AGENDA ITEM #10
November 13, 2018
Discussion

M E M O R A N D U M

November 9, 2018

TO: County Council

FROM: Craig Howard, Senior Legislative Analyst CH
Aron Trombka, Senior Legislative Analyst, OLO AT

SUBJECT: **Compensation Cost Trends**

PURPOSE: Briefing and discussion, no action required

Background

The Council President requested a briefing on Montgomery County Government compensation cost trends as a continuation of previous Office of Legislative Oversight/Council Central staff work and in alignment with the Council's request during the FY19 budget deliberations that staff "continue to review the long-term sustainability of all agency compensation and benefits costs in the context of continued slow revenue growth and the potential impact of fiscal decisions by the federal government."

This presentation builds on past efforts by the Council to review the factors driving the cost of government, including the November 2015 and January 2018 briefings, and OLO's 2010-2011 analysis of the County's structural budget deficit.

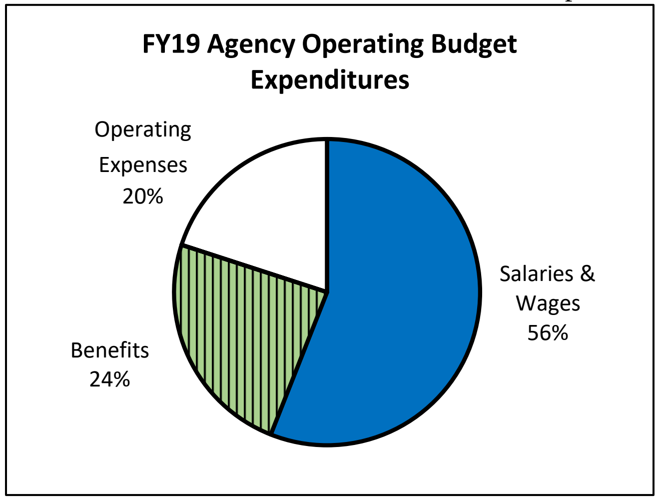
Some key takeaways from the prior presentations that provide important context for today's discussion:

- **The County is experiencing significant revenue pressures and has few options to address these pressures within the current tax structure.** As evidenced by the revenue write-down that necessitated the two FY18 savings plans, the County continues to feel revenue pressures despite the relatively strong national economic performance. Property and income tax revenue together represent 88% of county tax revenue and are either already at the maximum level allowed by State law (income tax) or difficult to change due to the Charter limit (property tax).

- **The County's fiscal policies have a significant effect on the budget.** Set asides for contingencies and pre-funding for known future obligations reduce the Council's budgetary flexibility in any given year. On the other hand, the County's rigorous standards of financial management reduce the cost of borrowing to pay for the infrastructure that supports the County's growth and quality of life.

- **A significant amount of budget pressure results from cost factors largely beyond our control.** Annual debt service cost, for example, is a function of past decisions and even a drastic reduction in the current CIP would have minimal impact on the current year debt service budget.

- **Factors within the County's control include the scope of County services, employee compensation and benefits, and workforce size.** Government is a labor-intensive enterprise. Across the four County-funded agencies, employee compensation costs (consisting of salaries and wages as well as benefits) comprise 80% of all agency operating expenditures. As such, the cost of government is driven by both the number of employees and the cost per employee. Since compensation costs are the dominant factor in the cost of providing County services, the long-term sustainability of County agency operating budgets is dependent upon maintaining a balance between compensation cost growth and revenue growth.



Summary of Presentation

To review the compensation cost trends for Montgomery County Government, the presentation includes two parts: a comparison of compensation costs and revenue growth trends; and spending on new positions versus cost increases for existing positions.

Much of the data included in today's presentation is not new; in fact, the Council has seen all of this in some fashion during budget worksessions, other presentations, or staff packets. However, while these data are typically reviewed within the context of a single year budget timeframe, this presentation reviews historical data from the last five years as well as projections for the next five years to understand how the various puzzle pieces fit together in the past and how they might fit together going forward. In short, the purpose of this review is to allow the Council to consider the question: "How can we tell if recent compensation cost trends will be sustainable in the long-term?"

