AGENDA ITEM #6
January 22, 2019
Discussion

MEMORANDUM

January 18, 2019

TO: County Council

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SUBJECT: Fiscal Plan and Expenditure Overview

PURPOSE: Briefing and discussion, no action required

Background

In December, the Council received its scheduled update from the Department of Finance on County revenues. Due to the timing of that update, the discussion focused solely on revenue changes and the Council President requested an additional discussion in January to more broadly review the factors affecting government revenues and expenditures and the historical context of the Council's budget decisions.

The Council typically receives fiscal information at several different times throughout the year from the Executive Branch and/or Council staff. These include fiscal plan updates, revenue projections, spending affordability guidelines process, quarterly expenditure updates, and other briefings requested by the Council (e.g., cost of government and compensation cost presentations). A chart summarizing the various updates received by the Council by month is included on page 5.[1]

Today's presentation is intended to pull together key information and components from updates provided to the Council at different points in the year to provide the contextual framework for Council decision-making. The presentation provides additional context related to the factors resulting in the FY19 savings plan proposed by the County Executive. Some key takeaways from today's presentation are summarized below:

- **Montgomery County residents expect high quality services from County agencies. The mix and intensity of services change as the County's demographics change.** Montgomery County is viewed as a great place to live and work for many reasons, and residents expect County agencies to continue to provide high quality services while at the same time meeting emerging or changing needs. The mix of services can also change over time with the County's population (e.g., services needed to address a growing senior population).

- **Over the past 15 years, national and local economic conditions have impacted the Council's ability to fund existing services and meet the demand for changing service needs.** The Council was forced to respond to the Great Recession by reducing personnel costs and reducing services. In the post-recession years, the Council has been able to restore most services that had been cut while also acting in FY17 to increase revenues to address service needs.

[1] Key words: #FiscalPlanUpdate, revenue structure, fiscal conditions

- **The County is experiencing significant revenue pressures and has few options to address these pressures within the current tax structure.** As evidenced by the revenue write-down that necessitated the two FY18 savings plans, the County continues to feel revenue pressures despite the relatively strong national economic performance. Property and income tax revenue together represent 87% of county tax revenue and are either already at the maximum level allowed by State law (income tax) or difficult to change due to the Charter limit (property tax).

- **Fiscal, policy, and/or legal commitments use up a substantial portion of budgetary "spending room" each year (many of these fiscal policies also result in long-term cost savings).** Set asides for reserves and pre-funding for known future obligations reduce the Council's budgetary flexibility in any given year. On the other hand, the County's rigorous standards of financial management reduce the cost of borrowing to pay for the infrastructure that supports the County's growth and quality of life.

Summary of Presentation

Today's presentation includes four components: 1) a summary of county demographic and economic indicators comparing FY04 to FY18; 2) a review of Council actions to respond to fiscal conditions during the recession and the recovery; 3) an overview of Montgomery County's revenue structure; and 4) a summary of how budget resources are allocated within the context of the County's fiscal, policy, and legal commitments.

1. Demographic and economic indicators

County demographic and economic indicators play an important role in understanding the demand for services as well as how the mix of services needed can change over time. Between FY04 and FY18 in Montgomery County:

- Total population increased by 14%;
- The percent of the population age 60+ increased by 32%;
- Total households increased by 11%;
- MCPS K-12 enrollment increased by 18%;
- Per capita personal income increased by 67%;
- Average household income increased by 28%;
- The assessable tax base increased by 101%;
- The percent of residents below the poverty level increased by 46%; and
- The percent of MCPS students receiving Free and Reduced Price Meals increased by 48%.

2. Council actions in response to fiscal conditions

During the timeframe in which these changes were occurring, the County went through the Great Recession followed by a sustained, slow economic recovery period. During the recession, the Council took several actions to address cost pressures while minimizing service impacts. These included employee furloughs and pay freezes, changes to group insurance cost share, and changes to retirement contributions. As the recession continued, the Council and the County Executive were required to take further cuts that did substantially impact county services – particularly in the Recreation and Public Libraries departments.

In the post-recession timeframe, the Council has slowly restored most of the services that were cut. At the same time, the Council acted in FY17 to increase the property and recordation taxes in order to meet additional service needs. Most significantly, these actions led to:

- 313 additional teacher positions to allow MCPS to reduce class sizes at all grade levels;
- New positions and funding for MCPS programs to address the opportunity and achievement gap;
- The addition of approximately $27 million per year for MCPS school construction projects; and
- An increase in dedicated revenue for rent subsidy programs by approximately $6 million per year.

3. Montgomery County revenue structure

The County has very limited "tax room." The income tax rate is already set at the maximum permitted by the State. With respect to property tax, nine votes are required to exceed the so-called Charter limit, which limits increases in property tax revenue to the rate of inflation plus tax revenue from new construction.

Property tax revenue is stable (and constrained) because it is linked to inflation. Persistently low inflation has contributed to recent budget pressures. Periodic property tax increases above inflation have relieved budgetary pressure but require unanimity on the Council and have been associated with high political costs. Recent trends suggest rising inflation rates, which could relieve some revenue pressure (while creating other cost pressures).

The income tax rate is set at the maximum allowed under State law; consequently, the County cannot increase revenue by increasing the rate. Revenue from income tax is volatile and highly dependent on economic conditions and on the behavior of a small number of high-income households. The *Wynne* case is a significant factor in reducing income tax revenue. The recent federal income tax changes will have an impact on income tax revenue, though it is not yet clear what the size of that impact will be, and in any event, most of the impact would be in FY20 and FY21.

