Open Work Session
Fund Balance Policy
August 21, 2018

Mrs. Dawn Parks, Director of Finance, and Mr. Wayne Strausburg, Director of Administration, came before Council. Mr. Strausburg explained, for the public's benefit, an effective fund balance policy basically ensures adequate reserves for emergencies and ongoing capital needs, but it also ensures that reserves are not accumulated in excess of an amount that can be reasonably justified, and which would result in excessive taxation. He said they believe their current policy is outdated and in need of revision, and that opinion has been expressed by credit rating agencies, as well as their bond advisors, Davenport and Associates. He said, after reviewing the Government Finance Officers Association (GFOA) Best Practices and Fund Balance Policies in other highly rated jurisdictions, they drafted the proposed policy that is before Council. He said it has been reviewed by Davenport and Associates, and they feel it is a very good policy. He said the Administration recognizes, however, that this is a complex matter, and that it warrants careful review and deliberation. He said they are here today to start that process and those discussions.

Mr. Kilmer asked them to explain the 12 to 17 percent, and walk them through the rate stabilization, to which Mr. Strausburg responded, he will let Mrs. Parks walk them through that. Mrs. Parks said she will start with the rate stabilization, and that is actually determined by the healthcare consortium. She said last year it was 14 percent, and this year they are dropping it to 12. She explained that it is based on their payments from the prior year so, if they hit a time when their healthcare expense is going to be more than what they budgeted, they have something to fall back on to help with that. She said, as far as the 12 to 17 percent, she looked at other jurisdictions, and some are going from 10 to 15 percent, and others are 12 to 17 percent. She said 17 percent seems to fit the County's circumstances more than 15 percent. She said they average about $10 million a month in recurring operating, and the 17 percent keeps them on the high-end of that. Mr. Kilmer clarified, they have the unassigned fund balance and the rainy day fund, so this would create another fund stabilization, to which Mrs. Parks responded, they already have a rate stabilization. She said they have the reserve fund, which is called the rainy day fund. She said normally when there is an unassigned fund balance policy, they do not also have a reserve, and that is why she has requested they change that to a disaster recovery. She said they have roads wash out, and there are times where their fund balance cannot handle that, so they would have funds put aside for it, or if there was something that happened, or a matter that Council felt they needed to go into those funds. She clarified, it would still stay the same at 5 percent as it has been since the 1990s. Mr. Kilmer asked what happened with the previous unreserved balance during the last recession, and whether it was drawn down a lot during the last recession when income tax revenue went down substantially. He then asked what the County history is in terms of being able to dip into this, to which Mrs. Parks responded, she can pull the history for Council so they can actually see it on paper. She said it did drop down, but with being conservative, they cut capital spending and they cut operating. She said she remembers that in January of that year no more capital was able to be done in order for them to maintain a fund balance. She said, through very conservative management, or pretty much aggressive management at that point, they were able to maintain a fund balance that would keep them through that time, and since then they have been building it back up. Mr. Strausburg explained, the rainy day fund was not utilized, and the majority of the response to the recession was austerity in terms of spending. He said he would like to make the point that each year they visit with the credit rating agencies, and the rating agencies recognize that the County has a revenue cap that places a limitation on their property taxes, and they also recognize the County is at the maximum marginal rate for local income taxes. He said, from the credit rating agency standpoint, those are two limitations that they are not necessarily thrilled about, but that is counterbalanced by the fact that they have the strongest fund balance in the State as a percentage of recurring revenue. He said they have expressed the opinion that the current fund balance policy does not adequately protect that fund balance, and that it would be helpful to the creditworthiness of the County to have a bit more robust fund balance policy. He said Davenport and Associates agreed with that, so, again, this is their proxy, and they wanted to open up this discussion to see if Council had an appetite. He said it is a complex matter that warrants a lot of discussion and a lot of consideration.

