CITY OF BROCKTON

MASSACHUSETTS

FINANCE DEPARTMENT

John A. Condon
Chief Financial Officer

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June 11, 2012

TO: Mayor Linda M. Balzotti
Members of the City Council
Members of the School Committee

FROM: John A. Condon, Chief Financial Officer

RE: FY13 Budget

I am writing to provide a commentary on financial trends which have affected the FY2013 budget. Like most of its most recent predecessors, this year's budget does not accomplish many of the improvements in services to the city which we would all like to see. As most of our services are delivered by employees, it is a challenge to serve the public without the staff to do so. On Exhibit 1, attached, it can be seen that most offices except the school department and police department are operating with staff levels even lower than those after the many layoffs for the FY1992 budget. Funding for the school department reflects a struggle to keep pace with cost inflation, growth in the total number of students, and especially growth in the numbers of neediest students. Funding for core municipal services, especially for staffing the police and fire departments, but also for the DPW Highway Division and City Hall offices is woefully short of need. Funding is available for only a small portion of the capital requests. These trends are caused by tepid revenue growth which is inadequate to match the substantial rates of growth in the cost of benefits and pensions for employees and retirees.

Attached as Exhibit 2 is a revenue comparison between FY02 and FY13. I've chosen FY02 because by that year, many of the positions lost to the layoffs of 1992 had been reinstated, the state's unrestricted revenue assistance reached its peak, and pension and benefit costs were much lower. The city's fiscal health was quite good, compared to now. We did not fully levy the annual increase under Prop 2 1/2, and we still added $1.8 million to our reserves.

Many conclusions can be drawn from this exhibit. Perhaps the most important involves the state's near abandonment of providing revenues to communities, other than the Chapter 70 aid associated with its constitutional obligation established by the lawsuit from the City of Brockton which led to the Education Reform Act.

The city receives $12.1 million less now than it received in 2002 in state aid other than Chapter 70, a 40% decline. Had that aid kept pace with inflation at 2.5 percent per year, the city would have had an additional $11.5 million in revenues in FY13, and many of the budget problems we now face could have been avoided. The second conclusion is a bit less obvious, because it is not directly observable in the exhibit, but the increase in Chapter 70 aid, which appears to have outpaced inflation at an average increase of 3.5 percent per year, in fact merely kept pace with inflation and student enrollment. Over that time period, the city's K-12 enrollment grew, so in fact Chapter 70 Aid merely kept up. The third conclusion is similar. While it appears that tax levy growth exceeded inflation and so ought to have

provided an added boost to funding budget needs, in fact, the loss of other state aid and the slight reduction of "other Local Receipts" revenue, totaling $12.5 million between the two, brought the net increase from higher tax revenues down to just over $26 million. This represented an increase of only 35.9% over 13 years, or an average rate of increase at only about the rate of inflation. Moreover, compliance with the Education Reform Act has required the city to devote in excess of an additional $10 million from its local revenues to "Net School Spending" as required "Minimum Local Contribution". Because of this, more than one-fourth of the increase in the tax levy was not available to support other purposes, and this brought the growth in revenue available for other purposes down to less than $16.0 million, or about 21% over thirteen years. This translates to well under 2 percent per year, less than the rate of inflation. In fact, the growth in health costs of school employees consumed the required increase in Local Contribution, so the school committee saw none of that increased funding as a benefit for classroom services. The final immediate conclusion is that the city has relied on reserves to "plug" the revenue gap, but this is a strategy which cannot be maintained over time. The city will need to replenish those reserves and that will require devoting revenues to that purpose. It is not apparent where those revenues will come from.

The third exhibit performs an analysis similar to the revenue analysis, but on expenditure categories instead. Only one major cost category demonstrates average growth rates well in excess of inflation. The cost of personnel benefits, primarily health insurance for active city and school employees and retirees, has grown at nearly eight percent per year, doubling from FY02 to FY13. The cost of Net School Spending, as mentioned, has about kept pace with inflation and enrollment, but the School Superintendent can inform you that this statistic masks a more telling one, which is that a higher percentage of the students now require either special education, or they are English language learners. Both kind of students are more expensive to educate. To compensate , Chapter 70 funding should have received an even greater increase, but it didn't, because the Chapter 70 per student formula does not adequately recognize such higher costs for those students.

