County of Fairfax, Virginia

MEMORANDUM

DATE: March 26, 2010

TO: Board of Supervisors

FROM: Anthony H. Griffin AHG
County Executive

SUBJECT: Future Budget Stabilization

The following information is in response to the Board of Supervisor's inquiry regarding the feasibility establishing a source of funds that could be drawn in times of economic decline to mitigate cuts to programs or needs for tax increases to address gaps in future budgets. This source of funds would be in addition to the County's existing reserve policy requirements as the rating agencies will continue to assess the adequacy of the County's overall level of reserves as well as compliance with stated reserve policies.

The County's existing reserve policy includes a Managed Reserve and a Revenue Stabilization Fund (RSF) as follows:

- A Managed Reserve shall be maintained in the General Fund at a level sufficient to provide for temporary financing of critical unforeseen disbursements of a catastrophic emergency nature. The reserve will be maintained at a level of not less than two percent of total Combined General Fund disbursements in any given fiscal year.
- A Revenue Stabilization Fund (RSF) of three percent of total Combined General Fund Disbursements shall be maintained in addition to the managed reserve at a level sufficient to permit orderly adjustment to changes resulting from curtailment of current year revenues. Accordingly, a withdrawal from the RSF will not be made unless the projected revenues reflect a decrease of more than 1.5 percent from the current year estimate and any such withdrawal many not exceed one-half of the RSF fund balance in that year. If funds are withdrawn from the RSF, a plan must be developed to replenish the fund.

The key difference between a new reserve and the existing reserves would be to offer more flexibility to the Board for use in mitigating potential future budgetary shortfalls.

According to the County's Financial Advisor, Public Financial Management (PFM), Inc., as a triple, triple-A rated municipality (i.e., Aaa/AAA/AAA general obligation ratings from Moody's Investors Service. Standard & Poor's, and Fitch Ratings, respectively), the County is held to a higher standard by the rating agencies and any approach to establishing a source of funds to mitigate future budgetary gaps should be carefully assessed prior to implementation. The County will need to address with the rating agencies any potential for such an approach to

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perpetuate an actual or projected structural imbalance in the budget (i.e., current year operating revenues do not cover current year operating expenses) as well as the appropriate parameters that should be met prior to the use of any sources of funds to close future budget year gaps. In addition, upon use of the funds the County must have procedures and plans in place that will provide forecasts of total use and a timeline for replenishment for future economic declines. Given the strength and history of the County's financial management and management team there will be confidence that the County can and will comply with the parameters set for a chosen approach affording the County the ability to craft this as a management tool.

Other AAA Jurisdictions
As shown in the attached survey of other triple, triple-A rated jurisdictions, the select group that have earned a AAA rating from each of the three major investment rating agencies, all have reserve policies. As these practices represent the best of the best, a brief review of how the County compares will be useful:

- Among counties and cities, Fairfax is the tied for the lowest with a stated aggregate policy target or minimum of 5 percent. A comparison of actual balances shows Fairfax as the second lowest as percent of total revenues among all AAA cities and counties.
- Fairfax has the highest budget and total collected balance of all AAA cities and counties. Aside from Montgomery County, MD, the Fairfax budget is nearly twice that of the next highest group and as much a nearly 10 times the smallest jurisdictions of the group of counties and nearly equal to the combined total of the 7 largest city budgets.
- As a general rule, the percentage size of the reserve is in inverse proportion to the size of the revenue base; or, in other words, the bigger and more diverse the revenue base, the smaller the reserve percentage. This is generally true for larger governments (including counties, cities and states) who enjoy fiscal stability and strength.
- When compared to states the Fairfax policies and reserves are more in line based on the size of the budget. Though at the low end of the state scale, the policy minimum of 5 percent is more representative of jurisdictions with budgets at least as large as or larger than Fairfax.
- Among those jurisdictions where staff was able to gather information on policy guidelines for use of the reserves, jurisdictions universally reported that such guidelines were strict and subject to a high degree of scrutiny from rating agencies, consistent with County's own experience in setting policy and abiding by its rules.

However, there are a number of very significant differences between a state and a county. Among these are a presumption by the credit rating agencies that many states have virtually unlimited legislative authority to raise revenue, whereas counties, as subordinate political subdivisions, especially in Virginia, do not and are generally at the mercy of state legislative authority.

New Reserve Guidelines

In view of the above survey and comparison with AAA jurisdictions and after consultation with rating agencies and the County's financial advisor, staff has concluded that the following minimum guidelines should be in effect if a new, more flexible reserve should be established:

1) A new reserve would be in addition to the current aggregate budgeted reserve of 5 percent;
2) A strict policy outlining economic and budgetary circumstances that would trigger the use of the reserve and strengthen the existing reserve policy for the RSR to provide a specific timeframe for replenishment;
3) The County will need to address with the rating agencies any potential for such an approach to perpetuate an actual or projected structured imbalance in the budget as well as the appropriate parameters that should be met prior to the use of any sources of funds to close future budget year gaps;
4) Provide for a timeframe for replenishment in the case of a draw also specific to the projections related to the economic decline at the time of each use;
5) Establish an order of precedence for replenishment should all three reserves be used in a single year, e.g. a major expenditure event such as recovery from a natural disaster (Managed Reserve); coupled with a current year revenue shortfall of more than 1.5 percent (Revenue Stabilization Fund); followed by a projected budgetary imbalance for the next year requiring the use of the new reserve.

