authorized full-time equivalent State positions declined from 57,000 in fiscal 2004 to 54,500 in fiscal 2013. The closure of a handful of State facilities including the Brandenburg (Allegany County) and Rosewood (Baltimore County) facilities for the developmentally disabled contributed to the downsizing of the workforce.

- **Employee Salaries:** While State employee salaries grew modestly over the 10 years, reductions in compensation occurred in fiscal 2010 and 2011 when employees were furloughed for 3 to 10 days. Furloughs actually began in fiscal 2009, but their impact was offset in that year by increments and a general salary increase.

- **Land Preservation Funding:** Operating budget spending on land preservation declined over the period at an average annual rate of 5.3%. The precipitous decline from fiscal 2004 to 2013 reflects the combination of a weaker real estate market, which reduced the transfer tax revenues available for land preservation, and the diversion of a portion of transfer tax revenues to the General Fund. More than half of the $922 million diverted to the General Fund was replaced with bonds.

- **Cigarette Restitution Fund (CRF) Spending for Cancer Treatment and Tobacco Prevention:** The amount of CRF revenues supporting cancer treatment and tobacco prevention programs declined from $44.6 million fiscal 2004 to $26.0 million in fiscal 2013. This averages to a decline of 5.8% per year.

Planned Increases for Other Programs Were Canceled or Deferred

Many other programs avoided deep cuts but were level funded or saw statutorily scheduled enhancements to their funding formulas deferred or rescinded:

- **K-12 Education Aid:** Legislation enacted during the 2009 session limited per pupil increases to 1%. However, these increases were unaffordable, and the legislature froze the per pupil foundaton each year from fiscal 2009 to 2012. For five years, from fiscal 2008 to 2012, the per pupil amount remained constant.

- **Community Colleges and Private Colleges:** Statutorily scheduled enhancements to community colleges and private colleges were stretched out over multi-year periods – extending the phase-in of the formula enhancements by two years from fiscal 2021 to 2023 – resulting in more modest growth over the period than was planned.

- **Disparity Grant:** Funding available through the Disparity Grant program was capped beginning in fiscal 2010.

Rapidly Growing Programs Were Restructured

- **Teachers Retirement:** Primarily due to the large investment losses suffered during the Great Recession, teachers' retirement costs grew from $566 million in fiscal 2008 to $850 million in fiscal 2011, which is 14% annual growth. Costs were expected to continue increasing at a high level in the out-years. Legislation enacted at the 2012 session required local school boards to pay a portion of the costs.

- **Pension Changes:** State pension benefits were enhanced in fiscal 2006 to better align the benefits with those provided in neighboring states. Investment losses during the Great Recession left the pension system severely underfunded – assets were adequate to cover only 64% of liabilities in fiscal 2010. Comprehensive changes to the State pension benefits were launched at the 2011 session to address (1) the long-term sustainability of the State's defined benefit pension plans and (2) the affordability of the State's contributions to those plans. The changes increased employee contributions, reduced the benefits earned by future hires, capped the annual cost-of-living adjustments provided to future retirees, and modified vesting rules. The reform legislation generated $120 million of budgetary savings for the State in fiscal 2012 and 2013.

Funding for Priority Programs Was Preserved or Expanded

While almost all programs experienced some fiscal constraint during this period, the State maintained certain priorities:

- **Developmentally Disabled:** Spending on services for the developmentally disabled climbed at an average annual rate of 5.4% from fiscal 2004 through 2013.

- **Medicaid:** Total spending on Medicaid rose from $3.8 billion in fiscal 2004 to $6.8 million in fiscal 2013. The growth reflects the rollout of the Medicaid expansion to adults in fiscal 2009, a recession driven enrollment surge, and medical inflation. Medicaid enrollment rose from 600,000 in fiscal 2004 to more than 1,000,000 in fiscal 2013. Reimbursement rates for many providers were temporarily reduced or frozen during this period, but significant service or rate cuts were largely avoided. The availability of almost $2.0 billion of enhanced Medicaid funding through the American Recovery and Reinvestment Act of 2009 (ARRA) helped mitigate program cuts.

- **K-12 Education:** The Bridge to Excellence in Education Act was implemented on schedule resulting in K-12 education aid growing by more than $2.0 billion from fiscal 2003 through 2008. The stress of the Great Recession led the State to cap the per pupil foundation amount from fiscal 2009 through 2013 resulting in modest growth in that period. The ability to sustain and even grow the Bridge to Excellence initiative during the Great Recession reflects State decisions about funding priorities and the availability of federal funds. Maryland received $719.7 million of federal ARRA funding over fiscal 2010 and 2011 to support K-12 education and an additional $124.0 million of federal Education Jobs Fund program dollars in fiscal 2011 for the same purpose.

- **Higher Education:** State funding for higher education institutions (excluding tuition and other revenues generated by the schools) grew by 4.2% during the period. Much of the growth reflected efforts to constrain tuition increases by augmenting State support for the University System of Maryland and Morgan State University.

- **Cover Crops:** The Resource Conservation Grants program provides cost-share grants to farmers that install best management practices to control soil erosion and runoff. Examples of best practices include planting cover crops in the fall. Spending increased from $3.0 million in fiscal 2004 to $25.1 million in fiscal 2013.

- **Weatherization, Regional Greenhouse Gas Initiative (RGGI), Energy Assistance, and Housing Assistance:** Funding the State's Weatherization Assistance Program, which supports energy efficiency improvements in the homes of low-income Marylanders, increased from $5.8 million in fiscal 2004 to $28.5 million in fiscal 2013. The program is now supported with special funds through RGGI, which receives proceeds from the sale of carbon dioxide emissions allowance credits. Funding for the Low-Income Home Energy

Assistance Program increased from $31.5 million in fiscal 2004 to $71.4 million in fiscal 2013, a 9.3% annual growth rate. Funding peaked at $110.2 million in fiscal 2009. With respect to housing, declining general funds were offset by increasing special funds so that Department of Housing and Community Development spending increased at an average annual rate of 5.0%.

As noted above, the State's ability to maintain its commitment to the Medicaid expansion and sustain the Bridge to Excellence in Education without making steep cuts to other programs was facilitated by the availability of temporary federal funding. Through the ARRA and the Education Jobs Fund program, the State received about $2.8 billion for K-12 education and Medicaid between fiscal 2009 and 2012. Another $160 million of the ARRA was utilized to preserve public safety and social service priorities in fiscal 2010 and 2011, while $531 million funded new investments in transportation infrastructure and services.

Chapter 3. Summary of Spending Trends

This chapter relates State spending from fiscal 2004 to 2013 to population and inflation. In addition, the chapter compares the budget shares by major categories of spending in fiscal 2004 and 2013. General funds include American Recovery and Reinvestment Act of 2009 (ARRA) spending as well as Education Trust Fund (ETF) spending, while appropriations to the Reserve Fund are excluded. ARRA funds were also used to supplant general funds for public schools, Medicaid, and other programs.

Similarly, the State authorized video lottery terminals and deposited a portion of the revenues in the ETF. These funds support public school grants, which are traditionally supported by general funds. Had the ETF not been created, the funds would be deposited into the General Fund.

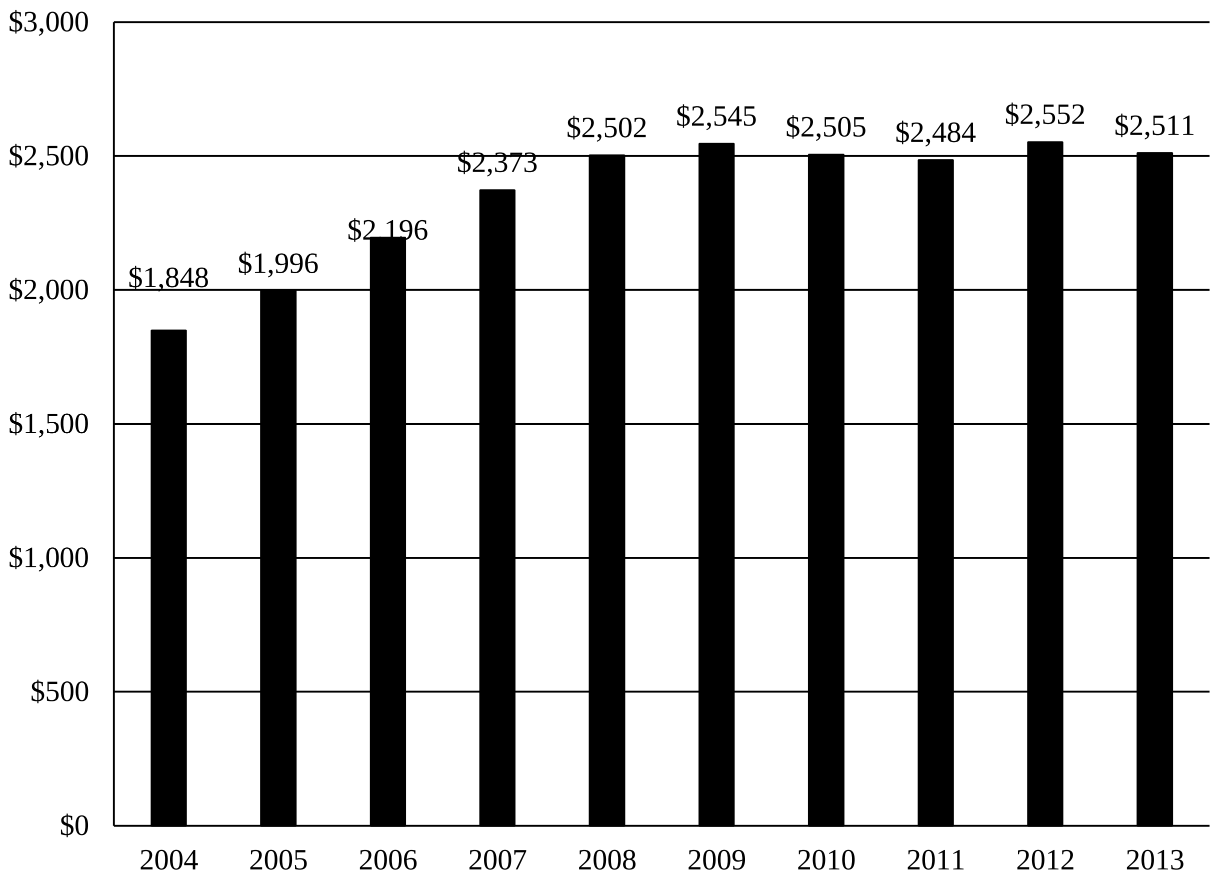
Finally, appropriations into the State Reserve Fund are not included in the general fund totals. The most significant account is the Revenue Stabilization Account, which is referred to as the Rainy Day Fund. These appropriations are not spending, instead they are appropriated to be spent at a later time. Rainy Day Funds are used by transferring a share of them into the General Fund and then appropriating the funds in the State budget. At that time, these funds are included in State general fund spending.

