Sage Policy Group, Inc.

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Restoring Economic Momentum in Montgomery County, MD

Submitted by:

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Empower Montgomery

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Table of Contents

List of Exhibits

Foreseeable Fiscal Fiascoes: Montgomery County, MD

Executive Summary

Constrained Quality of Life

In April 2018, Sage Policy Group, Inc. (Sage) produced a report analyzing economic and fiscal conditions in Montgomery County, MD. That study focused on big picture economics, with special attention given to the County's soft business formation, slow job growth, expanding tax burdens and rapid debt accumulation. Among the findings of that report was that business establishment formation has been virtually nonexistent in Montgomery County in recent years. That has not changed. Newly available data indicate that:

- Between 2011-2017, the county added just 88 net new establishments, or 0.3 percent.
- During that same period, the number of business establishments in Maryland increased by more than 7,500 (4.6 percent).
- Over the last 11 years (2006-2017), Montgomery County added 292 net new establishments while the District of Columbia added 8,113 net new establishments.

Relative tax burdens go a long way toward explaining Montgomery County's sluggish economic performance – performance that is especially soft beyond Bethesda's CBD. This report's case study analysis reveals that when one considers only business taxes, the difference in tax burdens between Montgomery County and Fairfax County (for instance) is reasonably small. Once one layers on State and local income taxes, however, Fairfax County emerges as a far superior proposition from the perspective of cost minimization. As every student of economics knows, profit maximizers are also cost minimizers.

Slow economic growth is among the reasons that many Montgomery County stakeholders fret about the community's future. They also wonder how Montgomery County's economy will fare once the federal government begins to deal in earnest with its $21 trillion national debt and impending Medicare insolvency.

They ask who will purchase the large homes presently occupied by Baby Boomers, many of whom are on the verge of retirement. They also wonder when fiscal strains will become so burdensome that quality of life will be sacrificed.

This report stands for the proposition that the period of constrained quality of life has already begun. After many years of soft economic growth, the County's budget is no longer able to support the quality of life to which long-time residents have become accustomed. The report doesn't end there. Like our initial report, we have benchmarked Montgomery County vis-à-vis other regional jurisdictions. The report also supplies some ideas to help reverse increasingly negative dynamics.

- Tax Base Hasn't Kept Up

Between FY2007 and FY2017, Montgomery County's primary government revenues expanded 2.5 percent annually on average. By comparison, Howard County's revenues expanded at an average annual rate of 3.7 percent. Had Montgomery County's revenues grown at Howard County's pace, it would have had $585 million more in revenues in FY2017.

The County's tax revenues actually have fallen short of budgeted amounts in recent years, meaning that even lowered expectations have generally not been met. As an example, Montgomery County's audited revenues were well below expected revenues in a number of significant categories in FY2017:

  - Income tax revenues fell $19.8 million short of expected revenues;
  - Energy tax revenues missed the mark by $9.7 million;
  - Property tax revenues produced $5.4 million worth of disappointment; and
  - Transfer and recordation tax revenues were $1.4 million below their anticipated level.

Eventually, the County revised its tax revenue forecasts for FY2018 and FY2019 downward by a total of $180.9 million.[1]

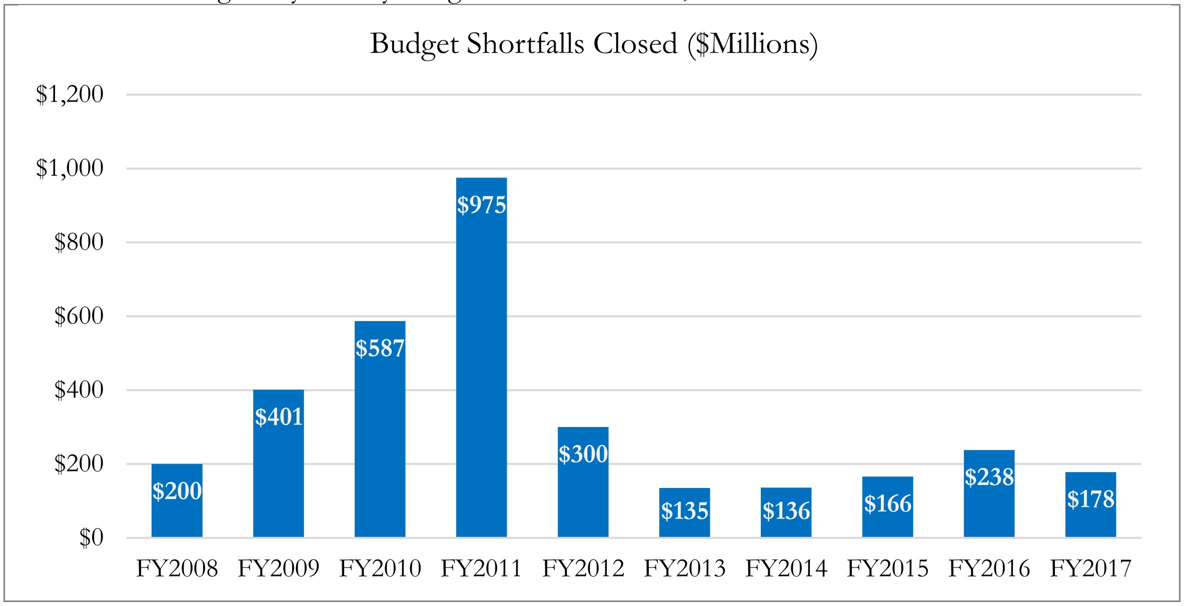
- Under Pressure

Revenue shortfalls translate neatly into fewer resources available to support shared quality of life. Accordingly, overall Montgomery County primary government expenditures have expanded less rapidly than in a number of other neighboring Maryland counties. From FY2007-FY2017 primary government expenditures grew more slowly in Montgomery County than in Howard, Charles, Anne Arundel, Prince George's, and Frederick counties. Had Montgomery County's expenditures expanded as rapidly as Howard County's during this period, Montgomery County's primary government expenditures would have totaled $5.3 billion in FY2017, or $717.9 million more than actually transpired.

The combination of weak economic growth, slow revenue growth and rising public demands has translated into annual budget shortfalls that must be closed each year. In total, Montgomery County was required to close cumulative budget shortfalls exceeding $3.3 billion during the FY2008-FY2017 period. Even after many years of economic expansion nationally and what has until recently been a booming stock market, Montgomery County's large budget shortfalls have persisted. As an example, Montgomery County's budget shortfall in FY2017 was nearly twice that estimated for Fairfax County that year.

[1] Montgomery County Office of Management & Budget and Department of Finance. "County Executive's FY2019 Operating Budget Forum Briefing". January 2018.

Exhibit E1. Montgomery County Budget Shortfalls Closed, FY2008-FY2017



Source: Montgomery County Office of Management & Budget and Department of Finance. "County Executive's FY2019 Operating Budget Forum Briefing". January 2018.

Not only has Montgomery County's tax base failed to keep up with need and expectations, the County's tax base is not especially diversified. Inordinately slow commercial tax base growth in recent years has induced Montgomery County into depending heavily upon its residential tax base. A bit more than 23 percent of total real property assessable tax base is commercial in Montgomery County. That compares to more than 42 percent in Alexandria, 31 percent in Prince George's County, and 25 percent in Fairfax County.

In FY2017, Montgomery County's commercial property assessed value totaled $41.3 billion.[2] If commercial property values were 16.9 percent higher to mimic Northern Virginia's per square foot valuations, total commercial assessed value would have equaled $48.2 billion. Applying Montgomery County's direct real property tax rate of 0.7734 per $100 of assessed value[3] to this increment of nearly $7 billion would yield additional annual tax revenue of approximately $54 million/annum.

Even at lower valuations and lower rents, Montgomery County remains vulnerable in terms of rising vacancy. According to a Partners for Economic Solutions analysis, there are General Services Administration (GSA) leases expiring in Montgomery County totaling 1,730,000 square feet in 2019-2023 and 1,680,000 square feet in 2024-2028.[4]

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[2] Montgomery County, Maryland. "Comprehensive Annual Financial Report, Fiscal Year 2017". Prepared by the Department of Finance. Table 8.
[3] Ibid., p. 235, Table 9-a.
[4] Partners for Economic Solutions (PES). "Office Market Assessment-Montgomery County, Maryland". Prepared for the Montgomery County Planning Department. June 18, 2015. p. 17.

Calm Before the Storm

We conclude that Montgomery County, MD is marching toward fiscal peril despite its swollen reserve fund. Principal measures of Montgomery County fiscal well-being and financial flexibility have deteriorated in recent years including net position and unrestricted fund balance.

Importantly, credit rating agencies often monitor levels of unrestricted fund balance in their evaluation of creditworthiness. Montgomery County's unrestricted general fund balances as a percentage of general fund revenues declined by 5 percentage points to 14.5 percent between FY2014 and FY2017. At the same time, this measure of fiscal health improved in Anne Arundel, Charles, Frederick, and Prince George's counties. Spending, including on personnel, education, transportation, and other categories has been highly constrained, strongly suggesting that many of the issues are attributable to very soft tax base growth as opposed to rapid spending growth.

Conclusion: Montgomery County's New Leadership Must Respond

We offer five ideas to help stimulate economic activity and tax base growth:

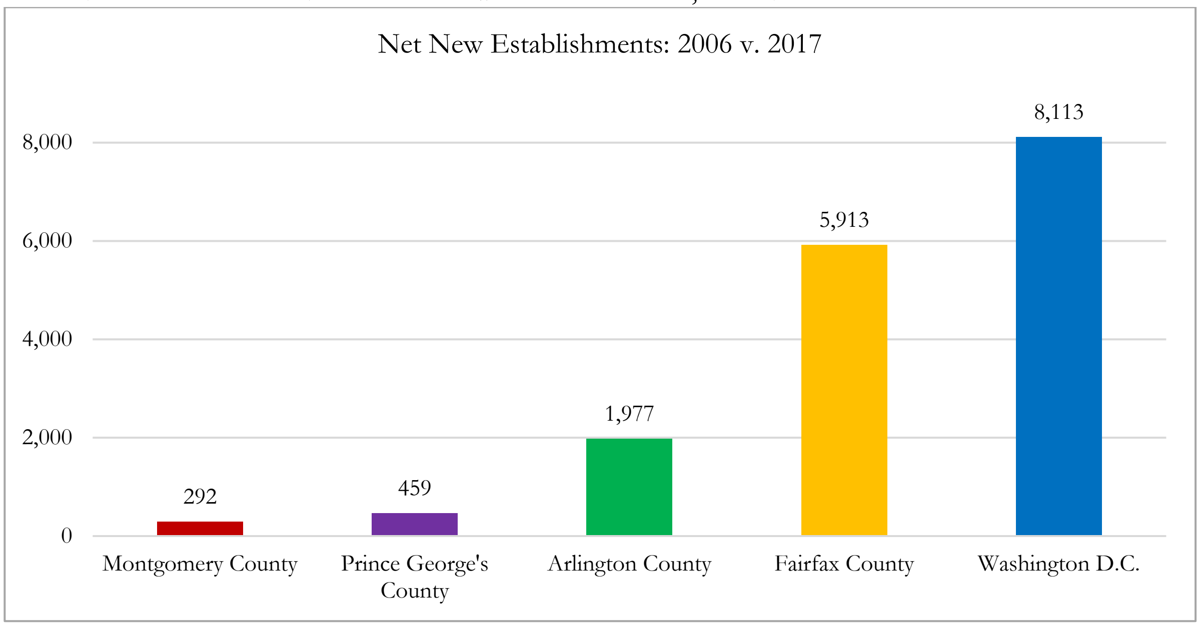
1. Add school capacity with an eye toward ending current development moratoria while improving student outcomes. One possibility is a STEM-oriented school in White Oak;
2. Pursue large-scale tax breaks and public-private partnerships at both White Flint and White Oak in conjunction with other tax incentives targeting startups and those relocating to these districts. Also establish an expedited, more predictable commercial permitting process in both White Flint and White Oak;
3. End the Department of Liquor Control's monopoly and invite in more attractive, customer-responsive enterprises before the DLC's dwindling profitability turns into large-scale losses;
4. Invest additional resources in the Montgomery County Economic Development Corporation and in successful initiatives like the Move Program;
5. Advocate statewide for a better business climate by leveraging Montgomery County's massive presence in Annapolis during the 2019 General Assembly and beyond.

Introduction

- What Gives?

In April 2018, Sage Policy Group, Inc. (Sage) produced a report analyzing economic and fiscal conditions in Montgomery County, MD. That study focused on big picture economics, with special attention given to the County's soft business formation, slow job growth, expanding tax burdens and rapid debt accumulation. The primary conclusion of that study was that increasing demand for services in the County was easily outstripping growth in the local economy and tax base.

Exhibit 1. Business Establishment Growth in Select Areas, 2006 v. 2017



Source: 1. U.S. Bureau of Labor Statistics; 2. Sage. Notes: Data are not seasonally adjusted (NSA). Yearly figures are annual averages.

Among the intentions of this sequel is to examine County finances at a far more granular level in order to help stakeholders understand dynamics regarding programmatic expenditure growth. The question is to what extent various expenditures, whether on social services, parks, or schools, are expected to expand and whether the County's tax base is up to the challenge given shifting public expectations, evolving demographics, the federal government's worsening financial position, rising costs of delivering public services, and aggressive economic development in other communities that can siphon away businesses, human capital and tax base in the future.

Interestingly, many of those who favor growth in social spending also tend to take a dim view on economic development. Many of these people decry the profit motivation that drives businesses to embrace the strategies and actions they adopt and undertake. To an economist or casual observer, this can be viewed as puzzling since the investments in people, equipment, and real estate made by business and the jobs they support supply a considerable share of the tax base needed to support public programs.

Sage's approach to this analysis is twofold. One is predictable – intense analysis of budget documents and other sources supplying financial intelligence. As with our initial report, we have also benchmarked Montgomery County using other jurisdictions located within the Washington-Baltimore metroplex.

The second approach is the development of several case studies to help stakeholders understand the firm-level decisions, including locational decisions, which shape macroeconomic outcomes. These case studies are presented in the pages that immediately follow and reveal much about what ails Montgomery County.

Ultimately, the objective of this report is to help Montgomery County residents, business and nonprofit leaders, public officials, including newly-elected ones, and other stakeholders to understand the extent to which public needs will be unmet going forward under the dynamic status quo. In other words, this report seeks to help inform stakeholders about the degree to which the dynamic status quo needs to be altered in order to support shared quality of life while preserving fiscal balance in Montgomery County, MD.

Finally, rather than simply critiquing Montgomery County's economic and fiscal performances, this report also provides ideas to help reshape economic outcomes. Virtually all would agree that Montgomery County is blessed with incredible location, human capital, and physical assets, but the recent decision by Amazon to select Crystal City/Arlington County for half of its second headquarters despite massive subsidies offered by the State of Maryland serves as a reminder that as of today Montgomery County is not yet able to compete with those communities presently at the vanguard of economic development.

