

COUNTY OF MILWAUKEE
INTEROFFICE COMMUNICATION

DATE : April 11, 2018

TO : Supervisor Theodore Lipscomb Sr., Chair, County Board of Supervisors

FROM : Joseph Lamers, Director, Office of Performance, Strategy, and Budget

SUBJECT : Operating Budget Gap for 2019

OVERVIEW

This report provides a preliminary operating budget gap estimate for 2019. A timeline for the 2019 budget process is also provided.

The Office of Performance, Strategy, and Budget (PSB) preliminary projects a budget gap of \$23.3 million for Fiscal Year 2019. This reflects the projected shortfall between growth in revenues compared to estimated increases for legacy healthcare and pension costs as well as inflationary operating cost growth.

The 2019 budget gap is part of an ongoing and persistent structural deficit at Milwaukee County, where stagnant and limited revenue growth is not sufficient to support increases in fringe benefit costs or inflationary operating expenses. Without actions taken, PSB preliminarily projects the budget gap will increase to \$43.6 million in 2020 and \$72.8 million in 2021.

This report provides additional background and detail on the projected gap. Broad options for eliminating the 2019 budget gap are also presented for consideration and direction.

While options for closing the 2019 gap are presented for consideration, these options include temporary fixes which would not address the ongoing structural deficit. In order to increase focus on the structural deficit, the Department of Administrative Services – Office of Performance, Strategy and Budget recommends that the County Board continues to work with the County Executive to focus on long term fiscal sustainability.

BACKGROUND

Every year dating back to the early 2000's, Milwaukee County has been faced with budget deficits when planning for the upcoming fiscal year. This means that County officials and policy makers have repeatedly been required to focus budget planning efforts on where to reduce expenditures while opportunities to make new programmatic investments are limited. The ongoing structural imbalance is caused by stagnant revenue growth which is limited by State statutes and is not sufficient to keep pace with increases in legacy healthcare and pension costs or with inflationary operating cost growth for utilities, commodities, and contract services.

Over the past four years, the average budget gap which policy makers have been required to

close within the annual budget process has been \$31.5 million. While the budget has been balanced as required on an annual basis, the structural deficit persists and is projected to continue into the future.

To demonstrate the impact of the structural deficit:

- Since 2000, full-time equivalent positions have been reduced from 7,338 to 4,317, a reduction of 3,021 headcount or 41%.
- Since 2013, the County has reduced its facilities footprint by approximately 1.6 million square feet.
- Staff compensation adjustments have not kept pace with inflation, while at the same time employees are required to contribute more to healthcare and pension benefits.
- On the capital side of the equation, an estimated funding gap of almost \$100 million is projected in 2019 alone, representing a large backlog of deferred maintenance needs. This relates to the operating gap because the capital project fund competes with the operating budget for limited dollars. The capital funding gap increases yearly as projects are deferred.

ANALYSIS

Based on preliminary estimates, the County will be facing a 2019 operating budget gap of \$23.3 million assuming no significant changes in service levels.

This projection also assumes that the 7.75% pension investment rate of return assumption is maintained in the 2019 budget, rather than reducing the rate of return down to 7.0% as recommended by pension actuaries, Segal Group. The impact of changing the pension rate of return to 7.0% is estimated at \$13.5 million for 2019 and this change would add to the gap.

Major factors contributing to the projected 2019 Budget Gap are shown in the chart below. These amounts reflect: projected increases in expenditure items compared to 2018, removal of one-time revenue sources that were included in the 2018 Adopted Budget, and increased revenue projections which are shown in the chart as a negative values because they reduce the projected gap.

Estimated 2019 Budget Gap (\$ in Millions)	
Description	Amount
Expenditure Items	
Salaries	\$ 3.8
Health Care	\$ 8.4
Pension	\$ 4.0
Debt Service Principle and Interest	\$ 0.5
Operating Cost to Continue Increases	\$ 6.6
Restore 2018 Operating Reductions	\$ 1.9
Return Capital Financing to 20% Cash Goal	
Innovation Fund	
Additional Investments	
Total Expense Change	\$ 25.2
Revenue Change - Lost Revenues	
Debt Service Reserve	\$ 6.6
Parks Parking Fees	\$ 1.6
Revenue Changes - Increased Revenue	
Property Tax	\$ (2.9)
Sales Tax	\$ (1.8)
VRF Increase	\$ (0.7)
Unclaimed Revenue	\$ (1.3)
State Shared Revenue	\$ -
Other Revenue Changes	\$ (3.5)
Total Revenue Change	\$ (1.9)
Gap Total	\$ 23.3

The following descriptions provide additional information regarding the assumptions used to develop the estimated gap. Please note, the numbers presented here are based on estimated changes for the 2019 budget and they are subject to variability as the budget process continues.