The year-by-year data and calculations used for this analysis are all available on page 5, and the key findings from the staff analysis are summarized below:

PART I – COMPARISON OF COMPENSATION COST AND REVENUE GROWTH TRENDS

1) **From FY14 to FY19, the average annual increase in County revenue (3.5%) was more than sufficient to accommodate the average annual increase in compensation costs (2.7%).** However, analyzing the trends within the compensation cost and revenue components provides important context when considering long-term sustainability.

2) **From FY14 to FY19, revenue growth was sufficient to cover compensation cost growth because of the FY17 tax rate increase and unprecedented reductions in retirement costs.**

   - During this period, wages (3.7%), social security (4.2%), and group insurance (6.3%) each increased at an average annual rate that exceeded the 3.5% growth rate for revenues. **Retirement costs, however, decreased at an average annual rate of 7.4%.**

- The decrease in retirement costs resulted from three factors: 1) sustained low inflation rates resulted in pension cost of living adjustments that were much lower than projected; 2) a strong stock market resulted in investment performance that significantly exceeded projections; and 3) revised demographic trends resulted in changes to actuarial assumptions that lowered required pension fund contributions.

- Without the FY17 tax increase, the average annual revenue growth would have been 2.6% - slightly below the 2.7% average annual rate of compensation cost growth even with the retirement cost reduction.

- Absent the tax rate increase and reduced retirement costs, growth in compensation costs would have created significant budget shortfalls – more than $100 million in FY19 alone.

3) **The approved Fiscal Plan projects annual average revenue growth of 2.7% through FY24. This revenue growth will be insufficient to cover projected compensation costs if wages, social security, and group insurance grow at the same rates and retirement costs are held constant.**

   - If wages, social security, and group insurance continue to grow at the same rates as FY14-19 and retirement costs are held constant at FY19 levels (0% growth rate), the projected average annual growth rate for compensation costs for FY20-24 is 3.8%.

   - Absent any changes to revenue, this projects to a five-year cumulative budget shortfall of nearly $200 million.

PART II – SPENDING ON NEW POSITIONS VERSUS INCREASES FOR EXISTING POSITIONS

4) **A budget trade-off exists – costs increases for existing positions compete for finite resources against the cost of adding new positions.** The ratio of dollars spend on new positions versus increases for existing positions varies greatly from year to year.

5) **Mid-year pay increases consume some of the next year's available revenues before that new year has begun.** For example, the annualized cost of mid-year County Government pay increases from FY19 means that $9 million in compensation resources are already committed in FY20.

Next Steps

Compensation cost increases are sustainable when anticipated available resources are sufficient to accommodate the growth in wage and benefit costs. As such, in a sustainable budget, the rate of compensation cost increases should roughly track the rate of revenue growth. Compensation cost sustainability is a function of five major factors:

1. Projected Revenue Growth;
2. Pay Adjustments;
3. Group Insurance Cost Trends;
4. Retirement Cost Trends; and
5. Changes in Workforce Size.

Staff suggests that the Council routinely review these cost factors in the context of its budgetary and fiscal oversight responsibilities. The Council may wish to discuss the sustainability of compensation costs two times each year – once in the fall and again in the spring. The Council could also request a check-in at different times in transition years or as circumstances warrant.

- **Fall Timeframe.** In the fall of each year, the Council could receive a mid-year update from the Executive on three of the factors listed above: projected revenue growth, group insurance cost trends, and retirement cost trends. The Executive already provides revised six-year revenue projections as part of the "Fiscal Plan Update" each December. Data on group insurance and retirement cost from the previous fiscal year also become available in the fall of each year. The Council could schedule a "Compensation Cost Update" each fall at which the Executive presents information comparing projected six-year revenue increases with anticipated group insurance and retirement cost increases. This analysis would provide insight about how much budget room remains for changes in workforce size and employee pay.

- **Spring Timeframe.** All five of the cost factors are incorporated into the Executive's recommended operating budget. During the annual budget review, the Council could request that the County Executive demonstrate that recommended compensation cost increases are sustainable over multiple years. For example, the Council could ask the Executive to demonstrate how proposed wage and benefit cost increases align with the six-year revenue growth projected in the County's Fiscal Plan.

