AGENDA ITEM 7
January 16, 2018
Discussion

MEMORANDUM

January 12, 2018

TO: County Council

FROM: Jacob Sesker, Senior Legislative Analyst

SUBJECT: Discussion – Factors Driving the Cost of Government

In January, the Council will consider the County Executive's FY18 recommended mid-year savings plan, an effort precipitated by an apparent FY17-18 revenue shortfall of $95 million and a negative FY17 closeout of negative $25 million. To better inform that discussion, the Council President requested a briefing on the factors that affect governmental revenues and expenditures. This discussion builds on past efforts by the Council, including a November 2015 briefing on the factors driving the cost of government and the Office of Legislative Oversight's 2010-2011 analysis of the County's then structural budget deficit.

Broadly speaking, the costs of government can be placed in several categories: **revenue pressures; the impact of fiscal policy choices; costs largely outside of our control; and costs largely within our control.** The factors affecting those costs in Montgomery County, as elsewhere, reflect multiple current and historical factors, including: demographic trends, historical growth patterns, the relevant legal and political context, and the effects of past policy decisions. This discussion provides an overview of the factors that are relevant to the current fiscal situation.

The memorandum is a summary of the four categories of factors driving the cost of government. **Attached to the memorandum are discussion slides, as well as longer appendices regarding each of the categories.** Slides on ©1-2 illustrate the pressure on County revenue and the cost of fiscal policy decisions. Slides on ©3-5 show the increase in agency expenditures from FY04 through FY18. Slides on ©6-7 highlight key demographic and economic indicators. The slides on ©8-9 highlight the size of the MCPS budget relative to other budgets, the cost of compensation and benefits relative to operating expenses, and the total and breakdown of employee and retiree benefits. Slides on ©10 illustrate the growth in the County and agency workforce. Slides on ©11-12 highlight the impact and growth of debt service. Appendix 1 on ©13-17 addresses revenue pressures. Appendix 2 on © 18-19 discusses the impact of fiscal policy choices. Appendix 3 on ©20-23 addresses cost factors largely beyond our control. Appendix 4 on ©24-28 highlights those cost factors largely within our control.

Revenue pressures

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.

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 88% 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.

Impact of fiscal policy choices

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.

Cost drivers largely outside our control

A significant amount of budget pressure is the result of cost factors largely beyond our control. Debt service—now 8.4% 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 55% of total operating budget expenditures, are constrained by State law. Maintenance of Effort 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.

Cost drivers largely within our control

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. Following four austere years from FY10 to FY13, employee compensation increased sharply from FY14 to FY16. The County Executive contended that arbitrators would likely award even steeper compensation increases than the ones that he agreed to accept. Workforce size, which actually fell for both County Government and M-NCPPC from FY04 to FY11, has grown by nearly 10% in the years from FY11 to FY18.

Other cost drivers

There are several other drivers of the County's cost of government, such as overtime use by County departments, group insurance costs, the operating cost of new facilities and infrastructure, economic development and IT initiatives, risk management costs, work rules embedded in labor agreements, and possible shortfalls in projected State aid and federal grants. Another driver is the long list of unmet needs and new initiatives developed by both the agencies and elected officials.

Controlling costs in the future

Going forward, controlling the cost of government will require a continuing sharp focus on all drivers, large and small, especially those that are more within our control: **scope and funding of services**, **employee salaries and benefits**, and **workforce size**. The Council will be forced, as it is every year, to consider the tradeoffs between the scope of services the County provides and the size and remuneration of its workforce.

Another important driver discussed on ©20 is the **size of the CIP and its impact on debt service.** Over the long term, reducing the size of the CIP will increase the County's fiscal flexibility.

Focus on the factors driving the cost of government is what enabled us to weather the unprecedented fiscal challenges of the Great Recession, which came to a head just eight years ago. At that time, the Council and Executive together closed a gap of nearly $1 billion. Under pressure in FY16, the Council and Executive again worked together to address a much smaller gap, finding savings of more than $50 million. In FY18 and FY19, a similar shared commitment will be necessary to ensure that the County can continue to provide the services that the community needs during a period of heightened political, economic, and fiscal instability around the globe.