Property and income tax revenue together constitute 87% of County tax revenue. Constraints on property tax revenue and income tax revenue have resulted in fiscal pressure that is periodically relieved through a variety of channels: increasing property tax revenue above the Charter limit, increasing in the fuel/energy tax or transfer and recordation taxes, and periodic income tax bounties that result from a combination of strong economic conditions and taxpayer behavior by a small number of high-income filers. The revenue tools at the Council's disposal are clearly limited.

Other tax revenues are minor as sources of revenue, but periodically they are instrumental in relieving fiscal pressure. The fuel/energy tax was increased significantly in response to the fiscal pressure that resulted both from the dot-com crash in the early 2000s, and the more recent Great Recession. Transfer and recordation taxes were recently increased, in large part to address school capacity challenges. Both revenue streams have key weaknesses—for example, a warming climate places downward pressure on energy consumption and transfer and recordation taxes are volatile.

4. Montgomery County allocation of resources

The County's fiscal policies result in both costs and savings. Set asides for contingencies and pre-funding for known future obligations reduce the Council's budgetary flexibility in any given year. On the other hand, the County's rigorous standards of financial management reduce the cost of County debt issued to pay for the infrastructure that supports the County's growth and quality of life.

A significant amount of budget pressure is the result of cost factors largely beyond our control. Debt service—now 8.5% of the tax-supported budget—is a function of past decisions, and even a significant reduction in the current CIP would have minimal impact on the current year debt service budget. Debt service has more than doubled over the past fifteen years and is projected to continue increasing. Education budgets, more than 50% of total operating budget expenditures, are constrained by State law. Maintenance of Effort (MOE) requirements limit the County's flexibility to reduce allocations to education budgets. The partial shift of teacher pension obligations from the State to the County has exacerbated the challenge of meeting the County's education funding requirements.

Overall, the County's fiscal, policy and legal commitments take up approximately 75% of available resources each year. The remaining 25% (approximately $1.3 billion in FY19) is what is left to fund: existing programs and services in the non-education agencies, pay increases for employees, increases in employee benefit costs, increases in workforce size, any new programs or services, and any education funding above the MOE required level.

Factors within the County's control include the scope of County services, employee compensation and benefits, and workforce size. The County addresses needs that other local jurisdictions do not and provides local funding well in excess of that provided by other local jurisdictions. Salaries (56%) and benefits (24%) constitute the lion's share of costs in the County's budget. On November 15, the Council received a detailed briefing on compensation cost trends within County Government[2] and the key findings from that presentation are summarized below.

- From FY14 to FY19, the average annual increase in County revenue (3.5%) was more than sufficient to accommodate the average annual increase in compensation costs (2.7%).
- From FY14 to FY19, revenue growth was sufficient to cover compensation cost growth because of the FY17 tax rate increase and unprecedented reductions in retirement costs. Absent the tax rate increase and reduced retirement costs, growth in compensation costs would have created significant budget shortfalls.
- The approved Fiscal Plan projects annual average revenue growth of 2.7% through FY24. This revenue growth will be insufficient to cover projected compensation costs if wages, social security, and group insurance grow at the same rates and retirement costs are held constant.
- A budget trade-off exists – costs increases for existing positions compete for finite resources against the cost of adding new positions.
- Mid-year pay increases consume some of the next year's available revenues before that new year has begun.

Additional Information

More detailed data and information prepared for the Council's January 15, 2018 Cost of Government update on revenue pressures, impacts of fiscal policy, cost drivers within the County's control, and cost drivers largely outside the County's control are attached in Appendices 1-4 on pages 6-17. While the data has not been updated for today's presentation, it provides some very useful background and historical detail on the issues discussed.

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[2] https://www.montgomerycountymd.gov/council/Resources/Files/agenda/col/2018/20181115/20181115_-5.pdf

	Summary of Fiscal/Budget Updates Received by Council		
	Council Action	**Council Briefings**	**Additional Reports**
January	• Council reviews current SAG, CIP guidelines	• Council briefings related to the State budget/aid	
February	• Council sets SAG for operating budget	• Council briefings related to the State budget/aid	• 2nd Quarter Update
March		• Council receives Executive's recommended budget • Council briefings related to the State budget/aid	
April	• Committees make recommendations for operating budget	• Council receives budget overview • Council holds public hearings • Council briefings related to the State budget/aid	
May	• Council approves CBAs for MCG employees • Council makes final budget decisions, including tax rates		• 3rd Quarter Update
June	• Council approves Fiscal Plan		
July	• Council approves schedule of revenue estimates		
August			
September	• Council approves SAG CIP (every 2 years)		
October			
November			
December	• Council approves year-end transfers	• Council reviews updated fiscal plan and revenues	
Other		• Other briefings as requested (e.g., comp/benefit study)	

Appendix 1: Revenue Pressure

The County enters calendar year 2018 facing fiscal headwinds. In December, Finance updated its revenue estimates for FY18 and projections for FY19-23. That update included downward revisions to all sources of revenue.

	Fiscal Plan December 2017 vs. June 2017							
	TAXES	**FY18**	**FY19**	**FY20**	**FY21**	**FY22**	**FY23**	**Total**
1	Property Tax	(0.881)	(13.498)	(10.969)	(6.033)	(3.393)	(0.578)	(35.352)
2	Income Tax	(78.805)	(54.314)	(14.488)	(9.008)	(25.438)	(29.868)	(211.921)
3	Transfer Tax	(1.670)	(2.440)	(7.120)	(10.350)	(9.890)	(8.980)	(40.450)
4	Recordation Tax	(0.872)	(1.269)	(3.674)	(5.329)	(5.140)	(4.635)	(20.919)
5	Energy Tax	(12.186)	(14.028)	(15.861)	(17.730)	(19.392)	(20.875)	(100.072)
6	Telephone Tax	(0.721)	(0.582)	(0.496)	(0.611)	(1.888)	(3.429)	(7.727)
7	Hotel/Motel Tax	(0.089)	(0.245)	(0.404)	(0.563)	(0.721)	(0.878)	(2.900)
8	Admissions Tax	0.179	0.184	0.191	0.197	0.203	0.210	1.164
9	E-Cigarette Tax	0.090	0.091	0.092	0.094	0.095	0.096	0.557
10	**Total Local Taxes**	**(94.956)**	**(86.100)**	**(52.730)**	**(49.333)**	**(65.564)**	**(68.937)**	**(417.620)**

a. Tax room

The County has very limited "tax room." The income tax is at the maximum rate permitted by the State (3.2%). With respect to property tax, nine votes are required to exceed the so-called Charter limit. These two taxes alone provide 88% of local tax revenue. Energy and cell phone tax rates are already high.

