

## MARYLAND'S FISCAL CRISIS

### WHAT IS THE PROBLEM AND HOW DID WE GET HERE?

Over the past few years, we have increasingly heard that Maryland has a “structural deficit” in its state finances. It is forecast that the deficit will be about \$1.5 billion or approximately 10% of the total state general fund budget for FY 2008.<sup>1</sup> A structural deficit is one that is built into the state finance system and is expected to continue over time – i.e., tax and other revenues of the state are growing more slowly than are needed expenditures.

This situation didn't occur overnight. Some trace its beginnings to the reduction in income tax rates from 5% to 4.75% between 1997 and 2002, others to significant increases in the cost of Medicaid in the late 1990s and the passage of the Bridge to Excellence (Thornton) Act in 2002. The structural deficit first became apparent during fiscal year 2002, when revenues actually declined compared to fiscal 2001. Declining revenues continued into fiscal 2003, and deficits were widely forecasted by fiscal 2004. For a variety of reasons, the state began to have surpluses, with ongoing revenues exceeding ongoing spending in fiscal 2005 through fiscal 2007. This dramatic \$1.7 billion turnaround resulted from (1) increases in fees and increased tax compliance - \$450 million, (2) spending reductions from baseline forecasts of \$600 million and (3) revenues exceeding the December 2002 forecast by \$640 million. A number of one-time transfers from dedicated funds to the general fund were used, as well, to balance the fiscal 2004 and 2005 budgets. The General Assembly, at the request of the new governor, balanced the fiscal 2008 budget with a \$978 million transfer from the state's “rainy day fund,” drawing it down to close to its statutory minimum.<sup>2</sup>

For the future, revenues, which exceeded 9% annual growth for three years, are now forecasted to grow 4% in fiscal 2007 and 2008. With fiscal 2007 almost complete, actual revenues appear to be tracking the forecast. Ongoing spending grew 11% in fiscal 2007 and is budgeted to increase 7% in fiscal 2008. Deficits of about \$1.5 billion are expected in fiscal 2009 and the fiscal years beyond unless revenues are increased or expenditures decreased. Since some very large expenditures, such as Medicaid, are entitlements, they can't be reduced, with the result that cuts are more highly concentrated in non-entitlement areas.

### HOW DOES MARYLAND COMPARE?

Before looking at some of the alternatives that have been proposed to address the deficit, it's worth knowing where Maryland stands relative to other states both in its expenditures and in its taxing ability.

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<sup>1</sup> Much of the information in this section is based on *Maryland's Fiscal Structure and the Deficit Within*, a presentation by the Department of Legislative Services, Office of Policy Analysis, Annapolis MD, June 27, 2007 and *Tax Fairness-Not Cuts-To Overcome Maryland's Fiscal Crisis*, a short paper which can be found at [progressivemaryland.org/page.php?id-1882](http://progressivemaryland.org/page.php?id-1882).

<sup>2</sup> See the Glossary at the end of this paper for definitions of terms.

Maryland has the fifth highest per capita income of any state in the United States, \$25,614 in 2000 according to the U. S Census Bureau,<sup>3</sup> yet it ranks 31<sup>st</sup> in the United States in per capita state and local spending and 51<sup>st</sup> in spending as a percent of income. (Government tax and spending figures are usually based on total state and local taxes and spending since each state has its own particular mix of where taxes are collected and expenditures made.) In 2006, Maryland ranked 40<sup>th</sup> in state and local government employees per 10,000 population. A recent study by the Annie E. Casey Foundation ranked Maryland 24<sup>th</sup> among all states for children's health, education and safety,<sup>4</sup> an indication that the state has unmet needs.

On the income side, in 2004, Maryland ranked 48<sup>th</sup> among the 50 states in state and local government revenues, including federal funds, as a percentage of personal income. Specifically, in 2004, Maryland was third in income tax collections, 30<sup>th</sup> in corporate income tax collections, 44<sup>th</sup> in sales tax collections and 34<sup>th</sup> in property tax collections. From the above, it's apparent that Maryland is not a high-tax state and is not a high-spending state when it comes to governmental expenditures. It is also apparent that, given its very high per capita income, Maryland could afford to increase taxes as well as cut expenditures to deal with the structural deficit.