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Cost of Government

Revenues

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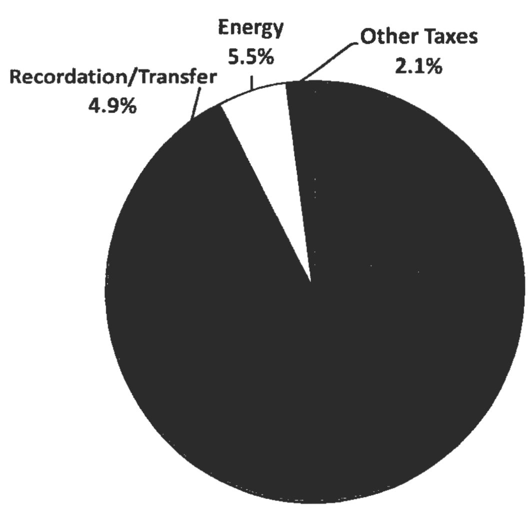
FY18 Tax Revenue by Category

Property and income taxes are 88% of tax revenue



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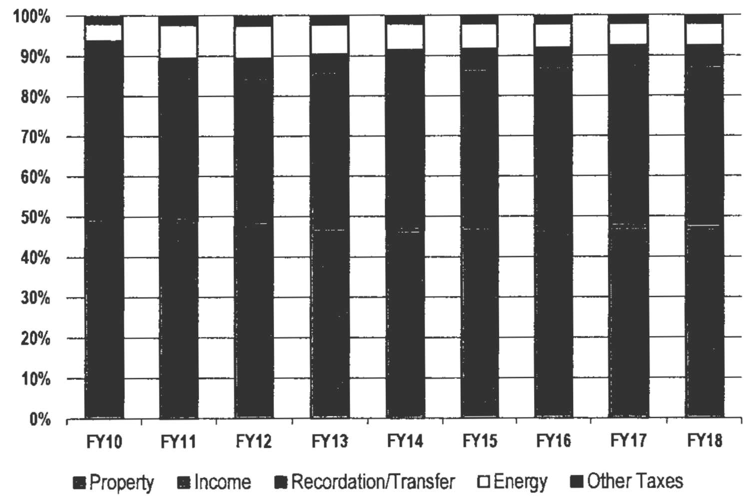
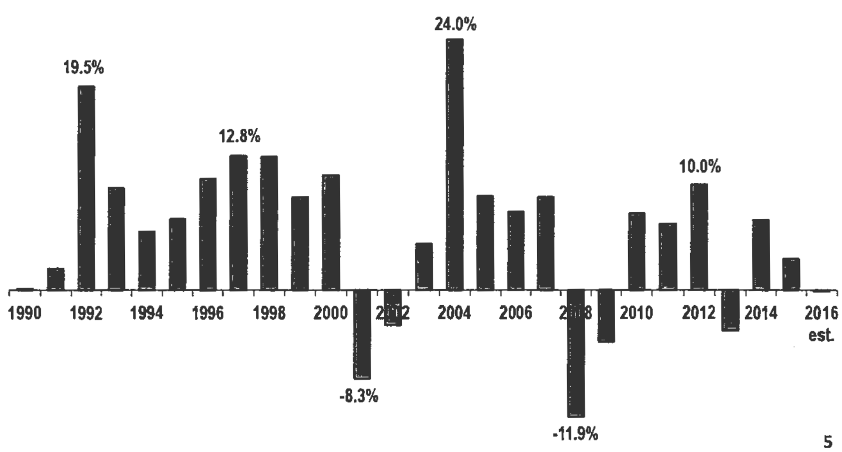
FY10-18 Tax Revenue by Category

Property and income taxes historically contribute 85%-90% of total revenues



Annual Percent Change in Income Tax Revenues from Withholdings, Estimated Payments, October 15 Filings, and Revenue Adjustments

Income tax volatility presents challenges



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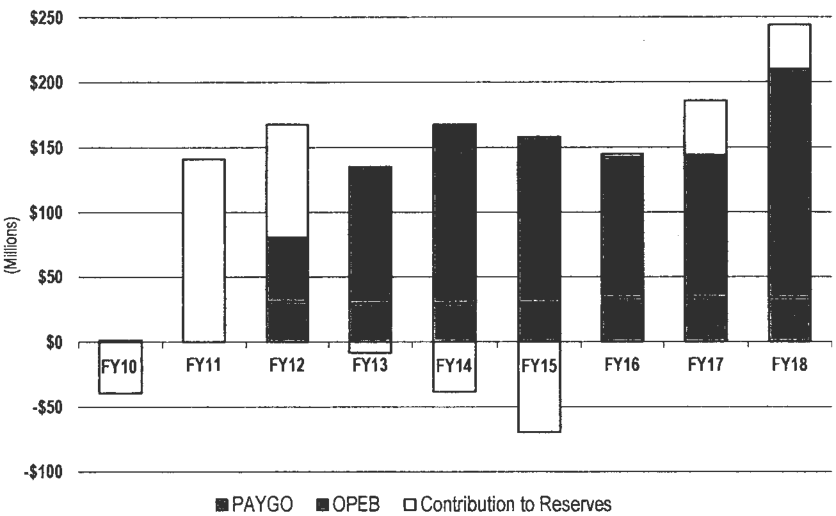
FY10-18 Fiscal Policy Expenditures