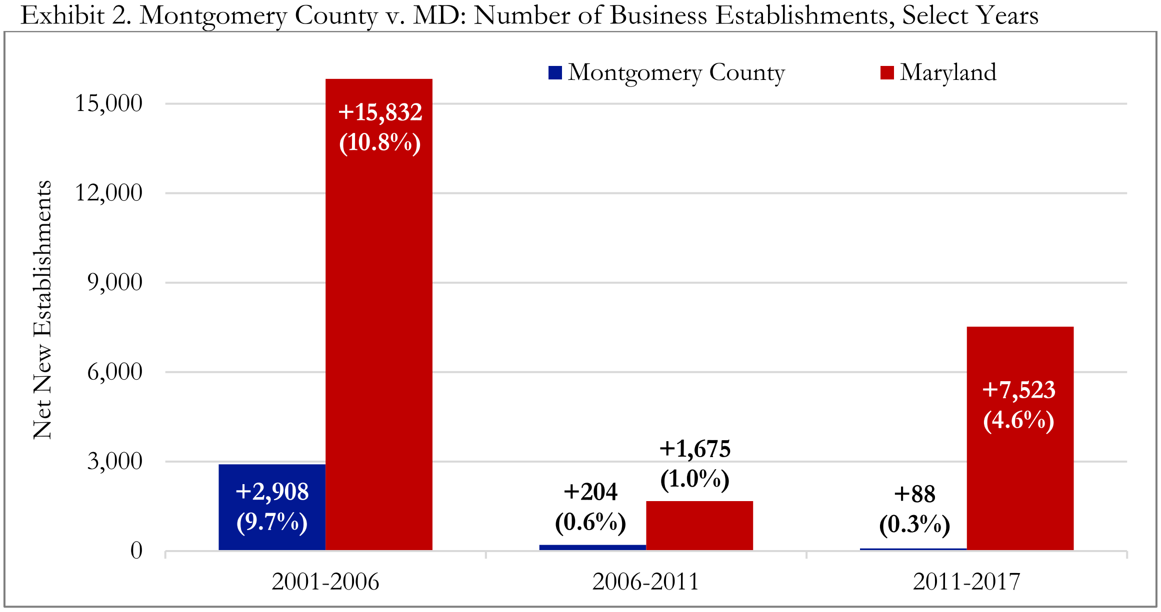
Explaining Macroeconomic Outcomes Using Micro-Level Analysis

Case Studies Help Pinpoint Sources of Montgomery County's Malaise

In our initial report, Sage researchers indicated just how slow business formation in Montgomery County has been in recent years. Indeed, no finding in our prior report garnered as much attention as the finding that between 2011 and 2016, Montgomery County added just 6 net new business establishments. During the same period, the number of business establishments in Maryland expanded by nearly 6,300.

Since Sage's first report, figures for 2017 have been released and the picture has changed little. Business formation in Montgomery County remains remarkably soft. Between 2011 and 2017, the number of businesses operating in Montgomery County expanded by 88, which translates into 0.3 percent growth over six years. In Maryland, the number of businesses expanded by more than 7,500, which translates into 4.6 percent growth.

Exhibit 2. Montgomery County v. MD: Number of Business Establishments, Select Years



Source: 1. U.S. Bureau of Labor Statistics; 2. Maryland Department of Labor, Licensing and Regulation (DLLR), Maryland Quarterly Census of Employment and Wages (QCEW) program; 3. Sage. Notes: Data are not seasonally adjusted (NSA). Yearly figures are annual averages.

In order to assess why the macroeconomic outcomes are disappointing, the Sage study team initiated this subsequent analysis with several case studies, each comparing and contrasting the business and household tax environments in Montgomery versus Fairfax County. The goal is to understand how firm-level decisions likely explain vastly different macroeconomic outcomes in terms of establishment formation, job growth, and tax base expansion over time.

Exhibit 3 supplies key tax rates used to drive the analysis. Some commentators have pointed out that while Montgomery County maintains high energy taxes, Fairfax County maintains a gross receipts tax that is largely offsetting. We sought to test this proposition among others.

Exhibit 3. Business Case Studies: Tax Rates Applied

Tax/Credit	Montgomery County	Fairfax County
Corporate Income/Franchise Tax (State Tax)	8.25%	6.00%
Unemployment Insurance (UI) Tax (State Tax)	0.3%-7.5% of the first $8K that each employee earns each year	0.1%-6.2% of the first $8K that each employee earns each year
Business Personal Property Tax (per $100 assessed value)	2.547%*	4.570%
Gross Receipts Tax (per $100 of gross receipts)	N/A	Software Developer: $0.00 Corporate Business (Prof. Services): $0.31 Retail Merchant: $0.17
Electricity Tax (Non-residential)	$0.01978 per kwh	$0.00594 per kWh up to a maximum tax of $1,000 per bill
Fuel Tax [(Non-residential)	$0.17026 per therm	$0.04794 per CCF up to a maximum tax of $300 per bill
Research & Development Tax Credits (State credits)	Basic Credit – 3.0% Growth Credit – 10.0%	15% of the first $167K of qualified R&D expenses
Individual Income Tax		
State (Brackets Differ in MD/VA)	2%-5.75%	2%-5.75%
County	3.2%	N/A

Source: Various government publications and websites. *Montgomery County's direct rate in FY2017 as reported in the County's FY2017 CAFR. County direct rate includes: County taxes that are levied County-wide, and County tax rates levied by the M-NCPPC. For County special taxing district tax rates that are levied substantially County-wide, the direct rate includes a prorate portion of the tax rate that corresponds to the portion of the County's assessable base against which the rate is levied.

Exhibit 4 supplies key assumptions and parameters attached to the two case studies. The first case study pertains to a software developer with 50 employees encompassing 30,000 square feet of office space. The second case study pertains to a regional corporate headquarters utilizing 60,000 square feet of space and employing 100 people locally. A third pertains to a representative retailer.

Exhibit 4. Business Case Studies: Assumptions

Category	Case Study I [Software Developer]	Case Study II [Regional Corporate HQ]	Case Study III [Clothing Retailer]
Office Space Rented (SF)	30,000	60,000	10,0000
Business's Gross Revenue	$30M	$31M	$2.9M
Income before Taxes	Approx. $2.4M (8%)	Approx. $4.34M (14%)	Approx. $261K (9%)
Business Personal Property Investment	$2.4M over 10 years	$5M over 10 years ($10M; 50% assumed in state)	$2M over 10 years
Business Personal Property	All acquired within the last 10 years, depreciation included		
Number of Employees	50	100 (200; 50% assumed in state)	20
Type of Business	C-corporation (I-A) Pass-Through Entity (I-B)	C-corporation	C-corporation
Base of Operations	One jurisdiction only	Headquartered in state, 50% of operations elsewhere	One jurisdiction only
Tax Rates	2017/2018 (Maximum applicable tax rates applied unless otherwise noted)		
Annual Energy Use			
Electricity (kWh/SF):	15.9	15.9	15.4
Natural Gas (cubic feet/SF):	26.8	26.8	19.9
Not included	Sales & use taxes; corporate registration fees; annual filing/administration fees		
Employees' Tax Filing			
Filing Status:		Single	
Deductions:		Standard	
Personal Exemptions:		1 Regular Exemption	

- **Case Study I-A: High-Technology Software Developer**

This scenario analyzes the economic consequences of choosing to locate in Montgomery County versus Fairfax County for a software developer operating as a C-corporation. The company invests in new software development and is eligible for research and development "R&D" tax credits.

It's important to note that the energy tax burden in this scenario may represent a conservative estimate. To the extent that the software-developer uses energy at higher intensities than the average office tenant, the actual burden may be meaningfully higher.

Interestingly, the business tax cost differential is limited. The total tax burden faced by the company on an annual basis is computed as $167,232 if it is located in Montgomery County, and $161,981 if located in Fairfax. That represents a difference of approximately 3.2 percent. In this particular example, Fairfax County's gross receipts tax doesn't feature into the computation since Fairfax County exempts software developers from this tax. What does feature heavily are R&D tax credits.[5,6] Were it not for those, Montgomery County's business tax burden for this particular type of firm would be much greater. It also makes a difference that the State of Maryland's corporate income tax (8.25%) is higher than the Commonwealth of Virginia's (6%), which also helps render a Montgomery County location less advantageous economically.

Exhibit 5. Estimated Annual Tax Burden for Medium-Sized High-Technology Software Developer

Tax	Montgomery County	Fairfax County
Corporate Income/ Franchise Tax	$205,374	$143,705
Unemployment Insurance (UI) Tax	$30,000	$24,800
Business Personal Property Tax	$0*	$15,307*
Gross Receipts Tax (BPOL)	N/A	$0**
Energy Taxes (typically paid by property owner)		
Electricity Tax	$9,435	$2,833
Fuel Tax	$1,420	$385
R&D Tax Credits	-$78,996	-$25,050
Total Taxes	**$167,232**	**$161,981**
Montgomery County v. Fairfax County	*+3.2%*	-

Notes: 1. The following parameters were based on those used in "Case Studies of Business Taxes in the District of Columbia a Comparison with Neighboring Jurisdictions" (2013), completed by the accounting firm of Councilor Buchanan & Mitchell for the D.C. Tax Revision Commission: office square footage, gross revenue, income before taxes, and capital investment. 2. The assessed values of business personal property were computed based on each jurisdiction's specific depreciation formula and the jurisdiction tax rate was applied to the assessed value. The makeup of business personal property assumed to be: 50% canned software; 37.5% computer equipment; 12.5% office furniture. *Maryland exempts Software Developers from business personal property taxes; for Fairfax County, assessed value does not include software. **Fairfax County exempts software development revenue from the BPOL.

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[5] Maryland offers two state income tax credits to businesses that have qualified R&D expenditures: the Basic R&D Tax Credit and the Growth R&D Tax Credit. The Basic R&D Tax Credit is 3% of eligible R&D expenses that do not exceed the Maryland Base Amount and the Growth R&D Tax Credit is 10% of eligible R&D expenses in excess of the Maryland Base Amount. The R&D tax credit remains in effect until January 1, 2020, subject to extension by the General Assembly. (Source: Maryland Department of Commerce, *Research and Development Tax Credit (R&D)*, http://commerce.maryland.gov/fund/programs-for-businesses/research-and-development-tax-credit)

[6] Virginia offers a refundable income tax credit for individuals and businesses for qualified R&D expenses. The tax credit amounts are 15% of the first $300,000 in qualified R&D expenses, or 20% of the first $300,000 of qualified R&D expenses if the research was conducted in conjunction with a Virginia public or private college or university, to the extent the expenses exceed a base amount. (Source: Virginia Department of Taxation, *Research and Development Tax Credit (Refundable)*, https://tax.virginia.gov/business-development-credits#research-development-credit)

As indicated later in this report, commercial rents in Montgomery County tend to be far lower than in Fairfax County on a property-adjusted basis. Therefore, it is conceivable that once one considers both tax and real estate-related expenditures, operating in Montgomery County may be a bit cheaper than operating in Fairfax County for a representative software development firm.

Why then have businesses tended to opt so frequently to locate in Fairfax County or other northern Virginia jurisdictions relative to Montgomery County? The answer to that appears to lie at least partially in Exhibit 6.

Exhibit 6 supplies estimates of individual income tax burdens for employees of the software-developer. Sage made assumptions regarding the number of employees by occupation group based on Bureau of Labor Statistics data regarding the occupational makeup of employment in the "Computer Systems Design and Related Services" industry (NAICS 541500). For purposes of simplicity and ease of comparison, all employees were assumed to be filing as single, claiming one regular exemption, and claiming the standard deduction.

Exhibit 6. Estimated Individual Income Tax Burden (Employees' Tax Burden)

Occupation Group	# of Employees	Median Annual Wage	Income Taxes (Per Employee/Filer)		X # of Employees	
			Montgomery	Fairfax	Montgomery	Fairfax
Software Developers-Applications	28	$106,710	$8,132	$5,652	$229,730	$159,679
Management Occupations	6	$102,590	$7,797	$5,415	$42,885	$29,785
Business & Financial Occupations	5	$67,710	$4,897	$3,410	$23,996	$16,708
Office & Adm. Support Occupations	5	$34,740	$2,276	$1,514	$10,811	$7,192
Sales Occupations	3	$27,020	$1,662	$1,070	$5,153	$3,318
All Other Occupations	4	$37,690	$2,511	$1,684	$8,787	$5,893
Total	**50**				**$321,362**	**$222,574**
Montgomery County v. Fairfax County					*+44.4%*	-

Notes: 1. Median annual wages from the Bureau of Labor Statistics, Occupational Employment and Wages, May 2017. 2. The standard deduction and exemption values are different in Maryland and Virginia. In Maryland, for single taxpayers, the standard deduction is $2,250 and the personal exemption is $800-$3,200 based on adjusted gross income level. In Virginia, for single taxpayers, the standard deduction is $3,000 and the personal exemption is $930.

Note that once one considers personal income taxes, Fairfax County becomes much less expensive than Montgomery County. Of course, one can work in Montgomery County, but live beyond Maryland's borders, but this would tend to result in longer commutes and potentially greater employee turnover. Many would agree that the issue of intra-regional mobility can be especially acute in the oft-gridlocked Washington metropolitan area.

There is at least one other consideration. This analysis is also impacted by State-level policymaking. In particular, the State maintains relatively high personal income taxes, an elevated corporate tax rate (8.25%), and unemployment insurance tax. Therefore, one of the solutions to Montgomery County's commercial malaise may be to advocate at the State level for policies that are more business friendly and would thereby position Montgomery County to compete more effectively with Northern Virginia and other communities.

- **Case Study I-B: The Case of the Pass-Through Entity**

This scenario is a variant of the first. The assumptions are the same, but the software developer operates as a pass-through entity (e.g. an LLC or subchapter-S corporation). In this instance, we assume that the business is located in either Montgomery or Fairfax County and that the owner of the pass-through entity resides in the same county as the business. The individual income tax burdens of employees of the business are the same as in the scenario of the business operating as a C-corporation, and therefore are not presented again.

Exhibit 7. Estimated Annual Tax Burden for Medium-Sized High-Technology Software Developer Operating as a Pass-Through Entity (e.g. LLC or S-Corporation)

Tax	Montgomery County	Fairfax County
Entity Level Taxes		
Corporate Income/ Franchise Tax	-	-
Unemployment Insurance (UI) Tax	$30,000	$24,800
Business Personal Property Tax	$0*	$15,307*
Gross Receipts Tax (BPOL)	N/A	$0**
Individual Level Taxes		
Tax on Entity Income	$221,184	$137,459
Energy Taxes (typically paid by property owner)		
Electricity Tax	$9,435	$2,833
Fuel Tax	$1,420	$385
R&D Tax Credits	-$78,996	-$25,050
Total Taxes	**$183,043**	**$155,735**
Montgomery County v. Fairfax County	*+17.5%*	-

Notes: 1. The following parameters were based on those used in "Case Studies of Business Taxes in the District of Columbia a Comparison with Neighboring Jurisdictions" (2013), completed by the accounting firm of Councilor Buchanan & Mitchell for the D.C. Tax Revision Commission: office square footage, gross revenue, income before taxes, and capital investment. 2. The assessed values of business personal property were computed based on each jurisdiction's specific depreciation formula and the jurisdiction tax rate was applied to the assessed value. The makeup of business personal property assumed to be: 50% canned software; 37.5% computer equipment; 12.5% office furniture. 3. The individual level income tax calculation includes no itemized deductions. *Maryland exempts Software Developers from business personal property taxes; for Fairfax County, assessed value does not include software. **Fairfax County exempts software development revenue from the BPOL.