Mr. Joe Holloway said it was stated that they want the County to have a more robust policy. He then asked if they are suggesting less of a fund balance, to which Mr. Strausburg responded, no. He said they like their fund balance, and they do not want to see it burnt through, particularly since they are 10 years into recovery. He said, if they look back at the economic history in the United States, typically they go through a recession at least every 10 years. He said they are limited on property taxes and limited on income taxes, and that is the majority of their revenue. He said credit markets like to see their reserve balances strong so they have that to fall back on. He said the most likely thing that could happen to the County that could trigger significant utilization of either the rainy day fund or the unreserved fund would be a category 2 hurricane, and they have dodged the bullet on that several times in the past couple of years. He said, again, they want to strike a balance between running up a reserve balance that is the result of what he would call over-taxation versus a fund balance that does not prepare them to weather that type of storm or downturn in recurring revenue, or the costs.

Mr. Joe Holloway said the Board of Education in particular has concerns about how much the County has in their fund balance. He said Mr. Kilmer mentioned history, but when the County was going through that recession, due to the fact that they had a good fund balance, they were still able to move forward with a lot of projects, so he feels it is very important that they keep that fund balance. Mr. Strausburg said it is also important to point out that their fund balance should not be utilized for recurring operating expenses. He said their fund balance should be used for one-time capital or one-time catastrophic costs, and not something such as funding a department an additional $2 million dollars where that $2 million dollars is going to occur every year in perpetuity because that is not an appropriate use of fund balance.

Mr. Cannon asked Mrs. Hurley if she has any comments in reference to this at all, to which Mrs. Hurley responded, she just wants to clarify that the rate stabilization reserve is to be spent only on healthcare. Mr. Strausburg said that is a hedge against premium increases. Mr. Joe Holloway then asked, due to the fact that healthcare is a moving target, should that be increased, to which Mr. Strausburg responded, the consortium just adopted that policy, so they review that on an annual basis based on experience, and it either moves up or moves down. Mr. Joe Holloway then asked what they came up with when they reviewed it, to which Mrs. Parks responded, 12 percent for this upcoming year. Mr. Joe Holloway asked if that is more, to which Mrs. Parks responded, it is 2 percent less. Mr. Strausburg said it was 14 percent. Mr. Joe Holloway asked why it was recommended to bring it down when they never know what is going on with healthcare, and they have heard from the Executive Office that healthcare, basically, is not going to be sustainable in the future as it is, to which Mr. Strausburg responded, the other two entities in this past year had a better experience than the County did in terms of claims versus premiums, so it is a majority rule. He said he would have been happy to leave it at 14 percent, but he is one vote.

Mr. Cannon asked Mr. Taylor if he has any questions, to which Mr. Taylor responded, he just has a couple of thoughts, and he has already put some in writing. He said, as Mr. Strausburg just said, it is not a good idea to spend their unassigned funds to their operating budget, but they are actually doing that, and at the end of the year they may have a surplus equal to or greater than the amount they are putting in each year. He said the last few years have probably been good because tax receipts, generally, have been going up. He said that may not always be the case, and it kind of violates the principle that was stated. He explained, if the unassigned funds were capped, this 17 percent level would be equal to about $22 million dollars. He said, if they continued to rollover about $10 million each year into the budget operating not knowing for sure at the end of the year whether they are going to get it back or not, at least during that particular year, the available remaining unassigned funds would be about $12 million dollars, and that is one thing to consider. He said another thing to consider is that most Counties and municipalities that put on a cap of any kind like this look at about three to five years long-run what their expenses are going to be. He said, if they have to start drawing down their unassigned funds and they cannot continue to do this rollover, there are only two ways to balance the budget, which are by either cutting things out of it like was done during the recession, or increase taxes. He said this all factors into a lot of things, and is a bigger ball of wax, he thinks, than just saying this number sounds good so they will use this number. He said, if he were doing it, he thinks that is what he would do, and look out at least five years. He said he thinks some of the things they need to think about are some of the things they have discussed at meetings that have come up, such as pre-kindergarten and what is going to happen there, what the decision is going to be, what it is going to cost, and how it is going to be paid for, as well as the new Municipal Separate Storm Sewer System (MS4) National Pollutant Discharge Elimination System (NPDES) stormwater regulations. He said MACo just wrote a letter to the State that the large Counties that have been under this for about five years on the Western Shore are now about halfway through that new requirement which Wicomico County is now subject to for restoration of stormwater systems, and it is costing them $1.3 billion. He said, if they just extrapolate, when they get to the end, that is going to be about $2.5 billion. He said, if they just did 1 percent of that, he thinks it would be $25 million. He said, obviously, Wicomico County is going to do less, so he is just using 1 percent as an example, but if they cut that in half it would be $12.5 million dollars, and that would, essentially, wipe out the surplus they have now. He said he thinks when they look at this on a big picture basis, there is a lot more to think about than that Davenport says it is great because Davenport does not sit here at these Council meetings and look at everything that is on their table. He said he has found that there are a lot of other Counties that do considerably more than 17 percent, to which Mr. Cannon responded, he thinks that is why they are here today, to try to figure out where that is.