The annual cost of fiscal policies limits budget flexibility

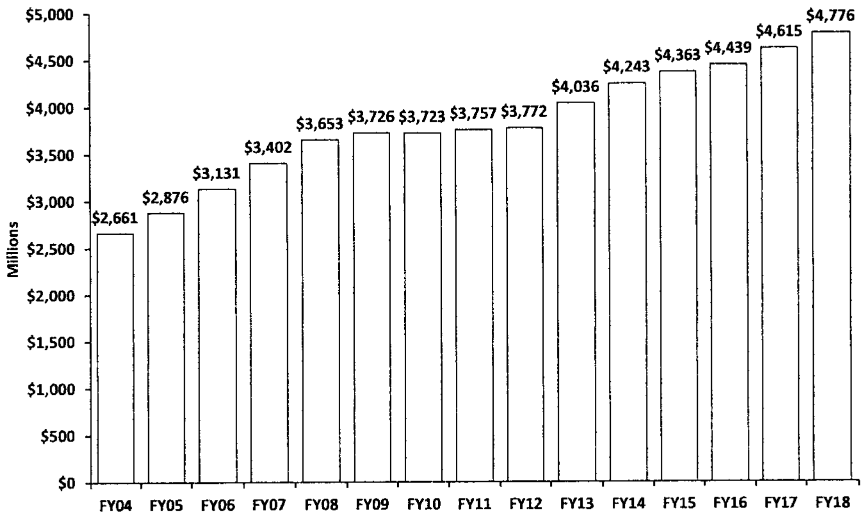


Cost of Government

Total Tax-Supported Expenditures

Total Tax Supported Expenditures

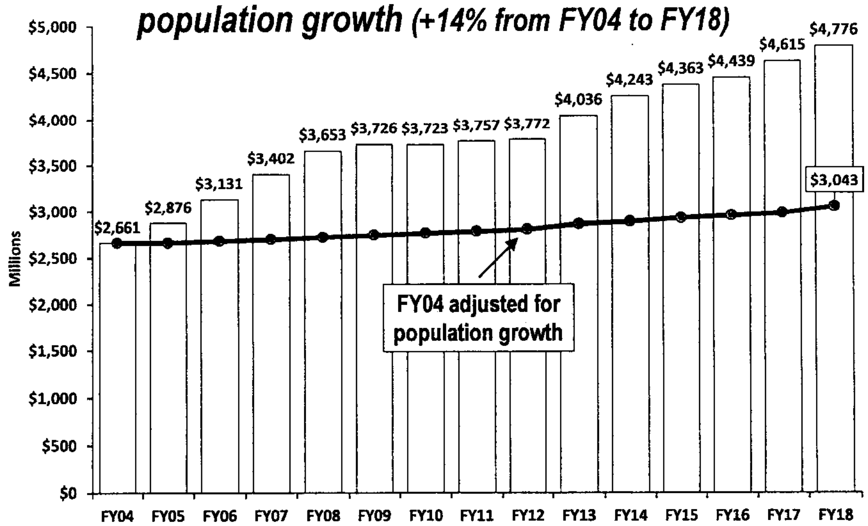
FY04 to FY18 Change: +80%



Total Tax Supported Expenditures

Actual compared to

population growth (+14% from FY04 to FY18)