The County's experience in the last 20 years shows long lasting economic cycles in which periods of decline measure at least 4 years in duration, followed by an equally long period of flat or slow growth, followed by an extraordinary period of 8 years of very strong growth, now followed by three straight years of decline. During that time there were only 3 years of what might be considered a pattern of "normal" growth, , about a 3 to 5 percent increase, to cover inflation and demographic pressure. The choice facing the Board is whether to "bank" a portion of the surplus generated during the strong part of the cycle, restore or expand programs curtailed during the previous period of decline, or return that surplus to the tax payer in the form a tax rate or revenue decrease. However, as a matter of perspective, it should be noted that a target that would have mitigated the tax rate changes and program adjustments necessary in these last two years would have required the set aside of literally hundreds of millions of dollars. Clearly a reserve of that magnitude would not have been considered reasonable or possible even during an era of double digit surpluses.

Reserve Options

There are various approaches that the County could take to mitigate the effects of economic declines on future budgets and each approach comes with its own considerations. Provided below are three fundamental approaches that could be used either independently or in combination as a template for the County's consideration in development of a potential specific practice and policy.

1. Increase Existing Reserves: an increase to existing reserves by 1 percent to a total of 6 percent in aggregate would strengthen current policies and not required any changes or further explanations to rating agencies. However, such change would not provide the flexibility sought by the Board.
2. Create a fluctuation, or Budget Stabilization Reserve: accumulate from $100 to $200 million, or roughly equivalent in value of 5 to 10 cents on the tax rate. Strict policy guidelines as noted above to avoid perpetuating a structural deficit would be devised for use, not to exceed 2 years in duration and providing for a rapid recovery within another 2 years. The most significant issues related to this method would the practical accumulation of such amounts of funds in the face of continuing revenue shortfalls, and gaining taxpayer acceptance of large amounts that otherwise could be used to reduce the tax rate. Also, given rating agency expectations for strict guidelines, strictly adhered to, the opportunity for increased flexibility would be constrained.
3. Establish a Budgeted Contingency: Set aside a designated amount in an appropriated budgeted contingency fund in anticipation of normal, but unpredictable as to detail, fluctuations in either disbursements or revenues. The amount can vary from year to year in response to the relative degree of budgetary stress and can be targeted towards anticipated specific events such as the $5 million used for the recent snow emergency, or the $21.7 million set aside in the FY 2011 budget recommendation in anticipation of further state budget cuts. As an appropriated reserve, criteria for use need not be as stringent, particularly if used for non-recurring expenses and replenishment is considered and set each year in response to changing conditions, thus providing flexibility.

Summary

The County would need to negotiate a clear understanding of how this reserve would work prior to adoption especially in view of the multi-year nature of our economic cycles as opposed to the rating agency preference for more immediate and direct action to resolve structural imbalances. The rating agencies view the adjustment of tax rates and control of expenditures to be positive management indicators of strong fiscal control. Reliance upon reserves for more than one year, on the other hand, is usually viewed as a sign of structural financial weakness.

In conclusion, establishing a new reserve or increasing existing reserves can be a positive development for the County and strengthen its already strong and well regarded fiscal management practices. However, it will be a challenge to craft a policy that provides the desired flexibility while protecting the County against perpetuating structural imbalances.

Staff is available for further discussion on this issue.

Attachments:
1. Summary of Aaa/AAA/AAA rated reserve policies
2. Charts of Aaa/AAA/AAA rated revenue and reserve levels