Expenditures:

Salaries / Compensation Increases: An estimated \$3.8 million is projected for compensation increases due to the County’s need to address internal equity and wage disparity issues. \$2.3 million of this amount reflects the fully annualized value of compensation increases approved in the 2018 budget, including a 1% increase to be implemented at mid-year 2018 and \$400,000 in equity adjustments funded in the 4th quarter of 2018. This estimate projects that a similar round of compensation increases will be built into the 2019 budget at a cost of \$1.5 million.

Health Care: Costs are projected to increase by approximately 7.5% which is consistent with recent experience, and is also based on information provided by health care advisors, Willis Consulting Services.

Employer Pension Contribution: Under the current 7.75% pension investment rate of return assumption approved by the Pension Board, costs are projected to increase by \$4.0 million in 2019.

As noted above, there is the potential for significant variability in pension costs in 2019 and/or future years. At the November Pension Board meeting Milwaukee County's actuarial consultant, the Segal Group, recommended reducing the long-term investment return assumption to 7.0%. This would increase pension contributions by an estimated \$13.5 million in 2019, \$9 million in 2020 and \$9 million in 2021. The current rates approved by the Pension Board are 7.75% in 2019 and 7.5% in 2020 and thereafter.

Debt Service Principal and Interest: An increase of \$500,000 is a preliminary estimate based on the debt service growth amount projected in the Comptroller's 2017 five-year financial forecast.

Other Operating Cost to Continue Increases: An estimated \$6.6 million increase is needed for other operating costs, excluding personnel items already quantified above. This is an estimate of what departments will need for their cost-to-continue at current service levels including inflation for operating costs such as utilities, commodities, professional services, and contracts. The estimate reflects less than 2% growth compared to what is budgeted in 2018 for these costs. A portion of this growth is offset by revenue.

Restoration of 2018 Operating Reductions: The 2018 adopted budget included operating reductions which were later restored. Maintaining this funding within the 2019 budget adds \$1.9 million to the projected budget gap. \$1.9 million in baseline restorations includes \$855,000 for senior centers, \$882,000 for transit, and \$200,000 for homeless shelter funding.

Return Capital Financing to 20% Cash Goal: This item is not factored into the \$23.3 million gap calculation but is important to note. The County has a goal to cash finance 20% of capital projects with the remainder of projects funded through bonds. The 2018 adopted budget cash financing contribution was only \$5.4 million or 12%. In order to return to the 20% cash goal in 2019 an estimated \$5.5 million is needed. Meeting this goal would require reduction of operating tax levy which would increase the projected operating gap.

Revenues:

Lost Revenues:

Debt Service Reserve: The 2018 budget included \$6.6 million in funding from the Debt Service Reserve which is considered a one-time revenue source.

Parks Parking Fee Revenue: The 2018 adopted Parks Department budget included \$1.6 million of parking fee revenues which ultimately were not approved by the County Board for implementation.

Increased Revenues:

Property Tax: The gap estimate includes approximately 1% growth or a \$2.9 million increase in property tax revenue related to net new construction.

Sales Tax: Based on the past two years of actuals, County sales tax receipts are projected to grow by 2.5% in 2019 or \$1.8 million.

Vehicle Registration Fee (VRF) Increase: The 2018 budget included \$16.0 million of VRF revenue. Actual annual VRF receipts are now estimated to be \$16.7 million, an increase of \$700,000 compared to the budget. The projected increase is due to the number of cars being registered. It is not tied to any change in the fee.

Unclaimed Revenue: Every other year the County Treasurer advertises the possession of unclaimed funds. Revenue of \$1.25 million is projected to again be realized in 2019.

State Shared Revenue: State shared revenue is projected to remain flat in 2019. This contributes to the County's budget gap because State funding is not added to cover the increased cost of mandated services. Between 2010 and 2017 State shared revenue distributed to Wisconsin localities has been reduced by 5%. During this same time period, overall statewide expenditures have increased by almost 10%. The State has distributed new funding to support increases in education, general services, human relations, and increased tax relief. Meanwhile the major components of the State budget that have been reduced are the environment, commerce, and State shared revenue to localities.

