Pennsylvania Intergovernmental Cooperation Authority

Staff Report
on the
City of Philadelphia's
Five-Year Financial Plan
for
Fiscal Year 2000 - Fiscal Year 2004

June 15, 1999

PENNSYLVANIA INTERGOVERNMENTAL COOPERATION AUTHORITY

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TABLE OF CONTENTS

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Pennsylvania Intergovernmental
Cooperation Authority

STAFF REPORT
ON
FY2000-FY2004
FIVE-YEAR FINANCIAL PLAN

SECTION I:

INTRODUCTION

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EXECUTIVE SUMMARY AND STAFF RECOMMENDATION

The City of Philadelphia (City) submitted its *Five-Year Financial Plan, Fiscal Year 2000-Fiscal Year 2004* (the FY2000-FY2004 Plan or the Plan) to the Pennsylvania Intergovernmental Cooperation Authority (PICA or the Authority) on May 24, 1999. The Plan failed to appropriate funding for the First Judicial District of Pennsylvania (FJDP), funding which PICA Staff believes to be legally mandated. PICA Staff was able to ascertain that funding was available but not allocated for such purpose.

Except for the failure to directly appropriate required FJDP funding (in both the Plan and the City's FY2000 budget), the Plan presents a reasonable prospect for balanced budgets in each year of its term. Such prospect, however, continues to be dependent on a variety of circumstances, many of which are beyond the City's control.

The Plan confronts six significant risks, three of which are quantifiable. These six risks include:

- Inclusion of unidentified "Future Target Reductions" in each of the final four years of the Plan ($60 million risk).
- An expected drop in Public Utility Realty Transfer Act (PURTA) tax revenue from the state, an amount unaccounted for in the Plan ($60 million risk).
- A School District expectation of continued $15 million annual contributions from the City's General Fund, an amount unbudgeted over the life of the Plan ($75 million risk).
- July 1, 2000 expiration of labor contracts with the City's four major municipal unions, with no explicit funding in the Plan for any costs associated with new labor contracts.
- Continued phase-in of welfare reform, with unpredictable effects on the City's economy and General Fund demands.
- Failure to appropriate FJDP funding in accordance with the State Supreme Court appointed Special Master's Plan and the approved Commonwealth budget, jeopardizing the continuance of a vital government function.

Additionally, the Plan's success will depend greatly on a strong economy. PICA Staff continues to believe that the City's economic projections are optimistic.

City's Future Ability to Weather Risks is Unknown

Even though many of the Plan's assumptions have a high degree of uncertainty, the Rendell Administration has repeatedly shown a willingness and ability both to control expenditures throughout the fiscal year and impose extraordinary measures when necessary to balance the budget. PICA Staff has no reason to believe that the current administration will not do so again if such actions are required.

However, 90% of the time period covered by the current Plan will occur under the watch of a successor administration. Of the $195 million in quantifiable risks to the Plan, at least $176 million will not affect the City until after Mayor Rendell leaves office. The next administration will need to remain focused on these risks in order to mitigate their potential impact.

City has Addressed Unfunded Pension Liability

As has been discussed in prior PICA Staff reports, the City remains burdened by a significant unfunded pension liability. In January, the City took the significant step of issuing $1.3 billion in Pension Funding Bonds to retire approximately half of the outstanding Pension Fund liability. By taking advantage of low bond interest rates and high investment returns, the City expects to save millions of dollars by this trade of pension debt for bond debt.

Having recommended this action to the City numerous times, PICA Staff commends the City for taking this extraordinary step. Even with this refunding of the pension liability, the Pension Fund remains underfunded, although at a level that is actuarially sound. Additionally, PICA Staff is concerned about the structure of the bond repayment schedule. While the payment requirement never exceeds $136 million annually through FY2028, an amount much lower than the payment otherwise required to the Pension Fund, the final payment in FY2029 will be $232 million. Although this large one-year jump in debt service is of concern, there are many mitigating factors, such as the refinancing of the last payment, that can come into play before that time.

Report Summary

As in recent years, this report focuses primarily on significant risks to the Plan, with discussion of some department-specific and other issues that have a direct relationship to maintaining fiscal stability. A Chart of Quantifiable Risks to the FY2000-FY2004 Plan appears at the end of this executive summary. PICA Staff continues to track departmental progress in numerous areas and will report on those areas as significant issues arise.

Quantifiable Risks

As already mentioned, the Plan confronts six significant risks to its successful implementation. The first three of those risks are quantifiable and included in the Chart of Quantifiable Risks at the end of this Executive Summary.

The Plan anticipates a total of $60 million in unspecified expenditure reductions over its final four years as a result of the continued use of target budgets. PICA Staff has previously expressed reservations as to the amount of savings that can be anticipated from future use of the target budget process. PICA Staff continues to have concerns about whether the use of target budgets as a management tool will result in monetary savings.

As the effects of deregulation in the electric industry have become more evident, it has become apparent that the City and the School District are at risk of experiencing a significant decline in Public Utility Realty Transfer Act (PURTA) tax revenue that is passed through the state. The Plan may overestimate PURTA tax revenue by as much as $60 million over the life of the Plan.

The School District of Philadelphia anticipates in its budget documents that the City will continue to provide the District $15 million annually over the next two years. School District officials indicate an expectation that such funding will continue even beyond that time frame. The Plan and FY2000 General Fund budget do not include any such funding. Given the political pressure that will likely come to bear, and the fact that the City's economic development incentives tend to be biased against the School District, it is reasonable to expect that the City will provide $75 million to the District over the life of the Plan.

Other Significant Risks

An arbitration award last fall provided the City with a two-year labor contract with the Fraternal Order of Police, Lodge 5 (FOP), costing the City $103 million over five years. The four labor contracts with the major collective bargaining units will all expire on July 1, 2000. The Plan provides no funding for any new costs that may result from future labor contracts.

State and federal welfare reform continues to phase in. Eligibility and the level of support provided to those in need have already been altered. Some of the changes to date have led to increased demands for City services, most particularly primary health care, emergency shelter and homeless prevention. These effects are likely to grow.

For the second consecutive year, the Plan provides no funding to the FJDP. The final FY2000 budget also does not appropriate any funding to the courts. Although PICA Staff believes that the City's efforts to speed Commonwealth funding of the courts is justified, by not explicitly appropriating FJDP funding the City jeopardizes its ability to carry out a vital government function. In accordance with the PICA Act and the PICA Agreement, PICA Staff felt it would have to recommend that the PICA Board not approve the Plan until funding was properly in place for the courts.

As was the case last year, the President Judge of the FJDP has instituted legal action to require that the Mayor and City Council take action to appropriate court funding. The City has identified to PICA Staff sufficient funding for the courts that is available elsewhere in the Plan and the FY 2000 budget. Even so, had the FJDP not forced the issue by its legal (mandamus) action, PICA Staff would have recommended that the otherwise viable Plan not be approved.

Other General Fund Concerns

While Philadelphia over the past two years has experienced its greatest amount of private sector job growth since 1988, job growth continues to lag regional and national trends. Additionally, the City continues to lose residents. The lack of real growth in real estate assessments reflects these two trends. PICA Staff continues to stress the importance of improving the underlying economic trends in Philadelphia. Without strong economic growth, the City cannot handle an increasing demand for public services.

The Department of Human Services has successfully and significantly increased its state and federal funding over the past eight years. This increased funding has allowed the City to enhance service levels, while simultaneously reducing net City costs. As programmatic and funding challenges threaten to increase net City costs in the future, the City must continue working diligently with the state to protect the funding it currently receives and to identify new funding streams.

The City continues to misstate the underlying economic growth assumptions in the Plan and has not ameliorated other persistent problems with its methodology for projecting growth in the real property tax base and delinquent tax collections. The Base Obligation Methodology for projecting expenditures other than personnel and debt service costs also continues to be problematic. The City needs to clearly articulate its assumptions and how those assumptions are applied throughout the Plan. The City also must be more diligent in using consistent data in the Plan and any supporting material.