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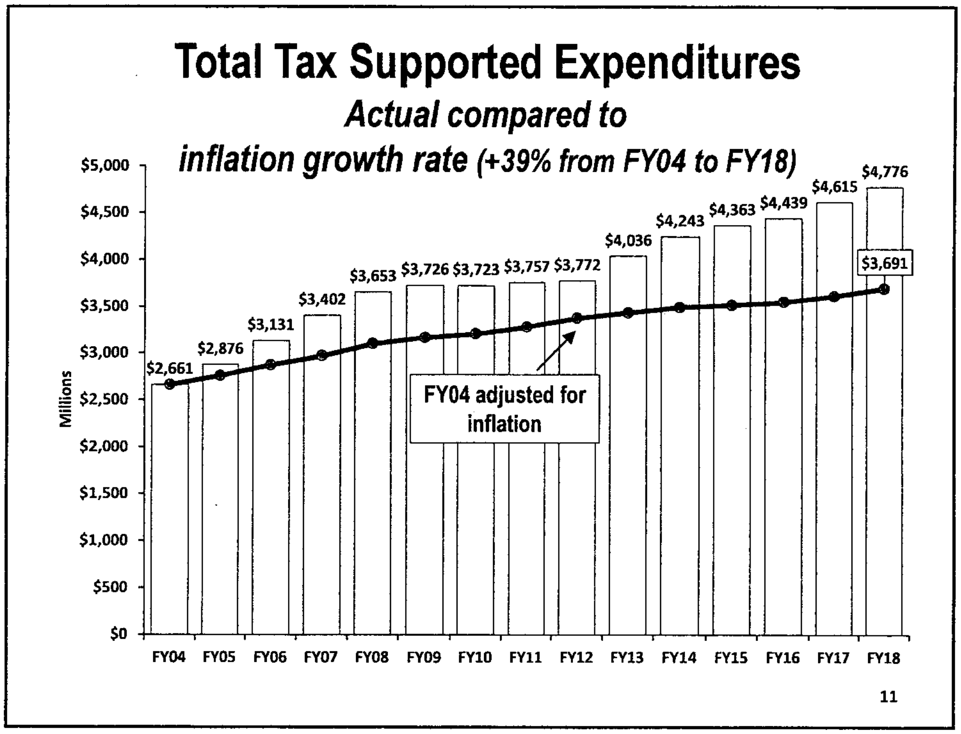
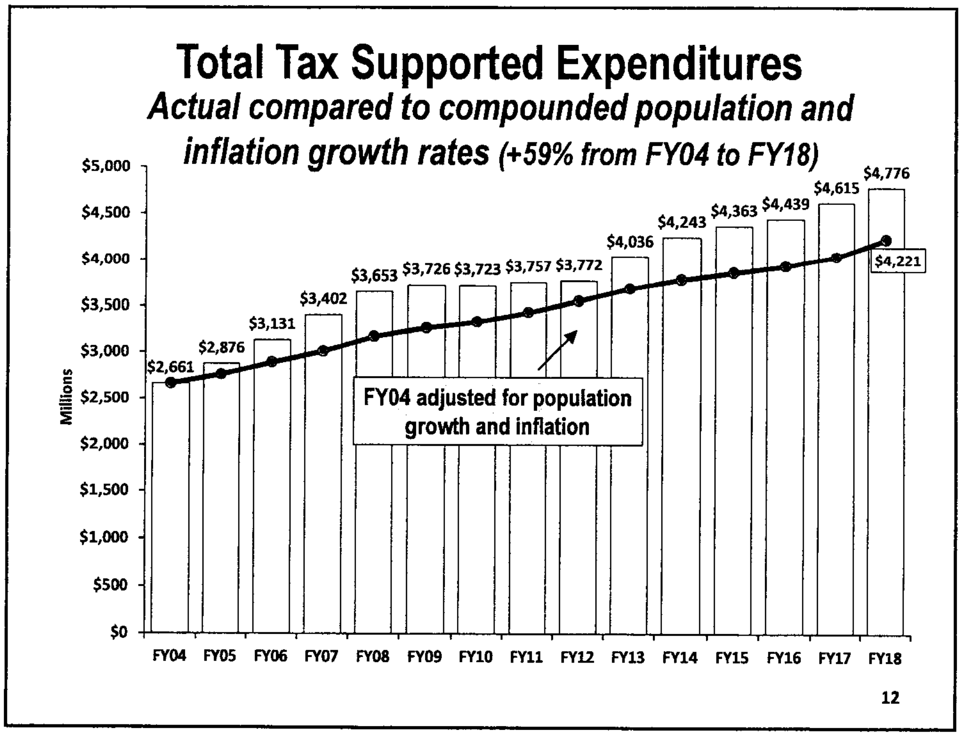

Total Tax Supported Expenditures
Actual compared to
inflation growth rate (+39% from FY04 to FY18)
Millions
$5,000
$4,500
$4,000
$3,500
$3,000
$2,500
$2,000
$1,500
$1,000
$500
$0
$2,661
$2,876
$3,131
$3,402
$3,653
$3,726
$3,723
$3,757
$3,772
$4,036
$4,243
$4,363
$4,439
$4,615
$4,776
$3,691
FY04 adjusted for inflation
FY04 FY05 FY06 FY07 FY08 FY09 FY10 FY11 FY12 FY13 FY14 FY15 FY16 FY17 FY18
11


Total Tax Supported Expenditures
Actual compared to compounded population and
inflation growth rates (+59% from FY04 to FY18)
Millions
$5,000
$4,500
$4,000
$3,500
$3,000
$2,500
$2,000
$1,500
$1,000
$500
$0
$2,661
$2,876
$3,131
$3,402
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$3,726
$3,723
$3,757
$3,772
$4,036
$4,243
$4,363
$4,439
$4,615
$4,776
$4,221
FY04 adjusted for population growth and inflation
FY04 FY05 FY06 FY07 FY08 FY09 FY10 FY11 FY12 FY13 FY14 FY15 FY16 FY17 FY18
12