Fund Balance Policy
Policies and Funding Levels for Aaa/AAA/AAA Rated Counties

	Policy Minimum	Policy Target
Arlington County, VA		
Operating reserve as a % of GF Budget	>=3%	5%
Baltimore County, MD		
Unreserved GF balance as % of GF Budget*	>=3%	7%
*County will ensure that the ratio does not fall to 3% for two consecutive years.		
Chesterfield County, VA		
Undesignated GF balance as % of GF Expenditures	>=5%	7.50%
Cobb County, GA		
GF Balance as a % of GF Budget*	>=9%	-
*County currently elects to set aside 10% rather than 9%.		
Fairfax County, VA		
Managed Reserve Fund (% of GF Disbursements)	>=2%	-
Revenue Stabilization Fund (% of GF Disbursements)	>=3%	-
Forsyth County, NC		
GF Balance as a % of GF Budget	14%~16%	-
Greenville County, SC		
Undesignated GF Balance as a % of GF Revenue*	>=25%	35%
*If at the end of a FY the GF Balance % fall below 25%, County shall rebuild the balance within 1 year.		
Hennepin County, MN		
General and Human Services Fund Reserve Policy*	>=20%	-
Undesignated GF Balance as a % of GF Revenue*	>=15%	-
*Currently proposed to revise the policy to Unreserved GF Balance as a % of Operating Revenue = 35%~50%.		
Henrico County , VA		
Undesignated General Fund Balance as % of GF Expenditures*	-	18.0%
*Policy level revisited annually during budget process.		
Howard County, MD		
Rainy Day Fund as a % of GF Expenditures*	-	7%
*Surplus of 7% can be only spent on capital projects, one-time expenditures or debt reduction.		
Johnson County, KS		
GF Balance as % of GF Revenue	10%	15%
Loudoun County, VA		
Unrestricted, Undesignated GF Balance as % of GF Expenditures	>=10%	-
Mecklenburg County, NC		
Undesignated GF Balance as % of GF Budget	>=8%	-
Montgomery County, MD		
Unreserved GF Balance plus Rate Stabilization Fund as % of GF Budget	>=6%	-
New Castle County, DE		
Budget Reserve Account as a % of Revenues*	-	20%
*Budget Reserve Account is withtin the GF & Sewer Fund. The Revenues will also be GF & Sewer Revenues.		
Palm Beach County, FL		
Unreserved GF Balance as % of GF Expenditures	>=25%	30%
Salt Lake County, UT		
Undesignated GF Balance as a % of GF Expenditures	>=10%	
Wake County, NC		
GF Balance as % of GF Budget	>=15%	-
Unreserved GF Balance as % of GF Budget	>=11%	-

*DuPage County, IL, Gwinnett County, GA, King County, WA, Monmouth County, NJ, St. Louis County, MO and Westchester County, NY Fund Balance Policies are not available at this time.

Fund Balance Policy
Policies and Funding Levels for Aaa/AAA/AAA Rated Cities

	Policy Minimum	Policy Target
City of Beverly Hills, CA		
GF Reserve as a % of GF Revenues	25%	-
City of Bloomington, MN		
Undesignated, Unreserved GF Balance as a % of GF Revenues	50%	-
City of Boca Raton, FL		
GF Reserve as a % of Operating Expenditures	10~15%	-
City of Cambridge, MA		
Unreserved, Undesignated GF Balance as a % of GF Revenues	15%	-
Total GF Balance as a % of GF Revenues	25%	-
City of Charlotte, NC		
Unreserved GF Balance as a % of GF Expenditures	8%	12%~14%
City of Columbus, OH		
Economic Stabilization Fund Balance as a % of GF Expenditures	5%	-
City of Coral Springs, FL		
GF Unappropriated Fund Balance as a % of GF Budgeted Expenditures	17%	-
City of Durham, NC		
Undesignated GF Balance as a % of GF Expenditures	8%	-
City of Greensboro, NC		
Undesignated GF Balance as a % of GF Budgeted Expenditures	9%	-
City of Manhattan Beach, CA		
GF Reserve Balance as a % of GF Budgeted Expenditures	20%	-
City of Norwalk, CT		
Revenue Reserve as a % of Revenues	5%~10%	-
City of Overland Park, KS		
Undesignated GF Balance as a % of GF Expenditures	13%~15% by 2013	-
City of Plano, TX		
Unreserved, Undesignated GF Balance as a % of GF Revenues	-	15%
City of Raleigh, NC		
Undesignated GF Balance as a % of GF Budget	14%	-
City of Santa Monica, CA		
GF Emergency Designation as a % of GF Budget	10%	-
Economic Uncertainty Designation as % of GF Budget	3%	-
City of Scottsdale, AZ		
GF Stabilization Reserve as % of Operating Expenditures	10%	-
City of Seattle, WA		
Revenue Stabilization Reserve as % of Revenue	-	5%
City of Westlake, OH		
GF Reserve should >= 3 months of projected operations exclusive of transfers & advances		
City of Winston-Salem, NC		
Unrestricted GF Balance as % of GF Budget	10%	-

