

July 8, 2009

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

The Honorable Michael E. Busch
Speaker of the House

The Honorable Ulysses Currie
Chairman
Senate Budget and Taxation Committee

The Honorable Sheila E. Hixson
Chairman
House Ways and Means Committee

The Honorable Norman H. Conway
Chairman
House Appropriations Committee

Lady and Gentlemen:

I am writing to report that it appears that the State budget is once again being overwhelmed by the deteriorating economy. Data presented today to the Revenue Monitoring Group show fiscal 2009 general fund revenue collections through June 30 lagging the budget estimate by nearly \$400 million. The final fiscal year results will not be known until final sales tax and personal income tax withholding revenues are counted in August.

While fiscal 2009 is still likely to end in the black, the implications of underattainment in fiscal 2009 for the fiscal 2010 budget are considerable and adverse. The fiscal 2010 budget was predicated on a balance of \$437 million being carried forward from fiscal 2009. The collections data indicate that the actual carry-forward will be about \$40 million. Taking into account the reduction in carry-forward, and the fact that the budget as passed anticipated an \$88 million fund balance at the end of fiscal 2010, when fiscal 2009 is closed, the 2010 budget automatically will be out of balance by roughly \$300 million.

But the bad news will not end there. The fiscal 2009 results also strongly suggest that the budget estimate for fiscal 2010 revenues is overstated as well. An official estimate incorporating the 2009 results and the most recent available economic forecasts will be available in mid-September. In the meanwhile, let us assume the adjustment will be roughly comparable to the fiscal 2009 underattainment of \$400 million. Combining the fiscal 2009 results with a potential revision of fiscal 2010 revenues of \$400 million would put the fiscal 2010 budget about \$700 million or 5% out of balance.

Addressing a shortfall of this magnitude will be a daunting task, all the more so as it occurs as the Executive is trying to formulate the 2011 budget. (We already estimate that the fiscal 2011 budget has a cash shortfall in excess of \$1 billion before any further revenue write-down.) The Administration has solicited reduction proposals from the agencies and has stated its intention to recommend budget reductions to the Board of Public Works early in the fiscal year. The next scheduled board meetings occur on July 22, August 5, and August 26.

It is unclear, however, what magnitude of reductions or other actions the Administration will propose. At a minimum, it is to be hoped the budget proposal taken to the board will close the gap resulting from the 2009 revenue shortfall as doing so will restore the budget to balance based on the results known so far, and the official March forecast for fiscal 2010.

This balance will be fleeting, however, because new, and almost certainly lower, revenue estimates will be made in September putting the budget officially out of balance once more. Accordingly, the Administration should be encouraged to promptly develop and present an aggressive plan to restructure the 2010 budget to a sustainable level and carry forward those changes into the 2011 budget it is formulating. As any significant restructuring is likely to require statutory changes to be made, this process should also proceed in full consultation with the legislature.

Even as the problem is addressed, it is reasonable to ask how our budget can get so far out of whack so fast. In my view, a large part of the problem rests with the interaction of our revenue structure and the budget calendar. Roughly half of our general fund revenue is derived from the personal income tax, a sizeable portion of which is paid in April when final payments are due. Knowing the April result before the budget is passed could greatly aid the accuracy of the revenue estimate on which the budget is based. For instance, this year we knew by mid-May that collections were more than \$200 million behind the estimate. A budget passed with this knowledge would not be so far out of balance as we believe the fiscal 2010 budget will be. Resolving this issue, however, will require a change to the Constitution, or to statutory law to authorize the session to stand in recess and to allow the 90-day session to conclude in May.

Another source of the problem, however, is with the data upon which our forecasters rely. In short, the economics profession has not distinguished itself in this recession, particularly the commercial and academic economic forecasters upon which we rely. They were slow to recognize the recession and have consistently failed to anticipate the pace and depth of the unraveling which has occurred. It is also the case, however, that our local forecasting process, to which the Department of Legislative Services contributes, has been reluctant to get too far ahead of the consensus view when forecasting revenues. The confluence has resulted in a succession of write-downs and under-attained revenues over the last two years.

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The situation confronting Maryland is extremely challenging and will only get more so as the stimulus is withdrawn. In Maryland's case, the current shortfall is only a modest prelude to the resolution of an underlying structural gap of around \$2 billion (about 15% of the current budget). As indicated above, prompt action is called for. If the budget is to be cut, for most ongoing items, sooner is better than later. State general funds are spent at an average rate of \$39 million a day, \$275 million a week, and \$1.1 billion a month. The longer the delay, the proportionately deeper the cut must be to yield the same dollars. At the same time, the action required must be substantial and durable. The present course of State finances is plainly unsustainable. In magnitude and urgency, it is equivalent, if not more substantial, than that which precipitated the special session of 2007. Addressing the immediate problem and the State's underlying structural infirmity will require no less an effort.

Sincerely,

Warren G. Deschenaux
Director

WGD/jhf

cc: Karl S. Aro