SPECIAL / REPORT

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FUNDING BOSTON'S COLLECTIVE BARGAINING CONTRACTS

What can the City of Boston afford to pay its employees in new collective bargaining contracts? The answer is starting to emerge with the successful negotiations of two union contracts and the Mayor's submission of his recommended fiscal 2005 operating budget. However, there remain 30 bargaining units without a contract with a few that expired as far back as June 30, 2002. Faced with two consecutive years of local aid cuts totaling $78.9 million and the prospect of relatively level state aid in the next few years, the Administration is cautious about agreements with higher cost obligations in the latter years. Some unions believe that the City has sufficient resources to support more generous contracts than now on the table. This view is held, in part, because of how union officials are interpreting certain data in Boston's financial statements. This *Special Report* responds to questions recently raised regarding possible resources available for collective bargaining agreements.

A key issue in these negotiations is how much of an increase is affordable and reasonable in fiscal 2006. The Administration should hold firm to its position and not deviate from already negotiated salary increase ranges in this fiscal environment. The City should be sensitive to the long-term cost implications of non-salary language changes. Back-loading higher salary increases in fiscal 2006, especially for public safety employees and teachers, presumes greater revenues will be available. If revenues fall below estimates, cuts in services may be required to help fund the contracts. In return for the salaries and benefits negotiated, the Administration should achieve language changes to improve service efficiencies. The changes should go beyond just moving the remaining half of Boston's employees to a bi-weekly payroll.

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New Contract Model

The two new contracts with the Salaried Employees of North America (middle managers) and the Boston Teachers Union set salary increase parameters of approximately 2.0% in fiscal 2004, between 2.0% and 2.5% in fiscal 2005 and between 2.5% and 4.0% in fiscal 2006. The Mayor's fiscal 2005 budget provides $32.1 million for collective bargaining for city contracts and $21.6 million for the BTU contract for a total of $53.7 million. The $32.1 million budget reserve is sufficient for approximately a 2.0% salary increase in fiscal 2005 after the compounding cost of the raises paid this year are carried over into fiscal 2005. Collective bargaining is a key factor in the Mayor's recommended fiscal 2005 budget in that the amount earmarked for collective bargaining next year represents 75.7% of the total budget increase of $70.9 million.

What Is Really Available

Q: ***How much of the City's reserves is available for contract costs and how is the amount decided?***

A: Boston is required to use two accounting methods to calculate reserves – the national GAAP and the Massachusetts statutory financial standards. **The statutory financial standard is the only legal means by which the City can establish a reserve to be appropriated for spending.** By that standard, Boston had $61.1 million in "free cash" available for fiscal 2004. The City has committed $40 million of free cash, leaving a remaining balance of $21.1 million.

By necessity, Boston's financial statements are prepared using two different standards for recording and reporting actual expenditures and revenues. To comply with standards prescribed by the Governmental Accounting Standards Board (GASB) for all governmental units in the United States, the City prepares financial statements using Generally Accepted Accounting Principles (GAAP). The bond rating services and others rely on this national standard to determine the credit worthiness of a city or state and as a basis of comparison with similar governmental units around the country. However, there is no money to spend from a GAAP account.

The Commonwealth has its own statutory accounting standards that the City must follow – the only legal means by which the city can spend reserves. In several cases, the two standards treat the same dollars differently in terms of the timing of booking expenditures and receipts and how liabilities are recognized. Based on the statutory financial statements for fiscal 2003, the Massachusetts Department of Revenue certified $61.1 million in budgetary fund balance or "free cash" for Boston. This free cash is the only amount available to the City for appropriation this year and possibly the next few years.

Boston's fund balance at the end of fiscal 2003 was $491.3 million based on national GAAP standards. However, this fund balance contains funds designated on a statutory basis for specific purposes in fiscal 2004 such as teacher retirement, school transportation and Quinn Bill payments and funds encumbered for other financial commitments. Subtracting these funds and reserves creates the GAAP undesignated fund balance of $331.5 million. Applying the Massachusetts standards and deducting statutory reserves for property tax abatements, deficit prevention (Tregor) and legal commitments not yet billed and prudent administrative reserves for purposes such as risk management create a statutory undesignated fund balance of $147.1 million. The City presented the statements for this fund to DOR for certification of free cash. State officials then excluded other property tax, excise and departmental receivables and any deficits in the capital and special revenue funds and added any deferred revenue. Following that process, DOR, on December 9, 2003, certified the budgetary fund balance or free cash for Boston at $61.1 million.