Note that this case study is enormously revealing. While this same enterprise operating as a C-Corporation generates business tax liabilities that are rather similar whether it is located in Montgomery or Fairfax County, when the business operates as a flow-through tax entity, the business tax implications are substantially different. Because owners of the business now pay taxes on their corporate profits on their personal returns, Maryland's lofty personal income tax burdens help translate into a nearly 18 percent difference in tax liabilities between the two counties.

This helps explain the dearth of net new business formation in Montgomery County in recent years. Knowing that their tax burdens are higher in Maryland, there is an incentive for the entrepreneur to not only locate their business in Virginia, but also to move their residence there. This means that Maryland and Montgomery County are jointly losing out on multiple types of tax revenues, including personal income and property taxes.

- **Case Study II: Large Regional Corporate Headquarters**

This scenario analyzes a regional corporate headquarters and the financial implications of locating in Montgomery versus Fairfax County. The headquarters is set to maintain 100 employees locally, including management, financial operations, IT, sales, and administrative positions. As indicated earlier, the operation will lease 60,000 square feet of Class A office space.

Again, when one fixates on business taxes, the difference between a Montgomery County and Fairfax County location is hardly overwhelming from the perspective of cost minimization. The difference in this instance is a bit less than 1.5 percent. In this instance, Fairfax County gross receipts tax makes a big difference, representing approximately a fifth of total computed business tax burden for the regional corporate headquarters. Montgomery County's energy taxes amount to far less.

Exhibit 8. Estimated Annual Tax Burden for Large Regional Corporate Headquarters

Tax	Montgomery County	Fairfax County
Corporate Income/ Franchise Tax	$353,467	$249,729
Unemployment Insurance (UI) Tax	$60,000	$49,600
Business Personal Property Tax	$55,554	$81,746
Gross Receipts Tax (BPOL)	$0	$96,100
Energy Taxes (typically paid by property owner)		
Electricity Tax	$18,870	$5,667
Fuel Tax	$2,839	$771
Total Taxes	**$490,730**	**$483,613**
Montgomery County v. Fairfax County	*+1.5%*	-

Notes: 1. The following parameters were based on those used in "Location Matters" (2015) by the Tax Foundation: office square footage, gross revenue, income before taxes, capital investment, business personal property, and employment. 2. The assessed values of business personal property were computed based on each jurisdiction's specific depreciation formula and the jurisdiction tax rate was applied to the assessed value. The makeup of business personal property assumed to be: 50% computer equipment; 50% office furniture and other equipment.

But Exhibit 9 supplies findings that indicate that once one considers personal income tax liabilities, a Fairfax County location emerges as far more economical. Sage deployed assumptions regarding the number of employees by occupation group based on Bureau of Labor Statistics data regarding the occupational makeup of employment in the "Management of Companies and Enterprises" industry (NAICS 550000). For purposes of simple juxtaposition, all employees were assumed to be filing as single, claiming 1 regular exemption, and claiming the standard deduction.

The difference in annual individual income tax burdens is in the range of 45 percent. Again, this reflects both State of Maryland and Montgomery County tax rates. Working in conjunction, State and local taxation render the Maryland jurisdiction far less competitive. This likely helps explain Amazon's recent decisions regarding HQ2.

While this case study pertains to a regional headquarters, the computation would scarcely be different if the subject of the inquiry were a law firm, architectural firm, or any enterprise comprised primarily of highly educated, well compensated professionals.

Exhibit 9. Estimated Individual Income Tax Burden (Employees' Tax Burden)

Occupation Group	# of Employees	Median Annual Wage	Income Taxes (Per Employee/Filer)		X # of Employees	
			Montgomery	Fairfax	Montgomery	Fairfax
Office & Adm. Support Occupations	26	$34,740	$2,276	$1,514	$58,267	$38,760
Business & Financial Occupations	22	$67,710	$4,897	$3,410	$109,207	$76,040
Management Occupations	20	$102,590	$7,797	$5,415	$152,048	$105,601
Computer & IT Occupations	11	$84,580	$6,238	$4,380	$69,869	$49,055
Sales Occupations	5	$27,020	$1,662	$1,070	$7,647	$4,923
All Other Occupations	17	$37,690	$2,511	$1,684	$42,178	$28,286
Total	**100**				**$439,216**	**$302,665**
Montgomery County v. Fairfax County					*+45.1%*	-

Notes: 1. Median annual wages from the Bureau of Labor Statistics, Occupational Employment and Wages, May 2017. 2. The standard deduction and exemption values are different in Maryland and Virginia. In Maryland, for single taxpayers, the standard deduction is $2,250 and the personal exemption is $800-$3,200 based on adjusted gross income level. In Virginia, for single taxpayers, the standard deduction is $3,000 and the personal exemption is $930.

- **Case Study III: Independent Clothing Store/Retailer**

This case study considers an independent clothing store. The retailer leases 10,000 square feet of office space and maintains 25 employees, most of whom are sales employees. The average revenue is assumed to be approximately $2.9 million with earnings before tax of 9 percent. These parameters are based on a 2015 study conducted by the Tax Foundation. Because of Fairfax County's business personal property tax and gross receipts tax, business tax liabilities are 9.1 percent *less* in Montgomery County than in Fairfax.

Exhibit 10. Estimated Annual Tax Burden for Small Independent Clothing Retailer

Tax	Montgomery County	Fairfax County
Corporate Income/ Franchise Tax	$19,411	$13,057
Unemployment Insurance (UI) Tax	$15,000	$12,400
Business Personal Property Tax	$25,711	$38,447
Gross Receipts Tax (BPOL)	$0	$4,930
Energy Taxes (typically paid by property owner)		
Electricity Tax	$3,046	$915
Fuel Tax	$351	$95
Total Taxes	**$63,520**	**$69,845**
Montgomery County v. Fairfax County	*-9.1%*	-

Notes: 1. The parameters are based on those used in "Location Matters" (2015) by the Tax Foundation: office square footage, gross revenue, income before taxes, capital investment, business personal property, and employment. 2. Assessed values of business personal property were computed based on each jurisdiction's specific depreciation formula and the jurisdiction tax rate was applied to assessed value. The makeup of business personal property is assumed to be: 30% computer equipment; 70% office furniture and other equipment.

The picture changes when one considers individual income taxes. Exhibit 11 details personal income tax liabilities for the retailer's employees. The number of employees per occupation is based on Bureau of Labor Statistics data regarding the occupational composition of employment in the "Clothing Stores" industry (NAICS 448100). For purposes of easy juxtaposition, all employees were assumed to be filing as single, to claim one regular exemption, and the standard deduction. Individual income tax burdens are approximately 53 percent higher for this retailer, and aggregate tax burdens are 10 percent higher when one considers both business and individual income taxes.

Exhibit 11. Estimated Individual Income Tax Burden (Employees' Tax Burden)

Occupation Group	# of Employees	Median Annual Wage	Income Taxes (Per Employee/Filer)		X # of Employees	
			Montgomery	Fairfax	Montgomery	Fairfax
Office & Adm. Support Occupations	2	$34,740	$2,276	$1,514	$4,552	$3,028
Management Occupations	1	$102,590	$7,797	$5,415	$7,797	$5,415
Sales Occupations	22	$27,020	$1,662	$1,070	$36,571	$23,544
Total	**25**				**$48,920**	**$31,987**
Montgomery County v. Fairfax County					*+52.9%*	-

Notes: 1. Median annual wages from the Bureau of Labor Statistics, Occupational Employment and Wages, May 2017. 2. The standard deduction and exemption values are different in Maryland and Virginia. In Maryland, for single taxpayers, the standard deduction is $2,250 and the personal exemption is $800-$3,200 based on adjusted gross income level. In Virginia, for single taxpayers, the standard deduction is $3,000 and the personal exemption is $930.

As we indicated in our initial report, economic and tax base growth in Montgomery County have been soft for years. These case studies help pinpoint why. These years of subpar economic performance have many implications, including for the County's fiscal health. We turn to those issues now, many of which are quite technical in nature.

Montgomery County Finances: Current & Future Challenges

- **Weak Revenue Growth Meets Growing Demands**

The County's tax revenues have fallen short of budgeted amounts in recent years. In FY2017, Montgomery County's audited actual revenues were well below expected revenues in a number of significant tax categories. Income tax revenues fell $19.8 million short of expected revenues, energy tax revenues missed the mark by $9.7 million, property tax revenues produced $5.4 million worth of disappointment, and transfer and recordation tax revenues were $1.4 million below the anticipated level. Eventually, the County revised its tax revenue forecasts for FY2018 and FY2019 downward by a total of $180.9 million.[7]

Perhaps anticipated expenditures will also fall short of expectations, but one can't count on that. A budget forum briefing supplied by the Montgomery County Office of Management & Budget and Department of Finance identifies the following areas for which there will be high structural cost increases going forward: debt service, reserves, and retiree health insurance. The briefing further notes that the cost pressure is actually greater once other factors are considered, including: 1. labor agreements – e.g., ongoing negotiations with the Fraternal Order of Police; 2. cost increases for group insurance, workers compensation, and general inflation; and 3. the operating cost of new facilities and infrastructure.[8]

The conclusion one reaches is that revenue growth must be much stronger than it has been in recent years to support known and/or anticipated growth in costs of service, including debt service. Ultimately, that implies a need for far better economic development outcomes.

Property taxes, income taxes and fuel energy taxes represent the County's three largest sources of tax revenue. From FY2007 to FY2017, property tax revenues grew by 4.8 percent on average annually and fuel energy taxes expanded at a 4.9 percent annual rate. Income tax growth, however, generated a far different trajectory. Income tax revenue grew by just 0.6 percent annually and property transfer taxes grew at just 1.0 percent annually.

This may be because some former Montgomery County residents left, in part to avoid high property, energy and income taxes. In our prior report, Sage noted that in-migrants to the county were associated with far less income than those leaving. That would help explain the soft growth in both income and recordation taxes observable in recent years.

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[7] Montgomery County Office of Management & Budget and Department of Finance. "County Executive's FY2019 Operating Budget Forum Briefing". January 2018.
[8] Ibid.

Exhibit 12. Growth in Montgomery County General Tax Revenues (Governmental Activities) by Tax, FY2007 v. FY2017

Tax	$ Millions		CAGR 2007-2017	% of Total Taxes	
	FY2007	FY2017		FY2007	FY2017
Property Taxes	$1,126.6	$1,792.9	4.8%	39.3%	48.2%
County Income Taxes	$1,388.9	$1,481.8	0.6%	48.4%	39.8%
Real Property Transfer Taxes	$106.9	$118.0	1.0%	3.7%	3.2%
Recordation Taxes	$72.7	$60.4	-1.8%	2.5%	1.6%
Fuel Energy Taxes	$118.9	$192.5	4.9%	4.1%	5.2%
Hotel-Motel Taxes	$17.5	$21.5	2.1%	0.6%	0.6%
Telephone Taxes	$29.4	$50.8	5.6%	1.0%	1.4%
Other Taxes	$7.0	$4.3	-4.7%	0.2%	0.1%
Total Taxes-Governmental Activities	**$2,867.9**	**$3,722.2**	**2.6%**	**100.0%**	**100.0%**

Source: 1. Montgomery County, Maryland. Comprehensive Annual Financial Reports. Fiscal Year 2017 and Fiscal Year 2016. Prepared by the Department of Finance. Table 2-b. 2. Sage. Notes: 1. Information is reported on the accrual basis of accounting.

Migration data suggest that a substantial number of people have left Montgomery County for Howard County. This is consistent with Howard County's ability to support more public services. Between FY2007 and FY2017, the CAGR of Montgomery County primary government revenues was 2.5 percent. That fell well short of Howard County (3.7%) and Anne Arundel County (2.8%).

Indeed, from FY2007 to FY2017, Montgomery County's total primary government revenues grew more slowly than most neighboring counties. Among the Maryland communities listed in Exhibit 13, only Prince George's County, an epicenter of the national foreclosure crisis several years ago, supported lower primary government revenue growth during this decade-long period. Had Montgomery County's revenues grown at Howard County's pace, it would have had $585 million more in revenues in FY2017. That would have allowed for significantly greater investment in education, public safety, public open space, infrastructure, and social services, including mental health.

Exhibit 13. Growth in Primary Government Revenues, Select MD Jurisdictions, FY2007 v. FY2017

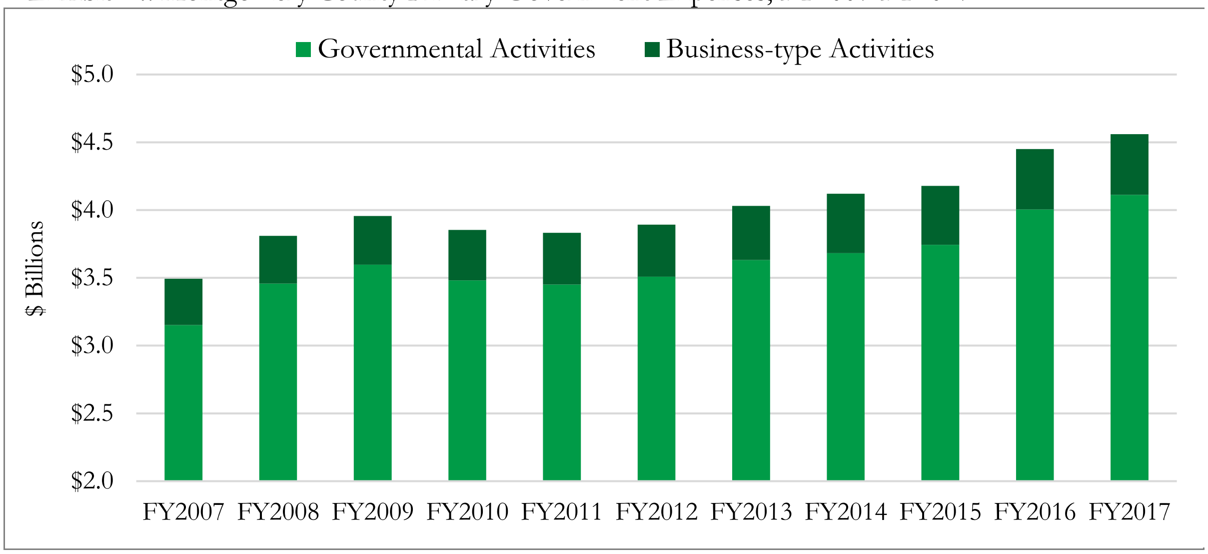
	Total Revenues ($ Millions)		CAGR 2007-2017
	FY2007	FY2017	
Anne Arundel County	$1,414.1	$1,871.6	2.8%
Charles County	$381.5	$509.8	2.9%
Frederick County	$583.1	$752.1	2.6%
Howard County	$998.9	$1,438.4	3.7%
Montgomery County	$3,711.7	$4,759.7	2.5%
Prince George's County	$1,842.0	$2,243.5	2.0%

Source: 1. Comprehensive Annual Financial Reports prepared by individual counties. Statistical section table: Changes in Net Position, Last Ten Fiscal Years. 2. Sage.

