2022 Spending Affordability Committee Report and Recommendations to the Governor and the Legislative Policy Committee

The Spending Affordability Committee was created in 1982 (Chapter 585). The committee is composed of equal numbers of senators and delegates and includes the Presiding Officers, the majority and minority leaders, the chairmen of the fiscal committees (or their designees), and other members appointed by the Presiding Officers. A citizen advisory committee assists the committee.

The committee's primary responsibility is to recommend to the Governor and the General Assembly a level of spending for the State operating budget that is reflective of the current and prospective condition of the State's economy. Historically, this has been in the form of a recommended growth limit. More recently, however, efforts to close the structural budget gap have been the focus of the committee's recommendations. The full list of the committee's prior recommendations and legislative action on the operating budget are reflected in the table in **Appendix 1**. Since its inception 39 years ago, the recommendation of the committee has been adhered to by the legislature in all but 1 year.

Growth in personal income is often used as a proxy for the State's economic performance. The committee notes that operating spending in relation to the State's economy, as measured by the personal income statistic, has fluctuated between 6.7% and 7.5% over the past 30 years. The unprecedented increases under the Bridge to Excellence in Public Schools Act of 2002 raised spending as a percentage of income during the period of 2004 to 2008. By 2009, the ratio reached 7.5%, the highest level since 1991, in part, due to falling income. Conversely, rising income and reduced State spending caused the ratio to drop to 7.2% in 2010; the rate has fluctuated between 6.9% and 7.5% since.

The committee's statutory responsibility is to consider spending in relation to the State's economy. In its review of the State's economy, the committee considered income and wealth factors in developing a broad understanding of Maryland's economic position. In determining the spending recommendation, the committee has considered economic performance, revenue estimates, and current and future budget requirements.

Economy

The economy continues to recover from the COVID-19 pandemic, which threw the U.S. economy into a deep but relatively brief contraction. Nationally, employment exceeded the prepandemic level in August 2022. U.S. wages grew 8.8% in 2021 and were up 9.6% in the first nine months of 2022. But accelerating inflation has undercut wage growth as the consumer price index (CPI) increased 4.7% in 2021, the highest annual growth since 1989. The average wage per worker (total wages divided by employment) was up 5.9% in 2021 compared to 2020 but only 1.1% when wages are adjusted for inflation. In the first six months of 2022, the average wage per worker was down 2.8% adjusted for inflation relative to the same period in 2021.

In Maryland, the impact of the pandemic-induced recession has been similar to the country as a whole. Between January and April 2020, the State saw employment fall by 402,800 jobs, or 14.5%. Employment growth resumed, but as of October 2022, total employment was below the prepandemic level by 48,400 jobs, or 1.7%. Wages grew strongly in Maryland in 2021, following the pickup in employment. Total average wage per worker was up 4.0% in 2021 compared to the prior year but down 0.6% when adjusted for inflation. In the first half of 2022, the wage per worker was up 3.9% over the same period in 2021 but down 4.0% adjusting for inflation.

Economic growth in calendar 2022 has been weaker than expected when the year began. Inflation-adjusted gross domestic product fell on a quarter-over-quarter basis in both the first and second quarters of 2022. The U.S. CPI was up 8.2% in the first 10 months compared to the same period in 2021. Already weak economic growth combined with the Federal Reserve's efforts to lower inflation via aggressive interest rate increases has increased the odds of a recession over the next year to 50% or more. Some economic forecasters have added a recession to their baseline forecast for the next 3 to 6 months.

In September, the Board of Revenue Estimates (BRE) issued a revised economic forecast for Maryland, its first since March 2022. BRE expects employment in Maryland to reach its prepandemic level by the first quarter of calendar 2024. The forecast assumes economic growth will slow, but the economy will not experience a recession. In December 2022, the BRE made mostly small changes to the economic outlook to reflect revised history and the performance to date in 2022. The exception was capital gains income which the BRE now expects to fall more significantly in both 2022 and 2023 than in their September forecast.

Revenues

Fiscal 2022 general fund revenues were above the estimate by $1.6 billion, or 7.0%. General fund revenues totaled $24.0 billion in fiscal 2022, an increase of 15.4% over fiscal 2021, while ongoing revenues grew 17.5% in fiscal 2022. The top three revenue sources all exceeded the estimate by significant amounts: $1.0 billion for the personal income tax; $268.0 million for the sales tax; and $93.8 million for the corporate income tax. The fourth largest revenue source, the State lottery, was under the estimate in fiscal 2022 by $12.2 million.