The treasurer's debt category has grown by about 3 ½ percent per year, or nearly 50 percent in thirteen years. Some of this growth derives from the permanent funding of the city's share of the cost of the construction of the George and Baker Schools. A larger share comes from the issuance of "pension obligation bonds" in 2005 to prefund a portion of the city's unfunded pension liability. This transaction resulted in a decrease in the annual pension assessment, so the annual net increase of pension costs has proceeded at an average pace a bit less than inflation. Because of the major declines in the securities markets in 2008 and early 2009, the city has not yet achieved the desired results on this transaction. According to the initial plan, the city would have eliminated its unfunded pension obligation in 2020. However, the appropriate measurement period is not 2012, but through the maturity date of the bonds in 2028.

The major "squeeze" on city budgets from a lack of growth in discretionary revenue, combined with extreme rates of growth in health costs, has meant that the city has failed to adequately fund spending for capital needs and ordinary maintenance, and the city has failed to replenish reserves. These trends can be seen in the $6.3 total decline of the category of "other appropriations". In addition, the cost of city employees has only grown at an average rate about 1 percent per year. During that time city employees have received contract and step raises; accordingly, as mentioned earlier, total city employment has been significantly reduced. That can be seen from the first exhibit.

The next several exhibits take a closer look at the city's health insurance costs. Here, two main conclusions may be drawn from these exhibits. The underlying rate of inflation in overall health costs has overwhelmed significant strategies employed by the city to shift costs from the city to its employees and retirees and to the federal government. If there had been a rate of health cost inflation more like the overall rate of inflation, the success of these strategies would be apparent. Perhaps as damaging as the rate of health cost inflation has been the rate of growth in the number of retiree subscribers covered by the city. This category now comprises more than one half of total enrollment.

In the fourth exhibit it can be seen that subscriber enrollment for employees, both city and school, has declined from FY02 to FY13. The decline on a percentage basis has been much greater for city than school employees. However, in both cases the cause is the decline of the number of staff employed as a result of budget cost pressures. Growth in enrollment by retiree subscribers has overwhelmed the decline for active employees. The number of retirees covered has increased by nearly one-third since FY2002. This trend, combined with health costs trends, portends dire consequences for the city which I will address at the conclusion of this memorandum.

The next exhibit provides an adjustment for enrollment changes to track increases on a cost per subscriber bases. The cost for the three categories of city, school, and retired subscribers displayed represents the city's share, not the total cost. Here can be observed a growth rate of about 7 percent per year for city/school actives, but only 2.4 percent per year for retirees. These rates understate the actual rate of total health cost increase experienced by both the city and its subscribers. The impact of health cost inflation on the city would have been much greater than 7 percent per year, except that the city generally increased the percentage of premium cost contributed by all subscribers to 25 percent from 20 percent. Exceptions to this were for the Master Medical indemnity plan, for which the employee contribution was increased to thirty percent, and for the contribution rates for retirees whose annual incomes are less than 200% of the federal poverty index, whose plans require only a 10 or 15 percent contribution from the retiree.

The savings from the cost controlling measures undertaken can be seen in the exhibit to consist of four benefits. Requiring active city employee subscribers to contribute more saved about $600 thousand compared to what would have been spent in FY13 at the old contribution rate. Similarly, requiring active school employees subscribers to contribute more saved about $1.6 million, so the total gross savings for the city in FY13 from higher contributions from active employees is about $2.2 million. About the same amount of savings derives from requiring most retirees to contribute more, so the total saved from contribution increases from subscribers to premium costs is about $4.4 million in FY13. On top of that, requiring retirees who were Medicare eligible to actually enroll in Medicare, thereby shifting some cost to the federal government, saved about $5.2 million for the city, so the total saving from all of these factors in FY13 is about $9.6 million. Absent these steps, the benefits cost to the city would have increased by nearly 140%, instead of just over 100%, at an average annual rate of nearly 11 percent per year.

