Change to Grow

BALTIMORE'S TEN-YEAR FINANCIAL PLAN

BY ANDREW KLEINE, KRISTIN BARCAK, AND MICHAEL NADOL

"Today, more than ever, we face a crossroads. We can make choices that serve the greater good,put us in a better position for the future, and honestly confront real challenges. Or we can make choices to serve ourselves, choices that leave us worse off than before, choices that deny trust and truth. As mayor, I'm choosing to head down the straight-talking, no sugar-coating path toward change and real progress for Baltimore. I am asking everyone in this great city to join me. This path is guaranteed to have bumps, obstacles, and even hardships, but if we stay strong and stick with it, it will take us where we need to go."

— from the Baltimore mayor's 2011 State of the City address

Revenues for the City of Baltimore, Maryland, have eroded in recent years, as they have for many other jurisdictions. Cyclical challenges — the most severe economic downturn in generations, while key expenditure drivers such as employee health care and retirement costs grew at unsustainable rates — compounded longer-term pressures caused by decades of post-industrial population loss and aging public infrastructure. But since early 2013, Baltimore's ten-year financial plan has been addressing these challenges.

As the GFOA best practice, Long-Term Financial Planning, suggests, Baltimore's plan establishes a set of actions designed to bring the city's recurring revenues and expenditures into structural alignment. At the same time, in using a ten-year horizon — longer than the more common planning period of four to five years — the city is also focused on areas such as infrastructure renewal and tax competitiveness where additional investment is critical for fostering truly sustainable economic growth, community vitality, and fiscal strength.

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Baltimore has already used the plan, now in the second year of implementation, as a framework for restructuring employee health-care and retirement benefits (while improving worker salaries), beginning to reduce regionally high property tax rates, and increasing investment in public infrastructure — along with a broad range of other initiatives. Building on recent trends of population stabilization and emerging local strengths in health care, technology, and higher education, the ten-year plan's name reflects Baltimore's goal: Change to Grow.

WHY A LONG-RANGE FINANCIAL PLAN?

Like many major American cities, Baltimore experienced a period of population decline as the manufacturing era ended. Traditionally a prosperous port and a production center, the city lost hundreds of thousands of jobs after World War II. Accompanying the job loss was the departure of thousands of residents for surrounding suburbs. From 1950 through 2010, Baltimore's population fell from 949,708 to 620,961, while neighboring counties grew.

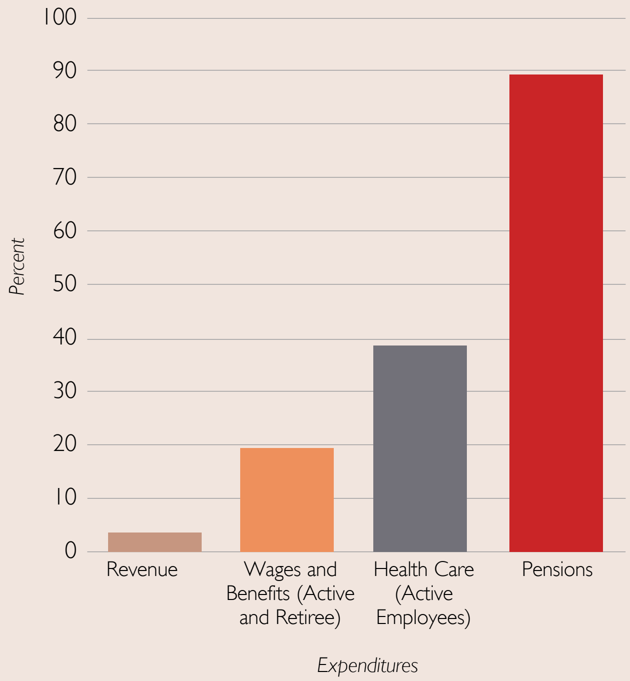
As tax rates were increased in an attempt to offset this erosion of the tax base, and important capital investments were deferred under chronic budget pressures, Baltimore was left with a legacy of high property tax rates — more than twice as much as most surrounding suburbs — aging infrastructure, and growing liabilities. This "vicious cycle" of disinvestment eroded both community and fiscal stability.