Adjusted for inflation, total net City costs (General Fund costs not funded with state or federal revenue) were higher in FY98 than in FY91, the height of the City's fiscal crisis. In many specific cost centers, the City's spending habits are not much different from what they were fifteen years ago. By reducing net costs in any one area, the City can redirect resultant savings to whatever purpose it determines urgent, whether alternative cost centers or new labor contracts. By reducing <u>total</u> net costs, the City will be able to provide more than marginal tax relief to its residents and make Philadelphia a more competitive place to live, work and visit.

In February, the state legislature appropriated state funding for new professional sports stadiums. While no funding or construction agreement is yet in place, it appears fairly certain that the City will provide funding for the construction of two new facilities. As Veterans Stadium is City owned and operated, the General Fund recognizes numerous direct, as well as indirect, revenues and obligations associated with the operation of the two major league teams that use that facility. Without a funding mechanism in place, there is no way to calculate what the net impact of two new stadiums will be on the General Fund. PICA Staff will be watching closely as details on local funding of stadiums emerge.

The City of Philadelphia issued a Citywide strategic plan in 1995 as an appendix to that year's Plan. Since that time, only five departments have provided PICA Staff with copies of their departmental strategic plans. With the exception of those put forth by the Mayor's Office of Information Services (MOIS) and the Water Department, the departmental strategic plans provided to PICA Staff to date have not demonstrated a commitment to fundamental change and improvement. Based on the lack of action to date, PICA Staff can only conclude that the City has not made the strategic planning process a serious priority.

PICA Staff is encouraged by the improvement shown by the City's Capital Program Office (CPO). Serious steps have been taken to address PICA's past concerns, resulting in a more professional CPO operation focused on maximizing the positive impact of the expenditure of capital project dollars. At the same time, PICA Staff notes the City's failure to act upon several key projects, including the creation of a central fleet maintenance facility and replacement of the severely outmoded Youth Study Center. CPO's success to date could be undermined if the City does not maintain a commitment to the current direction of that office.

The City has initiated many crime fighting efforts that have increased the number of prisoners housed in the City's prison system. Longer prison sentences have also helped to force the system to house more prisoners than its management goal for many months. Even with the new women's facility currently planned, the prison system is likely to continue to face budgetary and operational challenges from overcrowding.

As a result of its participation in the landmark $206 billion national tobacco settlement, the Commonwealth of Pennsylvania could potentially receive $11.3 billion over 25 years. The state has not yet determined how it would use these funds. There are many stakeholders statewide pursuing a portion of the state's share as compensation for smoking-related costs. As such, it is important for the City to continue to advocate for its interests and rights to a "fair share" of the proceeds.

Non-General Fund Concerns

The Philadelphia Gas Works (PGW) continues to confront numerous financial and managerial challenges. The most immediate threat to the City's General Fund is whether PGW will be able to continue to make its annual $18 million payment. In the long term, the utility still faces the prospect of deregulation and competition and has again been evaluating various options for improving operations. It remains to be seen if PGW can remain an economically viable entity in a competitive environment.

Staff Recommendation

Notwithstanding the identified potential risks to the General Fund, and only because the FJDP has instituted legal action which should resolve the matter of appropriating funding to the courts known to be available, the FY2000-FY2004 Plan presents a reasonable prospect for balanced budgets in each year of its term.

PICA Staff recommends that the Pennsylvania Intergovernmental Cooperation Authority approve the Plan as submitted to the Authority on May 24, 1999.

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Chart of Quantifiable Risks to the FY2000-FY2004 Plan

($ in thousands)

	FY 1999	FY 2000	FY 2001	FY 2002	FY2003	FY 2004	TOTALS
Quantifiable Risks							
Unidentified Reductions			(12,000)	(12,000)	(18,000)	(18,000)	(60,000)
PURTA Tax Revenues		(4,000)	(11,000)	(15,000)	(15,000)	(15,000)	(60,000)
School District Contribution		(15,000)	(15,000)	(15,000)	(15,000)	(15,000)	(75,000)
Other Significant Risks							
Labor Contracts[1]							
Welfare Reform[2]							
First Judicial District of PA[3]							
City's Revised Projections as of March 31, 1999							
Total Revenue	1,400						
Total Obligations	34,012						
Prior Year Adjustments	(5,000)						
Total Risks for Each Year	30,412	(19,000)	(38,000)	(42,000)	(48,000)	(48,000)	(164,588)
Cumulative Total Risks	30,412	11,412	(26,588)	(68,588)	(116,588)	(164,588)	
Plan-Projected Fund Balance	141,194	-	12,211	31,015	38,836	64,209	
Fund Balance if All Risks Realized	171,606	11,412	(14,377)	(37,573)	(77,752)	(100,379)	
Fund Balance if All Risks Realized as a Percent of:							
Individual Year	6.5%	0.4%	-0.5%	-1.3%	-2.7%	-3.4%	
Cumulative Plan	6.5%	0.2%	-0.2%	-0.3%	-0.6%	-0.6%	

[1] Although there is no way to project potential costs associated with new labor contracts expected to take effect in FY2001, the Plan makes no specific provision for any increases in personnel costs that may result from such contracts. According to the Plan, the latest round of labor contracts will have cost the City $233.5 million over their first four years.

[2] Changes to welfare programs are expected to increase demands on General Fund services by an unpredicatble amount.

[3] The Plan contains no direct appropriation for the FJDP. As the funding has been placed in two "reserve" line items, this does not necessarily present a financial risk to the Plan, but it does pose an operational risk.

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Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT
ON
FY2000-FY2004
FIVE-YEAR FINANCIAL PLAN

SECTION II:

QUANTIFIABLE RISKS

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TARGET BUDGETS AND "FUTURE TARGET REDUCTIONS"

The FY2000-FY2004 Plan anticipates a cumulative total of $60 million in unspecified expenditure reductions over its final four years as a result of the continuing use of target budgets. This is the third year in a row that the Plan has projected significant monetary savings resulting from the use of this management tool.

While applauding the City's continued use of target budgets to better manage departments, PICA Staff continues to have reservations about the ability of the target budget process to generate significant savings. Available evidence, some of which is presented below, indicates that while target budgets have provided a small budgetary cushion, a large part of the savings attributed to their use is actually a result of planned over-budgeting in certain cost centers.

This year's Plan anticipates a $64 million General Fund balance at the end of FY2004, enough to cover any shortfall that may result from the failure of target budgets to generate the projected $60 million in savings.

The Theory Behind Target Budgets

The target budget process was developed by the Rendell Administration as a way to constrain spending below budgetary levels. Following City Council's adoption of a budget, the administration develops target budgets for each department and cost center, typically below the appropriated level. Any savings generated by keeping to the target budget either provides a cushion for unexpected revenue shortfalls or expenditure needs during the year or adds to the end-of-year General Fund balance. The administration claims that target levels then become the base for the following year's budget.

For the second time since the target budget process was initiated, PICA Staff notes that the size of the cushion created by the target budget is less than the administration's past practice of reserving approximately 1.5% of total obligations. This year the target budget accounts for less than 1% of total obligations.

Cushion Created by Target Budget		
Period	Percent of Original Budget	Dollar Amount
FY93	1.35%	$30,975,746
FY94	1.59%	$37,838,312
FY95	1.48%	$34,062,475
FY96	.56%	$13,237,876
FY97	1.59%	$38,540,321
FY98	1.45%	$36,436,961
FY99	.96%	$25,381,477

Source: *Quarterly City Managers Reports,* First Quarter FY93, FY94, FY95, FY96, FY97, FY98 and FY99.

In the past, at least some of the savings generated through the use of target budgets has been used to pay for salary increases or one-time costs related to nonrecurring activities. This is demonstrated by the fact that during the six years that target budgets have been used, end-of-year total expenditures have exceeded target budget levels five times and originally appropriated levels three times. Two of the three years in which total expenditures exceeded originally appropriated levels were years when the City implemented new labor contracts.