This trend is obviously unsustainable. That fact can be observed not only on the impact on the present budgets, with depressed levels of city services; it is even more concerning when costed on the basis of the future impact. The last of the exhibits is a page from the most recent year of the city's prepared financial statements. It shows progress on funding the city's pension obligation and a similar obligation called "Other Post Employment Benefits", or OPEB. The impact on the city's pension system of the near

collapse in values in the stock market in 2008 and early 2009 can be seen from the status of funding progress. When the city issued its Pension Obligation Bonds in 2005, the funding status of the system increased from about 60 percent funded to nearly 90 percent. By the beginning of 2008, that percentage had increased to 92.0%. After 2009, it had declined back to about 60 percent, but by the beginning of 2012, it had climbed back to nearly 78 percent. In examining the pension costs of the city, it is important to remember that the majority of the unfunded liability derives from failing for years to adequately fund the future costs of people then working, now retired or nearing retirement age. The state law, which the city followed then and follows now, required for years that employees contribute only 5 percent of pay. It was then raised in steps, and current employees are contributing a much higher percent of pay toward their retirement, with the most recent hires contributing 9 percent plus an additional 2 percent for income over $30,000. In fact, many are nearly fully paying for their own retirement benefits in their payroll deductions. The second factor to recall is that in Massachusetts public employees do not earn Social Security benefits. Neither they nor their government employees pay the tax. However, the percentage contribution in addition to payroll to future retirement costs of employees of the city is slightly lower than the Social Security tax rate. If the present system were replaced for future retirees with Social Security, the city would pay a higher rate in Social Security taxes than its present "normal cost" in funding the system.

The OPEB benefits shown in the exhibit are primarily related to health insurance costs that the city provides to its retirees and their spouses. The calculated OPEB liability is essentially the value today in present dollars, of the cost of all future health benefit payments, which under present policies, have already been earned by current employees and retirees. This value is displayed as $693.6 million as valued by our actuaries at 6/30/2010. This value reflects a 10 percent increase from $635.2 million as valued at 6/30/2008. It is important to realize that while the size of the number can vary quite significantly with actuarial assumptions (for example, factors such as health insurance cost inflation, and the morbidity and mortality of benefit recipients), **the benefits thus costed have already been earned**. To reduce or increase the size of the OPEB estimate will depend on changes in part in the external factors represented by the assumptions. However, it can also be lowered by reducing the number of people eligible to receive the benefits or by reducing the level of benefits themselves.

In the costing of this liability, the city is also obligated to disclose its annual OPEB expense. This is calculated based on the annual required contribution (ARC) of the city as employer. The ARC represents a level of funding that if paid on an on-going basis, is projected to cover the "normal costs" each year and amortize any unfunded actuarial liability over a period of thirty (30) years. The "normal cost" is a calculation of future OPEB benefits being earned in the current year, as opposed to the unfunded OPEB liability, which is a costing of benefits already earned. The ARC for the 6/30/2011 financial statement was valued at $60.3 million. The city is not accruing for the "normal cost", nor is it reserving money to pay for the OPEB unfunded liability. It pays retiree health costs on the basis of the bills for the current year. The city actually paid out $20.2 million in such "pay as you go" health benefits in FY2011. The difference between the ARC and the "pay as you go" amount is $40.2 million. **I know of no source to obtain this added $40.2 million in the annual budget, but the cost of delaying the addressing of this issue is extreme.** According to our actuarial study, if the city remains on a "pay as you go" basis, the ARC will increase from $60.3 million for FY11 to $70.4 million for FY13 to $80.5 million for FY15. While that ARC represents an accounting entry devised to value a long term liability, not a cash payment, that rapidly increasing trend will continue into the future until we develop a strategy. Most of these increases come from not addressing the unfunded OPEB, not from increases in the normal cost.

