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# **Commission on Maryland's Fiscal Structure**

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## **2002 Interim Report**

**Annapolis, Maryland**

**December 15, 2002**

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# Commission on Maryland's Fiscal Structure

**Fred W. Puddester**  
Chairman

December 15, 2002

The Honorable Parris N. Glendening  
Governor of Maryland

The Honorable Thomas V. Mike Miller, Jr.  
President of the Senate

The Honorable Casper R. Taylor, Jr.  
Speaker of the House

Gentlemen:

On behalf of the Commission on Maryland's Fiscal Structure, I am pleased to submit a copy of its 2002 interim report.

The Commission on Maryland's Fiscal Structure is charged with examining and making recommendations for changes to the State's budget and tax structure. The commission is to help the Governor and the General Assembly develop long-term strategies for addressing future budget needs and shortfalls. In addition to studying the State's tax structure, the commission is directed to evaluate various methods for funding education, transportation, and health care needs; study the State budget process; and look at inefficiencies in and improvements to State government services.

The commission held a series of briefings on the State tax structure, national economy, education, transportation, health care, bond ratings, budget processes, and tax compliance issues before beginning its work sessions in mid-November. In addition, the commission received public testimony from interested parties regarding budget and revenue options. This report outlines the commission's interim work and provides a list of budget and revenue options for fiscal 2003 and 2004 that may be addressed in the 2003 legislative session.

While this interim report provides short-term findings and recommendations, we still have much work to do in examining the longer-term changes necessary to make improvements to and remove inefficiencies from our budget as well as making our tax structure more progressive; we will issue a final report on those issues by September 1, 2003.

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I wish to express my deepest appreciation to my fellow commissioners for the time, effort, and energy that they have given to the commission's work. Of course, our work would not have been possible without the professional and highly competent staffs of the Department of Legislative Services, the Department of Business and Economic Development, and the Comptroller of the Treasury. I would also like to thank the other executive department agencies that worked with the commission, as their work was integral to our efforts.

My colleagues and I are grateful for the opportunity to participate in this important endeavor. We believe that this report provides thoughtful and comprehensive options that will maintain Maryland's place at the forefront of economic and social development.

Sincerely,

Fred W. Puddester  
Chairman

FWP/JRB/msh

cc: Governor-elect Robert L. Ehrlich, Jr.  
Speaker-elect Michael E. Busch

# **Commission on Maryland's Fiscal Structure**

## **2002 Membership Roster**

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# Executive Summary

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## Charge and Overview

Chapter 343 (House Bill 1) of 2002 created the Commission on Maryland's Fiscal Structure, which is charged with examining and making recommendations for changes to the State's budget and tax structure. Chaired by Mr. Fred Puddester, a former Secretary of the Department of Budget and Management, the commission is a 17-member panel of legislative and executive branch members as well as members representing local governments and various interest groups.

The commission's charge is to help the Governor and the General Assembly develop long-term strategies for addressing future budget needs and shortfalls. In addition to studying the State's tax structure, the commission is directed to evaluate various methods for funding education, transportation, and health care needs; study the State budget process; and look at inefficiencies in and improvements to State government services.

## Summary of the Commission's 2002 Interim Work

In August, the commission began a series of briefings on the State budget and tax structure, the national economy, revenue and spending comparisons of Maryland and selected states, education, transportation, health care, state bond ratings, budget processes, and tax compliance issues. The commission also held a public hearing where public testimony on budget and revenue options was offered.

In mid-November, the commission began working on a series of budget and revenue options that it would provide to the Governor and the General Assembly. It is required to submit an interim report of its preliminary findings to the Governor and the General Assembly by December 15, 2002, and a final report by September 1, 2003.

The commission views Maryland's current fiscal situation as both a short-term and long-term problem. In this report, the commission provides a series of budget and revenue options that the Governor and General Assembly may wish to consider in meeting the short-term need to balance both the fiscal 2003 and 2004 budgets. The commission plans to look next year at longer-term solutions that will allow the State to better align its budget and tax structure to meet future fiscal challenges.

## Commission Options for the 2003 Legislative Session

In an effort to provide as many options as possible, several broad categories of actions to address the current situation were discussed by the commission. These include budget reductions, transfers/one-time items, tax compliance efforts, federal government mandates, temporary revenue measures, and the Rainy Day Fund.

Regarding budget reductions, the commission believes it is important to avoid options, to the extent possible, that would adversely affect the most vulnerable and needy populations of the State. In addition, the commission suggests that across-the-board cuts be avoided and that fund transfers

and one-time items only be used as a “bridge” until economic conditions improve. Tax compliance efforts should be enhanced to ensure fairness and to raise both short- and long-term revenues. The commission is also concerned about increased federal mandates on Maryland, especially in public education, Medicaid, and homeland security, and how they contribute to the State’s budget difficulties. It is recommended that dialogue with the federal government be initiated regarding the impact of these mandates.

If a budget gap still remains after budget reductions, transfers, and compliance issues are addressed, temporary revenue enhancement measures may be necessary. The commission suggests that taking a portion of the \$500 million in the Rainy Day Fund only be considered as a last resort – economic recovery may take several years and a financial cushion must be maintained.

In recognition of these principles, the commission offers a variety of options for addressing the fiscal 2003 and 2004 shortfalls.

### **Budget Options – Fiscal 2003**

Governor Glendening has proposed approximately \$500 million in fiscal 2003 budget reductions – this includes \$190 million from the Rainy Day Fund and \$172 million in across-the-board cuts for most State agencies. Considering that half the fiscal year has already passed, it is very difficult to make a significant impact with budget reductions – it is also difficult to pass down cuts to local governments in the middle of the fiscal year.

The commission suggests that the \$24 million in one-time fiscal 2003 salary bonuses for State employees be eliminated and that further State payroll cost reductions be explored. These reductions could include the abolition of currently funded vacant positions and/or the use of furloughs. A reduction in discretionary grants made by State agencies to private organizations could also provide savings.

The commission suggests that a preferred drug list for Medicaid prescription drugs be developed, as well as requiring prior authorization for drugs not on the list, and that supplemental rebates be sought from manufacturers seeking to add their companies to this list. Savings could be generated from encouraging utilization of lower-cost medications and obtaining additional discounts from pharmaceutical companies seeking inclusion of their products on the preferred drug list.

Several fund transfers could be authorized to gain fiscal 2003 revenues. A transfer of \$50 million from the State’s reserves for State employee workers’ compensation that is administered by the Injured Workers’ Insurance Fund (IWIF) could be considered. A transfer of \$60 million in transfer tax overattainment and unencumbered transfer tax revenues as well as a \$10 million transfer of excess highway user revenues could also be implemented.

Recouping PAYGO capital for the general fund could provide \$50 million, as these projects could be reauthorized as taxable bonds.

## Budget Options – Fiscal 2004

For fiscal 2004, an unallocated reduction in local aid of \$100 million administered through the local income tax could be warranted. While the commission recognizes that this option would require local governments to make difficult decisions regarding reductions to programs such as public safety and education, some reductions to local aid may be necessary given that it represents almost one-third of the State budget.

The commission also suggests (as for fiscal 2003) that reducing State payroll costs be explored. These reductions could include the abolition of currently funded vacant positions and/or the use of furloughs. In addition, providing no salary increments or pay-for-performance bonuses, increasing health care contributions, and eliminating the deferred compensation match could also be considered.

Considering the large growth in Medicaid and other health-related expenditures, it may be necessary to change eligibility, benefits, and/or payments to providers. Options could include:

- developing a preferred drug list for Medicaid prescription drugs, requiring prior authorization for drugs not on the list, and seeking supplemental rebates from manufacturers seeking to add their companies to the list;
- changing the provision of mental health services to Medicaid-ineligible populations; and
- delaying the second year of the developmental disabilities wage initiative.

A variety of options regarding State agencies, colleges, and universities could be considered – these include:

- level funding for State colleges and universities;
- consolidating, reducing, or abolishing some executive departments;
- deferring funding to reduce the State's unfunded liability for workers' compensation charges;
- liquidating the Maryland Housing Fund within the Department of Housing and Community Development (DHCD);
- deferring information technology projects;
- deferring additional HOPE scholarships and providing the scholarships only for teaching candidates; and
- deferring Private Donation Incentive Program payments another year.

A \$20 million transfer from the State's reserves for State employee workers' compensation could also be considered for fiscal 2004. Funding Program Open Space with bonds and shifting transfer tax revenues to the general fund could provide \$47 million in fiscal 2004 – eliminating the use of PAYGO capital and using taxable bonds if necessary to fund projects would provide another \$47 million in fiscal 2004.

As a last resort, transferring a portion of the Rainy Day Fund to the general fund could be considered; however, revenues from the fund should only be used in conjunction with a more permanent

structural solution for the budget and the fund should not be depleted.

## **Tax Compliance**

The commission suggests several tax compliance measures that could provide more fairness in taxation and generate additional revenues. These include:

- combined reporting for affiliated corporations and other measures related to the taxation of multistate corporations under the corporate income tax, as well as an increase in the Comptroller's audit staff;
- altering the due date for the payment of income tax withheld from wages, allowing the Comptroller to limit withholding exemptions of tax delinquents to that of the prior year, and permitting direct salary attachment for taxes other than income taxes;
- requiring the Department of Labor, Licensing and Regulation (DLLR), other State agencies, and clerks to verify State license holders' certifications of compliance with tax law; and
- streamlining the bank attachment process and lowering the threshold for tax payments via electronic funds transfer (EFT).