### **LWVMD PRINCIPLES REGARDING FISCAL POLICY**

The League of Women Voters of Maryland addressed fiscal policy issues as long ago as 1976 and as recently as 2004. In the course of its studies, the League developed a set of principals against which to judge tax proposals, the most important of which follow.

The Maryland revenue structure should be equitable, reliable, adequate and progressive overall.

Further, LWVMD supports a progressive income tax, which should be the first choice if a revenue income is necessary as well as a sales tax, with exemptions to decrease regressivity. It also strongly opposes expanding gambling and relying on video lottery games ("slots") to meet Maryland's revenue needs.

### **WHAT ARE THE OPTIONS?**

Maryland legislators and leaders have several options as they try to solve the budget crisis – drastically cut expenditures, increase taxes, make a combination of tax increases and expenditure reductions. They will also have to decide if they are going to have a bare-bones budget that will preserve the status quo, which will require \$1.5 billion, or if they are going to increase the budget to meet many of the unmet needs of Marylanders for some time into the future.

The Department of Legislative Services (DLS), Office of Policy Analysis was asked to develop a budget that would not require any new revenues. It presented that budget to legislative committees on July 27, 2007.<sup>5</sup> This budget has become popularly known as the "Doomsday Budget." DLS points out that compared to fiscal 2002, Maryland has 3,167 fewer executive branch positions, while higher education positions increased by 1,867. There has also been a significant shift in the way funds have been allocated over the past ten years, with higher proportions of appropriations going to local aid, primarily due to increases in funding for K-12 education (from 34.5% to 40.4%) and entitlements

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<sup>3</sup> Statistics in the section come largely from *Maryland's Fiscal Structure* op cit, and *Chartbook on Taxes in Maryland*, Fourth Edition, Maryland Budget and Tax Policy Institute, January, 2007.

<sup>4</sup> *Kids Count Data Book Online*, Annie E. Casey Foundation July 2007.

<sup>5</sup> *Balancing the Budget Without New Revenues*, Department of Legislative Services, Office of Policy Analysis, Annapolis MD June, 2007.

(from 15.8% to 18.3%) and lower proportions going to state agencies and “other.” In the Doomsday budget, the authors tried to protect services to the most vulnerable populations, deny inflationary and service expansion increase for remaining programs, increase cost recovery for some programs and “rebalance the state/local fiscal relationship in a manner sensitive to local fiscal capacity” among other criteria. What follows are ten pages of specific budget cut recommendations starting with elimination of all pay increases for state employees, reduction in drug benefits for state retirees, cuts in or elimination of many state agency programs, closing of some state facilities and an overall 10% reduction in state aid, primarily to schools and libraries. (Montgomery County would take the biggest hit, with a 23.9% reduction in total aid.)

As an initial step in closing the deficit, in May 2007, Governor O’Malley ordered state agencies to propose reductions of approximately \$200 million in the current year’s state budget. A total of \$213 million in savings were identified; 147 state government positions and 35 contractual positions would be eliminated. The agency with the largest reduction is the Department of Health and Mental Hygiene, with \$46 million. Long overdue increases in reimbursement rates for health care providers that were authorized in the last legislative session, and new services for mentally ill and developmentally disabled children will be eliminated; \$60 million will come from 2007 budget reversions and other adjustments. Other state agencies will take smaller cuts.<sup>6</sup>

Several options for increasing taxes are available to legislators. Most frequently mentioned are changes in corporation income tax “loopholes,” changes to the state’s personal income tax, changes to the state’s sales tax, increases in “sin” taxes and legalization of slot machine gambling.

In 2004, Progressive Maryland and Citizens for Tax Justice produced a report *Silver Bullet*<sup>7</sup> analyzing corporate loopholes and what they mean to the Maryland revenue stream. They estimate that corporate tax avoidance robs Maryland of up to 34% of the corporate income taxes that should be collected each year, and over the past 20 years, corporate taxes as a percent of all taxes decreased from 13% in 1980 to 7.6% in 2002. The main reason that many corporations pay no tax at all is that Maryland starts with “federal taxable income,” a number which itself has declined as taxes have been cut at the federal level. Only 68 of the largest 132 for-profit companies examined by the Maryland Comptroller paid income taxes in 2005<sup>8</sup>. The two groups recommend (1) use of a gross-receipts-based alternative minimum assessment such as New Hampshire, New Jersey and, most recently, Texas have adopted, (2) combined reporting of corporate income which would prevent corporations from siphoning off profits to out of state and sham subsidiaries, (3) elimination of industry-specific exemptions. Based on the report by the comptroller, the governor has indicated that he would seriously consider combined reporting for corporations.

