SPENDING AFFORDABILITY COMMITTEE
Anne Arundel County
January 31, 2018

The Hon. Steve Schuh, County Executive
The Hon. Michael Peroutka, Chair, County Council
Mr. Mark Hartzell, Chief Administrative Officer
Mr. John Hammond, Budget Officer
Ms. Karin McQuade, Controller
The Arundel Center, 44 Calvert Street
Annapolis, Maryland 21401

This report of the Spending Affordability Committee (SAC) for FY2019 is hereby submitted to you in accordance with Section 610 of the Anne Arundel County Charter. This section requires in part that "The Committee shall make advisory recommendations to the Office of the Budget, the County Executive, and the County Council relating to spending affordability including County spending levels to reflect the ability of the taxpayer to finance County services and long-term debt." Section 610 also tells the Spending Affordability Committee to "…examine current capital projects, the five-year capital improvement program, per capita wealth, debt service, pay-as-you-go funding and alternative sources of funding."

Committee Recommendation

The SAC has followed the practice of previous committees that "spending affordability" can best be determined by estimating the growth in personal income of County residents. The committee uses the definition of personal income provided by the U.S. Department of Commerce, Bureau of Economic Analysis (BEA), which is "income received by persons from all sources" (e.g., wages, employment benefits, business income, and investment income) whether taxable or not. To avoid placing additional financial burden on County residents, spending growth should remain in line with personal income growth. For example, if personal income of our residents should only increase one percent, then County spending should not increase more than that one percent. Simply put, if County spending were to increase faster than personal income, additional taxes and fees from County residents would likely be needed to support that spending.

Using this methodology, the SAC recommends that FY2019 spending be based on a personal income growth rate projection of 3.75%, which results in a forecasted personal income level for the County as a whole of $39,303,123,838. As shown in the table below, applying the 3.75% growth rate to the adjusted base budget for FY2018 results in a recommended FY2019 Current Expense (General Fund) budget of $1,515,487,663. This represents an increase of $55 million over FY2018. With respect to the Capital Budget, County budget policy stipulates that General Fund Debt Limit be less than 4% of forecasted personal income.[1] As shown, this results in a recommended General Fund Debt Limit of $1,572,124,954. This represents an increase of $5.9 million over FY2018.

The SAC's recommendation is based on data available as of the drafting of this report. However, the SAC agreed to meet again prior to our testimony to the County Council, currently scheduled for May 1st 2018. At that time, the SAC will examine actual economic data from the most recent quarter to determine if any

[1] Page 21, Approved Current Expense Budget and Budget Message for Fiscal Year 2018

adjustments to our recommendation are warranted. Specifically, if economic growth continues to improve as compared to the past several years, the SAC will consider whether or not a larger increase in County spending is supportable (e.g., 4.00% vs. the current 3.75% recommendation).

Current Expense Budget Recommendation	
(Adjusted Base Budget for Current Year x Estimated Personal Income Growth Rate for Budget Year)	
Approved FY2018 Budget	$1,518,854,800
- Appropriated Fund Balance	(54,143,800)
- Rainy Day Fund Contribution	(4,000,000)
Committee's Adjusted Base Budget - FY2018	$1,460,711,000
Estimated Increase in County Personal Income (FY18 to FY19)	3.75%
FY2019 General Fund Appropriation Limit (customary manner)	**$1,515,487,663**
Capital Budget Recommendation	
(Personal Income Forecast for Current Year x Estimated Personal Income Growth Rate for Budget Year x Standard)	
Average of RESI (Regional Economic Studies Institute of Towson University)	
Quarterly Forecasts for County Personal Income - FY2018	$37,882,529,000
Estimated Increase in County Personal Income (FY18 to FY19)	3.75%
Forecast Personal Income - FY2019	$39,303,123,838
Standard Applied in County's Debt Affordability Model	4.0%
FY2019 General Fund Debt Limit (customary manner)	**$1,572,124,954**