## **Video Lottery Terminals**

The enactment of video lottery terminals could generate annual gross revenues of \$800 million, according to estimates provided by the Department of Legislative Services. The amount of any revenues

received would depend on several factors, including the distribution of revenues. In addition, the timing of when revenues would be received is unknown and revenues may not be available until fiscal 2005.

## **Short-term Revenue Options**

According to 1998-99 U.S. Census data, while Maryland ranks relatively high for income taxes when compared to other states, it ranks relatively low on sales and property taxes. When compared to other states on a per capita state and local tax burden basis, Maryland ranks twelfth on overall taxes, fourth on the personal income tax, twenty-eighth on the property tax, and forty-first on the sales tax. On a percentage of personal income tax burden basis, Maryland ranks thirty-eighth on overall taxes, fourth on the personal income tax, thirty-sixth on the property tax, and forty-fifth on the sales tax.

Keeping those rankings in mind, a variety of short-term revenue enhancement options, potentially enacted for a period of two years, could be considered.

For the income tax, these options could include increasing the top tax rate for incomes over \$100,000 (\$150,000 for joint returns), increasing the corporate income tax rate, eliminating graduated income tax withholding, and crediting corporate income tax revenues to the general fund.

For the sales tax, options include increasing the tax rate, eliminating the vendor discount, imposing the tax on various services or repealing various exemptions, and crediting remaining sales tax on vehicle rental revenues to the general fund.

For the property tax, options include increasing the State property tax rate to cover more debt service costs and enacting controlling interests legislation for recordation and transfer taxes.

Other tax options include increasing the tobacco tax and eliminating the tobacco tax wholesaler discount, expanding the insurance premium tax to health maintenance organizations, and increasing the alcoholic beverage tax rates.

### **Transportation Trust Fund**

The commission is concerned about reductions in federal funding for transportation projects and increasing costs for maintaining the State's existing transportation infrastructure. Substantial funding for homeland security costs must also be addressed.

While the commission plans to look at a variety of transportation funding options during the 2003 interim, current needs could be met in a number of ways – these include increasing the motor fuel tax by 10 cents, increasing the motor vehicle excise (titling) tax, and eliminating the motor vehicle excise tax and motor fuel tax vendor discounts.



# Commission on Maryland's Fiscal Structure

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## Commission's Charge

During the 2002 legislative session, the General Assembly determined that the structural budget deficit situation needed to be addressed in a systematic, comprehensive fashion. As part of this effort, Chapter 343 (House Bill 1) of 2002 created the Commission on Maryland's Fiscal Structure.

The commission is charged with examining and making recommendations for changes to the State's budget and tax structure. Chaired by Mr. Fred Puddester, a former Secretary of the Department of Budget and Management, the commission is a 17-member panel of legislative and executive branch members as well as members representing local governments and various interest groups.

The commission's charge is to help the Governor and the General Assembly develop long-term strategies for addressing future budget needs and shortfalls. In addition to studying the State's tax structure, the commission is directed to evaluate various methods for funding education, transportation, and health care needs; study the State budget process; and look at inefficiencies in and improvements to State government services.

The commission held its first meeting in early August, at which time the commission was briefed on the various components of the State budget and on revenue and spending comparisons of Maryland and selected states. The commission subsequently met for briefings on the State tax structure, national economy, education, transportation, health care, bond ratings, budget processes, and tax compliance issues.

In mid-November, the commission began considering a series of budget and revenue options that could be provided to the Governor and the General Assembly. The commission is required to submit an interim report of its preliminary findings to the Governor and the General Assembly by December 15, 2002, and a final report by September 1, 2003.

The commission is looking at Maryland's current fiscal situation as both a short-term and long-term problem. In this report, the commission provides a series of budget and revenue options that the Governor and General Assembly may wish to consider in meeting the short-term need to balance both the fiscal 2003 and 2004 budgets. The commission plans to look next year at longer-term solutions that will allow the State to better align its budget and tax structure to meet future fiscal challenges.

## Overview of Commission Activities

### Condition of the U.S. Economy

Economic conditions at the national level have deteriorated over the better part of the last two years. After unprecedented economic growth throughout most of the 1990s, the U.S. economy entered a yearlong recession in March 2001. This recession, while relatively mild, was exacerbated by the terrorist attacks of September 11, 2001.

At its October 10 meeting, the commission heard from Dr. Alice Rivlin of the Brookings Institution, a highly regarded national expert on the U.S. economy and state tax policies. Dr. Rivlin indicated that our current economy is now dominated by the uncertainty of terrorism and the potential of military action against Iraq, but she is hopeful that the country can quickly return to a period of moderately good economic growth. She believes there will be reasonably strong growth in the gross national product but not in the stock market. She indicated that, while the U.S. economy is resilient and flexible, the uncertainty of war and escalation of terrorism interferes with any long-term planning and investments, both for government and business.

Dr. Rivlin advised that the ten-year federal budget funding outlook is not a good one and the cost of the 2001 federal tax cut was understated. While Dr. Rivlin indicated that the tax cut was good for the economy in the shortterm, the surpluses after the tax cut looked much rosier than they actually were, and significant federal budget deficits are likely for most of the rest of the decade. This is especially true with post-September 11 priorities that require increased spending for the military and homeland security.

Dr. Rivlin commented that raising taxes and cutting spending are the most counterproductive things that can be done during a recession; nevertheless, these are the tools available to states that have to balance their budgets. Dr. Rivlin believes a national debate about how to finance states should be undertaken. Income taxes are generally progressive while sales taxes are more reliable but more regressive.

At the State level, Dr. Rivlin suggested that Maryland:

- continue to put money in the Rainy Day Fund – and that the rules for contributions be increased as the State gets back to good times – she cautioned that the State should not increase spending more than is justified;
- attempt to broaden the tax base so that the State has a good mix of cyclical and noncyclical revenues; and
- collectively address the interstate competition issue by forming interstate compacts that would focus on cross-border sales issues – this could be done by all states or on a regional basis.



## **Condition of Maryland's Economy and General Fund Outlook**

At the commission's first meeting on August 8, the Department of Legislative Services (DLS) provided an overview of Maryland's fiscal structure and general fund outlook. The overview of the fiscal structure also focused on presenting revenues and expenditures for the Transportation Trust Fund (TTF) and higher education.

DLS pointed out that the personal income tax is the largest general fund revenue source, followed by the sales tax. Much of the State's spending is basically mandated – about one-third of the general fund budget is for aid to public schools, libraries, and other local aid. Regarding transportation revenues, titling tax collections are now fast approaching motor fuel tax collections (for comparison purposes) and there is a competition between the commitment to mass transit operating funding and capital funding for highways.

Regarding higher education, there is a tension between tuition and fees and the State appropriation – higher tuition affects access to education unless it is offset somewhat with need-based student financial aid. The \$2.7 billion capital budget for fiscal 2003 comprises about \$1.5 billion in operating monies (most of the operating monies are related to transportation) and more than \$1.1 billion in bonds.

At the October 24 meeting, Ms. Claire Cohen from Fitch Ratings discussed bond ratings and the role of credit ratings in State bond finances. Ms. Cohen provided background on the ratings themselves and said that she does not see anything on the horizon that will hurt Maryland's AAA rating, although significant fiscal issues face the State.

Ms. Cohen mentioned that three or four factors are looked at to determine the ratings. The first is debt burden, which is the relative ability to repay money borrowed – this is called net tax-supported debt (more specifically general obligation bonds), which is backed by the full faith and credit of the State, as well as any bonds for which State resources are used as a repayment source. The State's debt burden is measured by looking at the net tax-supported debt to personal income ratio – states are generally very modest in the use of debt, with the average being about 2 to 3 percent of income. The other method used is comparing debt service to revenues – while this is the best measurement, it is used less often because states sometimes issue debt through several agencies and it is hard to get the numbers and compare them.

Ms. Cohen said that reserve levels are examined – having 5 percent of revenues has traditionally been the benchmark. Having less than 5 percent has generally denoted a structural problem and not just a lower attainment of revenues. She said that reserve funds should only be used to allow for time to reach a more permanent budget solution. The overall state of the economy is a major factor as well.

Ms. Cohen said that Maryland is a long-term AAA rated state – this is a result of low levels of debt and the implementation of the debt affordability standards; basically, the State sets limits and lives up to them. In addition, Maryland's 15-year bond maturity requirement (which

is shorter than the standard 20-year requirement) helps, as does the diverse tax base and fairly well-managed pension funds. Ms. Cohen also commented on other forms of debt financing – she noted that issuing variable rate bonds is certainly an option. Taxable debt is generally viewed as fine and usually used for projects that exceed public purpose guidelines.

Ms. Cohen said that Fitch's overall outlook is generally negative and the rating agencies will be watching what states do to resolve their fiscal 2004 budgets. Tolerance of some one-time measures has occurred, but there is a magnitude problem and long-term solutions are now needed.

At the commission's November 14 meeting, DLS provided updated information on the general fund outlook for the near future – the anticipated budget shortfall for fiscal 2003 is estimated at \$590 million and at almost \$1.2 billion for fiscal 2004. These shortfalls will be further exacerbated by the large funding increases associated with the Bridge to Excellence in Public Schools Act enacted during the 2002 legislative session.

Maryland employment is expected to be down by 0.6 percent in 2002, but is expected to rise by 1.1 percent in 2003. Personal income growth, which was as high as 7.8 percent in 2000, is expected to be about 3.2 percent in 2002 and 4.6 percent in 2003.