Other Revenue Changes: \$3.5 million of other inflationary revenue increases are projected, largely tied to fees and operating cost-to-continue inflationary increases.

Gap Closing Options

Three broad based options are presented here for consideration and direction as part of the 2019 budget process. These options include: Divest, Temporary Fix, and Sustain.

Strategies to close the gap within these scenarios include: containing inflationary cost-to-continue increases, issuing departmental tax levy reduction targets, withdrawing funds from debt service reserve, and raising new revenues. Below is a chart which summarizes these options and shows the variance between each of the choices. This is followed by narrative descriptions of each option. Ultimately, a hybrid scenario which crosses multiple options may be chosen to close the gap.

Estimated 2019 Budget Gap (\$ in Millions)		Budget Balancing Scenarios		
Description	Amount	Divest	Temporary Fix	Sustain
Expenditure Items				
Salaries	\$ 3.8	\$ 2.3	\$ 3.8	\$ 3.8
Health Care	\$ 8.4	\$ 8.4	\$ 8.4	\$ 8.4
Pension	\$ 4.0	\$ 4.0	\$ 4.0	\$ 17.5
Debt Service Principle and Interest	\$ 0.5	\$ 0.5	\$ 0.5	\$ 0.5
Operating Cost to Continue Increases	\$ 6.6	\$ -	\$ -	\$ 6.6
Restore 2018 Operating Reductions	\$ 1.9	\$ 2	\$ 1.9	\$ 1.9
Return Capital Financing to 20% Cash Goal		\$ -	\$ -	\$ 5.5
Innovation Fund		\$ -	\$ 0.5	\$ 1.0
Additional Investments		\$ -	\$ -	\$ -
Total Expense Change	\$ 25.2	\$ 17.1	\$ 19.1	\$ 45.2
Revenue Change - Lost Revenues				
Debt Service Reserve	\$ 6.6	\$ (0.4)	\$ (0.4)	\$ 6.6
Parks Parking Fees	\$ 1.6	\$ 1.6	\$ 1.6	\$ 1.6
Revenue Changes - Increased Revenue				
Property Tax	\$ (2.9)	\$ (2.9)	\$ (2.9)	\$ (2.9)
Sales Tax	\$ (1.8)	\$ (1.8)	\$ (1.8)	\$ (1.8)
VRF Increase	\$ (0.7)	\$ (0.7)	\$ (0.7)	\$ (0.7)
Unclaimed Revenue	\$ (1.3)	\$ (1.3)	\$ (1.3)	\$ (1.3)
State Shared Revenue	\$ -	\$ -	\$ -	\$ -
Other Revenue Changes	\$ (3.5)	\$ (3.5)	\$ (3.5)	\$ (3.5)
Total Revenue Change	\$ (1.9)	\$ (8.9)	\$ (8.9)	\$ (1.9)
Gap Total	\$ 23.3	\$ 8.2	\$ 10.2	\$ 43.3
Remaining Gap to Close:				
Departmental Expense Reductions		\$ 8.2		
New Revenues and/or Non-Departmental Expense Savings			\$ 10.2	\$ 43.3

Divest Option

The divest option relies on departmental budget reductions and inflationary cost containment to close the budget gap. A withdrawal from the debt service reserve is also assumed. Specifically, under this option the projected \$23.3 million gap would be closed with the following strategies:

- New salary increases to address equity issues would not be funded in 2019 for an estimated savings of \$1.5 million. The salary increase amount of \$2.3 million, shown in above chart, is solely related to the annualized value of increases approved in the 2018 budget.
- Requiring departments to absorb cost-to-continue operating increases saves an estimated \$6.6 million. This is essentially a reduction to departments because they will have to identify savings to offset inflationary increases for contracts, professional services, etc.
- Withdraw \$7 million from debt service reserve. \$7 million reflects the amount most recently projected by the Comptroller to be added to the reserve from 2017 surplus. Continued reliance on the debt service reserve to fund the operating budget gap presents a risk in the event of an emergency.
- After the above savings are realized a remaining budget gap of \$8.2 million exists. The divest option assumes this amount would be closed within departmental budgets through tax levy reduction targets. This would amount to an approximately 3% reduction to departmental tax levy, and is in addition to not funding cost-to-continue increases.