FY03 Fund Account	$ in Ms
GAAP Fund Balance	$491.3
GAAP Undesignated	331.5
Statutory Undesignated	147.0
Certified Free Cash	61.1
Approp. In FY04	25.0
Recommend in FY05	15.0
Free Cash Balance	$21.1

From this free cash, the Mayor and City Council appropriated $25.0 million for the FY04 operating budget in response to cuts in local aid. The Mayor's recommended budget for fiscal 2005 includes use of $15.0 million in free cash, leaving a budgetary fund balance of $21.1 million. Because Boston is not expected to end the next two years with surpluses substantially more than in FY03 ($1.8 million), this free cash balance will need to be carefully applied over the next few years. Free cash from the statutory fund balance is used by the City as non-recurring revenue and should be appropriated for only one-time or certain fixed costs and to fund extraordinary and non-recurring expenses. The last time the City used free cash for operations was in fiscal 1992 during the last recession. The bottom line….Boston can only use funds from the statutory certification.

GAAP Fund Balance Increase

Q: ***Since there was an increase of $89.2 million in the GAAP fund balance in fiscal 2003, can any of it be used to fund contracts?***

A: No. The GAAP fund balance increase is inconsequential to available dollars because it is only the statutory financial statements that determine what reserves are available for spending.

The City's GAAP fund balance increase from $402.1 million to $491.3 million represents the impact of new accounting rules, increased property tax revenue and the fiscal 2003 budgetary surplus. Based on a new accounting rule, an additional $25.0 million is realized after only those liabilities due June 30, 2003 or shortly thereafter are recognized. The longer-term liabilities still exist but now are not recorded in these financial statements. Property tax revenue increased by $63.0 million under GAAP but these funds had already been recorded as received under the state's statutory standards. Finally, the City's fiscal 2003 operating surplus of $1.8 million is included in this balance. The increase in Boston's GAAP fund balance is positive for rating agencies and intercity comparisons, but as a GAAP balance it does not represent new resources available to the City for operational expenses.

Overlay Surplus

Q: ***The City reported a surplus of $88.0 million in its overlay reserve for abatements last year. Is any of that available to fund employee contracts?***

A: No. These funds have already been committed. An increase of $59.5 million in the City's pension liability was offset by the surplus and the balance was included in the City's most recent free cash certification.

An overlay is a reserve established each year when the tax rate is set to fund anticipated property tax abatements and uncollected taxes for that levy year. Funds are maintained in the overlay reserve as long as potential abatement and uncollected tax liabilities for that levy year remain. When the Commissioner of Assessing determines that no further liabilities exist for a levy year, he may declare the balance as surplus and the funds may be appropriated for operational expenses. The City determined by an analysis of its overlay reserves and potential liabilities for fiscal 2000 and prior years that a surplus of $88.0 million existed. An overlay surplus should be treated as non-recurring revenue and applied to one-time or certain fixed expenses. Overlay surpluses not appropriated in the year they are declared surplus will revert to fund balance at the end of the fiscal year and are included in the certification of free cash or budgetary fund balance for the next fiscal year.

Based on a 1957 law (Ch. 717 of the Acts of 1957), Boston was required to raise an overlay of no less than 5.0% or more than 6.0% of its levy. All other municipalities were able to determine their overlay requirements with approval of the Department of Revenue. In the early 1990s, the City did encounter periodic deficits in the overlay accounts as real estate values declined. However, in the late 1990s and fiscal 2000, due to improved assessing practices, better collection rates and a growing economy, Boston's minimum overlay reserve of 5.0% proved to be greater than needed, resulting in surplus reserves. The actual overlay reserve surplus established for fiscal years 2000 and prior was $115.1 million. However, property taxes not collected for those levy years totaled $27.1 million, which reduced the overlay surplus to a net $88.0 million.