In recent years, however, Baltimore's population has stabilized, the city has become a hub for knowledge-economy jobs, and multiple neighborhoods are experiencing growth and reinvestment. Economically, Baltimore is now at a turning point, poised to grow again — but only if finances remain stable, quality-of-life services are improved, and tax rates become more competitive.

During the Great Recession, all of these conditions were put under strain as both local and state revenues eroded. Throughout that period, the city was forced to make painful and unsustainable choices — a series of service cuts, furloughs, hiring freezes, layoffs, tax hikes, and curtailments of capital investment. While the city also used

Exhibit 1: Growth in Revenues versus Workforce Expenditures

Fiscal 2007 - 2012 (Budget)



outcome-based budgeting to prioritize spending, the growth in costs so outpaced revenues that Baltimore's economic progress was placed at risk.

Wage and benefit costs increased by 19.6 percent between fiscal 2007 and 2012, despite efforts to contain them. Over the same five-year period, revenues rose just 3 percent. (See Exhibit 1.)

After years of retrenchment, city leaders recognized that beyond the roller coaster ride of the housing bubble and Great Recession, Baltimore faced a structural fiscal imbalance that even a relatively strong economic recovery would not cure. It was time for the city to step back and develop a strategy for long-term sustainability and resilience.

TEN-YEAR PLANNING HORIZON

Before it implemented the ten-year financial plan, Baltimore was already developing and publishing three-year budget projections. Financial plans with durations of four to five years have provided the basis for recovery for many local governments that have addressed fiscal distress over the years — from New York City in the 1970s to Philadelphia in the 1990s to Pittsburgh in the 2000s. For Baltimore's long-range planning initiative, however, the city adopted a ten-year horizon — and this approach provided a very different perspective on the city's future and investment needs.

Although shorter-term forecasts are inherently more accurate, even a five-year period can "crop the photo" such that critically important fiscal impacts and consequences are left out of the picture. For example:

- Even significant pension reforms — no matter how essential for the long term — may not move the needle on the near-term operating budget.
- Changes in tax policy can have an immediate impact on receipts, but the longer-term effects of such changes on a community's tax base will often take years to see.
- Similarly, infrastructure investments often have delayed budget impacts as debt service ramps up, and even greater lags in terms of the returns on such investment within a local economy.

In contrast, when a financial plan begins with the question of what the community will look like in ten years if the status quo continues, the picture — even allowing for inherent uncertainties — brings such longer-range issues into much sharper focus.

BASELINE FORECAST

At the outset of the long-range planning process, the city organized a project team and steering committee, and engaged a consultant team including financial, actuarial, and benefit experts who collaborated with senior-level, in-house staff. These outside advisers provided important technical support and capacity, but the city's leadership team remained fully and actively involved at every step.

As a starting point for the financial planning process, this joint project team first developed a baseline, status quo forecast for the city's general fund. Conceptually, this was intended to represent a "carry forward" or "current services" set of projections prior to any corrective action, with no assumed changes in services, headcount, or tax rates, except where they have already been adopted into current law or are consistent with existing policy.

In support of these projections, the team also developed a detailed, multi-year budget model that applied assumptions about future growth to thousands of individual revenue and expenditure line items. This model could be used to evaluate alternative economic scenarios. These forecasts built on the finance department's three-year projections and incorporated a range of other inputs such as actuarial projections for retiree benefits, insights from operating departments about agency-level budget drivers, and a layering of assumed debt service for future bond issuance at historical levels, on top of the city's existing debt profile.

To broadly evaluate the range of potential conditions the city might face, three ten-year forecasts were developed, including a pessimistic scenario that assumed comparatively weak economic performance and an optimistic forecast that assumed more robust growth than most economists were anticipating. The core ten-year financial plan process, however, was organized around a primary set of baseline projections intended to align with mainstream economic expectations.

Under all three scenarios, future revenues were not projected to grow at levels needed to sustain projected expenditures for current services. In the baseline forecast, absent corrective action, this structural deficit was projected to result in a fiscal gap of approximately $30 million in fiscal 2014, growing to more than $124 million by fiscal 2022 and totaling nearly $745 million over ten years.