The most significant event during the fiscal 2004 to 2013 period is the Great Recession, primarily due to the impact on State revenues. The Great Recession led to a period of constrained spending growth. State spending increased at a much greater rate from fiscal 2004 to 2007 than it does after fiscal 2008. When adjusting general fund spending for inflation, the general fund spending actually declines after fiscal 2009.

Per Capita Spending Growth

Since fiscal 2004, State general fund spending per person increased, as shown in **Exhibit 3.1,** from $1,848 in fiscal 2004 to $2,511 in fiscal 2013. As expected, spending per person increased sharply from fiscal 2004 to 2007 when it first exceeded $2,500 per person. There are also some years of decline in fiscal 2010 and 2011.

Exhibit 3.1
General Fund Spending Per Resident
Fiscal 2004-2013

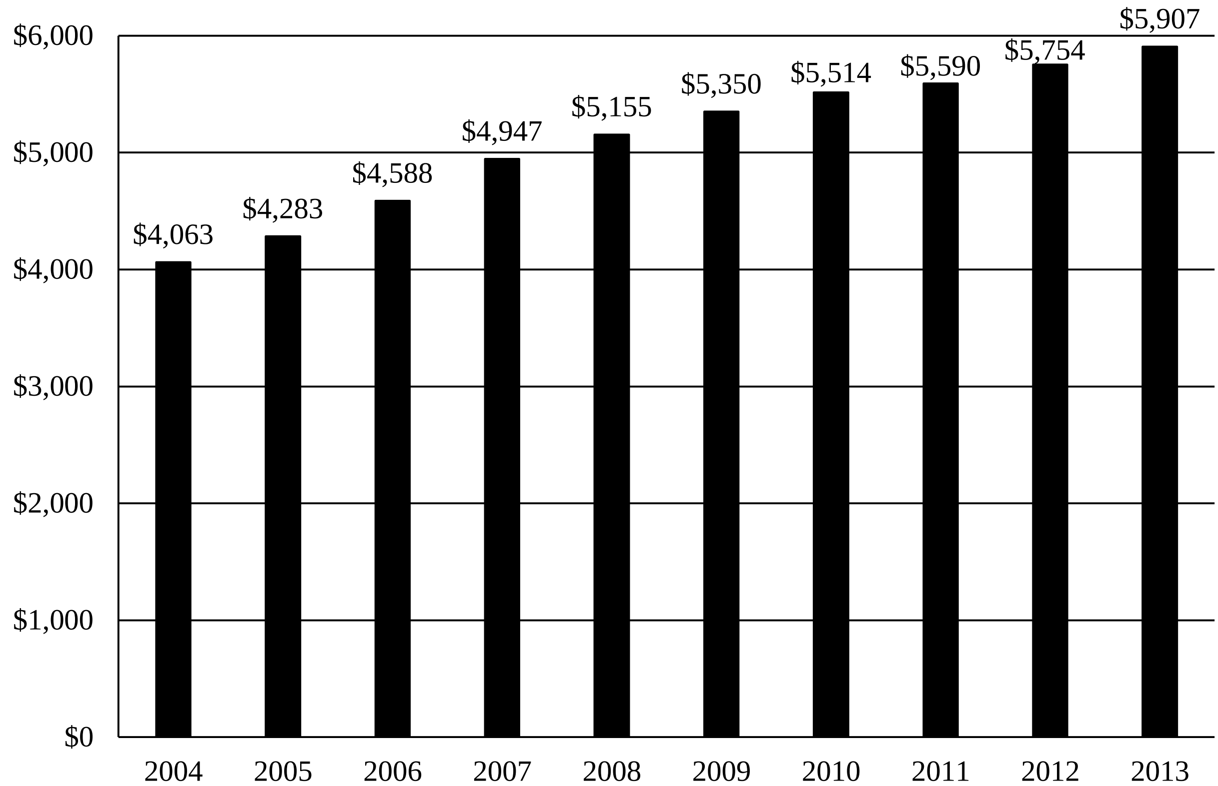


Note: General fund spending includes federal American Recovery and Reinvestment Act of 2009 grants that supplanted general funds and Education Trust Fund appropriations. Spending also excludes appropriations to the State Reserve Fund.

Source: Department of Budget and Management; Department of Legislative Services; U.S. Census Bureau

Unlike general fund spending per resident, total spending per resident increases every year. **Exhibit 3.2** shows that it increases from $4,063 in fiscal 2004 to $5,907 in fiscal 2013.

Exhibit 3.2
Total Spending Per Resident
Fiscal 2004-2013

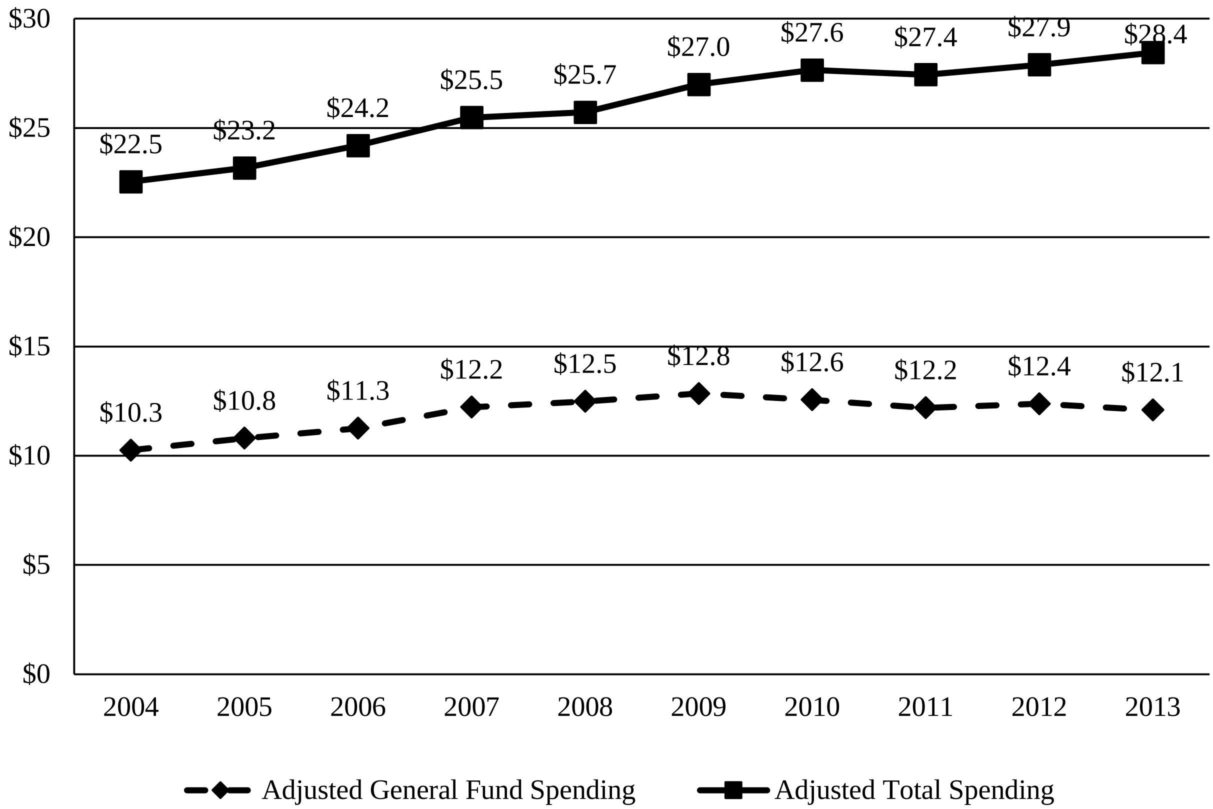


Source: Department of Budget and Management; Department of Legislative Services; U.S. Census Bureau

Comparing Spending Increases to Inflation

Adjusting for inflation shows a decline in real general fund spending that began in fiscal 2010. **Exhibit 3.3** shows that total fund spending tends to increase after adjusting for inflation.