End-of-Year Total Expenditures have Exceeded Target Budget Levels Five Times and Originally Budgeted Levels Three Times in the Past Six Years (Amounts in Thousands)

Period	Original Budget	Target Budget	Year-End Actual	Actual Over Original?	Actual Over Target?
FY93	$2,293,446	$2,262,470	$2,337,303	Y	Y
FY94	$2,384,579	$2,346,741	$2,346,033	N	N
FY95	$2,295,907	$2,261,845	$2,267,211	N	Y
FY96	$2,366,917	$2,353,679	$2,370,971	Y	Y
FY97	$2,416,797	$2,378,257	$2,463,930	Y	Y
FY98	$2,510,072	$2,473,635	$2,479,617	N	Y
FY99	$2,632,731	$2,607,350	n/a	n/a	n/a

Source: *Quarterly City Managers Reports*, First Quarter and Fourth Quarter FY93, FY94, FY95, FY96, FY97, FY98 and FY99.

As of mid-year, $15 million of the $25 million target budget "savings" for FY99 had been set aside for the School District. Other changes to the target budget as of mid-year had further reduced the target budget cushion to $6.1 million.

At that point, the target budget cushion stood at less than 0.2% of the total budget. The Quarterly City Managers Report for the third quarter of FY99 shows a target budget cushion of $11.9 million, or 0.4% of the total budget.

Target Budgets do not Appear to be as Effective as Claimed

It is difficult to gauge the effectiveness of the target budget process and how it affects the City's General Fund balance. A multitude of decisions coupled with unexpected costs throughout the fiscal year affect target budgets and actual expenditures. Determining how each one affects the target budget process and the General Fund balance is a subjective effort.

What can readily be noted, though, is that over the past six fiscal years, most of the target budget savings projected in the beginning of the year have come from a small group of cost centers. Significantly, the first year target budgets were used, which was also the first full fiscal year of the Rendell Administration, the projected savings were distributed more equally across all cost centers. The following chart illustrates the last three fiscal years.

Most Projected Target Budget Savings Tend to come from Six Cost Centers			
Cost Center	FY97	FY98	FY99
Debt Service	$ 0	$ 3,267,042	$ 1,606,746
Employee Benefits	6,931,390	5,292,350	2,512,567
Human Services (DHS)	2,752,205	6,224,985	0
Police Department	0	9,000,000	1,567,267
Public Health (DPH)	8,011,710	4,707,236	1,771,668
Vehicle Purchase	11,599,589	195,000	11,018,750
These Cost Centers as a Percent of the Total	**76%**	**79%**	**73%**

Source: *Quarterly City Managers Reports*, First Quarter FY97, FY98 and FY99.

Of these six cost centers, DHS and DPH tend to be conservatively budgeted in order to provide sufficient spending authority in case the City receives large amounts of state and federal funding. Hence, these two departments typically end the year under their originally appropriated level regardless of the use of target budgets. Debt service has been significantly over-budgeted the past few years because of annually postponed plans to issue new debt; an issuance finally occurred this past fall. Vehicle purchases, while not necessarily over-budgeted, is a highly flexible line item. The decision to spend the appropriation is frequently postponed until late in the fiscal year, once it is determined that the funds are not needed elsewhere.

In the case of the Police Department, which is funded almost exclusively with local funds, the $9 million in savings projected in FY98 were not realized. Indeed, the department ended the year $300,000 over its original appropriation. The City was able to cover this gap through other "savings" such as $25 million from debt service, which, as mentioned above, resulted from the City's decision to postpone the issuance of new General Obligation debt.

The rest of the Target Budget “savings” (about 25% of the total) come from the other cost centers. However, as an example, in the first quarter of FY98, 30 of the 63 other cost centers listed in the Quarterly City Managers Report did not project any savings resulting from the use of target budgets. While it is fairly clear that the City uses target budgets to annually squeeze the budgets of certain departments, on the whole this is not done.

At a minimum, when they are properly used, target budgets force departments to justify their expenditure needs to the administration during the fiscal year, to the degree that they need appropriation power above their target budget level. The administration can then push departments to find offsetting efficiencies or savings elsewhere in their budget. However, the evidence indicates that the use of target budgets has not resulted in large amounts of savings.

Given this history of target budgets, it is questionable whether they will produce the level of savings the City projects in the Plan.

Projected Savings are Questionable

The Rendell Administration has demonstrated that some minimal savings can be derived from the use of target budgets. Of greater significance are the cost reducing efficiencies or revenue enhancements implemented during a fiscal year that do not result from the use of target budgets, but significantly contribute to meeting overall budget goals. Even though such efficiencies and enhancements are likely to occur in the future, it is difficult for PICA Staff to gauge whether the Plan's projected out-year savings are reasonable without an adequate explanation of how those savings might realistically be achieved or any attribution of reductions to particular departments.

PICA Staff continues to believe that under current circumstances--even in the absence of sufficient supporting detail--it is *possible*, although in no way certain, that the Rendell Administration can achieve savings through the use of target budgets. However, it is unknown whether a new administration, called upon to generate the $60 million in savings anticipated in the Plan, would be able to garner such results.

There are two mitigating factors regarding the "Future Target Reductions" projected in the Plan. One is that the Plan projects a $64 million General Fund balance at the end of the Plan period, more than enough to cover the $60 million in "Future Target Reductions" if the latter are not recognized. Secondly, according to the Quarterly City Managers Report for the third quarter of FY99, the City is projected to generate a General Fund balance of $172 million this fiscal year. This balance is $31 million above the $141 million projected in the Plan, reducing by such amount the need to rely on "Future Target Reductions" to generate General Fund balance.

Target Budgets are a Management Tool, while Appropriations are the Law

PICA Staff also has concerns as to whether this or any future administration will be able to continue to use target budgets to maintain departmental expenditures below budgeted levels. City Council has ultimate budgetary authority through its appropriation power. While the mayor can exercise managerial discretion over how money is spent, he is limited to departmental budgets as they are approved by City Council.

Target budgets are essentially a management tool. Despite the current administration's effort to focus budget decisions on service levels instead of monetary levels, City Council may in the future look unfavorably upon a mayor who systematically does not spend money as it has been budgeted.

Conclusions

PICA Staff recognizes that target budgets can be an innovative and effective management tool which provide the administration with extra leverage to ensure department accountability. PICA Staff will encourage the next administration to continue the use of this tool. However, any future Plan that projects savings from target budgets will need to demonstrate General Fund balance in each fiscal year of the Plan regardless of whether such savings are realized.

The proposed Plan projects an ending General Fund Balance of $64 million in FY2004. This amount is sufficient to cover the $60 million in "Future Target Reductions" should those reductions not materialize.

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PENNSYLVANIA PUBLIC UTILITY REALTY TRANSFER ACT

As a result of deregulation in the electric generation industry, the City and School District are both at risk of experiencing a significant decline in Public Utility Realty Transfer Act (PURTA) tax revenue which is collected and distributed by the state. Simultaneously, recent changes to the PURTA tax rate and defined tax base may compound this decline in revenue.

As it does not account for these events, the Plan overestimates PURTA tax revenue by as much as $60 million over its five-year period. The School District's two-year projection overestimates its FY2000 and FY2001 receipts by $1 million and $3 million respectively.

Electric Deregulation and Legislative Changes will Reduce PURTA Tax Revenue

As prescribed by the Electric Deregulation Act of 1996, the Public Utility Commission has granted public utilities under its purview the ability to accelerate the depreciation of electric generation facilities. This was expected to result in a drop in PURTA funding for local governments in FY2000. The Plan overlooks this reduction in funding.