- **Enormously Constrained Expenditures**[9]

Between FY2007 and FY2017, Montgomery County's primary government expenses expanded slightly faster than revenues (2.7% annually on average vs. 2.5% annually on average). Governmental expenditure categories including education, public safety, and a variety of other public services represent 90 percent of total expenses. Business-type activities, primarily liquor control and solid waste activities, comprise the remaining approximately 10 percent of expenses. Exhibit 14 paints the picture.

Exhibit 14. Montgomery County Primary Government Expenses, FY2007-FY2017



Source: 1. Montgomery County, Maryland. Comprehensive Annual Financial Reports, Fiscal Years 2015-2017. Prepared by the Department of Finance. Table 2-a. 2. Sage. Notes: 1. Information is reported on the accrual basis of accounting.

It may be of concern that since FY2007, the share of total government expenditures on education has slipped from 53 percent to less than 50 percent while the share expended on public safety has declined from nearly 17 percent to 15.6 percent. The health and human services category has also slipped, albeit only marginally (8% to 7.8%).

At the same time, the category known as "general government" has boldly advanced in terms of budget share, from less than 9 percent in FY2007 to more than 13 percent ten fiscal years later. In absolute terms, the increase in general government expenditures is staggering, rising from $274 million in FY2007 to $540 million by FY2017. That represents a compound annual growth rate of 7 percent, which easily exceeds the growth rate of every other category with the exceptions of community development/housing (10.8% CAGR) and environment (8.4% CAGR). Together, these two rapidly growing categories of expenditure represented less than 2 percent of government expenses in FY2017.

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[9] Exhibits in this section are based on Sage's analysis of data reported in Montgomery County's annual Comprehensive Annual Financial Reports (CAFRs). The basis of reporting differs from the manner in which numbers are reported in operating budgets and are therefore not directly comparable.

Exhibit 15. Montgomery County Primary Government Expenses, FY2007 v. FY2017

Governmental Activities	Expenses ($ Millions)		CAGR 2007-2017	% of Total Govt. Activities Expenses	
	FY2007	FY2017		2007	2017
Expenses					
General Government	$274.0	$540.0	7.0%	8.7%	13.1%
Public Safety	$529.7	$641.6	1.9%	16.8%	15.6%
Public Works & Transportation	$210.4	$258.6	2.1%	6.7%	6.3%
Health & Human Services	$252.1	$319.9	2.4%	8.0%	7.8%
Culture & Recreation	$103.8	$134.8	2.7%	3.3%	3.3%
Community Development & Housing	$18.2	$50.6	10.8%	0.6%	1.2%
Environment	$13.0	$29.1	8.4%	0.4%	0.7%
Education	$1,669.7	$2,037.0	2.0%	53.0%	49.5%
Interest on Long-term Debt	$81.3	$100.9	2.2%	2.6%	2.5%
Total Governmental Activities Expenses	**$3,152.1**	**$4,112.6**	**2.7%**	**100.0%**	**100.0%**
Business-Type Activities	**Expenses ($ Millions)**		**CAGR 2007-2017**	**% of Total Business-Type Activities Expenses**	
	FY2007	**FY2017**		**2007**	**2017**
Expenses					
Liquor Control	$180.2	$273.8	4.3%	52.79%	61.28%
Solid Waste Activities	$103.5	$92.1	-1.2%	30.30%	20.62%
Parking Lot Districts	$26.6	$34.4	2.6%	7.80%	7.70%
Permitting Services	$23.5	$36.1	4.4%	6.87%	8.07%
Community Use of Public Facilities	$7.7	$10.4	3.1%	2.24%	2.32%
Total Business-Type Activities Expenses	**$341.4**	**$446.8**	**2.7%**	**100.0%**	**100.0%**

Source: 1. Montgomery County, Maryland. Comprehensive Annual Financial Reports, Fiscal Years 2015-2017. Prepared by the Department of Finance. Table 2-a. 2. Sage. Notes: 1. Information is reported on the accrual basis of accounting.

Liquor. Exhibit 15 also reveals the role of liquor control in County finances. With respect to business-type activities (activities directly generating revenues), liquor control's share of expenses expanded from 53 percent in FY2007 to more than 61 percent a decade later. Expenses rose from $180 million to $274 million over this period, a CAGR of 4.3 percent.

The performance of the County's Liquor Control Board is a matter of enormous public interest. There is evidence strongly suggesting that the County's liquor monopoly may be negatively impacting economic activity, which is hardly surprising given that monopolies tend to produce sub-optimal outcomes.

As an example, available data regarding per capita alcohol deliveries indicate levels much lower in Montgomery County than the statewide average or in neighboring counties. Because many Montgomery County residents commute for work, it is reasonable to assume that residents often purchase alcohol in neighboring Maryland jurisdictions or in the District of Columbia instead of inside the county.

The Maryland Comptroller's Bureau of Revenue Estimates (BRE) evaluated the impacts of removing Montgomery County's monopolistic restrictions and concluded that doing so would result in employment and economic activity in the alcohol industry increasing to per capita levels comparable with neighboring jurisdictions. Specifically, the BRE estimates that Maryland would experience an estimated $193.7 million in new economic activity, the creation of 1,364 jobs generating $52.6 million in additional wages, and $22.8 million in State and local taxes and fees.

The BRE concluded that the majority of new demand would come from sales that would otherwise occur in the District of Columbia, suggesting that much of this computed benefit would inure to Montgomery County.[10] Importantly, this economic activity could potentially more than compensate for lost revenues due to discontinuation of some of the DLC's operations.

- **Constrained Public Service Provision**

Despite the rapid growth in "general government" expenditures, overall Montgomery County primary government expenditures have expanded less rapidly than in a number of other neighboring or proximate Maryland counties. This is revealed in Exhibit 16, which indicates that primary government expenditures have risen more slowly in Montgomery than in Howard, Charles, Anne Arundel, Prince George's, and Frederick.

While Montgomery County primary government expenditures rose 2.7 percent on a CAGR basis between FY2007 and FY2017, it expanded 4.2 percent on that basis in Howard County. It expanded by at least 3.2 percent in all other comparison counties listed in Exhibit 16. Given the astonishing growth in general government expenditures, we do not view this as representing superior expenditure management. Rather, the slow growth in Montgomery County's primary government expenditures is the result of a tax base that is not expanding nearly as rapidly as it is in a number of other Maryland jurisdictions.

Exhibit 16. Growth in Primary Government Expenses, Select MD Jurisdictions, FY2007 v. FY2017

	Total Expenses ($ Millions)		CAGR
	FY2007	FY2017	2007-2017
Anne Arundel County	$1,332.9	$1,836.7	3.3%
Charles County	$360.4	$514.2	3.6%
Frederick County	$526.0	$718.4	3.2%
Howard County	$990.5	$1,496.3	4.2%
Montgomery County	$3,493.5	$4,559.5	2.7%
Prince George's County	$1,795.9	$2,472.3	3.2%

Source: 1. Comprehensive Annual Financial Reports prepared by individual counties. Statistical section table: Changes in Net Position, Last Ten Fiscal Years. 2. Sage.

To put this into context, had Montgomery County's expenditures expanded as much as Howard County's during this period, Montgomery County's primary government expenditures would have totaled $5,277.3 million in FY2017, or $717.9 million more than actually transpired ($717.9 combined governmental and business-type activities). If one held expenditures constant at FY2007 expenditure shares, $343.7 million more would have been

[10] Comptroller of Maryland, Bureau of Revenue Estimates. "Economic Impact Analysis-Private Sector Competition-Montgomery County Alcohol Sales & Distribution". December 22, 2015.

available for education, $109 million more for public safety, $43.3 million for public works and transportation and $51.9 million for health & human services.

Personnel Costs. Published operating budget schedules and Montgomery County Council documents indicate that employee salaries and wages comprise 56 percent of total agency operating expenditures, and benefits for employees and retirees comprise an additional 24 percent of total agency operating expenditures.[11] In other words, it is virtually impossible to deal with annual funding shortfalls without impacting Montgomery County's local government workforce.

During the recession Montgomery County and many other jurisdictions froze or restricted compensation increases in response to fiscal strains. In Montgomery County, government employees received no step increases for three years (FY2011-FY2013) and no general wage adjustments for four (FY2010-FY2013). The County also increased employees shares of health and retirement benefits costs and implemented progressive furloughs in FY2011.

With the economic expansion now in its 10th year, local government finances have generally improved across the country. Improvement is also apparent in Montgomery County. From FY2014 through FY2018, Montgomery County government employees and MCPS employees received general wage adjustments and service increments each year.[12]

Accordingly, average salaries have drifted higher in recent years despite the retirement of a growing number of highly experienced, well-compensated public employees. Between FY2014 and FY2019, total wages of Montgomery County employees expanded by 20 percent overall and by 11 percent per FTE. Overall compensation costs, which include the cost of benefits, grew by 14.5 percent during the same period. Excluding retirement costs, which decreased by 32 percent during that period, total compensation costs grew by 22.5 percent, or 4.1 percent on average per annum. At the same time, Montgomery County's tax supported revenues grew by 18.6 percent, or 3.5 percent on average.

Exhibit 17. Montgomery County Govt. Tax Supported Compensation Costs, FY2014 v. FY 2019

($ Millions)	FY2014	FY2019	FY14 v. FY19		FY14-FY19 Avg. Annual Change	
			Net	%	Net	%
FTEs (Work-years)	7,757	8,382	625	8.1%	125	1.6%
Wages	$573.0	$687.4	$114.4	20.0%	$22.9	3.7%
Social Security	$42.4	$52.2	$9.8	23.0%	$2.0	4.2%
Retirement	$125.8	$85.5	-$40.3	-32.0%	-$8.1	-7.4%
Group Ins. (Active Employees & Retiree PAYGO)	$110.7	$150.1	$39.4	35.6%	$7.9	6.3%
Total Compensation Costs	**$852.0**	**$975.2**	**$123.3**	**14.5%**	**$24.7**	**2.7%**
Total Excluding Retirement Costs	*$726.1*	*$889.7*	*$163.6*	*22.5%*	*$32.7*	*4.1%*

Source: Montgomery County Council, Agenda Item 10. November 13, 2018 Discussion. https://www.montgomerycountymd.gov/council/Resources/Files/agenda/col/2018/20181113/20181113_10.pdf.

From FY2014-FY2019, Montgomery County's tax supported revenues were sufficient to more than fully countervail compensation cost growth. This was primarily due, however, to one-time factors as opposed to permanent ones.

[11] Montgomery County Council, Agenda Item 7. April 17, 2018 Work-session. http://montgomerycountymd.granicus.com/MetaViewer.php?view_id=169&clip_id=14887&meta_id=153849.
[12] Ibid.

For instance, there was a tax increase that impacted FY2017. In late-May 2016, the Montgomery County Council delivered final approval to a $5.3 billion budget that encompassed the most substantial property tax hike in seven years. That budget also trimmed pay raises the County had promised to unionized workers. The nearly 9 percent property-tax increase was expected to add $326 to the average residential tax bill. There was also an increase in recordation taxes associated with the addition of $455 to the cost of purchasing or selling a $500,000 home.[13]

There was also an unprecedented reduction in retirement costs that also improved observed fiscal performance. Massive reductions in retirement costs stemmed from low inflation rates, surging equity markets, and other factors.[14] The decline in retirement costs averaged 7.4 percent/annum during that period and helped to subtract 1.4 percentage points from the average pace of compensation growth between FY2014-FY2019. There are no guarantees that declines in retirement costs will persist going forward.

The following parameters reveal just how tenuous County finances remain. For the sake of illustration, let's suppose that retirement costs expand at a 0 percent annual rate and that remaining compensation costs grow at FY2014-FY2019 rates. Under these assumptions, total compensation costs will expand 3.8 percent annually between FY2020-FY2024. Revenues are projected to grow at an average annual rate of 2.7 percent. Absent any reduction in compensation cost growth or increase in revenue growth, this in and of itself will result in five-year cumulative budget shortfall approaching $200 million.[15] A significant recession would likely create additional, significant fiscal pressures.

As indicated above, at the heart of these issues is Montgomery County's slowly growing tax base, which is expanding slowly because proximate jurisdictions are often able to supply superior value propositions to entrepreneurs and their employees. However, recent years have also been associated with relatively rapid increases in County employee compensation, which serves to further strain County finances.

Exhibit 18 juxtaposes average salary adjustments for employees of Fairfax and Montgomery counties from FY2010 through FY2018. Between FY2014 and FY2018, the percentage increase in compensation for police, fire, and general county government employees averaged well over 5 percent in Montgomery County, or about 3 percentage points above the corresponding Fairfax County average. The implication is that in future negotiations with unions, Montgomery County may need to better benchmark its step and COLA increases with other regional jurisdictions.

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[13] Turque, Bill. "Biggest tax hike since 2009 is now official in Montgomery County". *The Washington Post*. May 26, 2016. http://wapo.st/1sd2BZQ?tid=ss_tw&utm_term=.fce26e20487b.
[14] Montgomery County Council, Agenda Item 10. November 13, 2018 Discussion.
[15] Ibid.

Exhibit 18. Montgomery County v. Fairfax County: Government Employees' Average Salary Adjustments, FY2010-FY2018

*Police, Fire, & General County Govt. Employees	% Increase [Step Increases + COLAs]	
	Montgomery County, MD	**Fairfax County, VA**
FY2010	3.50%	0.00%
FY2011	0.00%	0.00%
FY2012	0.00%	2.00%
FY2013	0.00%	5.08%
FY2014	6.18%	0.18%
FY2015	6.18%	3.29%
FY2016	5.50%	3.48%
FY2017	4.50%	3.46%
FY2018	5.50%	1.65%
FY2014-FY2018 Average	**5.57%**	**2.41%**

Source: 1. Montgomery County Council, GO Committee Memorandum: "Compensation and Benefits for All Agencies". April 25, 2018. 2. Fairfax County, Virginia. Lines of Business (LOBs) Presentation to the Board of Supervisors. May 2016. 3. Sage.

As an example of the advantages this could create for fiscal sustainability, reducing the average general wage adjustment per annum from 1.4 percent to 1.0 percent and reducing the step increment from 3.5 percent to 2.0 percent for a total of a 3 percent per annum increase would save a combined $5.3 million in tax supported costs in FY2019 ($8.6 million over a 12-month period).

