

# VACANCY SAVINGS/PERSONAL SERVICES BUDGETING STUDY

A Report Prepared for the

## **Legislative Finance Committee**

by

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May 30, 2002

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## **EXECUTIVE SUMMARY**

As required in HB 2 and under the direction of the Legislative Finance Committee, the Legislative Fiscal Division has completed a study of vacancy savings and personal services budgeting. Although the two topics are interrelated in practice, the report that follows looks at them as separate topics. Vacancy savings is just one budgeting tool while personal services budgeting refers to the broader subject of budgeting in general.

Vacancy savings as a budgeting tool is a rather mundane topic but it is in fact an effective and often times realistic method for budget development and budgetary control. Many states apply vacancy savings and there are various ways in which it can be estimated and applied. This report discusses the pros and cons of vacancy savings, describes some variations that can be considered, and concludes that a fair, easy to implement methodology is similar to the current methodology, but would exempt the cost of 20 FTE from the calculations for each agency. This would somewhat “level the playing field” for agencies, big and small. The Legislative Finance Committee is being asked to consider the options and make a recommendation to the executive for a methodology that will work for both the Governor’s Executive Budget submission and for legislative budget deliberations.

Personal services budgeting in Montana state government has been a source of concern for legislators for a long time. The current process applies an incremental budgeting approach that is tedious as a process but, in the end, does not offer the legislature much control over growth of personal services costs. For example, management decisions for promotions and position upgrades are automatically built into the base budget without even a cursory review by the legislature. Many increases are approved directly by the legislature, but the accumulative impact of various measures or increments are not easily determined until after the money is appropriated and spent. The result is an average annual growth in personal services costs of 4.5 percent over a ten year period while pay plan (cost of living) increases approved by the legislature averaged 2.7 percent (annual average) over the same period. State employee health insurance increases added another 0.3 percent. The point is that besides cost of living inflation, there are other forces at work that cause the cost of personal services to increase, some that the legislature controls and some that they do not control.

The report discusses the current methodology by describing the process steps and comparing the current budgeting process to alternative philosophies. Pros and cons of the current process are listed. The report goes on to propose an alternative approach (lump-sum budgeting) that reduces the detailed structure, and focuses budget development on discussions of legislative policy and prescribed outcomes for each agency and program. While not a performance-based option, the proposed alternative does encourage more dialogue regarding performance issues, besides putting all decisions regarding the funding of personal services increases in the hands of the legislature.

The report ends with two options: 1) Stay with the current methodology, or 2) implement the lump-sum budgeting alternative.

## INTRODUCTION

For many years, the legislature has budgeted for personal services through a methodology that includes detailed information on each position (FTE or full-time equivalent). Historically, the total personal services budget in the state budget is the sum of the costs of all individual positions, with a reduction for anticipated vacancy savings. Over the years, legislators have expressed concern over the use of vacancy savings for various reasons. As a result, the 2001 legislature directed the Legislative Finance Committee (LFC) through the resources of the Legislative Fiscal Division (LFD) to study this methodology and to consider alternatives for funding personal services. This document is the final report of that study.

### HB 2 REQUIREMENT

The following is the language adopted in House Bill 2 (page BP-2) of the 2001 Legislature, which provides the requirement for this study:

*Section 8. Vacancy savings analysis. The legislature is concerned about the use of the concept of vacancy savings in establishing funding for personal services. It is the intent of the legislature that an analysis of vacancy savings be completed prior to the 2003 legislative session to include the consideration of alternative options for funding of personal services at an appropriate level. The legislative finance committee is requested to include this analysis as part of the House Bill No. 613 personal services study if House Bill No. 613 is passed and approved or to include the analysis in the committee work plan for the legislative fiscal division. The legislative finance committee is encouraged to work cooperatively with the governor's budget director in completing this analysis.*

House Bill 613 did not pass; therefore, the study has been incorporated into the 2001-2002 interim work plan of the LFD.

### CONCERNS OF THE LEGISLATURE

Legislators are concerned about the way the state budgets for personal services. The following is a summary of those concerns:

- There is a lack of understanding of the concept of vacancy savings. It is manifested in concerns that individual agencies are adversely affected by what is perceived as an under-funding of the FTE that may very well occur if the agency does not experience the level of vacancy savings that is anticipated in the budget. While an anticipated level of vacancy saving is likely realized in the aggregate (across all agencies), some individual agencies might not experience the position vacancies that allow them to manage within the amount appropriated for personal services. On the other hand, some agencies might gain a funding advantage relative to other agencies because of a higher than average turnover rate. This has been addressed in recent years with the use of a contingency pool.

- The cost of personal services from one biennium to the next continues to grow at rates that usually exceed inflationary trends. Personal services has increased at an average annual rate of 4.5 percent over the past 5 biennia while the pay plan increases have averaged 2.7 percent, with increases in state employee health insurance adding another 0.3 percent. This growth in personal services is the result of factors such as promotions, upgrades, addition of positions, etc. For example, if an agency obtains approval of an upgrade for a class of employees, it can fund it in the current year by using existing funds, but it is then built into the base for future biennia. There is an expectation that the movement of agency personnel management toward “broadbanding” will have similar impacts.
- Agency personnel spend time and effort adjusting positions solely because of the budgeting method and budgeting and control requirements. Once the cost of an upgrade or promotion is built into the base, it is there to stay.
- The legislature’s control over the size and composition of state government is limited by the current methodology for personal services budgeting. For example, the executive branch makes decisions (through an established review process) on promotion, upgrades or broadbanding and once the impact is in the base budget, it is automatically funded under the current methodology. The bottom line is that, under current methodology, the legislature picks up the tab for all management actions that increase personal services costs. The legislature must have the opportunity to exercise appropriate public policy oversight over this significant component (personal services) of the cost of state government.
- There is a desire to focus personal services budgeting more on what it will take to achieve certain outcomes rather than on a set number of current FTE.

This report addresses each of these concerns in options offered for consideration.

## **SCOPE OF STUDY**

The scope of this study of personal services budgeting methodology is driven primarily by the known and perceived problems identified by legislators. This report is a compilation of those issues and contains three parts: 1) an analysis of vacancy savings; 2) a discussion of current personal services budgeting methodology; and 3) a discussion of an alternative “lump sum” budgeting concept. The assumption from the beginning was that the final outcome could be a budgeting methodology that represents the status quo, the lump-sum concept, or something in-between those options. Part 1 and Part 3 of this report end with some options for implementation that the LFC and ultimately the legislature might consider.

## PART 1 - VACANCY SAVINGS

The purpose of Part 1 is to provide background information regarding the use of vacancy savings as a budgeting tool and to provide the legislature with some examples for applying the concept of vacancy savings. The goal is to provide an understanding of vacancy savings along with options that might mitigate some, if not all, of the concerns that have been raised concerning the use of vacancy savings.

Vacancy savings is the difference between the full-appropriated cost and the actual cost of authorized employee positions during a budget period. Since 1979, the legislature has periodically applied a vacancy savings factor to agency budgets in recognition of the fact that staff turnover and vacancies often result in personal services expenditures lower than the amounts appropriated.

### DETERMINING THE PERCENT OF VACANCY SAVINGS

Over the years, the percent of vacancy savings applied to the personal services budgets has varied. The percent that is used is generally a product of how much savings is needed to help balance the budget along with a consideration of what is considered realistic for agencies to achieve, either through normal turnover or by forcing savings by leaving positions open longer. Typically, a proposal of vacancy savings is included in the Executive Budget, but the legislature makes the final decision as to the level of vacancy savings to be applied. For example, the Executive Budget might include a 3 percent vacancy savings, but the legislature could adopt a budget that applies a higher or lower vacancy savings percent. To put this budgeting tool into perspective, total budget reductions, resulting from applying 4 percent vacancy savings for the 2003 biennium, amounted to about \$19.0 million general fund and \$23.1 million other funds over the 2003 biennium.

### CONTINGENCY FUNDS

Vacancy savings are assessed against personal services budgets on the assumption that actual vacancy savings will be sufficient to cover the reduction. Sometimes, agencies don't generate enough actual vacancy savings, resulting in a shortfall in the personal services budget. This shortfall can occur because of: 1) insufficient turnover; 2) the need for filling a position at the same or at a higher grade; 3) the need to hire the replacement early to allow for

Figure 1  
Personal Services Contingency Funds Allocated  
1995 Biennium to 2003 Biennium

Biennium	Fund Source	Authorized	Allocated to Agencies
2003	General Fund	\$ 1,300,000	(1)
	Other Funds	3,000,000	(1)
2001	General Fund	700,000	386,586
	Other Funds	950,000	198,121
1999	General Fund	2,246,554	1,926,305
	Other Funds	8,801,803	147,674
1997	General Fund	500,000	387,350
	Other Funds	1,000,000	765,715
1995	General Fund	982,131	881,631
	Other Funds	2,748,300	2,556,268

(1) Note: Current biennium - none allocated as of 4/11/02

training; 4) sizable termination payouts; or 5) upgrades and promotions.

