

M E M O R A N D U M

December 5, 2019

TO: County Council

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SUBJECT: **Compensation Cost Trends**

PURPOSE: Briefing and discussion, no action required

Background

In November 2018, the Council received a presentation on compensation cost trends that focused on: 1) a comparison of compensation cost and revenue growth trends from FY14-FY19; and, 2) a comparison of spending on new positions versus increases for existing positions. The November 2018 presentation built 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.

As part of the FY20 operating budget discussion last May, the Council endorsed a series of follow-up discussions and actions to help address long-term compensation cost sustainability, including: **Formalize a structure for annually reviewing compensation cost sustainability and communicating the findings to the Executive. This analysis can provide insight about how much budget room is potentially available for changes in workforce size and employee pay given current fiscal policies and anticipated revenues.**

Today's presentation builds on the prior work and responds to the Council's request for an annual update by:

- 1) Reviewing updated one- and six-year compensation cost trend data;
- 2) Comparing compensation cost projections with updated revenue projections through FY25; and
- 3) Recommending that the Council adopt a policy statement relating to how long-term compensation cost sustainability is addressed as part of the Executive's recommended operating budget.

Key Takeaways from Prior Presentations

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

- **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-downs that necessitated the FY18 and FY19 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 budget 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.
- **From FY14 through FY19, the average annual increase in County revenue (3.5%) was sufficient to cover the average annual increase in compensation costs (2.7%) because of tax rate increases and unprecedented reductions in retirement costs.** Absent these circumstances, growth in compensation costs would have created significant budget shortfalls – more than \$100 million in FY19 alone.
- **The FY19-24 Fiscal Plan projected annual average revenue growth of 2.7% through FY24. This revenue growth was insufficient to cover projected compensation costs if wages, social security, and group insurance grew at the same rates and retirement costs were held constant.** If wages, social security, and group insurance continued to grow at the same rates as FY14-19 and retirement costs were held constant at FY19 levels (0% growth rate), the projected average annual growth rate for compensation costs for FY20-24 was 3.8%. Absent any changes to revenue, this projected to a five-year cumulative budget shortfall of nearly \$200 million.

Summary of Today’s Presentation

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.

While compensation cost data are typically reviewed within the context of a single year budget timeframe, this presentation reviews historical data from the last six years as well as projections for the next five years to understand how the various puzzle pieces 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 takeaways from the staff analysis are summarized below:

1) Total approved tax-supported FY20 compensation costs (wages and social security, group insurance, and retirement) for Montgomery County Government total \$1,057.6 million. Updated one- and six-year growth rates for each compensation element are shown below.

Annual Growth Rates		
Compensation Cost	FY19-FY20	FY15-FY20 Average
Wages + Social Security	5.6%	3.7%
Group Insurance	-2.2%	4.4%
Retirement	1.7%	-9.4%

- The comparatively high rate of wage growth from FY19-FY20 included several atypical pay increases such as past year increments and lump sum payments. Absent these increases the FY19-20 wage and social security increase would have been approximately 4.1%.
- Group insurance includes active employee, retiree pay-as-you-go, and OPEB pre-funding costs. The 2.2% decrease from FY19-20 was primarily due to a \$9 million decrease in OPEB pre-funding based on revised actuarial assumptions (budget-to-budget comparison). While no OPEB pre-funding was paid in FY19, the budget-to-budget comparison allows for a more accurate reflection of the true cost of the benefit and therefore more accurate projections moving forward.
- The six-year trend for retirement costs reflects reductions due to low inflation, larger than projected investment returns, and changes in actuarial assumptions that occurred between FY15-19. As anticipated, this trend turned in FY20 with the first retirement cost increase in six years.

2) Funding compensation growth in FY21 and beyond at rates similar to those of recent years may be extremely challenging given projected future year revenues.

- The updated fiscal plan shows significantly reduced revenue growth, both in the short- and long-term. The December update shows no revenue growth in FY21, and annual average growth of 2.1% from FY20-25. In comparison, the fiscal plan approved in June assumed 2.0% revenue growth in FY21 and an annual average increase of 2.7% from FY20-25.
- Mid-year pay increases continue to consume some of the next year’s available revenues before that new year has begun. The annualized cost of mid-year County Government pay increases from FY20 mean that approximately \$9 million in compensation resources are already committed in FY21, prior to any decisions on pay adjustments and workforce.

3) Continuation of recent compensation spending trends could generate costs that are \$300-\$400 million greater than can be sustained by revenue growth over the next five years.