Exhibit 19. Implications of Slower Compensation Growth

Total Tax Supported Costs	
FY2019 Budget Request	**Annualized Cost [12-month period]**
General Wage Adjustment (GWA): 1.4% avg.	$13,498,619
Service Increment: 3.5%	$11,120,339
Total Cost of Pay Adjustments	$24,618,958
Hypothetical Increase	**Annualized Cost [12-month period]**
GWA: 1.0% avg.	$9,628,122.57
Service Increment: 2.0%	$6,354,477.82
Total Cost of Pay Adjustments	$15,982,600
Cost of 1% Increase	
Cost of 1% GWA*	$6,868,655
Cost of 1% Increment for employees not at top of grade*	$1,687,923

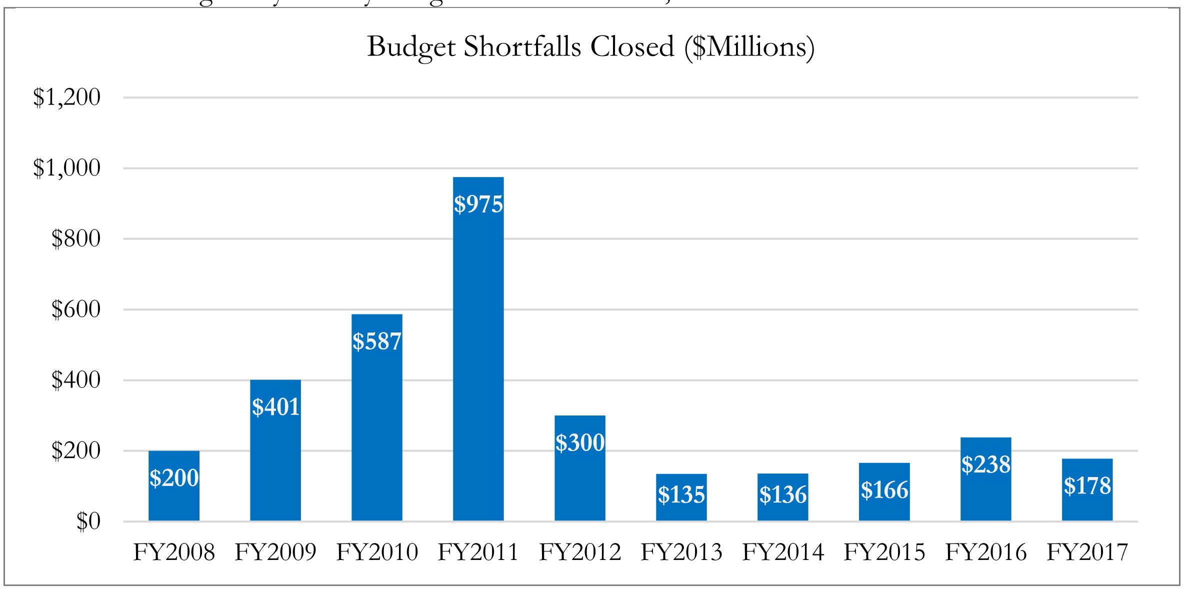
Source: 1. Montgomery County Council, GO Committee Memorandum: "Compensation and Benefits for All Agencies". April 25, 2018. 2. Sage. **Total cost of general wage adjustment and service increment. Total does not include other possible pay adjustments such as performance-based pay, longevity adjustments, and other adjustments) **Wages, social security, retirement.

Parenthetically, the Sage study team would be delighted if County employees would benefit from even larger compensation increases going forward. However, County finances represent a significant barrier to those outcomes. The next section of the report takes a deeper dive into County finances. Among other things, the discussion below will demonstrate that despite tax increases and good fortune along certain dimensions, County finances have deteriorated markedly in recent years.

- **Under Pressure**

The combination of slow revenue growth and rising public demands has translated into annual budget shortfalls that must be closed each year. This represents another indication of a loss of operating flexibility, though the annual shortfalls are far smaller than they were during the worst of the financial crisis and its immediate aftermath. In total, Montgomery County was required to close cumulative budget shortfalls exceeding $3.3 billion during the FY2008-FY2017 period.

Exhibit 20. Montgomery County Budget Shortfalls Closed, FY2008-FY2017



Source: Montgomery County Office of Management & Budget and Department of Finance. "County Executive's FY2019 Operating Budget Forum Briefing". January 2018.

Gaps identified in late-2017 and early-2018 resulted in County officials adopting a number of measures, including an FY2018 Budget Savings Plan, adjustments to the FY2018 Retiree Health Benefit Trust, transfers from nontax-supported funds, intergovernmental funding, a delay in payments required by the Wynne case, and a highly constrained FY2019 recommended budget.[16]

With America home to more than 7.0 million available jobs at the time of this writing, wage pressures will continue to build over the near-term. Montgomery County projections indicate that for the period FY2020-FY2024, total revenues in tax-supported budgets are expected to increase at an average annual rate of 2.7 percent.[17] This essentially represents revenue growth at only slightly above the rate of inflation.

[16] Montgomery County Council, April 27, 2018 Worksession. GO Committee Memorandum: "Compensation and Benefits for All Agencies". p. 2.
http://montgomerycountymd.granicus.com/MetaViewer.php?view_id=169&clip_id=14979&meta_id=155716.
[17] Montgomery County Council, Agenda Item 10. November 13, 2018 Discussion.

Indicators of Fiscal Health

This section is rather technical, and includes discussion of a number of fiscal health measures. Among these are net position, unassigned fund balance, and unrestricted fund balance.

Net position represents an especially useful indicator of fiscal health.[18] The difference between a government's assets and liabilities is known as its net position, which is analogous to equity on a company's financial statements.[19] More specifically, net position is defined as follows: Assets + deferred outflows of resources – liabilities – deferred inflows of resources.[20] Over the decade-long period from FY2007-FY2017, Montgomery County's net position declined at an average rate approaching 6 percent per annum. By FY2017, the County's net position was nearly $1 billion lower than it was ten years prior.

A useful measure of a government's net resources available for spending at the end of a fiscal year is the *unassigned fund balance* of public sector funds that account for the majority of expenditures (such as the General Fund, Debt Service Fund, and Capital Projects Fund).[21] At FY2017's close, Montgomery County's unassigned fund balance was $118.3 million, which represents resources available for spending at the County's discretion. These are the funds that are often used to further elevate quality of life by funding special projects, including community-driven initiatives. Since FY2014, the County's unassigned fund balance has declined by more than $120 million. The implication is that the County has lost much of its fiscal flexibility with incredible velocity and therefore a considerable share of its capacity to respond quickly and meaningfully to quality of life exigencies.

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[18] In June 2011, the Governmental Accounting Standards Board (GASB) issued GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, Deferred Inflows of Resources, and Net Position.* As a result of this pronouncement, the state of financial position for state and local governments focuses on *net position* rather than on net assets. See GASB *Replaces Net Assets with Net Position* by Stephen J. Gautier at http://www.gfoa.org/sites/default/files/GFR_OCT_11_62.pdf for additional detail.
[19] Mercatus Center, George Mason University, "Ranking the States by Fiscal Condition, 2017 Edition,", p. 8.
[20] Montgomery County, Maryland. "Comprehensive Annual Financial Report, Fiscal Year 2017". Prepared by the Department of Finance. p. 3-4.
[21] Ibid., p. 13.

A third measure of financial health is *unrestricted fund balance*.[22] This includes only those resources that either lack constraints on spending or resources for which spending constraints have been imposed by the relevant government itself. "Rainy day" funds are frequently reported within the four corners of a county's unrestricted fund balances.[23]

Comparing Montgomery County's unrestricted general fund balances with those of other Maryland counties as reported in various county CAFRs supports the proposition that Montgomery County has lagged its peers in recent years. Not coincidentally, this is consistent with our findings regarding relative economic performance in our earlier report.

As indicated by Exhibit 21, while Montgomery County's unrestricted general fund balance as a share of general fund revenues dipped by 5 percentage points, it increased by 8 percentage points in Charles County, 5.1 percentage points in Prince George's County, and 4.1 percentage points in Anne Arundel County. Importantly, credit rating agencies often monitor levels of unrestricted fund balance in their evaluation of creditworthiness.[24]

Exhibit 21. Unrestricted General Fund Balances, Including Rainy Day Funds, Select MD Counties, FY2014 v. FY2017

County	Fund Balances ($ Millions)		CAGR FY2014-FY2017	Fund Balances as a % of GF Revenues		FY2014 v. FY2017 Chg.
	FY2014	FY2017		FY2014	FY2017	
Anne Arundel County	$100.38	$170.57	19.3%	8.1%	12.2%	+4.1% pts.
Charles County	$38.57	$73.68	24.1%	11.8%	19.8%	+8.0% pts.
Frederick County	$74.84	$91.85	7.1%	15.6%	16.8%	+1.2% pts.
Howard County	$126.27	$125.58	-0.2%	13.6%	12.2%	-1.4% pts.
Montgomery County	**$593.57**	**$486.39**	**-6.4%**	**19.5%**	**14.5%**	**-5.0% pts.**
Prince George's County	$277.30	$436.19	16.3%	17.8%	22.9%	+5.1% pts.
Total MD Counties	$2,387.75	$2,540.37	2.1%	17.9%	17.0%	-0.9% pts.

Source: 1. Maryland Department of Legislative Services, "Overview of Maryland Local Governments", 2018. 2. Sage.
Notes: 1. Unrestricted funds include all committed, assigned, unassigned, and rainy day funds. 2. Three counties in Maryland, including Montgomery and Prince George's counties, report rainy day funds in the restricted category, and those rainy day amounts are included in the unrestricted funds balance presented above. 3. Information for Prince George's County is unaudited. The audited financial statements were not available.

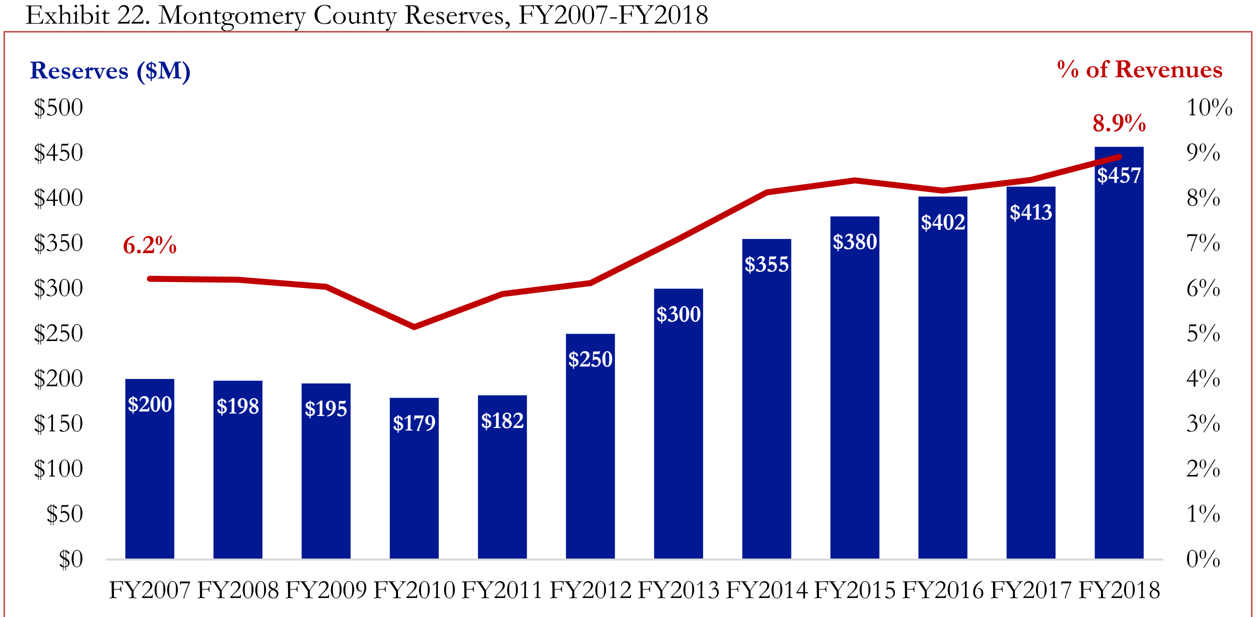
[22] General fund balances reported in Comprehensive Annual Financial Reports (CAFRs) are divided into five categories designated by the Governmental Accounting Standards Board (GASB): non-spendable, restricted, committed, assigned, and unassigned. These categories serve to distinguish the extent to which a county government is bound to honor restrictions placed on the manner in which funds can be utilized. The fund balance categories labeled committed, assigned, and unassigned are often grouped together and termed "unrestricted fund balance".
[23] Maryland Department of Legislative Services, "Overview of Maryland Local Governments", 2018. p. 103.
[24] Ibid., p. 103.

- **On the Defensive**

Emerging fiscal risks have placed Montgomery County on the financial defensive. This is reflected in part in its reserve policy. By law, the County is required to budget for a reserve in the General Fund. The reserve is set at five percent of General Fund Revenues in the preceding fiscal year.[25] However, Montgomery County's adopted fiscal policies require it to take meaningfully larger steps. These policies call for the County to maintain the sum of Unrestricted General Fund Balance and the Revenue Stabilization Fund Balance at 10 percent of Adjusted Governmental Fund Revenues. Withdrawals may be used only to support appropriations that have become unfunded. These withdrawals require the vote of six or more council members.[26]

In FY2007, the County had reserves of $200 million, or approximately 6 percent of revenues. By FY2018, the County's reserves had more than doubled, reaching $457 million.[27] That $457 million represented approximately 8.9 percent of adjusted governmental revenues. The County is expected to reach its goal of combined reserves of 10 percent of adjusted gross revenues in FY2020. That fiscal year, total reserves are projected to be $537 million.[28]

Exhibit 22. Montgomery County Reserves, FY2007-FY2018



Source: 1. Montgomery County Office of Management & Budget and Department of Finance. "County Executive's FY2019 Operating Budget Forum Briefing". 2. Operating Budgets, Schedules A and C. 3. Montgomery County Council resolutions. January 2018. Note: For FY2007-FY2010 reserves as % of estimated revenue; For FY2011-FY2018 reserves as % of adjusted governmental revenues.

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25 Montgomery County, Maryland. "Comprehensive Annual Financial Report, Fiscal Year 2017". Prepared by the Department of Finance. p. xiii.
26 Ibid., p. xiii-xiv.
27 Montgomery County Office of Management & Budget and Department of Finance. "County Executive's FY2019 Operating Budget Forum Briefing". January 2018.
28 Montgomery County Office of Management & Budget. "FY19 Approved Operating Budget and FY19-FY24 Public Services Program". July 2018. p. 79-143.