The only solution to this dilemma, which will swamp the city's balance sheet financials over time and may ultimately result in bond ratings downgrades, is to attack the underlying benefit levels themselves. This will require some very difficult discussions and hard decisions in future years.

JAC/amw

XC: Anthony Zeoli, City Clerk
Matthew Malone, School Superintendent

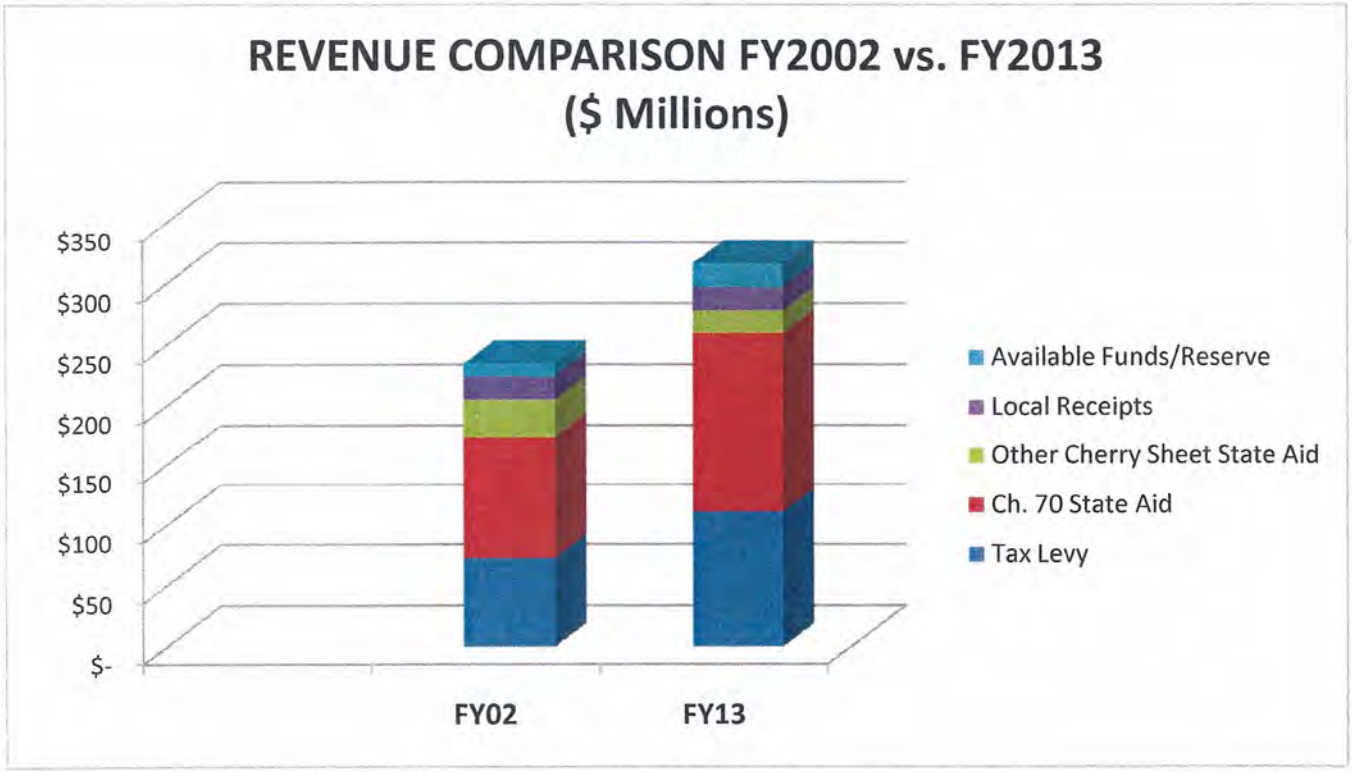
Attachments

BUDGETED FULL-TIME EQUIVALENT EMPLOYEES

	1981	1992	2002	PT + Other	2010	PT + Other	2011	PT + Other	2012	PT & Other
FINANCE & ADMINISTRATION										
ASSESSOR	16	10	11		7	1	7	1	7	1
AUDITOR	17	11	9		8		8		8	
CONSERVATION	1	1			0		0		0	
ITC	7	5	9	1	8		7		8	
DEVELOPMENT/INDUSTRIAL	2	0			0		0		0	
FINANCE	0	2	4		3		3		4	
LAW	1	2	8		7		7		5	2
PERSONNEL	0	0	4		4		4		2	2 Trust
PLANNER/PLANNING BD	3	2	3		1		2		2	
PROCUREMENT	0	0	1		1	1	2		2	
TREASURER/TAX COLLECTOR	28	20	18		14	1	14	1	14	
MAYORS OFFICE										
MAYOR	8	10	9		5	1	6		6	
HUMAN RES	2	1			0		0		0	
CLERK, COUNCIL, ELECTIONS										
CITY CLERK/CITY COUNCIL	12	11	14		9		8		7	1
ELECTION COMMISSION	11	8	6		4		4		4	
DEPT. OF PUBLIC WORKS										
DPW - COMM	5	3	3		3		3		3	
DPW - HWY	56	40	39		30		29		28	
DPW - ENG	8	6	7		4		4		4	
