OFFICE OF THE NEW YORK STATE COMPTROLLER

Thomas P. DiNapoli • State Comptroller

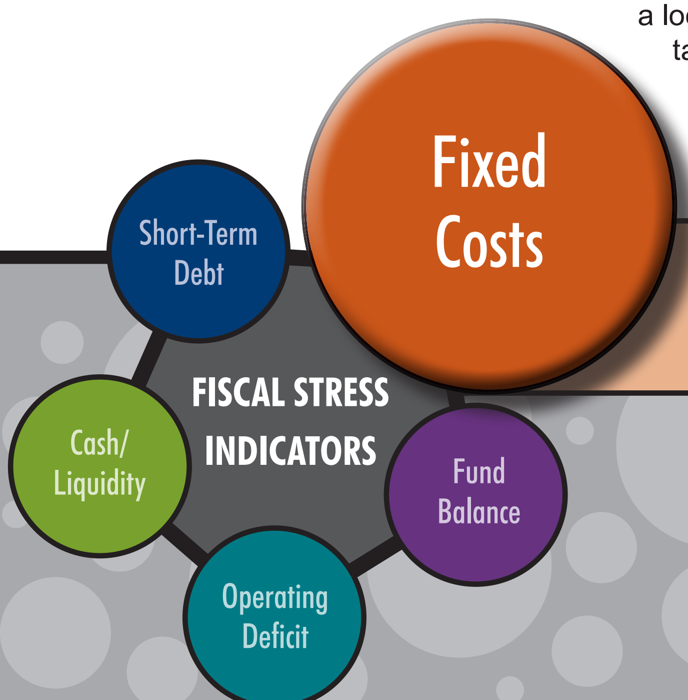
Fiscal Stress Close-Up

Fixed Costs

Fixed costs are expenditures that are required and recurring. Both individuals and governments often find that much of their spending goes toward fixed costs. Similar to an individual who has certain costs that are difficult to reduce and control such as a vehicle loan, a home mortgage or rent, local governments also have fixed costs that must be paid, regardless of other priorities or problems.[1]

An individual who goes through a difficult financial period may look to try to reduce expenses, but this will usually involve eliminating nonessential purchases or putting off purchases that are not urgent. Required and recurring costs can only be reduced to a limited degree, or with considerable sacrifice. When local governments need to reduce spending, they look to make similar adjustments in their budgets, cutting more flexible items. Once a local government has maximized these types of reductions, however, the remaining fixed costs will make up a larger proportion of what remains. As a result, the local government will then have reduced budget flexibility, so that any additional needed cuts may likely affect essential services.

This close-up focuses on two kinds of fixed costs, debt service and personal services costs. Debt service is the amount necessary to pay principal and interest on a local government's bonds and notes. Defaulting on debt service payments is likely to have serious consequences on credit ratings, the ability to borrow and the local government's finances in general. Costs for personal services – salaries, wages and benefits – can also be reduced, but reductions in staff may reduce the ability of a local government to perform necessary functions, and must take into account collective bargaining agreements or other employment contracts.



- High Debt Service Expenses
- High Personal Service and Employee Benefit Costs

Fixed costs is one of five categories of indicators for the Office of the State Comptroller's (OSC's) Fiscal Stress Monitoring System (FSMS).[2] The FSMS defines fixed costs as either:

- Debt service as a percentage of revenues; or
- Personal services (salaries and wages) and employee benefits as a percentage of revenues.

Local governments borrow for various purposes, including the funding of long-term infrastructure construction or improvement projects, so some level of debt service costs is normal. Under OSC's FSMS, the threshold for high debt service costs is 10 percent of total revenues, with any level over 20 percent receiving maximum FSMS points.

Since every local government provides various services, it is to be expected that a fairly large proportion of local expenditures will be on associated costs for personal services and employee benefits. The threshold in the FSMS for high personal service and employee benefit costs is 65 percent of total revenues, with anything over 75 percent assigned the maximum FSMS points. Increases in employee benefit costs in recent years (including things like health insurance and pension fund payments) have been a significant factor driving increases in total fixed costs for local governments.