Mr. Cannon said, in all honesty, if the reserves were eight times what they are right now, they would definitely need a policy, and he thinks everyone would agree to that and ask where they want to draw that line, and what that percentage would be. Mr. Strausburg said, just to clarify, their budget use of prior year revenue, which is fund balance, is in the operating budget, but it is always for one-time capital and is not for recurring expenses, so that is a point that needs to be clarified. He said he would also clarify that Davenport probably knows as much about the County's financial condition as their Finance Director does, and they do a five-year forecast. He said they pride themselves on being very diligent in terms of how they analyze, and, when they put something forward to this Council, it is well thought out, to which Mr. Cannon responded, he understands.

Mr. Cannon asked how would they see Item 1:C in the proposed draft Resolution playing out, and if they could just give him an idea because they are referencing three options, which are retaining unassigned, considering supplementing the pay-as-you-go, or the third option to prepay County debt. He asked, if they were in that scenario where they had a 17 percent limit and they were at 19 percent, how would that play out through the year since the initial CIP is done at one time, and then goes through a three-year process. He said he is just curious about how they would address these three scenarios once they found themselves in that position, to which Mrs. Parks responded, they already do this. She clarified, this is putting into place a practice they already have. She said their use of prior year fund balance in the budget is already for one-time purchases, departmental capital, and pay go. She said the other option is also to prepay County debt. She said, if they find they have above 17 percent and they are not looking at going into another recession because times are good, they can pay down debt if they want to. She clarified, this is just putting in writing the practice they are already following. Mr. Cannon asked if creating a hard and fast rule really is not going to create anything additional, to which Mrs. Parks responded, no because it is a practice they follow. Mr. Strausburg added, it would depend on the environment they found themselves in. He said it would depend on the interest rate, the environment they were in at that given time, what their debt capacity was at that point in time, and it would depend on what unavoidable capital needs they had. He said they look through that prism each time they go into the CIP cycle. He explained, when they are looking at the CIP they are already thinking about what they believe is going to be affordable in terms of borrowing and pay go in that next budget cycle, and the one after it. He added, that is the process they go through. Mr. Cannon said he did not know if this was going to create any greater sense of urgency, to which Mr. Strausburg responded, he thinks this codifies practice, but he also thinks it serves the County well to have this discussion. He said, if they want to have further discussion and look at modeling of how this would work under different scenarios, he thinks that is a very good idea, but he will conclude by saying their current policy is not appropriate for today's environment, and it really needs to be looked at.