It is important to note that almost every other state in the nation is having economic and budget problems. According to the National Governors Association and the National Association of State Budget Officers, 37 states were forced to reduce their enacted budgets by about \$12.8 billion in fiscal 2002. About midway through fiscal 2003, 23 states plan to reduce their net enacted budgets by more than \$8.3 billion.

## **Transportation**

At the September 12 meeting, DLS and the Maryland Department of Transportation (MDOT) provided an overview of the Transportation Trust Fund and transportation policy issues.

The Transportation Trust Fund's major revenue sources are the motor fuel tax and titling tax – these sources are not earmarked and the funding flows out to different transportation purposes. The main distribution is to local governments, and funds from the federal government provide the most significant source of funding. MDOT sold bonds for \$150 million in fiscal 2002, but over the last few years the department has not sold bonds every year.

Several policy and funding issues were discussed – the construction of the new Woodrow Wilson Bridge, mass transit initiative funding, the Purple Line Metro, the Inter-County Connector (ICC), and homeland security costs.

MDOT specifically discussed its concerns about funding for costs associated with homeland security, the funding of current and future infrastructure needs, and reduced funding

from the federal government. The levels of State and federal funding for the Woodrow Wilson Bridge are still uncertain – 80 percent of this project is to be funded by the federal government. A reduction in transportation funding from the federal government appears to be likely.

MDOT is counting on \$205 million in transfers from the general fund to the Transportation Trust Fund from fiscal 2004 through 2006 – without this funding, capital projects currently in the pipeline could be affected. The department has significant concerns about the funding of costs associated with homeland security – annual ongoing operating costs are over \$8 million and could increase, and \$200 million in capital costs for baggage screening equipment (mandated by the federal government) must also be provided. The department indicated that no new projects could likely be initiated without a gas tax increase and additional revenue sources would almost certainly be necessary to fund potential projects such as the Inter-County Connector, which is not currently in the MDOT Consolidated Transportation Program.

The fiscal condition of the TTF is relatively good as compared to the general fund – there is nothing to suggest negativity in fiscal 2003.

## **Primary and Secondary Education**

On September 26, DLS and the Maryland State Department of Education (MSDE) provided an overview of K-12 education.

An increasingly significant portion of the State budget, K-12 education comprises about 29 percent of the general fund budget and the recently enacted Bridge to Excellence in Public Schools Act will increase this percentage. Federal, State, and local funding percentages for education aid remained remarkably stable from fiscal 1987 through fiscal 2002 – generally about 5 percent federal funds, 41 percent State funds, and 54 percent local funds. In 1987, the local boards of education had \$2.9 billion in funding, increasing to \$7.1 billion by fiscal 2002.

To put future education funding increases into perspective, the estimated overall fiscal 2005 general fund growth is \$379 million, and \$365 million in education aid growth is expected from the Bridge to Excellence Act. These same numbers for fiscal 2007 are \$550 million and \$450 million. In the 2004 legislative session, the General Assembly is to pass a joint resolution that would allow the Bridge to Excellence Act to be fully implemented, if revenue projections allow for that. If this resolution is not passed, the additional funding in the Act would be phased in at a much more modest level (\$300 million versus \$1.3 billion by fiscal 2008).

The federal No Child Left Behind legislation is bipartisan legislation that is the most prescriptive public education legislation in history. This legislation makes major changes for each of the states – Maryland must meet the proficiency levels for all students by 2014, so MSDE has revamped its testing system to meet the federal requirements.

## Higher Education

On September 26, DLS and the Maryland Higher Education Commission (MHEC) provided an overview of higher education.

State funding for higher education almost entirely comes from the general fund and general fund appropriations have increased dramatically since the mid-1990s. The five categories of Maryland student financial aid were discussed in detail. Some comparisons with selected states were also provided – a few states have reduced their higher education appropriations – New Jersey reduced its appropriation by 4 percent, Virginia by 4 percent for fiscal 2002 and by 12 percent over two years, Iowa by 5 percent, and Kentucky by 2 percent. Maryland is eighteenth in the nation in higher education appropriations on a per capita basis, and fourth when compared to the selected states – as a percentage of personal income, the State ranks thirty-seventh in the nation and eleventh as compared to the selected states.

Maryland is at its highest head count enrollment in history, student retention and graduation rates have also increased, transfer rates at community colleges have increased, and more Maryland residents are going to college at Maryland institutions. Maryland ranks first in the nation on research funding from the National Institutes of Health (NIH) and the National Aeronautics and Space Administration (NASA) and second overall behind California in total federal research dollars. The State has one of the best-educated workforces in the nation, as 31 percent of Marylanders over the age of 25 have at least a bachelor's degree.

## Health Care

At the November 7 meeting, DLS and the Department of Health and Mental Hygiene (DHMH) discussed health care issues. The DLS presentation focused on health programs, funding trends, and cost containments. As with K-12 education, spending on health programs has become a significant portion of the State budget – the major growth in general fund spending for DHMH has been in Medicaid as well as in the Alcohol and Drug Administration. DHMH now has about 8,000 positions, which has declined slightly due to recent position cuts and the statewide hiring freeze. An overview of the Maryland Medical Assistance Program, which consists of three programs – Medicaid, the Maryland Children's Health Program (MCHP), and the Maryland Pharmacy Assistance Program (MPAP) – was provided. Just over 600,000 people received benefits from one of these programs in fiscal 2002.

DHMH discussed the department's three main objectives – health care financing, community health, and regulating quality. The least attention has been paid to the regulatory part of the department's work – it is both underfunded and overburdened. DHMH regulates the quality of health care facilities, professionals, and public products/facilities. Growth in the department's budget is related to enrollment increases, rising medical costs, and new mandates. In fiscal 2004, the number of positions is projected to increase due to federal funding for bioterrorism. The department's priorities are the financial stability of Medicaid, meeting the

needs of the mentally ill, providing core public health services, emergency preparedness, and ensuring quality of long-term care.

In addition, comprehensive health care reform proposals for Maryland from the House Speaker's office and the Maryland Citizens Health Initiative were discussed. The five parts of the Speaker's proposal include Medicaid expansion to cover adults up to 150 percent of federal poverty guidelines with a federal waiver, sliding scale financial support to assist those who cannot afford coverage, individual insurance market reforms that would create a health purchasing pool, small group market reforms with a one-stop shop, and tax incentives with an advanceable credit.

The Maryland Citizens Health Initiative's plan encompasses three important points, which were endorsed by a number of members of the General Assembly. First, maintain CareFirst BlueCross BlueShield as a nonprofit plan – the initiative believes the proposed conversion would be a bad deal for the people of Maryland. Second, increase the tobacco tax by 36 cents – earlier increases have had positive outcomes in reducing teen smoking and enhancing revenues. Third, the initiative supports the regulations proposed by DHMH for prescription drugs and the Speaker's plan for a purchasing pool.

### **Taxation from an Economic Development Perspective**

At the October 24 meeting, the Department of Business and Economic Development (DBED) provided perspectives on business expansion, development, and where taxes fit in Maryland.

According to DBED, taxes do play a role in business decisions, but they are only one of many concerns. The biggest concern is having a highly skilled and educated workforce. To promote the State, DBED pursues leads, sends representatives to trade shows, meets with companies, and focuses on strategic industries. DBED tries to attract technology and knowledge-based jobs, ones that are family supporting. At this point in the economy, there are a limited number of business prospects; capital investment was down in 2001 by more than 5 percent, and by at least 5 percent in 2002. Maryland has been doing well, and DBED realizes that businesses have choices with many suitable locations.

The overall cost of living is good in Maryland; the State has cost advantages and is extremely competitive. The department addresses taxes when necessary and is comfortable doing this – publications like *Money* magazine have provided unfair comparisons over the years in characterizing Maryland as a high-tax state. The department pitches the tax structure as fair and consistent – low corporate taxes, no gross receipts taxes, a uniform sales tax that is fairly low, and low workers' compensation insurance costs. The tax structure is especially good for manufacturers. With regard to taxes, the perception is as much reality as anything else. Of course, there sometimes have to be adjustments to the tax system, as the department wants to still

be able to sell Maryland as a good place for business. Taxes are important, but other issues keep Maryland in the game.

## **Overview of Maryland Budget Processes**

DLS briefed the commission on Maryland's budget processes – this included the operating budget process and the State debt authorization process. The detailed processes for both the executive and legislative branches were outlined, as well as the Spending Affordability and Capital Debt Affordability processes.

## **Revenue and Spending Comparisons for Maryland and Selected States**

At the August 8 meeting, DLS provided an overview of revenue and spending comparisons for Maryland and selected states.

In summary, Maryland is a wealthy state but raises and spends less than other wealthy states. Taxes play a greater role in Maryland's revenue structure than in other states, partially because Maryland depends less on federal funding for health programs and transportation. Maryland's revenue structure is most similar to that of Illinois, but the mix of taxes in Maryland is quite different.

When compared to other states on a per capita state and local tax burden basis, Maryland ranks twelfth on overall taxes, fourth on the personal income tax, twenty-eighth on the property tax, and forty-first on the sales tax. On a percentage of personal income tax burden basis, Maryland ranks thirty-eighth on overall taxes, fourth on the personal income tax, thirty-sixth on the property tax, and forty-fifth on the sales tax. When compared to other states regarding state and local spending, Maryland ranks thirty-fifth on the per capita measure and fiftieth on the personal income measure.