This year's omnibus state tax legislation, enacted in May, changed the PURTA tax base altogether from depreciated book value of utility realty to market value. It also replaced the fixed tax rate with a floating rate. For FY2000, to protect local governments from any drop in PURTA funding that could be expected to result from these two changes, the tax legislation included a base level of PURTA funding equivalent to the amount otherwise expected. Even though the final legislation includes unclear language, it is reasonable to assume that the City and School District will be held harmless in FY2000 from these two changes, although there will still be a reduction due to depreciation as discussed in the previous paragraph. These two recent legislative changes will likely further reduce City and School District PURTA tax revenue beginning in FY2001.

The May legislation clarified that electric generation facilities will be exempt from PURTA altogether beginning January 1, 2000. This will dramatically reduce the amount of PURTA funding available to local governments beginning in FY2001. Although the electric generation facilities will now be subject to local taxation, Philadelphia is not home to any major facility and as a result the City and School District will each suffer a significant loss in revenue.

City will lose $60 million over Five Years

The Plan projects $25 million in PURTA tax revenue annually for the next five years. Based on projections of statewide PURTA distributions developed by the State Department of Revenue, and what historically has been the City's share, PICA Staff projects that the City will receive less than $21 million in PURTA tax revenue in FY2000. Most if not all of the $4 million drop is attributable to the accelerated depreciation of electric generation assets.

City PURTA tax revenue will drop again in FY2001 to $14 million and then to $10 million annually beginning in FY2002 due to a combination of the removal of electric generation facilities from the PURTA tax base, the change in the definition of the tax base and the change in the tax rate. As the Chart of Quantifiable Risks in the Executive Summary of this report illustrates, the City can now anticipate that PURTA tax revenues will be $60 million less than projected over the life of the Plan.

School District will also lose Progressively more over the next Three Years

The School District of Philadelphia will also suffer a loss of PURTA tax revenue resulting from these events, although its loss will be smaller in magnitude than the City's. PICA Staff estimates that the School District's loss in FY2000 will be just over $1 million, growing to $3 million in FY2001 and $4 million annually thereafter.

SCHOOL DISTRICT OF PHILADELPHIA

In its FY2000 budget, as well as in its multi-year budget projection, the School District of Philadelphia (School District) continues to recognize annual contributions of $15 million from the City. Neither the City's FY2000 budget nor its FY2000-FY2004 Plan provides for such annual contributions.

The School District has been able to stave off projected deficits over the past few years at least in part through one-shot actions and recurring, initially unbudgeted $15 million annual contributions from the City. The School District projects significant deficits in the future, even after anticipating continued annual City contributions of $15 million. Given the School District's financial projections, it is reasonable to expect that significant political pressure will come to bear on the City to continue to provide $15 million annually from its General Fund.

Some of that pressure will result from the fact that many of the tax incentive programs the City uses to promote economic development disproportionately rely on the abatement of School District tax revenue.

Certain Economic Development Incentives are Biased against the School District

The City has utilized a number of tax incentive programs over the past two years to further promote economic development. These new tax incentive programs include Keystone Opportunity Zones (KOZs), Tax Increment Financing (TIF) and a ten-year property tax abatement program for conversions of certain business properties to residential use. TIFs and tax abatements redirect what would otherwise be growth in tax collections, while KOZs eliminate taxes altogether for eligible businesses.

These incentive programs tend to be biased toward City tax collections at the expense of School District collections. School District tax revenues are comprised primarily of Real Estate and Use and Occupancy Taxes. These two taxes are eliminated altogether in a KOZ for up to twelve years, while the City benefits from the additional Wage and Earnings Taxes that result from a KOZ project. Under a TIF, both the City and School District give up at least a portion of the Real Estate Tax collections that would otherwise result from property improvements, but again the City realizes the benefits of the Wage and Earnings Tax and also of applicable business taxes. Tax abatements for conversions also eliminate the Real Estate Tax, but again the City benefits significantly from increases in its other tax revenue streams that result from the conversion.

The City argues that the above incentives are used only when a project would not otherwise be undertaken. Therefore, in the City's opinion, the City and the School District are not losing any revenue as a result of the use of these incentives. The City claims that without the incentives the project would not happen. This reasoning is questionable. In most cases it is impossible to determine what would have happened had a particular incentive not been provided.

Even if the City's argument is correct, these incentive programs still result in the

School District forgoing much more revenue than the City. Also, the City benefits much more than the School District from any developments that result from the use of these incentive programs.

Given all of the incentive programs available, it is questionable whether the incentives mentioned above are the best ones for the City to be using in its promotion of economic development. In many cases, there may be other incentive programs available that would provide similar or better final results. The City needs to exercise caution in its use of economic development incentives that rely disproportionately on School District tax revenue streams.

Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT
ON
FY2000-FY2004
FIVE-YEAR FINANCIAL PLAN

SECTION III:

OTHER SIGNIFICANT RISKS

LABOR CONTRACTS AND THE MUNICIPAL WORFORCE

The City's four major collective bargaining units are now covered by labor contracts that are due to expire on July 1, 2000. These contracts cover only the first of the five years in the Plan.

While the next mayoral administration will be responsible for negotiating the final terms of the forthcoming four labor contracts, initial contract proposals are likely to be made by the Rendell Administration prior to its departure from office in January 2000. PICA Staff views these circumstances as both a major challenge for both administrations and an opportunity to set the tone of labor/management cooperation for years to come.

Paying for the Current Labor Contracts

PICA Staff has been pleased by the City's recent practice of identifying sources of anticipated recurring savings to help fund the cost of new labor contracts. In addition to savings resulting from the contracts themselves, the City has earmarked savings from cost reductions in several areas not related to labor contracts in an effort to prove it can pay for the increasing costs of labor contracts.

To help cover the costs of the present contracts in FY2000, the City anticipates utilizing a portion of its FY99 General Fund balance. PICA Staff is concerned that once the City's accumulated General Fund balance is spent, the only identified potential source of funding for the continuing costs of new labor contracts is unspecified "Future Target Reductions". As is discussed elsewhere in this report, PICA Staff does not believe that the use of target budgets will necessarily result in General Fund savings.

The Potential Cost of the Next Labor Contracts

In discussing the cumulative additional costs which arose from the most recent labor contracts, the City Workforce chapter of the Plan projects that the City's four labor agreements will have cost the City an additional $233.5 million from FY97 through FY2000.[1] Additionally, based on figures provided to PICA, these contracts will result in ongoing additional annual costs of $138.6 million beginning FY2001. The Plan already accounts for these costs.

While the Plan states that "looking forward…it is likely that the City will be well-positioned to negotiate moderate wage increases"[2], it makes no specific provision for any increases in personnel costs that may result from the new labor contracts. As the above paragraph makes clear, even what has been termed "modest" wage increases can be extremely costly on an ongoing basis.

In addition to across-the-board wage adjustments provided for in labor contracts, municipal employees also benefit from salary increases resulting from longevity (i.e., length of service) and promotions. When increases for longevity and promotions are factored in, total labor costs are always experiencing upward forces.

1 *Five-Year Financial Plan Fiscal Year 2000-Fiscal Year 2004, p. 123.*
2 Ibid., p. 130.

An example cited in the Plan states:

> "… between January 1, 1993 and December 31, 1994, more than half of the City's unionized employees received an increase in pay, even though there were no across-the-board raises during this period. For these employees, the average increase of $2,255 was equivalent to a raise of 7.8 percent over the same two years."[3]

The annual percentage increase in base pay for City uniformed and non-uniformed personnel averaged approximately 3.6% between FY97 and FY2000. The Rendell Administration indicated during City Council's hearings on the Plan that a one-percent across-the-board raise could cost the City between $11 million and $13 million annually.

The suggestion of "modest" wage increases, without currently identified funds to pay for such potential increases, places great pressure on the next administration and does not bode well for the forthcoming contract negotiation process.

PICA Staff recognizes the City's concern that providing (i.e., identifying) any amount for potential future labor contracts would compromise the City's ability to negotiate such contracts. (The union negotiators could view such amounts as a base line for negotiations.) However, it is important to remain aware that the current administration has an obligation both to prepare for the potential result of the upcoming negotiation/arbitration processes and not to burden the next administration by not providing for reasonable additional labor costs.