Overlay Surplus
FY00 and Prior Years
Figures in 000's

Overlay Balances *	$115,060
Property Tax Receivables	(27,051)
Overlay Surplus	$88,009
ERI Pension Liability	(59,500)
Net Surplus **	$28,509

* Overlay reserve balances less remaining overlay requirements

** Incorporated into FY04 free cash certification

The overlay surplus of $88.0 million has been further reduced to fund a one-time spike in the City's pension liability in fiscal 2003. In an effort to reduce employee numbers because of a cut in local aid of $43.2 million after the fiscal year started, Boston offered an Early Retirement Incentive (ERI) that was accepted by 476 employees. However, the number of retirements, earlier than normally allowed, created a jump in the City's pension liability estimated at a net present value of $59.5 million if paid at that time. However, if amortized like a mortgage over 20 years, principal and interest costs on this liability could cost between $85 and $95 million. Establishing a reserve for a pension liability is not legally required nor the normal approach for funding pension costs. However, the confluence of a new liability with the establishment of a new overlay surplus afforded the Administration a unique opportunity to pay the liability and save millions in future interest costs if it acts soon. In fiscal 2003, the City established a Post Employment Benefit Liability Account of $59.5 million to recognize the added pension costs associated with the ERI program. Funding this liability will free-up resources for other purposes each year that otherwise would have been needed to pay the pension liability. Accounting for the $59.5 million liability was offset by the $88.0 million surplus, for a balance of $28.5 million. The balance of $28.5 million became part of the free cash certification in fiscal 2003. The bottom line….the overlay surplus is not available to pay for salary increases.

Fiscal 2004 Overlay Reduction

Q: ***The City freed up $9.6 million when its overlay reserve standard was relaxed in fiscal 2004. Is this money available to fund contracts?***

A: No. These savings either have been committed for increased operating expenses or applied to cover decreased revenue estimates for fiscal 2004.

Boston's fiscal 2004 overlay reserve for abatements and uncollected taxes was set at $51.7 million based on the state's 5% standard in force when the budget was approved in June 2003. Legislation was passed in July 2003 that lifted the special requirement for Boston and allowed city officials to establish the overlay reserve as it deemed appropriate subject to the approval of the Department of Revenue. This same process is utilized for all other municipalities. In revising its budget as part of the tax rate setting process in March 2004, the Administration established the overlay reserve at $42.1 million or 4.0% of the levy, thereby freeing up operating funds of $9.6 million. However, other adjustments made in budget expenditures and revenue estimates absorbed the full $9.6 million, leaving no remaining balance. Additional spending totaling $4.9 million was added due to adjustments in pension obligations of $1.9 million and in the Suffolk County Sheriff's Department of $999,527. Also, two supplementary appropriations were approved totaling $2.1 million for the Office of Property Management and the Police Department. A few revenue estimates initially set in April 2003 were lowered based on March 2004 data. For example, the room occupancy excise was reduced by $1.0 million, the jet fuel excise by $1.5 million, parking fines by $3.0 million and interest on investments by $2.0 million. In the end, no balance remained in the freed-up overlay funds. Not addressed was an expected deficit in the Fire Department due, once again, to overtime spending and not implementing planned organizational changes.

Other Reserves

Q: ***Are there other reserves established by the City that can help fund negotiated contracts?***

A: No. While there are other reserves, it would not be financially prudent to borrow from them to fund recurring contract costs.

Most of the reserves are statutorily created for specific purposes only or administratively established for legitimate reasons and should not be an ongoing source of funding for annual salary and other contract expenses. For example, the Tregor Reserve Fund ($21.1 million) was created by special legislation in 1986 to be available after June 1 to fund extraordinary or unforeseen expenditures in an effort to prevent the City from incurring an operating deficit. Funded by appropriations, this reserve must be equal to 2.5% of the prior year's departmental appropriations, excluding the School Department. Any amount utilized is required to be replaced in the very next fiscal year, creating a financial incentive to keep it intact. The Surplus Property Disposition Fund ($36.1 million) retains the proceeds from the sale of city property and is intended to be used only for purposes for which the City is legally entitled to borrow. With a majority vote of the City Council and approval of the Mayor, funds from this account can be used for operating expenses and has been the source for local housing resources to support the Leading the Way program. These funds are considered non-recurring revenues and should be used for one-time expenses. These reserves and funds are viewed positively by the bond rating agencies as mechanisms of responsible financial management and they contribute to the City's high bond rating that results in lower annual interest costs.