DPW - MAINT (includes Forestry in FY81	13	4	4		2		2		2	
HEALTH, INSPECTIONS, PUBLIC PROPERTY, WEIGHTS/MEASURES										
HEALTH	13	8	13	1	10	4	12	4	11	
P PROPERTY	58	32	35	1	26	1	26	1	24	
W/M	1	1	2		2		2		2	
PUBLIC SAFETY										
ANIMAL CONTROL	6	3	5		5		5		5	
FIRE	260	209	209	2 NON	167	2 NON	184	2 NON	177	2 NON
LICENSE	2	2	1		1		1		1	
POLICE	224	168	183	14 other fnds	174	4 other	173	13 other	171	4 CDBG
				34 NON		18 NON		20 NON	20 NON	1 Comm
										1 SCHL
TRAFF COMM	1	2	1		0			0	0	
EMERGENCY MANAGEMENT	0	0	1		0	2		2		2
HUMAN SERVICES										
AGING	2	1	3		1	1	1	1	1	2 grant
CEMETERIES	14	7	5	1	2	1	2	1	4	1
CONSUMER ADVISORY	1	0.5	0		0		0			
VET COUNCIL/SERVICES	13	7	4	2	2	2	2	2	2	1
WAR MEMORIAL	2	2	0		0		0		0	
LIBRARY										
LIBRARY	33	26	22	26	20	15	22	17	31	9
SUB TOTAL	820	605	633	32	520	30	540	30	535	17
ENTERPRISE & SELF SUPPORTING										
DPW - REFUSE	81	6	5		6		6		6	
DPW - SEWER	59	18	21		23	2	20	2	20	4
DPW - WATER	99	46	51	1	52	3	52	3	44	4
PARK/GOLF	34	26	14	2	10	1	10	1	10	
PARKING AUTH	0	0	3	10	3	10	3	9	3	9
SUB TOTAL	1093	701	727	45	614	46	631	45	618	34
SCHOOL DEPARTMENT										
EMPLOYEES	1,837	1,652	1,652		2,781	N/A	2,920	272		
GRAND TOTAL	**2,930**	**2,353**	**2,379**	**45**	**3,395**		**3,551**	**317**	**618**	**34**