During the recession of the early 1990s the Council raised taxes on income, energy, and telephones, but as fiscal conditions improved later in the decade, the Council reduced those taxes (and, also abolished the beverage container tax). The Council was then able to use this "tax room" to counter the sharp downturn in the early years of the last decade. Similar "tax room" is less available now.

b. Property tax

Property tax is a stable revenue source. The property tax rate is, in part, a function of the assessed value of property, property tax credit amounts set by the Council, and the resources necessary to fund the budget. Under the Charter, the amount of property tax revenue in each year is a function of the previous year's property tax revenue, inflation, and new construction.[3]

Because the County has little tax room, budget pressure is occasionally relieved by Council action to exceed the Charter limit. Most recently this happened in FY17, when property tax revenue was set at $140 million above the limit, largely as a way of addressing school overcrowding. Prior to FY17, the limit had been exceeded four times: in FY03-05 by $4.3 million, $29.2 million, and $37.3 million, and in FY09 by $117.5 million.

[3] Charter §305 limits the growth in real property tax revenue to the rate of inflation, excluding new construction, development districts, and other minor exceptions. Overriding the limit requires the vote of all nine Councilmembers; until 2008 seven votes were required.

- **Persistently low inflation has created downward pressure on the County budget.** The FY19 write-down ($13.5 million) is attributable to inflation falling below projection. That write-down will affect the revenue from this source in subsequent years.
- **Base-broadening efforts, such as eliminating credits or compliance enforcement, do not increase revenue at the Charter limit because the Charter limit is calculated based on the previous year's revenue.** Instead, the effect of eliminating credits would be to reduce rates. Generally, the credits in the code have a significant impact on a small number of taxpayers, whereas the rate reductions that would result from eliminating a credit would be very small.

c. ***Income tax***

Income tax revenue is now projected to be $79 million below the FY18 approved budget amount, and by $211 million below during the six-year period from FY18 through FY23. This unexpected decline is significant because revenue from other sources is either stable (as is the case with property tax revenue at the Charter limit) or relatively minor (as is the case with all other taxes, which together produce only 12% of total tax revenue).

Income tax revenue volatility is a fact of life for Montgomery County. Income tax revenue is more volatile than other local tax revenue. In the pre-recession years (FY05-08), revenue rose 37% from $941 million to $1,291 million. It was flat in FY09 before falling 19% to $1,042 million in FY10. Income tax revenue bottomed in FY11 at $1,039 million before rising 21% in FY12 to $1,255 million. For FY18, income tax revenue had been projected to reach $1,558 million, but now is projected to come in nearly $79 million below that number. The volatility of income tax revenue from year to year, and within any year, presents challenges for fiscal planning.[4]

To a large degree, that volatility is the result of the year-to-year variations in the capital gains income of a small number of County residents. In FY18, income tax revenue has fallen short of projection in large part because of a sharp decline in the 2016 capital gains of the County's top 50 taxpayers. In 2015, the top 50 taxpayers realized capital gains of $1.2 billion. In 2016, the capital gains income of those same taxpayers was reduced by half. Consequently, County income tax revenue from those 50 taxpayers dropped by $21 million (Revenue Administration Division of the Maryland Comptroller). Similarly, a review of tax return data published by the Comptroller indicates that roughly 1.8% of Montgomery County returns report income of $500,000 or greater. On average, these returns explain more than half of any year-to-year increases in income tax revenue and more than 100% of any year-to-year declines in income tax revenue.

County income tax revenue has also been reduced as a consequence of a 2015 decision by the U.S. Supreme Court. *Maryland State Comptroller of the Treasury v. Brian Wynne, et ux.* stems from the Maryland tax code provision that allowed a credit for income taxes paid to other states with respect to the state income tax, but not the county income tax. The Court of Appeals ruled on January 28, 2013 that "failure to allow a credit with respect to the county income tax for out-of-state income taxes paid to other states on 'pass-through' income earned in those states discriminates against interstate commerce and violates the Commerce Clause of the federal Constitution."[5] The Court stayed enforcement of its ruling pending resolution of the State's petition to the U.S. Supreme Court. The Supreme Court granted *certiorari* and heard oral argument on November 12, 2014. On May 18, 2015 the Court, by a vote of five to four,

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[4]A November 2016 State report, *Report on Revenue Volatility and Approaches to Reduce Risk to the State Budget*, suggested capping the amount of non-withholding revenue that will be appropriated in the budget. See http://mgaleg.maryland.gov/pubs/budgetfiscal/2016-revenue-volatility-report.pdf

[5] See http://mdcourts.gov/opinions/coa/2013/107a11.pdf for the Court of Appeals opinion. Brian and Karen Wynne filed suit after the Comptroller ruled that they could not deduct from their Howard County tax bill the $84,550 they paid in income taxes to other states in 2006. The income stemmed from their ownership share in a Maryland company that does business nationwide.

affirmed the Court of Appeals holding that Maryland's personal income tax scheme violates the Commerce Clause.[6]

- The total cost (including interest) of repaying the State for past claims is now estimated to be $136.6 million.
- In addition to the repayment obligations, the current estimate of ongoing annual revenue loss from *Wynne*, starting in FY17, is $30 million (up from $16.7 million one year ago).
- For FY19, the projected revenue loss associated with *Wynne* is $43.7 million, followed by $57.3 million in FY20-23, $43.7 million in FY24, and $30 million each year thereafter.