## **Tax Compliance and E-Commerce Issues**

At the October 10 meeting, the Comptroller's Office discussed the Delaware holding companies issue, which pertains to three cases pending before the Court of Appeals since 2001 and provides opportunities for business tax planning. The Comptroller's Office then discussed several tax compliance changes that could provide more revenues without tax rate changes.

In reference to e-commerce and the Streamlined Sales Tax Project, the Comptroller's Office advised that the State has been working with other states for three years on a simplified sales tax system that would be mandated by the U.S. Congress yet not too painful for the states. Maryland has been a participant since the outset – there has been great progress, but some problems still exist. The project is not currently ready to go to Congress, although a few states

may take this up in their 2003 legislative sessions. In its present form, Maryland revenues would decrease by \$40 million and the Comptroller is recommending that the State not proceed in the upcoming session. Instead, Maryland should wait to see what other states do and let the problems get worked out.

E-commerce revenue losses for fiscal 2001 in Maryland have been estimated at \$103 million, rising to \$355 million by fiscal 2006. These numbers are probably too high, but it is hard to determine accurate numbers – this is especially true now that Internet growth rates are not as high as previously estimated. The estimated total State revenue loss for all mail-order/Internet sales was estimated at \$260 million for fiscal 2001 and \$688 million in fiscal 2006.

The Maryland Retailers Association supports the Comptroller's position that Maryland should take a wait-and-see approach and that it is fiscally irresponsible to do anything without Congressional blessing. It would be feasible to enact a bill with a delayed effective date, but it would be better to have Congress take action first.

## **Overview of Maryland's Tax Structure and Discussion of Budget/Revenue Options**

After spending the late summer and fall being briefed on the major components of the State budget, the commission began to examine both budget and revenue options in mid-November. At the November 14 meeting, DLS provided an overview of the State's tax structure, including detailed descriptions of the income tax, the sales tax, and various other taxes. At the same meeting, Chairman Puddester asked DLS to provide the commission with a wide variety of budget and revenue options for consideration.

## **Public Testimony from Interested Parties**

At the November 21 meeting, the commission received testimony from a variety of individuals and groups regarding the budget and revenue options that were presented to the commission as well as other ideas for addressing the State's budget difficulties.

Many of the groups testified that the commission should refrain from presenting options that would cut programs for public education and programs that serve children and the disabled, as there are still substantial unmet needs in these areas. Other testimony included the views that State employee salaries should not be cut and State transportation programs should be maintained. Several groups expressed interest in revenue enhancements, but few specific options were provided.

## Guiding Principles for Options

At the December 6 meeting, commission members agreed that several guiding principles should be applied as the commission debated options. Six broad categories of actions to address the current situation were discussed – budget reductions, transfers/one-time items, tax compliance efforts, federal government mandates, temporary revenue measures, and the Rainy Day Fund.

Regarding budget reductions, the commission believes it is important to consider all options available. However, to the extent possible, options that would adversely affect the most vulnerable and needy populations of the State should be avoided. It is also important to be sensitive to the overall impact of any budget actions that will directly affect State employees.

In addition, the commission suggests that across-the-board cuts be avoided and encourages open communication between State agencies, local governments, and private-sector service providers as to inefficiencies in current programs that may be addressed and actions that may be taken. The commission suggests that fund transfers and one-time items only be used as a “bridge” until economic conditions improve.

Tax compliance efforts should be enhanced to ensure fairness and to raise both short-term and long-term revenues. The commission is concerned about increased federal mandates on Maryland, especially in public education, Medicaid, and homeland security, and how they contribute to the State’s budget difficulties. Dialogue with the federal government on funding for these mandates is critical.

If a budget gap still remains after budget reductions, transfers, and compliance issues are addressed, temporary revenue measures may be considered. The State took similar action during the recessionary period of the early 1990s.

The commission suggests that taking a portion of the \$500 million in the Rainy Day Fund only be considered as a last resort – economic recovery could take several years and a financial cushion must be maintained. The balance in the fund is at the statutory minimum of 5 percent of general fund revenues and every effort should be made to preserve that statutory minimum. It is worth noting that current law has a required payback provision of \$50 million if the level in the fund falls below 5 percent, so a withdrawal does not particularly help the State’s fiscal situation.

For fiscal 2003, Governor Glendening has proposed approximately \$500 million in budget reductions – his plan relies primarily on one-time fund transfers/revenues (including \$190 million from the Rainy Day Fund) and \$172 million in across-the-board cuts for most State agencies. Considering that half the fiscal year has already passed, it is very difficult to make a significant impact with budget reductions – it is also difficult to pass down cuts to local governments in the middle of the fiscal year.

With the short-term and long-term shortfalls that must be addressed, it is important to put as many options as possible up for discussion purposes. In recognition of these principles and



the Governor's proposed fiscal 2003 reductions, the commission offers a wide variety of options for addressing the fiscal 2003 and 2004 shortfalls.

## **Budget Options – Fiscal 2003**

### **State Employees/Agencies**

- **Eliminate one-time salary bonus for employees**

In lieu of a general salary increase, money for State employee bonuses was provided in the fiscal 2003 budget, pending Board of Public Works certification that the bonuses are affordable. As these monies have not been allocated, this could provide \$24 million in fiscal 2003.

- **Reduce State payroll costs**

While an across-the-board reduction of 1 percent for all State employee salaries could yield about \$15 million, the commission suggests other payroll reduction options be considered, such as the abolition of currently funded vacant positions and/or the use of furloughs.

- **Reduce grants**

A reduction in discretionary grants from or made by various State agencies could provide additional budget relief.

The commission suggests that any reductions be considered in light of the populations that may be served and taken from entities that have better abilities to fundraise from private or other government sources.

### **Health/Social Services**

- **Develop a preferred drug list for Medicaid prescription drugs, require prior authorization for drugs not on the list, and seek supplemental rebates from manufacturers seeking to add their companies to the list**

Savings could be generated from encouraging utilization of lower-cost medications and obtaining additional discounts from pharmaceutical companies seeking inclusion of their products on the preferred drug list. This could generate \$2 to \$4 million in partial-year fiscal 2003 savings.

## Transfers

- **Transfer from the State’s reserves for State employee workers’ compensation that is administered by the Injured Workers’ Insurance Fund (IWIF)**

This is the State’s reserve toward the liability for State employee workers’ compensation. The State self-insures for workers’ compensation and IWIF administers the compensation structure, charging State agencies workers’ compensation “premiums” to fund these liabilities. Approximately \$50 million could be transferred from the fund to the general fund for fiscal 2003.

- **Transfer fiscal 2002 and 2003 transfer tax overattainment and unencumbered transfer tax revenues**

Under this option, revenues that have been received from the transfer tax that are to be used to fund Program Open Space and other land preservation programs would instead be transferred to the general fund. This could yield up to \$60 million in fiscal 2003.

- **Transfer highway user revenues over-estimate**

Transferring these “excess” revenues could provide \$10 million.

## Capital

- **Recoup PAYGO capital**

Recouping PAYGO capital for the general fund could provide \$50 million; these projects could be reauthorized as taxable bonds.

## Budget Options – Fiscal 2004

### Local Aid

- **Provide for an unallocated reduction in local aid of \$100 million administered through the local income tax**

Under this option, local aid would be reduced by \$100 million in fiscal 2004, and the State would simply retain income tax revenue that would otherwise go to local jurisdictions. This would be easier administratively from the State's point of view, but local governments would have to reduce programs and/or services.

To put this level of reduction into context, this would be \$100 million of approximately \$3.9 billion in State aid to local governments for fiscal 2004 – State aid comprised over 27 percent of local government budgets in 2001, not including the impact of the Bridge to Excellence in Public Schools Act.

In addition, local governments put much reliance on the property tax, with about 25 percent of local revenues related to that tax. However, while a still strong real estate market has spurred substantial growth in property tax revenues, tax caps in several counties and the homestead tax credit have limited this growth.

The commission recognizes that this option would require local governments to make difficult decisions regarding vital programs such as public safety and education. However, given that local aid represents almost one-third of the State general fund budget, some reductions to local aid may be necessary.

## **Health/Social Services**

Considering the large growth in Medicaid and other health-related expenditures in recent years and the continued growth expected in the future, it may be necessary to change eligibility, benefits, and/or payments to providers.

- **Develop a preferred drug list for Medicaid prescription drugs, require prior authorization for drugs not on the list, and seek supplemental rebates from manufacturers seeking to add their companies to the list**

Savings are generated from encouraging utilization of lower-cost medications and obtaining additional discounts from pharmaceutical companies seeking inclusion of their products on the preferred drug list. This could generate \$8 million in fiscal 2004 savings.

- **Change provision of mental health services to Medicaid-ineligible populations**

Prior to July 1, 2002, \$40 million in mental health services was provided to certain Medicaid-ineligible clients through the fee-for-service public mental health system. This is in addition to services delivered through a series of grants and contracts via local core service agencies. Some of these services are now being delivered through grants, and income eligibility for new clients was lowered to 116 percent of federal poverty guidelines.

Fee-for-service as a means of providing mental health services to Medicaid-ineligible clients would no longer be used, as a safety net of grant and contract-based mental health services would be provided. This could generate savings of \$20 million in fiscal 2004.

The commission believes this option could help to bring these services into future fiscal stability.

- **Delay second year of developmental disabilities wage initiative**

Legislation enacted in 2001 established an initiative to achieve parity in wages for direct care workers employed by community-based developmentally disabled service providers and similar workers employed by the State in State residential centers for the developmentally disabled. The cost of the initiative is based on annual wage surveys adjusted for effects of wage increases on retention, benefits, and cost-of-living increases. Considering that the State may have to make some adjustments in State employee compensations, some adjustment in this area may also be necessary.