Maryland’s personal income tax is one of the least progressive income taxes in the United States since the top rate, 4.75%, is paid on all incomes above \$3,000. In comparison, Vermont’s lowest bracket begins at \$30,650 and increases in five steps with the highest at \$336,550. Rates increase from 3.6% in the lowest bracket to 9.5% for incomes above the highest step. California and New Jersey similarly have several brackets with tax rates increasing as incomes increase. Governor O’Malley has suggested that the Maryland brackets be significantly revised so that wealthier Marylanders would pay more

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<sup>6</sup> Governor O’Malley Cuts Over \$280 Million from State Budget to Address \$1.4 Billion Deficit. Press release from the Office of the Governor. July 10, 2007.

<sup>7</sup> *Silver Bullet, The Corporate Tax Cut and Loophole Elimination Plan*, Sean Dobson, Matthew Gardner and Kelly Ross, Progressive Maryland Education Fund, October, 2004

<sup>8</sup> Baltimoresun.com, July 25, 2007

taxes.<sup>9</sup> The League of Women Voters has long supported the concept of increasing progressivity of the Maryland income tax. Other, more modest proposals include increasing the income tax to 6% for joint filers with taxable incomes over \$225,000 and creating an income tax surcharge for those making more than \$500,000. An interesting point has been raised by some Montgomery County leaders. Since Montgomery County is the highest income county in the state, a progressive income tax would have a greater impact on Montgomery County taxpayers than on other Marylanders. This could impact the ability of the county to raise property taxes to pay for needed services since these leaders believe that there is a limit to how much people will pay in taxes.

### Comparison of Maryland Personal Income Tax Structure with More Progressive Structures<sup>10</sup>

Maryland*		New Jersey		Vermont	
Single Filer Earns	Tax Rate	Single Filer Earns	Tax Rate	Single Filer Earns	Tax Rate
Up to \$1,000	2.0%	Up to \$20,000	1.4%	Up to \$30,650	3.6%
Up to \$2,000	3.0	Up to \$35,000	1.75	Up to \$74,200	7.2
Up to \$3,000	4.0	Up to \$40,000	3.5	Up to \$154,800	8.5
Over \$3,000	4.75	Up to \$75,000	5.525	Up to \$336,500	9.0
		Up to \$500,000	6.37	Over \$336,500	9.5
		Over \$500,000	8.97		

\*Maryland counties impose an additional income tax that ranges from 1.25% in Worcester County to 3.2% in Montgomery, Prince George's and Howard Counties.

One of the easiest ways to increase state tax revenues is to increase the already existing sales tax an additional one cent on the dollar bringing it to 6%. Compared to other states, Maryland raises a relatively small percentage of tax revenues because of its low general sales tax rate of 5% and the large number of exemptions that Maryland grants from the sales tax – e.g., food, drugs, repair services, et al.<sup>11</sup> Tax analysts point out that that sales taxes are highly regressive since people with lower incomes pay a higher percentage of their assets for goods than do people with higher incomes. According to the Department of Legislative Services, Maryland households with incomes between \$10,000 and \$15,000 per year on average pay 2.0% of their incomes in sales tax each year, while households with over \$70,000 per year on average pay 0.6% of their incomes.<sup>12</sup> It has also been proposed, most recently during the last legislative session, that the sales tax be extended to selected services. If done carefully – i.e. by taxing “high end” or business services such as accounting, advertising, etc. – this tax would be much less regressive. So called “sin taxes,” taxes on alcohol and tobacco products are often targeted for increases when revenues are needed. Sometimes they are proposed to be dedicated to specific programs such as health care but often they are not. They are promoted as public health measures as