Exhibit 3.3
Spending Adjusted for Inflation
Fiscal 2004-2013
($ in Billions)



Note: General fund spending includes federal American Recovery and Reinvestment Act of 2009 grants that supplanted general funds and Education Trust Fund appropriations. Spending also excludes appropriations to the State Reserve Fund. Adjusted by Consumer Price Index in 2004 dollars. Total funds exclude appropriations to the State Reserve Fund and reimbursable funds.

Source: Bureau of Labor Statistics, U.S. Department of Labor; Department of Budget and Management; Department of Legislative Services

Changes in Spending by Major Spending Categories

As outlined in Chapter 2, there were a number of actions taken to address the budget challenges confronting the State from fiscal 2004 to 2013. These actions, in conjunction with the funding of priorities such as the Bridge to Excellence in Education Act, results in different rates of spending growth across major categories of State spending. For comparing spending in fiscal 2014 to spending in fiscal 2003, the spending is grouped into four categories:

- local aid, such as grants to local boards of education, health departments, community colleges, libraries, and county and municipal governments;
- entitlements, which include Medicaid, foster care, and other assistance payments;
- State agencies; and
- remaining costs such as debt service, pay-as-you-go (PAYGO) capital, and the State Reserve Fund.

Since fiscal 2004, State general fund spending has increased in all categories. **Exhibit 3.4** shows that the largest increase was realized in local aid, as annual spending increased by $2.3 billion, or 5.5%, per year. Local aid spending in fiscal 2013 exceeded State agency spending by $82 million. Over the period, State agency spending increased by $1.6 billion, or 3.4%, per year.

Exhibit 3.4
General Fund Spending Category
Fiscal 2004 and 2013
($ in Millions)

	2004	2013	Total Increase	Total Percent Change	Annual Percent Change
Local Aid	$3,807	$6,154	$2,346	61.6%	5.5%
Entitlements	1,937	2,682	745	38.4%	3.7%
State Agencies	4,507	6,072	1,565	34.7%	3.4%
Debt Service, Capital, Reserve Fund	11	41	30	275.6%	15.8%
Total	**$10,261**	**$14,948**	**$4,687**	**45.7%**	**4.3%**
General Fund Revenues	**$10,255**	**$14,885**	**$4,630**	**45.2%**	**4.2%**

Source: Department of Budget and Management; Department of Legislative Services

In fiscal 2004, State agency spending was the largest share of general fund spending. **Exhibit 3.5** shows that local aid spending increased to over 41% of spending and was the largest share of spending in fiscal 2013.

Exhibit 3.5
General Fund Spending by Category
Fiscal 2004 and 2013

	2004 Share	2013 Share	Change
Local Aid	37.1%	41.2%	4.1%
Entitlements	18.9%	17.9%	-0.9%
State Agencies	43.9%	40.6%	-3.3%
Debt Service, Capital, Reserve Fund	0.1%	0.3%	0.2%
Total	**100.0%**	**100.0%**	**0.0%**

Source: Department of Budget and Management; Department of Legislative Services

As discussed previously in this report, most of the spending growth occurred prior to fiscal 2009. **Exhibit 3.6** shows that local aid increased at a rate of 11% per year from fiscal 2004 to 2008, compared to 1% growth from fiscal 2008 to 2013.

Exhibit 3.6
General Fund Spending Changes by Category
Before and After Fiscal 2008

	Total Change 2004-2008	Annual Percent Change 2004-2008	Total Change 2008-2013	Annual Percent Change 2008-2013
Local Aid	$1,966	11.0%	$380	1.3%
Entitlements	614	7.1%	131	1.0%
State Agencies	1,323	6.6%	242	0.8%
Debt Service, Capital, Reserve Fund	323	135.3%	-293	-34.3%
Total	**$4,227**	**9.0%**	**$460**	**0.6%**

Source: Department of Budget and Management; Department of Legislative Services

In response to constrained general funds, the State did increase fees to support priorities. **Exhibit 3.7** shows that total State spending (general, special, and current unrestricted funds) increased at a higher rate than general fund spending. This is especially pronounced in entitlement programs where new special fund fees, such as hospital assessments supporting Medicaid, provided additional State funding.

Exhibit 3.7
State Fund Spending Category
Fiscal 2004 and 2013
($ in Millions)

	2004	2013	Total Increase	Total Percent Change	Annual Percent Change
Local Aid	$4,222	$6,623	$2,401	56.9%	5.1%
Entitlements	2,082	3,693	1,611	77.4%	6.6%
State Agencies	8,034	12,007	3,973	49.4%	4.6%
Debt Service, Capital, Reserve Fund	672	1,078	406	60.5%	5.4%
Total	**$15,010**	**$23,401**	**$8,391**	**55.9%**	**5.1%**

Source: Department of Budget and Management; Department of Legislative Services

Overview of Total State Spending Changes

Total State spending trends differ from general fund spending trends. Unlike general fund spending, total State agency spending is substantially higher than local aid and entitlement spending. This is because there are a number of large State agencies that rely on significant non-general fund revenues. Higher education institutions are also supported by tuition revenues, research grants and other non-general fund revenues. The Maryland Department of Transportation (MDOT) is supported by the Transportation Trust Fund (TTF) and federal funds. The Department of Health and Mental Hygiene and the Department of Human Resources also receive substantial amounts of federal funds. Total capital appropriations are also many times greater than general fund capital appropriations. The MDOT capital program is funded by the TTF and federal funds, and the Department of Housing and Community Development has programs supported by special funds. Environmental agencies also receive special funds for capital programs.

Exhibit 3.8 shows that entitlements realized the largest percent increase, which was 7.2% per year. Much of the entitlement growth is attributable to receiving additional special and federal funds for Medicaid. In addition, the Supplemental Nutrition Assistance Program, whose benefit is entirely supported by federal funds, increased by 19.0% per year to almost $1.2 billion. State agency general fund spending increased more moderately (3.4% annually) than total State agency spending (4.4% annually), reflecting the State's efforts to constrain general fund spending after the Great Recession.

Exhibit 3.8
Total Change in Spending by Category
Fiscal 2004 and 2013
($ in Millions)

	2004	2013	Total Increase	Total Percent Change	Annual Percent Change
Local Aid	$4,920	$7,447	$2,528	51.4%	4.7%
Entitlements	4,546	8,518	3,972	87.4%	7.2%
State Agencies	10,845	15,948	5,104	47.1%	4.4%
Debt Service, Capital, Reserve Fund	2,237	3,206	968	43.3%	4.1%
Total	**$22,547**	**$35,120**	**$12,572**	**55.8%**	**5.0%**

Source: Department of Budget and Management and Department of Legislative Services

Exhibit 3.9 shows that the share of entitlement programs increased from 20% to 24%, while shares of other spending declined.

Exhibit 3.9
Total Spending by Category
Fiscal 2004 and 2013

	2004 Share	2013 Share	Change
Local Aid	21.8%	21.2%	-0.6%
Entitlements	20.2%	24.3%	4.1%
State Agencies	48.1%	45.4%	-2.7%
Debt Service, Capital, Reserve Fund	9.9%	9.1%	-0.8%
Total	**100.0%**	**100.0%**	**0.0%**

Source: Department of Budget and Management; Department of Legislative Services

Chapter 4. Major Programmatic Shifts

This chapter examines some of the major programmatic shifts from fiscal 2004 to 2013. While the State has over 750 programs, much of the spending is concentrated in a few areas. In fiscal 2013, State general fund spending totaled $14.9 billion. Almost three-quarters of these expenditures supported the following areas:

- $5.1 billion for schools;
- $2.3 billion for Medicaid;
- $2.2 billion for salaries and wages excluding pensions and higher education; and
- $1.3 billion for pensions.

This chapter examines how general fund spending in these programs changed between fiscal 2004 and 2013.

Public School Aid

A substantial share of Maryland's budget provides grants to local boards of education. The largest State aid programs include:

- **Foundation Program:** determines aid based on a formula that provides a minimum level of aid. This program received $3.0 billion in fiscal 2013.
- **Compensatory Education Formula:** provides supplemental funding based on the number of students eligible for free and reduced-priced meals. This program received $1.1 billion in fiscal 2013.
- **Special Education – Formula Aid:** provides additional resources based on the number of students with special education needs. This program received $266 million in fiscal 2013.
- **Special Education – Nonpublic Placements:** subsidize the cost of placing special education children who cannot receive an appropriate education in the public schools. This program provided $110 million in fiscal 2013.
- **Student Transportation:** supports transportation to and from public schools, including disabled students. This program received $251 million in fiscal 2013.

- **Geographic Cost of Education Index:** recognizes regional differences in the cost of educational resources. Unlike the rest of the major State aid programs, the formula is not mandated. This program was fully funded with $129 million in fiscal 2013.