Mr. Kilmer asked how many years they have been in a position where they actually added to the fund balance, to which Mr. Strausburg responded, at least five straight years. Mr. Kilmer said it is great to build up, and he likes having a large reserve for these situations, but after so many years go by they get to the point that Mr. Strausburg hinted at, if not said explicitly, where maybe they are overtaxing because they are collecting more money than they are spending every year. He said maybe they should also have a discussion that after six or seven years of adding to the fund balance, maybe they recognize that maybe they should lower taxes, and maybe that should be a policy. He said then, if there is a recession, they have the ability to raise that rate. He said right now they are at the max, essentially, for property tax and income tax, so it is good to have a balance built up because they cannot really raise taxes in a recession, but if they are continuing year after year to collect excess revenue, he thinks tax cuts should really start being looked at. He clarified, maybe not the first and second year because that could just be a blip, but maybe once they start to see a trend, although that will not last forever. Mr. Strausburg responded, they open themselves up to a legitimate complaint when they are collecting more in taxes than what they are spending for public needs. He said the environment they have been through during the time he has been with the County was that they were at the depth of the recession when he came in, so they were extremely gun-shy about spending, and they have been very, very conservative by and large with spending. He said where they have really experienced the lift in revenue has been in income taxes because their employment trajectory really accelerated, and they were very conservative with what they thought their income tax revenue would be. He said, at some point in time, particularly when they go into a recessionary cycle, there is going to be pressure on those local income tax revenues. He said, if they were to say they believe they are accumulating too much of a reserve and they really need to peel back on revenue, they have to go through the calculus of whether it is better for the citizenry and the County to lower the marginal local income tax rate, or is it better to lower the property tax rate, and that takes quite a bit of analysis because that is a moving target. He said different tax payers are going to be sensitive to different tactics in that regard. He said he does not think they are there yet, but they always have to be mindful that, by and large, they should be budgeting as best they can not to produce excess reserve but to take in as much as they are going to spend, and that the spending is reasonable spending.

Mr. Cannon said he will add to what Mr. Kilmer said because that is a really good point. He said he thinks that maybe on Section C a fourth option would be necessary to include in there. He then asked if Mrs. Parks and Mr. Strausburg agree, to which Mrs. Parks responded, she thinks that would be part of a new revenue policy. She said her overall goal is to do a full financial policy, but it is a lot to bring at one time, so doing a section at a time is her plan. She said the dropping of tax rates would fall under a revenue policy. Mr. Cannon clarified, that would be separate from this policy, to which Mrs. Parks responded, yes, but then they would all come together into one. Mr. Cannon said this Resolution does not create that obligation because it is pretty much just establishing what it considers their options to be, and there are three options which are to spend the revenue, as is suggested in these three options, or, as Mr. Kilmer said, realize that maybe they need to reduce the revenue stream. He said, if they do not think so, that is fine because they are not voting today.

Mr. Dodd said he agrees with what Mr. Kilmer said. He said just because something is requested in the budget does not mean it is really a necessity, so at some point in time the taxpayers may warrant a break or cut. He then said he has a question on the policy where they redefined rainy day fund. He read "The rainy day reserve will be known as a disaster recovery reserve which will remain committed and may not be utilized without the approval of the County Council for natural disasters, manmade disasters, such as terrorism, or a condition considered at the sole discretion of the County Council." He then asked what the condition is because that is kind of open, to which Mrs. Parks responded, that was part of the original policy, so she left it in there. Mr. Dodd said that last part just seems too vague, and it could be used for anything, to which Mr. Strausburg responded, it gives them some flexibility, and he would respond to that by saying it may be employed in the event of a recession, or a true depression where they could not really manage their expenses and their revenue quickly enough to avoid significant harm to the general public. He said it is a little soft, to which Mr. Dodd responded, he understands that, and he understands there may be a time where they need that additional funding, but to throw that in there with a disaster is just too vague. Mr. Strausburg said they can wordsmith it, and they are open to that.

Mr. Joe Holloway said they have heard the word recession a dozen times today, and politicians a lot of times are in denial that it is going to happen. He said he thinks they need to be conscious of when the last recession happened that there were a lot of warnings prior to it happening, and they were not heeded in the County Government. He reiterated, that is something they need to take into account when they do this, to which Mr. Strausburg responded, absolutely. Mr. Dodd said, with that being said, when the recession hit, it really hurt the taxpayers because there were City, County, and State employees who had to do furloughs, and many of them never got reimbursed for that expected income.

