At the request of the Montgomery County Council, the Office of Legislative Oversight examined the tax supported revenue and spending trends over the past ten years and projected for the next six years. The purpose of the review, which included Montgomery County Government, Montgomery County Public Schools, Montgomery College, and the Maryland-National Capital Park and Planning Commission, was to:

- Quantify patterns of revenue and spending, and analyze how agency budget growth compared to changes in factors such as inflation and population, and increases in school enrollment.
- Identify past and emerging "cost drivers," and improve understanding of how previous decisions regarding revenue and spending affect current and future budgets.
- Compile data on the County's spending "commitments," defined as items that the County is obligated by law and/or policy to fund; these commitments include debt service, health insurance for active and retired employees, pension plan payments, and contributions to the County's fund reserves.
- Based on the revenue assumptions contained in the most-recently adopted Fiscal Plan, describe the parameters of the County's future challenge to achieve a structurally balanced budget.

A. THE STRUCTURAL BUDGET CHALLENGE DEFINED

The cost pressures and difficult trade-offs facing Montgomery County are by no means unique. Vigorous debates are taking place across the country about how to recover from the most serious recession since the Great Depression. With few exceptions, state and local governments are grappling with how to address fiscal projections that show a massive imbalance between expected revenues and desired expenditures.

The imbalance today between projected revenues and desired expenditures in Montgomery County, similar to the imbalance in other places, contains both cyclical and structural components. A "cyclical budget gap" is a short-term imbalance between projected revenues and desired expenditures that reflects the ups and downs of the business cycle. In contrast, a "structural budget gap" exists when projections of expenditures exceed projections of ongoing revenues on a persistent and recurring basis. The distinction between the two is that a structural budget gap continues to exist even when revenue growth resumes.

A common ingredient of the budget challenge facing jurisdictions across the country is the increasing portion of tax supported budgets that must be allocated to fixed spending commitments. In Montgomery County, these commitments include debt service, health insurance for active and retired employees, pension plan payments, current revenue contributions to the capital budget (PAYGO), and contributions to the County's fund reserves. A structural budget problem becomes increasingly evident when the projected cost increases of a government's commitments exceed its projected revenue growth. This is precisely the situation facing Montgomery County for the foreseeable future.

The traditional scenario for making annual budget decisions no longer works when a jurisdiction faces a structural budget problem. Under the traditional scenario, projected revenue for the upcoming fiscal year is sufficient to: fully fund the current year's budget (again), absorb growth in the cost of commitments, and pay for new initiatives, such as program expansions and pay increases for employees. In the current climate, revenue growth for the foreseeable future is unlikely to keep pace with the steadily rising costs of the public sector's spending commitments. **Montgomery County, like many other governments, now faces the extraordinary challenge of bringing projected revenues and spending into alignment, which can only be accomplished by raising more revenue or making reforms that bend the future cost curves downward.**

B. OVERVIEW OF REVENUE AND SPENDING FY02-FY11

1. **From FY02 to FY11, the tax supported agency budgets in Montgomery County collectively increased 59% from $2.1 billion to $3.4 billion.** The macro-cost curve shows annual increases of 7-9% between FY02 and FY08. Total tax supported spending leveled off in FY09 and posted actual declines in FY10 and FY11. During the same ten year period, inflation was 29%, the County's population grew 12%, median household income increased 21%, and the County's assessable property tax base increased 114%.

2. **The County's increased budgets supported some notable expansions in agency services, including**:

Montgomery County Public Schools
- Reduction in class size
- Expansion of full-day Kindergarten
- Enhanced staff development programs

Montgomery College
- Expanded services to meet 32% enrollment increase
- Opening of new facilities

County Government
- Additional public safety personnel
- Expanded Ride-On service hours
- More resources for health & housing programs

M-NCPPC (Montgomery County portion)
- 12% increase in park land
- Creation of the Legacy Open Space Program

3. **The County's budget growth was funded by a combination of more property tax revenue, higher income and excise tax rates, and substantial growth in State aid (mostly to MCPS).** Over the ten years, revenue growth in the County outpaced inflation and population increases by about 20%. The ten year average annual revenue growth rate of 6% (FY02-FY11) is twice the forecast for the next six years, which is for an average annual growth rate of 3%.

