Special Report

BOSTON MUNICIPAL RESEARCH BUREAU

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## Highlights

- A record $2B budget is still short on service restoration or expansion.
- Boston relies on the property tax for 57% of its operating revenue.
- Salaries and employee benefits have absorbed 85.8% of the budget growth in FY06.
- Spending for employees has increased by 23.1% over the past five years while inflation has increased by 11%.
- Boston should reduce its reliance on non-recurring revenue and control its employee costs.

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# Boston's $2 Billion Budget

## Employee Driven Spending Causes Tight Operations

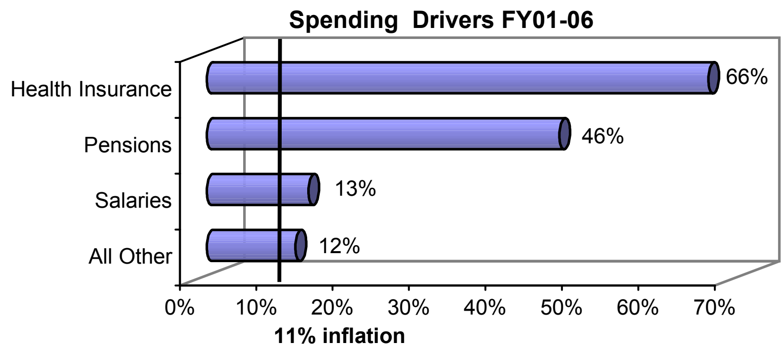
Boston's fiscal 2006 budget has exceeded the $2 billion mark for the first time at $2.049 billion, an increase of $119.3 million or 6.2%. That compares with a 4.6% increase in the Commonwealth's fiscal 2006 budget. A few key highlights of this year's budget are:

- **Revenue** - The primary revenues sources continue to be the property tax (56.6%) and state aid (26.5%), totaling 83.1% of total operating revenues. The City does depend on $29.2 million of non-recurring revenue to balance its budget this year.
- **Expense** - The rise in spending is due principally to increases for salaries, pensions and health insurance that account for 85.8% of the budget increase. That leaves little room for program restoration or expansion for most departments.
- **Observation** -The tight budget reinforces the need for continued strong management and restraint. The bigger issue is that Boston faces a long-term challenge of employee-related costs absorbing the bulk of limited revenue growth. The ability to manage these expenses will affect the amount of additional resources available to improve basic city services. The City should strive to reduce its budget reliance on non-recurring revenues and control its employee costs.

### Spending Drivers

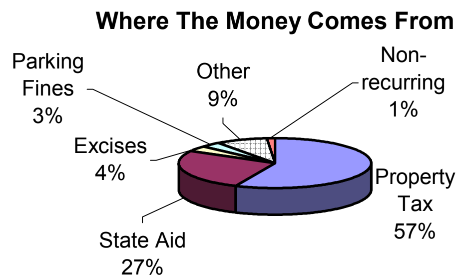
Over of the past five years, Boston's spending for employees has increased by $256.1 million or 23.1%. The drivers of employee spending have been:

- **Collective bargaining** – Contract agreements have provided generous salary increases and have expanded employee benefits.
- **Benefits** – Health benefits continue to increase at a double-digit pace while the City's overall revenue growth is significantly lower – not a sustainable situation.
- **Pensions** – Pension costs grow as employees with higher salaries retire and live longer, changes are made that increase the total pension liability and investment returns are affected by market conditions.



## Where The Money Comes From

The primary general fund revenue sources for Boston in fiscal 2006 continue to be the property tax and state aid which constitute 83.1% of the total $2.049 billion budget and 61.7% of the $119.3 million overall increase. Boston relies on non–recurring revenue for $29.2 million, an increase of $12.4 million or 10.4% of the growth in fiscal 2006.

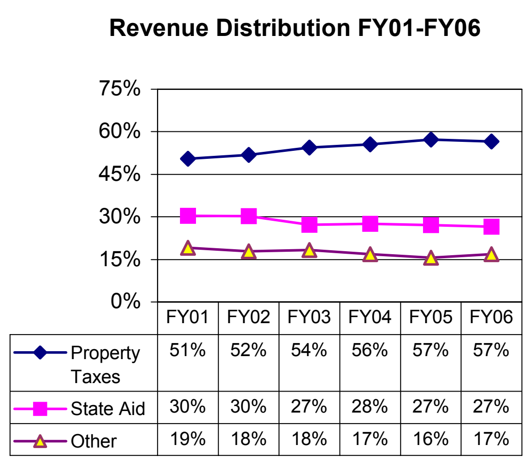



**Property Tax.** The mainstay of Boston's general fund revenue continues to be the property tax, which at $1.159 billion represents 56.6% of total operating revenue. The property tax is budgeted to increase by $53.9 million or 4.9%. That increase represents the normal 2.5% increase over the prior year's levy limit and an estimate of $22 million in new growth. Also, the Administration reduced its overlay reserve for abatements to 3.5% of the net levy, down from 4.0% last year. That reduction created an additional $5.6 million for operational spending this year. The increase in new growth is due primarily to capturing the remaining new commercial value of 33 Arch Street and the Manulife and Merck buildings and added value from personal property and new luxury condominiums. In December, new growth could increase slightly based on final property reviews when the tax rates are set.