The Bridge to Excellence in Public Schools Act increased State funding for local public school systems. Some of the key features of the legislation included an enhanced foundation program providing per pupil funding to all jurisdictions, additional funding based on students with special needs, a guaranteed tax-based program to provide incentives for low wealth jurisdictions to increase local school funding, and additional student transportation aid. The legislation incrementally increased State support for public schools over a five-year period beginning in fiscal 2004. The estimated cost of the legislation at the time of enactment was:

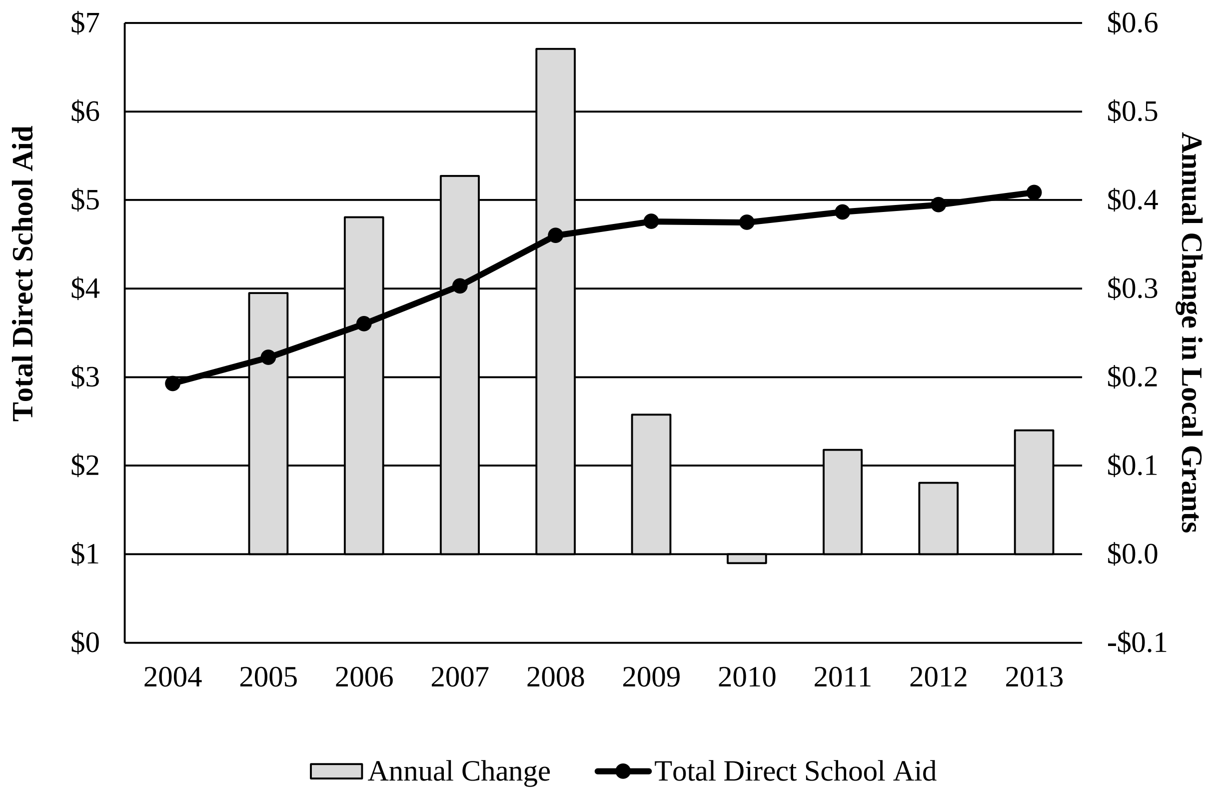
- $148 million in fiscal 2004;
- $364 million in fiscal 2005;
- $639 million in fiscal 2006;
- $948 million in fiscal 2007; and
- $1,306 million in fiscal 2008.

The legislation increased the cigarette tax from 66 cents to $1 per pack. This was projected to generate approximately $70 million per year. Estimates prepared when the legislation was enacted assumed that this revenue would decline over time; the tax increase was expected to generate $76 million in fiscal 2004 but only $73 million in fiscal 2007. While the additional general funds are substantial, they are quite small in comparison to the increase in general fund spending.

Exhibit 4.1 shows that local public school grants increased from $2.9 billion in fiscal 2004 to $4.8 billion in fiscal 2008.[1] This is an average annual increase of 12%. The funding growth slowed after fiscal 2008. From fiscal 2008 to 2013, the average annual increase is 2%.

[1] The State also funds the local teachers' pensions. In fiscal 2004, the State appropriation was $384 million, which increased to $755 million. Since this reduces local costs, pension contributions are usually included in State aid totals. Since this chapter addresses pension costs in a separate section, pension costs are excluded from this school aid discussion.

Exhibit 4.1
Total Direct School Aid
Fiscal 2004-2013
($ in Billions)



Note: State appropriations for local pensions are excluded from direct school aid.

Source: Department of Legislative Services

In the 2007 session, the legislature enacted the fiscal 2008 budget, which fully phased in the Bridge to Excellence in Public Education increases. At the time, the State faced an out-year structural deficit that totaled $1.3 billion. To address this deficit, the Governor called a special session to increase revenues and reduce spending. The legislation enacted during the special session included a provision to freeze the per pupil foundation amount for fiscal 2009 and 2010.

At the 2009 legislative session, State finances were under considerable stress. Fiscal 2009 revenues were written down $432 million in September 2008 and another $415 million in December 2008.

To limit out-year spending, the legislature enacted legislation at the 2009 session to limit growth in the foundation per pupil amount to 1% in fiscal 2012. This 1% cap was extended to fiscal 2015. It turned out that even these 1% increases were unaffordable until after fiscal 2012. Each year from 2009 to 2012, the legislature froze the foundation per pupil. For five years, from fiscal 2008 to 2012, the amount remained at $6,694.

In fiscal 2010 and 2011, the State received $297 million and $422 million of federal American Recovery and Reinvestment Act of 2009 (ARRA) funding to support education aid. Critically, these funds could be used to supplant general funds. This allowed the State to maintain local aid levels; prior to the enactment of the ARRA, the State was contemplating making reductions to State aid. Later, the State also benefitted from the federal Education Jobs Fund program that provided $124 million in federal funds in fiscal 2011. Since the State had fully funded the education aid in fiscal 2011, local education agencies saved an equivalent amount in fiscal 2011 to be used in fiscal 2012. This allowed the State to reduce the fiscal 2012 general fund appropriation without reducing the resources available for public schools.

Additional public school funding was also provided through video lottery terminals (VLT). In the 2007 special session, legislation authorizing VLTs in five locations (Allegany, Anne Arundel, Harford, and Worcester counties, as well as Baltimore City), was enacted. A portion of the revenue generated by VLTs is deposited into the Education Trust Fund (ETF), which is used to support the grants to public schools.[2]

Implementing the VLT program required a constitutional amendment, which the voters approved in a referendum in 2008. The legislation was expanded in the second special session of 2012. The expansion authorized table games, added a sixth facility in Prince George's County, and modified how the revenues were used. VTLs generated $94 million in fiscal 2012 and $284 million in fiscal 2013. These costs offset general fund costs supporting public school aid.

In conclusion, Maryland provides a substantial amount of aid to local public schools in the State budget. The average per pupil foundation amount increased from $4,766 in fiscal 2004 to $6,761 in fiscal 2013. This increased steadily from fiscal 2004 to 2008, as mandated by the Bridge to Excellence in Public Schools Act of 2002. In response to large structural budget deficits, aid grew considerably slower from fiscal 2008 to 2013. State public school aid is almost entirely funded with general funds. In response to the Great Recession, temporary federal aid allowed the State to maintain its funding commitments to public education. VLT revenues provide a new ongoing revenue source for education aid.

[2] Although the ETF is a special fund, these funds are included in general fund totals when analyzing the budget. If these funds were not deposited into the ETF, the funds would be deposited into the General Fund. These funds also support a general fund mandate. The ETF essentially is a general fund dedicated to public school grants.

Medicaid

The Medical Care Programs Administration, a unit of the Department of Health and Mental Hygiene (DHMH), is responsible for administering the Medical Assistance program (Medicaid) and the Maryland Children's Health Program. Medicaid (Title XIX of the Social Security Act) is a joint federal and State program that provides assistance to indigent and medically indigent individuals.

In fiscal 2004, Medicaid eligibility was limited to children, pregnant women, elderly or disabled individuals, and indigent parents. To qualify for benefits, applicants must pass certain income and asset tests.

2007 Medicaid Expansion

Chapter 7 of the 2007 special session enacted the Working Families and Small Business Health Coverage Act, which expanded Medicaid by:

- extending Medicaid eligibility to parents and caretaker relatives with household income up to 116% of the federal poverty guidelines, which was implemented in 2009; and
- incrementally expanding Primary Adult Care (PAC) benefits over four years to childless adults with household income up to 116% of the federal poverty level (FPL).

