EXECUTIVE SUMMARY

This report is the second part of the Office of Legislative Oversight's two-part assignment on achieving a structurally balanced budget in Montgomery County.

As requested by the County Council, the purpose of Part II is to inform a discussion of options to help the County navigate toward long-term fiscal sustainability. As with the many other jurisdictions that face similar budget pressures, the County's fiscal picture for the foreseeable future requires decisions that will inevitably require some to pay more and others to receive less. Marginal, short-term, and one-time fixes will not produce a sustainable solution for the County.

The options outlined in OLO's Part II report offer an array of potential budget savings and revenue raising choices. Some would yield substantial savings in the short term, and others would yield even greater savings but only in the longer term. Many of the options are not mutually exclusive and could be combined to achieve some savings in the short term and more over time.

The cost containment and/or revenue raising options that the Council decides to consider will be influenced by some key information that is not yet in hand. This includes updated revenue projections, updated estimates of the County's pension and OPEB (retiree health trust) liabilities, and the agencies' and County Executive's future budget requests, which will reflect the collective bargaining agreements reached between the County Executive and the County Government unions and the Board of Education and the school unions.

The rest of this executive summary provides a general background and roadmap to the contents of OLO's Part II report, which consists of eight issue papers and an appendix of related information. This executive summary concludes with some recommended next steps for the Council's consideration of the report's contents.

BACKGROUND

OLO's Part I analysis concluded that Montgomery County faces a structural budget problem.[1] By FY16, the combined cost of the County's legal and policy commitments (i.e., employee pensions, health insurance for active and retired employees, debt service, and current revenue contributions to the capital budget, retiree health trust fund, and County's fund reserves) is projected to total $1.6 billion, or roughly one-third of all available tax revenue.

In the current climate, revenue growth for the foreseeable future is unlikely to keep pace with the steadily rising costs of our public sector's spending commitments. Consequently, the approach of previous years - where projected revenue for the upcoming fiscal year was sufficient to fully fund the current year's budget, absorb the increased cost of commitments, and support new initiatives (e.g., program expansions, salary increases) - no longer works.

As a result, Montgomery County, like many other state and local governments across the nation, faces the extraordinary challenge of making decisions that will result in long-term fiscal sustainability, a task that can only be accomplished by permanently raising more revenue or making reforms that reduce future government costs.

[1] OLO's Part I findings, presented to the Montgomery County Council on 11/23/10, are available at: http://www.montgomerycountymd.gov/content/council/olo/reports/pdf/2011-2.pdf

WHAT GUIDED OLO'S SELECTION OF OPTIONS TO INCLUDE?

The options that OLO selected to examine flow directly from our Part I analysis, which identified the major cost drivers of the tax supported budgets for the four agencies: County Government, Montgomery County Public Schools, Montgomery College, and M-NCPPC.

In order to deliver a useful product to the Council, OLO selected a finite number of cost savings and revenue raising options to assess and present. The Appendix (©4) contains a list of additional options worthy of mention, any of which are potential candidates for further development.

OLO's selection of specific cost containment and budget reduction options is based on the following factors:

1. **The experience of other jurisdictions**. The cost pressures and difficult trade-offs facing Montgomery County are by no means unique. OLO was guided by research into how other state and local governments are addressing their own structural revenue and expenditure imbalances. The Appendix (©119) contains examples of cost containment strategies for retirement benefits and health insurance costs undertaken in other places.

2. **The advice of subject matter experts**. Throughout the study period, OLO's work was guided by the advice of subject matter experts, particularly on the technically complex issues of public sector finance and employee benefits. OLO consulted extensively with the many knowledgeable professionals in the agencies' respective budget, finance, and human resources offices. OLO also reviewed a plethora of articles, reports, and research briefs written in recent years about balancing public sector budgets and ongoing fiscal sustainability.

3. **The potential for substantial and recurring agency savings.** OLO placed priority on options that, if implemented, could result in substantial and recurring reductions in tax supported agency costs. Because employee pay and benefits constitutes 82% of tax supported spending, this is where we concentrated our effort. The first five issue papers address options to reduce agency spending on the building blocks of personnel costs: employee salaries, retirement/pension benefits, health benefits for active employees, health benefits for retirees, and workforce size.