List of Resources from Prior Council Discussions

- FY19 Operating Budget Overview (4/17/17)
  http://montgomerycountymd.granicus.com/MetaViewer.php?view_id=169&clip_id=14887&meta_id=153849

- Council worksession on FY19 Compensation and Benefit for All Agencies (5/1/18)
  http://montgomerycountymd.granicus.com/MetaViewer.php?view_id=169&clip_id=14979&meta_id=155716

- Council discussion on Factors Driving the Cost of Government (1/16/18)
  http://montgomerycountymd.granicus.com/MetaViewer.php?view_id=169&clip_id=14376&meta_id=147823

- Council discussion on Factors Driving the Cost of Government (11/17/15)
  http://montgomerycountymd.granicus.com/MetaViewer.php?view_id=169&clip_id=10488&meta_id=92904

- OLO Report 2011-2, Achieving a Structurally Balanced Budget in Montgomery County. Part I: Revenue and Expenditure Trends (11/19/10)
  https://www.montgomerycountymd.gov/olo/resources/files/2011-2.pdf

- OLO Report 2011-2, Achieving a Structurally Balanced Budget in Montgomery County. Part II: Options for Long-Term Fiscal Balance (12/07/10)
  https://www.montgomerycountymd.gov/olo/resources/files/2011-2Part-II.pdf

Montgomery County Government

FY14 - FY19 Tax Supported Compensation Costs

		FY14	FY15	FY16	FY17	FY18	FY19	FY14 - FY19 Change	FY14 - FY19 Avg. Annual Change
FTEs (Workyears)	Number	7,757	7,990	8,121	8,203	8,384	8,382	625	125
	% Change	--	3.0%	1.6%	1.0%	2.2%	0.0%	8.1%	1.6%
Wages	$ Amount	$572,967,441	$607,931,989	$625,222,246	$649,578,094	$676,030,211	$687,389,689	$114,422,248	$22,884,450
	% Change	--	6.1%	2.8%	3.9%	4.1%	1.7%	20.0%	3.7%
Social Security	$ Amount	$42,427,236	$45,027,602	$46,632,010	$47,699,750	$49,942,005	$52,193,304	$9,766,068	$1,953,214
	% Change	--	6.1%	3.6%	2.3%	4.7%	4.5%	23.0%	4.2%
Retirement	$ Amount	$125,845,308	$142,212,631	$134,397,738	$94,036,294	$90,610,138	$85,519,780	-$40,325,528	-$8,065,106
	% Change	--	13.0%	-5.5%	-30.0%	-3.6%	-5.6%	-32.0%	-7.4%
Group Ins. - Active Employees and Retiree PAYGO	$ Amount	$110,719,494	$114,321,711	$121,933,971	$143,124,182	$145,240,909	$150,108,414	$39,388,920	$7,877,784
	% Change	--	3.3%	6.7%	17.4%	1.5%	3.4%	35.6%	6.3%
TOTALS	$ Amount	$851,959,479	$909,493,933	$928,185,965	$934,438,320	$961,823,263	$975,211,187	$123,251,708	$24,650,342
	% Change	--	6.8%	2.1%	0.7%	2.9%	1.4%	14.5%	2.7%

FY14-19 Tax Supported Revenue

		FY14	FY15	FY16	FY17	FY18	FY19	FY14 - FY19 Change	FY14 - FY19 Avg. Annual Change
Revenues	$ millions	$4,155.3	$4,274.3	$4,440.3	$4,698.1	$4,833.5	$4,928.3	$773.0	$154.60
	% Change	--	2.9%	3.9%	5.8%	2.9%	2.0%	18.6%	3.5%

FY19 - FY24 Tax Supported Revenue Projections from Approved Fiscal Plan

		FY19	FY20	FY21	FY22	FY23	FY24	FY19 - FY24 Change	FY19 - FY24 Avg. Annual Change
Revenues	$ millions	$4,928.3	$5,064.5	$5,182.0	$5,305.1	$5,451.8	$5,618.3	$690.0	$138.00
	% Change	--	2.8%	2.3%	2.4%	2.8%	3.1%	14.0%	2.7%