The City also administratively has established a Risk Retention Reserve ($9.4 million) to protect the budget from a large unexpected financial loss incurred during the year. Other funds supported by special revenues that are appropriated each year for related purposes include the Parking Meter Fund ($27.1 million) to support parking operations of the Transportation Department and Cemetery Trust Fund ($8.5 million) from cemetery trust monies to support the maintenance of city cemeteries. A Street Opening Fund supported by deposits and permits paid by utilities and contractors is used for permanent repair and road paving estimated at $10.0 million this year. Finally, the City self-insures the indemnity health insurance program for those employees who chose the plan and, as required by law (Ch. 32B), has established a Health Insurance Trust Fund ($7.9 million) that maintains balances for incurred but not reported claims as required.

Maintaining Flexibility

Q: ***Does the City have other means within its operating budget to help fund the contracts?***

A: The budget parameters for fiscal 2004 and fiscal 2005 are known and probably will not change in any material way but some options may exist for fiscal 2006.

For the current budget and recommended budget for next year, Boston has provided for some flexibility in its budget planning but not enough to allow for larger salary increases than now on the table. Along with reserves for collective bargaining, the City is able to make minor adjustments in its budgets that will enable it to fund raises consistent with those contracts that have been settled. Keeping revenue estimates conservative is one means of maintaining flexibility. The Mayor and City Council approve a budget in June based on March/April estimates and have the opportunity to make adjustments during the course of the year. Any remaining flexibility allows the City to address unexpected spending requirements or revenue adjustments and end the year with a small surplus. Any operating surplus for the year becomes part of the fund balance and is included in the free cash certification. Operating surpluses have been relatively small in relation to total expenditures, averaging $4.7 million over the past 10 years. The City's surplus in fiscal 2003 was $1.8 million or 0.1% of total expenditures.

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With a year to plan for fiscal 2006, the Administration can consider options to help support the contract costs in fiscal 2006. However, these same options may be required for other services so all factors should be considered before deciding what resources will be able to support new contracts. Some revenue options may not be appropriate for contract spending but could be applied more prudently thus making other operational funds available. For example, the Administration has indicated that it will analyze the overlay reserves and potential liabilities for fiscal years 2001-2003 to determine whether additional funds could be declared surplus and be available for one-time or certain fixed expenses. For fiscal years 2004 and 2005, the overlay reserve is set or recommended at 4.0% but continued progress on abatements may suggest that a lower overlay reserve may be sufficient in future fiscal years. Further analysis of encumbrances for prior year commitments may determine additional funds could be applied to fund balance and free cash certification. On the other hand, new property tax growth over the next three years is expected to be less than the $30+ million level of the past three years. The Mayor's fiscal 2005 budget recommends an aggregate departmental increase of 0.2% when health and salary increases are excluded, which will create pressure for increased spending in fiscal 2006. Based on an actuarial analysis being prepared that reflects early retirements and lower investment earnings, pension costs will rise in fiscal 2006 as will debt service as the City increases its borrowing over the next four years.

Conclusion and Recommendations

The City's financial position of two consecutive years of state aid cuts and relatively level state aid expected in fiscal 2005 is understood generally by union officials and should lead to contracts negotiated that provide for salary increases of approximately 2.0% in fiscal 2004 and up to 2.5% in fiscal 2005. How much more of an increase is affordable and reasonable in fiscal 2006 is the issue to be resolved.

- The Administration should hold firm to its position and not deviate from already negotiated salary increase ranges in this fiscal environment.

- The Administration also should be sensitive to the long-term cost implications of non-salary contract provisions such as sick leave buy-backs.

- Back-loading the contract by negotiating higher salary increases in the last year, especially for the public safety employees and teachers, presumes that greater revenues will be available. However, whether the improving economy will translate into larger state aid increases for Boston in fiscal 2006 is uncertain at this time.

- Whatever the agreement, when the first year costs are approved by the City Council, the City is obligated to pay for all the remaining years. If the revenue estimates were too optimistic, cuts in other services will be required to fund the contracts and that will cause further employee reductions.

- In return for the salary increases and other benefits negotiated, the Administration should be expected to achieve language changes in the contract for cost savings and service improvements. Such changes should involve more than moving the remaining half of Boston's employees from a weekly to a bi-weekly paycheck that is so basic that it should just be implemented.