DEVELOPING INITIATIVES

To help inform the strategies for closing this gap and to prioritize areas for additional investment, the city convened a

n overall guidance committee, along with two working groups focused specifically on pensions and health-care benefits. Each committee included city council members, representatives from the mayor's office, department leaders, and subject matter experts from the Baltimore business and non-profit sectors.

Under the direction of these guidance committees, the project team developed a strengths, weaknesses, opportunities, and threats (SWOT) analysis, benchmarked key cost centers and activities, researched best practices, and interviewed a broad set of additional stakeholders — including community and business leaders, additional city operating departments, union representatives, and elected officials. Through this process, Baltimore developed a set of initiatives centered around four major themes, developed below.

Structural Budget Balance. The city needed to break free from the annual cycle of cutback budgeting to establish a greater degree of structural fiscal balance. This required a mix of efficiency initiatives, technology investments, and other creative strategies — and it also required the city to address the workforce costs that were outpacing revenues. Benchmarking demonstrated that the city's health, paid leave, and retirement benefits were substantially more generous than private-sector norms and regional public employers. The city's cash compensation, on the other hand, is relatively less generous. This imbalance represents the worst of both worlds because many workers focus more closely on wages and salary when choosing among job opportunities, while the city's dollars are disproportionately flowing to benefit programs with high-cost growth rates that are increasingly difficult to sustain. To restructure, the ten-year plan included a series of initiatives to "rebalance the city's total compensation portfolio" by bringing health, pension, and leave benefits into the mainstream while simultaneously investing in steady, incremental pay increases.

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Tax Competitiveness. Baltimore has the highest tax burden and lowest tax capacity in the state of Maryland. During interviews, stakeholders cited high property tax rates again and again as one of the most significant impediments to neighborhood and economic growth. To achieve a more competitive tax structure within the ten-year period, Baltimore created a targeted homeowner's tax credit to reduce the effective tax rate for owner-occupied residential properties by 20 cents by 2020. Funded through a combination of gaming revenues and general budget savings, this credit allows the city to focus limited tax expenditure resources to promote population growth. Already by 2014, the city has reduced the effective real property tax rate for owner-occupied residential properties by 11 cents — a 5 percent reduction on the real property tax rate of $2.268 for every $100 of assessed value. Looking forward, the financial plan outlines strategies to extend these cuts through revenue diversification.

Infrastructure Investment. Based on a high-level capital needs analysis conducted as part of the financial plan, the city would need to invest a cumulative $1.1 billion in local infrastructure through fiscal 2022, above the levels included in the baseline forecast, just to maintain the current state of repair for capital assets and to begin some slow progress toward improvement. To address these critical needs, the plan includes a commitment to increase city pay-as-you-go and debt-financed capital investment (while remaining within conservative debt affordability guidelines), incorporates dedicated funding for priority school facility improvements, and outlines opportunities for state and regional partnership.

Addressing Long-Term Liabilities. As of 2012, Baltimore had an aggregate unfunded retiree liability of more than $3.2 billion across its three pension systems and other postemployment benefit program. To reduce these burdens on future generations, the financial plan includes a series of reforms for pensions and retiree health care. These reforms are designed to maintain competitive benefits that provide career employees with a dignified retirement, but through a more sustainable approach. In addition, these initiatives seek to reduce the taxpayers' exposure to unsupportable market risk by establishing hybrid retirement benefits that complement a reduced defined benefit pension with a defined contribution supplement.

IMPLEMENTATION

The city's finance director is directly accountable for the implementation of the plan and remains actively involved in oversight and support of this process. The finance office also dedicated two full-time employees to plan implementation. Further, to promote inter-agency coordination, the finance office created 18 cross-agency work groups, establishing an implementation network throughout the government.

Within the first year after the plan was released, Baltimore was able to close $395 million of the $745 million projected fiscal shortfall, with additional initiatives in the pipeline. Major initiatives the city has already implemented include:

- Redesigning the health-care plan for both active employees and retirees, saving more than $20 million annually.
- Adopting a modified pension plan for current civilian employees, requiring employee contributions for the first time, and putting a more sustainable cost-of-living-adjustment structure into place.
- Negotiating a new firefighter schedule that increases average weekly hours from 42 to 47, eliminating the need for 155 positions by attrition and enabling a one-time wage adjustment.
- Ending a series of wage freezes and furloughs, providing 2 percent raises for most employees.