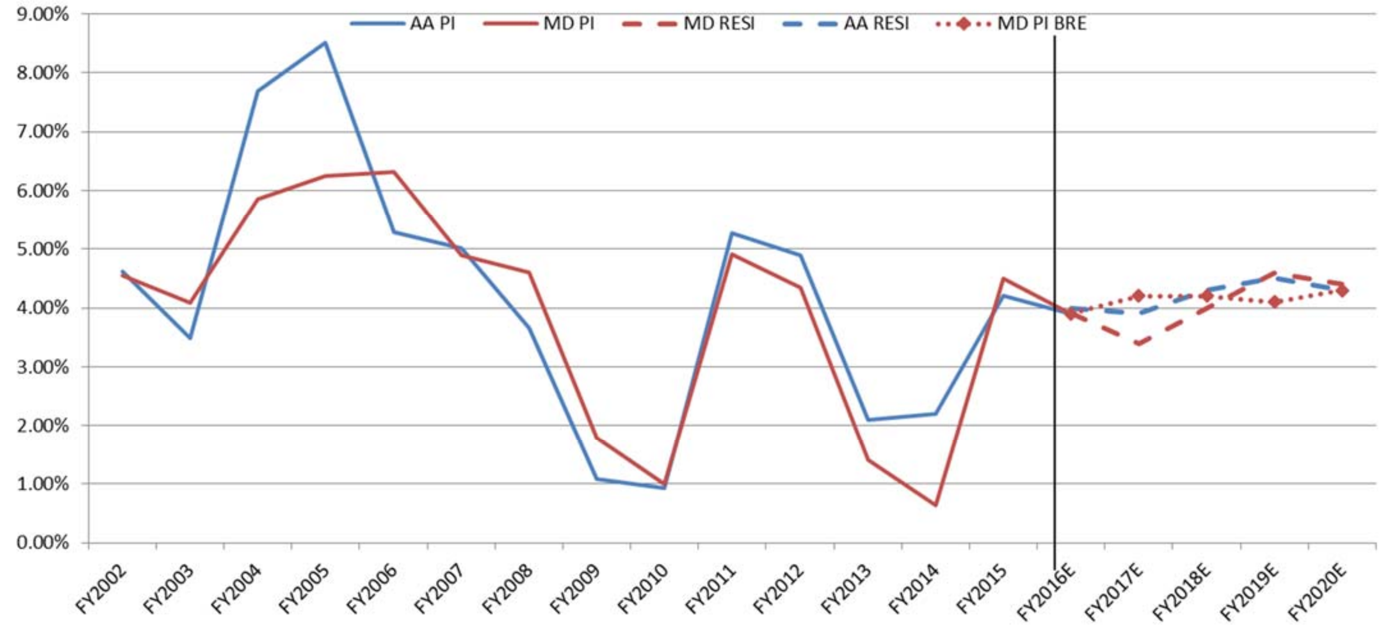
Background

Historically, the State of Maryland has contracted with four firms (Sage Policy Group, Moody's, Global Insight, and the Regional Economic Studies Institute [RESI] of Towson University) to provide economic data and personal income estimates. Based on these four estimates, the State Board of Revenue Estimates makes its own additional estimate for Maryland. One of these firms, RESI, also provides data and forecasts for Anne Arundel County. The RESI estimates are derived from an economic model known as REMI PI+. This model is informed by personal income data from the BEA, employment data from the Bureau of Labor Statistics (BLS), and population data from the U.S. Census Bureau. The following table summarizes the most recent personal income growth estimates for Maryland and Anne Arundel County. As shown, these forecasts project a 4.3% personal income growth rate for FY2019 for Maryland, with a slightly higher growth rate (4.5%) projected by RESI for Anne Arundel County.

Comparison of Personal Income Forecasts (Date of Estimate)		**Fiscal Years**			
		2016	2017	2018	2019
State of Maryland	Board of Revenue Estimates (Dec 2017)	3.9%	4.2%	4.2%	4.1%
	Sage Policy Group (Nov 2017)	3.7%	4.1%	4.3%	3.7%
	Moody's (Nov 2017)	3.8%	4.3%	4.8%	4.3%
	Global Insight (Aug 2017)	3.9%	4.3%	4.7%	5.0%
	RESI of Towson University (Dec 2017)	3.9%	3.4%	4.0%	4.6%
	Average	3.8%	4.1%	4.4%	4.3%
Anne Arundel County	RESI of Towson University (Dec 2017)	4.0%	3.9%	4.3%	4.5%

The following graph shows the actual annual growth rates in personal income from FY2002 to FY2016 for Maryland and Anne Arundel County as reported by the BEA, along with the forecasts described above for FY2017 and beyond. If viewing in black and white, the higher (blue) line in 2005 is Anne Arundel and the lower (red) line in 2005 is Maryland. For the most recent year where data is available (FY2016), the actual personal income growth rate was 4.0%.