**State Aid.** The second largest revenue source is state aid, which is budgeted at $543.0 million or 26.5% of the total. This represents a growth of $19.7 million or 3.8%. Reimbursements for teacher pensions, is the primary driver of this increase, growing by $15.1 million for a total of $76.5 million in fiscal 2006. This is followed by lottery receipts that are expected to grow by $6.6 million or 12.2% for a total of $60.6 million. Chapter 70 education aid will increase by only $3.1 million or 1.6% for a total of $203.6 million. Chapter 70 provided the largest aid increases until fiscal 2003.

**Other City Revenues.** Other city revenues are expected to generate $317.3 million, an increase of $33.4 million or 11.8%. Fueling this growth in other revenue sources are excise taxes (+$8.6 million), interest on investments (+$8.7 million) and parking fines ($3.6 million). Increase in revenues will also come from building permits (+$2.0 million) and Chapter 121A urban redevelopment payments (+$3.3 million).

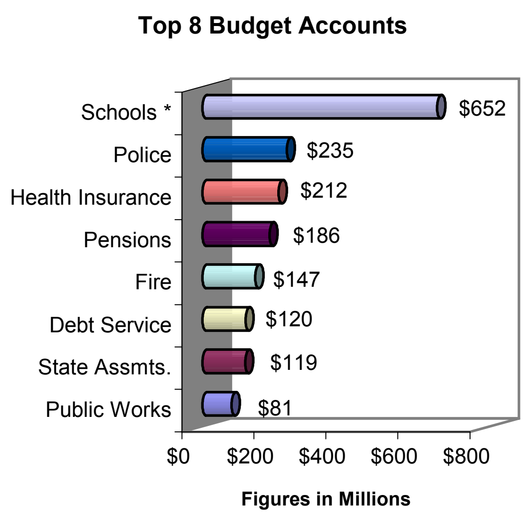
**Non-Recurring Revenue.** The fiscal 2006 budget is not fully funded by recurring revenues, as the City will depend on $29.2 million of non-recurring revenue to balance its budget. The Administration has tapped into its budgetary fund balance (free cash) for $20 million, an increase of $5 million over last year. With this appropriation, the remaining certified free cash balance is $36.3 million. The second source is the Surplus Property Disposition Fund from which $9.2 million will be applied for housing programs ($7.5 million), a Risk Retention Reserve ($1 million) and after school programming ($726,000).




## Where The Money Goes

The growth in this budget is due principally to increases for salaries, pensions and health insurance that represent 85.8% of the total increase. That explains why despite the increase in the Mayor's fiscal 2006 recommended budget of $119.3 million or 6.2%, this budget represents another year of tight departmental spending outside of negotiated salary increases. Also, the City's first $2.0 billion budget does not change the fact that a relatively few accounts represent the bulk of city general fund spending. As shown in the chart on the next page, eight budget accounts, out of the total of 62 accounts, represent 83.8% of the total recommended budget. Of those eight accounts, only four are city line departments.

**Departmental Services.** Total departmental spending is budgeted to increase by $118.1 million or 7.2%, $41.3 million of the increase is for salaries, overtime and new positions. A brief description of how the three largest departments are affected follows.

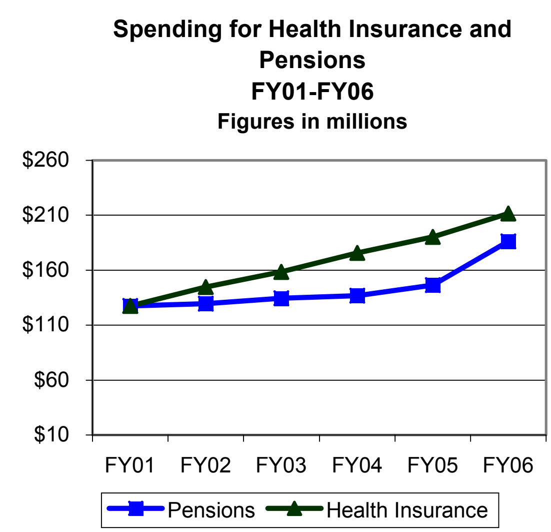



***School Department*** - The School Department is one of the few departments whose budget will enable it to restore limited services this year. The proposed operating budget for fiscal 2006 is $652.5 million (excluding health benefits), an increase of $23.4 million or 3.7%. Personal services spending will increase by $19.0 million or 4.2% due to collective bargaining increase for salaries and step raises. Overall, staffing will decrease by 13 FTEs. The budget is built around an expected enrollment of 57,420 students, a decrease of 1.4% from the fiscal 2005 actual enrollment. Two comprehensive high schools will be restructured into several small autonomous schools. All schools will receive an additional 1% to restore part of the 7% cut made in fiscal 2003. The budget funds an additional 21 K1 classes for 4-year olds in 18 schools.