4. **The legal feasibility of structural changes to employee pay and benefits.** Shortly after being assigned this project, OLO requested an opinion from the County Attorney on the legal issues related to changing employee pay and benefits. All of the options included in OLO's issue papers adhere to the guidance outlined in the memo from the County Attorney, which is included in its entirety in the Appendix (©8).

5. **Reforms that would reduce per employee costs.** OLO's Part I analysis showed that the primary driver of agency personnel expenditure growth is not a larger workforce, but rather higher per employee costs. Based on this finding, the papers that deal with personnel cost issues focus on changes to the structure of employee salaries and benefits that either lower or reduce the growth rate of the agencies' per employee costs.

6. **The need to address the issues of workforce size, but without duplicating work of the Organizational Reform Commission and Cross-Agency Resource-Sharing Committee.** One way to lower personnel costs is to reduce the workforce. Concurrent to this OLO project, two efforts underway are expected to identify potential budget savings based on functional reorganizations or consolidations and increased efficiency of government operations. Specifically:

   - The Organizational Reform Commission was established jointly by the Council and County Executive earlier this year. The Commission was created to make recommendations for potential reorganization or consolidation of functions performed by the County-funded agencies. The Commission was tasked with submitting a final report to the Council and Executive by January 31, 2011.

   - The Cross-Agency Resource-Sharing Committee (CARS) is a major inter-agency effort launched earlier this year by the County Government's Chief Administrative Officer, for the stated purpose to provide a "forum among County agencies to share ideas/best practices, develop potential resource-sharing strategies to achieve operational efficiencies, reduce costs, and improve the quality of services offered to our residents." CARS is on schedule to submit its first round of recommendations to the CARS Executive Committee later this month.

   The Appendix (©48-67) contains more information about both groups and the status of their work to date. In order to supplement and not duplicate the efforts of these two initiatives, OLO's issue paper on workforce size provides a macro-perspective on the number of positions (measured in workyears) that would need to be abolished in each agency in order to lower personnel costs, calculated in increments of $10 million.

7. **The role of debt service in the competition for tax supported revenue.** OLO's Part I analysis high-lighted the rising cost of debt service over the past ten years, and its projected growth going forward. Because dollars spent on paying back debt are not available to fund the annual agency operating costs, OLO includes several options that show how reducing debt issuance frees up more resources for agency operating budgets.

8. **The inclusion of options to raise more revenues.** While the bulk of OLO's Part II report provides options that would reduce spending, the final issue paper addresses options to raise more revenue. Should there be interest in seeking additional tax supported revenue to pay for existing spending commitments and emerging budget priorities, the choices are either to:

   - Adjust the rates for current revenue sources; or
   - Identify new revenue sources.

   In selecting options for raising revenue, OLO included one for each of the major sources of local revenue: property tax, income tax, excise taxes, and user fees.

OVERVIEW OF THE EIGHT ISSUE PAPERS.

The next three pages contain brief overviews of the eight issue papers. Details on the sources of data and methodology used to calculate potential costs savings are included in the Appendix (©68).

A. Employee Salaries

Salaries represent the largest component of personnel costs. Between FY02 and FY11, employee salaries across the four agencies grew by 50% in the aggregate and by higher amounts (up to 80%) for individual employees. Issue Paper A includes one approach that would actually reduce the total cost of salaries and a series of options to slow the rate of salary growth:

- The first option presents cost savings associated with three different levels of an across-the-board salary rollback (1%, 3%, and 5%) for all agency employees. A salary rollback is a permanent reduction in an employee's base salary. A 1% salary rollback implemented in FY12 across the four agencies would save about $23 million.
- The other salary-related options explore a range of alternatives for modifying the current structure of general wage adjustments and step increases. Modifying the structure of pay increases could substantially lower the growth rate of personnel costs going forward, compared to their growth rates over the past decade.

B. Retirement/Pension Benefits

From FY02 to FY11, tax supported costs of pension and retirement benefits for employees across the four agencies increased by 226%, from $59 million to $193 million. By FY16, annual agency retirement costs are projected to cost more than $264 million. (This estimated amount does not include any costs related to a potential shift of pension liability from the State to the County for MCPS, Montgomery College, and library employees.)

Issue Paper B presents options to lower the projected increases in locally paid annual pension and retirement benefit costs for County Government and MCPS, including approaches to:

- Replace defined benefit retirement plans with lower cost defined contribution or hybrid plans;
- Increase the share of retirement costs paid by employees; and
- Reduce benefit levels.