Demographic factors are also placing pressure on income tax revenue. An aging population[7] places downward pressure on productivity and wage growth. The increasing share of housing units that are multi-family units also places downward pressure on income tax revenue as new growth skews more to housing types that typically accommodate lower income households.

Finally, it is important to acknowledge the destabilizing effect of federal tax reform on County revenue. Changes to exemptions, deductions, rates, procedures, and calculations will affect tax behavior and state and local income tax revenues.

d. Fuel/Energy tax[8]

The fuel/energy tax—the County's third largest revenue source—generates 5.4% of local tax revenue. Revenue from this tax depends on consumption, and consumption is affected by weather conditions, economic conditions, and other public policy interventions that are intended to reduce fuel/energy consumption. Fuel/energy tax revenue is now projected to decline by $12 million in FY18 and by $100 million over the period from FY18 through FY23. That projected decline in revenue stems largely from two consecutive warm winters.

The history of the fuel/energy tax tracks the two most recent fiscal crises facing state and local governments. In FY03 receipts from the energy tax were $24 million. The following year, in the face of a revenue shortfall, the tax was tripled. In 2010, when governments nationwide once again faced severe revenue shortfalls, the Executive proposed a significant rate increase in his recommended FY11 budget and subsequently revised that number twice, ultimately recommending that rates be set to double fuel/energy tax revenue.[9] The Council ultimately decided to place less of the burden of increased rates on businesses than the Executive had recommended, but agreed as to the extent to which fuel/energy tax revenue would close the budget gap. When the dust had settled, revenue from the tax in FY12 was $243 million, ten times the FY03 amount.

From FY11 through FY15, the fuel/energy tax was central to discussions about the County's fiscal and economic conditions. The Council modified the Executive's plan to reduce the burden of the

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[6] See http://www.scotusblog.com/case-files/cases/comptroller-v-wynne/ for a detailed history of the case. Also see http://www.scotusblog.com/2015/05/opinion-analysis-marylands-personal-income-tax-violates-the-commerce-clause/ for an analysis of the decision.

[7] The portion of the County population that is age 60+ increased from 17.29% in 2007 to 20.68% in 2016. Over that same decade, the portion of the metropolitan area population that is 60+ increased somewhat less, from 14.55% in 2007 to 17.73% in 2016 (US Census Bureau).

[8] The tax is imposed on providers of electricity, fuel oil, gas, steam, or liquefied petroleum gas. Providers then pass the cost of the tax on to their customers. One-third of revenue is from energy provided to residential users and two-thirds is from energy provided to non-residential users. Electricity accounts for the lion's share of revenue, with the much smaller amount of revenue from natural gas.

[9] See http://www.montgomerycountymd.gov/council/Resources/Files/REPORTS/FY10-11_BudgetAdjustments.pdf.

increase on businesses.[10] The County Executive, after originally recommending that the increase in fuel/energy taxes sunset after FY12, did not propose any reduction to fuel/energy taxes in his recommended FY13 budget. His rationale was that "the energy tax is far more broad-based than either the property or income taxes since it includes taxes on energy usage of institutions and facilities (such as the federal government) that otherwise do not pay anything in taxes to the County." The Council instead reduced the increase by 10% ($11.4 million) for FY13. The Council reduced the increase by another 10% for FY14 and by 7% more for FY15. The Council declined to make further reductions in FY16, FY17 and FY18.

e. Transfer and recordation taxes

Revenue from both the transfer tax and the recordation tax are volatile. In December, Finance wrote down transfer and recordation tax revenue by a combined $61 million. In spite of this volatility, the Council has looked to these taxes to relieve fiscal pressure. Most recently, the Council reduced the General Fund portion of the recordation tax. Slow home sales and relatively flat home sale prices are among the factors that have led to sluggish revenue. By FY24 it is still expected to be $37.2 million below its FY06 peak.

- Large commercial transactions, and the absence thereof, are a significant driver of revenue volatility.
- Other factors potentially affecting these revenues include the declining portion of the residential properties changing hands that are single-family detached homes[11] and the reduced frequency at which households move.[12]
- Prospectively, it is possible that changes to federal tax law (e.g., limiting deductions for state and local taxes, limiting mortgage interest deductions to $750,000) will place downward pressure on sale prices. Moody's Analytics estimates that changes to federal income tax law will result in a 3.2% reduction in Montgomery County home values.

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[10] To help ensure a balanced close to the FY10 budget, which was under great pressure, the Council raised residential rates by 323% and non-residential rates by 118% for the May 20-June 30, 2010 period.

[11] According to the American Community Survey, in 2010 single family units were 67.4% of total units in Montgomery County. Between 2010 and 2015, five-eighths of net new units were multi-family, and the SF share dropped 2 points.

[12] Seemingly every year, the mover rate sets all-time lows. See, for example: https://www.census.gov/newsroom/press-releases/2017/mover-rates.html Comparing 2010 and 2015 illustrates the point. For 18- to 24-year-olds, 45.2% moved in 2015, down from 48.0% in 2010. Among 25- to 29-year-olds, 61.2% moved in 2015, down from 65.5% in 2010. For 30- to 34-year-olds, 52.5% moved in 2015, while 57.0% moved in 2010.