Fiscal Stress Monitoring System (FSMS): What Does It Measure?

"Fiscal stress" refers to the difficulties in generating enough revenues to meet expenditures in the long term. OSC's FSMS measures a local government's ability to balance its budget, pay its bills, keep its debt in check and have some funds left over at the end of the fiscal year. It does not measure the quality or quantity of services provided, their cost-efficiency or how hard local officials have worked to achieve this balance given the local economic climate.

FSMS has five categories of indicators: fund balance, liquidity, short-term debt, operating deficits, and fixed costs. These indicators contribute to a local government's final classification of Significant Stress, Moderate Stress, Susceptible to Stress or No Designation. More information on the scoring system for each of the indicators can be found in OSC's "Fiscal Stress Monitoring System" report.

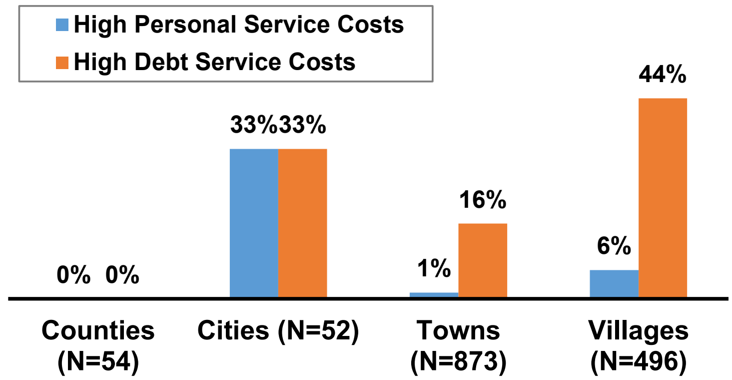
This report, which focuses on fixed cost indicators, is one of a series examining each of the five FSMS indicator categories. These reports will discuss the circumstances under which a high score in any category is cause for concern.

How common are high fixed costs?

High fixed costs are common for school districts, which devote a large share of their expenditures to personnel, and also for other local governments that provide services associated with high personnel costs, such as public safety. Since there is not much variation in the level of fixed costs across school districts, fixed cost indicators were not used to evaluate fiscal stress in the FSMS for schools. However, a look at personal service costs and debt service costs show quite a different picture for the other classes of government.

Cities usually have high personal service and benefit costs because they typically are responsible for providing a set of services that are more labor intensive (police and fire departments, for instance) than those delivered by towns and most villages. About one-third of all cities exceeded the FSMS threshold for high personal service and employee benefit costs (greater than 65 percent of revenue). The median city had personal service and employee benefit costs that equaled 63 percent of revenues. Only about 1 percent of towns had comparably high personal service and employee benefit costs, while 6 percent of villages had high personal service and employee benefit costs.

Percentage of Local Governments with High Fixed Costs, By Class, Fiscal Year Ending 2013



Source: Office of the State Comptroller (OSC).

Fixed Cost Indicators: Performance by Type of Local Government and Fiscal Stress Status for the Fiscal Year Ending in 2013

Class	Number of Local Governments Scored	Median 3-Year Average of Personal Services and Employee Benfits as a Percentage of Revenues	Median 3-Year Average of Debt Service as a Percentage of Revenues
Counties	**54**	**40%**	**3%**
In Fiscal Stress	10	40%	4%
No Designation	44	40%	2%
Cities	**52**	**63%**	**8%**
In Fiscal Stress	7	57%	15%
No Designation	45	63%	8%
Towns	**873**	**42%**	**4%**
In Fiscal Stress	17	54%	5%
No Designation	856	42%	4%
Villages	**496**	**38%**	**8%**
In Fiscal Stress	16	42%	10%
No Designation	480	38%	8%
Total	**1475**		
In Fiscal Stress	50		
No Designation	1425		

Source: OSC. "In Fiscal Stress" includes all three levels of fiscal stress: significant, moderate and susceptible.