Cost of Government

Demographic and Economic Indicators

County Demographic Indicators

Indicator	FY04	FY18	% Change
Population	931,000	1,062,500	+14%
Households	342,000	381,000	+11%
MCPS K-12 Enrollment	139,200	163,700	+17%

County Economic Indicators

FY04-FY18 Rate of Inflation: 39%

Indicator	FY04	FY18	% Change
Per Capita Personal Income	$51,500	$91,210	+77%
% Residents Below Poverty Level	4.8%	6.9%*	+44%
Resident Employment	503,000	539,200	+7%
Assessable Tax Base	$94 billion	$190 billion	+102%

* 2016 estimate

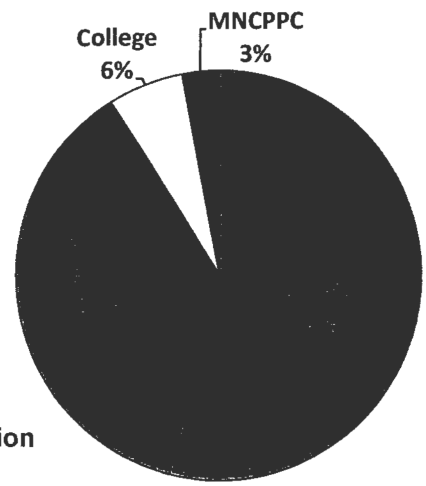
Cost of Government

Use of Tax-Supported Resources

Tax Supported FY18 Operating Budget

(excluding Debt Service)

MCPS comprises more than half of budget



Total = $4.4 billion

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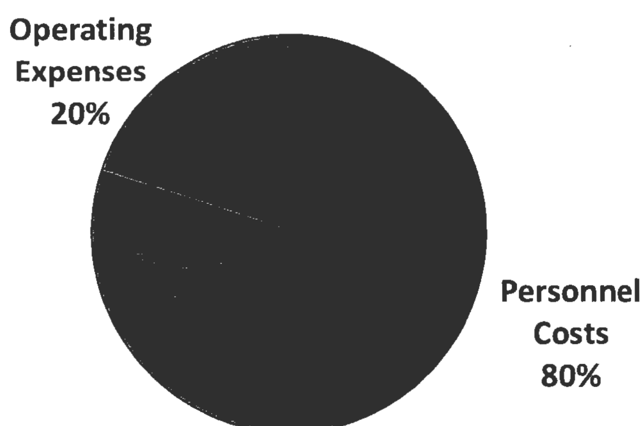
FY18 Agency Tax-Supported Operating Budgets

Personnel costs account for 80% of spending



Total = $4.4 billion

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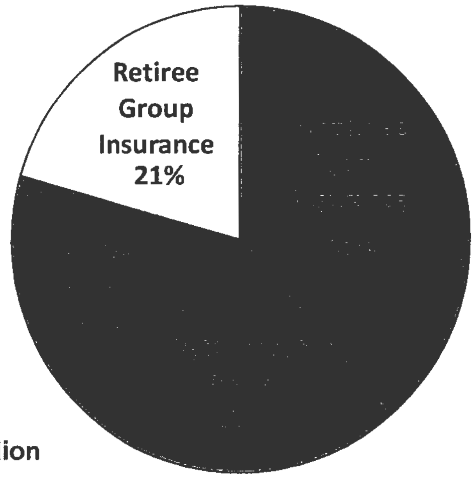
FY18 Employee and Retiree Benefits Costs

County agencies expend more than $1 billion on employee and retiree benefit costs.



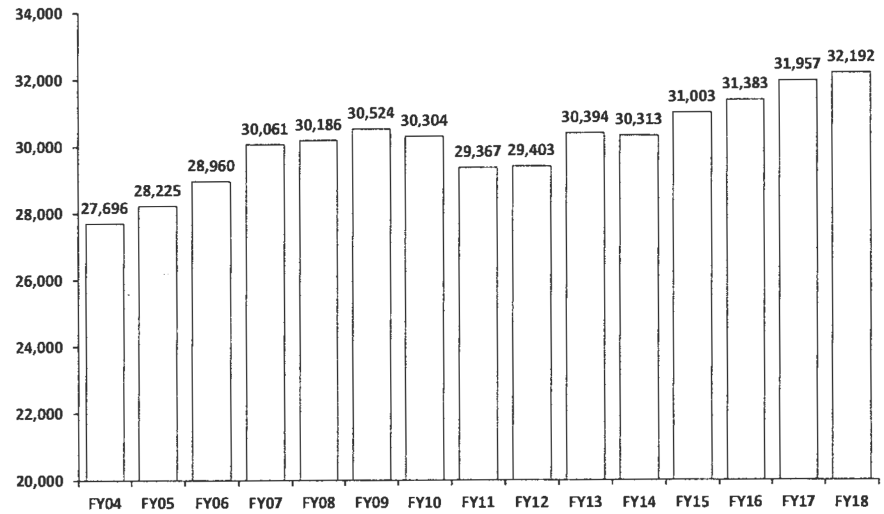
Total = $1.0 billion

Cost of Government

Workforce

Total FTEs (All Agencies)