Temporary Fix

The temporary fix option aims to hold departmental budgets flat at 2018 levels with the exception of adding 1% compensation increases to address equity issues. It also withdraws funds from debt service. After taking these actions into consideration, a remaining \$10.2 million budget gap would be funded with a combination of new revenues and/or non-departmental expenditure savings to be identified in the budget process. Adding new revenues would avoid further divesting into departments. This option is referred to as a temporary fix because if these strategies are chosen to close the gap, a similar or larger budget gap can be expected next year. To summarize, under the temporary fix the projected \$22.3 million gap would be closed by:

- Requiring departments to absorb cost-to-continue operating increases saves an estimated \$6.6 million. This is essentially a reduction to departments because they will have to identify savings to offset inflationary increases for contracts, professional services, etc.
- Withdraw \$7 million from debt service reserve. \$7 million reflects the amount most recently projected by the Comptroller to be added to reserve from 2017 surplus. Continued reliance on the debt service reserve to fund the operating budget gap presents a risk in the event of an emergency.
- Adding \$500,000 to support the Innovation Fund increases the 2019 gap amount but is expected to result in efficiency savings in future years. In 2014, funds were added to support an Innovation Fund which was directed to projects that enhance operational efficiencies, reduce ongoing operating or debt service costs, and improve service delivery

and the County's long term fiscal sustainability. Financial support for the Innovation Fund has not been maintained. This option considers a cost of restoring funds for this purpose.

- The remaining gap amount of \$10.2 million would be funded with a combination of new revenues and/or non-departmental expenditure savings to be identified in the budget process.

Sustainability

The sustainability option increases the projected 2019 budget gap from \$23.3 million up to \$43.3 million, in order to make investments can be expected to benefit the long term fiscal health of the County. These cost increases include the following:

- Revising the pension investment rate of return assumption from 7.75% down to 7.0% costs an additional \$13.5 million. While this results in a higher pension cost in 2019, it reflects the assumed investment return amount recommended by the County's actuary, the Segal Group. In the long term it is expected that paying down the unfunded liability at actuarial recommended levels will result in reduced interest payments over time.
- The sustainability option adds \$5.5 million back to the capital projects fund, in order to allow the fund to return to the established 20% cash financing goal.
- Under the sustainability option, a \$1 million investment is made into the Innovation Fund. In 2014, funds were added to support an Innovation Fund which was directed to projects that enhance operational efficiencies, reduce ongoing operating or debt service costs, and improve service delivery and the County's long term fiscal sustainability. Financial support for the Innovation Fund has not been maintained. This option considers a cost of restoring funds for this purpose.
- Unlike the divest and temporary fix options, the sustainably scenario adds funding to department budgets for inflationary costs-to-continue at current service levels. Additionally, the sustainability option would not rely on use of the debt service reserve to balance the operating budget.

These sustainability option changes would result in a \$43.3 million budget gap to be filled for 2019. While this is a significant increase in the gap, it reflects the cost of current services, provides funds needed for deferred capital projects, and funds the pension liability at recommended levels. The sustain option assumes this gap would need to be closed primarily with new revenues rather than reducing expenses and would not further divest in programs.

Given the magnitude of this ongoing funding challenge, the Department of Administrative Services – Office of Performance, Strategy and Budget recommends that the County Board continues to work with the County Executive to focus on long term fiscal sustainability.

NEXT STEPS: 2019 Budget Process

Resolving the 2019 budget gap will be done through the budget process which takes place through the following timeline:

- **April-June** – Departments develop their budget requests
- **May** – Presentation of Budget Gap and Structural Deficit to County Board
- **June-September** – Follow up with County Board on Budget Gap and Structural Deficit
- **July** – Departments submit their budget requests to the Office of Performance, Strategy, and Budget
- **August-September** – County Executive works with DAS-PSB and departments to finalize the County Executive Recommended Budget
- **October-November** – The Finance and Audit Committee reviews and requests information on the Recommended Budget
- **November** – The County Board adopts the 2018 budget
- **December** – DAS-PSB and the Comptroller's Office work to implement the 2018 budget.

RECOMMENDATION

This report is for information purposes only. No action is required. The administration looks forward to working with the Board to develop a long term financial sustainability plan for the County.



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