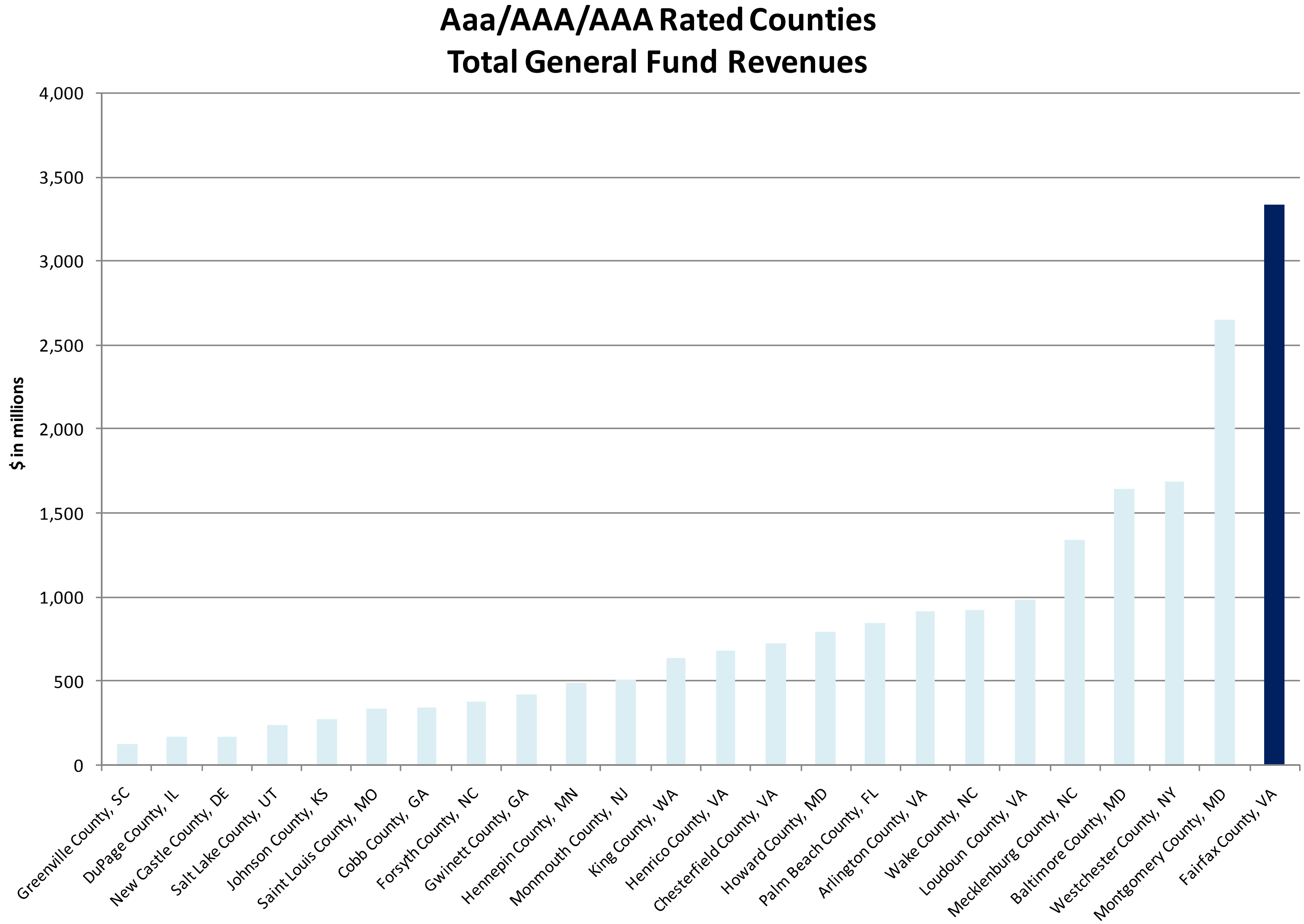
* City of Summit, NJ's Fund Balance Policy is not available at this time.