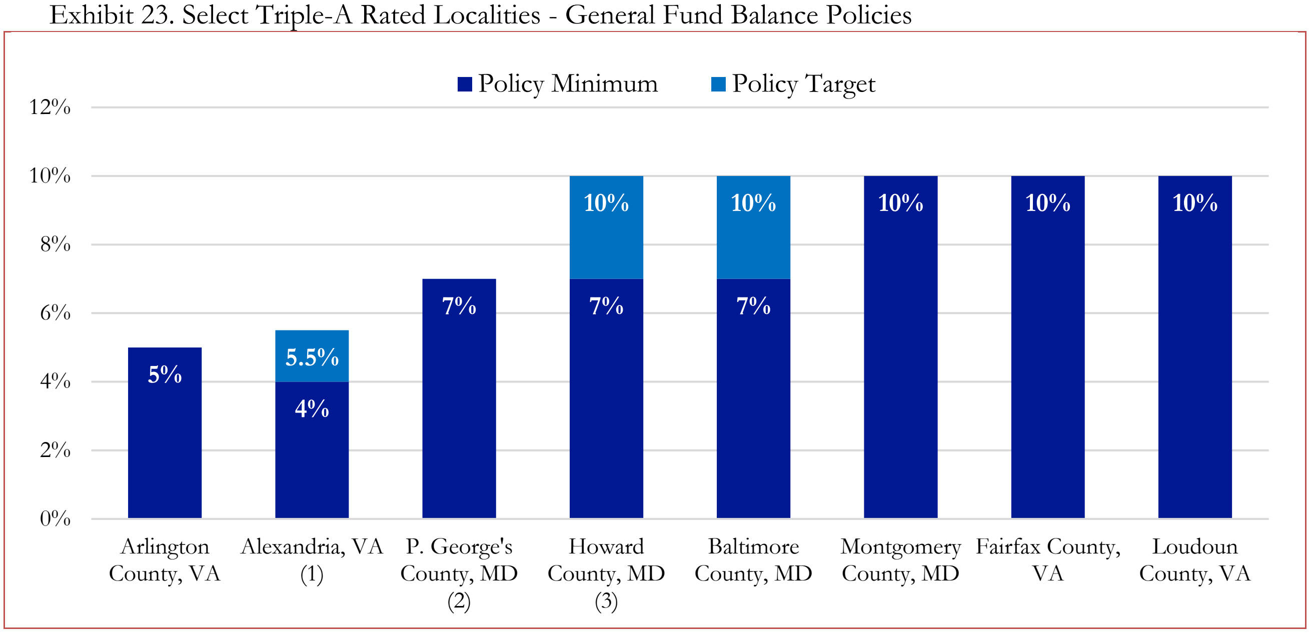
This appears to be fiscal prudence, and perhaps it is. But every dollar placed into reserve is a dollar that is not spent on education, health/human services, or transportation. These reserves may be an indication of a county that has lost confidence given years of stagnant economic performance and the specter of demographically-driven programmatic expenditure growth. Reducing the FY2020 reserve to 9 percent of Adjusted Governmental Revenues would free up $55.5 million. Reducing that reserve to the reserve level of Arlington County, VA (5%) would free up $269.5 million.

It is true that other jurisdictions in the Washington metropolitan area have a reserve policy target, including Loudoun and Fairfax counties, two other AAA-rated communities. But the situation there is different. There, tax base has been expanding rapidly over time, which means that the opportunity costs of maintaining large reserves is not a significant.

Here's the point. Montgomery County's reserve is viewed as a way to defend the AAA bond rating. We agree that that bond rating is of great importance, including to the County's fiscal sustainability and to community prestige.

But as reflected in Exhibit 23, it is possible to maintain a AAA bond rating with a much smaller reserve. Arlington County, one of the Amazon HQ2 winners, stands for this proposition (5% minimum reserve). We suspect that bond rating agencies would find improved economic and fiscal performance far more persuasive than a swollen reserve fund.

Exhibit 23. Select Triple-A Rated Localities - General Fund Balance Policies

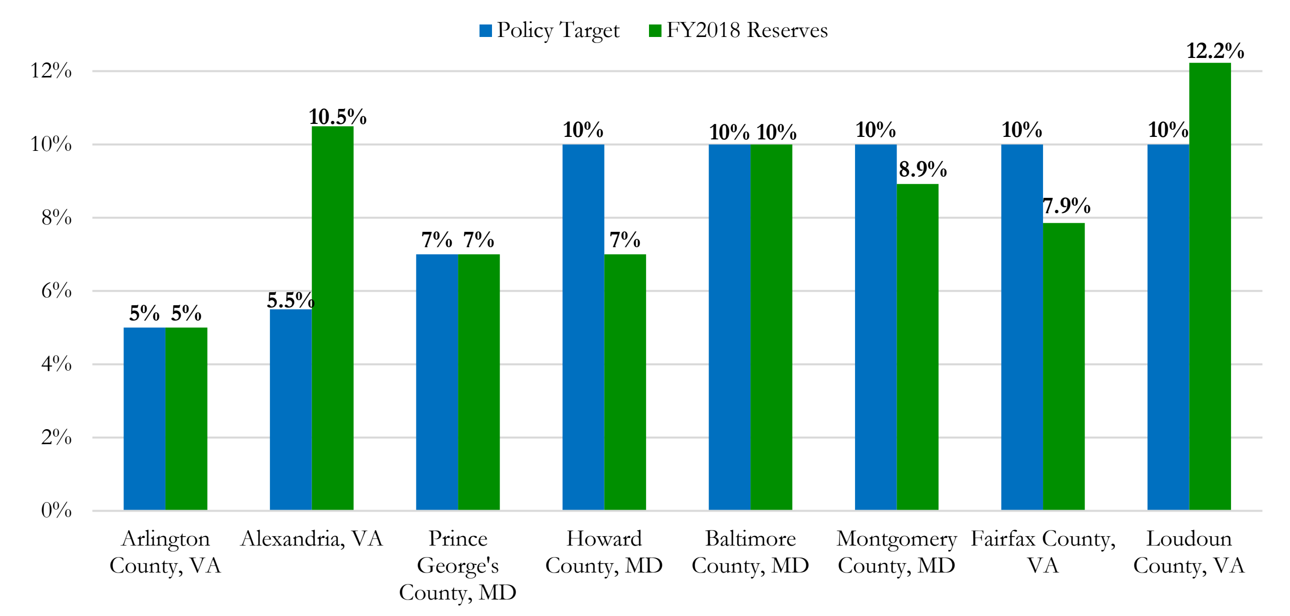


Source: 1. Public Financial Management, Inc. (pfm). "Arlington County, Virginia-Presentation to the County Board-Reserve Policy Review". April 18, 2017. 2. Individual counties' operating budgets and CAFRs. 3. Sage. Notes: *(1).* The City of Alexandria has two financial policies related to fund balances: Unassigned Fund Balance as a Percentage of General Fund Revenue - 4% floor; 5.5% target/Spendable fund balance as a percentage of general fund revenue - 10% floor; no target. *(2).* Prince George's County's reserve is made up of a Charter rainy day fund of 5% + a an unrestricted, committed 2% operating reserve = 7%. *(3).* Howard County has decided to establish a policy to maintain a contingency reserve fund in excess of the mandated 7% reserve. In FY2017 Howard County allocated $5 million to this contingency reserve as the first step toward the goal of establishing a contingency reserve of 3% of general fund disbursements within 10 years. *(4).* For Arlington, Fairfax, and Howard counties the denominator is general fund expenditures. All others use general fund revenues.

It's important to note that the information in Exhibit 23 reflects policy targets. Actual reserves may be lower. As reflected in Exhibit 24, Fairfax County's policy target is to maintain reserves equal to 10 percent of general fund disbursements (combined Revenue Stabilization Fund, Managed Reserve, and Economic Opportunity Reserve). Like Montgomery County, Fairfax has made significant progress over time toward reaching that goal. Still, in FY2018, Fairfax County maintained reserves of 7.9 percent of general fund disbursements, meaningfully below its target.[29] Fairfax County continues to maintain its AAA bond rating and there appears little doubt that that will continue.

If Montgomery County were to improve its economic performance, it, too, could effectively guarantee its current bond rating without maintaining a 10 percent reserve. But for now, Montgomery County is a community on the defensive.

Exhibit 24. Select Triple-A Rated Localities - General Fund Balance Policies & Reserves, FY2018



Source: 1. Public Financial Management, Inc. (pfm). "Arlington County, Virginia-Presentation to the County Board-Reserve Policy Review". April 18, 2017. 2. Individual counties' operating budgets and CAFRs. 3. Sage.

[29] Fairfax County, Virginia. "FY 2019 Adopted Budget Plan Overview". p. 21-22.

- **A Disproportionate, Unhealthy Reliance on Residential Tax Base**

In Montgomery County, a bit more than 23 percent of total real property assessable tax base is commercial. That compares to more than 42 percent in Alexandria, 31 percent in Prince George's County, and 25 percent in Fairfax County.

Exhibit 25. Commercial v. Residential Real Property Assessed Value, Select Jurisdictions, FY2017

Jurisdiction	% of Total Real Property Assessed Value	
	Residential	Commercial
Howard County, MD	82.5%	17.5%
Charles County, MD*	80.8%	19.2%
Frederick County, MD	77.3%	22.7%
Anne Arundel County, MD	77.0%	23.0%
Montgomery County, MD	76.7%	23.3%
Fairfax County, VA	75.1%	24.9%
Prince George's County, MD*	69.2%	30.8%
Alexandria, VA*	57.8%	42.2%
District of Columbia	55.4%	44.6%
Arlington County, VA	≈51%	≈49%

Source: 1. Comprehensive Annual Financial Reports prepared by individual counties. Statistical section table: Assessed and Estimated Value of Taxable Property, Last Ten Fiscal Years. 2. Maryland Department of Assessments & Taxation, "Seventy-Third Annual Report FY2017". Table V. 3. Sage. Notes: 1. For all counties except for Montgomery County, assessed value is 100 percent of estimated actual value. For Montgomery County, assessed value is approximately 93.6% of estimated actual value. *For Charles County and Prince George's County percentages refer to share of assessable base, not actual assessed value. For purposes of analyzing the share of total tax revenue however, the difference is negligible. In other words, the residential/commercial share of assessable base is nearly identical to the residential/commercial share of assessed value. **Source for Arlington County is Arlington County CAFR, FY2017, p. 4.

Some will point out that one of the reasons for this relative reliance on residential as opposed to commercial tax base is because homes in Montgomery County are so valuable. There's a considerable amount of truth in that. As of October 2018, the average price of a home sold in Montgomery County exceeded $511,000, which was 57 percent above the statewide average ($325,715), and 74 percent above the Prince George's County average ($293,920) according to MRIS.[30]

Still, a relatively small commercial assessable tax base means that residents are responsible for a heavy fiscal lift each year, and potentially face future tax increases. Not only has the commercial tax base grown slowly in recent years, which we indicated in our prior report, but the current level of valuation suggests a community that is very prestigious and expensive for residential purposes and is not as valued for commercial ones.

[30] Maryland Association of Realtors (MAR), "Housing Statistics: October 2018".

- **Commercial Real Estate Valuations Are Relatively Unimpressive**

Transwestern, a commercial real estate company, supplies office market statistics for Washington, DC, Northern Virginia and Maryland submarkets. Transwestern's reports include sales prices for notable office building sales. Exhibit 26 supplies the sales price per square foot for office building sales in select markets. Across four Montgomery County submarkets (Bethesda/Chevy Chase, Rockville, North Bethesda, and North Rockville), the average sales price per square foot reported by Transwestern was $232. The average sales price per square foot in Northern Virginia submarkets was $272, almost 17 percent (16.9%) higher.

Put another way, this means that the sale price per square foot in Montgomery County was just 85.5 percent of the average sales price per square foot across Northern Virginia submarkets. Excluding transactions in the Bethesda/Chevy Chase submarket, the average sale price per square foot in the remaining Montgomery County markets was $170. That is just 62.7 percent of the sales price in Northern Virginia.

This points to one of Montgomery County's primary issues – beyond Bethesda, the local economy has been largely stagnant. At some point, the current development cycle in Bethesda will wind to a close, and the county's performance in terms of commercial tax base growth will deteriorate further *ceteris paribus*.

Comparing various submarkets is instructive. For example, the average price per square foot in Rockville was $223. In Herndon, it's nearly 65 percent higher. In Old Town Alexandria, it's 39 percent higher. In pre-HQ2 announcement Crystal City, it was 34 percent higher. The average value of office space in Tysons Corner is 73.7 percent higher than in North Bethesda and the average value of space in Merrifield is 96.7 percent higher than in North Rockville.

Exhibit 26. Recent Office Market Sales in Select Markets: Sales Price Per SF (5 Transactions in Each Submarket)

Montgomery County		Northern VA		Washington DC	
Submarket	**$ Per SF**	**Submarket**	**$ Per SF**	**Submarket**	**$ Per SF**
Bethesda/Chevy Chase	$418	RCB Corridor** (Arlg.)	$596	East End	$816
Rockville	$223	Herndon (Fairfax)	$367	Washington CBD	$681
North Bethesda	$167	Old Town Alexandria (Alex.)	$310	NoMa/Capitol Hill	$540
North Rockville	$121	Crystal City/Pent. City (Arlg.)	$299	Georgetown/West End*	$447
		Tysons Corner (Fairfax)	$290	Capitol Riverfront	$244
		Merrifield* (Fairfax)	$238		
		Route 28 South-Chantilly	$223		
		Reston* (Fairfax)	$185		
		I-395/I-95 Corridor*	$120		
		Fairfax Center (Fairfax)	$87		

Source: 1. Transwestern. 2. Sage. Note: Data are for notable sale transactions reported by Transwestern that occurred between December 2013-June 2018, with the vast majority (94/112 transactions) occurring between January 2017-June 2018. *Average sale price per SF is across 5 transactions for each submarket except where noted. Average is across 4 transactions instead of 5 for the following submarkets: Columbia; Reston; Merrifield; I-395/I-195 Corridor. Average is across 6 transactions for the following submarkets: Georgetown/West End. **Rosslyn, Courthouse, Ballston.

There are likely many reasons for the disparity in commercial real estate values in Northern Virginia versus Montgomery County. Northern Virginia is an economic dynamo punctuated by the presence of Dulles Airport and the Pentagon. Terrific school systems in Fairfax and Loudoun counties also have an impact as employers have moved to the area to access the highly educated and talented workforce drawn to high quality schools.

One of the other factors may be business climate. Virginia routinely ranks higher than Maryland in terms of supplying a favorable environment for business to thrive. In CNBC's most recent Top States for Business Ranking, Virginia ranked fourth overall behind only Texas, Washington, and Utah. Among states east of the Mississippi, Virginia easily ranked first. Maryland ranked 31st among the 50 states, or 15th east of the Mississippi.[31] This may help explain the relative dearth of institutional investor interest in many Montgomery County markets. Institutional monies have a far greater tendency to flow to Northern Virginia and the District of Columbia according to brokers interviewed for this report.

This has obvious implications for the County's financial health. In FY2017, Montgomery County's commercial property assessed value totaled $41.3 billion.[32] If commercial property values were 16.9 percent higher to mimic Northern Virginia valuations, total commercial assessed value would have equaled $48.2 billion. Applying Montgomery County's direct real property tax rate of 0.7734 per $100 of assessed value[33] to this increment of nearly $7 billion would yield additional annual tax revenue of almost precisely $54 million/annum.