4. **In FY11, MCPS received 57% of total tax supported agency allocations and County Government received 34%; the balance went to Montgomery College (6%) and M-NCPPC (3%).** The allocation among the four tax supported agencies remained largely unchanged during the past decade, although how money is spent within each agency evidenced some shifts. Notable trends included a higher portion of agency budgets spent on employee benefits and a higher portion of County Government resources dedicated to public safety services.

5. **Conceptually, debt service can be considered a fifth agency because it must be paid from the same pot of tax supported dollars.** 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), the cost of debt service will increase to $391 million in FY16, a 50% increase from FY11. By FY16, debt service is projected to cost more than the combined tax supported budgets of the College and M-NCPPC.

C. TRENDS IN COSTS OF THE WORKFORCE (EMPLOYEE PAY AND BENEFITS)

1. **Personnel costs (pay and benefits) account for 82% of all tax supported spending. Between FY02 and FY11, personnel costs increased 64% while the total number of workyears increased 10%.** The workforces at all four agencies fluctuated during the past decade, but only MCPS and the College workforces are measurably larger today compared to ten years ago. Specifically, from FY02-FY11, MCPS' workyears increased 14% while MCPS enrollment increased 6%; Montgomery College's workyear growth of 30% paralleled the College's enrollment growth of 32%.

2. **Between FY02 and FY11, the primary driver behind higher personnel costs was not an increase in the size of the workforce but rather the increase in average costs per employee.** Across the four agencies, employee salaries grew by 50% in the aggregate and by higher amounts (up to 80%) for individual employees, while the costs of health and retirement/pension benefits increased upwards of 120%. **In FY11, the combined agency cost of employee benefits is almost $740 million, or 22% of all spending.** (This total would be higher had the agencies made FY11 payments to their OPEB trust funds.)

3. **Another way to track the rise in spending on employee benefits is to calculate their cost as a percent of salary.** As one example, for County Government, the aggregate cost of employee benefits as a percent of salary increased from 35% in FY02 to 52% in FY11. This means that for every $1 the County spends on salary, it now pays 52 cents for benefits. The drivers behind these rising costs are the overall rise in health care costs, and major increases in annual pension/retirement plan contributions. Especially noteworthy is that during the past decade, the per employee cost of a defined benefit pension increased at more than twice the rate of a defined contribution retirement plan.

D. LOOKING FORWARD

1. **The balanced six-year Fiscal Plan adopted by the Council shows tax supported revenues (within the Charter limit) steadily increasing at about 3% per year.** Although these projections show FY16 tax supported revenue that is 16% higher than current year (FY11) revenue, it is important to recognize that the County's revenue is projected to grow at half the rate it did during the past decade.

2. **Looking ahead to FY12-FY16, the County's budget allocation decisions will increasingly be dominated by costs that are resistant to change.** The most striking trend contained in agency cost projections is the steady growth in the total costs of the County's legal and policy commitments, which by FY16 will sum to about $1.6 billion, or about one-third of all available resources. The calculation of these commitments includes the costs of debt service, health insurance for active and retired employees, retirement/pension benefits, and contributions to the OPEB trust, PAYGO, and County fund reserves.

OLO concludes that the County faces a structural budget problem. The steadily rising costs of the County's legal and policy commitments, many of which are resistant to change, are projected to exceed the growth in anticipated revenues for the foreseeable future. The magnitude and recurring nature of these costs means that one-time solutions are insufficient to resolve the problem**.** In order to achieve long-term fiscal sustainability, the County must consider reforms that either raise more revenue or lower the projected cost curves associated with ongoing government operations and future promises.

E. OPTIONS FOR LONG-TERM FISCAL BALANCE

OLO's Part II report (scheduled for Council release on 12/7/10) will contain options for changes that could help achieve long-term fiscal balance in the County. The report will consist of a series of issue papers on the topics listed below. Part II will also contain some comparative information about reforms being considered by other state and local governments, and a County Attorney's opinion on the legal issues related to changing employee pay and benefits.

- Salaries and wages
- Pension/retirement benefits
- Health benefits for active employees
- Health benefits for retirees
- Workforce size
- Operating expenses
- Debt
- Revenue