The personal income tax performance was driven almost entirely by returns filed for tax year 2021, reflecting strong growth in nonwage income. Refunds for tax year 2021 were below expectations by 6.3%, while payments with returns were above the estimate by 45%. The net impact of lower refunds and higher payments accounted for roughly $890 million of the $1 billion general fund overattainment in fiscal 2022. Income tax withholding, by far the largest component of the personal income tax, was over the estimate slightly (0.4%) in fiscal 2022. Combined, nonwithholding payments accounted for 64% of the growth in the personal income tax in fiscal 2022.

Sales tax gross receipts in fiscal 2022 were up 21% over fiscal 2021. Fiscal 2022 reflected the first full year of collections from digital downloads and streaming services, but overall, online sales contributed only marginally to the total increase. Higher inflation added to growth but likely a relatively small portion as the sectors that have been driving inflation are generally not subject to the sales tax such as gasoline, cars, groceries, and housing. Ultimately, strong income growth combined with drawing down savings built up over the last two years provided consumers with ample resources to support spending. The impact of legislation related to the distribution of sales tax revenue to the Blueprint for Maryland's Future Fund (Chapter 33 of 2022) accounted for about $65 million of the general fund overattainment. The legislation's June 1, 2022 effective date eliminated the Blueprint distribution for the last two months of fiscal 2022. The adjusted fiscal 2022 estimate accounted for only a one-month impact, and revenues from online sales were stronger than anticipated.

In September, BRE increased their estimate for fiscal 2023 general fund revenues by $1.2 billion, or 5.5%. The personal income tax estimate was revised up by $966.1 million (3.5%), while the sales tax was revised higher by $367.8 million, or 6.4%. Total ongoing revenues are forecasted to grow 2.2% in fiscal 2023 and 3.2% in fiscal 2024. In December, BRE made small changes to the forecast reflecting year-to-date revenues and the revised outlook for capital gains income. The estimate for fiscal 2023 was revised up by $55.8 million (0.2%), and fiscal 2024 was revised down by $166.8 million (0.7%). Ongoing revenues are now projected to grow 2.4% in fiscal 2023 and 2.3% in fiscal 2024.

Budget Requirements

Taking into consideration the revenue projections by BRE in December 2022, the committee currently projects an ending general fund balance of nearly $2.6 billion at the close of fiscal 2023. The projected balance represents an extraordinary level of balance reflecting continued strong performance of revenues, particularly personal income from nonwithholding sources. Fiscal 2023 general fund deficiency appropriations are expected to reduce general fund spending by a net of $205 million.

The largest anticipated area of deficiencies supports capital expenditures that were originally funded with bond premiums, which due to higher than anticipated interest rates will not be available. The second largest area of deficiencies represents the anticipated general fund share of a 4.5% cost-of-living adjustment (COLA) provided to State employees on November 1, 2022. These increases were more than offset by savings in other areas, the largest of which are from higher than budgeted vacancies and an unexpected extension of the enhanced federal Medicaid match for the first nine months of fiscal 2023.

The baseline estimate for fiscal 2024 projects general fund spending will decline by 8.1% ($2.25 billion) compared to the fiscal 2023 legislative appropriation after adjusting for anticipated deficiencies. The fiscal 2024 general fund ending balance is projected to be a surplus of $2.2 billion. The significant general fund spending decline reflects approximately $1.5 billion of one-time spending included in supplemental budgets in fiscal 2023 and a decrease of $1.5 billion in the appropriation to the Reserve Fund resulting primarily from a lower required appropriation to the Revenue Stabilization Account (Rainy Day Fund) in fiscal 2024 ($1.1 billion) compared to fiscal 2023 ($2.4 billion). The largest increase is in the area of entitlements, primarily for Medicaid and behavioral health spending ($533.7 million) due to the return to typical levels of Medicaid match for the full fiscal year as well as provider rate increases and lower availability of special funds. The elimination of the enhanced Medicaid match also results in an increase in general fund spending of $70.2 million in the Developmental Disabilities Administration.