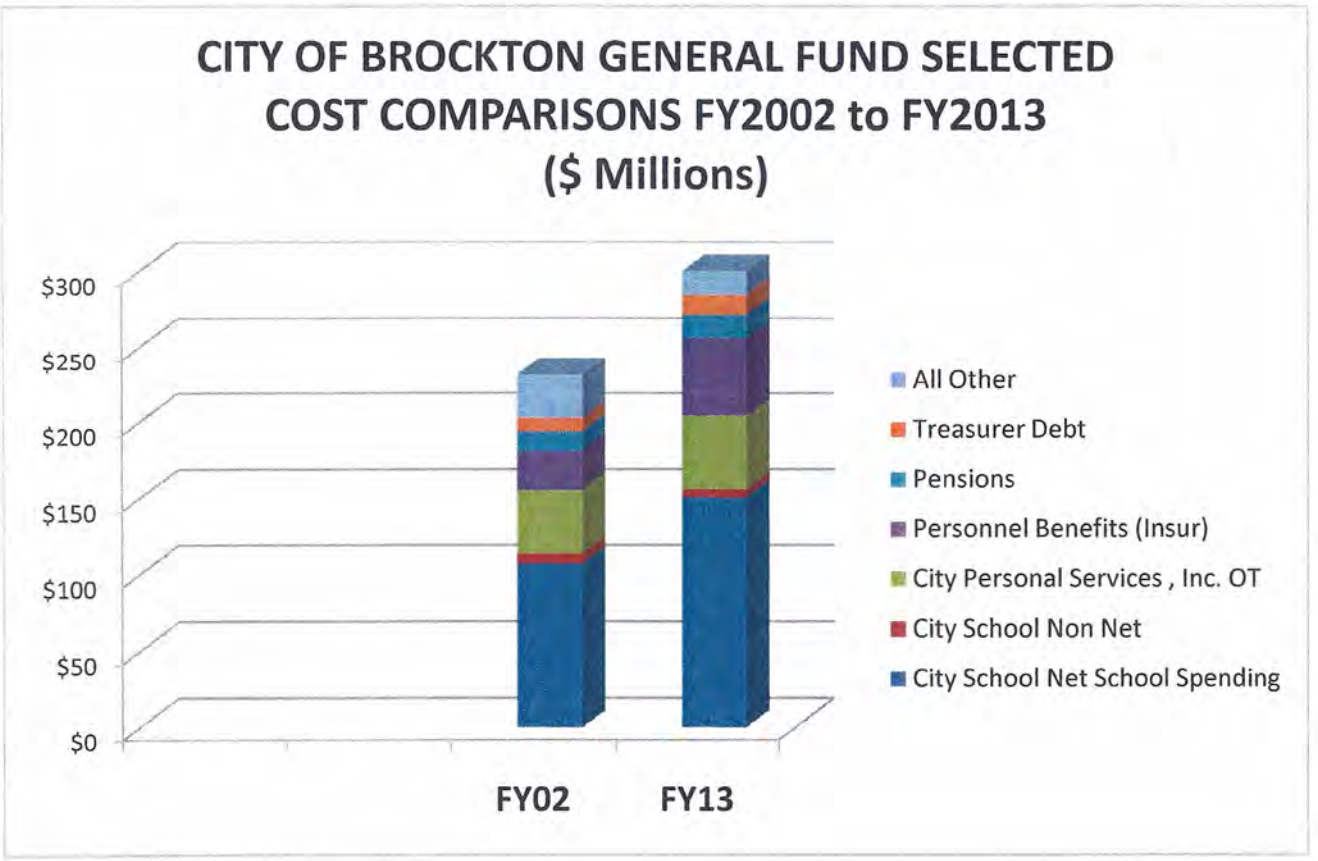
City of Brockton General Fund
Revenue Comparison
FY2002 Vs. FY2013
($ in Millions)

Revenue Category	FY2002	% of Total	FY2013	%of Total	$ Change	% Change	Annual Avg. % Change
Tax Levy	$ 72.8	31.0%	$ 111.4	35.3%	$ 38.6	53.0%	4.1%
Ch. 70 State Aid	$ 101.6	43.3%	$ 148.1	46.9%	$ 46.5	45.8%	3.5%
Other Cherry Sheet State Aid	$ 30.3	12.9%	$ 18.2	5.8%	$ (12.1)	-40.0%	-3.1%
Local Receipts	$ 19.8	8.4%	$ 19.4	6.1%	$ (0.4)	-2.0%	-0.2%
Available Funds/Reserve	$ 10.1	4.3%	$ 19.0	6.0%	$ 8.9	88.1%	6.8%
Total	$ 234.6	100% *	$ 316.1	100%	$ 81.5	34.7%	2.7%