<sup>9</sup> *MD Officials Weigh Overhaul of Income Tax Rates*, John Wagner, *Washington Post*, July 18, 2007

<sup>10</sup> *Washington Post, Rate Overhaul Weighed to Help Budget Gap*, July 20, 2007

<sup>11</sup> *Chartbook on Taxes in Maryland*, op cit

<sup>12</sup> *Fiscal and Policy Note to HB 393*, Department of Legislative Services, Maryland General Assembly, 2007 Session, p. 4.

well as revenue raisers. These taxes are of course also sales taxes, and studies have shown that they also fall disproportionately on the poor. Revenues from these taxes can be expected to decline over time if they do discourage people from buying alcohol and tobacco. Gasoline taxes, often dedicated to transportation purposes, also are regressive sales taxes.

Legalization of slot machine gambling in Maryland has been proposed many times in the recent past. Bills have been introduced to allow such gambling but so far have not been enacted. Many of these bills propose locating the slot machines at horse racing tracks as a mechanism for attracting more people to the race tracks, which have been suffering economically. It is also argued that people are leaving the state to gamble, and we should try to retain as much of the revenue as possible. Opponents raise moral arguments as well as pointing out that again the poor are the biggest users of these types of machines.

The following table was produced by the Department of Legislative Services in November 2002; while somewhat out of date, gives an idea of the relative sizes of various tax proposals.<sup>13</sup>

### Estimated Revenues from Selected Tax Proposals

Proposed Tax Revision	Estimated Annual Revenue Increase
Increase top income tax rate to 6% for incomes over \$100,000, \$150,000 for joint returns	\$200 million
Provide for combined reporting and address other issues related to multi-state corporations	\$100 million
Increase corporate tax rate from 7 to 8%	\$57 million
Increase general sales tax to 6%	\$520 million
Repeal current exemptions to the sales tax such as food for off-premises consumption, residential sales of energy, property used in manufacturing, sales for agricultural services	\$595 million
Taxation of services	
Business services	\$600-700 million
Information services	\$325-285 million
Financial services	\$150 – 230 million
Personal services	\$75-115 million
Repair services	\$50-80 million
Increase state property tax rate to 14.4 cents	\$200 million
Increase auto titling tax from 5% to 6%	\$99 million
Increase tobacco tax by 25 cents per pack	\$51 million
Double alcoholic beverage tax rate	\$25 million
Legalization of video lottery terminals	Up to \$800 million depending on the number authorized

<sup>13</sup> *Budget and Revenue Options*, Presentation to the Commission on Maryland's Fiscal Structure, Department of Legislative Services, Office of Policy Analysis, Annapolis MD November 2002

**WHAT DOES THE PUBLIC THINK?**

The LWV of Maryland has been meeting with a coalition of like-minded organizations, Alliance for Tax Fairness, to get a head start on addressing the issues surrounding the budget crisis. The two principles that we all agree on state that whatever revenues are raised, they should be sufficient to pay for additional services (i.e. exceed \$1.5 billion) and that the tax system overall should be made fairer. The Alliance commissioned a poll early this summer to see how Maryland citizens feel about all of this. Generally, Marylanders from around the state felt that we should invest more in education, healthcare and natural resources. A total of 36% would close the budget gap with spending cuts, but 50% say the solution should include both spending cuts and increased taxes. A total of 62% agreed that they are willing to see the state spend more money on desired programs even if this involves increased taxes, and 74% think lawmakers should include in the budget more revenues than just needed to close the gap. Overall, people seem to want a fairer tax structure and are willing to pay more to keep or improve services.<sup>14</sup> The table below shows some of the specific responses of the people polled.