In order to assist agencies that have insufficient authority to meet all personal services costs, the legislature has in recent years provided a contingency fund. The amount of funds authorized varies as is evident in Figure 1 (previous page), which also shows the amount allocated to agencies each biennium. The legislature, however, has not reviewed the reasons for which the contingency moneys are used, including the circumstances that cause an agency to experience a shortfall in their personal services budget.

## **RECENT HISTORY OF VACANCY SAVINGS APPLIED IN STATE BUDGET**

During the 1997 biennium, the legislature included varying vacancy savings rates among selected agencies, and among programs within agencies, in order to fund the executive pay plan. A contingency fund containing \$500,000 general fund and \$1,000,000 in other funds was included for agencies that could not meet vacancy savings targets.

During the 1999 biennium, the legislature applied a uniform 3 percent vacancy savings rate against all positions in state government, with the exception of those positions in agencies with fewer than 20 FTE. The legislature also assumed that any new positions added via new proposals would not be hired at the very beginning of the fiscal year as a result of the need to recruit and to meet other requirements demanding the expenditure of time. Operating under the assumption that such positions would not be filled for the first three months of the fiscal year, the legislature applied a 25 percent vacancy savings rate in the first year. The legislature also provided \$2.2 million general fund and \$8.8 million in other funds for the biennium in support of a contingency pool for those agencies that could not meet their vacancy savings targets.

For the 2001 biennium, the legislature adopted a vacancy savings rate of 3 percent on all personal services except insurance. This rate was not applied to agencies with fewer than 20 FTE, elected officials, or to direct care workers within the Department of Corrections. The legislature funded a contingency pool of \$700,000 from the general fund and \$950,000 in other funding for the biennium.

For the 2003 biennium, the legislature established a 4 percent vacancy savings rate on all personal services, including insurance, for most agencies and programs. As in the 2001 biennium, agencies with fewer than 20.0 FTE (with the exception of the Board of Crime Control, which, due to a reorganization, was reduced to fewer than 20.0 FTE during the legislative session) as well as university system faculty are exempt. In addition, the legislature adopted lower rates on certain agencies and higher rates on other programs. The legislature also included a contingency fund of \$1.3 million general fund and \$3.0 million from other funds for the biennium to meet potential costs involved for those executive and judicial agencies that do not meet vacancy savings targets, and an additional \$200,000 general fund for the legislative branch.



## **VACANCY SAVINGS AS A BUDGETING TOOL (SEEKING REALITY) VERSUS A BUDGET-BALANCING TOOL (CUTTING COSTS)**

There is little to be analyzed concerning the use of vacancy savings as a budgeting tool. It is fairly straightforward in its application. It really comes down to three things: 1) whether the legislature wants to apply vacancy savings; 2) why vacancy savings is applied; and 3) to what degree?

The first and third questions are quite simple. Some states do and some states don't use vacancy savings, and the amount or percent of reduction is at the legislature's discretion. Of course, this is complicated by the fact that it is difficult to identify a "natural" vacancy savings by agency or even statewide. The level of vacancy savings applied is usually based upon other considerations. Also, most of the consequences for individual agencies are not apparent to the legislature when the budget is being set.

The second question implies that there are different motives for using vacancy savings. There may be. One person might argue that vacancy saving is a budgeting tool designed to allow policy makers to adjust the personal services budget down to address the reality that vacancies occur and agencies would not otherwise spend their full personal services allotment. Another person might argue that vacancy savings is a budget-balancing tool allowing policy makers a way to reduce costs and place the burden of managing to available dollars on the agency managers. In actuality, vacancy savings is probably both.

### **PROS AND CONS OF USING VACANCY SAVINGS**

The following is a list of pros and cons for using vacancy savings as a budgeting tool:

#### **Pros:**

- Logical to assume that agencies will experience such savings because turnover occurs and it takes time to hire replacements.
- Useful and commonly used budgeting tool (and for balancing the budget).
- Can be applied across-the-board, so it spreads impact to all agencies.
- Dollars saved by applying vacancy savings can be used to fund other priority programs or reduce overall revenue required to fund government.
- When used with the contingency fund concept, can be applied without serious consequences to most agencies.
- Can result in significant reductions in the amount appropriated for personal services, which probably better reflect the actual costs of personal services.
- The application of vacancy savings limits the diversion of savings in salaries to other expenditure categories.

#### **Cons:**

- Vacancies do not occur at the same level in all agencies and an agency might experience significant turnover in one year but not in another. Smaller agencies are often less able to absorb vacancy savings. There is no guarantee that the historical trends are an accurate predictor of future experience.

- Agencies sometimes must leave positions vacant longer in order to generate the vacancy savings that is anticipated by the reduction. In this sense, vacancy savings have a way of become a self-fulfilling prophecy. It is difficult to manage personnel budgets at institutions (which require staff 24 hours a day, 7 days per week) when vacancy savings are imposed. For example, there are some positions, such as correctional officers, which cannot be left open. If left open, the post has to be filled by paying overtime to another correctional officer to cover that shift. When these employees make up a significant portion of an agency's personal services budget, the agency is placed in a very tough position if it has to generate 3-4 percent in vacancy savings. This can adversely impact a program, reducing government services and spreading workload to other staff. Shifting the impacts of vacancy savings to other staff or to other parts of the budget may result in the agency forgoing other activities or services which may be a less desirable policy option had the legislature been given the choice upfront.
- The rate of vacancy savings is often times established by the executive or the legislature to achieve a desired result in budgeting.
- Vacancy savings may not be realized when large sick leave or annual leave payouts are necessary.
- Agencies that do not experience vacancies anticipated by the reductions can be adversely affected if sufficient contingency funds are not made available. Conversely, agencies that typically experience heavier turnover may have a funding advantage.
- There are inequities in current practices; i.e., an agency with 20 FTE would be exempted and an agency with 21 would have vacancy savings applied.
- Vacancy savings may lead to budget requests for new FTE.
- The imposition and implementation of vacancy savings can mask issues that result in high agency turnover, such as low pay, high work stress, or inadequate staffing levels.

## **OPTIONS FOR APPLYING VACANCY SAVINGS REDUCTIONS**

This section contains options for the use of vacancy savings in personal services budgeting. Later in this report is a discussion of a concept of “lump-sum” budgeting of personal services. Vacancy savings is likely inherent in a lump-sum budget methodology although it probably would not be a visible component after the first biennium. If the committee chooses to not pursue lump sum budgeting, then vacancy savings options would certainly apply to the current personal services budgeting methodology.

As part of this study, other states were contacted (a summary of state responses is included in Appendix A). The following are six options, gleaned from Montana experience and other states, which the LFC might consider recommending regarding the use of vacancy savings as a budget tool.

- 1) Do not apply vacancy savings.
- 2) Status Quo – Global Application of Reduction to Personal Services Budgets, exempting small agencies (20 or less FTE). A variation of this option would

exempt certain positions for some reason, such as prison or institution positions that require 7 day, 24 hour per day coverage of duties.

- 3) Exempt First 20 FTE of Every Agency from Reduction. This is suggested by OBPP as a way to level the playing field for agencies of varying size. As opposed to selecting 20 specific FTE, 20 FTE at an average cost could be exempted from the calculation.
- 4) Vary Vacancy Savings Percent by Agency Experience (base year or average of 3 years). Agency experience is not very easy to determine with existing data. There may need to be some rules established concerning how agencies maintain position control information in SABHRS.
- 5) Vary Vacancy Savings Percent by Agency Size (based upon FTE or budget). A sliding scale of vacancy savings rates would be applied, the theory being that the larger the agency, the more flexibility it has for absorbing a reduction. For example:

<u>Number of FTE</u>	<u>Vacancy Savings Rate</u>
0 – 20 FTE	0.0%
21 - 50	1.0%
51 – 100	2.0%
101 – 500	3.0%
501 and greater	4.0%

or

<u>Personal Services Budget</u>	<u>Vacancy Savings Rate</u>
Less than \$500,000	0.5%
\$500,000 - \$1,000,000	1.0%
\$1,000,000 - \$2,000,000	2.0%
\$2,000,000 - \$3,000,000	3.0%
\$3,000,000 and up	4.0%

With this option, adjustments might need to be considered for agencies with programs requiring 7 day, 24 hour per day coverage of duties.