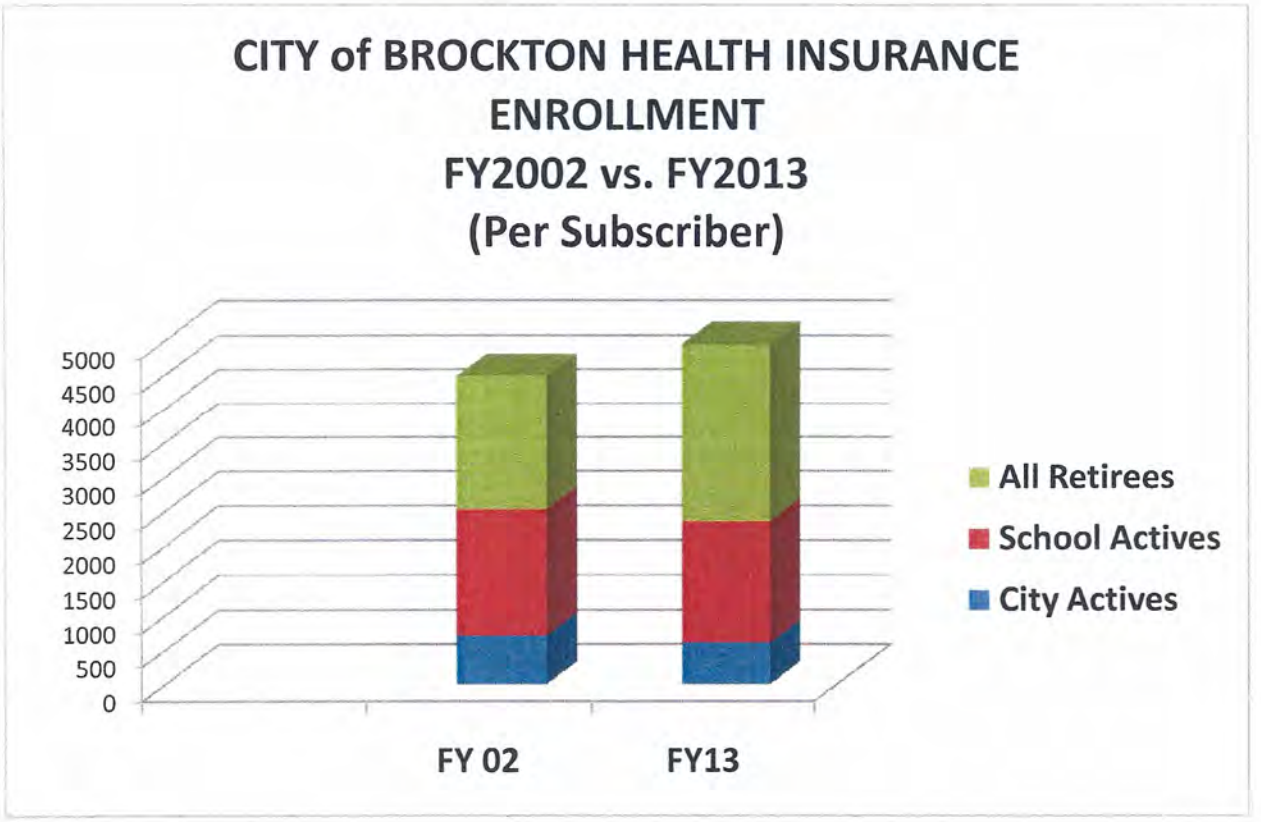
City of Brockton General Fund
Selected Cost Comparison
FY2002 Vs. FY2013
($ in Millions) ( ) = Negative