State agency spending, excluding the replacement of the enhanced Medicaid funds and one-time spending in the supplemental budgets, is projected to increase by approximately $570 million, of which more than half ($329.9 million) is related to compensation changes. These changes include the annualization of the COLA provided on November 1, 2022, and a change in fund source for a portion of the COLA expenses that were supported with the Fiscal Responsibility Fund in fiscal 2023, as well as the anticipation of a 2% COLA for most State employees and a 5% COLA for State Law Enforcement Officer Labor Alliance employees consistent with collective bargaining agreements and a merit increase. Public higher education funding, excluding employee compensation and pension rate related increases, results in $84.1 million of general fund spending growth largely related to mandates, changes in fund source for some mandates, and formula-related increases for St. Mary's College of Maryland and Baltimore City Community College.

The committee projects that the State will close fiscal 2024 with a balance of $3.9 billion in the Rainy Day Fund, which represents 15.7% of general fund revenues and would be the highest percentage in more than 20 years.

As previously noted, current baseline projections estimate the General Fund to have a cash surplus of $2.2 billion at the close of fiscal 2024. The structural surplus is projected to be $1.4 billion. As shown in **Exhibit 1**, which provides the cash and structural balance projections for the General Fund through fiscal 2028, the cash outlook is expected to remain strong through the forecast period. The structural surplus is projected to exceed $1.0 billion from fiscal 2023 through 2025 before beginning to decrease due to the impacts of the investment loss on pension contributions in the out-years and the need for general funds to support costs related to the Blueprint for Maryland's Future beginning in fiscal 2028, the first year in which the Blueprint for Maryland's Future Fund no longer fully supports the costs, Even with these additional cost, however, the structural; surplus remains greater than $600 million in fiscal 2028.

Exhibit 1
General Fund Budget Outlook
Fiscal 2023-2028 Est.
($ in Millions)

	Working Appropriation 2023	Est. 2024	Est. 2025	Est. 2026	Est. 2027	Est. 2028
Cash Balance	$2,627	$2,212	$4,363	$4,668	$4,951	$5,060
Structural	1,582	1,363	1,402	934	835	695

Recommendations

In light of the considerations discussed earlier, the committee proposes the following recommendations for the 2023 session:

1. Operating Budget Spending Limit and Sustainability

State revenues continue to benefit from pandemic-related federal aid and stronger than anticipated economic performance in recent years, placing the State in a strong fiscal position throughout the forecast period. Although the fiscal 2024 baseline projects a $1.4 billion structural surplus, the current forecast reflects a diminishing structural balance over the five-year period as ongoing spending outpaces ongoing revenues and does not account for weakening economic conditions that could lead to a recession. **To ensure sustainability throughout the long-term forecast period, the committee recommends ongoing revenues exceed ongoing spending by at least $100 million in the fiscal 2024 budget. This will enable the State to make investments in vital State services that have been overlooked and underfunded in recent years. This includes investments in our State workforce that will ensure the delivery of timely and effective services to Marylanders, expanded availability of behavioral health services for our residents, and full funding of existing State programs and commitments. The committee also recommends that the surplus be used for one-time investments in our transportation infrastructure and to ensure the sustainability of commitments to providing a world class education for our children before committing to new ongoing funding requirements.**

2. General Fund Balance and Use of Cash Surplus

Estimated cash balances, after assuming a 10% balance in the Rainy Day Fund, total $3.1 billion at the close of fiscal 2023. Although this surplus continues to provide the State with the opportunity for investment in unmet needs and priorities, it is largely the result of increased nonwithholding income tax revenues, a historically unreliable revenue source. When considered in combination with the potential for an economic downturn, the committee acknowledges the need for the State to bolster available resources for the future and be wary in committing a significant portion of the surplus toward ongoing commitments. **As such, the committee recommends:**

- **achieving a minimum ending general fund balance for fiscal 2024 of $350 million to cover normal operating deficiencies and protect the State against revenues falling short of estimates;**

- **maintaining a Rainy Day Fund balance of 10% of general fund revenues to further ensure the availability of resources during periods of economic stress and to meet new needs in such periods;**

- **committing cash toward pay-as-you-go (PAYGO) capital needs to supplement general obligation bonds, offset the impact of construction inflation, and provide funds for legislative bond initiatives;**

- **to the extent practical, reducing other underfunded liabilities, including eliminating the deficit in the health insurance account for employees and retirees; and**

- **allocating one-time revenues to support important State investments, including State workforce, education, and transportation needs.**