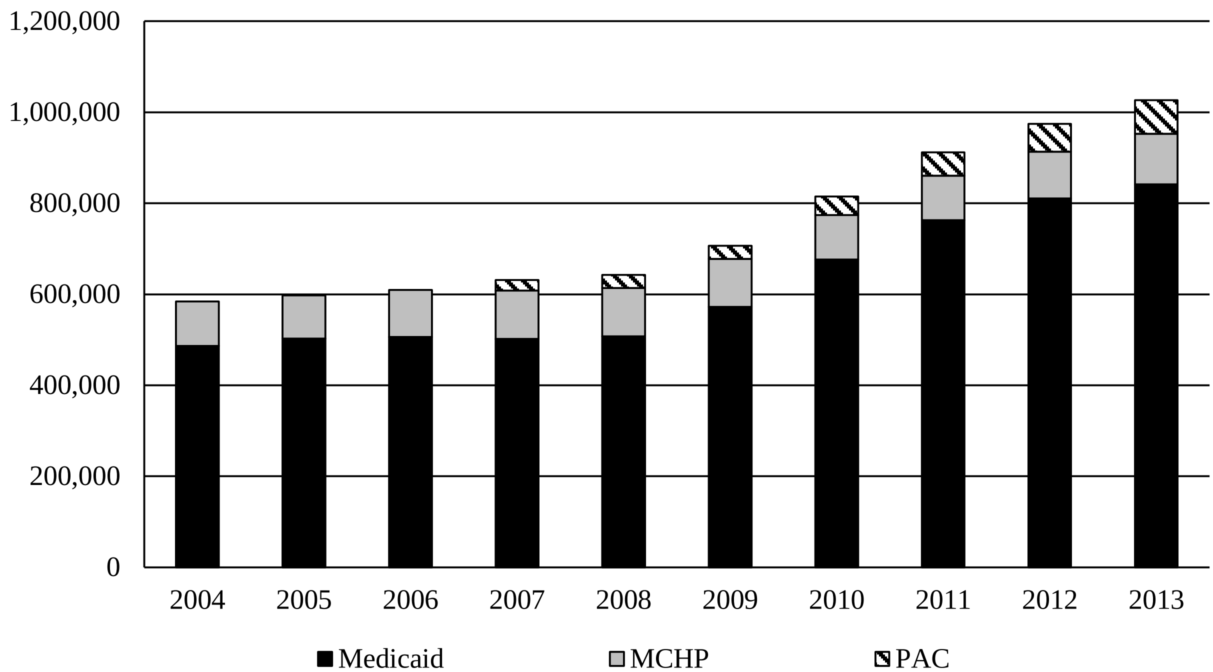
The statute provided that, to the extent funds are provided in the State budget, benefits for childless adults were phased in as follows:

- in fiscal 2010, specialty medical care and hospital emergency department services were made available;
- in fiscal 2011, outpatient hospital services were added;
- in fiscal 2012, inpatient hospital services were added; and
- in fiscal 2013, childless adults under 116% of the FPL were to be eligible for full Medicaid benefits.

The statute provided DHMH with the discretion to cap enrollment or limit the benefit package for childless adults. Full Medicaid benefits for PAC were delayed and ultimately never implemented until this population became eligible for Medicaid under the Affordable Care Act Expansion after January 1, 2014.

Exhibit 4.2 shows that enrollment began to increase substantially in fiscal 2009. This increase also coincides with the Great Recession and the expansion of Medicaid under Chapter 7 of the 2007 special session.

Exhibit 4.2
Medicaid Enrollment
Fiscal 2004-2013



MCHP: Maryland Children's Health Program
PAC: Primary Adult Care

Source: Department of Health and Mental Hygiene; Department of Legislative Services

These increased caseloads led to increased funding requirements. **Exhibit 4.3** shows that general funds increased at a moderate 4% annually when comparing fiscal 2004 to 2013. Special funds increased more than 25% annually. In fiscal 2004, general funds were 43% of total costs. By fiscal 2013, the general fund share of total costs declined to 34%. The lower share of general funds was offset by an increase in special funds. From fiscal 2004 to 2013, special fund expenditures increased from 3% to 15% of total costs.

Exhibit 4.3
Medicaid Funding
Comparing Fiscal 2004 to 2013 Growth Rates
($ in Billions)

	2004	2013	Total $ Increase	Annual % Change
General Funds	$1,623	$2,312	$688	4.0%
Special Funds	129	986	857	25.4%
Subtotal State Funds	***$1,752***	***$3,298***	***$1,546***	***7.3%***
Federal Funds	2,015	3,467	1,452	6.2%
Total	**$3,767**	**$6,764**	**$2,997**	**6.7%**

Source: Department of Budget and Management; Department of Legislative Services

Enhanced Special and Federal Funds

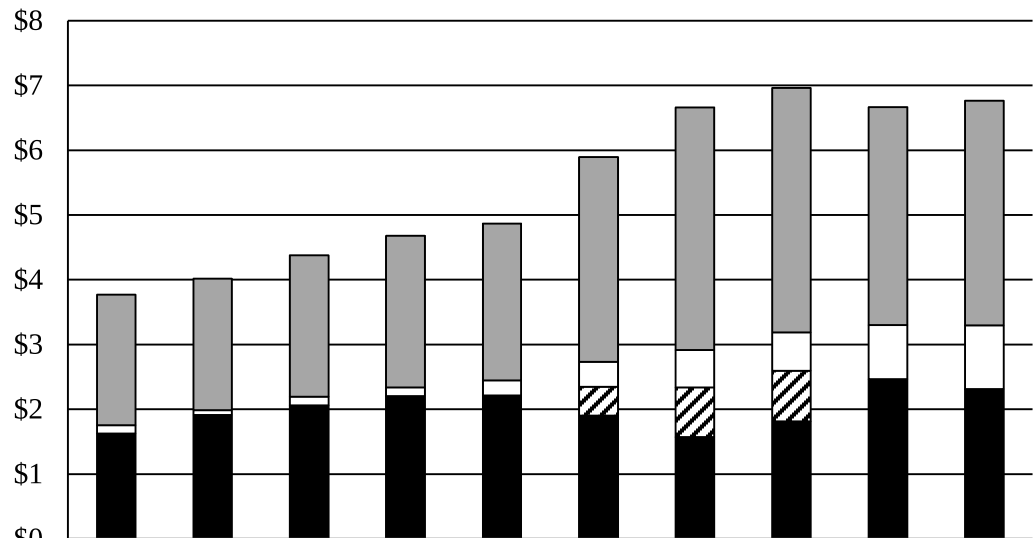
The mix of funds used to support Medicaid between fiscal 2004 and 2013 also changed. Medicaid now relies on a higher level of special funds. In the middle of the period, the ARRA provided federal funds for Medicare that were used to supplant general funds.

To fund Medicaid, the State has added hospital assessments, nursing home assessments, and a premium tax on managed care organizations and health maintenance organizations (funding which flows through the Rate Stabilization Fund). Hospital assessments were enacted in the Budget Reconciliation and Financing Act (BRFA) of 2011. This required that the Health Services Cost Review Commission approve a combination of assessments and remittances to support Medicaid. In fiscal 2013, it provided almost $388 million in special fund revenues. The Rate Stabilization Fund generated $109 million in fiscal 2013.

As previously discussed, the ARRA provided a substantial level of funding for Medicaid. Between fiscal 2009 and 2011, the ARRA temporarily increased the federal share of Medicaid that Maryland receives beyond 50%, which is Maryland's rate. The federal share varied based on unemployment and could change from year to year. These funds supplanted general funds.

Exhibit 4.4 shows the extraordinarily large share of federal funds from fiscal 2009 to 2011 as well as the dip in general funds.

Exhibit 4.4
Medicaid Funding
Fiscal 2004-2013
($ in Billions)



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Federal Funds	$2.02	$2.03	$2.18	$2.34	$2.42	$3.16	$3.75	$3.77	$3.37	$3.47
Special Funds	0.13	0.07	0.13	0.13	0.23	0.39	0.58	0.59	0.84	0.99
ARRA	0.00	0.00	0.00	0.00	0.00	0.44	0.77	0.78	0.00	0.00
General Funds	1.62	1.91	2.06	2.20	2.21	1.90	1.57	1.81	2.46	2.31

ARRA: American Recovery and Reinvestment Act of 2009

Source: Department of Budget and Management; Department of Legislative Services

From fiscal 2004 to 2013, Medicaid spending increased from $3.8 billion to $6.8 billion. These increases were driven by increasing caseloads attributable to need as well as increasing caseloads attributable to enhancing benefits. In spite of increased caseloads, the State has been able to moderate general fund spending by increasing special funds for Medicaid and using additional federal funds that were made available.

Employee Compensation

General fund salary and benefit spending for State employees (excluding higher education) totaled $2.5 billion, or 16.8%, of total general fund spending in fiscal 2013. Personnel costs are influenced by State personnel policies that are uniform across agencies.

When examining personnel costs, higher education personnel costs are excluded. Higher education has its own personnel system that is different than other State agencies. Higher education also does not have the same grade and step system that State agencies have. The data that the Department of Legislative Services receives from the Department of Budget and Management (DBM) does not have sufficient detail to analyze higher education personnel with the level of detail that other agency personnel are analyzed. Funding for higher education institutions is essentially a grant that the institutions use to support operations.[3] The funds are budgeted as current unrestricted funds and do not necessarily directly correspond with higher education salary actions. For example, in times of fiscal stress, higher education grants have been reduced without regard to salary actions or needs. For all these reasons, higher education is excluded from the personnel analysis.

Exhibit 4.5 shows that total spending for salaries and benefits increased from $1.8 billion to $2.5 billion, an annual increase of 3.7%.