**Selected Results from Maryland State Budget Survey**

<b>Attitudes on State Spending</b>	<b>Invest More</b>	<b>Invest Less</b>	<b>Cutting Expenditures</b>	<b>% in Favor</b>	<b>% Opposed</b>
Improve K12 public education	61	7	Fire, EMS	11	89
Ensure affordable healthcare	61	9	Local government funds for libraries, parks, etc.	19	81
Protect natural resources, clean water	60	6	Early childhood, all day K, small class size	24	74
Public safety- police/fire	55	4	Raise tuition/cut university funding	24	73
Improve transit options/ roads	39	12	Deny COLA and freeze pay	28	69
			Across the board 5% cuts	41	54

<b>Ways to Increase State Funds</b>	<b>% in Favor</b>	<b>% Opposed</b>	<b>Taxed Too Much</b>	<b>% agree</b>
Require MD companies with profits to pay some income tax	87	10	Large corporations	6%
Ensure developers pay cost of permit laws	84	10	Small business	27%
Increase cigarette/tobacco taxes	72	15	Wealthy people	10%
Personal income surcharge for those making \$500k or more	68	31	Middle class	75%
Legalize slot machine gambling	60	38	Low income	30%
Increase state income tax rates and create new, higher rates for wealthy	53	44		
Raise sales tax by 1%	43	55		
Raise gas tax by 12cents/gal	20	78		

<sup>14</sup> *Maryland State Budget Survey, 2007.* Goodwin Simon Victoria Research.

## **WHERE DO WE GO FROM HERE?**

As this Fact Sheet is being written, we are still waiting to hear if the governor will call a special session to deal with the budget issues. It is generally believed that he will not call one unless there is substantial agreement among the principal players in the House, Senate and the governor's office. If there is no special session, people expect that the budget problems will be the main (maybe the sole) topic of discussion during the regular session of the legislature, which starts in January 2008.

The Alliance for Fair Taxes has met with Senate President Miller, House Speaker Busch and staff of the governor's office and held a press conference to deliver our message, which is supported by many statistics and background reports and by the results of the survey. We will be coordinating our efforts to educate our members, governmental leaders and the public about these issues.

Under the leadership of state Senator Paul Pinsky, a group of 14 senators (including six from Montgomery County) have written a letter to the governor laying out what they believe the goals of the state's fiscal policy should be: It should be adequate to meet the needs and priorities of Maryland's families. It should provide comprehensive long-term solutions. It should, as a whole, be progressive, shifting the relative burden off working families, small business and those with fixed incomes and it should promote healthy practices in our communities and a cleaner environment.<sup>15</sup> The Alliance for Fair Taxes has also been in discussion with this group of legislators and will be working to coordinate our efforts. The League of Women Voters of Maryland and some of the other coalition organizations have written to each of the senators thanking them for taking the lead on this issue.

Solving the budget deficit and providing for the needs of Marylanders now and in the future won't be easy. Whatever the solutions that are devised by the legislature and the governor, someone will have to pay. It's a question of who that will be.

## **Glossary**

### **DEFICITS**

**Budgetary Deficit** – when revenues are projected to be lower than expenditures. When a Budgetary Surplus exists, revenues are projected to exceed expenditures.

**Actual Deficit** – when actual revenues are lower than actual expenditures. An Actual Surplus occurs when actual revenues exceed actual expenditures.

### **TYPES OF REVENUE**

**General Funds** – primarily revenues from broad-based taxes not dedicated to a specific purpose.

**Dedicated Funds** – Other state revenues, primarily from taxes and fees, dedicated to specific purposes. In Maryland, tuition for higher education and transportation revenues account for over two-thirds of these funds.

**Federal Funds** – Revenues from the federal government for specific purposes.

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<sup>15</sup> Letter to Governor Martin O'Malley dated July 16, 2007 from 14 Maryland state senators.

## TAXES

Regressive – One in which people with lower incomes pay a higher percentage of their income in tax than those with higher incomes. Example: sales taxes are generally regressive because lower income people spend a higher percentage of their incomes on goods which are taxed than those with higher incomes.

Progressive – One in which people with higher incomes pay a higher percentage of their income in tax than those with lower incomes. Example: a graduated income tax (one with graduated rates increasing with incomes).

## EXPENDITURES

Entitlements – Programs, such as Medicaid and Temporary Assistance for Needy Families (TANF), formerly Aid for Dependent Children, which a state is required by the federal government to provide to all who are eligible. While the federal government pays a significant percentage of the cost of these programs, the state is also required to pay a portion, and its overall expenditures can increase or decrease based on the number of people served and the benefits provided.

This Fact Sheet was researched and written by Barbara Hankins, with input from Melpi Jeffries, Carla Satinsky and Nancy Soreng