3. Capital Budget

A. General Obligation Debt

In September 2022, BRE increased its estimate of general fund revenues through fiscal 2028. The improved revenues reduced the State's debt service to revenues ratio from 7.7% in November 2020 to 6.7% in November 2022. Despite the improved debt affordability ratio, the Capital Debt Affordability Committee (CDAC) recommended limiting fiscal 2024 general obligation (GO) bond authorizations to $600 million, which is $525 million below the amount programmed in the 2022 *Capital Improvement Program* (CIP) and $605 million below the level recommended by the Spending Affordability Committee (SAC) in December 2021. CDAC last recommended that GO bond authorizations be $600 million or less in 2002, when State revenues were not nearly as high. The percentage decrease from the fiscal 2023 level to the proposed fiscal 2024 level is the largest in at least 30 years.

The committee is concerned that the CDAC recommendation does not provide a level of capital investment necessary to address current commitments, rising construction costs, and the need to continue to invest in the critical infrastructure needs of the State. The capital program is one of the State's best tools to respond to opportunities to meet the infrastructure needs of large employers considering relocating to Maryland.

The committee finds reducing GO authorizations to $600 million unnecessary given the State's outstanding affordability ratios and therefore recommends adhering to the $1.205 billion level of new GO bond authorizations for the 2023 session recommended by the committee in December 2021. The committee further recognizes that current capital commitments will require upward of $2.8 billion of combined GO bond and general fund PAYGO in the 2023 session and therefore recommends substantial use of one-time cash balances to support the capital program. The capital plan should:

- **fund projects preauthorized by the General Assembly for fiscal 2024 and fiscal 2023 authorized capital projects supported with unrealized bond premiums;**

- **provide funds necessary to address rising construction costs, including providing an appropriation to the Construction Contingency Fund sufficient to provide a fund balance of a least $20 million at the beginning of fiscal 2024 as a further hedge against rising construction inflation;**

- **allocate funds to make strategic capital and operating investments in facility renewal for State facilities managed by the Department of General Services and higher education facilities; and**

- **set aside GO bonds for allocation by the General Assembly.**

As to the long-range plan, the committee continues to support the CDAC debt affordability criteria, which limits debt service to 8% of State revenues and debt outstanding to 4% of State personal income. The committee is concerned, however, that the CDAC recommendation through the planning period, which does not return the authorization level to the amounts currently programmed in the CIP until fiscal 2026 ($1.145 billion), is unnecessary at current debt affordability ratios and does not account for construction inflation, which has increased at an average annual rate of 14% since calendar 2020. **Accordingly, the committee recommends GO bond authorization levels consistent with the December 2021 SAC recommendation. This includes rebasing authorization levels beginning in fiscal 2024 to a level of $1.205 billion and applying annual 4% increases as opposed to the 1% currently recommended by CDAC.**

B. Higher Education Debt

The University System of Maryland (USM) intends to issue up to $30 million in academic debt for fiscal 2024, which is the same amount authorized in fiscal 2023 and is consistent with the amount programmed in the 2022 CIP for fiscal 2024. This level of issuance will result in a debt service ratio within the 4.5% of current unrestricted funds and mandatory transfers criterion recommended by the system's financial advisers.

The committee concurs in the recommendation of CDAC that $30 million in new academic revenue bonds may be authorized in the 2023 session for USM.

4. State Employment

Personnel costs comprise approximately 20% of the State's operating budget. The committee anticipates a net increase of 986 positions in the fiscal 2024 budget compared to the fiscal 2023 legislative appropriation. This is comprised of 492 positions added in higher education and 494 new positions in the Executive Branch, most of which are the result of recent legislation. The resulting authorized number of State employees would be 81,844 in fiscal 2024.

The State currently has a historically high vacancy rate of 13.4% with almost 6,500 Executive Branch vacancies in October 2022 excluding higher education. Over the past year, the number of vacancies has increased by 710, continuing this worrisome trend. The trend coincides with the elimination over 3,300 Executive Branch positions and a nationwide shock to the labor force from the COVID-19 pandemic and its subsequent recovery. The position eliminations and vacancies impact State agencies in various ways: increased use of overtime; difficulty performing mandated responsibilities; higher caseload to staff ratios; and slow implementation of legislative reforms. While the committee has continuously raised concerns about the high level of vacant positions in State government, few actions have been taken to reverse these trends.