Transwestern data also indicate just how slowly the assessed value of Montgomery County office buildings has climbed over time. As noted in Sage's prior report, the assessed value of office buildings increased by only 13.1 percent from 2006 to 2016. Excluding the Bethesda/Chevy Chase submarket, assessed value expanded by only 4.8 percent over the course of a decade, which equates to an compound annual growth rate of 0.47%/year.[34]

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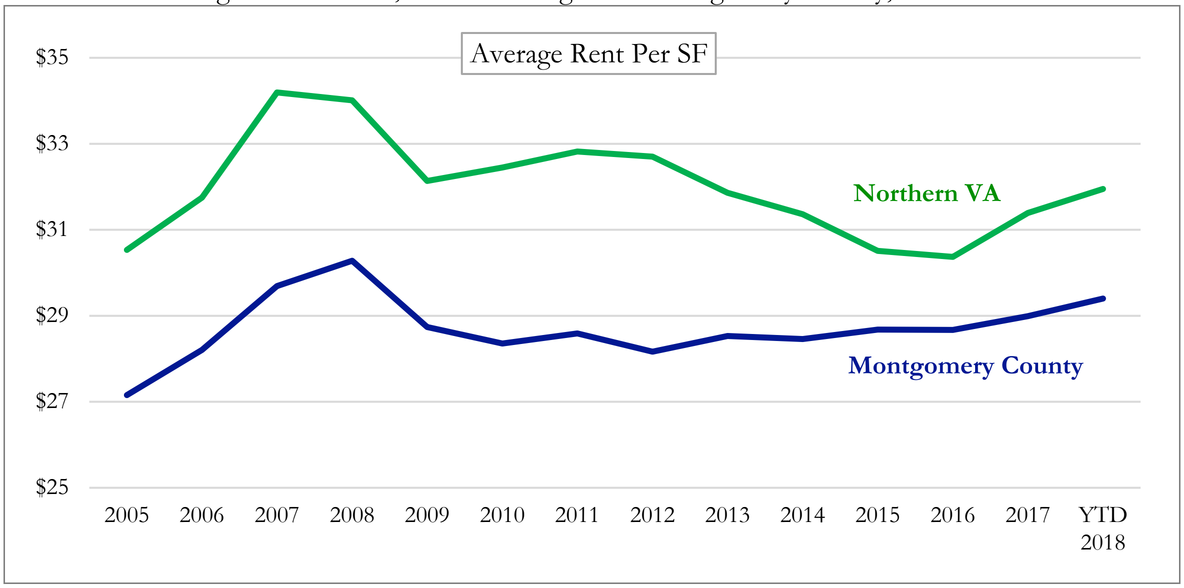
[31] CNBC, America's Top States for Business 2018. https://www.cnbc.com/2018/07/10/americas-top-states-for-business-2018.html.
[32] Montgomery County, Maryland. "Comprehensive Annual Financial Report, Fiscal Year 2017". Prepared by the Department of Finance. Table 8.
[33] Ibid., p. 235, Table 9-a.
[34] Transwestern; Sage. Note: *306 properties sampled. Office buildings > 50,000 square feet; built prior to 2006.

Exhibit 27. Average Office Rents, Northern Virginia v. Montgomery County, 2005-2018



Source: 1. Costar; Transwestern. 2. Sage.

In 2015, an office market analysis commissioned by the Montgomery County Department of Planning and conducted by Partners for Economic Solutions supplied recommendations to render the county's office market more competitive. One recommendation was to retrofit office spaces to render them more contemporary. Another was to reduce the supply of non-competitive office space by converting vacant space to other uses. The report also recommended competing for office tenants more effectively and increasing County economic development initiatives that provide support for local entrepreneurs.[35]

The need to stimulate commercial demand for available office space is immense and immediate. The General Services Administration (GSA) leases a significant portion of space in Montgomery County. According to the Partners for Economic Solutions analysis, there are GSA leases expiring in Montgomery County totaling 1,730,000 square feet in 2019-2023 and 1,680,000 square feet in 2024-2028. The GSA and other agencies have been pursuing a strategy to move federal operations to government-owned space.[36] If the GSA decides not to renew a significant number of leases with private operators, Montgomery County's private office space could experience a dramatic increase in vacancy in coming years. This represents another source of vulnerability to a commercial tax base that is at least arguably much too small already.

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[35] Partners for Economic Solutions (PES). "Office Market Assessment-Montgomery County, Maryland". Prepared for the Montgomery County Planning Department. June 18, 2015. p. V.
[36] Ibid., p. 17.

Recommendations

1. Build Schools to Improve Student Outcomes & End Development Moratoria

Earlier this year, Montgomery County's planning department declared development moratoria in several communities, including Silver Spring, Wheaton, and sections of Bethesda, because certain schools are projected to be over capacity. The result is that new development in these areas is forestalled until 1) enrollment declines; 2) students and their families are subjected to boundary change processes (redistricted); or 3) additional classroom space is made available.[37]

These development moratoria represent little more than waiting for decline. Waiting for enrollment declines is effectively waiting for families to move out or kids to grow up. Neither is consistent with persistent tax base growth.

Accordingly, we recommend that the County begin to more aggressively build school capacity. Not only is this good for 21st century scholarship, it would also open up the possibility of development in transit-served communities like Silver Spring, Wheaton, and Bethesda. This would create new tax base. It is time to go on offense.

One possibility is to alter the policy regarding fiscal reserves. Prior to FY2011, Montgomery County's policy was to maintain combined operating margin and Revenue stabilization Fund reserves equal to 6 percent of total resources.[38] In June 2010 and November 2011, Montgomery County adopted fiscal policies requiring it to maintain the sum of Unrestricted General Fund Balance and the Revenue Stabilization Fund Balance at 10 percent of Adjusted Governmental Fund Revenues.[39] Accordingly, the County's reserves have more than doubled since FY2007.

Every dollar placed into reserve is a dollar that is not spent on education, capital stock, health/human services, or transportation. The County's combined reserves are expected to total 10 percent of adjusted gross revenues in FY2020.[40] Reducing that by just one percentage point to 9 percent of Adjusted Governmental Revenues would free up approximately $56 million. This money could be used to fund school construction or other needed investments that can in turn spur economic development.

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[37] Reed, Dan. "Montgomery County says no new homes in Silver Spring because the schools are full". *Greater Greater Washington*. September 11, 2018. https://ggwash.org/view/69029/montgomery-county-says-no-new-homes-in-silver-spring-because-the-schools-ar.
[38] Montgomery County, Maryland. "Comprehensive Annual Financial Report, Fiscal Year 2010". Prepared by the Department of Finance. p. xiv.
[39] Montgomery County, Maryland. "Comprehensive Annual Financial Report, Fiscal Year 2017". Prepared by the Department of Finance. p. xiii.
[40] Montgomery County Office of Management & Budget. "FY19 Approved Operating Budget and FY19-FY24 Public Services Program". July 2018. p. 79-143.

Some may view this as a one-time bonus -- it isn't. Under this proposal, each year, the County would set aside 9 percent of Adjusted Government Revenues as opposed to 10 percent. That frees up a full percentage point to invest in services, including into support for school construction.

The need for improved and expanded school capacity has already been recognized. In October 2017, Montgomery County Public Schools Superintendent Jack R. Smith proposed a $1.8 billion plan for school construction projects over 6 years. The proposal embodies 30 building projects. While the most important consideration regarding the timing of school projects relate to student achievement, County policymakers could also consider which school projects stand to open the door to new development, thereby expanding jobs and tax base while creating additional resources for future waves of school investment.[41]

The notion of transforming older, under-utilized commercial structures into schools has also been considered and given the current level of economic dynamism makes a good deal of sense. There is a need to adaptively reuse many commercial structures that are no longer economically competitive.

2. Accelerate Public & Private Investment in White Flint & White Oak

There are two areas of Montgomery County that stand out as representing future centers of innovation and dynamic growth – White Flint and White Oak. To secure the county's future, both of these developments must become home runs. Above all, that means a) accelerating infrastructure investment and b) creating a more level competitive playing field vis-a-vis Northern Virginia.

- Accelerate the Pace of Infrastructure Improvement Projects

<u>White Flint.</u> The White Flint Sector Plan encompasses approximately $601 million of targeted infrastructure enhancements to improve mobility, nearly 10,000 new homes, 5.7 million square feet of commercial/office space, new parks, hotels, and an urban boulevard with a tree-lined median, bike lanes, and space for future bus rapid transit. In other words, it is an embodiment of many of the ideal elements of the contemporary built environment.[42]

In 2011, the Montgomery County Council established a White Flint Special Taxing District that levies a property tax and to fund transportation infrastructure improvements. The

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[41] St. George, Donna. "New schools and classroom additions planned for fast-growing Md. school system". *The Washington Post*. October 24, 2017. http://wapo.st/2yPLYtN?tid=ss_tw&utm_term=.70c35f29941a.
[42] Cooper, Rachel. "The White Flint Development of the Pike District". *TripSavvy*. Updated 5/14/2018. https://www.tripsavvy.com/white-flint-development-pike-district-rockville-1039214.

Council also authorized the issuance of bonds and outlined conditions for the loaning or advancing of County funds to the District [43]

Despite that, policymakers have collectively failed to supply the infrastructure investment required to realize White Flint's potential. As an example, early in 2018, a County Council committee voted to delay an extension of Montrose Parkway, a key element of White Flint Sector Plan realization.[44]

White Oak. The Montgomery County Council approved the White Oak Science Gateway Master Plan on July 29, 2014. The plan area encompasses nearly 3,000 acres and is bounded by the Capital Beltway on the south, Northwest Branch Stream Valley Park on the west, US 29 and Cherry Hill Road on the north, and Prince George's County on the east.

At the time of Plan adoption, existing development included more than 7,100 dwelling units and approximately 11 million square feet of commercial space. A traffic model indicates that White Oak could ultimately support approximately 25 million square feet of commercial development and 15,000 dwelling units supported by a transit system and additional road infrastructure. As the Plan indicates, "there are significant challenges. The area is not currently served by high-quality transit. Traffic congestion is a persistent problem and a possible deterrent to growth."[45]

In light of frustrated development in these two critical areas, we recommend that Montgomery County government commit forward funding or advance funding for infrastructure projects in order to promptly implement the White Flint Sector Plan and White Oak Science Gateway Master Plan. The goal should be to finance major infrastructure upgrades and to vastly expand local tax base, including both real property and income tax bases.

We understand that there has been historic antipathy to tax increment financing in Montgomery County. Accordingly, the County may have to explore other mechanisms/arrangements to fund infrastructure improvements. Public-private partnerships could provide a means to accelerate development. Another possibility is to extend additional tax incentives to private property owners willing to develop or improve mixed-use properties that provide some public use, such as a park.

The County could also explore the idea of construction of a STEM high-school at a site in White Oak. Maryland is home to 9 high schools that recently made the U.S. News & World

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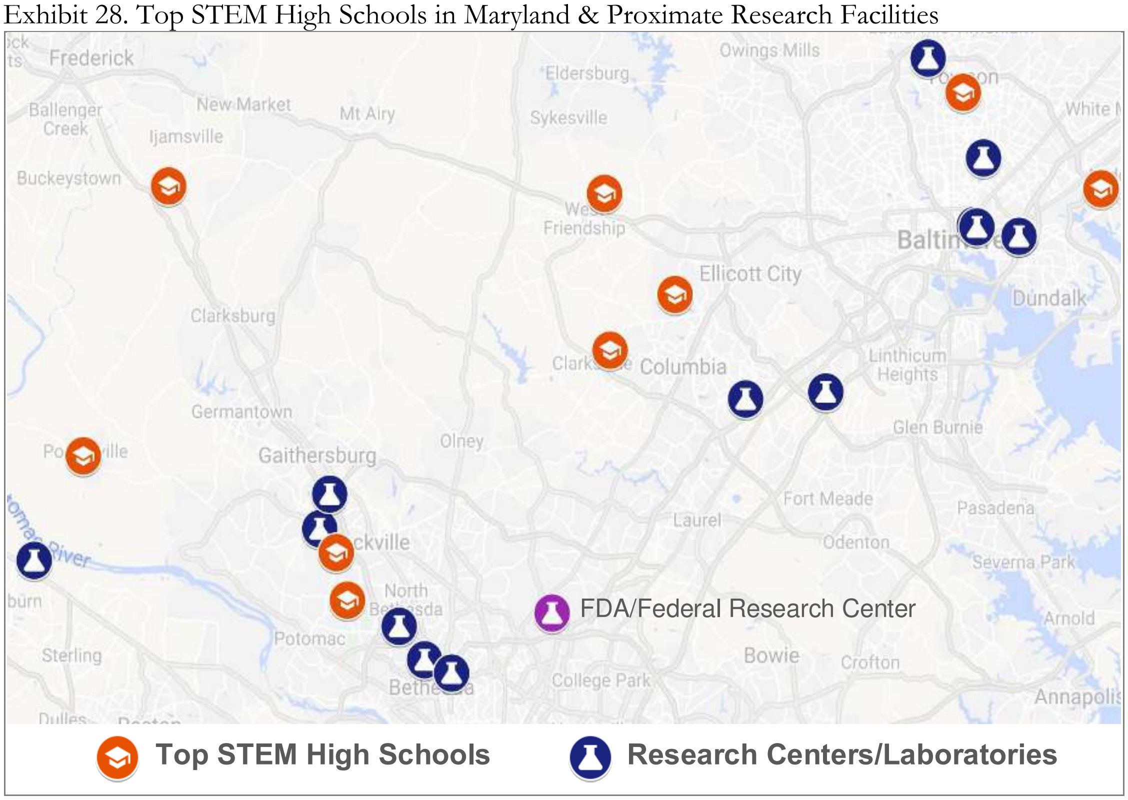
[43] Montgomery County, MD. Capital Budget, FY2019 Approved. White Flint Redevelopment Program. https://apps.montgomerycountymd.gov/BASISCAPITAL/Common/Project.aspx?ID=P151200.
[44] Iannelli, Nick. "Committee votes to further delay Montrose Parkway East project". March 8, 2018. https://wtop.com/montgomery-county/2018/03/montgomery-co-could-further-delay-parkway-project/.
[45] White Oak Science Gateway Master Plan Approved and Adopted, July 2014. http://www.montgomeryplanning.org/community/wosg/documents/approved_and_adopted_final.pdf. p. 23.

Report's list of the best STEM high schools.[46] Three of these schools are located in Montgomery County -- Winston Churchill High, Thomas S. Wooton High, and Poolesville High. Winston Churchill High and Thomas S. Wooton High are both located proximate to research laboratories/facilities.

The map below shows the 9 Maryland high schools that made U.S. News & World Report's STEM ranking and proximate research facilities. Winston Churchill High is located north of Sunrise Medical Laboratories, the National Human Genome Research Institute (NHGRI), and the Stanley Medical Research Institute. Thomas S. Wooton High is located south of the University of Maryland - Institute for Bioscience and Biotechnology Research and Westat, an employee-owned research corporation.

The location of a high school with a focus on STEM in White Oak, near the FDA/Federal Research Center, could become an important driver for revitalization of the area, including by inducing highly educated households to locate to the area. Students would benefit from the possible internships with a number of STEM-oriented employers, including the FDA itself.

Exhibit 28. Top STEM High Schools in Maryland & Proximate Research Facilities



Source: 1. U.S. News & World Report. Best STEM High Schools, 2018; 2. Google Maps; 3. Sage.

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46 U.S. News & World Report. Best STEM High Schools, 2018. https://www.usnews.com/education/best-high-schools/national-rankings/stem.