Exhibit 4.5
Comparing General Fund Salary and Benefit Spending
Fiscal 2004 to 2013
($ in Billions)

	2004	**2013**	**Change**	**Total Percent Change**	**Annual Percent Change**
Salaries and Wages	$1,253	$1,512	$258	20.6%	2.1%
Overtime	49	79	30	61.9%	5.5%
Health Insurance	271	428	156	57.6%	5.2%
Pension Costs	87	274	187	213.8%	13.5%
Workers' Compensation	15	47	32	207.5%	13.3%
Remaining Costs	127	167	40	31.8%	3.1%
Total	**$1,803**	**$2,506**	**$704**	**39.0%**	**3.7%**

Note: Excludes higher education.

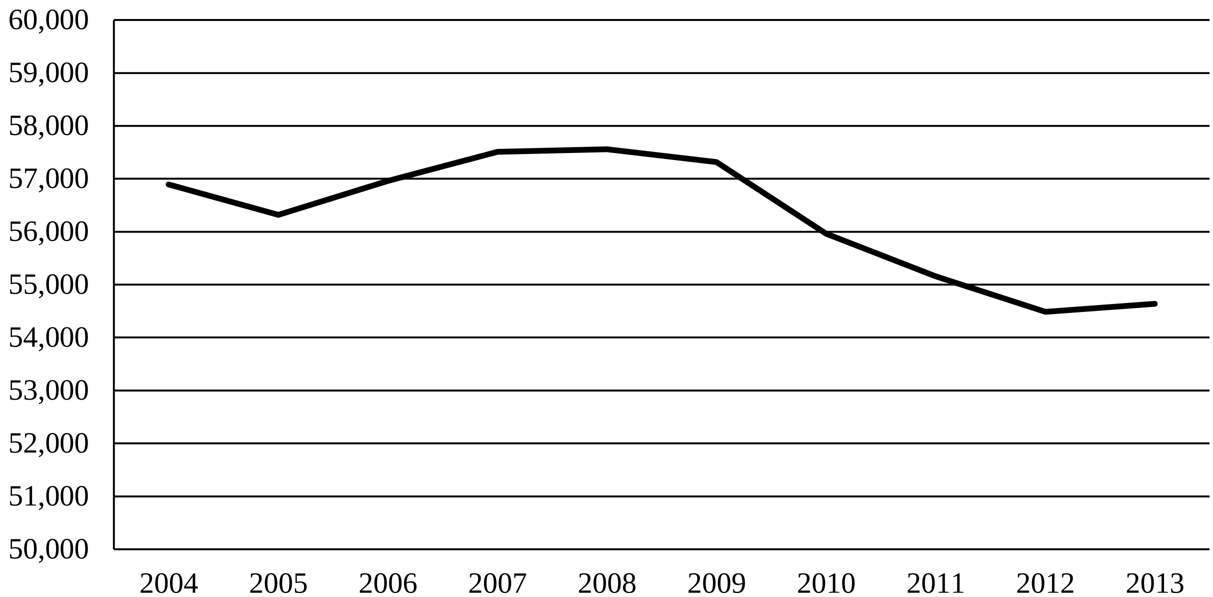
Source: Department of Budget and Management; Department of Legislative Services

[3] There are also other differences. Another difference is how positions are created during the fiscal year. To create a new position during the year, other Executive Branch State agencies need Board of Public Works approval while higher education institutions do not.

State Positions

The number of State positions in nonhigher education executive agencies, the Judiciary, and the legislature fluctuated over the 10 years. **Exhibit 4.6** shows that between fiscal 2005 and 2008, the number of positions increased and peaked at approximately 57,600. From fiscal 2008 to 2012, the number of positions declined to about 54,500.

Exhibit 4.6
Positions in Executive Agencies, Judiciary, and Legislative Branch
Fiscal 2004-2013



Note: Excludes higher education positions.

Source: Department of Budget and Management; Department of Legislative Services

Positions were lost as the State trimmed spending in response to the Great Recession. To reduce positions, a number of actions were taken, including:

- **Abolishing Vacant Positions:** Numerous actions were taken to abolish positions. The Governor abolished over 800 positions in March 2009, and legislative actions abolished an additional 102. The following year another 568 positions were abolished through legislative actions.

- **Abolishing Filled Positions:** When abolishing positions, the Administration's priority was to abolish vacant positions. Consequently, the vast majority of abolished positions were vacant. But some filled positions were abolished. Often this was due to restructuring agency operations. For example, 52 filled positions were deleted in fiscal 2010. Agencies affected include DHMH, the Department of Juvenile Services (DJS), the Department of Natural Resources (DNR), and the Department of Business and Economic Development.

- **Implementing a Voluntary Separation Program in Fiscal 2011:** The program received 1,347 applications, of which 1,068 were deemed appropriate for consideration. A total of 653 positions were abolished.

- **Closing State-run Facilities:** Facilities closed include the Brandenburg (Allegany County) and Rosewood (Baltimore County) Department of Developmental Disabilities facilities and Upper Shore (Kent County) and Carter (Baltimore City) mental health facilities.

- **In Addition to Abolishing Authorized Positions, the State Generated Personnel Savings by Implementing a Hiring Freeze:** The number of appointments declined from approximately 4,700 in fiscal 2007 to 2,700 in fiscal 2010.

Salary and Benefit History

In its annual personnel report, DBM provides personnel cost data. This includes data about average employee salary and fringe benefits. The State offers fringe benefits such as health care and pension plans and is required to pay Social Security, unemployment insurance, and workers' compensation costs. From fiscal 2006 to 2009, the State provided up to $600 per year to match contributions to 401(k) type deferred compensation plans, but this has since been discontinued.

Exhibit 4.7 shows that fringe benefit costs have been increasing at a higher rate than salary costs. In fiscal 2004, fringe benefits were 23% of the average employees' salary; by fiscal 2013, fringe benefits were 30% of employee costs. Pension contributions increased most substantially at a rate of almost 12% annually. Though health insurance costs increased at a higher rate than salaries, their costs are somewhat understated. In fiscal 2013, the State contributed less new money, due to an availability of fund balances, than in previous years.

The increasing cost of benefits was mitigated by increasing employees' share of the costs. Retirement contributions in the employees' and teachers' plans increased from 2% of salary in fiscal 2004 to 7% of salary[4]. State health insurance costs were mitigated by actions such as increasing the employee share of premium costs, increasing coinsurance costs, and increasing prescription drug deductibles.

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[4] Employee contributions were increased to 3% in fiscal 2007, 4% in fiscal 2008, 5% in fiscal 2009, and 7% in fiscal 2012.

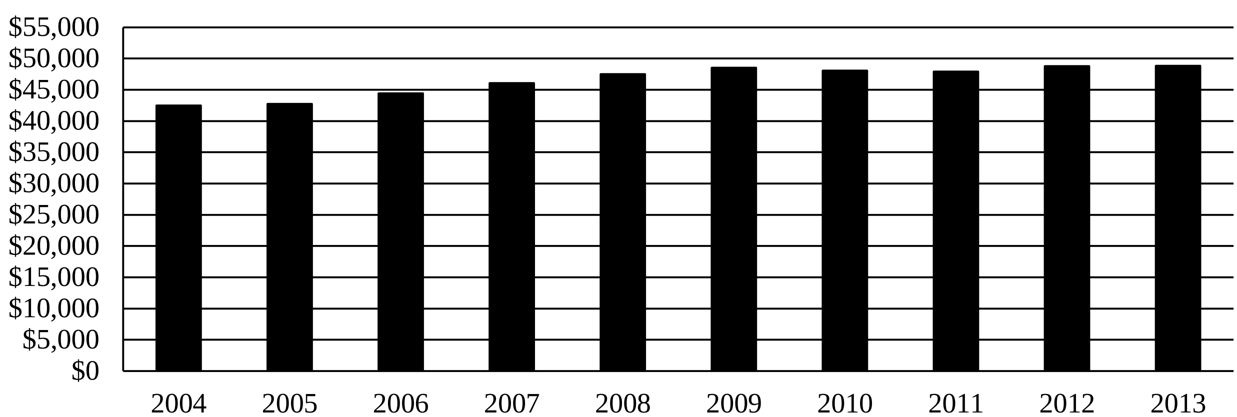
Exhibit 4.7
Change in Direct Salary and Benefit Costs for the Average Employee
Fiscal 2004 and 2013

	2004	**2013**	**Total Change**	**Annual Percent Change**
Salary	$42,505	$48,829	$6,324	1.3%
Health Insurance Payments	6,483	8,657	2,174	2.7%
Pension Contributions	2,067	7,424	5,357	12.3%
Other Fringe Benefits	3,832	4,826	994	2.1%
Total	**$54,887**	**$69,736**	**$14,849**	**2.2%**
Fringe Benefit Share of Total Cost	23%	30%		

Source: Department of Budget and Management Annual Personnel Reports

Exhibit 4.8 shows that the average employee salary increased from approximately $42,500 in fiscal 2004 to $48,800 in fiscal 2013. Although the trend was for salaries to increase, this was not always the case. For example, salaries decreased in fiscal 2010 and 2011.