Current workforce size exceeds pre-recession high



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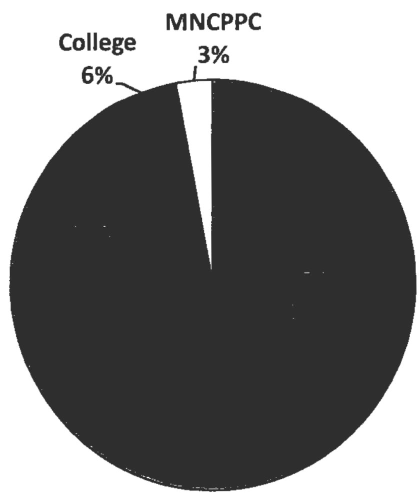
FY18 Approved FTEs by Agency

MCPS currently accounts for nearly two-thirds of all FTEs



Total = 32,200 FTEs

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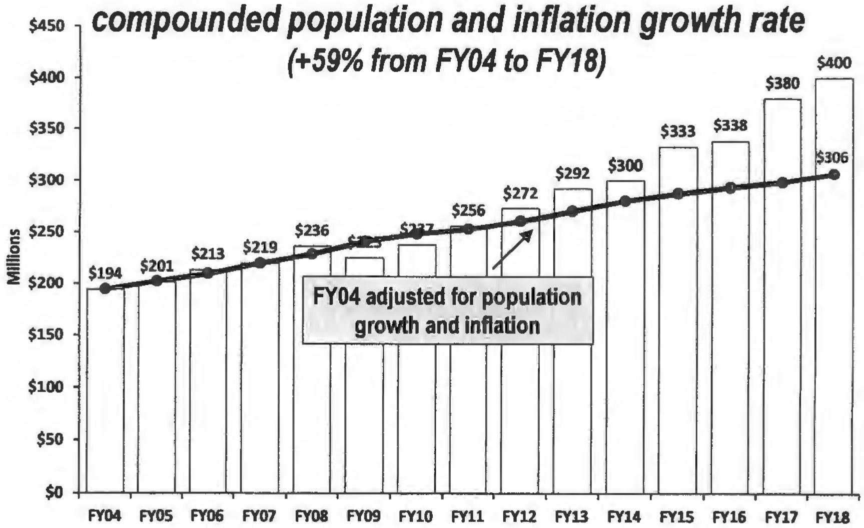
Cost of Government

Debt Service

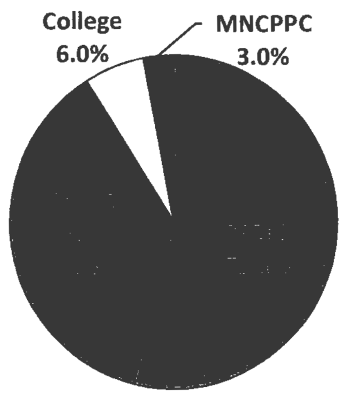
Annual Debt Service

Actual compared to
compounded population and inflation growth rate
(+59% from FY04 to FY18)