Villages are most likely to exceed the FSMS threshold for debt service, with 44 percent above that level (greater than 10 percent of revenue); the median village has debt service equal to 8 percent of revenues. Cities also tend to have high debt service costs, with about one-third exceeding the FSMS threshold. The median city in fiscal stress has debt service costs of 15 percent of revenues. For towns, 16 percent exceed the FSMS threshold; the median town has debt service equaling 4 percent of revenues.

No counties had high enough fixed costs to score any FSMS points. This is likely because a large part of a county's budget is devoted to Medicaid, which is jointly funded by the federal and State government and passes through the county with relatively low local personnel costs. The median county has personal service and employee benefit costs that account for about 40 percent of revenue, and debt service equal to 3 percent of revenue.

Personal Service Cost Containment

In 2008, the Office of the State Comptroller released a publication on Personal Service Cost Containment as part of the Local Government Management Guide (LGMG) series. This publication offers ideas on containing certain personal service costs. The LGMG breaks down options for reducing personnel costs in the following areas:

- **Health Insurance Costs.** Employers can try to reduce costs by:
  - Bringing in competition,
  - Offering cash payments in lieu of health insurance,
  - Offering a self-insurance health plan,
  - Offering a pre-tax benefit plan, and
  - Providing health and wellness programs.
- **Unemployment Insurance Costs.** Savings can be found through the employer selecting the most economical funding method, either through a tax contribution method or a benefit reimbursement method.
- **Workers Compensation Costs.** Employers can:
  - Manage costs by seeking out competition,
  - Assess for accuracy of existing job classification and the apportionment of gross wages and salaries,
  - Emphasize prevention of accidents, and
  - Establish strong claims procedures.
- **Overtime Planning and Management.** In particular, the use of alternative work schedules can be beneficial.

For more information, see the OSC publication:
http://www.osc.state.ny.us/localgov/pubs/lgmg/costcontainment08.pdf.

Why are high fixed costs considered a symptom of fiscal stress?

When fixed costs begin to comprise an exorbitant portion of a budget, the ensuing loss of financial flexibility can signal an upcoming inability to respond to changes in policy, unexpected events, or swings in the economy. For example, high debt service costs may be an indication that the local government is borrowing more than it can easily pay back. Excess debt, and the associated interest costs, can lead to cash flow problems and difficulty meeting other obligations, such as payroll. Other high fixed costs, such as personal service and employee benefit costs, in many ways can be considered part of doing business for some local governments. However, when they become too high they diminish the ability of governments to react to changing economic circumstances. The manageable level of fixed costs varies, and can depend on the local cost of living and the tax base, among other circumstances.

Are high fixed costs ever justifiable?

Some regions have higher personnel and equipment costs than others areas. These higher costs might not be related to municipal fiscal stress but could still present a financial challenge. For example, downstate municipalities (Westchester County and Long Island, especially) have a higher cost of living than the rest of the state. Therefore, salaries and employee benefits would also tend to be higher. Nevertheless, the required and recurring nature of these costs tend to make it more difficult for these local governments to deal with any other stress factors, should they arise.

Notes

[1] "Local governments," as used in this report refers to counties, cities, towns, villages and school districts, and does not include New York City.

[2] The FSMS financial indicators are calculated using data filed by local governments in annual update documents (AUDs) and by school districts in annual financial reports (ST-3s). All FSMS results presented in this report relate to the fiscal years ending between December 31, 2012 and July 31, 2013. FSMS points are assigned based on the resulting percentage for each indicator; high scores signify fiscal stress. The fixed costs indicators carry a weight of 10 percent in the calculation of a local government's fiscal stress score. For more detail on the FSMS indicators, visit the Comptroller's Fiscal Stress Monitoring website: **http://www.osc.state.ny.us/localgov/fiscalmonitoring/index.htm.**
See also, OSC, Fiscal Stress Monitoring System,
http://www.osc.state.ny.us/localgov/pubs/fiscalmonitoring/pdf/fiscalstressmonitoring.pdf.

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