PERSONAL INCOME GROWTH BY YEAR FOR ANNE ARUNDEL AND MARYLAND



The SAC applied our collective experience and background in business, economics, finance, and Federal/State/Local government to assess the forecasts provided by the State's four econometric modeling firms. As part of our deliberations, the SAC compared actual BEA-reported personal income growth in Anne Arundel County to previous forecasts. We also examined changes over time in forward-looking personal income growth projections. This analysis showed that, in recent years, the Maryland State Board of Estimates and their four econometric firms have had to revise downward their estimated personal income growth for Maryland. For example, in December 2014, the average of the five estimates was 5.4 percent for FY2017. In November 2015, the estimate dropped to 4.8 percent. In December 2016, the average estimate was further decreased to 4.5 percent. In December 2017, the average estimate was decreased to 4.1 percent. At the time of this report, complete data is not available for FY2017. However, based on the most recent preliminary data, it appears that the actual growth in Maryland personal income for FY2017 will be even lower, probably in the 3.4 percent range.

Similar to the Maryland projections, RESI has reduced their personal income forecast for Anne Arundel County. For example, in December 2016, RESI forecast growth rates in Anne Arundel of 5.1, 5.6 and 5.0 percent for FY2016 through FY2018. In December 2017, RESI reported actual personal income growth in Anne Arundel County of 4.0% for FY2016, and reduced their FY2017 and FY2018 forecasts to 3.9 and 4.3 percent respectively.

Based on this analysis, the SAC believes it is likely that actual results for FY2019 will be lower than currently forecast. This analysis is the primary factor in the SAC's recommendation to base the FY2019 budget on a more conservative 3.75% growth rate, as compared to RESI's current projection of 4.5%.

Additional factors leading to our recommendation include the following:

- **Lower Forecasted Growth for 2020 –** All four of Maryland's econometric firms forecast that personal income growth will slow in 2020 as compared to 2019. This may be related to a slowing job market. Data indicates that Maryland as a whole is approaching full employment level, with an unemployment rate of 3.8 percent in October 2017. While full employment typically results in higher wages, it also potentially slows job growth. RESI projections indicate that Anne Arundel employment levels will peak in 2019 and then remain relatively flat through 2021. The SAC believes it prudent to maintain steady year-over-year growth in the County budget. As such, we recommend budgeting below currently forecasted personal income growth for FY2019. If the economy does slow in 2020, this will allow the County to maintain a more consistent year-over-year budget while mitigating concern of a potential revenue shortfall. Conversely, if revenue outperforms projections, this will provide the County with additional budgeting flexibility.

- **Shift from High Wage to Low Wage Jobs –** Overall, annual wages in Anne Arundel County increased nearly $2,700 from 2016 to 2017, significantly outpacing inflation. While positive, the SAC notes that the largest employment growth is being realized in industries with relatively low wages. For example, the fastest growing industry in Anne Arundel County is Food Services and Drinking Places with 4.7% employment growth in the first quarter of 2017, but with an average annual wage of only $19,604. Service industry jobs also generate tips (increasing take home pay); however, they generally do not come with significant benefits (a component of personal income). While Professional and Technical Services remains a large industry in the County at an average annual wage of $100,932, employment in this area rose by only 0.4 percent. Overall, the 15 fastest growing industries in Anne Arundel have an average annual wage of $51,843, which is 12 percent below the current County-wide average annual wage of $58,273. The SAC believes the County should consider this trend when formulating long-term economic development policy.

- **Shift from Full Time W-2 Employment to Part Time and Self Employment –** While data on part time and self-employment (i.e., 1099) was not presented, the SAC believes that increasing numbers of County residents fall into these categories (a trend first noted in our report for FY2017). As noted above, the BEA definition of personal income includes employment benefits (insurance, pension, employer's contribution to social security, etc.). Because many of these benefits are not available to part time employees and self-employed individuals, this trend has the potential to negatively impact personal income.