- If wages, social security, group insurance, and retirement continue to grow at the same rates as FY19-20, the projected average annual growth rate for compensation costs for FY21-25 is 3.8%. Absent any changes to revenue, this projects to a five-year cumulative budget shortfall of \$395 million.
- If wages, social security, and group insurance continue to grow at the same rates as FY15-20 and retirement costs are held constant at FY20 levels (0% growth rate), the projected average annual growth rate for compensation costs for FY21-26 is 3.5%. Absent any changes to revenue, this projects to a five-year cumulative budget shortfall of \$302 million.

Staff Recommendation

Staff recommends that the Council adopt the following policy statement relating to how compensation cost sustainability is addressed as part of the Executive's recommended operating budget:

As a means to preserve long-term budget sustainability, the annual growth rate of total compensation costs (including all wage and benefit costs) should be similar to the annual growth rate of tax-supported revenues. In submitting a recommended annual operating budget, the Executive should indicate how recommended compensation cost increases compare with projected rates of revenue growth. Should recommended compensation cost increases exceed the projected one-year or six-year rate of revenue growth, then the Executive should provide a written explanation of: (a) how operating budget resources are re-allocated to pay for total compensation costs; and (b) how the recommended rate of compensation cost growth can be sustained over time.

List of Resources from Prior Council Discussions

- Council worksession on FY20 Compensation and Benefits for All Agencies (4/30/19)
https://www.montgomerycountymd.gov/council/Resources/Files/agenda/col/2019/20190430/20190430_7-8.pdf
- Council Discussion on Compensation Cost Trends (11/13/18)
https://www.montgomerycountymd.gov/council/Resources/Files/agenda/col/2018/20181113/20181113_10.pdf
- Council discussion on Factors Driving the Cost of Government (1/16/18)
http://montgomerycountymd.granicus.com/Viewer.php?view_id=169&clip_id=14376&meta_id=147823
- 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
FY15 - FY20 Tax Supported Compensation Costs

		FY15	FY16	FY17	FY18	FY19	FY20	FY15 - FY20 Change	FY15 - FY20 Avg. Annual Change
FTEs (Workyears)	Number	7,990	8,121	8,203	8,384	8,382	8,531	541	108
	% Change	--	1.6%	1.0%	2.2%	0.0%	1.8%	6.8%	1.3%
Wages	\$ Amount	\$607,931,989	\$625,222,246	\$649,578,094	\$676,030,211	\$687,389,689	\$727,078,784	\$119,146,795	\$23,829,359
	% Change	--	2.8%	3.9%	4.1%	1.7%	5.8%	19.6%	3.6%
Social Security	\$ Amount	\$45,027,602	\$46,632,010	\$47,699,750	\$49,942,005	\$52,193,304	\$54,086,280	\$9,058,678	\$1,811,736
	% Change	--	3.6%	2.3%	4.7%	4.5%	3.6%	20.1%	3.7%
Retirement	\$ Amount	\$142,212,631	\$134,397,738	\$94,036,294	\$90,610,138	\$85,519,780	\$87,013,801	-\$55,198,830	-\$11,039,766
	% Change	--	-5.5%	-30.0%	-3.6%	-5.6%	1.7%	-38.8%	-9.4%
Group Insurance - Active Employees + Retiree PAYGO + OPEB Budgeted	\$ Amount	\$152,899,191	\$165,454,031	\$186,637,732	\$188,639,229	\$193,671,074	\$189,459,675	\$36,560,484	\$7,312,097
	% Change	--	8.2%	12.8%	1.1%	2.7%	-2.2%	23.9%	4.4%
TOTALS	\$ Amount	\$948,071,413	\$971,706,025	\$977,951,870	\$1,005,221,583	\$1,018,773,847	\$1,057,638,540	\$109,567,127	\$21,913,425
	% Change	--	2.5%	0.6%	2.8%	1.3%	3.8%	11.6%	2.2%

FY20 - FY25 Tax Supported Revenue Projections from Updated Fiscal Plan (December 2019)

		FY20	FY21	FY22	FY23	FY24	FY25	FY20 - FY25 Change	FY20 - FY25 Avg. Annual Change
Revenues	\$ millions	\$5,095.9	\$5,100.4	\$5,219.0	\$5,349.7	\$5,502.6	\$5,650.6	\$554.7	\$110.94
	% Change	--	0.1%	2.3%	2.5%	2.9%	2.7%	10.9%	2.1%