Appendix 2. Impacts of Fiscal Policy

The County's rigorous standards for sound financial management are of crucial importance. They are not beyond our control, but they represent a major draw on revenue. In the context of any individual budget year, fiscal policies can be viewed as a constraint that limits budgetary flexibility. In the context of Montgomery County's long-term fiscal planning these policies are a critical tool, enabling the County to borrow at a low cost in order to provide the infrastructure that is necessary to support the County's growth. The standards are outlined in Resolution No. 16-1415, *Reserve and Selected Fiscal Policies* (June 29, 2010), which the Council adopted during the depth of the Great Recession. The Council added specific annual reserve targets in Resolution No. 17-312 (November 29, 2011).[13]

a. Reserve

Our difficult experience during the recession confirmed that a large reserve, consisting of unrestricted General Fund reserve and the Revenue Stabilization Fund, is essential to sound financial management. Without it, funds for core County services may not be available when residents need them most.[14] Before the recession our policy called for a 6% reserve. Under current policy, the target rises until it reaches 10% for FY20 and after.[15] In the current fiscal plan, the 10% target is $530.6 million. The target 10% reserve in FY20, under current projections, would require $212.2 million more revenue than a 6% reserve.

FY18 and FY19 illustrate both (a) the value of having a reserve and (b) the cost associated with maintaining it. The unrestricted General Fund reserve, along with any savings realized as part of the FY18 Savings Plan, are what will fill the gap created by the unexpected $95 million shortfall in FY18 revenue. On the other hand, replenishing that reserve in FY19 will require significant resources that otherwise might be used to meet the growing needs of the community.

The reserve policy is also essential to maintaining the County's AAA bond rating. For more than four decades, Councils and Executives have given top priority to maintaining the AAA bond rating, even in the face of extreme fiscal pressures. The County has held a AAA rating since 1973 and is currently one of 45 of the more than 3,000 counties nationwide with a AAA rating from all three rating agencies. In October, the agencies again reaffirmed the AAA rating.

b. PAYGO and OPEB

Resolution No. 17-312 also states: "The County should allocate to the CIP each year as PAYGO [cash] at least 10% of the amount of general obligation bonds planned for issue that year." PAYGO was $34.0 million in FY18 and is currently projected at $34.0 million annually in FY19-24.[16]

The resolution also refers to OPEB (Other Post-Employment Benefits), including pre-funding for retiree health benefits. While most governments have not met their full annual required contribution, the County reached that goal starting in FY15. The tax supported cost for all agencies in FY18 was $122.2 million, another significant draw on revenue.

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[13] The resolution also called for the annual adoption of a fiscal plan that is balanced in each year of the six-year period. The Council approved the first such plan in June 2010 and has done so each June since then. See Resolution 17-312: https://www.montgomerycountymd.gov/council/resources/files/res/2011/20111129_17-312.pdf
[14] The purpose of maintaining a reserve is not just fiscal, but also economic. Countercyclical economic programs – such as the earned income tax credit, workforce training, and business attraction – are most valuable during economic downturns when resources are often scarce.
[15] The target for FY18 is 8.9%, followed by 9.4% in FY19 and 10.0% in FY20.
[16] The cost of this fiscal policy is driven by the amount of GO debt to be issued. If GO debt issued in FY19 is $330 million (down from $340 million), then PAYGO will be $33 million (rather than $34 million).

Appendix 3. Costs Largely Beyond Our Control

a. Debt service[17]

Debt service represents 8.4% of the FY18 tax supported budget, $399.9 million—far more than Montgomery College, M-NCPPC, or any department of County Government. Debt service is projected to rise steadily to $486.7 million by FY23, and the debt service budget and its current trajectory reflect decisions already made.

The County's capital improvements program (CIP) has been much more robust than that of most other jurisdictions. While other counties rarely provide more local funding than is needed to match their State school construction aid, the County is funding 82% ($1.4 billion) of MCPS's $1.7 billion CIP. The County's own $275 million allocation for road construction is lower than it has been, but it dwarfs that of other jurisdictions in the region. The County also has a significant program to add, replace, or renovate fire stations, police stations, libraries, recreation centers, parks, bridges, hiker-biker trails, and public amenities. In the past two decades, it has also invested heavily in the campuses of Montgomery College, and is currently investing in a new headquarters for several departments, including the Parks and Planning departments of the Maryland-National Capital Park and Planning Commission.

Most of these improvements have been funded by General Obligation (G.O.) bond proceeds. The principal and interest on these bonds, along with payments on short-term and long-term leases, are projected to consume nearly 12% of General Fund operating revenue over the next few years, much higher than the traditional 10-11% of General Fund revenue. As noted above, debt service consumes more than 8% of the operating budget (all funds). Debt per capita, debt/total income, and debt/total assessed value are at historic highs, all below the Council's standards:

	Standard	FY12	FY14	FY16	FY18	FY20	FY22	FY24
Debt/Assessable Base	**≤1.5%**	1.56%	1.76%	1.87%	1.85%	1.82%	1.79%	1.78%
Debt service % of GF	**≤10%**	10.10%	10.31%	11.06%	11.30%	11.74%	11.92%	11.80%
Debt/Capita	**≤$2,200**	$2,675	$2,848	$3,180	$3,173	$3,153	$3,253	$3,174
Debt/Income	**≤3.5%**	3.60%	3.71%	3.93%	3.85%	3.72%	3.60%	3.57%

By historical standards, these values are poor. Debt has normally not exceeded 1.5% of real property value in any year, but the projection is that debt will exceed that standard in every one of the next six years. The debt/income rate also normally has not exceeded the 3.5% standard, but the projection is that it will be exceeded in all years. The debt/capita standard has been exceeded by a wide margin for many years, now exceeding the standard by about 40%. The debt service as a percentage of operating revenue is often above 10% but rarely above 11%; now the projection is for a ratio close to 12% nearly every year (and would be above 12% if property tax revenue had not exceeded the Charter limit in FY17). These figures would be even worse, but the Finance Department has proactively issued refunding bonds to take advantage of lower interest rates when they are available.