- **Population Growth –** Personal income growth is driven primarily by a combination of wage growth (higher pay), employment growth (more jobs), and population growth (more wage earners). With respect to the latter, RESI's personal income forecast is based on a projected population growth of approximately 0.75 percent year-over-year. However, the Committee reviewed data presented in the Draft Anne Arundel County 2017 Land Preservation, Parks and Recreation Plan[2] from the U.S. Census Bureau and Maryland Department of Planning Round 8A Population Projections. This data indicated a lower population growth rate through 2035 (closer to 0.5 percent). Further, this same data showed the percentage of retirees (persons aged 65 and older) living in the County increasing from 13% of the population in 2015 to 21% of the population in 2035. Lower than projected population growth and

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[2] Page II-9, Draft Anne Arundel County 2017 Land Preservation, Parks and Recreation Plan
http://www.aacounty.org/departments/recreation-parks/lpprp/index.html#.Wk61AAjF-h4.aolmail

accelerated aging of the County population both represent risk factors to forward-looking personal income projections.

- **Impact of Federal Spending –** While no concrete data is available, it is the sense of the SAC that the County's economy is heavily dependent on Federal spending. This is driven by employers located in the County (e.g., Government employees at BWI, the Naval Academy, and Ft. Meade, as well as businesses serving those locations). It also driven by residents who commute to Federal and related jobs outside the County. While the County benefits significantly from Federal discretionary spending, the SAC notes that such spending typically increases about 2% year-over-year (i.e., less than forecasted personal income growth). Moreover, personal income growth forecasts rely on BLS data. However, many Government agencies involved in national security do not report employment data to the BLS, potentially impacting the models used by RESI and others.

- **Real Estate Values –** Real estate taxes are the County's largest source of revenue, with Recordation and Transfer Fees representing the third largest source of revenue. The SAC considered whether or not changes in interest rates, U.S. Tax Code or other factors might impact these revenues going forward. Data presented by RESI shows that Anne Arundel home sale prices and the number of homes sold still remain below pre-2007 levels, but are recovering steadily. As such, our budget recommendation for FY2019 was not influenced by concerns over the real estate market. However, this topic should continue to be monitored closely given the County's dependence on these revenues.

- **Effect of the National Economy –** It is well documented that the national economy has been growing steadily since the last recession in 2008, and that the pace of growth has accelerated in 2017. While this is a positive factor for the County's economic outlook, the SAC remains cautionary. As noted above, we believe the prudent approach is to plan based on more conservative growth expectations and to hedge against an unexpected recession. That said, unlike previous years, the SAC did agree to reconvene in the April 2018 timeframe and revisit our recommendations once an additional quarter of economic data is available. If growth remains strong, we may consider amending our recommendation upward when we present to the County Council in May.

Finally, consistent with the SAC charter to consider the ability of the taxpayer to finance County services and long-term debt, the SAC would like to recognize that the analysis presented above does not consider other demands on personal income. In other words, under the methodology used above, County spending is considered "affordable" if it remains consistent as a percentage of overall personal income. However, even if taxes and fees paid to the County remain stable, increased costs in other areas (health care, insurance, tuition, etc.) potentially mean that less discretionary income is available to County residents. While this is a subjective consideration, it nonetheless supports our recommendation to increase the FY2019 County budget at a rate less than forecasted personal income growth.

Conclusion

Based on the analysis presented above, the SAC recommends an increase of 3.75% in the FY2019 General Fund budget as compared to FY2018. While this recommendation is less than the personal income growth currently forecast by the Maryland Board of Revenue Estimates and the State's four econometric modeling firms, we still believe the economic outlook for Anne Arundel County is strong. Our recommendation is based on a measured approach that maintains steady growth while hedging against a potential downturn and allowing the County budgeting flexibility in future years should revenues exceed expectations.

The Committee once again extends its heartfelt appreciation to our County employees, especially to Assistant Budget Officer Hujia Hasim and Budget Officer John Hammond. The quality of governmental services that they provide is second to none. We sincerely hope that the evidence assembled for this report will help manage expectations and inform fair and just analysis of the difficult choices facing our elected leaders.

Sincerely,

David G. James, Chair

Spending Affordability Membership for 2017 to 2018:

District	Name	Resolution #	Appointed on	Term Expires
1	Carl Joe Carrick	70-16	November 21, 2016	December 1, 2018
2	Ejaz Younas, CPA-CISA-MSc, Secretary	19-17	May 1, 2017	December 1, 2020
3	John W. Spencer	52-13	December 2, 2013	December 1, 2017
4	Jerome W. Klasmeier	66-16	July 7, 2016	December 1, 2020
5	J. Timothy Connolly, Vice Chair	42-15	October 1, 2015	December 1, 2018
6	Jerry L. Pesterfield	42-15	October 1, 2015	December 1, 2018
7	David G. James, Chair	45-17	September 19, 2016	December 31, 2021