Fund Balance Policy

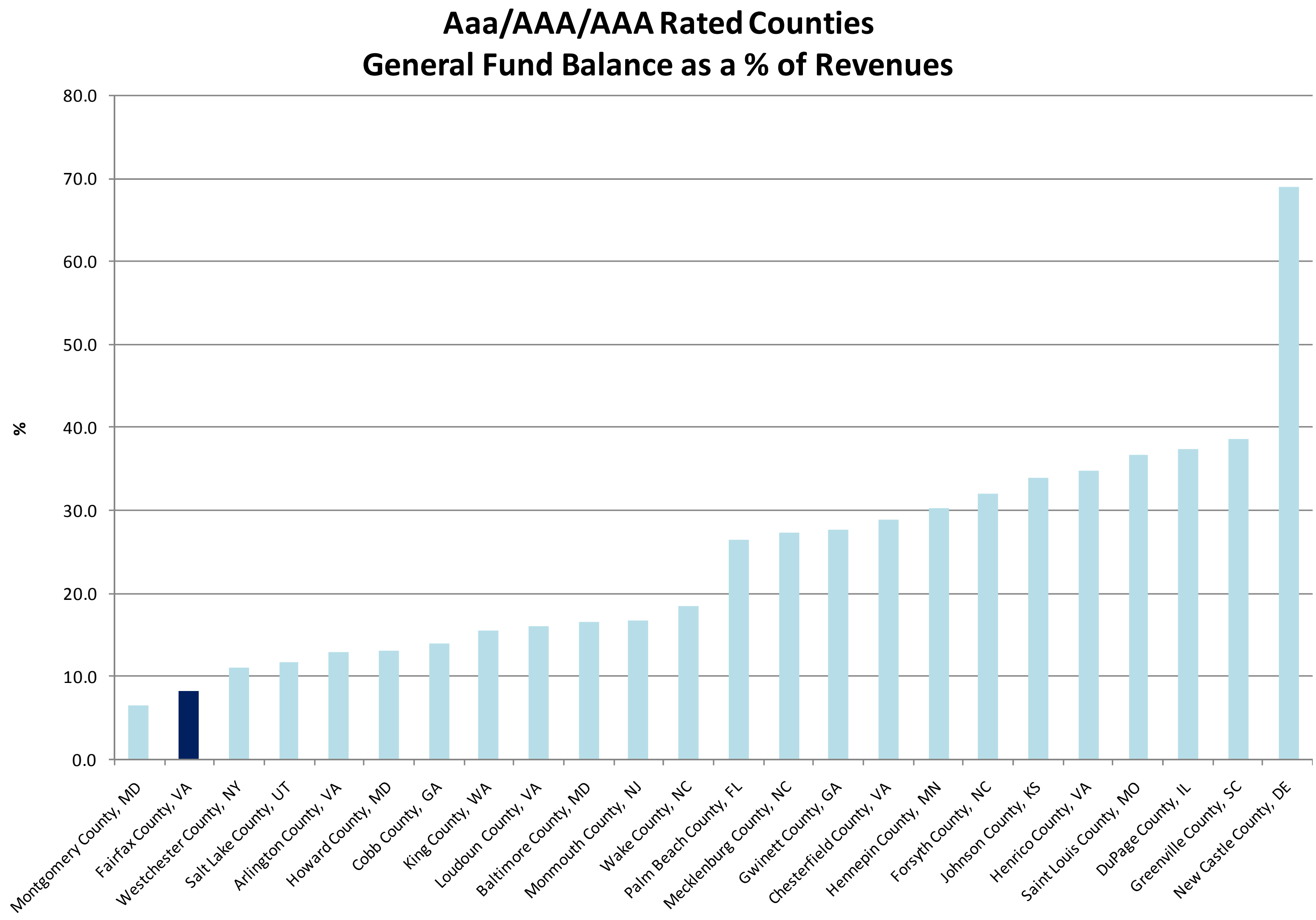
Policies and Funding Levels for Aaa/AAA/AAA Rated States

	Policy
State of Delaware	
Budget Reserve as a % of GF Revenues	5%
State of Georgia	
Revenue Shortfall Reserve as a % of Revenue	3%
State of Maryland	
Revenue Stabilization as a % of GF Revenue	5%
State of Missouri	
Budget Stabilization Fund as a % of GF	5%
State of North Carolina	
Savings Reserve as a % of GF	5%
State of Utah	
Budget Reserve as a % of GF	8%
Commonwealth of Virginia	
Revenue Stabilization Fund as a % of the average annual tax revenues*	10%
*Average annual tax revenues for 3 fiscal years immediately preceding.	

Attachment A



*Source: Moody's Municipal Financial Ratio Analysis Database, all data as of 2008. Fairfax data is as of 6/30/2009.