In October 1992, in the midst of a less severe recession than the most recent one, the Council approved guidelines that reduced the G.O. bond portion of the CIP from $810 million to $600 million – a 26% reduction – while public demands for schools, transportation, and other public facilities were arguably as high as they are now. **That course correction set the County's debt service situation on a healthy fiscal path for the next two decades.** However, since FY12 the indicators have slipped into uncharted territory, well beyond the standards adopted in the early 1990s.

[17] See http://montgomerycountymd.granicus.com/MetaViewer.php?view_id=169&clip_id=13851&meta_id=143772 for the October 3, 2017 Council packet on spending affordability guidelines for the FY19 capital budget and the FY19-24 Capital Improvements Program.

Little can be done to reduce the cost of debt service in the short term and reducing the cost over the long term requires large and/or sustained reductions in borrowing. One potential approach is to substantially cut back the size of the CIP, as was done in 1992. The other is to slowly ratchet back the size of the debt-funded CIP – or at least keep it flat – over the next 10 or 12 years. This would allow time for growth in the assessable base, population, and income to catch up to the growth in debt. This is in fact the approach that the Council supported last fall during its initial discussion of the spending affordability guidelines for the capital budget.

b. The MCPS Budget[18]

MCPS is a world-class school system and a vital contributor to the County's high quality of life. The $2.5 billion tax-supported MCPS budget for FY18 is about half of the total tax supported budget (including debt service). For many years MCPS has received over half of all available agency spending (not including debt service), including 54% in FY18.

In FY18 an additional $316.4 million was appropriated in the County Government budget. That amount included debt service on school construction bonds ($150.4 million), pre-funding MCPS retiree health benefits ($74.2 million), multiple support services ($65.8 million), and technology modernization ($26.0 million). To illustrate the magnitude of this commitment, note that it is more than the allocation for any of our largest County Government departments (Police, Fire and Rescue, or HHS). The County does not get credit for these County expenditures when the State determines whether the County has met its Maintenance of Effort requirement (discussed in detail below).

The primary formulas to distribute State aid are wealth-equalized. Consequently, most years the County receives the second or third lowest per pupil amount of direct school State Aid. In FY18, the County's own revenue funded 66.1% of the tax supported MCPS budget, including the amount required for the State pension payment, whereas State aid accounted for 27.0% of the MCPS tax supported budget.

MCPS enrollment has grown steadily in recent years. The preliminary enrollment for this year is 161,936, a one-year increase of over 2,900 students or 1.8%. Over the past 10 years enrollment has increased by over 23,000 students and is projected to increase by another 7,000 students in the next six years. A large part of enrollment growth has come in students from low-income families, who comprise 34.5% of total enrollment this year, and students receiving English as a Second Language (ESOL) services, who comprise 14.2% of total enrollment this year. MCPS reflects the changing demographics of the County; its students come from 157 different countries and speak 150 languages.

The State Maintenance of Effort (MOE) law requires local jurisdictions to fund school systems at the same amount per pupil as the prior year. Any increase to the County contribution of new dollars above MOE adds to the base calculation for the next year and cannot be reduced in future years (absent a waiver).

Since MOE is a per pupil amount, the total funding level adjusts according to enrollment changes. Recent enrollment increases have resulted in County contributions increasing by $24.2 million in FY16, $20.0 million in FY17, and $28.1 million to meet MOE in FY18.

The most significant cost associated with MOE is not the annual increases tied to enrollment growth, but rather the long-term effects of exceeding it. From FY01-09, Montgomery County funded

[18] See http://montgomerycountymd.granicus.com/MetaViewer.php?view_id=169&clip_id=13345&meta_id=138864 for the May 15, 2017 Council packet on the FY18 MCPS operating budget. Summary data and analysis are available at http://montgomerycountymd.granicus.com/MetaViewer.php?view_id=169&clip_id=13108&meta_id=134851, the April 18, 2017 Council packet on the FY18 operating budget overview.

the school system a cumulative $576 million above MOE. During the Great Recession, this level of local funding became unsustainable. In FY10 and FY11 the County sought waivers from the State Board of Education, and ultimately rebased MOE to a lower lever in FY12. The MOE law, as revised by the General Assembly in 2012, requires a State waiver to reduce the MOE level. The law also authorizes intercepting counties' income tax revenue to meet the level and overriding voter-approved limits on property taxes.

The last six years are a mixed picture. From FY13-16 the Council funded the school system at MOE as the slower than anticipated economic recovery cautioned against increasing the MOE base and locking in higher future spending requirements. In FY17, in collaboration with the Board of Education, the Council funded that school system $89.3 million above MOE in an effort to direct more resources to class size reduction and addressing the academic opportunity and achievement gap. In FY18 the Council funded MCPS $21.2 million over MOE.

Maintenance of Effort for Montgomery College requires that the County provide the same amount of local funding as in the previous year. The College's MOE, unlike MCPS', does not adjust for enrollment. While this means that appropriations need not increase when enrollment is rising, it also means that the County may not decrease the appropriation in response to declining enrollment. FY18 was the fifth consecutive year of declining enrollment for the College. After the difficult years of the Great Recession, County funding for the College increased each year from FY14 through FY18.

An additional pressure on the County budget is the MCPS pension shift. In its 2012 session, the General Assembly required that counties begin contributing local funds toward the cost of the State pension plan for teachers (and other school employees eligible to participate in the State pension system). The law established a set phase-in schedule of contributions for each local jurisdiction from FY13 through FY16, with full funding required in FY17. For Montgomery County, this requirement began at $27.2 million in FY13 and rose to $58.6 million in FY18.