- 6) Periodic Reversions of Vacancy Savings Amounts. This would involve tracking the vacancy savings as it occurs through the year and periodically (monthly, quarterly, etc.) reducing the agencies’ budgets by the amount of savings. In some states, this reversion is transferred to a central pool account possibly for some specific purpose (e.g., a contingency pool). A methodology for tracking vacancy savings would need to be developed.

### What Choices Does the Legislature Have?

Comparing the options to the “pros and cons” of using vacancy savings can assist the committee in coming to a conclusion. When considered relative to the negative points (see “cons” beginning on page 7), most of the options have little impact on those concerns. Certainly, the first option of not applying vacancy savings would eliminate the “cons” but it would ignore the positive reasons for using vacancy savings as a budgeting

tool in the first place. All other options are supported by the positive points (“pros”, listed on page 7).

The key considerations for options 2 through 6 would relate to finding a methodology that addresses the negative points to at least some degree: That methodology should:

- be relatively easy to implement,
- be as equitable to all agencies as it can be,
- mitigate the unpredictability of the level of vacancy savings that occurs in an agency, and
- allow the legislature to retain some control over personal services expenditures.

The following is an assessment by this staff of the options based upon these considerations:

1. Options 2 and 3 would be easiest to implement. Option 4 and 6 would be the most difficult to implement because of the need for ongoing analysis. Option 5 would require some extra effort for the Office of Budget and Program Planning (OBPP) or LFD analysts to determine the appropriate factor to apply and might cause some confusion among legislators seeing varying rates of vacancy savings.
2. Option 6 probably offers the most equity because the savings is recouped after the fact. Option 3 is second as it levels the playing field to some degree for small agencies at least. Options 4 and 5 would provide additional equity in a perfect world but this is offset by the unpredictability of actual vacancy savings.
3. Option 6 is the only option that removes the prediction factor as it addresses vacancy savings after it has occurred. However, use of a contingency pool (as has occurred for the last several years) in tandem with Options 2 through 5 is intended as a tool for offsetting the unpredictability of vacancy savings. It is important to realize that the use of Option 6 results in the amount of vacancy savings not being available to the legislature to immediately appropriate for other priority purposes.
4. Options 2 through 5 allow the legislature to retain some control of personal services expenditures because the legislature sets a level of vacancy savings before agencies begin to spend and agencies therefore must manage to that appropriated level. Under Option 6, the legislature loses some control because agencies can attempt to spend potential vacancy savings before it is reverted. On the other hand, Option 6 limits an agency’s ability to fund an unforeseen emergency expense.

Based upon this assessment, Option 3, with a contingency pool, offers an easily implemented and fairer methodology than the most recently applied methodology, while allowing the legislature to retain a similar degree of control.

## **PART 2 - PERSONAL SERVICES BUDGETING CURRENT PRACTICE**

### **ANALYZING THE CURRENT PROCESS**

State budgeting requirements are outlined in Title 17, chapter 7 of MCA. While statute does not specifically provide a preferred method for calculating the state's personal services budget, it does require that the executive's budget plan include aggregate FTE positions along with all budget data.

As stated on page 4 of this report, legislator concerns with the current process include:

- Agency personnel spend time and effort adjusting positions solely because of the budgeting method and budgeting and control requirements.
- The legislature's control over the size and composition of state government is limited by the current methodology for personal services budgeting. Under current methodology, the legislature picks up the tab for all management actions that increase personal services costs.

Therefore, we start by looking at the current process used to calculate the personal services budget (and subsequent legislative modifications) to illustrate exactly why these are legitimate concerns.

### **Calculating the Starting Point, or the 'Adjusted Base'**

The base for personal services expenditures includes all actual personal services expenditures during the base fiscal year for House Bill 2 appropriations, minus any one-time-only (OTO) appropriations. However, most commonly, the 'adjusted base' is used as the starting point for the personal services budget. Therefore, most of the discussion will center on calculating the adjusted base, and the changes that are automatically included in that figure.

Calculating the proposed budget for personal services starts with a "snapshot" of FTE during the base fiscal year. This snapshot is simply a recording of existing FTE and all related data at a certain point in time. For the purposes of creating the budget, this data includes occupied (filled) and vacant positions but only FTE whose authorizations are tied to House Bill 2, proprietary, or statutory appropriations are included in the snapshot. Therefore, no modified (added after legislative approval of budget) FTE are included. Additionally, FTE attached to OTO appropriations are removed from the recorded data. For the upcoming budget cycle, the snapshot will be recorded as of fiscal 2002.

In preparation for the snapshot, agencies must spend time ensuring the accuracy of all position data. Included in the data is all pertinent position and personnel information, including pay plan, salary, grade, workers' compensation code, time in service, and benefits information. For positions vacant at the time, default data (i.e., entry-level salary, longevity of zero years) is used where needed.

When all data is set for each FTE, and the database has been ‘scrubbed’ of all FTE not allowed in the base budget, adjustments for pay plan and longevity increases in the second year of the base biennium are made to each position’s salary where appropriate. At this point, the full cost of each FTE (not including any proposed pay plan adjustments for the upcoming biennium) is calculated. This number constitutes the adjusted base budget for personal services. The difference between the base and the adjusted base is added to the budget as part of the “state-wide present law adjustments” made by OBPP. Any proposed vacancy savings are also added at this time as a separate statewide present law adjustment.

### **The Final Executive Budget and Subsequent Legislative Changes**

Subsequently, any changes to the adjusted base for personal services are included in the budget request as a decision package. Decision packages may or may not include FTE information, depending on the change desired. However, the common requests include the addition or removal of FTE along with the associated monetary change to the budget. During the 2001 legislative session, the preferred method of dealing with these common requests was to have the legislature specify the number of FTE included in a change, and then let the legislative budgeting system calculate the actual monetary amounts. Applying a vacancy savings reduction is a final step for the development of the executive budget, but it can be modified as the process continues in the legislative deliberations.

From this discussion, it is clear that the legislature often has no oversight (and therefore little control) over the management decisions during the interim that drive increased personal services costs in future biennia. A useful alternative may provide the legislature with some measure of oversight and control over these increases.

### **DIFFERING PHILOSOPHIES**

Also noted in the legislator concerns on page 4 was “a desire to focus personal services budgeting more on what it will take to achieve certain outcomes rather than on a set number of current FTE.” It is obvious that various philosophical approaches can be taken when budget-building. To fully understand how our current process differs from other approaches, it would be useful to compare various philosophies that represent aspects of our current process.

#### **Decision Making: Micro- vs. Macro-level**

When making funding decisions, the approach taken can range from the micro- to the macro-levels. Our current method of budgeting for personal services most often resembles the micro-level approach. Budget decisions focus on the specifics of each FTE, i.e. grade, pay plan, and salary, and the affects on a specific program or division. Discussion and decisions often do not clearly tie each modification to the overall outcomes or goals of the agency. Therefore, each decision is made on the narrow context of the effect on the immediate budget/function of the agency.

Another approach would require that agency goals be defined first, which would then help drive determination of the budget. In this instance, each FTE or group of FTEs

would be analyzed in the broad context of its contribution to agency outcomes, and the resulting affect on public policy.

### Process Driven vs. Policy Driven

A budget is a strong policy tool. It is as important to sculpting public policy as any other tool possessed by the executive or the legislature. With that in mind, it is interesting to examine the relationship between policy-making and budget-making.

Our current process for calculating personal services budgets is primarily process-driven. State accounting and budget systems are used to build the personal services adjusted base budget based on the input of specific personnel data. Modifications can take the form of lump-sum adjustments or adjustments based on data for a specific position. Subsequently, it can be argued that the current method used to build and modify the budget often results in the system and process driving the budget calculation, and therefore, public policy decisions.

In contrast, another approach would emphasize making the public policy decisions first, and then modifying the budget to best fit those decisions. Agency goals, objectives, and performance measures would be used during the budgeting process to ensure that budget decisions consider the public policy implications.

### Input/Output Oriented vs. Outcome Oriented

The relationship between budgeting and policy sometimes takes on a ‘chicken or the egg’ quality, as in “which should come first?” The answer, in reality, is both are inter-related. However, the initial approach to building a budget can vary widely.