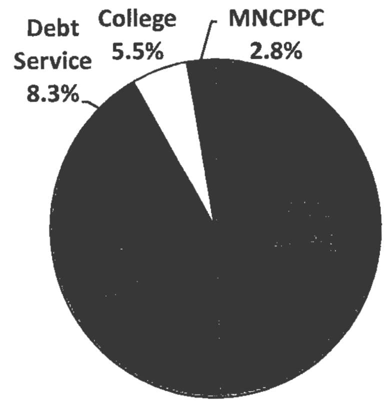
Tax Supported FY18 Operating Budget

Excluding Debt Service



Total = $4.4 billion

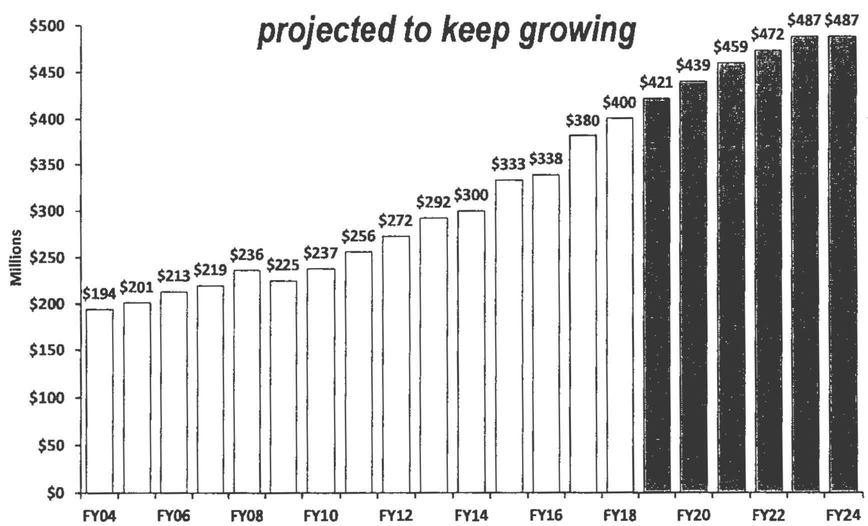
Including Debt Service



Total = $4.8 billion

Annual Debt Service

More than Doubled from FY04 to FY18; projected to keep growing



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.[1]

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

[1] 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.

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.

- **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.[2] A slide attached on ©2 illustrates the volatility.

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

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[2]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

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."[3] 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, affirmed the Court of Appeals holding that Maryland's personal income tax scheme violates the Commerce Clause.[4]

- 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[5] 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. Finance will provide a preliminary summary of the effects during the January 29 briefing regarding State legislation, but other briefings will surely follow. Two recent items worth noting:

- **On December 20 the Baltimore Sun reported that Governor Larry Hogan expects state and local tax revenue to increase as a result of the new tax bill.** He indicated that he would seek ways to return the excess to Maryland taxpayers. Comptroller Peter Franchot indicated that he will present an analysis of the impact of the bill in mid-January.
- **On December 26 the Council authorized the County to accept prepayment of 2018 property taxes when it enacted Expedited Bill 42-17.** The bill was enacted in order to provide an opportunity for County residents to prepay property taxes in 2017 and claim the deduction on their itemized 2017 return. Many taxpayers here and in similar jurisdictions across the nation were interested in doing so because the tax reform bill limits the total deductions for state and local income, property, and sales taxes to $10,000 beginning in tax year 2018. However, this decision will result in lost income

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[3] 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.

[4] 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.

[5] 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).

tax revenue because Maryland taxable income (and by extension, Montgomery County taxable income) would be affected by any reduced federal income tax obligations.

d. Fuel/Energy tax[6]

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.[7] 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 increase on businesses.[8] 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.

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[6] 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.

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

[8] 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.

- 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[9] and the reduced frequency at which households move.[10]
- 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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[9] 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.

[10] 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).[11]

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.[12] Before the recession our policy called for a 6% reserve. Under current policy, the target rises until it reaches 10% for FY20 and after.[13] 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.

From time to time we are asked what the fiscal impact – leaving aside the reputational impact – of a rating agency downgrade would be. **The Finance Department's thorough analysis on ©29-30 confirms the fiscal importance of maintaining a AAA rating.**

b. PAYGO

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[11] 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

[12] 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.

[13] The target for FY18 is 8.9%, followed by 9.4% in FY19 and 10.0% in FY20.

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.[14]

c. ***OPEB.***

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.[15]

[14] 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).

[15] Meeting the full annual required contribution for OPEB represents a dramatic turnaround from the recession years. In FY11 the County's original five-year phase-in schedule called for a $149 million tax supported contribution, but the actual contribution was zero. Starting in FY15, the annual required contribution was sharply reduced when all four agencies implemented the Medicare Part D Employee Group Waiver Program (EGWP). For OPEB details, see http://montgomerycountymd.granicus.com/MetaViewer.php?view_id=169&clip_id=13125&meta_id=135144 for the April 20, 2017 Council packet on FY18 compensation and benefits for all agencies, pages 10-14.

Appendix 3. Costs Largely Beyond Our Control

a. Debt service[16]

The table on ©11 shows that 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. The graph on ©12 shows that debt service is projected to rise steadily to $486.7 million by FY23. 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.

[16] 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.

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.

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[17]

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). See ©12. 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

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[17] 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.

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 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.[18]

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

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[18] 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.

- 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
- 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."[19]

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."[20] 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

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[19] 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.

[20] 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.

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 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 graphs on ©10 show changes in workforce size for the four agencies combined and for each agency over the 15 years since FY04. The numbers reflect tax supported FTEs – for example, 8,384 for County Government in FY18, compared to the total number that includes non-tax supported FTEs, 10,235. The table below provides a useful overview of the information in the graphs:

	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. See ©6.

- 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.