- Completing a health benefit eligibility audit that removed more than 1,500 non-qualified dependents from city-funded coverage.
- Accelerating the reduction in homeowner property taxes, as the city's revenue mix was diversified by adding outdoor advertising and taxi taxes, adopting a storm water charge, and extending a parking tax rate that had been scheduled to sunset to a lower level.
- Launching a $1.1 billion capital program to rebuild city schools, funded through a combination of sources including a new local beverage tax, a share of gaming revenues, and partnership with the State of Maryland.
- Boosting capital investments for blight elimination, transportation, information technology upgrades, and community recreation centers.
- Debt refinancing to reduce exposure to variable rates and swaps.

For 2014 and beyond, examples of additional initiatives in the pipeline include:

- Further reducing effective homeowner property tax rates.
- Adopting new, hybrid pension plans for future hires.
- Rebidding the city's health benefit programs and establishing a stronger wellness and disease management program.
- Negotiating reforms to benefits for injuries incurred while employees are on duty, and to payout of accrued, unused leave.
- Reducing the city's fleet.
- Exploring public-private-partnership options to generate additional, one-time capital funding.
- Renewing partnership agreements with the city's tax-exempt, non-profit institutions to support core services.

As Baltimore moves forward, and as evolving conditions inevitably change the city's broader economic and fiscal context, continuous updates and creativity will be required to develop and advance additional initiatives.

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LESSONS LEARNED

Other cities that seek to develop a financial plan might consider the following lessons drawn from Baltimore's experience.

Be Bold. A long-term plan is no place for half-measures. In most jurisdictions, incremental changes to the status quo are not enough to achieve the vision of a better, safer, and stronger community. While stakeholder input is critical in the planning process, don't get hung up on having consensus around every initiative if it means the plan, even on paper, falls short. Initiatives will inevitably be debated and negotiated in the implementation phase; you want to make sure that half a loaf is enough to sustain your progress.

Build a Baseline. A baseline revenue and expenditure projection is the starting point for your financial plan. More than that, it sets the context for change. In Baltimore's case, the prospect of growing budget shortfalls and deferred capital investment was a call to action for political and civic leaders. A common excuse for not doing long-term planning is that "we don't know what tomorrow is going to look like, much less five or ten years from now." Uncertainty is exactly why planning is so important. Tackle it by developing at least three alternative economic scenarios.

Think Beyond the Horizon. This article makes the case for planning a decade ahead, instead of the usual three to five years. The fact is that Baltimore thought beyond the ten-year horizon and included in its plan a number of initiatives that won't generate serious savings until many years into the future, such as leave reform and hybrid pension plans for new hires. Turn the ticking fiscal time bombs you inherited into ticking gift boxes for the next generation.

Maintain a Cushion. Simply put, use conservative savings and revenue projections for the initiatives in your plan and, if possible, include extra initiatives beyond what you need to achieve your goals on paper. These steps are important for political and practical reasons. Politically, you won't bat 1.000 in getting your initiatives implemented, no matter how brilliant you think they are. Practically, as you implement your plan, you will discover technical issues, misunderstandings, and even errors that change the impact of initiatives. Further, long-range revenues and expenditures will inevitably vary from even the best forecast, such that contingencies may be needed to adapt to the changing circumstances.

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Commit Fully to Implementation. Plans don't implement themselves. Success will require sustained leadership commitment and a lot of plain old elbow grease. Baltimore is keeping two highly capable staffers — and yes, consultants — more than busy coordinating working groups, writing legislation and policy, negotiating labor agreements, diving deeper on initiatives in the pipeline, tracking and communicating progress, and, in some cases, re-selling plan initiatives inside and outside City Hall. Be mindful that implementation begins while the plan is under development. A plan that is carefully researched and well understood by key officials will have the smoothest ride after rollout.

CONCLUSIONS

Over the past five years, Baltimore has emerged from the toughest economic period in generations with a healthier fund balance, lower property tax rates, increasing capital investment, and shrinking unfunded liabilities. Looking forward for the next ten years, the city also has a long-range plan and strategy that is guiding Baltimore to a future of growth.

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