This initiative is intended to be five years in length beginning in fiscal 2003 – this option would defer the second year of the initiative. This could provide \$16 million in savings – \$11 million to the general fund and \$5 million in federal funds.

## **State Employees**

- **Reduce State payroll costs**

While an across-the-board reduction of 1 percent for all State employee salaries could yield about \$30 million in fiscal 2004, the commission suggests other options be considered, such as reducing payroll costs through the abolition of currently funded vacant positions and/or the use of furloughs. Providing no salary increments or pay-for-performance bonuses, as well as increasing health care contributions and eliminating the deferred compensation match, could also be considered.

## **State Agencies/Colleges and Universities**

- **Level fund State colleges and universities**

Maintaining funding for these institutions at fiscal 2003 levels would provide \$38 million in fiscal 2004 savings.

Many other states are making sizable cuts to higher education, and it may be necessary to make reductions in this area. The Governor's budget reduction proposal for fiscal 2003 would reduce higher education funding by \$34 million.

- **Consolidate/reduce/abolish executive departments**

Merging, reducing, or abolishing some executive departments could yield additional savings. The commission did not analyze any specific proposals but suggests that agency consolidations be pursued.

- **Defer funding to reduce the State's unfunded liability for workers' compensation charges**

Keeping these funds for the general fund would generate fiscal 2004 savings of \$20 million.

- **Liquidate the Maryland Housing Fund**

This fund within the Department of Housing and Community Development (DHCD) is to help ensure affordable housing by insuring loans in order to stimulate private capital investment in such housing; no new insurance has been issued since 1997. Liquidating this fund could provide \$20 million in fiscal 2004.

- **Defer information technology projects**

Under this option, projects would be delayed, as there is no management structure in place for implementing them. This could save \$20 million in fiscal 2004.

- **Defer additional HOPE scholarships and provide the scholarships only for teaching candidates**

HOPE scholarships are designed for high school seniors and Maryland residents who will work or currently work in a designated job one year for each year of aid received. Maintaining the HOPE program at the fiscal 2003 level and providing the scholarships only for teaching candidates would save \$12 million in fiscal 2004.

- **Defer Private Donation Incentive Program payments another year**

Deferring the State match of private donation incentive payments to higher education and community colleges to fiscal 2005 could save \$4.7 million. There is already a liability of \$8 million.

## Transfers

- **Transfer from the State's reserves for State employee workers' compensation that is administered by the Injured Workers' Insurance Fund**

Approximately \$20 million could be transferred from the fund for fiscal 2004.

- **As a last resort, consider transferring a portion of the Rainy Day Fund to the general fund**

The Rainy Day Fund currently contains \$500 million. If the amount in the fund falls below 5 percent of general fund revenues, there is a payback requirement of \$50 million in the next fiscal year. Revenues from the Rainy Day Fund should only be used in conjunction with a more permanent structural solution for the budget and the fund should not be depleted, as it is the only remaining safeguard for catastrophic needs.

## Debt Service/Capital

- **Fund Program Open Space with bonds and shift transfer tax revenues to the general fund**

Under this option, bonds would be used to pay for land preservation efforts undertaken by the State, and transfer tax revenues would be transferred to the general fund. This would yield \$47 million in fiscal 2004.

- **Eliminate use of PAYGO capital**

Using taxable bonds if necessary to fund capital projects would provide \$47 million in fiscal 2004.

## Tax Compliance

- **Provide for combined reporting for affiliated corporations and other measures related to the taxation of multistate corporations under the corporate income tax, including giving the Comptroller authority to challenge transfer pricing for related corporations**

Under current corporate income tax law, Maryland is a "separate entity" state, which means that Maryland's tax is calculated on the separate income of each corporation doing business in Maryland, including each separate subsidiary of a commonly controlled enterprise. Separate entity reporting in commonly controlled enterprises facilitates tax planning opportunities for corporations to avoid payment of State income taxes. Some

of these tax planning activities arise because several state corporate income tax statutes, including in particular those of Delaware and Nevada, do not tax income from intangibles such as trademarks, patents, copyrights and royalties.

As a partial result of this (known as the Delaware holding company issue) and other tax planning efforts on the part of corporations, the share of total State taxes contributed by the corporate income tax has dropped in recent years. Addressing these issues by providing for combined reporting and related measures could generate \$100 million in annual revenues.

- **Increase audit staff**

According to the Comptroller's Office, each additional auditor could generate an annual revenue increase of about \$450,000.

- **Alter due date for payment of income tax withheld from wages**

Under current law, the due date for filing an income tax withholding return and paying the income tax withheld to the Comptroller is generally the fifteenth of the succeeding month. For the four months following the end of a calendar quarter, however, the due date is the thirtieth. Changing the due date for payment of the income tax withheld to be the date required for payment of federal income tax withheld would result in additional interest earnings, generating about \$14 million annually.

- **Require the Department of Labor, Licensing and Regulation (DLLR), other State agencies, and clerks to verify State license holders' certifications of compliance with tax law**

Under current law, State license holders must certify that they are current on State taxes, but there is no action required by DLLR to verify that certification. DLLR licenses a variety of occupations and professions, from accountants and architects to cosmetologists and barbers. Roughly 170,000 licenses are issued by DLLR annually. This is already required for State contracts of over \$100,000.

Professional and business licenses other than those regulated by DLLR could be made subject to the same procedure. This option could provide \$15 to \$20 million in annual revenues.

- **Streamline bank attachment process**

Under current law, the Comptroller must get a court judgment for authority to attach a bank account when a tax lien is issued. After hearing from the court, the Comptroller then notifies banks of the names and amounts of the accounts to be attached by certified mail. When the banks respond as to whether or not they hold the proper account, the Comptroller must go back to court for a condemnation. Streamlining this process by no

longer requiring the condemnation proceeding could generate approximately \$10 million annually.

- **Lower the threshold for tax payments via electronic funds transfer (EFT)**

Under current law, any single business tax payment of \$20,000 or more must be paid via electronic funds transfer. Generally, the Comptroller cannot require payment by EFT for amounts under \$20,000. Currently, about two-thirds of both sales tax and income tax withholding revenue is received electronically, as is about four-fifths of corporate income tax revenue. Reducing the threshold to \$5,000 or \$10,000 could generate \$2 million annually.

- **Allow the Comptroller to limit withholding exemptions of tax delinquents to that of the prior year**

Under current law, the Comptroller can only do this if fraud is proven; expanding this authority could provide \$5 million annually.

- **Permit direct salary attachment for taxes other than income taxes**

Expanding the Comptroller's authority to attach salaries for other taxes would generate \$5 million.

## **Video Lottery Terminals**

- **Enact legislation to provide video lottery terminals**

The enactment of video lottery terminals could generate annual gross revenues of \$800 million, according to recent estimates provided to the commission by DLS.

The amount of any revenues received would depend on several factors, including the distribution of revenues. In addition, the timing of when revenues would be received is unknown and revenues may not be available until fiscal 2005.

## **Short-term Revenue Options**

While the commission is providing a series of options for budget reductions, transfers, and tax compliance items, it may be necessary for the Governor and General Assembly to also consider revenue enhancements in order to solve the current budget shortfalls. Considering that the commission plans to evaluate long-term changes to the State's tax structure during the 2003 interim, an examination of a series of short-term revenue enhancement options, possibly enacted for a two-year duration, may be appropriate.



## **Income Tax**

- **Increase the top income tax rate for incomes over \$100,000, and \$150,000 for joint returns**

Under current law, the top income tax rate is 4.75 percent – imposing a higher tax rate for high incomes would be similar to action taken on a temporary basis in 1992.

- **Increase the corporate income tax rate**

Last increased in 1968, the corporate income tax rate of 7 percent will yield \$396 million in fiscal 2003 revenues. About 24 percent of corporate income tax revenues go to the TTF, with the remainder to the general fund.

- **Eliminate graduated income tax withholding**

Having the Comptroller provide for all withholding at the 4.75 percent income tax rate could generate \$45 million in one-time revenues – these revenues would eventually be returned to taxpayers via refunds.

- **Credit corporate income tax revenues to the general fund**

These revenues were originally dedicated to the Port of Baltimore – when the various transportation revenue sources were consolidated in 1970, this revenue source was maintained for transportation.

Taking these revenues from the TTF and crediting them to the general fund would yield \$95 million annually.

## **Sales Tax**

- **Increase the sales tax rate**

The current sales tax rate of 5 percent has been in effect since 1977 and is estimated to generate about \$2.6 billion in fiscal 2003 revenues.

- **Eliminate sales tax vendor discount**

Under current law, vendors receive a commission for collection and remittance of the sales tax. As a result of legislative action in the 2002 session, the discount was cut in half for fiscal 2003 and 2004 – the current discount is either 0.6 or 0.45 percent. For fiscal 2004, eliminating the discount would result in \$11 million in additional revenues; in future years, this amount would be \$23 million annually.

- **Impose the sales tax on various services or repeal various sales tax exemptions**

While services are a growing portion of the State's economy, the 5 percent sales tax generally does not apply to most services. In addition, there are a number of exemptions from the sales tax under current law. Consideration could be given to changes in these areas.

- **Credit remaining sales tax on vehicle rental revenues to the general fund**

Taking these revenues from the TTF and crediting them to the general fund would yield \$20 million annually.