- Leverage Existing and Additional Incentives to Radically Accelerate Business Retention and Attraction

Opportunity Zones (OZs) can further help stimulate momentum in and around White Oak and White Flint. These zones are attached to a new federal tax incentive program designed to attract long-term capital to underserved areas through robust federal tax incentives. Fourteen census tracts in Montgomery County have been designated OZs, including two census tracts in White Oak and along Rockville Pike between Rockville Town Center and Twinbrook Metro Station.[47]

Opportunity Zones may be leveraged to encourage investment in other areas of the county as well. There is no prohibition regarding the use of OZ capital in combination with existing state/local incentives such as Enterprise Zones. There are also a number of OZs in Montgomery County that overlap with other state/local designations. For instance, the Wheaton Central Business District OZ overlaps with a Maryland Enterprise Zone and a Maryland Arts and Entertainment District. Census tracts designated as OZs in parts of Gaithersburg, Long Branch and Takoma Park overlap with Maryland Enterprise Zones, and the Germantown OZ is home to the Germantown campus of Montgomery College, which was recently also recently designated a Maryland RISE Zone, rendering private developers eligible for real property and income tax credits.[48,49]

Other possibilities including exempting employees of businesses from outside the county that locate in White Oak or White Flint from the County's income tax. Alternatively, the County could render these areas exempt from energy taxes.

These may appear to be extraordinary steps to take, but Montgomery County desperately needs to expand its tax base to guarantee a sustainable fiscal future. Temporary measures designed to jumpstart development at White Flint and White Oak appear necessary given the historic pace of development there.

Nontax-related initiatives can be deployed in addition to traditional property tax incentives. Research produced by the W.E. Upjohn Institute for Employment Research concludes that in certain instances, supplying customized business services (such as job training and manufacturing extension services) can have a much larger economic impact than tax breaks.

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[47] Montgomery County Government. "Leggett Hails "Opportunity Zones" for Economic Development in Montgomery County". Press Release. 6/11/2018. https://www2.montgomerycountymd.gov/mcgportalapps/Press_Detail.aspx?Item_ID=22226.

[48] Montgomery County Economic Development Corporation (MEDC). "Opportunity Zones in Montgomery County, Maryland". https://www.arcgis.com/apps/MapJournal/index.html?appid=e7c51dca138b4d599e712ca64cf1ca19.

[49] Arcieri, Katie. "Developers can now get Md. tax incentives for building on this MoCo college campus". *The Washington Business Journal*. 10/23/2018. https://www.bizjournals.com/washington/news/2018/10/23/developers-can-now-get-md-tax-incentives-for.html.

Job training services can be especially effective when targeting small or medium-sized companies that lack the financial resources to acquire such services on their own.[50]

Separately, based on its review of existing research, the Lincoln Institute of Land Policy report identifies the following examples of nontax business incentives as being most to least effective:

> *Most Effective Options:* 1. Customized job training; 2. Labor market intermediaries; and 3. Regulatory assistance.
>
> *Moderately Effective Options:* 1. Worker-oriented job training; 2. Incubators; 3. Business Services; and 4. Business improvement districts (BIDs).
>
> *Less Effective Options:* 1. Creative class strategies; and 2. Trying to replicate Silicon Valley.[51]

Exhibit 29. Most Effective Nontax Business Incentives

Option	Summary	Example
Customized Job Training	*Under customized job training programs businesses are treated as clients, with training designed to meet the specifications of each individual firm. According to the Lincoln Institute of Land Policy's review of literature, research suggests that these programs are 10-25 times more cost-effective in creating jobs than traditional tax incentives. The most cost-effective customized job training programs cover the costs of training, but not salaries, and require firms to share some of the training costs to ensure the training is useful from the firm's perspective.*	State of North Carolina: Customized Training Program
Labor Market Intermediaries	*Labor market intermediary programs focus on matching unemployed workers with firms looking to hire. For example, "first-source" programs consult with businesses on their labor needs, and then reduce hiring costs for local employers by training and screening unemployed workers for them. Typically, businesses are encouraged, but not required, to hire these individuals.*	City of Berkeley, CA: First Source program
Regulatory Assistance	*Regulatory assistance programs involve assisting firms with complex regulations and taxes, providing information on useful programs, and resolving issues with state or federal agencies. Government staff are in a good position to provide this type of service to businesses, and this is typically a very low-cost incentive program.*	Many examples

Source: 1. Kenyon, Daphne A., Adam H. Langley, and Bethany P. Paquin. 2012. "Rethinking property tax incentives for business". Lincoln Institute of Land Policy. 2. Sage.

The Lincoln Institute of Land Policy report notes that nontax alternatives are particularly effective if they focus on increasing local productivity and target businesses that export large shares of their goods/services out of the area. Businesses associated with a large export share are likely to enjoy competitive advantages that emerge from the community itself. From a Montgomery County perspective, this would implicate the life sciences, information technology (e.g. cyber, big data, applications development), defense contracting, and outsourced R&D, including medical research.

[50] Bartik, Timothy J. 2018. "Improving Economic Development Incentives." Policy Brief. Kalamazoo, MI: W.E. Upjohn Institute for Employment Research. https://doi.org/10.17848/pb2018-1.
[51] Kenyon, Daphne A., Adam H. Langley, and Bethany P. Paquin. 2012. "Rethinking property tax incentives for business". Lincoln Institute of Land Policy.

Lincoln provides the following guidance for local governments that offer incentives and we tend to agree with it:

a) Establish objective criteria for the types of projects eligible for incentives;
b) Limit total spending on incentives;
c) Open the process for decision making regarding incentives (transparency);
d) Forge regional cooperative agreements (e.g. with Howard County, Frederick County, etc.); and
e) Target incentives to mobile firms that export goods or services out of the region.[52]

- Establish an Expedited Commercial Permitting Process in White Flint/White Oak

Expedited permitting can be used is an economic development tool to support businesses and property owners in order to encourage investment and occupancy. Expedited permitting allows projects to move quickly through the development process while still adhering to established standards.[53] Montgomery County should establish an expedited commercial permitting process in White Flint and White Oak.

Frederick County's Expedited Commercial Permit Process provides a useful example. Frederick County's Department of Permits and Inspections offers a walk-through plan review and permitting process for certain types of commercial projects. The process is primarily for commercial occupancies that do not require construction or commercial projects that involve minor construction such as interior renovations. For those projects that meet eligibility requirements, applicants can receive a permit during a single "while you wait visit."[54] Depending on the project, at least one inspection of the property is required, which can be scheduled for the following day of permit issue if requested by 2 p.m. Once inspections have been satisfied, the Certificate of Occupancy is issued."[55]

Policymakers adopted Frederick County's Expedited Commercial Permit Process following a series of discussions between business community representatives and staff from the County's Division of Permitting and Development Review and Office of Economic Development in late-2010. Those discussions revealed that: "a higher level of predictability, more efficient and timely reviews, less regulation and lower fees were important to property owners and business owners trying to occupy existing tenant spaces." Policymakers created the Expedited Commercial Permit Process to supply Frederick a competitive advantage in maintaining and attracting quality of opportunity enhancing businesses.[56]

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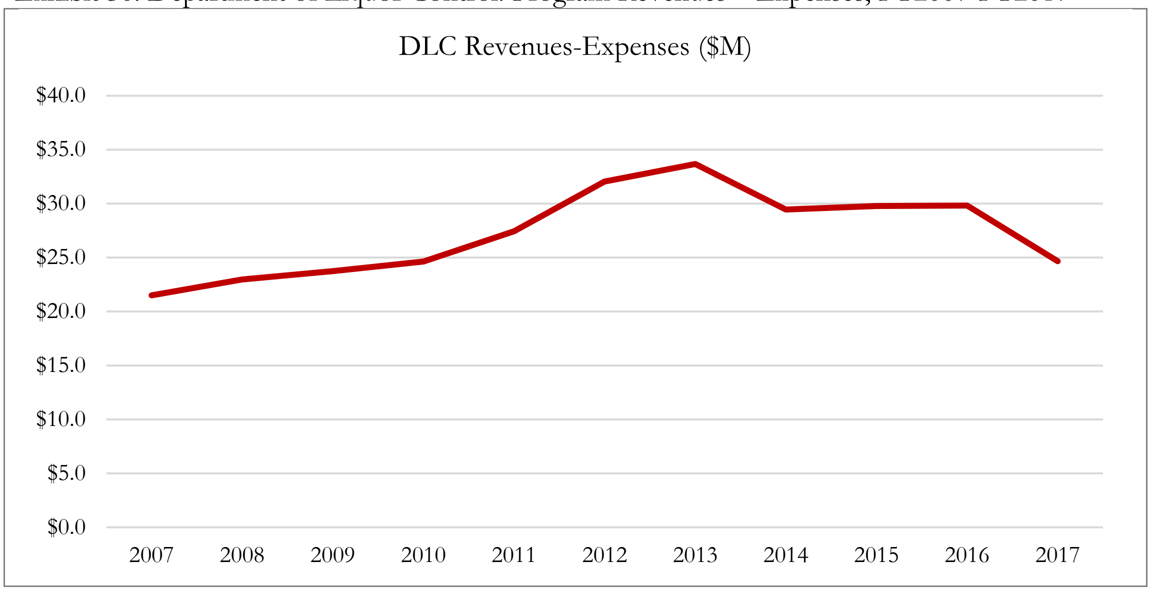
[52] Ibid.
[53] Frederick County, Maryland Office of Economic Development. "Fast Track Permitting". http://www.discoverfrederickmd.com/fast-track-permitting.
[54] Frederick County, Maryland. "Walk-Through Permits". https://frederickcountymd.gov/1642/Walk-Through-Permits.
[55] Frederick County, Maryland. "Occupancy Permits for New Businesses". https://frederickcountymd.gov/4753/Occupancy-Permits-for-New-Business.
[56] Gary Hessong, Director of Frederick County Permitting and Development Review Division. Memorandum to Frederick County Board of County Commissioners. January 28, 2011. https://www.frederickcountymd.gov/DocumentCenter/View/18479/23-permit-process?bidId=.

3. Remove Montgomery County's Monopolistic Liquor Restrictions

Our analysis indicates that the Montgomery County Department of Liquor Control (DLC) not only limits local economic activity, but that its operating expenditures are expanding rapidly. This is precisely what one would expect. Imperfect competition is both theoretically and practically associated with inefficient operations and foregone economic activity. It's time for the County to move toward a more market-oriented approach. Policymakers have previously considered bills that would open the county to private alcohol wholesalers and retailers, ending the Department of Liquor Control's monopoly. It makes sense to do this at this time before dwindling DLC profits turn into large-scale losses.

Exhibit 30. Department of Liquor Control: Program Revenues – Expenses, FY2007-FY2017



Source: 1. Montgomery County, Maryland. "Comprehensive Annual Financial Report, Fiscal Year 2017". Prepared by the Department of Finance. Table 2-A. 2. Sage.

The Maryland Comptroller's Bureau of Revenue Estimates (BRE) evaluated the impacts of removing Montgomery County's monopolistic restrictions and concluded that doing so would result in an estimated $193.7 million in new economic activity in Maryland, the creation of 1,364 jobs generating $52.6 million in additional wages, and $22.8 million in State and local taxes and fees. The BRE concluded that the majority of new demand would come from sales that would otherwise occur in the District of Columbia, suggesting that much of this computed benefit would inure to Montgomery County.[57]

[57] Comptroller of Maryland, Bureau of Revenue Estimates. "Economic Impact Analysis-Private Sector Competition-Montgomery County Alcohol Sales & Distribution". December 22, 2015.

4. Invest Additional Resources in Economic Development

Montgomery County supports a number of incentives for expanding businesses, including the Montgomery County Economic Development Grant and Loan Program, the Montgomery County Small Business Revolving Loan Program, and the Montgomery County Move Program. The Move Program supplies grants for businesses that are new to the county and lease up to 20,000 square feet of Class A or B space. According to the County, at present, "all available funds have been allocated". The County should strongly consider expanding the Move Program with the goal of meaningfully accelerating the population of businesses in Montgomery County. This represents a reiteration of a recommendation we delivered in our prior report.

5. Advocate for an Improved Statewide Business Climate

No county in the state has more to gain from an improved business climate in Maryland than Montgomery County, at least in absolute terms. As the case studies supplied in this report demonstrate, a considerable fraction of Montgomery County's economic development disadvantage vis-à-vis Fairfax and other Northern Virginia counties emerges from differences in state-level treatment of income and profits.

During the 2019 General Assembly, Montgomery County will send 8 senators (out of 47 total) and 24 delegates (out of 141) to Annapolis. This means that among 188 State-level legislators, 32 will be from Montgomery County, or more than one in six elected representatives.

This mighty force can do much good, including by advocating for a more competitive Maryland. Despite offering a massive economic incentive package to Amazon, one worth about $5 billion more than the Commonwealth of Virginia's the company still chose Arlington County over Montgomery County. This is consistent with the long-lived notion that Maryland is not considered a favorable place in which to engage in business by too many decision-makers.

Advocacy for a better business environment, including a lower State corporate tax rate (8.25% in Maryland versus Virginia's 6%) would benefit others, including Washington County in their perpetual competition with West Virginia, Worcester County in its competition with Delaware, and Central Maryland in its competition with Pennsylvania. Greater competitiveness would increase total statewide tax base, which would ultimately translate into more money for various priorities, including school construction dollars available in Montgomery County.

Conclusion

Many years of being outcompeted by proximate jurisdictions inside and outside of Maryland along the dimension of economic development has left Montgomery County, MD with a weakened fiscal position and a growing inability to support quality of life through spending on education, transportation, public safety, and health/human services. Though the county is home to many first-tier economic development professionals, elevated tax rates, an elaborate regulatory apparatus, and a County monopoly on liquor distribution have helped to contribute to a business climate that is generally viewed as unfriendly.

Vulnerability is increasing, with GSA leases expiring in Montgomery County totaling 1,730,000 square feet in 2019-2023 and 1,680,000 square feet in 2024-2028. It is of course not too late to respond, but the current fiscal trajectory is unsustainable. Montgomery County was required to close cumulative budget shortfalls exceeding $3.3 billion during the FY2008-FY2017 period, with shortfalls persisting despite a U.S. economic recovery cycle that is now the second lengthiest in the nation's history. The solution lies in attracting more job-creating private investment and expanding the county's commercial tax base – one that is far smaller in relative terms than in many other Washington area communities.

To help the County's leadership expand tax base more quickly, we offer 5 recommendations:

1. Add school capacity with an eye toward ending current development moratoria while improving student outcomes. One possibility is to site a STEM-oriented school in White Oak;
2. Pursue large-scale tax breaks and public-private partnerships in both White Flint and White Oak in conjunction with other tax incentives targeting startups and those relocating to these districts. We further recommend an expedited commercial permitting process in White Flint/White Oak;
3. End the Department of Liquor Control's monopoly and invite in more attractive, customer-responsive enterprises before the DLC's dwindling profitability turns into large-scale losses;
4. Invest additional resources in the Montgomery County Economic Development Corporation and in successful initiatives like the Move Program;
5. Advocate statewide for a better business climate by leveraging Montgomery County's massive presence in Annapolis during the 2019 General Assembly and beyond.