Our personal services budgeting process tends to place primary emphasis on aspects of the budget, versus the corresponding review of agency performance and desired outcomes. Currently, agency outputs during the base year are used as the starting point for the upcoming budget. Therefore, the focus tends to be on inputs and outputs instead of outcomes or agency performance.

Generally, under our current process, once the base and adjusted base budgets are built, the agency’s goals are tailored towards what they can accomplish within the budget, or goals are so generic that performance is not measurable.

Conversely, decision-makers could focus first on agency goals. Figure 2 on the following page presents one example of a policy-based, outcome-oriented approach. In this approach, the creation of strategic plans would be seen as the vital first step to determining an agency budget. Individual agency performance plans would be a necessary part of the statewide performance plan, which would tie directly to the statewide budget. Therefore, the focus is on outcomes, or agency performance, with the inputs (budget) and outputs (specific tasks/functions) being tailored to meet agency goals.

Figure 2

**The Federal Example**

The June 1996 General Accounting Office (GAO) report, titled “Executive Guide – Effectively Implementing the Government Performance and Results Act,” contains several insights to the possible future of governmental budgeting and performance measuring. Specifically:

*“Today’s environment is results-oriented. Congress, the executive branch, and the public are beginning to hold agencies accountable less for inputs and outputs than for outcomes, by which is meant the results of government programs as measured by the differences they make, for example, in the economy or program participants’ lives.”*

Additionally, the report explains the difference between outputs and outcomes:

*“A federal employment training program can report on the number of participants. That number is an output. Or it can report on the changes in the real wages of its graduates. That number is an outcome. The difference between the two measures is the key to understanding government performance in a results-oriented environment.”*

But even if performance outcomes are important for measuring success, how does this tie to budgeting? The GAO reported that among other directives, the Government Performance and Results Act of 1993 (GPRA) required agencies to develop strategic plans covering at least five years and, starting in fiscal year 1999, submit an annual performance plan to OMB. Subsequently, OMB is to incorporate the individual performance plans into an overall federal government performance plan to be submitted annually to Congress with the president’s budget. Clearly, each agency’s individual goals are to be used in developing the budget for that agency.

**ANALYZING THE HISTORICAL GROWTH OF PERSONAL SERVICES**

One of the major concerns noted by legislators (listed on pages 3 and 4) is that “the cost of personal services from one biennium to the next continues to grow at rates that usually exceed inflationary trends.” While this statement in itself is true, it is necessary to take a detailed look into those figures to effectively determine where improvements may be made.

**Features of Personnel Management that Impact Budget Development**

There are activities related to personnel management that can put a strain on an agency personal services budget. Historically, promotions and reclassification upgrades will increase costs in the biennium in which they occur for an obvious reason – they cost more. Pay plans, group insurance plans, longevity increases, increased need for overtime, and other features have definite impact on the development of the budget. In the next section of this report, several of these features are discussed in the context of what causes the personal services budget to increase.

The jury is still out on the impact that implementation of the new “broadband” pay plan might have. It has begun to be implemented in the past few years. Because it offers some flexibility to managers, there is sometimes concern that it might result in increases to personal services costs beyond traditional pay plan increases. Broadband pay plans are the subject of a separate report being prepared for the LFC.



## Components of Personal Services Increases

The fact that the cost of personal services increases every year is clear. This section discusses the increases in greater detail to provide an understanding of what causes the growth in personal services and to what extent the legislature can control that growth. To begin this discussion, we looked at the increases that occurred from one biennium to the next. The 1999 biennium and 2001 biennium are chosen because they are the most recent completed biennia for which actual expenditures are available. Actual expenditures (excluding the university system and including only general fund, state special revenue funds, federal funds and proprietary funds) increased by \$121.8 million (14.5 percent) from the 1999 biennium to the 2001 biennium. Figure 3 shows in more detail the components of this increase. The data used in this analysis does not lend itself easily to a specific breakdown of increases, so it should be stated that the amount shown for each component is only an estimate.

Figure 3 Components of Personal Services Increase A Comparison of Actual GF, SSR, FF, and PF Expenditures 1999 Biennium to 2001 Biennium (Dollars in Millions)		
Description	Amount	Comments
Pay plan cost of living increases	\$38.7	The legislature approved a 3 percent increase for each year of the 2001 biennium, implemented Oct. 1 <sup>st</sup> of each fiscal year.
Pay plan insurance state share	\$3.9	The legislature approved increases of \$15 per month as of 1/1/00 and another \$10 per month as of 1/1/01 for the state share of employee health insurance.
Annualization of Pay Plan of Previous Biennium	\$20.8 *	Because implementation of the pay plan was delayed for the 1999 biennium, there are additional costs to fund those increases in the following biennium.
Longevity increase	\$2.7	The legislature approved an increase in the amount allowed for longevity increases for state employees.
Promotions and reclassifications	\$4.6 *	Promotions and reclassifications occur in the course of agency operation under authority given by the legislature to the executive branch.
Positions added in HB 2	\$9.2	Spending authority for 192 FTE was authorized by the legislature in HB 2.
Positions added that are not authorized in HB 2	\$26.1	Spending authority for 545 FTE was added in the 2001 biennium beyond what was added by HB 2. These additional FTE resulted from "cat & dog" legislation, budget amendments, statutory appropriations, proprietary operations, and other administrative actions. Positions not authorized in HB 2 or other legislation go away at the end of fiscal year. Such positions can be reestablished in the subsequent years as long as funding is available.
Overtime increases	\$11.7	Overtime is a "zero-base" item with authority provided each session by the legislature. In the 2001 biennium, there was a higher occurrence of this type of pay than in the 1999 biennium.
Differential increase	\$0.7	Differential pay is a "zero-base" item with authority provided each session by the legislature. An incremental hourly rate is determined to compensate the individual for time worked in a somehow unique or higher paid role. In the 2001 biennium, there was a higher occurrence of this type of pay than in the 1999 biennium.

Termination pay	\$3.0	Payouts of annual leave, sick leave, or comp. time balances to retiring or terminating employees is a normal expense but the 2001 biennium saw an increase in this expense. These costs are paid from existing authority unless a specific request is made for consideration by the legislature.
Compensatory time payout	\$0.9	Compensatory time payouts occur in instances in which an employee cannot possibly use the time. They are allowed in instances where funding is available to cover the expense of this action. The 2001 biennium saw an increase in this expense over the 1999 biennium.
Workers compensation	(\$2.6)	The cost of workers' compensation insurance coverage for state agencies decreased from 1999 biennium to 2001 biennium.
Other	\$2.1	Increases occurred in other expenditure categories, including inmate pay, non-salary compensation, and miscellaneous benefits.
<b>TOTAL</b>	<b>\$121.8</b>	(Excludes university system and includes only general fund, state special revenue funds, federal funds and proprietary funds.)

*\* Note: The amounts with asterisk (\*) indicate items that are included in the "statewide present law adjustments" in the budget analysis presented to the legislature. In addition to these items, the statewide present law adjustments include a restoration of vacancy savings applied in the previous biennium, although typically a similar factor is applied as a reduction in the next budget.*

This analysis does not focus on the general fund costs for personal services but an observation is appropriate at this point in the discussion. Of the \$121.8 million increase shown above, \$64.4 million, or about 52.9 percent, is general fund. Of the total funds (GF, SSR, FF, and PF) spent on personal services in the 2001 biennium, 36.7 percent was general fund, while for the 1999 biennium, general fund was 34.3 percent of the total. These percentages indicate that the general fund share of the total increased at a greater rate than the four funding sources combined in the 2001 biennium. In fact, actual personal services costs for the four funding sources increased by 14.5 percent and the general fund portion alone increased by 22.4 percent.

Appendix B provides additional discussion regarding some of the items shown in Figure 3 above.

### 10-year Comparison of Personal Services

An analysis was done of ten years (1992-2001) of actual expenditures. The detailed results can be found in Appendix C at the end of this report. This analysis looked at expenditures from the general fund, state special revenue fund, federal fund, and proprietary fund. The university system was excluded. The average growth in personal services costs over the 10 years was 4.5 percent, while at the same time, expenditures for operating budgets overall (personal services, operating, and equipment) grew at an average of 5.6 percent. To some degree, personal services growth is likely shown lower because of a shift of some personal services to contracted services, resulting in the higher growth in operating budgets. Regardless, the 4.5 percent growth is considerably higher than the 2.7 percent (3.0 percent if health insurance increases are included) average pay plan increase over the same period. Over the last five years (1997-2001), the growth in personal services costs averaged 5.8 percent while operating budgets increased at an annual average of 5.2 percent.