Exhibit 4.8
Average State Employee Salary
Fiscal 2004-2013



Source: Department of Budget and Management Annual Personnel Reports

The exhibit also shows that salary changes resemble a stairway; periods with little growth are followed by periods of steady growth, which are again followed by periods with little growth. **Exhibit 4.9** shows that salaries were flat and increased at less than 1% annually in fiscal 2004 and 2005 and was essentially flat from fiscal 2009 to 2013. From fiscal 2005 to 2009, the average salary increased over 3% annually.

Exhibit 4.9
Annual Percent Increases in the Average State Employees Salary
Fiscal 2004-2013

Fiscal Years	Annual Percent Change
2004 to 2005	0.6%
2005 to 2009	3.2%
2009 to 2013	0.2%

Source: Department of Budget and Management Annual Personnel Reports

Not surprisingly, periods of slow salary growth correspond with the State withholding increments[5] and not providing for a general salary increase. **Exhibit 4.10** shows that State employees did not receive any general salary increases or increments in fiscal 2003, 2004, 2010, 2011, and 2012. These were periods of little or no salary growth. Increments and general salary increases were received from fiscal 2005 to 2009, which was the strongest sustained salary growth.

[5]Personnel reform in 1996 (Chapter 347) implemented a pay-for-performance plan for employees. DBM has developed strategies to reward satisfactory service to the State, based on the results of employee performance appraisals. One such strategy is to allow advancement from one step to the next within a grade, and an employee must be rated as "satisfactory" in the evaluation to move to the next step. These increases are referred to as increments.

Exhibit 4.10
Permanent Statewide Salary Actions
Fiscal 2003-2013

Fiscal Year	Date of Increase	General Salary Increase	Increments
2003	July 1, 2002	None	None
2004	July 1, 2003	None	None
2005	July 1, 2004	$752	On time
2006	July 1, 2005	1.5%	On time
2007	July 1, 2006	2.0% with $900 Floor and $1,400 Ceiling	On time
2008	July 1, 2007	2.0%	On time
2009[1]	July 1, 2008	2.0%	On time
2010[2]	July 1, 2009	None	None
2011[2]	July 1, 2010	None	None
2012[3]	July 1, 2011	None	None
2013	January 1, 2013	2.0%	None

Temporary statewide salary actions:
[1] 2- to 5-day furlough.
[2] 3- to 10-day furlough.
[3] One-time $750 bonus.

Source: Department of Budget and Management

Like other large areas of spending, employee compensation was affected by economic cycles. In the aftermath of the 2001 recession, employees did receive general salary or merit increases. During and after the Great Recession, compensation actually declined. Employees were furloughed while their annual rate of pay remained flat. Total employee costs did increase due to health care inflation and the decline in pension asset values.

Health insurance costs have increased at a higher rate than salary increases over the period. In spite of the decline in personnel, costs have increased 5.0% per year. The State has attempted to slow this growth. For example, benefits of active and retiree prescription plans were reduced by increasing copays in fiscal 2012, and coinsurance for hospital stays was introduced for point-of-service and preferred provider organizations' plans. Although costs did increase, changes made by the State slowed the increase so that the State costs increased at a rate that was less than medical care inflation; from fiscal 2004 to 2013, the cost per employee increased 33.5% while the U.S. Medical Consumer Price Index[6] increased by 37.1%.

[6] This measure paid for services at the retail level.

Of the other personnel expenditures, workers' compensation and overtime are the two largest categories. Overtime expenditures increased by $41.9 million with an annual growth of 4.3% from fiscal 2004 to 2013. Over 90.0% of this increase is due to four agencies: the Department of Public Safety and Correctional Services (DPSCS) ($15.6 million), the Department of State Police ($8.7 million), the Department of Human Resources ($8.0 million), and DJS ($5.9 million).

Workers' compensation increased by $46.8 million with an annual growth of 13% from fiscal 2004 to 2013. DBM accounted for $13.1 million of the increase, which primarily reflects statewide deficiencies budgeted in fiscal 2012 and 2013 to cover costs of a contract with the Injured Workers' Insurance Fund. The Maryland Department of Transportation accounted for $10.5 million, and DPSCS accounted for $8.2 million of the increase.

Employee Pensions

The State offers pension benefits to its employees. Most plans offered are defined benefit plans. Generally, the benefit is a function of salary, years worked, and a multiplier. For example, an employee retiring after 30 years with a $50,000 salary and a 1% multiplier would receive an annual benefit totaling $15,000 (30 x $50,000 x 1%).

The State Retirement Agency (SRA) manages the pension plans. SRA hires an actuary to estimate the cost of the benefit. Each year, the State makes an appropriation that is equal to the benefit earned by employees that year. This is referred to as the normal cost. This is invested in a fund. The fund earns a return on its investment.

The nature of defined benefit plans is that the employer bears the investment risk. If earnings are insufficient, a fund is deemed underfunded. The actuary then estimates how many additional funds need to be appropriated to compensate for investment losses. The State currently has an unfunded liability and is appropriating amounts in excess of the normal cost to reduce this unfunded liability.

The State's major defined benefit pension plans are:

- **Employees' Combined System:** This plan is for State employees that are not in other plans listed below. In fiscal 2004, there were two main plans: Employees' Retirement System (ERS) and Employees' Pension System (EPS). ERS was established in 1941 and closed in 1980. Employees hired on or after January 1, 1980, are in EPS.

- **Teachers' Combined System:** This plan is for employees at local boards of education, community colleges, and libraries, as well as a limited number of State employees. In fiscal 2004, there were two main plans: Teachers' Retirement System (TRS) and Teachers' Pension System (TPS). TRS was established in 1927 and closed in 1980. Employees hired on or after January 1, 1980, are in TPS. The benefits earned in EPS and TPS are identical.

- **State Police Plan:** This plan is for State troopers.

- **Law Enforcement Officers Pension System:** This is for uniformed police officers that are not State troopers. Agencies with officers in the Law Enforcement Officers Pension System (LEOPS) include DNR, the Maryland Aviation Administration, the Maryland Transportation Authority, and the Department of General Services.

- **Judges Pension System:** This plan is for judges.

- **Correctional Officers' Retirement System:** This is for correctional officers and other specified employees who work in the State's correctional facilities.

The State also offers higher education institution employees a defined contribution plan, referred to as the Optional Retirement Plan (ORP), instead of a defined benefit plan. This is attractive to many employees because the ORP is portable. An employee can easily take what is in their plan to another employer. The disadvantage to the employee is that they will bear the investment risk.

2006 Pension Enhancement

Concerns were raised that other mid-Atlantic states had pension plans that provided better benefits than Maryland's pension plans. The BRFA of 2005 expressed the intent that the State enhance the employees' and teachers' pension plans. At the time, employees' and teachers' multiplier was 1.2% for service earned before July 1, 1998, and 1.4% for service earned on or after July 1, 1998. This was less than neighboring states. For example, Pennsylvania's multiplier was between 2.0% and 2.5%, Delaware's was 1.85%, Virginia's was 1.7%, and West Virginia's was 2.0%. All of these states also had higher employee contribution rates, ranging from a low of 3.0% in Delaware to a high of 7.5% for Pennsylvania teachers.

Chapter 110 of 2006 enhanced pension benefits for State employees and teachers by increasing the multiplier for service earned after July 1, 1998, from 1.4% to 1.8%.[7] For an employee hired after July 1, 1998, and who works 30 years, the final benefit increases from 42.0% to 54.0% of salary. The legislation also increased the employee contribution from 2.0% in fiscal 2006 to 3.0% in fiscal 2007, 4.0% in fiscal 2008, and 5.0% in fiscal 2009 and thereafter.

The fiscal note estimated that the legislation would increase State costs by $1.9 billion. Amortizing those benefits over 25 years would increase State fiscal 2008 spending by $122 million, of which $106 million is general funds. The costs were anticipated to increase an average of 4% annually.

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[7] The legislation let participating governmental units (PGU) decide if it would keep the prior benefit or offer the new, enhanced benefits. To offer the new benefits, PGUs would have to opt to elect the enhance benefits by June 30, 2007.

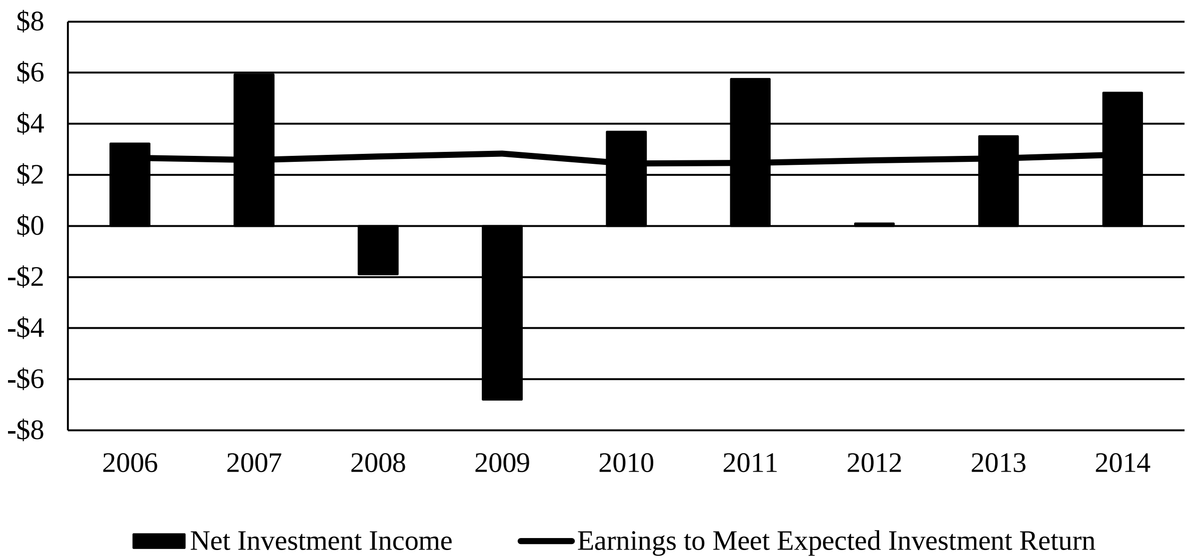
The benefit was retroactive to 1998, meaning that nine years of benefits were enhanced prior to the effective date of the law or the date that employee contributions were increased to support the enhancement. This retroactive share of the benefit was fully funded by the State. The fiscal note advised that retroactive benefits totaled $78 million of the $122 million, which is 64% of the cost of the enhancement.