The combination of the pension shift and MOE has exacerbated budget pressure. For FY13 through FY16 these amounts were required in addition to a county's MOE requirement. The law required that these payments be included in the MOE base beginning with the FY17 per pupil calculation. As a result, the MOE per pupil amount increased by nearly $300 from FY16 to FY17 solely due to the addition of the state pension shift in the calculation.

Going forward, the MCPS budget must absorb the normal cost impact of salary improvements and workforce growth determined by the Board of Education and changes in benefit levels and plan assumptions made by the State. **None of these factors are in the County's control, but the County will ultimately be asked to pay the bill.**

Appendix 4: Costs More Within Our Control

a. *Scope and funding of services*

The Finance Department has noted: "In the municipal bond market, the name Montgomery County, Maryland is synonymous with the highest quality bonds." **The County is also defined by the overall excellence of the services it provides.** This fact is routinely cited by residents and businesses throughout the County.

A good example is consumer protection. Except for Howard County, which has a small office, all other Maryland counties rely on the Consumer Protection Division of the Attorney General's office to perform this function. The County's OCP, funded at $2.4 million in FY18, provides a wide range of services that enjoy strong public support and would not otherwise be available. For a detailed review of these services, see the April 29, 2011 Public Safety Committee packet.[19]

This added dimension of effort to serve the County's diverse population, often in ground-breaking ways, is a bedrock characteristic of all County agencies – MCPS, Montgomery College, and M-NCPPC as well as County Government. In many service and policy areas, the County provides local dollars well above the level of most local jurisdictions. Through upfront investments the County has sought to improve opportunities for children's success and achieve long-term savings in the cost of energy, chronic health conditions, and other areas. Initiatives to provide direct services, support the work of community organizations, and offer incentives for businesses and residents include the following:

Transportation and Pedestrian Safety

- The County's Ride On bus system transports more than 26 million passengers annually and has lower-cost options for seniors, people with disabilities, and youth.
- Senior transportation and mobility management services that provide flexible fixed route services in neighborhoods and limited door-to-door services to senior centers.
- The Pedestrian Safety Initiative, which includes new sidewalks, bus stop improvements, fuller compliance with the American with Disabilities Act, bikeway and pedestrian intersection improvements, education, and enforcement.
- Funding for planning, design, and right-of-way acquisition for the initial phase of Bus Rapid Transit.

Protecting the Environment

- Requirements for County buildings to meet LEED standards and investing in energy efficient systems such as geothermal heating and cooling.
- Property tax credits for energy and environmental design, renewable energy devices (geothermal, solar), and voluntary clean-up of a qualified Brownfields site.

Safety Net and Income Support Services

- Health care for the uninsured
- Supplemental funding to support organizations providing direct services to the developmentally disabled and vulnerable seniors in need of foster care or day care
- Funding for the production and preservation of affordable housing and rental assistance for low-income and disabled residents

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[19] http://www.montgomerycountymd.gov/COUNCIL/Resources/Files/agenda/cm/2011/110429/20110429_PS2.pdf
Note in particular the OCP Director's memo on ©3 of that packet, the memo from the Director of the State's Consumer Protection Division on ©12, and comments on OCP's role and importance from the Police Chief, the State's Attorney, and others starting on ©23.

- County match to the Earned Income Tax Credit
- County funding for child care subsidies and expansion of full-day Head Start classes

Health and Wellness

- Highly competitive agency health plans for employees and dependents, and employee wellness initiatives to reward healthy behaviors.
- The Montgomery Cares program for low-income, uninsured adult residents and the Care for Kids program for uninsured children.
- Programs that support the health and wellness of MCPS students, including School Health Services, School-based Health Centers, High School Wellness Centers, Youth Opportunity Centers, Linkages to Learning, child and adolescent mental health services, weekend food programs, and after-school programs such as Rec Extra and Excel Beyond the Bell.

Support for Arts and Humanities, and Community-based Non-Profit Organizations

- Funding to the Arts and Humanities Council for operating support grants to arts organizations, advancement grants, and administration.
- Funding to the Montgomery Coalition for Adult English Literacy (MCAEL) for community grants, workshops, and instructor training.
- Executive and Council grants to local non-profit organizations providing emergency and safety net services and youth development programs directly to residents.

Neighborhood redevelopment, business, and workforce development

- Neighborhood redevelopment capital projects in Wheaton, East County/White Oak, and other communities total $300 million over the next 6 years.
- Local funding for economic development incentives well in excess of other Maryland jurisdictions.
- Support for unique economic and workforce development programs, such as an impact grant program for local bioscience innovators, and assistance for participants in certain career pathway training programs to help minimize economic barriers to success.

Parks and Recreation

- County funding that supports 417 parks and the management of more than 37,000 acres of parkland, including 151 local parks, five regional parks, and 290 athletic fields.
- Support for Recreation Department facilities, including community and neighborhood recreation centers, senior centers, and aquatic centers. Programming includes after-school programs, sports leagues, senior programs, and therapeutic recreation.

b. Employee salaries and benefits

Local governments are labor-intensive. As in past years, salary and benefit costs for active and retired employees of all agencies account for 80% of the County's FY18 tax supported budget. For MCPS alone, the figure is 90%.

Here as throughout the nation, compensation was severely constrained during the Great Recession. For example, in the FY10-13 period County Government employees received no general wage adjustments (COLAs) for all four years and no service increments (step increases) for three years; their share of health and retirement benefit costs was increased; and there were progressive furloughs in FY11. These measures helped the County manage large position cuts with almost no layoffs. These changes resulted in savings of $469 million, with annual ongoing savings of $156 million.