For further discussion of the 10-year comparison analysis, see Appendix C.

## **PROS AND CONS OF THE CURRENT PERSONAL SERVICES BUDGET PROCESS**

Given the above analysis of our current process for budgeting personal services, staff has defined the pros and cons of our current process below. Every attempt was made to keep the list objective. Therefore, variations of certain aspects of the process may show up in both parts of the list.

### **Pros:**

- Using the detailed approach, there is a better understanding of what makes up the personal services portion of the budget. Agencies have a clear picture of what positions make up their base.
- Since the FTE is not budgeted (only the dollars), the process retains some flexibility for agencies in managing their personal services budget.
- A clearly defined base allows a ‘reasonable’ starting point for budget deliberations.
- Identifying base positions ensures a starting point equal to that approved by legislature for prior biennium.
- Full funding (neglecting vacancy savings) of positions in the adjusted base provides agencies ‘what they need’ vs. ‘what they spent’.
- Approving each modification in a decision package ensures legislative oversight of agency changes.

### **Cons:**

- Decision-making focus is on details and the process rather than broader policy issues, including tying the budget to agency goals and objectives.
- Discourages innovative change by using what was spent/accomplished in base year as a starting point for budget deliberations, with a positive vote necessary to change from that starting point.
- Process can be cumbersome technically, due to the detail needed to make changes to the budget.
- Tying of funding to specific FTE/grades can, at least conceptually, limit agency flexibility in personnel structure.
- Agencies spend time and resources making technical changes to conform to the legislatively assumed FTE levels for budgeting purposes.
- Agencies can adjust position data/salaries throughout the year. These changes are consequently automatically included in the “snapshot”. As a result, the legislature does not have the opportunity to discuss many of the policy changes and decisions.
- Across the board cuts are often implemented without a corresponding review of agency goals, objectives, and performance measures.

In summary, our current process for calculating and determining personal services budgets has resulted in legislative concerns over its effectiveness. The process is very technically complex, and may limit the legislature’s ability to focus on policy and

outcome oriented decision-making. Additionally, although it has positive aspects, the process has several negatives, which could be considered arguments for an alternative method for budgeting personal services. Therefore, the next part of this report will provide a discussion of such an alternative.

## **PART 3 - PERSONAL SERVICES BUDGETING ALTERNATIVE**

Identifying an alternative for consideration is difficult, since there are many facets of the current process that could be altered. Therefore, to narrow the discussion, criteria were set for identifying and analyzing an alternative. These criteria are:

- The alternative should promote legislative review of all funding increases.
- The alternative should support the policy-oriented philosophy discussed in the section titled “Differing Philosophies.”
- The alternative should address most/all of the negatives associated with the current process.

Using these criteria and examples provided by other states, a ‘lump-sum’ concept of budgeting was chosen as the alternative to be analyzed and presented to the legislature for consideration. This methodology for funding personal services can (at least partially) satisfy all of the criteria, although successful transition, along with a corresponding move to policy-based, outcome-oriented decision making, will require changes to the state’s current processes for determining goals, setting standards, and measuring performance.

### **DEFINITION**

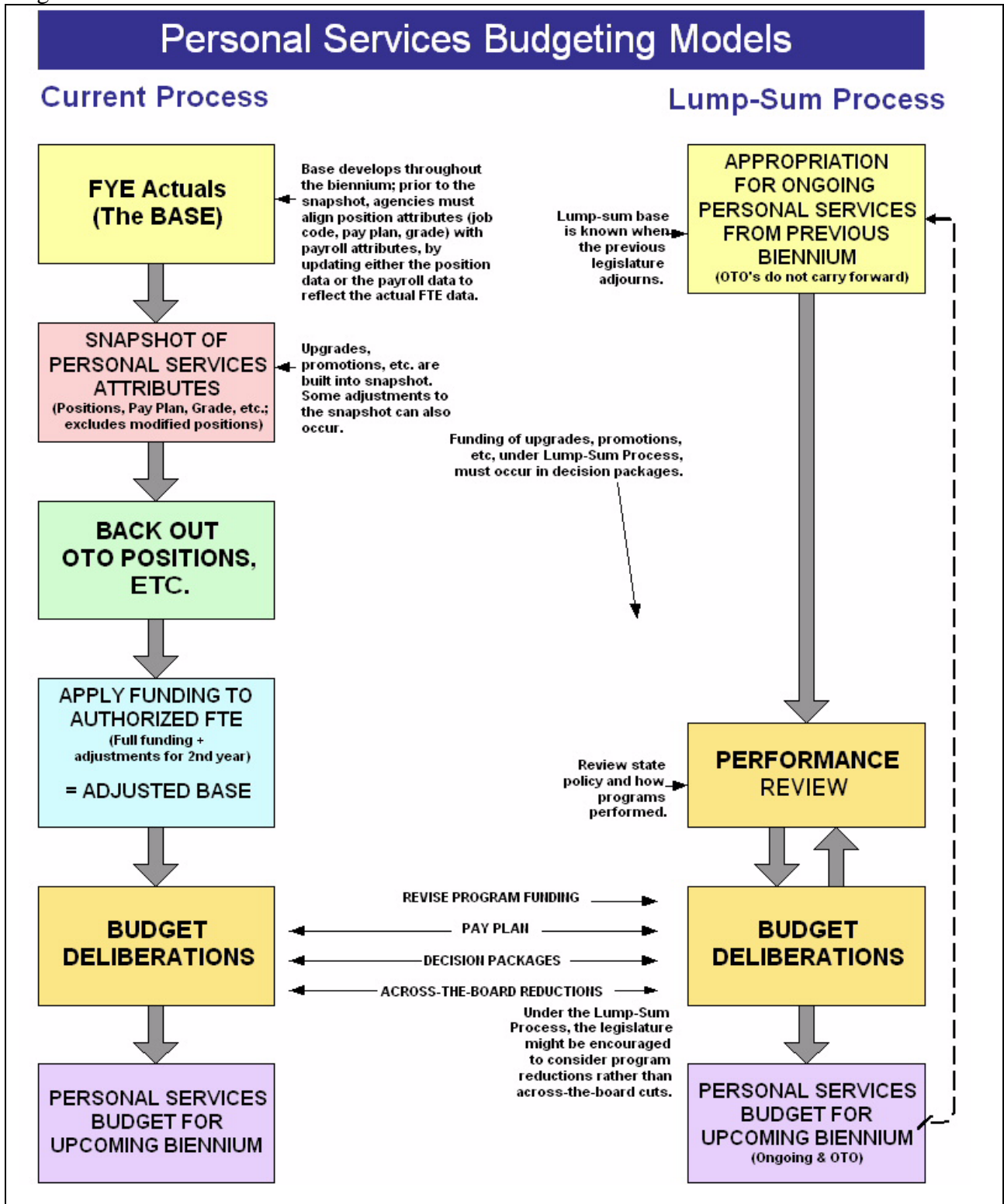
Figure 4 illustrates the lump-sum process proposed in this report, and compares that process to our current method for budgeting personal services. One disclaimer is necessary - this model contains several assumptions that could be modified by the legislature as desired.

For the purposes of this discussion, lump-sum budgeting will be described as:

“A process where the agency is given a set amount of funding with little or no directives as to number or grade of FTE, and no designation as to the amount of funding associated with categories of expenditures.”

In the case of personal services, the agency would then have the flexibility to use its personal services funding as it deems necessary as long as it furthers the agency’s accomplishment of its established goals. The broadest interpretation of this flexibility would allow agencies to use this funding for contracted personal services in place of agency FTE. Although this definition applies a very broad leniency to agency use of funding, the legislature could apply limitations as appropriate.

Figure 4



The starting point for the lump sum would be the prior biennium's personal services appropriations, minus any one-time-only (OTO) appropriations (It should be noted that the amount of vacancy savings added into the prior biennium's funding would therefore be automatically part of the new budget, and would not need to be considered each year). From this starting position, the deliberation process would begin. The flowchart in Figure 4 demonstrates the critical nature of using policy decisions to shape budget decisions. Policy deliberations would result in decisions affecting organizational structures and agency missions, goals, and objectives, which would in turn effect decisions during the budget process. The process is inter-related, as a budget decision may also influence a policy decision, as in the case of across-the-board cuts or other budget reduction measures.

At the end of the deliberations, the agency would have its personal services budget for the upcoming biennium, with both on-going and OTO appropriations. Subsequently, the on-going appropriations would carry over as the starting point, or 'base' for the next biennium's personal services budget. If lump-sum budgeting is only applied to personal services, the legislature may wish to maintain limitations or reporting requirements on any funding transfers between personal services and other categories of expenses.