The Great Recession Devastates the State Pension Fund

The value of assets declined sharply during the Great Recession. The State pension fund's market value of assets totaled $36.7 billion at the end of fiscal 2007. By the end of fiscal 2009, the fund's market value declined to $26.3 billion. Over the same period, the funded status declined from 77% to 64%.

Exhibit 4.11 shows that fund's assets lost $1.9 billion in fiscal 2008 and another $6.8 billion in fiscal 2009. At the time, the State expected that the fund's average earnings would be 7.75%. Comparing these losses to the expected investment return suggests that the fund's assets were valued at approximately $14.0 billion less than anticipated in fiscal 2007.

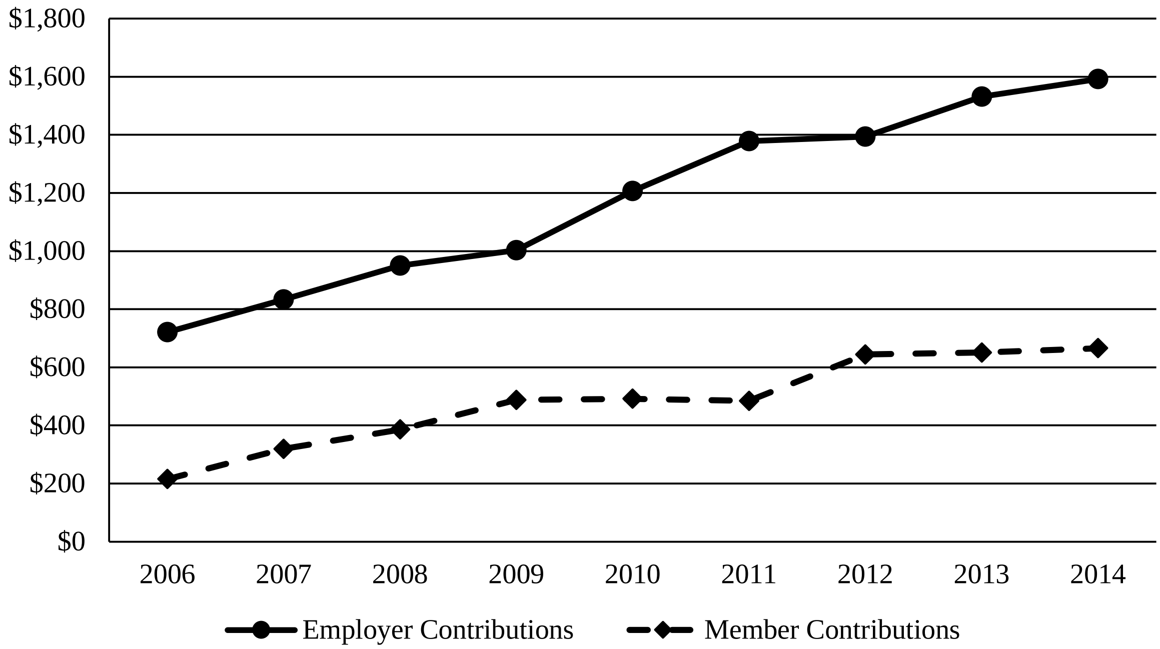
Exhibit 4.11
Pension Fund Earnings Compared to Expected Earnings
Fiscal 2006-2014
($ in Billions)



Source: *Comprehensive Annual Financial Reports*, State Retirement Agency

To provide sufficient funds for retirement, investment losses are amortized over a number of years. This leads to an increase in annual contributions. Since the State assumes the risk for investment losses, State contributions to the fund need to increase. **Exhibit 4.12** shows that annual contributions increase from $1.0 billion in fiscal 2009 to almost $1.4 billion in fiscal 2011, an increase of more than 17% annually.

Exhibit 4.12
State and Member Contributions to State Pension Plans
Fiscal 2006-2014
($ in Millions)



Source: *Comprehensive Annual Financial Reports*, State Retirement Agency

2011 Pension Changes

After sustaining substantial pension fund losses during the Great Recession, concerns were raised about the size of the unfunded liability and the size of the State appropriations required to fund the pension plans. To address these concerns, a commission was formed in fiscal 2010 to develop recommendations to reach an acceptable funded status more quickly and to limit State appropriations. Based on the commission's recommendations, the BRFA of 2011 enacted a series of pension changes to achieve these two goals. Specific plan modifications include:

- reducing the multiplier for employees hired after June 30, 2011, to 1.5. This rate provides an employee working 30 years a benefit that is 45.0% of his/her salary;

- increasing the vesting period for employees hired after June 30, 2011, to 10 years. Previously hired employees' vesting period remains at 5 years;

- increasing the number of years used to calculate the retirement salary to 5 years for employees hired after June 30, 2011. This remains 3 years for previously hired employees;

- beginning in fiscal 2012, increasing the employee contribution from 5.0% to 7.0% for EPS and TPS employees. Rates for the LEOPS plan were also increased;

- limiting the cost-of-living increase for service credit earned after fiscal 2011 to 2.5% for years in which the State earns in actuarial investment rate of return and 1.0% in years that the State does not earn its actuarial investment rate of return; and

- reinvesting a portion of the savings into the pension fund to achieve 80.0% funding within 10 years, fiscal 2023.

Since many of the changes affected employees that had not yet been hired, more of an impact is realized over time. For example, contribution rates for the teachers' plan have begun to moderate because they have hired a greater share of the workforce since June 30, 2011.

Reducing benefits and increasing member contributions were expected to reduce the State's annual contribution by $360 million in fiscal 2014; these savings were expected to increase at a rate of 6% annually in the short term.

Member contributions also increased. As shown in Exhibit 4.12, contributions increased from $485 million in fiscal 2011 to $644 million in fiscal 2012. Since employee's wages were stagnant and the workforce was not growing, member contributions remain fairly flat from year to year. Some years, they even decline. From fiscal 2010 to 2011, member contributions declined from $492 million to $485 million. This is not surprising, since employees did not receive a general salary increase or merit increases, instead there was a furlough and temporary salary reduction.

Local Pension Contributions

TRS had been funded by the State since it was established in 1927. Due to investment loses realized during the Great Recession, State appropriations for local pensions increased from $566 million in fiscal 2008 to $850 million in fiscal 2011. This is a 14% annual rate of increase.

To limit State spending, the Administration proposed to share teacher pension costs equally between the State and local school boards at the 2012 legislative session. However, local school boards preferred to be responsible only for the normal cost. This means that the State would assume all the investment risk and that the locals would assume costs associated with the salary enhancements that they provide.

The BRFA of the first special session of 2012 included a provision that required local school boards to be responsible for funding the normal cost for teacher pensions. This was phased in over five years. To provide a greater degree of budgetary certainty, the specific amounts were listed in the bill. Had this not been the case, the amounts would have changed from year to year since the State updates its retirement contribution estimates each year. The local share is:

- $137 million, or 50%, in fiscal 2013;
- $173 million, or 65%, in fiscal 2014;
- $222 million, or 85%, in fiscal 2015;
- $255 million, or 100%, in fiscal 2016; and
- the normal cost as estimated by the actuary in fiscal 2017.

Summary

Since fiscal 2004, there have been four major events that affected the State pension system. The first as a benefit enhancement in fiscal 2006. The enhancement was partially supported by increased employee contributions, but because the enhancement was retroactive, it increased the State's unfunded liability.

The second key event was the Great Recession, from which substantial investment losses in fiscal 2008 and 2009 decreased the funded ratio and increased the State contribution. The effect of the investment losses on the funded liability was many times larger than the effect of the enhancement from 2006.

In response, the State reduced benefits in 2011. Much of the reduction, such as a lower multiplier, affected employees hired after June 30, 2011. However, increased employee contributions affect employees in the State employees' and teachers' pension plans, as well as LEOPS.

Finally, the State now requires local jurisdictions to support a portion of pension costs. This does not affect the cost of State pension, but it does reduce the State's costs by shifting these costs to locals. This was done so that the State still assumes the investment risk, and the locals assume the normal costs, which is related to the benefits earned each year, thus aligning benefits earned with the payer of those benefits.