## **Property Tax**

- **Increase the State property tax rate to cover more debt service costs**

The current State property tax rate is 8.4 cents and revenues from the tax are dedicated to cover debt service costs for State general obligation bonds. Although full property valuation enacted several years ago caused the rate to decrease, the rate has not been adjusted to increase or decrease revenues since 1982. While the rate has not changed to attain more revenues, debt service costs have increased dramatically due to growth in the capital budget and general funds are required to cover additional costs.

For fiscal 2002 and 2003, the amount of general funds necessary to cover debt service costs was around \$200 million; this amount is expected to be around \$180 million in fiscal 2004.

- **Enact controlling interests legislation for recordation and transfer taxes (House Bill 557 of 2002)**

Considered during the 2002 session, this legislation would have imposed recordation and transfer taxes on the transfer of real property, with a value of \$500,000 or more, when the transfer was achieved through the sale of a "controlling" interest in a specified corporation, partnership, limited liability company, limited liability partnership, or other form of unincorporated business. This would have closed a tax loophole that businesses have used to avoid these taxes through the creation of a "shell" corporation into which a property is transferred. If this legislation were enacted, State special fund revenues could increase by \$10 million and local revenues could increase by \$32 million beginning in fiscal 2004.

## **Tobacco Tax**

- **Increase the tobacco tax**

Under current law, the tobacco tax is \$1.00 per pack; this tax was increased from 66 cents in 2002. The tax was also increased in 1999 from 36 cents to 66 cents. Five states currently have higher tobacco taxes than Maryland.

Tobacco tax revenues are general fund revenues, except for \$80 million in fiscal 2003 dedicated to various purposes.

- **Eliminate tobacco tax wholesaler discount**

Under current law, wholesalers receive a commission of 0.82 percent for buying and affixing tobacco tax stamps. Eliminating this discount could provide \$2 million annually.

## **Health Taxes**

- **Expand the insurance premium tax to health maintenance organizations (Senate Bill 10 of 2002)**

Under current law, the insurance premium tax is 2 percent imposed on gross premiums for insurance coverage on risks located in the State. Health maintenance organizations (HMOs) and nonprofit hospital health service corporations are exempt from the tax.

This tax is estimated to generate \$197 million in general fund revenues for fiscal 2003 – expanding the tax to HMOs would increase revenues by \$40 million annually.

## **Alcoholic Beverage Taxes**

- **Increase the alcoholic beverage tax rates**

The distilled spirits tax of \$1.50 per gallon was last increased in 1955 and the beer and wine taxes (9 cents and 40 cents per gallon, respectively) were last increased in 1972.

## **Transportation Trust Fund**

In 1999, the Commission on Transportation Investment recommended that \$27 billion in transportation initiatives would need to be funded over the next 20 years. Additional revenues may be needed to obtain the projected annual spending level of \$1.5 billion.

Reductions in federal funding for transportation projects, including reduced federal funding for the Woodrow Wilson Bridge and mass transit, are significant concerns, as are increasing costs for maintaining the State's existing transportation infrastructure. MDOT is counting on \$205 million in transfers from the general fund to the TTF from fiscal 2004 through 2006 – without this funding, capital projects currently in the pipeline could be affected.

Substantial funding needs for homeland security costs must also be addressed – annual ongoing operating costs are over \$8 million and could increase, and \$200 million in capital costs for baggage screening equipment (mandated by the federal government) must also be provided.

The commission will look at other transportation revenue options during the 2003 interim.

- **Increase the motor fuel tax by 10 cents**

Under current law, the motor fuel tax rate is 23.5 cents and was last increased in 1992. The revenues go to the TTF, and 30 percent of the revenues are distributed to local jurisdictions.

An increase of one cent would increase State revenues for the TTF by \$20 million, and 10 cents would generate \$200 million (excluding local revenue distributions and increased bonding authority).

An increase in the rate to 33.5 cents would give Maryland the highest motor fuel tax rate in the country; however, Maryland is unusual in that the State funds two major urban transit systems solely with transportation-related revenue.

- **Increase the motor vehicle excise (titling) tax**

Under current law, a 5 percent tax is imposed on the fair market value of motor vehicles at the time of sale and/or resale. This brought in \$650 million in fiscal 2002.

- **Eliminate the motor vehicle excise tax and motor fuel tax vendor discounts**

Under current law, vendors receive a commission for collection and remittance of these taxes (as with the general sales tax). As a result of legislative action in the 2002 session, the motor vehicle excise tax discount of 1.2 percent of the gross tax collected up to \$24 per vehicle was cut in half for fiscal 2003 and 2004 and the motor fuel tax discount of 1 percent of the first 10 cents of fuel tax liability per gallon was permanently cut in half. For fiscal 2004, eliminating these discounts would result in a combined \$2.7 million in additional revenues; in future years, this amount would be \$5.4 million annually.

**HOUSE BILL 1**  
**EMERGENCY BILL**

Unofficial Copy  
Q7

2002 Regular Session  
(2lr1236)

***ENROLLED BILL***

*-- Ways and Means/Budget and Taxation --*

Introduced by **Delegates Hixson, Taylor, Arnick, Busch, Conway, Dewberry, Doory, Harrison, Howard, Hurson, Kopp, McIntosh, Menes, Montague, Owings, Rawlings, Rosenberg, Vallario, and Wood** **Wood, W. Baker, Barkley, Bobo, Burns, Cadden, Cane, Carlson, Crouse, C. Davis, DeCarlo, Donoghue, Dypski, Franchot, Frush, Fulton, Giannetti, Gladden, Goldwater, Healey, Hecht, Heller, Hubers, James, A. Jones, V. Jones, Kirk, Love, Mandel, McHale, Minnick, Moe, Parrott, Pitkin, Riley, Rosso, Rudolph, Shriver, Stern, Turner, Valderrama, and Weir**

Read and Examined by Proofreaders:

\_\_\_\_\_  
Proofreader.

\_\_\_\_\_  
Proofreader.

Sealed with the Great Seal and presented to the Governor, for his approval this  
\_\_\_\_ day of \_\_\_\_\_ at \_\_\_\_\_ o'clock, \_\_\_\_ M.

\_\_\_\_\_  
Speaker.

CHAPTER \_\_\_\_\_

1 AN ACT concerning

2 **Commission on Maryland's Fiscal Structure**

3 FOR the purpose of establishing a Commission on Maryland's Fiscal Structure;  
4 requiring the Commission to review and evaluate the State's budget and fiscal  
5 structure; requiring the Commission to make recommendations on changes to  
6 the State budget process and the State tax structure; requiring the Commission  
7 to make recommendations on methods to address certain funding needs for  
8 education, transportation, and health care and for addressing inefficiencies and  
9 improvements in State government services and operations; providing for the  
10 membership of the Commission; requiring an interim report by a certain date;

2

**HOUSE BILL 1**

1 providing for the staffing of the Commission; requiring a final report by a  
 2 certain date; making this Act an emergency measure; and generally relating to  
 3 the Commission on Maryland's Fiscal Structure.

4 SECTION 1. BE IT ENACTED BY THE GENERAL ASSEMBLY OF  
 5 MARYLAND, That:

6 (a) There is a Commission on Maryland's Fiscal Structure.

7 (b) The Commission shall review and evaluate the State's current budget and  
 8 fiscal structure and make recommendations for:

9 (1) changes to the State budget process ~~and procedures~~, Spending  
 10 Affordability process, and Capital Debt Affordability process that would allow for  
 11 more effective development and enactment of the annual State budget;

12 (2) ensuring that the State will have a progressive tax structure through  
 13 examination of the income, sales, property, excise, and business taxes, including any  
 14 changes that may be necessary to ensure equity and efficiency in the State's tax  
 15 system;

16 (3) methods to address funding sources for the education needs outlined  
 17 in the report of the Commission on Education Finance, Equity, and Excellence, the  
 18 transportation needs outlined in the report of the Commission on Transportation  
 19 Investment, and the health care funding needs outlined in recent years;

20 (4) addressing inefficiencies in and improvements to State government  
 21 services and operations; and

22 (3) ~~new State and local revenue sources that may be considered in future~~  
 23 ~~years; and~~

24 (4) (5) changes to the State's tax structure that would allow the State  
 25 to be more competitive with surrounding states regarding economic development.

26 (c) The Commission shall be composed of ~~15~~ 17 members as follows:

27 (1) a chairman appointed by the Governor;

28 (2) ~~two~~ four members of the Senate Budget and Taxation Committee,  
 29 appointed by the President of the Senate;

30 (3) two members of the House Committee on Ways and Means, appointed  
 31 by the Speaker of the House of Delegates;

32 (4) two members of the House Appropriations Committee, appointed by  
 33 the Speaker of the House of Delegates;

34 (5) the Comptroller of the Treasury;

3

HOUSE BILL 1

- 1           (6)    the Secretary of the Department of Business and Economic  
2 Development;
- 3           (7)    the Director of the Department of Assessments and Taxation;
- 4           (6)    a representative of the Maryland Association of Counties;
- 5           (7)    a representative of the Maryland Municipal League;
- 6           (8)    the Superintendent of the State Department of Education;
- 7           (9)    the Secretary of the Department of Transportation;
- 8           (10)   the Secretary of the Department of Budget and Management; and
- 9           (8)    a representative of the Maryland Chamber of Commerce; and
- 10          (9)    a representative of the Maryland Association of Nonprofit  
11 Organizations; and
- 12          (11)   (9)    (10)   two ~~four~~ three members of the public, appointed by the  
13 Governor.

14   (d)    The Department of Legislative Services, the Department of Business and  
15 Economic Development, and the Comptroller of the Treasury shall provide staff  
16 support to the Commission.