Workforce Size

Since 1990, it is estimated that the City of Philadelphia has experienced a population loss of approximately 150,000 residents. While the City for the time being has adjusted to the resulting shrinkage of the tax base, there is nonetheless a need to address whether or not the size of the City workforce is currently appropriate given the City's diminished population.

This situation is highlighted by a comparison between City population and municipal workforce over time. In 1952, the first full year under the current City Charter Philadelphia's population was over 2 million compared to a current U.S. Census estimate of less than 1.5 million. In comparison, full-time General Fund employees numbered approximately 21,500[4] in 1952, as compared to over 25,000 currently. This represents a 1952 citizen to City employee ratio of 93:1 versus a current ratio of 60:1.

The City prefers to use the FY55 full-time General Fund employment of 24,132 for employment benchmarking as operational changes resulting from the 1951 City Charter change may have still been in progress during FY52. It should be noted that,

[3] Ibid., p. 129.

[4] According the City's Budget Office, the number of FY1952 General fund employees was 23,345, of which 21,563 where identified as full time.

using the City's preferred date, from FY55 to FY98 the number of full-time General Fund employees grew by 1.1%, even as the City's population fell by over 25%. As discussed elsewhere in this report, population is projected to continue to decline. The Plan does not project any corresponding reduction in the municipal workforce.

Significant changes in technology and society have necessitated workforce growth in certain departments and service areas. Examples include the Water Department's modern water treatment operation and the Departments' of Health and Human Services shift toward serving a growing population of impoverished citizens. However, these trends do not entirely account for the growth in the number of City employees per resident.

A failure to specifically address diametrically opposing trends--declining population and a growing work force--could prove troubling during the span of the proposed Plan and beyond. While the City's population is projected to continue its decline, the Plan makes no recognition of this fact and likewise lacks a recognition of a need to deal with "right-sizing" the City's workforce.

PICA Staff commends the Rendell Administration for taking steps during its tenure to align the cost of government with available revenues. However, that effort should not be misconstrued as addressing the long-term need to match the size of the City workforce with the population it serves. While workforce numbers have remained below the FY91 figure of 24,591 during every year of the Rendell Administration, the workforce, on average, has been growing since FY94. The table below illustrates that the City workforce, during the current fiscal year, is projected to *exceed* its size during the year prior to the beginning of the Rendell Administration.

Trends in General Fund Positions

	Positions	% Change from Prior Year
FY91	24,591	N/A
FY92	24,051	-2.20%
FY93	22,841	-5.03%
FY94	22,939	0.43%
FY95	23,342	1.76%
FY96	23,249	-0.40%
FY97	23,463	0.92%
FY98	24,350	3.78%
FY99*	25,072	2.97%
Average annual change between FY94 and FY99:		1.58%

*Plan Projection

Absent a meaningful (but unexpected) growth trend in both the population and tax base of the City, it becomes increasingly difficult to justify a proportionally large and growing City workforce. Thus, the City, through contract negotiations and labor management cooperation, must develop other innovative solutions such as competitive contracting, flexible scheduling and alternatives to full-time employment--including temporary, volunteer and part-time employment where appropriate--in order to manage and maintain an appropriately sized workforce.

PICA Staff takes issue with the Plan's assertion that "…too much of the fat has already been trimmed from the City budget for additional deep cuts to spare meat and bone."[5] Failure by the City to reduce its ongoing costs will inhibit its ability to reduce the tax burden in Philadelphia.

Redesigning Government Initiative

As part of the most recent labor contracts, the City agreed to a moratorium on new competitive contracting initiatives that would result in either layoffs or demotions of current City employees. As an alternative, a labor-management initiative was established with AFSCME District Councils 33 and 47 that aims to improve services and minimize costs for selected City functions.

The Office of Labor Relations is the coordinating City office for this initiative, which is also benefiting from the assistance of Harvard University's John F. Kennedy School of Government. The City is attempting to concentrate this effort on areas it had previously identified for its competitive contracting initiative. Other areas for improvement may also be identified during this process.

PICA Staff is disappointed that the City has given up the ability to contract out existing activities, even if only temporarily. On the other hand, since the people who serve on the frontline in unionized positions often know best how to improve City government, there is great potential for labor-management cooperation on improving City government.

Considering that progress to date has been limited to a small number of department-specific initiatives with few quantifiable gains, PICA Staff remains skeptical about what the net benefit might be from this otherwise innovative approach. As a result, PICA Staff strongly suggests that the City revisit the issue of competitive contracting in the next series of labor contract negotiations.

Conclusion

The citizens of Philadelphia will best be served if the Rendell Administration, as it prepares the initial new contract proposals, faithfully follows the principles spelled out in the current Plan:

- Overall, increases in wages should not exceed the growth of the local tax base that funds employee compensation, nor impede the incremental tax reduction effort so

[5] Ibid., p. 140.

essential to Philadelphia's effort to retain and strengthen this base;

- Wages and benefits provided to public employees should not grow out of balance with wages and benefits earned in the local labor market by the general public that ultimately funds most costs of municipal government;
- To help fund any compensation increases, the City should strive to capture any economies that may exist in its personnel cost structure that would not substantially affect the quality of life for individual employees if changed-- for example by working with its unions to develop more cost-effective systems for administering benefits;
- The City must retain the tools it needs to deliver public services effectively and efficiently--including the flexibility to set schedules, redesign jobs, introduce technology, contract for services where appropriate and determine the size of workforce; and
- Continued partnership between labor and management should be encouraged, focusing workers and managers alike on improving service to the public.[6]

The next administration must also adhere to such principles. The viability of the City depends upon it.

[6] Ibid., p. 126-127.

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WELFARE REFORM

Numerous changes have been made to the welfare system over the past few years, the most publicized being the transformation of Aid to Families with Dependent Children (AFDC) to Temporary Assistance to Needy Families (TANF). To a large degree, the City has already felt the negative effects of the other welfare changes made, including cuts to General Assistance, Medical Assistance and Food Stamps. The negative effects of TANF reforms, though, have yet to be fully realized in Philadelphia.

The Plan estimates that the City will incur additional annual costs of $13.1 million for every 1,000 families that turn to the City for shelter, medical care and foster care services.[7]

Families Subject to the Work Requirements

On March 3, 1999, the first group of 23,000 TANF households in Philadelphia reached the two-year time limit that now requires the head of the household to be working at least 20 hours per week. Thousands more are reaching their two-year deadline every month.[8] The state estimates that more than one-third of TANF households reaching the two-year time limit are eligible for temporary exemptions or are already in compliance with work requirements.

Rather than immediately purging the TANF rolls on March 3, as the City had initially feared, the state decided to use that deadline as the date to begin a concerted effort to contact each TANF household reaching the two-year deadline. The state is requiring that heads of these households meet with Pennsylvania Department of Public Welfare (DPW) caseworkers to determine employment status and, when appropriate, link them to employment opportunities. DPW staff has stated that TANF households will not be sanctioned (i.e., lose TANF benefits) unless they are unresponsive, unaccounted for or uncooperative.

The City's Departments of Public Health (DPH) and Human Services (DHS), as well as the Office of Emergency Shelter and Services (OESS), work with significant numbers of TANF households. Each has been working with DPW to locate affected families and determine if they are exempt from the new TANF work requirements. The City agencies report that DPW has demonstrated neither the technological ability to deal with this effort nor the commitment to respond to City requests in a timely fashion.

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7 *Five-Year Financial Plan Fiscal Year 2000 – Fiscal Year 2004*, p. 150.

8 Paradoxically, the number of TANF households that had reached the two-year time limit fell from March to April, apparently a result of cases closing faster than cases reaching the two-year limit. A case closing does not necessarily mean that that household had improved economically or that it is no longer in need of cash assistance.

What the Work Requirement Means

The new welfare system requires the head of a TANF household to be working at least 20 hours per week. There are exemptions made, such as in the case of a parent with a newborn, but generally these exemptions are short-term and have life-time limits.