## **IMPLEMENTATION ISSUES**

### **Why Switch?**

As stated at the beginning, a goal of our report was to address the stated concerns of legislators that are listed starting on page 3. Additionally, our proposed alternative should address the negatives associated with the current process. The lump-sum concept of budgeting for personal services can effectively address all of those concerns. Specifically:

- The cost of personal services (excluding modified FTE) from one biennium to the next would be fixed, and would only increase if specifically authorized by the legislature. The legislature will have greater review over policy decisions affecting funding levels;
- There would be no incentive for agency personnel to adjust positions with the purpose of enhancing the base budget, since changes would no longer be automatically funded in the adjusted base. Agencies would have to specifically request and justify any increases over their "base" funding;
- Lump-sum budgeting can be used in partnership with a policy-based, outcome-oriented budgeting philosophy;
- Lump-sum budgeting can provide agencies with the flexibility to implement and pursue innovative improvements to their business practices;
- In the presence of policy-based decision making, across the board cuts will drive the necessary policy discussions/decisions (however, in the absence of policy-based decision making, across the board cuts will not specifically trigger the necessary discussions);

- Providing funding which doesn't specifically tie dollars to FTE details eliminates agency, OBPP, and LFD workload associated with making detailed inputs for each personal services budget change across the entire budget cycle; and
- The base for the next biennium is known when the legislature adjourns, making establishing the initial budget for the next budget cycle much less cumbersome for the agencies and OBPP.

These reasons present a compelling argument for modifying the state's approach to budgeting personal services, both technically and philosophically. However, there are negative aspects to such a modification, and implementing such a change will require a substantive investment of time and effort for agencies, OBPP, LFD, and the legislature. Some issues that require further discussion include:

- Establishing initial funding levels;
- Changing the focus of budget deliberations;
- Measuring performance;
- Should lump sum budgeting be expanded beyond personal services?
- Presentation to the legislature; and
- Potential negatives of lump-sum budgeting.

Each of these issues are discussed in detail in the following sections.

### Establishing Initial Funding Levels

Implementing a change to lump-sum personal services funding would be a challenging transition. At the forefront of the implementation issues will be the question of establishing initial funding levels. A couple of options are:

- 1) Start with the prior biennium's personal services budget excluding the OTO appropriations (assumed in Figure 4); or
- 2) A complete bottom-up review and funding determination.

Although the most thorough and (arguably) most accurate method of determining funding levels, a bottom-up review of any agency will be a very manpower-intensive effort that may not currently fit into the current process and timelines. To accomplish this effort may require a change to statutory timelines and/or additional manpower.

Provided there are no major changes to the mission, goals, objectives, or performance measures for an agency, the first option may be a reasonable method by which to define initial funding levels for agencies under the lump-sum concept.

Once the starting point is chosen, the legislature may wish to consider agency goals and performance measures during the deliberation process. If so, that is actually another implementation issue within itself.



## Changing the Focus of Budget Deliberations

One of the criteria used to select lump-sum budgeting as an alternative to the current process was that the methodology selected should support a policy-oriented philosophy. The lump-sum concept can support a policy-oriented philosophy, but it will not by itself drive that philosophy. Without a concentrated intent to change the focus of budget deliberations, even lump-sum budgeting cannot force policy-oriented decisions. A key component of successfully migrating to lump-sum personal services budgeting is legislative buy-in and a desire to ***keep policy issues at the forefront of budget deliberations***. An option to foster this focus on policy would be a statutory change more closely tying budgets to agency goals, performance measures, and strategic plans, somewhat like the Federal Government Performance and Results Act (GPRA) mentioned in Figure 2 on page 14. If such a change were initiated, setting goals and measuring an agency success in reaching those goals would be a vital part of the overall budgeting process.

## Measuring Performance

Measuring performance in itself seems like an easy proposition. However, in reality there are many challenges to effectively measuring performance. Some of these challenges include:

- Who determines the agency's overall mission and objectives?
- Who is responsible for setting the standards for performance?
- How can performance be measured objectively, in a manner that provides useful feedback and areas for improvement?
- Based on measured performance, who is responsible for determining success?
- What criteria should be used to determine whether or not a program should be continued, re-structured, or discontinued?

There are numerous other policy questions that will have to be answered before a policy-based look at agency performance can be implemented. If the legislature wishes to implement lump-sum budgeting, it may wish to also factor in a timeline that allows for the definition and/or refinement of individual agency performance measures before using them to determine funding levels.

## Should Lump-Sum Budgeting be Expanded Beyond Personal Services?

If the decision is made to migrate to lump-sum budgeting of personal services expenses, the legislature may at some time wish to address the option of extending lump-sum budgeting to other expenses beyond personal services. Ideally some benefit would be gained from the simplicity of using the same methodology for all budgeting purposes. This option could be implemented at the same time as budgeting for personal services, or at a later date after evaluation of lump-sum personal services funding.

## Presentation to the Legislature

If lump-sum budgeting were used for some or all expenses, what form should the presentation to the legislature take? Regardless of the form chosen, it will be very important to include accurate, detailed information.

Ideally, the form chosen would still contain easily identifiable details of personal services and other expenditures, by category. Additionally, changes to the budget would still require identification, both by type and by fund source. Although budgeting may not be driven by individual FTE details, that information will still be vital to staff analysis of the executive budget. All data on actual expenditures would still be available on the State Accounting, Budgeting, and Human Resources System (SABHRS).

Additionally, the budget analysis presentation may need to include agency (program) goals and objectives, as well as performance measures and progress towards meeting them. The legislature could require this information in order to make the necessary policy decisions that will in turn drive budget decisions.

## Potential Negatives of Lump-Sum Budgeting

The proposed alternative to our current personal services budgeting process could potentially have several negative aspects, including:

- Reduced budget detail may make it more difficult to define individual components of the base budget (However, it is assumed that detailed expenditure data will still be readily available via SABHRS);
- Potential increase in legislative workload due to 1) increased number of funding requests, and 2) the need for additional agency/legislature dialogue regarding goals and outcomes; and
- If not implemented with a policy-based approach, this concept could actually result in a less effective form of budgeting, where the legislature loses oversight of actual agency expenditures/operations without gaining oversight of its goals and outcomes.

## Summary

The current process for budgeting personal services has several weaknesses, not the least of which is that personnel structure or detail changes during the base year are automatically included in the adjusted base commonly used as the starting point for agency budgets. As a result:

- 1) Personal services expenditures have experienced average growth well above inflationary levels; and
- 2) The legislature does not get to review and/or approve many of the changes that contribute to the growth.

Additionally, agency and OBPP personnel expend much energy and time refining/modifying position detail information solely in preparation for budget formulation.

Using lump-sum budgeting for personal services (or other expenditures) is one method that can address these weaknesses. Specifically, lump-sum budgeting can:

- 1) Allow the legislature to maintain control over the growth of personal services expenditures and the size and structure of state government as a whole;
- 2) Provide the legislature an improved tool for determining and maintaining personal services budgets, ideally along with simplification of the processes followed by agencies and OBPP; and
- 3) Provide the legislature with an avenue for increased focus on policy and outcomes.

However, successful implementation of lump-sum budgeting will require the legislature to make decisions on several issues, including establishing initial funding levels; changing the focus of budget deliberations, measuring performance, and establishing the format for presentation to the legislature.

### **OPTIONS FOR PERSONAL SERVICES BUDGETING ALTERNATIVE**

Using the above points of discussion, the options available to the legislature for implementing an alternative to our current personal services budgeting process include:

- 1) Remain with the current process;
- 2) Implement lump-sum budgeting during the 2003 session; or
- 3) Implement lump-sum budgeting at a later date, and use the 2003 session for passage of any desired legislation and establishment of processes to reinforce its focus on policy-based, outcome-oriented decision making.

Obviously, option one will make no changes to the current process, and will address neither the previously stated legislator concerns nor any of the staff-listed negatives associated with the current process. (However, an increased emphasis on policy-based, outcome oriented analysis and decision-making could be directed or encouraged.)

Options two and three both will implement lump-sum budgeting. The only difference between the two options is the timeframe for implementation. Option two would have the legislature provide agencies with a lump-sum personal services budget for the 2005 biennium, whereas option three would allow the legislature to make any desired statute and/or process changes (including those to reinforce a focus on policy issues and agency outcomes) and delay lump-sum budgeting to a subsequent biennium.