17   (e)    The Commission shall submit a *an interim* report of its *preliminary*  
18 findings and recommendations to the Governor and, in accordance with § 2-1246 of  
19 the State Government Article, to the General Assembly by ~~November 1, 2003~~  
20 December 15, 2002.

21   (f)    The Commission shall submit a final report of its findings and  
22 recommendations to the Governor and, in accordance with § 2-1246 of the State  
23 Government Article, to the General Assembly by September 1, 2003.

24   ~~SECTION 2. AND BE IT FURTHER ENACTED, That this Act shall take~~  
25 ~~effect July 1, 2002.~~

26   SECTION 2. AND BE IT FURTHER ENACTED, That this Act is an  
27 emergency measure, is necessary for the immediate preservation of the public health  
28 or safety, has been passed by a yea and nay vote supported by three-fifths of all the  
29 members elected to each of the two Houses of the General Assembly, and shall take  
30 effect from the date it is enacted.

## Commission on Maryland's Fiscal Structure

Fred Puddester, Chairman

### 2002 Interim Meeting Schedule

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<u>Date</u>	<u>Day</u>	<u>Time</u>	<u>Topics</u>
Aug. 8	Thursday	1:00 pm	(1) Overview of Maryland's Fiscal Structure (2) Organizational Matters
Sept. 12	Thursday	1:00 pm	Transportation Overview
Sept. 26	Thursday	1:00 pm	(1) K-12 Education Overview (2) Higher Education Overview
Oct. 10	Thursday	1:00 pm	(1) Dr. Alice Rivlin on State Tax Policies (2) Tax Compliance/E-Commerce Issues
Oct. 24	Thursday	1:00 pm	(1) Budget Issues Overview (2) Bond Ratings Overview (3) Overview of Taxation from an Economic Development Perspective
Nov. 7	Thursday	1:00 pm	Health Care Overview



Appendix 2 (Continued)

Nov. 14	Thursday	1:00 pm	(1) Overview of Maryland's Tax Structure (2) Work Session
Nov. 21	Thursday	1:00 pm	(1) Public Testimony from Interested Parties (2) Work Session
Dec. 6	Friday	1:00 pm	Discussion of Draft Interim Report
Dec. 10	Tuesday	2:30 pm	Discussion and Approval of Final Interim Report

## **Commission on Maryland's Fiscal Structure**

### **Detailed Meeting Schedule – 2002 Interim**

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#### **Thursday, August 8 – Organizational Meeting/Briefings**

- Review commission goals (House Bill 1).
- Discussion of organizational items.
- Overview of Maryland's fiscal structure and general fund outlook.
- Revenue and expenditure comparisons of Maryland and selected states.

#### **Thursday, September 12 – Transportation Issues**

- Presentations by the Department of Legislative Services and the Maryland Department of Transportation regarding the Transportation Trust Fund and transportation policy issues.

#### **Thursday, September 26 – K-12 Education and Higher Education Issues**

- Presentations by Legislative Services and the Maryland State Department of Education on the funding of K-12 education in Maryland, the work and recommendations of the Commission on Education Finance, Equity, and Excellence, and the Bridge to Excellence in Public Schools Act of 2002.
- Presentations by Legislative Services and the Maryland Higher Education Commission regarding the 1999 recommendations and legislation from the Task Force to Study the Governance, Coordination, and Funding of the University System of Maryland, as well as an overview of higher education in Maryland.

#### **Thursday, October 10 – State Tax Policies/Tax Compliance and E-Commerce Issues**

- Presentation by Dr. Alice Rivlin of the Brookings Institution on state tax policies.
- Presentation by the Comptroller's Office on tax compliance issues.
- Presentation by the Comptroller's Office and the Maryland Retailers Association on e-commerce issues.

**Thursday, October 24 – Budget Issues**

- Overview by Legislative Services on the formulation of the annual State operating and capital budgets, the Spending Affordability Committee process, and the Capital Debt Affordability Committee process.
- Presentation by Fitch Ratings on bond ratings.
- Presentation by the Department of Business and Economic Development on taxation from an economic development perspective.

**Thursday, November 7 – Health Care Issues**

- Presentations by Legislative Services and the Department of Health and Mental Hygiene on State health care funding and policy issues.
- Overview of Speaker Taylor's proposed health care initiative.
- Overview of the health care initiative proposed by the Maryland Citizens Health Initiative.

**Thursday, November 14 – Overview of Maryland's Tax Structure/Budget and Commission Work Session**

- Presentation by Legislative Services on the State's major taxes and the fiscal 2004 budget outlook.
- Discussion of recommendations.

**Thursday, November 21 – Public Testimony/Work Session**

- Public testimony from interested parties.
- Discussion of recommendations.

**Friday, December 6 – Discussion of Draft Interim Report**

**Tuesday, December 10 – Discussion and Approval of Final Interim Report**

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## **Budget and Revenue Options**

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**Presentation to the Commission on Maryland's Fiscal Structure**

**Department of Legislative Services**

**Office of Policy Analysis**

**Annapolis, Maryland**

**November 14, 2002**

**Potential Items for Balancing  
the Fiscal 2003 General Fund Budget  
(\$ in Millions)**

	<u><b>FY 2003</b></u>
<b>Aid to Local Governments</b>	
Unallocated reduction to local aid (administered through the local income tax)	\$90
<b>Aid Subtotal</b>	<b>\$90</b>
<b>State Employees/Government</b>	
No one-time bonus	\$24
1% reduction in employee salaries	15
Reduce grants	15
Increase prescription co-pays	5
<b>Employees/Government Subtotal</b>	<b>\$59</b>
<b>Fund Transfers/Shifts</b>	
Transfer FY 2002 and 2003 overattainment of and unencumbered transfer tax revenues	\$60
Transfer from the State's reserves for State employees workers compensation administered by the Injured Workers Insurance Fund (IWIF)	50
Highway user revenues over-estimate	10
Joseph Fund balance	8
<b>Transfers Subtotal</b>	<b>\$128</b>
<b>Capital</b>	
Recoup PAYGO capital	\$50
<b>Capital Subtotal</b>	<b>\$50</b>
<b>Revenues</b>	
Eliminate graduated withholding	\$45
<b>Revenues Subtotal</b>	<b>\$45</b>
<b>Total Actions</b>	<b>\$372</b>

**Potential Items for Balancing  
the Fiscal 2004 General Fund Budget  
(\$ in Millions)**

	<u>FY 2004</u>
<b>Debt Service on State Bonds</b>	
Reduce General Fund support for debt service	\$70.0
<b>Debt Service Subtotal</b>	<b>\$70.0</b>
<b>Aid to Local Governments</b>	
Unallocated reduction to local aid (administered through the local income tax)	\$100.0
Accelerate termination of funding for Teachers Salary Challenge (current law phases out all funding by FY 2006)	36.0
Eliminate or phase-out utility property tax grants	30.0
Freeze State payments for teachers retirement at FY 2003 level (local governments would be responsible for additional costs)	29.0
Freeze General Fund State aid for counties, community colleges, and health departments	12.0
1% reduction in General Fund State aid for counties, community colleges, and health departments	4.7
<b>Aid Subtotal</b>	<b>\$211.7</b>
<b>Health/Entitlements</b>	
Eliminate fee-for-service coverage of Medicaid ineligible mentally ill and fund a safety net system through grants to providers	\$20.0
Delay second year of developmental disabilities wage initiative	16.0
Develop a preferred drug list for Medicaid prescription drugs, require prior authorization for drugs which are not on the list, and seek supplemental rebates from manufacturers seeking to add their companies to the drug list	8.0
Reduce Medicaid managed care payments and delay a portion of the calendar 2003 increase until calendar 2004	6.0
Freeze temporary cash assistance rates at November 2002 levels	3.5
<b>Entitlement Subtotal</b>	<b>\$53.5</b>
<b>State Employees</b>	
No employee increments and no pay-for-performance bonuses	\$37.0
Abolish 1,000 positions	30.0
1% reduction in employee salaries	30.0

## Appendix 3 (Continued)

No deferred compensation match (was reduced from \$600 to \$500 in FY 2003)		13.2
Raise employee share of health insurance costs by five percent (e.g. from 15% to 20% for HMOs), effective January 2004		8.0
Eliminate out-of-state travel		2.3
	<b>Employees Subtotal</b>	<b>\$120.5</b>
 <b>State Agencies/Colleges and Universities</b>		
Level fund State colleges and universities		\$38.0
Executive department reduction/consolidation - merge DBED and DHCD, merge DNR and MDA, merge Military and State Police, reduce funding for MDP and MHEC, and abolish OCYF and LMBs		35.0
Defer funding to reduce the State's unfunded liability for workers' compensation charges		20.0
Defer information technology projects		20.0
Liquidate the Maryland Housing Fund		20.0
Provide HOPE scholarships only for teaching candidates		7.0
Defer additional HOPE Scholarships		4.8
Defer Private Donation Incentive Program payments another year		4.7
No increase in substance abuse treatment (STOP) grants to counties		4.0
Use collective bargaining process to attempt to preserve service levels and quality through revision of work processes and staffing patterns in ways which improve productivity -- if the process is not effective in cooperatively resolving workforce issues, consider its repeal		
	<b>Agency Subtotal</b>	<b>\$153.5</b>
 <b>Fund Transfers/Shifts</b>		
Fund Program Open Space and related programs with bonds -- shift remaining transfer tax revenues to GF		\$47.0
Transfer from the State's reserves for State employees workers compensation administered by the Injured Workers Insurance Fund (IWIF)		20.0
Fund entire State Police Aviation Division and Maryland Emergency Management Agency through the Maryland Emergency Medical System Operations Fund (would eventually require a vehicle registration fee increase)		9.0
	<b>Transfers Subtotal</b>	<b>\$76.0</b>
 <b>Capital</b>		
No PAYGO capital (use taxable bonds if necessary)		\$47.0
	<b>Capital Subtotal</b>	<b>\$47.0</b>
 <b>Total Actions</b>	 33	 <b>\$732.2</b>