The picture for the FY14-16 period was quite different. For merit system County Government employees not at their maximum salary (now 67% of the total workforce), the compound pay increases negotiated by the Executive and approved by the Council for these three years totaled 20.6% for general government employees and still more for public safety employees eligible for make-up service increments.

While pay increases at other County agencies are sometimes on a different schedule, the pattern over time is similar. As in past years, data from our regional compensation survey and from OHR's Personnel Management Review show that pay increases in most other jurisdictions were smaller.

The Executive's agreements in 2017 with County Government bargaining units – UFCW Local 1994/MCGEO, FOP Lodge 35, and IAFF Local 1664 – included both general wage adjustments and service increments. The Executive negotiated two-year agreements with MCGEO and IAFF and a one-year agreement with the FOP. For employees eligible for both the general wage adjustment and service increments, the increases in FY18 and FY19 are 5.5%. OMB projected the total cost for all provisions at $33.67 million in FY18 and $36.04 million in FY19. (Since the Executive entered into a one-year agreement with the FOP, the cost estimate for FY19 assumed that the FOP will receive the same general wage adjustment and service increment as negotiated in FY18.)

The results of contract negotiations over the years stem in part from the structure of the County's collective bargaining laws. In its January 2011 report, the Organizational Reform Commission proposed several changes that in its view would "create a more equitable balance between the need of County tax supported employees and the needs of County residents."[20]

Another factor in recent years has been the Executive's view that arbitration-related court decisions in 2012 and 2013 impel him to reach agreement with our bargaining units and avoid arbitration. As the Executive wrote in his FY14 Recommended Operating Budget, in discussing the large FY14-15 pay increases detailed above, "the result [otherwise] would likely have been arbitrator-mandated decisions on raises that could double or triple the rates of raises contained in the package I negotiated with our unions."[21] Whether one agrees with the Executive's view, it is the Council that by law must approve any term or condition in an agreement that requires an appropriation of funds or enactment, repeal, or modification of a County law or regulation.

While salaries represent 56% of the total tax-supported budget, health and retirement benefits for the agencies' active and retired employees represent an additional 24%. The agencies' benefits are also highly competitive with those of other local governments and the private sector. For example, except for non-public safety County Government employees hired since October 1994, all agency employees are eligible for defined benefit pension plans and retiree health insurance, both of which are increasingly rare in the private sector.

Benefits for MCPS employees are especially attractive. For example, while the MCPS employee share of health care premiums has risen in recent years, it remains well below the share for County Government employees. If the share were the same, the result would be annualized saving in the range of $24 million. As for retirement (leaving aside the $58.6 million cost of the pension shift in FY18), MCPS is the State's only school system with a county-funded supplement to the State pension benefit. Funding the supplement alone was projected to cost $25.3 million in FY17. Given the pressing need for more classroom resources, the Council has urged the Board of Education to sharpen its focus on these issues. This review is especially important because of the coming spike in projected MCPS benefit costs. Pre-funding MCPS retiree health benefits in FY18-23 is now projected at $547.8 million, $207.6 million (61.0%) above the December 2016 projection, because of revised actuarial assumptions. MCPS pension fund costs of $71.8

[20] See http://www.montgomerycountymd.gov/council/Resources/Files/doc/2015/MCORC.pdf for the Commission's report, pages 33-43. The Council approved two of the Commission's proposed changes: to repeal "effects bargaining" with the police bargaining unit and require that an arbitrator evaluate and give highest priority to the County's ability to pay. Other changes proposed by the Commission would require an arbitrator to determine first if a final offer is affordable without raising taxes or lowering the existing level of public services; replace the single arbitrator with a three-person arbitration board, with each party selecting one member and the two members selecting a third member; and increase openness and public input in the collective bargaining process.

[21] See http://montgomerycountymd.granicus.com/MetaViewer.php?view_id=6&clip_id=4962&meta_id=48530 for the April 16, 2013 Council packet on the FY14 Operating Budget overview, pages 6-7.

million in FY18 (apart from $56.8 million for the State's partial pension cost shift) are now projected to increase by $21.1 million (29.4%) to $92.9 million in FY23.

c. *Workforce size*

Workforce size is another cost driver that is more within our control. The table below provides a useful overview of the change in workforce size for the four agencies combined and for each agency over the 15 years since FY04:

	FY04	FY11	FY18	Total Change, FY04-18
Total Four Agencies	**27,696**	**29,367**	**32,192**	**16.2%**
Change from prior	**--**	***6.0%***	***9.6%***	
County Government	7,390	7,375	8,384	13.5%
Change from prior	--	*-0.2%*	*13.7%*	
MCPS	18,002	19,439	21,091	17.2%
Change from prior	--	*8.0%*	*8.5%*	
Montgomery College	1,443	1,773	1,802	24.9%
Change from prior	--	*22.8%*	*1.6%*	
M-NCPPC (Montgomery)	861	780	915	6.2%
Change from prior	--	*-9.4%*	*17.3%*	

Several points emerge from this overview:

- Total workforce growth in FY04-18 was 16.2%. This compares with increases in population of 14%, households 11%, and K-12 enrollment 17% during the same period.
- Total workforce growth in FY04-18 falls into two distinct periods. FY04-11 includes the Great Recession; FY11-18 includes the post-recession recovery years. Total workforce growth in these two periods was 6.0% and then 9.6%.
- Except for MCPS, workforce changes by agency show a different pattern for the two periods. County Government and M-NCPPC showed declines in the first period, followed by large increases in the post-recession period. Montgomery College showed the opposite trend, with a large increase in the first period and a small increase in the second. The workforce trends for the College reflect enrollment that increased significantly during the recession and has subsequently declined.

A full understanding of these agency workforce changes requires a careful review of the specific factors that underlie them, including precisely where and why the changes have occurred. Controlling the cost of government will continue to require restraint in this area as well.