Above all, lump-sum budgeting should be looked at as a philosophy that can result in any one of a number of budgeting methodologies. In considering a move to lump-sum budgeting, the legislature must review all aspects of the issue, including the many positives and the associated negatives. Successful implementation will rely upon a concerted effort to address several critical decisions necessary to define the final version of the methodology.



## OTHER VARIATIONS OF VACANCY SAVINGS METHODS

The following information from other states provides some idea of how various states address vacancy savings.

- **Nebraska** indicates that vacancy savings is included within the appropriation at the discretion of each analyst. Vacancy savings works well for some agencies but not for others, thus the discretion given to analyst.
- In **Minnesota**, a state that budgets with a lump-sum methodology, vacancy savings is a consideration in developing the appropriation bill.
- In **South Dakota**, vacancy savings are sometimes considered when formulating the budget, but not on a systematic basis.
- For **Iowa**, the amount of funding included in the "Salary Adjustment Bill" is calculated using a computer salary model. This model takes into account; cost of living increases, salary driven fringe benefits, and vacant and temporary positions. The vacancy factor is based upon historical trends for each agency.
- **Alaska** tracks position information in the budget process, but appropriation bills contain no information on the number or pay range of positions. Essentially, agencies are free to add or move positions as long as doing so is within their spending authority. Spending authority is adjusted for vacancy, but the vacancy factors depend on appropriation size and are mostly used for adjustment purposes (possibly to balance a budget). Agencies are also free to move funds between line items, so the personal services issue is somewhat ambiguous.
- In **Arizona**, vacancy savings is incorporated for most of an agency's personal services budget, as follows. Up until the mid-1990s, vacancy savings rates were calculated for each agency. Generally, the vacancy savings rates for each agency depended upon the number of FTE positions, as shown below:

<u>FTE Positions</u>	<u>Vacancy Savings Rate</u>
0 – 25	0%
26 – 50	1%
51 – 100	1.5%
101 – 250	2%
251 and over	3%

- In the mid-nineties, agency vacancy savings rates were frozen at a standard rate, thereby locking in a particular dollar amount of vacancy savings into an agency budget.
- **Wyoming** does not calculate any vacancy savings factors.
  - In **Idaho**, personnel costs are built into the base in all state agency budgets based on the number of FTE authorized in its budget. Vacancy savings is not factored into agency budget requests.
  - **New Hampshire** budgets for personnel costs in a manner similar to Montana although New Hampshire does not apply a vacancy savings factor. It utilizes the "snapshot" approach building in all steps and increases due to promotions. It also handles any cost of living adjustment in a separate action, not buried in the

budget. An overall lapse factor is computed and vacancy savings would be a part of the lapse factor; however, vacancy savings is not identified separately.

In a report on vacancy savings prepared by this office in 1986, it was reported that some states track vacancy savings through the year and revert the amount of vacancy savings periodically, i.e., quarterly, semiannually, etc., as it occurs.

## ADDITIONAL DISCUSSION OF COMPONENTS OF PERSONAL SERVICES INCREASES

### Cost of Living

Each legislative session, pay increases are proposed that are intended to allow state wages to keep pace with the cost of living. These proposed increases, for most state employees, are a product of negotiations between the Governor and employee organizations (e.g., Montana Public Employees Association) or unions that represent a large majority of state employees. The proposed increases are incorporated into the Executive Budget that is presented to the legislature at the beginning of each session.

Proposed increases are usually percentages but have taken other forms in past years. Flat amount increases or combinations of flat amounts and percentages have been used in the past. The annual rate of increase has varied over the years, from zero percent in 1994 to 7.4 percent in 1992. Figure B-1 shows the rate of increase approved by the legislature from 1992 to 2001.

	Fiscal Year									
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
% Increase	7.4%	5.2%	0.0%	1.5%	2.5%	2.5%	1.0%	1.0%	3.0%	3.0%
Average Annual Increase Over Ten Years =					2.7%					

The pay plan for the current biennium allowed a 4 percent increase each year. Keep in mind that the percent increase is an increase in salary and other costs that are based upon salary, such as employer retirement contributions or other payroll based costs. There are other personal services costs that are not impacted by the cost of living increase.

### Benefit Rate Increases

The employee pay plan also included adjustments for the state contribution toward employee health insurance benefits. From fiscal 1991 to fiscal 2001, the state share increased from \$150 to \$295 per month. Figure B-2 shows the annual percentage increase over that same period.

**Figure B-2**  
**Percent Increases in State Health Insurance Contribution - 10 Years**

	Fiscal Year									
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
% Increase	13.3%	11.8%	10.5%	9.5%	-4.3%	2.3%	8.9%	10.2%	5.6%	3.5%
Average Annual Increase Over Ten Years =					7.0%					

The state share for health benefits for the current biennium is \$325 in fiscal 2002 and \$366 in fiscal 2003, increases of 10.2 and 12.6 percent, respectively. Note that these percent increases are increases in the state share only and as a percent of total personal services, would be much less.

### Annualization of Pay Plans

In recent years, the employee pay plan increases and increases in state share of health benefits have been “phased-in” (e.g., for the 2003 biennium, pay increases were effective October 1 of each fiscal year and the increase in the state share of health insurance was effective January 1 of each year). This practice lowers the cost of the increase in the implementation year but must be annualized in the following year, resulting in a large adjustment to the budget of that following year. For example, the delayed implementation dates for the 2003 biennium will require adjustments in the 2005 biennium estimated at \$52.5 million general fund and \$64.2 million other funds. In terms of percent of increase from one year to the next, the annualization of the pay plan or state share has a negligible effect on the rate of increase as long as the implementation strategy is applied consistently each year. If the pay plan were implemented on July 1 after a year in which it was delayed to October 1, then the annualization of the previous pay plan would have a more significant impact as a percentage increase in the personal services costs.

For the comparison in Figure 3 on page 15, annualization of the pay plan is factored in, based upon the estimates of the cost of implementing the pay plan in the 1999 biennium.

### Longevity

Longevity increases occur automatically for employees as they reach established thresholds of state service (each five years of uninterrupted state service), at which time, the employee receives an incremental increase in salary (1.5 percent after 5 years, an additional 1.5 percent after 10 years, an additional 2.0 percent after 15 years, and so on). The data accessed for this analysis did not contain specific longevity costs. In most years, longevity increases as a component of change in personal services costs would be negligible because as some employees receive an increase, others would be retiring or leaving state service. The increase shown in Figure 3 on page 15 is a result of action taken by the 1999 legislature that increased the rate for longevity increases after 15 years of service and is an increase estimated at that time.



## Promotions and Upgrades

For purposes of this analysis, promotions and upgrades are considered together because of how information is gathered and reported in the State Accounting, Budgeting, and Human Resources System (SABHRS). Promotion refers to the assignment of an employee to a higher grade position. This occurs for many reasons that need not be discussed here. When a promotion occurs for an individual worker, there is simply an increase in personal services costs for that individual. To determine the impact of promotions on the budget, it is necessary to look at it in a broad perspective rather than by position. Often times, a promotion of an individual into a vacant position (possibly at a rate lower than the previous incumbent) means that the individual's former position is made vacant and available for hiring someone probably at a lower salary. Thus, in some instances, a promotion may result in lower costs. On the other hand, if a promotion occurs within a position as a result of an upgrade or movement out of a training assignment into the intended position, then costs will increase. The net impact of promotions is difficult to determine. Regardless of the impact, these costs are absorbed by the agency in the biennium in which they occur, but become part of the adjusted base for future biennia.

Position reclassifications are changes from one pay grade to another. The authority for development of a position classification plan and the requirement for a continuous review of all positions is contained in Title 2, Chapter 18, Part 2, MCA. Reclassifications occur as the result of a review of position attributes such as responsibilities, duties, supervision, etc. If a position is determined, relative to other similar positions, to be misclassified, then it can be upgraded to a higher grade or downgraded to a lower grade. The primary reason for the review is to ensure that the position is fairly classified for the duties that it performs and to ensure that it is compensated at a rate equitable to other similar positions in and out of state government. Historically, upgrades greatly outnumber downgrades, implying certainly that reclassifications generally increase the costs of personal services for the state. For the 2001 biennium, the annualized cost of reclassifications is approximately \$4.0 million. With benefits costs added, it increases to about \$4.6 million. These costs are absorbed by the agency in the biennium in which the upgrades occur, but become part of the adjusted base for future biennia.