**Potential Revenue Items for  
Balancing the Fiscal 2004 Budget  
(\$ in Millions)**

	<u>Annual Amount</u>
<b>Personal Income Tax -- Rate</b>	
Increase the top income tax rate to 6% for incomes over \$100,000, \$150,000 for joint returns	\$200.0
<b>Rate Subtotal</b>	<b>\$200.0</b>
<b>Personal Income Tax -- Repeal Current Deductions</b>	
Home mortgage interest deduction	\$355.0
Charitable contributions deduction	135.0
Real property tax deduction	105.0
Social Security benefits subtraction	70.0
Pension income subtraction	55.0
<b>Deductions Subtotal</b>	<b>\$720.0</b>
<b>Corporate Income Tax*</b>	
Provide for combined reporting and address other issues related to multi-state corporations	\$100.0
Increase the corporate income tax rate to 8%	57.0
<b>Corporate Subtotal</b>	<b>\$157.0</b>
<b>Sales Tax -- General</b>	
Increase sales tax rate to 6%	\$520.0
Eliminate sales tax vendor discount	22.0
Advance sales tax due date by one day	0.3
<b>General Sales Subtotal</b>	<b>\$542.3</b>
<b>Sales Tax -- Taxation of Services</b>	
Business services	\$600-\$700
Information services	325-385
Professional services	200-260
Transportation services	200-250
Financial services	150-230
Personal services	75-115
Repair services	50-80
<b>Services Subtotal</b>	<b>\$1,600-\$2,020</b>



Appendix 3 (Continued)

**Sales Tax -- Repeal Current Exemptions**

Food for off-premises consumption (1% = \$56 million)	\$280.0
Residential sales of energy	145.0
Property used in manufacturing	115.0
Medical/health supplies	70.0
Sales to charitable, educational, or religious organizations	70.0
Sales for agricultural purposes	55.0
<b>Exemptions Subtotal</b>	<b>\$735.0</b>

**Property/Transfer Taxes**

Increase State property tax rate from 8.4 cents to approximately 14.4 cents to cover debt service	\$200.0
Enact controlling interests legislation for recordation and transfer taxes (House Bill 557 of 2002)	10.0 **
<b>Property Tax Subtotal</b>	<b>\$210.0</b>

**Transportation Taxes -- Revenues**

Increase the motor fuel tax by seven cents	140.0 ***
Increase the titling tax from 5% to 6%	99.0
Eliminate titling tax vendor discount	4.0
Use tire fee to support general environmental programs	2.0
Eliminate motor fuel tax vendor discount	1.4
<b>Revenues Subtotal</b>	<b>\$246.4</b>

**Transportation Taxes -- Fund Transfers from the TTF**

Credit corporate income tax revenues to the GF	\$95.0
Credit remaining sales tax revenues on vehicle rental revenues to the GF	20.0
<b>Transfers Subtotal</b>	<b>\$115.0</b>

**Tobacco Tax**

Increase the tobacco tax by 25 cents per pack	\$51.0
Eliminate tobacco tax wholesaler discount	2.0
<b>Tobacco Subtotal</b>	<b>\$53.0</b>

**Health Taxes**

Expand the insurance premium tax to HMOs (Senate Bill 10 of 2002)	\$40.0
Nursing home provider tax	33.0
<b>Health Subtotal</b>	<b>\$73.0</b>

Appendix 3 (Continued)

**Alcoholic Beverage Taxes**

Double the alcoholic beverage tax rates	\$25.0
<b>Alcoholic Beverage Subtotal</b>	<b>\$25.0</b>

**Tax Credits**

Eliminate the Heritage Structure Rehabilitation Credit	\$50.0
Freeze the refundable earned income tax credit (EITC) at 16%	16.0 ****
Eliminate the Maryland-Mined Coal Credit	12.0
<b>Credits Subtotal</b>	<b>\$78.0</b>

**Tax Administration**

Accelerate collection of withholding taxes	\$14.0
Expand license clearance to DLLR, DNR, DHMH, MDE, and MVA	10.0
Require clearance before clerks issue business and other licenses	10.0
Streamline bank attachment process	10.0
Give Comptroller the authority to challenge transfer pricing for related corporations	10.0
Require withholding on out-of-state contractors	5.0
Allow Comptroller to limit withholding exemptions of tax delinquents to actual shown on prior year's return	5.0
Permit direct salary attachment for taxes other than income taxes	5.0
Lower the \$20,000 threshold for electronic funds transfer payments	2.0
Add 1% to the current minimum interest rate of 13%	2.0
Miscellaneous compliance activities for the Comptroller	2.0
Require withholding at racetracks	0.4
<b>Administration Subtotal</b>	<b>\$75.4</b>

**Total Actions** **\$4,830-\$5,250**

\* 24% of the revenues would go to the TTF.

\*\* \$32 million annually to local governments.

\*\*\* Assumes local distributions under the current formula and does not include increased bonding authority.

\*\*\*\* \$8 million reduction for fiscal 2004.

# Video Lottery Terminals -- Considerations

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- Number and location of video lottery sites
- Number of machines per location
- Average daily play per machine
- Prize payout to winners
- Ownership and administration of the machines
- Where the net proceeds go
- Impact on other gaming activities

# Video Lottery Terminals -- Revenues

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- It is estimated that up to \$800 million in annual revenues could be generated, after prize payouts and before any revenue distributions.
- This estimate assumes that four locations in the State would each have 2,500 video lottery terminals, with approximately 90% of gross proceeds paid out in prizes and an average daily revenue of \$217 per machine. It also assumes a 10% reduction in State lottery revenues.

# Securitization of Tobacco Settlement

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- To securitize means to issue bonds backed by the tobacco settlement payments
- Several states created special entities to securitize a portion of their future payments in exchange for an up-front lump sum payment. The proceeds have been used:
  - to fund special endowments;
  - to fund one-time expenditures; and
  - as a temporary supplemental funding source for ongoing operating expenses.

## Issues Surrounding Securitization

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- Higher Costs
  - Issuance costs and interest rates higher than GO
- Uncertain Revenue Stream
  - Payments fluctuate and may be insufficient for debt service
- View of Rating Agencies
  - Debt not counted but considered an indicator of financial management
- Determining a Minimum Rate of Return
  - Weighing future payments against current needs
- Use of Proceeds
  - Short-term fixes or long-term benefits

# Scenario Review

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Securitize 25% of Settlement Proceeds

	<b><u>Total Cash Flow</u></b>
<b>No Securitization</b>	\$3,824.1 million
Estimated Payments 2002 – 2023	
<b>Securitization Proposal</b>	
Net Proceeds from sale	\$ 355.3 million
Payments 2002 - 2023 (excludes debt service)	\$3,190.6 million
Total amount available	\$3,545.8 million
Payments foregone 2002 - 2023	\$ 633.5 million

How much the State realizes from a sale of bonds is subject to various estimates:

- 93 cents on the dollar (total available divided by no securitization)
- 56 cents on the dollar (proceeds divided by foregone payments)

# Comparison of Debt Vehicles

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Yields A Net Proceed of \$355 Million

	Tobacco Settlement Bonds	General Obligation Bonds
<u>Issuance Components</u>	<u>(\$ Millions)</u>	<u>(\$ Millions)</u>
Par Amount	\$ 423.8	\$ 355.2
Discount	(10.1)	*
Debt Service Reserve Fund	(41.2)	n/a
Capitalized Interest	(12.2)	n/a
Issuance Expenses	( 5.0)	( .2)
<b>Total Issuance Costs</b>	<b>\$ (68.5)</b>	<b>\$ ( .2)</b>
<u>Repayment Components</u>		
Interest Rate	6.7%	4.0%
Last Expected Payment	14 years	15 years
Average Annual Payment	\$ 45.3	\$ 32.7
<b>Total Repayment Costs</b>	<b>\$702.1</b>	<b>\$490.9</b>
Interest	\$278.3	\$135.7
Principal	\$423.8	\$355.2

\* The State has received \$46.9 million in premiums from the last two bond sales.



# Move Toward Real Results Based Management

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- Develop legislative/executive consensus on
  - Missions of state agencies and programs
  - Measures of efficiency, quality, outcomes
- Develop performance goals for agencies and programs
- Develop a culture where performance matters
  - Devote necessary resources to collecting, analyzing and reporting data
  - Make managers accountable for results
  - Provide incentives for success
- Use performance information in decisions to
  - Expand, reduce, or eliminate programs
  - Revise or restructure agencies or programs
- Requires
  - Legislative participation and a statutory basis
  - Ongoing, hands-on Executive oversight of operations

# Budget Process Improvements

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- Convene an executive/legislative commission to study modernization of process
- Questions could include:
  - Should the Governor be expressly required to keep the budget in balance during budget implementation?
  - Should the legislature's power to mandate future appropriations be limited?
  - Should limits be put on the Governor's authority to introduce Supplemental Budgets?
  - Should the Governor's authority to initiate spending be shared with the legislature?