As the work requirement can be fulfilled with uncompensated employment, both the City and the state have set up programs to get TANF clients into unpaid positions in an effort to help them retain TANF eligibility. However, these programs are not intended to be long-term placements. Rather they are considered initial work experiences from which a TANF recipient will acquire basic work skills to be able to obtain a permanent compensated position within a few months.

A common complaint about Pennsylvania's system is that it requires job placement to the exclusion of education or job training. The federal legislation simply requires a "work activity", including education and job training, after 24 months of receiving TANF benefits. But Pennsylvania does not recognize education or job training as a "work activity". There is an effort underway to get the state legislature to broaden its definition of "work activity" to more closely match the federal definition.

TANF households subject to sanctions (i.e., the loss of cash assistance) and those in which the parent begins working remain eligible for other benefits, such as Medical Assistance. Anecdotal evidence appears to indicate that at least some of these families may also be incorrectly losing these other entitlements. If these families are still eligible for other entitlements, they can again enroll.

Once a household without other income loses its TANF cash assistance and possibly its Medical Assistance as well, even if only temporarily, it will turn to other supports to meet its needs. Anecdotal evidence indicates that some households are able to turn to family and friends for support, if only temporarily. Eventually, though, unless these households are able to begin receiving cash assistance again, or work their way off financial dependency, they will turn to the City and local non-profits to meet their housing, food and medical needs.

Indeed, demands for services in these three areas of need have noticeably increased over the past three years. Some of these demands are reflected in City service levels and budgetary changes.

What the Impacts have been on the City

The impacts of welfare reform have been building over the past few years. Most of the changes have resulted in the extraction of significant amounts of state and federal funding from the local economy, reducing revenue for businesses that serve low-income residents and diminishing City tax collections. Without funds for medical care, food stamps or cash assistance, more services are going uncompensated. Already many hospital systems are feeling the financial pressures of reduced payments from Medicaid and Medical Assistance. It would appear, though, that the continued strength of other economic sectors has masked the negative effects of welfare changes on the local economy.

Of City departments, DPH's District Health Centers have felt the greatest impact so far, with much greater numbers of uninsured clients and visits. Homeless services have seen a gradual rise in demands too, while DHS caseloads have not seen the growth that the department had initially projected.

DPH

To date, the City has felt the greatest impact of welfare reform in its District Health Centers. Act 35 of 1996 eliminated Medical Assistance benefits for 62,000 Philadelphians who, at that time, were under the age of 59 and not working at least 100 hours per month. As the City provides primary health care services to anyone, regardless of health insurance status, many of these individuals have turned to the City's District Health Centers for primary medical care.

In FY95, the year before Act 35, there were 128,471 uninsured visits to the District Health Centers, 44% of all visits. By FY98, there were 191,155, 61% of the total. According to March's Quarterly City Managers Report, this number is expected to continue to rise to 198,400 in FY99. The Plan notes that the unreimbursed costs of care, which are borne by taxes and other local revenue sources, have risen from $8.8 million in FY96 to $10.7 million in FY98.[9]

In addition to the changes in eligibility for Medical Assistance, the City fears that families working their way off TANF or subject to TANF sanctions may also be inappropriately losing their Medical Assistance benefits. To counter this phenomenon, the District Health Centers have hired four health insurance counselors to register uninsured patients who may be eligible for Medical Assistance or the Children's Health Insurance Program (CHIP).

OESS

OESS has experienced a dramatic increase in the number of intake contacts it has made over the past three years, from 21,477 in FY95 to 31,691 in FY98. As of mid-fiscal year, the FY99 level was 5,400 more than at the same point in FY98, indicating over 40% growth in the last year. The number of placements in shelter as of mid-year had grown by a similar amount. The mild weather the past two winters and the increased number of transitional and permanent housing units available to homeless individuals and families have both contributed to the City's ability to handle the increased demand for temporary shelter.

The future is not as promising. OESS expects the demands for emergency shelter and transitional housing to increase as welfare reform continues to be phased in. While the City successfully lobbied the state legislature to reinstate a $2.2 million grant in FY99 that had been not appropriated the previous two years, the state's FY2000 budget reduces

[9] *Five-Year Financial Plan Fiscal Year 2000-Fiscal Year 2004, p. 307.*

the grant to $1 million. Federal funds also appear limited. Additionally, financial challenges and programmatic changes to the Section 8 housing program in Philadelphia may limit the number of Section 8 certificates available to shelter and transitional housing clients, impeding the flow of clients through the shelter and housing system.

DHS

In its needs-based budget request for FY98, submitted to the state in August 1996, DHS projected a 10% increase in the number of protective service reports it receives and a 13% increase in its dependency caseload as a result of Act 35 welfare reforms. Fortunately, those predictions did not come to pass. DHS is now projecting a more modest increase in dependency caseload as a result of welfare reforms.

It remains unknown how welfare reform will affect the demand for children and youth services. Much of it will depend on how the state enforces TANF work requirements. DPW still has not developed a definitive process for handling TANF recipients or dispensing sanctions and exemptions. DPW has not explained what its plans may be and, as indicated above, appears reluctant to work with the City to coordinate state and local efforts to reach out to TANF recipients subject to the work requirement.

The Plan provides for annual increases in costs related to children and youth services, with corresponding increases in state and federal revenues. It is impossible to gauge how reasonable these projections are, not in small part because it remains unclear what the state's plans for TANF may be. Given the vagaries of the needs-based budget process, it may be difficult to obtain sufficient state funding if the projections for the next two years prove to be too low. Even if they are not, the City will be increasing its out-of-pocket costs in order to make up its local share for these increased costs.

The Full Impact of Welfare Reform will not be Realized until 2002

This section has discussed how welfare reform has affected City services and the General Fund budget to date. As the state begins to enforce work requirements and sanction households, service and budget demands on the City can be expected to grow. The City needs to keep pressing the state and federal governments to share in the expense of handling these increased demands.

The Plan makes no projections and does not budget any increases for the effect of the five-year lifetime limit for receiving TANF benefits. TANF households will start reaching this five-year limit in the beginning of 2002 and, given the experience to date, it is reasonable to expect that DPH, OESS and DHS will see another jump in service demands and costs at that time.

First Judicial District of Pennsylvania

Each of the past two PICA Staff Reports on the City’s Five-Year Financial Plan has identified the First Judicial District of Pennsylvania (FJDP) as a cost center of significant concern. The State Supreme Court had directed the Commonwealth of Pennsylvania to assume financial responsibility for the state courts on or before January 1, 1998. PICA Staff initially expressed its concern that (as happened) the City would be forced to maintain funding beyond the first six months of FY98. An additional concern at that time was that, if the “zero-growth” budget agreement was not renewed, the City might be required to provide funding to the FJDP above and beyond what the City was known by PICA Staff to be holding in reserve in the Plan.

Subsequent to the approval of the FY98-FY2002 Plan, the State Supreme Court appointed “Master” issued a four-phase plan, under which the Commonwealth is instructed to gradually assume responsibility for statewide funding of a unified court system. However, Phase I of the Court Master's Plan (spanning FY99 through the end of FY2000) and likewise the Commonwealth’s adopted FY99 and FY2000 budgets provide for only approximately $2.4 million annually in state court funds for the FJDP. None of these actions have resulted in any new state funding for the FJDP.

As was the case last year, the current Plan contains no direct appropriation for the FJDP. The City Administration has based this budgeting policy on the premise that the state--in response to court rulings--will provide for all Pennsylvania court funding, including the FJDP. The state however has not budgeted for the full funding of the FJDP. The combined current state and City actions would leave the FJDP with a funding gap in excess of $100 million for FY2000. For the second consecutive year, the FJDP has initiated legal action to require the Mayor and City Council to appropriate such funding. PICA Staff is concerned that the City's failure to initially appropriate funds for a vital government function may jeopardize the viability of the Plan.