## Positions Added

As can be seen in Figure 3 on page 15, the largest component of the increase in personal services costs from the 1999 biennium to the 2001 biennium results from an increase in the number of positions. Over the past 10 years, the most growth occurred in the 2001 biennium. OBPP data shows that the level of FTE (excluding the university system) increased from 11,690 in fiscal 1999 to 12,427 in fiscal 2001, an increase of 737 FTE. A net funding increase for 192 FTE was authorized in HB 2. The other 545 FTE were established in other legislation, by budget amendment, etc. FTE data is not available for authorized FTE by funding source, but based upon the increases in actual personal services expenditure data relative to the total number of FTE, over the past 10 years, a vast majority of the additional FTE are funded from state special revenue accounts and proprietary accounts. In recent years, the same data shows a significant increase in general fund FTE and costs, although the methodologies for the analysis of the data is

still being reviewed. Analysis continues for a method of tracking the FTE data by funding source.

### **Overtime, Differential Pay, Termination Pay, and Compensatory Time Payouts**

These components of the increase totaled \$16.3 million with overtime increasing the most at \$11.7 million. This analysis does not explore the reasons for these increases, but rather simply points out that these are a component of the increases for the 2001 biennium.

### 10-YEAR COMPARISON OF PERSONAL SERVICES

Figure C-1 offers a look at state government expenditures from the general fund, state special revenue funds, federal funds, and proprietary funds over the past 10 years. The intent is to compare the growth of personal services expenditures with broader categories of expenditures that include personal services. Therefore, the dollar columns in Figure C-1 below represent personal services only, expenditures for operating costs (personal services, operating expenses, and equipment), and total expenditures. The average annual growth in personal services expenditures from 1992 to 2001 was 4.5 percent, while expenditures for operational costs during that time grew at 5.6 percent. Total expenditures grew at 4.2 percent. Over the past five years (1996 to 2001), the picture is somewhat different. Personal services costs grew at a faster rate (5.8 percent), while expenditures for operating costs grew at a slower rate (5.2 percent), and total expenditures grew at a much faster rate (7.0 percent).

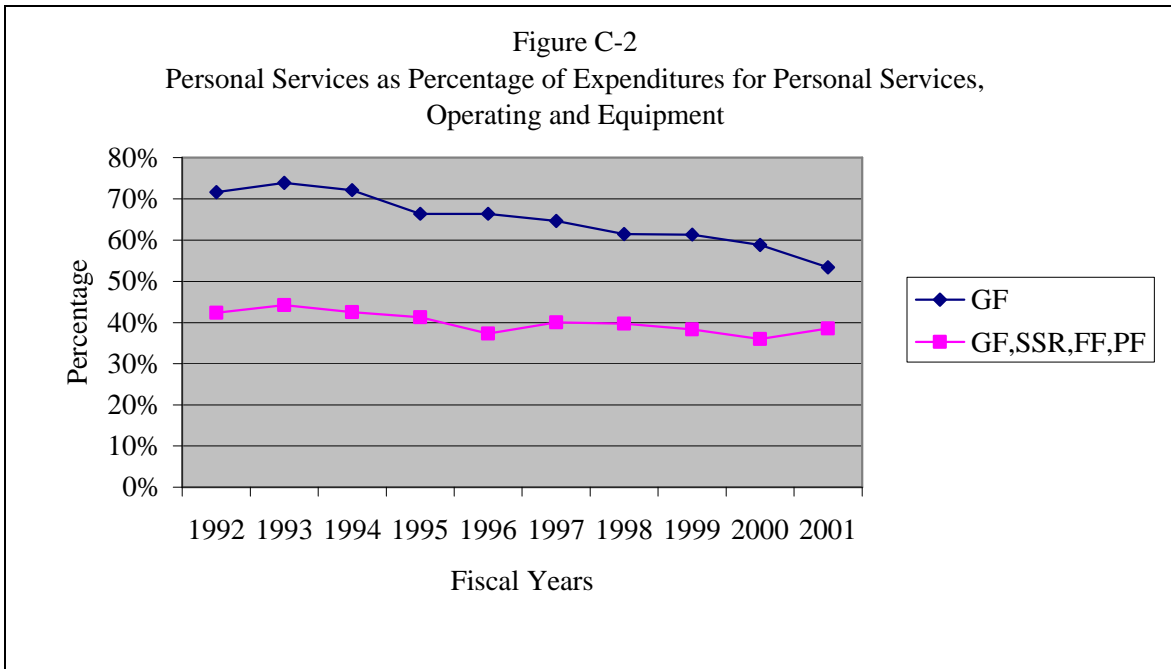
There is not a significant difference in growth of personal services as compared to total expenditures over the same period. Over the last five years, total expenditures have grown at a faster rate than expenditures for personal services.

Fiscal Year	Expenditures		
	Pers Svcs	PS, Oper, Equip	Total
1992	\$ 337,649,623	\$ 797,078,517	\$ 2,480,094,728
1993	361,909,885	818,030,957	2,573,774,246
1994	361,263,225	849,984,009	2,573,560,868
1995	372,101,676	900,512,992	2,730,409,222
1996	376,414,374	1,008,487,202	2,565,558,364
1997	400,696,440	1,000,476,223	2,828,094,422
1998	406,761,109	1,023,185,304	2,835,826,280
1999	431,535,832	1,126,106,484	2,989,502,882
2000	459,416,318	1,277,790,894	3,318,586,819
2001	499,746,987	1,296,994,854	3,598,026,603
9-Year growth	48.0%	62.7%	45.1%
Average Growth			
Last 5 Years	5.8%	5.2%	7.0%
Last 9 Years	4.5%	5.6%	4.2%

What is significant about these growth figures is the degree to which they exceed pay plan increases of the same period. For comparison, pay plan increases over ten years averaged 2.7 percent (health insurance increases added another 0.3 percent). Components of the increase in personal services costs are discussed on page 15 and in

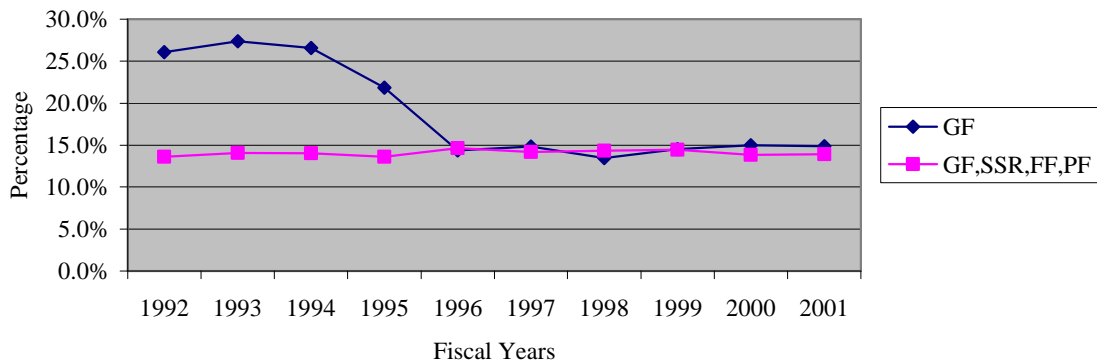
Appendix B. The greater increase in operating costs over the last nine years can be attributed to a large degree to a shift of some types of personal services expenditures to contracted services (i.e., the information technology area has seen a shift from in-house systems development and maintenance staff to using contracted services for such tasks).

Figure C-2 compares personal services expenditures to the larger category of operating expenditures (personal services, operating expenses, and equipment). As a percentage of total operating costs, the portion that is personal services has decreased from 42.4 percent to 38.5 percent when looking at a combination of fund sources. The percent that personal services are of operating costs for general fund drops more dramatically over the 10-year period.



As shown in Figure C-3, when comparing personal services costs and total expenditures (and focusing on 1996 through 2001), the share that personal services costs are of the total expenditures is fairly constant, regardless even of the fund source. The first four years (1992 through 1995) include the effects of the school equalization account (de-earmarked in 1995), so they are not comparable when looking at the general fund trend.

Figure C-3  
Personal Services as Percentage of Total Expenditures



From these 10-year comparisons, the conclusion is that the cost of personal services relative to other expenditures (whether operating cost only or total expenditures) has stayed relatively constant or has decreased. This is during a period when the number of FTE has increased, although specific numbers are difficult to find for all of the relevant years because of various changes in fiscal policy that change how information is reflected over the years. Over the past 10 years, personal services costs have seen steady growth. The reasons for this growth would undoubtedly be pay plan increases, additional FTE, promotions, upgrades, longevity, benefit rate increases, etc. Given these factors, the 4.5 percent average rate seems reasonable in a sense that so many things can contribute to the growth.