The committee remains concerned about the high number of vacant positions, which has continued to grow despite recent salary increases. With a large structural surplus forecast for the next few years, it is time for the new Administration and the General Assembly to restaff and adequately fund State government.

5. Transportation

The target closing balance for the Transportation Trust Fund (TTF) is intended to ensure that the Maryland Department of Transportation (MDOT) has sufficient working cash to administer its operating and capital programs. System preservation spending is necessary to maintain or bring capital assets into a state of good repair, which is where assets are performing as designed, and the chance of breakdowns is small. MDOT has an identified 10-year shortfall of nearly $4 billion between programmed spending for state of good repair and needed spending. The committee recommends:

- **a fiscal 2024 target closing balance of $200 million for the TTF; and**

- **fiscal 2024 spending on system preservation of at least $1.2 billion, which is $150 million more than the average spent over the previous 10 years.**

Appendix 1
Prior Recommendations and Legislative Action on the Operating Budget
($ in Millions)

	Committee Recommendation		Legislative Action	
Session Year	**Growth Rate**	**Amount**	**Growth**	**Amount**
1983	9.00%	$428.0	5.70	$269.8
1984	6.15%	326.7	8.38	402.0
1985	8.00%	407.2	7.93	404.6
1986	7.70%	421.5	7.31	402.2
1987	7.28%	430.2	7.27	429.9
1988	8.58%	557.5	8.54	552.9
1989	8.79%	618.9	8.78	618.2
1990	9.00%	691.6	8.98	689.7
1991	5.14%	421.8	5.00	410.0
1992	No recommendation		10.00	823.3
1993	2.50%	216.7	2.48	215.0
1994	5.00%	443.2	5.00	443.2
1995	4.50%	420.1	4.50	420.0
1996	4.25%	415.0	3.82	372.8
1997	4.15%	419.6	4.00	404.6
1998	4.90%	514.9	4.82	506.6
1999	5.90%	648.8	5.82	640.6
2000[1]	6.90%	803.0	6.87	800.0
2001[2]	6.95%	885.3	6.94	884.6
2002	3.95%	543.2	3.40	468.1
2003	2.50%	358.2	0.94	134.1
2004	4.37%	635.2	4.33	629.0
2005[3]	6.70%	1,037.1	6.69	1,036.3
2006[3]	9.60%	1,604.7	9.57	1,599.0
2007	7.90%	1,450.0	7.51	1,378.4
2008	4.27%	848.7	4.16	826.8
2009[4]	0.70%	145.7	0.19	39.2
2010[4]	0.00%	0.0	-	-626.9
2011	Reduce fiscal 2012 structural deficit by 33⅓%		36.90%/46.00%[5]	
2012	Reduce fiscal 2013 structural deficit by 50.0%		50.60%	
2013	Reduce fiscal 2014 structural deficit by $200.0 million			-211.2
2014	4.00%	937.8	2.76	646.4
	Reduce fiscal 2015 structural deficit by $125.0 million			-126.1
2015	Reduce fiscal 2016 structural deficit by 50.0%		68.27%	
2016	4.85%	1,184.2	4.55	1,111.2
2017	Reduce fiscal 2018 structural deficit by at least 50.0%		90.19%	
2018	Eliminate 100% of the fiscal 2019 structural deficit		100%	
2019	3.75%	1,019.0	3.31	900.7
	Maintain structural balance in fiscal 2020			76.0[6]
2020	Maintain structural balance in fiscal 2021			160.2
2021	Limit fiscal 2022 structural deficit to $700 million or less			63.0
2022	Maintain structural balance in fiscal 2023			276.0

[1]2000 legislative action does not reflect $266 million of Cigarette Restitution Fund (CRF) appropriations. CRF dollars were excluded because it had not previously been available to the State. The 2000 growth rate, including CRF dollars, was 9.16%.
[2]Methodology revised effective with the 2001 session.
[3]The committee initially approved a limit of 5.70% for 2005 and 8.90% for 2006.
[4]Legislative action calculation includes federal funds under the American Recovery and Reinvestment Act of 2009 used in lieu of ongoing general fund spending.
[5]Spending reduction/total reduction.
[6]Amount reflects difference between the estimated structural deficit of $64 million in the Governor's allowance and the structural surplus of $12 million in the legislative appropriation.