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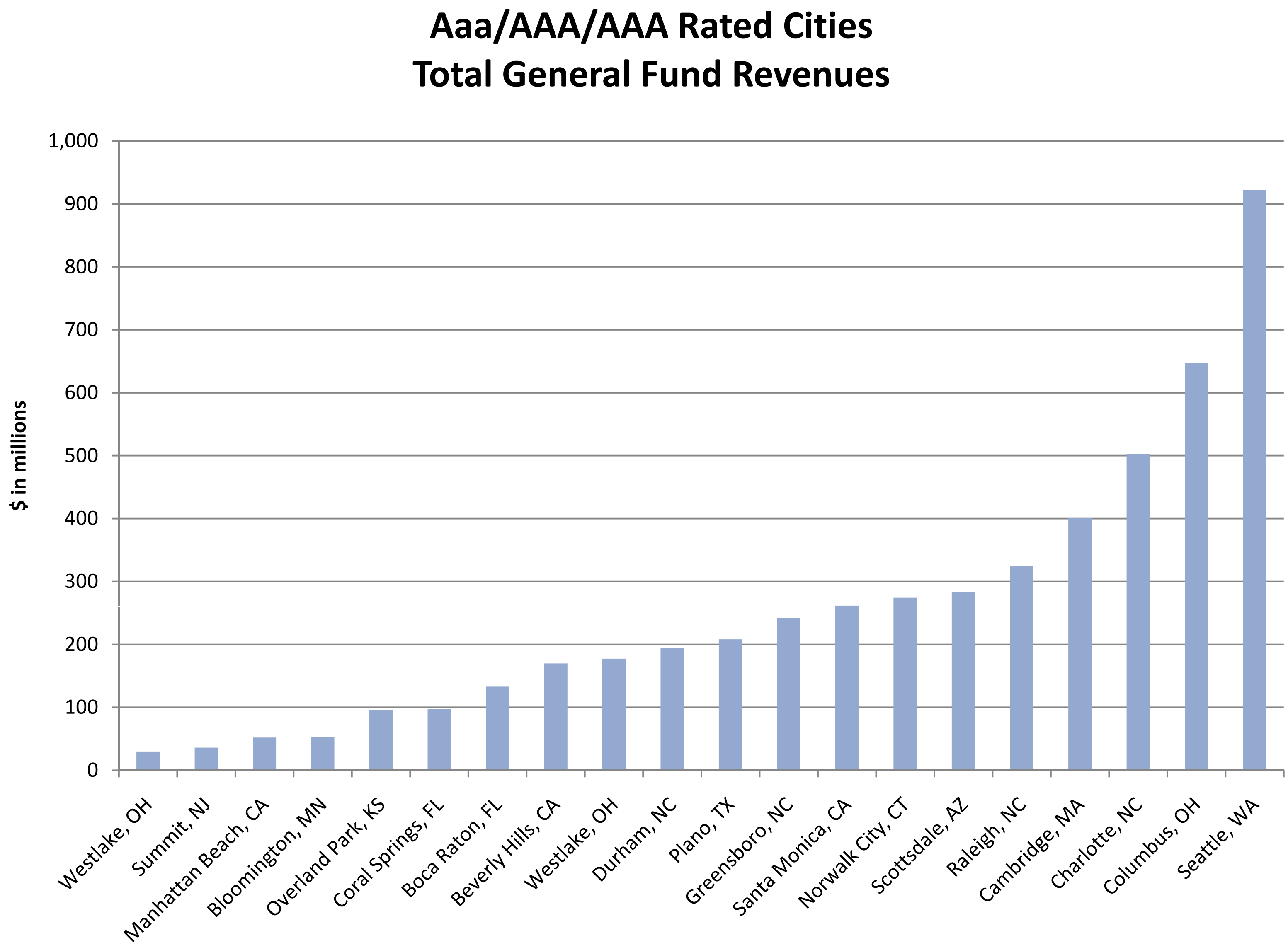