The Financial Impact of a Downgrade

April 2014

Prepared by the Montgomery County Department of Finance

The purpose of bond ratings is to indicate to the investor community the relative likelihood that a bond issuer will make timely and required debt service payments on outstanding bonds. The question as to the relative costs associated with being downgraded from an AAA rated county is not answered with a simple mathematical calculation. Below, we attempt to both define and quantify the impacts of a downgrade in the County's general obligation bond rating on various components of the County's financial operations, and especially on its borrowing and transaction costs.

Nearly every single financial transaction that the County enters into with a financial institution has some element of risk for that institution and that risk has a price associated with it. So from a more subjective standpoint, a lower rated county pays more for banking services and credit card merchant fees, receives less interest on investments, pays higher lockbox fees, has a less lucrative P-card rebate program, pays higher fees for financial advisors and bond counsel, pays higher underwriting and remarketing fees, etc.

It would be difficult, if not impossible, to quantify all of the additional costs associated with being a lower rated county. Too many subjective and objective attributes are calculated and considered in pricing certain financial services. However, as a triple AAA rated issuer of debt, and one of the top 250 counties in the nation issuing debt, it is highly probable that Montgomery County is paying some of the lowest fees for its financial services and, more importantly, has one of the lowest costs of funds.

It is not difficult to quantify in dollars some of the more obvious differences in higher and lower rated general obligation debt. For example, if the County priced its $295 million of general obligation bonds sold on November 13, 2013 as an AA+ rated issuer, over the 20-year life of that bond issue, the County would pay approximately $4.51 million more in interest expense. In the current market the average spread between AAA and AA+ interest rates is about 15 basis points. To place this additional cost in the context of the County's 6-year CIP program, if one assumes equal future annual borrowings; debt service would increase by about $27 million.

The County maintains standby liquidity facilities to back its $600 million variable rate note programs. These programs include the County's $500 million commercial paper program (BANs) and its $100 million variable rate demand obligation program. Based on information provided by the County's financial advisor, as an AA+ rated issuer of short-term notes, the County would pay an additional 20 basis points for its lines of credit. In real terms, the additional annual fee would be $1.2 million. Again, that is an annual fee for programs, which at different amounts, have been in place since 1988.

Typically, debt issued by the County that is "appropriation backed" is not backed by the "full faith and credit of the County" and is therefore priced slightly below the County's AAA bonds.

Appropriation backed debt issues, which would include lease revenue bonds and certificates of participation, are generally rated one to two steps below the County's GO rating, with each step costing approximately 15 basis points in the current market. Therefore, appropriation backed debt now would become AA or AA- rated debt instead of AA+ or AA rated.

The average basis point spread over the last year between an AA+ bond and an AA bond with a maturity of 10 years is about 15 basis points. The County issued certificates of participation for about $38 million in December 2013. The certificates were rated AA+; had they been rated AA, the additional debt service cost over the life of the certificates would have been about $644,000.

Another example of the benefit of the AAA rating is the access to the credit markets. During the historic credit market disruptions of 2008 the County was able to maintain its access to a liquidity facility for its commercial paper program because of its strong credit rating. During this same time period many lower rated municipalities were not able to access the credit markets.

The last few examples of costs associated with being a lower rated county are probably some of the most obvious and expensive examples. Since FY12, the County has been able to save over $46 million in long term debt service savings through bond refundings. This level of savings would not have been possible without the County's strong credit rating. The County has a $25 million master lease program, through which over the last 10 years it has leased various assets such as computer equipment, fire trucks, ambulances, and buses. Without question, the cost of those leases would have been higher if the County had lower ratings. Over the last few decades, the County frequently issued debt that did not fall into the categories described above. The County issued development district bonds, various varieties of revenue bonds, term notes, short term debt for bus, apparatus, and equipment financings, and acted as a conduit issuer for not-for-profit borrowers. Suffice it to say, all those terms would have been more costly had the County been lower rated.

Finally, one should remember that a downgrade in a credit rating not only affects the issuer's new debt, but it also influences all existing debt of that issuer. That is, in the case of a downgrade, all the outstanding debt of the issuer becomes cheaper or the market value shrinks. A municipal investor who is holding onto an AAA rated County bond is now holding a lower rated security that is not worth as much as it was before the downgrade. That could potentially discourage investors from purchasing future County bonds and drives up the County's cost of funds.

For decades, the County has enjoyed and benefited from having the highest ratings from all three rating agencies. In the municipal bond market, the name Montgomery County, Maryland is synonymous with the highest quality bonds. County bonds often trade at levels equal in price and yield to similarly rated state bonds. There are only 40 other counties in the United States that enjoy AAA ratings from all three rating agencies. While it is difficult to achieve and maintain that status, from a financial perspective the rewards are voluminous.