***Police Department*** - The Police Department budget of $234.5 million represents an increase of $9.6 million or 4.3%. However, the personal services budget will increase by $10.5 million or 5.3%, indicating a squeeze in non-personnel spending. The budget will enable the uniform force levels to offset attrition and actually increase slightly by January 2006. Two classes totaling 65 officers will start this year, with a class of 35 officers entering the academy in October 2005 and a second class of 30 starting in the spring of 2006.

***Fire Department*** - The Fire Department's budget of $147.1 million for fiscal 2006 will raise authorized spending by $7.5 million or 5.4% over the prior year. Of that increase, spending for salaries, overtime and added staff accounts for $7.2 million or 95.9% of the total. To increase manning levels, a total of 75 firefighters from two classes were added in fiscal 2005 and a new class of 30 firefighters will be added in October 2005 to replace firefighters lost through attrition.

***Employee Benefits*** – Health insurance and retirement benefits for employees total $398.1 million and account for the largest budget increase at $61.3 million or 18.2%. The spike in pension costs represents the bulk of this growth as the budget for the State Boston Retirement System grew by $39.7 million or 27.1%, for a total of $186.2 million. This unusual increase reflects the impact of the early retirement incentive of 2002 and the weakness of past investment performance reflecting the market. Another year of double-digit health insurance increases for city and school employees caused this account to grow by $21.3 million or 11.2% for a total of $211.5 million. A




new benefit this year for selected employees is the Housing Trust, negotiated with AFSCME and SEIU, to provide lower paid employees with rental and housing purchase assistance at $320,000.

**Mandatory Accounts.** The mandatory accounts of debt service and state assessments total $238.5 million, growing by only 0.1% over fiscal 2005. Debt service for fiscal 2006 is budgeted at $119.8 million, a decrease of $1.6 million. The reduction is due, in part, to the application of debt savings from prior refunding loans. Debt service as a percent of operating expenditures in fiscal 2006 is 5.8%, which is below the City's debt standard of 7%. State assessments will total $118.7 million in fiscal 2006, an increase of $1.8 million or 1.6%. Included in this category are the City's MBTA assessment of $65.2 million, charter school tuition of $48.9 million and other minor items.

## External Budget

In addition to the operating budget of $2.049 billion, Boston expects to receive approximately $320.4 million in state, federal and private funding earmarked for specific services in fiscal 2006. These funds focus primarily on education, housing, economic development, public safety and public health services and are either competitive or reimbursement grants. Over 90% of the City's external funds are utilized by six of 22 departments and agencies that receive such funds. The School Department is the largest recipient of external funds at an estimated total of $140 million. Neighborhood development activities are supported by Community Development Block Grant funds of $30.3 million this year.

**External Funds - Figures in 000's**

| Department | Budget FY05 | Budget FY06 | FY06 % of Total |
|---|---|---|---|
| Schools | $142,474 | $139,959 | 43.7% |
| Neighborhood Dev. | 71,700 | 78,663 | 24.6% |
| Emergency Prep. | 65,646 | 18,944 | 5.9% |
| Public Health | 39,168 | 42,630 | 13.3% |
| Library | 10,791 | 11,432 | 3.6% |
| Police | 12,960 | 8,203 | 2.6% |
| Other | 20,357 | 20,546 | 6.4% |
| Total | $363,095 | $320,378 | 100.0% |

## Capital Budget

Boston's five-year capital budget (FY06-FY10) totals $1.25 billion, an increase of $150 million over last year's $1.10 billion budget. General obligation (G.O.) bonds will fund 64.8% of this budget with the balance coming from federal, state and trust funds. This budget identifies 483 new and continuing projects and proposes $115.4 million in new project authorization. The City is planning to increase its G.O. borrowing over the next five years from the $80 million in fiscal 2006 to $100 million starting in fiscal 2008. Five city departments account for 84.4% of total planned capital expenditures with the School Department topping the list at $35.8 million for 36.2% of total planned spending this year.

## Conclusion

The allocation of over 85% of the revenue growth in this budget to employee-related expenses leaves little room for program restoration or expansion but reinforces the need for continued strong management and restraint even with an improving economy. This scenario is likely to be repeated in subsequent years for which the City must be prepared. That also will mean guarding against the addition of non-essential positions that will increase spending obligations that bring long-term fiscal implications. The significant increase in the average cost of a police officer or firefighter over the past several years will require a more efficient redeployment of the uniform force and increased utilization of civilian employees.

The Housing Trust account is the start of the price the City is paying for the conflict of its mandatory residency policy for employees (paid for in earlier contract negotiations) with the high cost of housing in Boston. Addressing this conflict over the next few years will likely cause the City to either expand this housing assistance to more employees or agree to greater flexibility in its residency policy.

A more fundamental problem facing Boston is the long-term budget challenge of employee-related expenditures absorbing the bulk of limited revenue growth. Addressing these issues will require hard choices to be made at the state and local level. Increasing the co-payments or deductibles for health visits and limiting the time that employee contracts can be negotiated retroactively are just two examples of choices that can affect future expenses. Also, the growing costs of retiree benefits must be considered in future decisions. The Research Bureau will release a report on these issues in September.