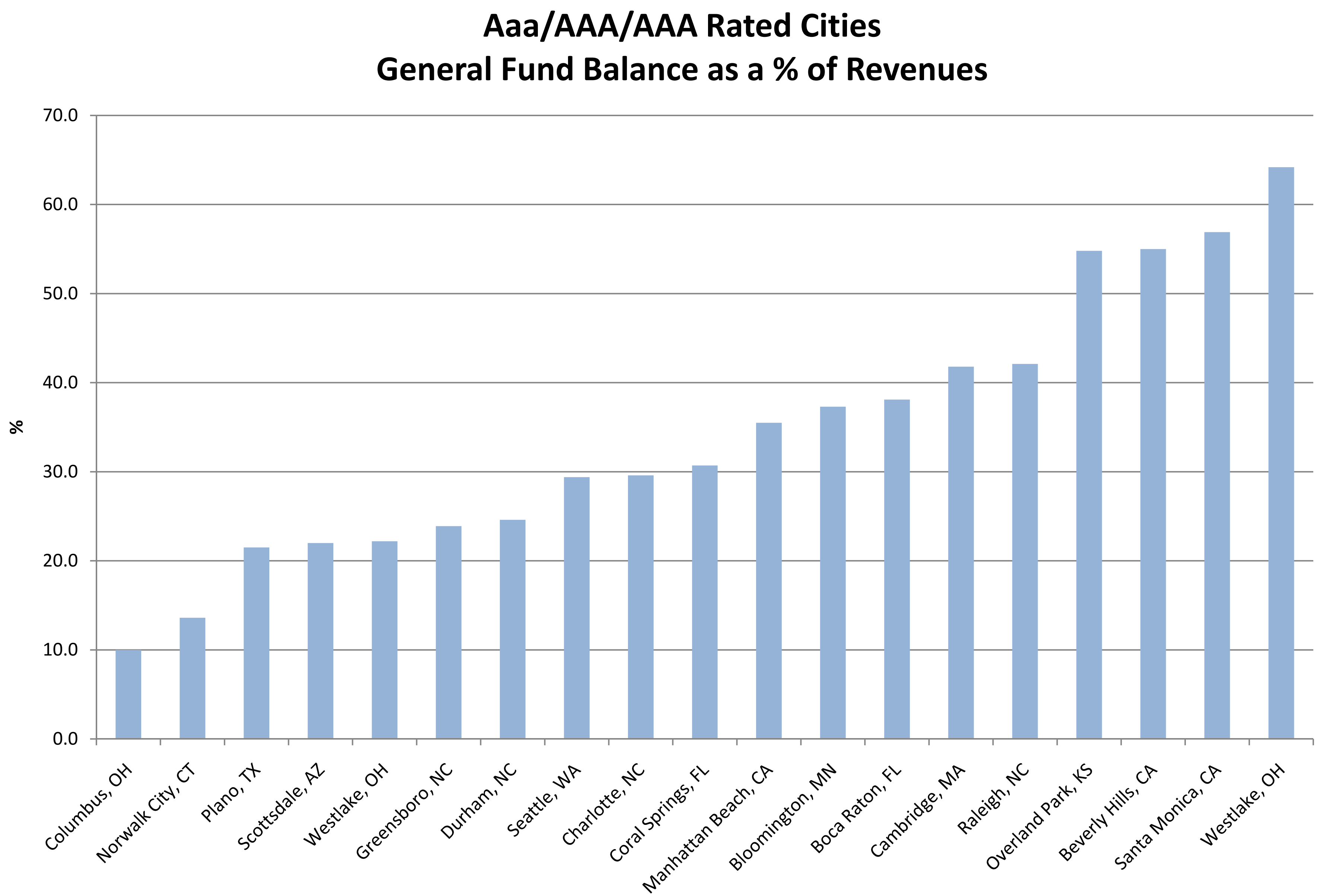
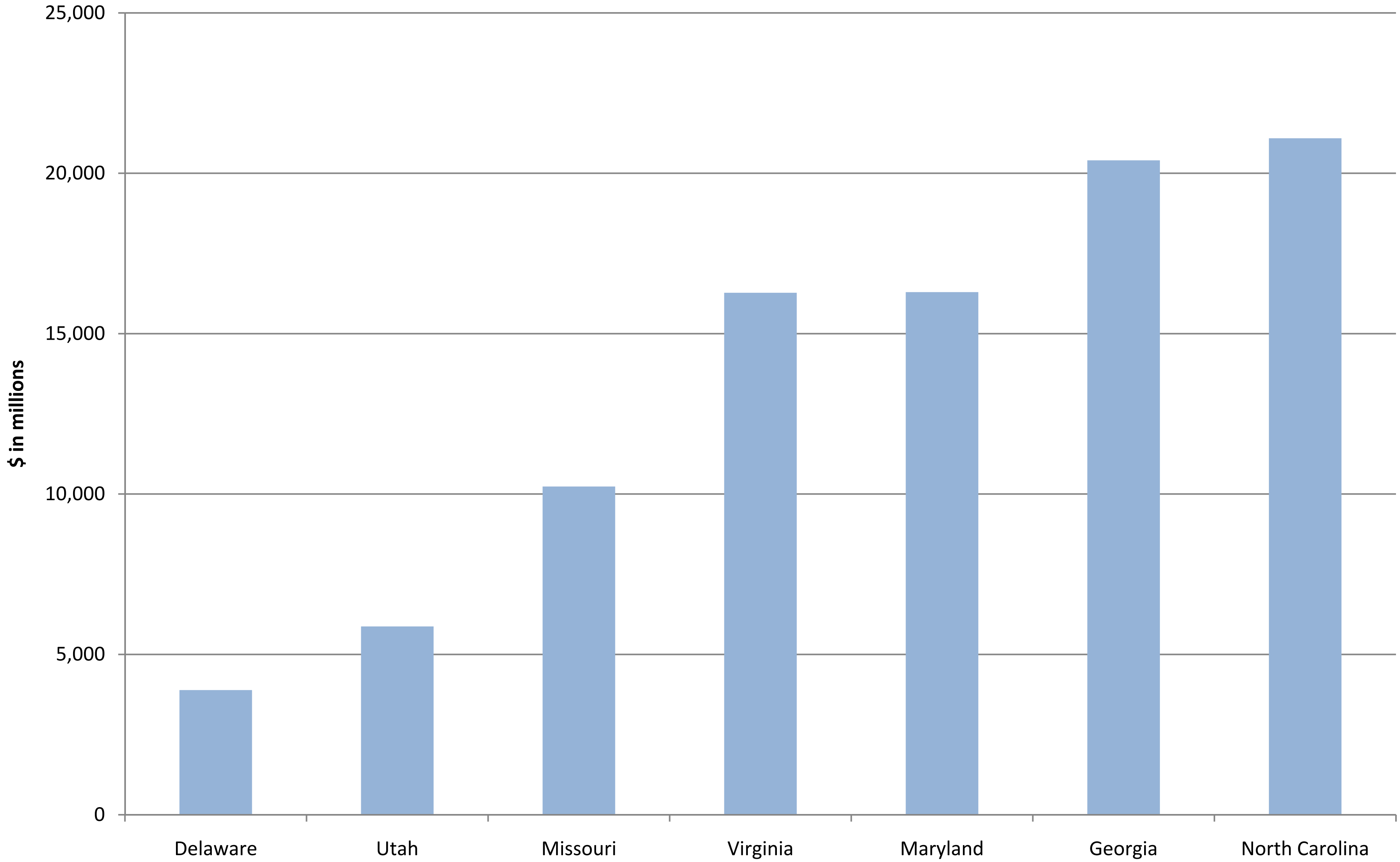