Category	FY02	% of Total	FY13	% of Total	$ Change	% Change	Annual Avg. % change
City School Net School Spending	$ 107.3	46.4	$ 150.5	49.1%	$ 43.2	40.3%	3.1%
City School Non Net	$ 6.6	2.9	$ 5.9	1.9%	$ (0.7)	-10.6%	-0.8%
City Personal Services , Inc. OT	$ 41.7	18	$ 47.7	15.6%	$ 6.0	14.4%	1.1%
Personnel Benefits (Insur)	$ 25.7	11.1	$ 52.0	17.07%	$ 26.3	102.3%	7.9%
Pensions	$ 12.7	5.5	$ 15.4	5.0%	$ 2.7	21.3%	1.6%
Treasurer Debt	$ 8.8	3.8	$ 12.9	4.2%	$ 4.1	46.6%	3.6%
All Other	$ 28.4	12.3	$ 22.1	7.2%	$ (6.3)	-22.2%	-1.7%
Total	$ 231.2	100%	$ 306.5	100%	$ 75.3		



The City of Brockton Health Insurance Enrollment
FY2002 Vs. FY2013

Subscriber Category	FY 02	% Total	FY13	% Total	Change	% Change	Avg. Annual % Change
City Actives	709	15.8%	603	12.2%	(-106)	-15.0%	-1.2%
School Actives	1820	40.6%	1757	35.6%	(-63)	-3.5%	-0.2%
All Retirees	1953	43.6%	2588	52.3%	635	32.5%	7.7%
Total	4482	100%	4948	100%	466	10.4%	0.6%



City of Brockton Health Insurance Cost per Suscriber
FY 2002 vs. FY 2013

Subscriber Category	FY02 Avg Annual Cost per Subscriber	FY13 Avg. Annual Cost per Subscriber	$ Change	% Change	Avg Annual % Change
City Actives	$ 7,114	$ 13,655	$ 6,541	92.0%	7.1%
School Actives	$ 6,962	$ 12,953	$ 5,991	86.1%	6.6%
All Retirees	$ 4,885	$ 6,426	$ 1,541	31.6%	2.4%

Estimated Savings in Requiring Medicare & Contribution Increase

FY2013 Cost per subscriber if growth rate = 90%. Like actives, from FY2002 to FY2013, = $9,282

Actual FY2013 Avg Cost per Subscriber = $6,426
Difference = $2856 per subscriber

Total Difference = $2,856 X 2588 = $7,391,328
OR This, almost $2.2 million is from increasing percent contribution by retirees, and about $5.2 million is from shifting city costs to Medicare.

Estimated Gross Savings in Increasing Contribution % From Active Employees

FY2013 Average Contribution %, Current City Actives = 25.6%
FY2002 Contribution % City Active = 20%
FY2013 City Savings from 5.6% cost shift to City Employees = $0.6 Million
FY2013 Average Contribution %, Current School Actives = 25.2%
FY2013 Contribution %, School Actives = 20%
Savings FY2013 from 5.2% cost shift to School Employees = $1.6 Million
Total Gross Savings, city plus school = $2.2 Million
Total Savings From Retiree and Active % Shift = $4.4 Million
Total in FY2013 for All steps, including requring Medicare enrollment = $9.6 Million

CITY OF BROCKTON, MASSACHUSETTS

Required Supplementary Information

June 30, 2011

(Unaudited)

(Dollar amounts in thousands)

Schedules of Funding Progress

Actuarial valuation date	Actuarial value of assets (a)	Actuarial accrued liability (b)	Unfunded (b-a)	Funded ratio (a/b)	Covered payroll (c)	((b-a)/c)
			Pension			
January 1, 2010	$ 351,526	453,213	101,687	77.6%	$ 70,882	143.5%
January 1, 2008	377,647	410,270	32,623	92.0	69,345	47.0
January 1, 2007	361,767	398,969	37,202	90.7	67,660	55.0
			Other Post Employment Benefits			
June 30, 2010	$ —	693,570	693,570	—%	$ 171,103	405.4%
June 30, 2008	—	635,224	635,224	—	147,088	431.9

Schedule of Contributions from City – Pension

	Annual required contribution	Percentage contributed
Year ended December 31:		
2009	$ 9,709	100%
2008	9,742	100
2007	9,470	100

See accompanying independent auditors' report.