Changes to retirement/pension plans hold the potential for saving hundreds of millions of dollars in the long-term. However, if changes are restricted to new hires, the savings will not be large in the immediate term. Actuarial analysis is necessary to determine the specific dollar savings that is achievable for any options related to retirement benefit changes.

C. Health Benefits for Active Employees

Over the past decade, total tax supported agency spending on group insurance (primarily health insurance and prescription drug coverage) for active employees increased 134%, from $134 million to $315 million. The costs of group insurance (assuming no change to the current structure) are estimated to increase another 55% to $487 million by FY16.

Issue Paper C presents options to reduce the cost of health benefits through restructuring how the premium is split between the employer and the employee. Specific options included are to:

- Set a uniform employer cost share of 70% for all plans;
- Charge employees who enroll dependents a higher cost share; and
- Set a uniform employer cost share of 60% for part-time employees.

Implementing the options outlined in this paper (as of January 2012) could produce savings for the four agencies that range from $7 million to $46 million in FY12, and from $19 million to $123 million by FY16. Phasing in changes over several years also provides cost savings, but at a slower rate.

D. Health Benefits for Retirees

Over the past ten years, total pay-as-you-go agency spending on group insurance for retired employees more than doubled from $31 million to $79 million. Absent changes to the current structure, these costs are estimated to increase another 57% to nearly $124 million by FY16. According to the latest actuarial estimates, the County's total future liability for retiree group insurance costs is estimated at $2.7 billion.

Issue Paper D presents options to lower the projected increases in agency retiree health insurance by:

- Eliminating retiree group insurance benefits for new employees;
- Reducing the employer's share of premium costs; or
- Changing current eligibility criteria and/or benefit levels for retiree health insurance.

Actuarial analysis is necessary to determine the potential savings that could be achieved by implementing any of these options. Changing the structure of retiree health benefits holds the potential to save tens of millions of dollars every year; however, if the changes are only applied to new hires, then the savings in the near term will be relatively modest.

E. Workforce Size

OLO's Part I analysis found that the primary cost driver behind increased personnel costs over the past decade has been higher costs per employee as opposed to substantial growth in the workforce. Nonetheless, reducing positions, measured in workyears, represents one way to reduce personnel costs.

The content of the issue paper on workforce size was designed to supplement and not duplicate the work of the Organizational Reform Commission and Cross-Agency Resource-Sharing Committee. Both of these groups have been tasked with recommending potential budget savings that would result from functional reorganizations/consolidations and increased efficiency of government operations.

Issue Paper E provides an overview of the allocation of workyears across the agencies, and calculates the number of workyears (for each agency) that must be eliminated in order to yield increments of $10 million in savings. To provide some additional perspective, Issue Paper E also includes illustrative examples of what $10 million in workyears "buys" in each agency.

F. Operating Expenses

"Operating expenses" consist of everything in an agency's operating budget other than personnel costs. Examples include spending for contractual support, utility payments, facility and vehicle maintenance, office and program supplies, and technology. In FY11, budgeted operating expenses represent about 9% of MCPS' tax supported spending and 32% of County Government's tax supported spending.

Issue Paper F summarizes the major components of tax supported operating expenses for County Government and Montgomery County Public Schools, and discusses two approaches to reduce FY12 operating costs in order to achieve increments of $10 million in savings. One approach is an "across-the-board" reduction that decreases operating expenses in all departments by a uniform percent. Another approach is for targeted reductions in operating expenses using priority-based criteria.

G. Debt Service

During the past decade, debt service payments increased 47% from $177 million in FY02 to $260 million in FY11. If the County issues General Obligation bonds at the rate projected in the most recent CIP ($325 million/year), debt service will increase to $391 million in FY16, an amount that is projected to exceed the combined tax supported budgets of Montgomery College and M-NCPPC.

Issue Paper G calculates the projected savings in annual debt service that would result from reducing annual general obligation bond issuance. In addition, this paper identifies the potential consequences of reducing the amount of debt issued.

H. Revenue

Issue Paper H presents four options to generate additional revenue for tax supported expenditures. One option is presented for each of the major locally generated sources of revenue:

- Property taxes,
- Income taxes,
- Excise taxes, and
- Fees/charges.