*Source: Moody's Municipal Financial Ratio Analysis Database, all data as of 2008.
Note: Data from the City of Summit, NJ is not available.



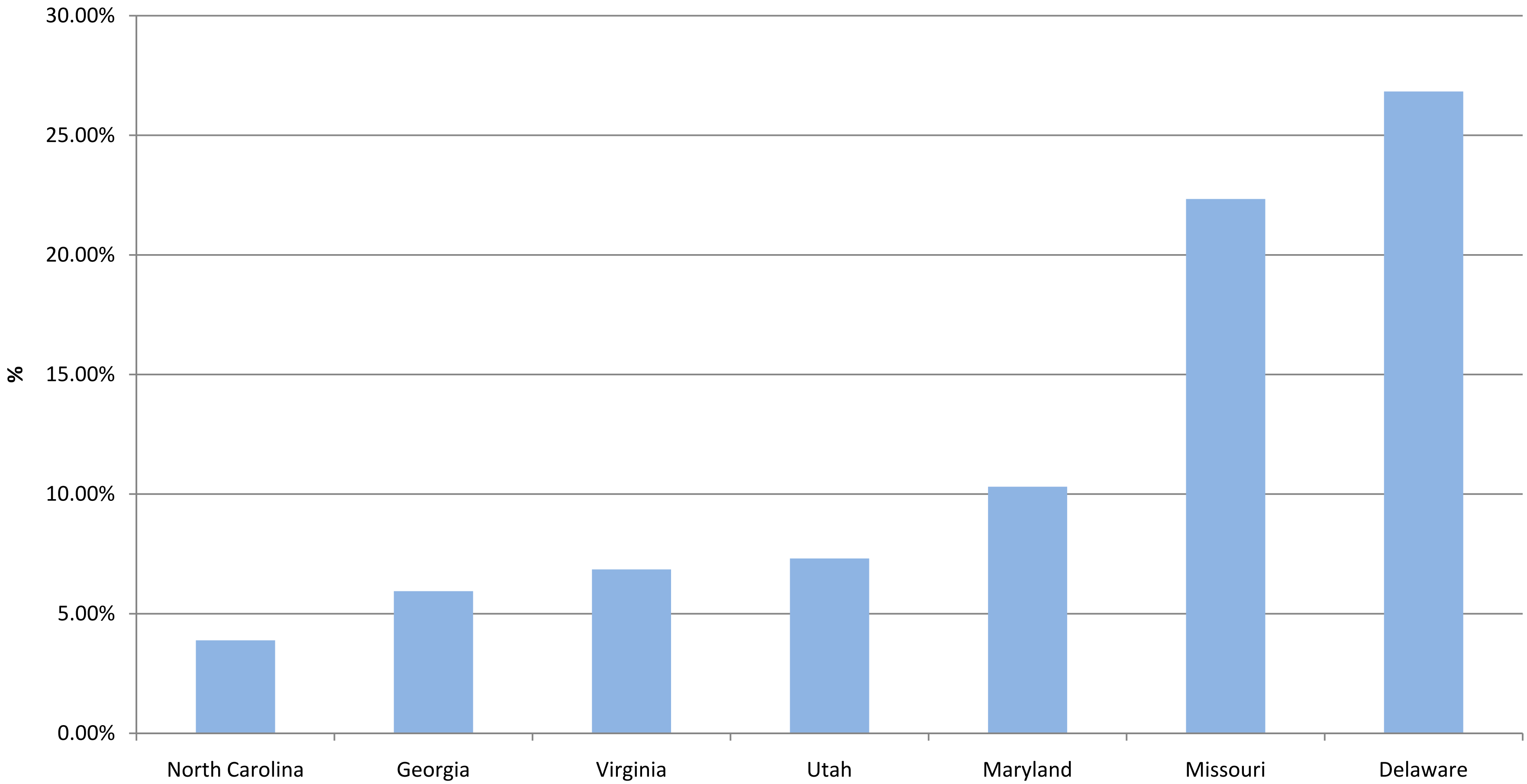
*Source: Moody's Municipal Financial Ratio Analysis Database, all data as of 2008.
Note: Data from the City of Summit, NJ is not available.

Aaa/AAA/AAA Rated States
Total Operating Funds Revenues



*Source: Moody's Municipal Financial Ratio Analysis Database, all data as of 2008.

Aaa/AAA/AAA Rated States
Unreserved, Undesignated Operating Fund Balance & Available Reserves as a % of Total Operating Funds Revenues



*Source: Moody's Municipal Financial Ratio Analysis Database, all data as of 2008.

** Available Reserves: Emergency, budget stabilization or rainy day fund balance, as reported in the states financial statements, available for contingencies but not included in the states other unreserved, undesignated operating fund balances.