Mr. Cannon asked if they are going to have another Work Session on this, and what they see as the timeline. He also asked whether they are looking to have it come back as a Resolution, or another Work Session, to which Mr. Strausburg responded, his thought is that they could come back to Council with some modeling and show them how this would behave under certain assumptions. He said they are about a week away from a five-year forecast that they will take to New York with them, so they could take those five-year assumptions, look at fund balance and how fund balance would behave if they were utilizing this policy, and that may be helpful for a discussion, and would probably open up more questions and more thoughts. He said they can have that done by the second Council meeting next month.

Mr. Cannon said Mr. Taylor did make a good point that they have the pre-kindergarten issue, and the MS4 that will be with them, and he is sure they are taking that into consideration in their five-year planning, to which Mr. Strausburg responded, they looked at that. He said he asked Mr. Bruce Ford to give him five-year fulltime equivalent enrollment figures, and they cast that forward and tried to estimate what the five-year moving average is, cost per pupil at the State level down to the local level, factored in some inflation assumptions, and some interest rate assumptions, and they are modeling that, and they are pretty conservative assumptions. He clarified, conservative from the standpoint of anticipating inflation and anticipating higher interest rates, and anticipating increased enrollment, so they are doing a very conservative budget five-year-forward look to see how skinny it gets, and it is prudent to do that. Mr. Cannon said part of that will be to see what happens when the Kirwan Commission comes out, and what the State of Maryland decides to do, to which Mr. Strausburg responded, that is a wild card because they have no idea, but he thinks they need to factor in the things they can reasonably anticipate. He said there is a revenue projection presentation that was done by Andy Schofel from DLS, and he believes the Counties that are anticipating the recovery is going to continue on its current trajectory for the next five years are probably going to be surprised. He said he would much rather be wrong on the conservative side than wrong on the aggressive side. He said they prefer conservative assumptions in terms of revenue and what could happen with the expense environment versus assuming that because they have been experiencing 6 percent revenue growth that it will continue for the next five years because he does not believe it will. He said they are modeling that, and they will come back before Council with that to show them, and he thinks that will be good with regard to going into the CIP cycle and the next budget cycle, but it will also give Council a broader perspective on how they should be looking at this fund balance policy. Mr. Cannon asked if they are under any time constraints, to which Mr. Strausburg responded, no, they are not. Mr. Cannon said they will work with whatever Mr. Strausburg's agenda allows.

Mr. Taylor said he has just one other suggestion. He said he thinks Mr. Strausburg's idea of modeling is really good, but he would suggest modeling for maybe two major events. He said they had the recession, and imagine what would have happened if they had one of those category 2 hurricanes that they dodged during that period. He said it is a little bit like an expression they have in the military that says "Size your Armed Forces for two wars, not one," and this is just a thought to take a hard look at that.

Mr. Joe Holloway said he has a question regarding the rate stabilization reserve. He said Mr. Strausburg stated it is established by the consortium. He then asked if those funds are combined, to which Mr. Strausburg responded, no, they are separate funds. Mr. Joe Holloway then asked, if they set it at 12, can the County set it at 14 if they want, to which Mr. Strausburg responded, he thinks they can through the budget process. He said, if they decide to do that, they can do that. Mr. Joe Holloway said he thinks that would probably make the employees feel a little bit better knowing that reserve is there in case there is a problem as there has been a problem with morale with employees sometimes, to which Mr. Strausburg responded, that is fair.

Mr. Cannon asked Mr. Roser if he has any comments, to which Mr. Roser responded, the Auditors have not had a chance to review it yet, but they are in the process, and will be happy to weigh in and help in any way they can. There was no further discussion.

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John T. Cannon, President

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Larry W. Dodd, Vice President, District 3

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Ernest F. Davis, District 1

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Marc Kilmer, District 2

___absent______________________
John B. Hall, District 4

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Joe Holloway, District 5

__absent_______________________
Matt Holloway, At-Large

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Laura Hurley, Council Administrator