Three of the four options would generate revenue that would be available for unrestricted use. The fourth option would raise revenue for transportation projects that add new capacity. The paper provides estimates of potential additional revenue associated with each option, which ranges from $3-$20 million in FY12 to more than $150 million by FY16.

Appendix

The Appendix contains additional background and reference materials, including:

- A primer on the State's Maintenance of Effort law;
- Memoranda from the County Attorney on the Council's authority to modify employee salaries and benefits, and the Council's role in collective bargaining;
- Regional comparative data on health and retirement benefits; and
- Case studies of changes to employee retirement and health benefits in other jurisdictions across the country.

In addition, the Appendix includes a glossary of terms, copies of Council resolutions related to fiscal and debt policies, and additional information on the charges and work to date of the Organizational Reform Commission and the Cross-Agency Resource-Sharing Committee.

RECOMMENDED NEXT STEPS

County leaders face a large and complex challenge of bringing projected revenue and spending into long-term alignment. To assist in this effort, the Council requested the Office of Legislative Oversight to develop options that can form the basis for an informed discussion about various ways to raise revenue and/or bend the agencies' future cost curves downward.

As stated earlier, the number and choice of specific cost containment and/or revenue raising options that the Council will need to consider will depend, at least in part, on some key information that is not yet in hand. This includes: updated revenue projections, updated estimates of the County's pension and OPEB (retiree health trust) liabilities, and the agencies' and County Executive's future budget requests, which will reflect the collective bargaining agreements reached between the County Executive and the County Government unions and the Board of Education and the school unions.

Although the exact size of the FY12 and future year structural budget "gaps" that the Council needs to close is not yet known, OLO recommends that the Council prepare for the upcoming budget deliberations by adopting an explicit time line for discussion of this Part II report that includes the following steps:

1. An initial period designated for the Council to ask questions and for staff to prepare answers, with the overall purpose of enabling a common understanding of the options presented.

2. A step for seeking feedback from the general public as well as known stakeholders. The Council should consider coordinating the timing of such input with any outreach efforts that the Council holds on the recommendations of the Organizational Reform Commission and the Cross-Agency Resource-Sharing Committee.

3. A date by which the Council selects a short list of options for further research and analysis that might involve, for example, more refined estimates of cost savings, more detailed analysis of the potential impact on employees, a proposed implementation schedule, and the gathering of more specific comparative data. Included in this step would be any Council requests for additional legal advice or cost estimates related to options that require retaining actuarial services.

4. A decision and action phase, during which the Council decides which, if any, of the options to support, and then takes the legislative, policy, and/or budget actions necessary to move forward with implementation.

As the Council works its way through this next phase of gathering more information, soliciting feedback, weighing alternatives, and making decisions, OLO offers some closing observations on key facts to keep in mind:

- Government is a people-intensive business, so it is no surprise that the great majority of the County's resources is allocated to human capital. Unfortunately, the corollary to this reality is that achieving substantial budget savings requires the County to reduce spending on personnel. There are two ways to reduce personnel costs: shrink the workforce and/or lower costs per employee.

- The County Government and Montgomery County Public Schools (MCPS) together account for 91% of all tax supported spending. MCPS accounts for two-thirds of all tax supported workyears. In order to yield substantial savings, any cost containment option that involves reducing personnel costs must extend to both County Government and MCPS.

- Structural changes to pay or benefits that reduce per employee costs but only apply to newly hired employees will not yield large savings in the near term. There are some options, however, such as changing the structure of pension benefits and retiree health benefits, that hold the potential for substantial dollar savings in the longer term even if only applied to new hires.

For the many governments currently struggling to align revenues and desired expenditures, it certainly would be desirable if some options existed that magically provided win-win solutions. However, as with so many other jurisdictions, the reality of the County's fiscal picture, at least for the foreseeable future, requires decisions that involve asking some to pay more and/or others to make do with less. In other words, the reality is that none of the options promise an outcome where everyone wins.

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The Office of Legislative Oversight appreciates the cooperation received from the leadership and staff of the County Government, Montgomery County Public Schools, Montgomery College, and Maryland-National Capital Park and Planning Commission. This assignment was a major undertaking during a compressed time period. OLO's work was greatly facilitated by the reliable and constructive assistance of the four agencies involved. Special thanks are also owed to the Council Staff Director and the many other Council staff members with whom we consulted regularly.