Background on the FJDP

The FJDP is made up of three judiciaries that together comprise the Philadelphia Court System: Court of Common Pleas; Municipal Court; and Traffic Court. The FJDP is not a City department. It is a separate institution entirely under the direction and control of the Pennsylvania Supreme Court. Despite the lack of direct authority to control expenditures, Philadelphia--like all of Pennsylvania’s counties--is responsible for funding the bulk of its court (FJDP’s) costs locally, as part of its General Fund budget.

Predictably, being presented with a substantial unfunded mandate by the state, and with a lack of authority over the courts’ operations, there has historically been disagreement over what amount the Philadelphia courts require for annual operating funds and what the City should pay. This disagreement, worsened by the City’s fiscal crisis, reached an impasse when the City rejected the FY91 budget request of the courts.

Ultimately, the State Supreme Court intervened and created the FJDP.

Consequently, beginning in FY92, the FJDP began to operate under an (adjusted) zero-growth (and zero-reduction) budget agreement between the City and the State Supreme Court. That agreement has worked reasonably well in comparison to past practices and was last informally renewed in January 1999.

Legal Rulings Related to Court Unification

In it's 1987 ruling in County of Allegheny v. Commonwealth of Pennsylvania, 517 Pa. 65, 534 A.2d 760 (1987) (hereinafter Allegheny I), the Pennsylvania Supreme Court voided county funding for local courts "as offending the constitutional mandate for a unified [judicial] system." (p. 765). Until the 1996 successor case to Allegheny I, Pennsylvania State Association of County Commissioners, et al. v. Commonwealth of Pennsylvania et al., 545 Pa. 324; 681 A.2d 699 (Pa. 1996) (hereinafter Allegheny II), the Pennsylvania Supreme Court had not sought to enforce its 1987 decision.

Following the 1987 decision in Allegheny I, the Pennsylvania legislature did not attempt to execute the State Supreme Court's ruling--with the minor exception of appropriating $1 million for the purpose of studying the issue. However, those funds were not expended and subsequently lapsed back into the State's General Fund.

As a result of Allegheny II, in July of 1996, a Court Master was appointed to recommend a plan to implement the unification of Pennsylvania's various courts. In essence, the Allegheny II justices granted the petition for a "writ of mandamus", a decree which set a deadline for the General Assembly to implement the unified funding scheme by January 1, 1998.

The City's Response to Legal Rulings on Court Unification

The Rendell Administration has taken the position that "the General Assembly [should] accept its constitutional responsibility to fund Pennsylvania's courts."[10]

The FY98-FY2002 Plan and the initial City budget for FY98 appropriated full funding for the FJDP for the first half of FY98 only--July 1, 1997 through December 31, 1997--and then ceased any further appropriations to the FJDP. Last year and this year, the City has made no initial appropriation for the FJDP in either the Plan or the budget.

Funds to cover the second half of FY98 and all of FY99 and FY2000 and beyond were not entirely deleted from the respective Plans and City budgets, but rather were placed into line items. Those funds for FY98 and FY99 have since been restored to the FJDP, with City Council first approving transfer ordinances to officially return the funds to the FJDP budget items.

Initially, the Administration went on record with its funding priorities in the event that any new funds became available as a result of a transition of funding responsibility to the state. Those priorities include: accelerating the City's multi-year tax reduction program; additional support to the School District of Philadelphia; and additional support

[10] *City of Philadelphia Five-Year Financial Plan, Fiscal Year 2000-Fiscal Year 2004*, p. 198.

to the City's Economic Stimulus Program.

The Mayor has more recently called for one hundred percent of any savings generated from a shift of court funding responsibility to the state to be directed exclusively to the School District.[11]

The Court Master's Plan

Senior Justice Frank J. Montemuro was appointed in July 1996 by the State Supreme Court to recommend a plan to unify Pennsylvania's various courts.

On July 31, 1997, Justice Montemuro issued his report that outlined a four-phase plan--the first two phases of which would take place during the period from July 1, 1998 to July 1, 2000. Phase I calls for the state to take over the cost of funding approximately 150 administrative court personnel statewide. According to the Administrative Office of Pennsylvania Courts (AOPC), of those 150 positions, the FJDP would account for twelve. Based on the figures provided by the AOPC, the estimated cost of funding those twelve court employees will total $2.4 million in both FY99 and FY2000.

The state's FY99 and FY2000 budgets included funding for statewide implementation of Phase I of the Montemuro Plan. However, the Commonwealth failed to provide specific appropriation authority that would have provided funds to the FJDP. As a result, to date, the FJDP has not received any funds as a result of the State Supreme Court's findings.

FJDP Seeks Mandamus Action for the Second Time

As was the case regarding the City's FY99 budget, the President Judge of the FJDP, recognizing that the City did not properly appropriate funding for the FJDP in the FY2000 budget, instituted legal action on May 28, 1999 to compel the Mayor and City Council to appropriate such funding.

While acknowledging that the City's efforts to speed Commonwealth funding of the courts is arguably justified, PICA Staff has previously gone on record that it could not endorse the City's course of action. Had the FJDP not forced the issue by its legal actions, *PICA Staff would have recommended that the Plan not be approved*.

Relevant Factors Considered in PICA Staff Analysis of City's FJDP Funding Strategy

PICA Staff has studied what it considers to be relevant factors, including:

- the Court Master's funding plan;
- the Commonwealth FY99 and FY2000 budgets;
- the threat to the City of legal action by the FJDP;

[11] Mayor Edward G. Rendell Budget Address to Philadelphia City Council, January 26, 1999.

- the City's ability to act in a timely manner to remedy the court funding crisis before the start of FY 2000; and

has concluded that such factors place the City's ability to carry out a vital function of government in jeopardy. In accordance with the PICA Act and the PICA Agreement, PICA Staff decided it would have to recommend that the PICA Board not approve the Plan until funding was properly in place for the courts. By initiating legal action on the court funding issue, the FJDP obviated any need for PICA Board disapproval of the Plan.

Conclusion

The methodology used two years ago of appropriating only six months of FJDP funding in FY98 was deemed viable inasmuch as it conformed to the circumstances at that time. The decision by the City the past two years to take a “no-appropriation” stance has not been deemed viable and appears to jeopardize the continuance of a vital governmental function. Due to the initiation of legal action by the President Judge of the FJDP, final determination as to whether the City needs to appropriate such funding now resides in the hands of the courts.

PICA Staff will continue to closely monitor the legal rulings related to court funding and likewise the actions taken by the City in response to those rulings. In absence of a court ruling favorable to the City, or the provision of additional state funds to operate the FJDP, PICA Staff believes that the City will be required to re-appropriate the funds currently being held in reserve line items to the FJDP. Further, under such circumstances, the City will be required to revise its funding policy as well as amend this and future Plans in accordance with the guidelines set forth in the PICA Act and PICA Agreement.

PICA Staff is also concerned about the precedent of not directly appropriating funds and instead holding funds in reserve. Under the prior cooperative climate between this Mayor and City Council, the risk of those appropriations ending up anywhere but their intended destination was minimal. PICA Staff is concerned about whether or not under different conditions, either with the current lame duck Council and mayor, or with a new mayor and a different mayor/council relationship, the appropriations in question can reasonably be viewed as secure.

Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT
ON
FY2000-FY2004
FIVE-YEAR FINANCIAL PLAN

SECTION IV:

OTHER GENERAL FUND CONCERNS

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ANALYSIS OF THE CITY'S ECONOMY

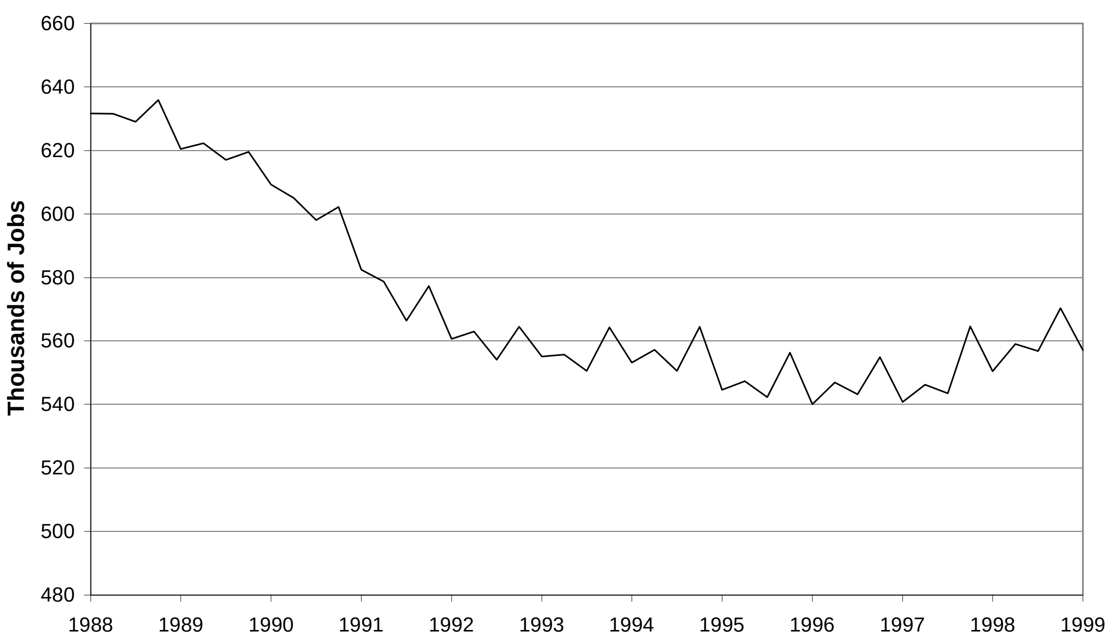
Over the past two years, Philadelphia has experienced its greatest amount of private sector job growth since 1988, mostly in retail trade and service industries. The increase continues to lag behind corresponding growth in both the Philadelphia suburbs and nationally. Additionally, although the City disputes the actual number, Census Bureau estimates indicate that Philadelphia continues to lose residents. Real estate assessments reflect these trends. While the value of Center City office space has increased over the past two years, residential property assessments indicate flat or declining values.

Given the uncertainties surrounding the unprecedented national economic expansion and the fragile state of the City's economy, the City cannot reasonably count on any further significant job growth. Accordingly, the City's projection of modest job growth over the life of the Plan is appropriate. At the same time, the City is likely to continue to lose population. The combined effects of weak job growth and continued loss of population will make it difficult, although not impossible, for the City to achieve its projections of growth in property assessments as presented in the Plan.

Philadelphia is Finally Enjoying Job Growth but Lags the Rest of the Region

As of the end of 1998, the City had experienced six straight quarters of private sector job growth, the longest stretch of growth since 1988. In fact, private sector job growth was so strong during that eighteen-month period that the City ended 1998 with more private sector jobs than it has had since the fourth quarter of 1991.

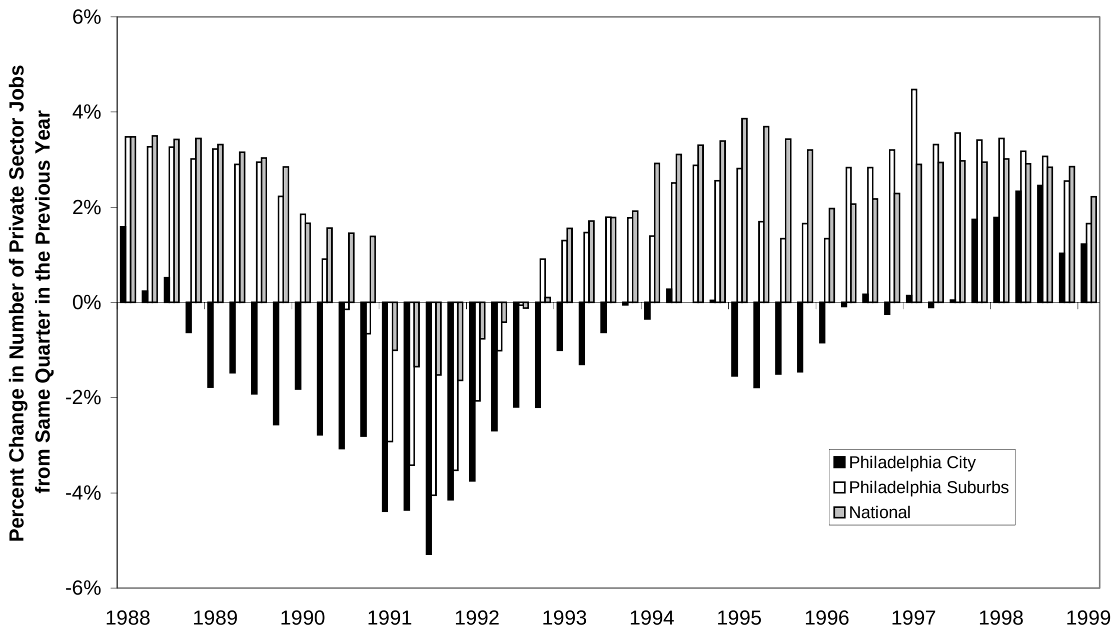
While the City Ended 1998 with More Private Sector Jobs than it has had since the Fourth Quarter of 1991...



Source: U.S. Bureau of Labor Statistics

At the same time, Philadelphia continues to lag the rest of the region, as well as the nation, in private sector job growth. Absent Philadelphia, the rest of the region (Bucks, Chester, Delaware and Montgomery Counties in Pennsylvania and Burlington, Camden, Gloucester and Salem Counties in New Jersey) has experienced job growth for the last 25 quarters. The national economy too has been adding private sector jobs for the last 25 quarters. The suburban portion of the Philadelphia region has added private sector jobs at a faster rate than the national economy over the past three years.

...Private Sector Employment Growth in the City
Continued to Lag such Growth in the Suburbs and Nationally



Source: U.S. Bureau of Labor Statistics

Most of the job growth in the City has occurred in retail trade and service industries such as business, health, private education and social services. Employment growth in the health services sector is surprising given the upheavals and financial challenges in that industry, particularly for hospitals. Given the ongoing challenges in Philadelphia's health services industry, it would be imprudent to rely on continued growth in this industry. As a comparison, the City lost over 3,000 banking jobs (15% of its total) over the past two years, reflecting the major shifts in the banking industry.

The Plan's presentation of job growth trends in Philadelphia uses data that was already outdated in December, when the Plan was compiled. Additionally, county and regional employment data published by the Bureau of Labor Statistics is updated every March for the previous two calendar years, so the charts above include the most recent data. The national data has not yet been updated for 1997 and 1998.

Due to a January 1997 change in methodology for allocating Department of

Defense jobs to the City and region, it is impossible to compare total job numbers from before that time to today. However, the number of federal, state and local government jobs in Philadelphia each declined during 1998. This led the total number of jobs in the City to grow by only 2,000, or 0.3%, from the fourth quarter of 1997 to the fourth quarter of 1998.

The City's Job Growth Projections are Appropriately Conservative

Even with relatively strong private sector job growth over the past 18 months, the total number of jobs in the City during the first quarter of 1999 exceeded the number from two years prior by only 3%. Additionally, private sector job growth appears to have peaked in the third quarter of 1998. Growth occurred at less than half that rate in the fourth quarter of 1998 and the first quarter of 1999.

In this light, the Plan's projected job growth of between 0.1% and 0.5% annually over each of the next five years is appropriate. Given the unprecedented length of the national economic expansion, uncertain international economic situations and the continuing fragility of the City's economy, it would be unreasonable to expect the City to experience job growth above these levels.

PICA Staff is pleased that the City continues to check its projections against those developed by its recently acquired economic forecasting model designed by Regional Economic Models, Inc. (REMI). According to the Plan, the REMI model projected average annual employment growth of 0.8% over the life of the Plan, a level somewhat higher than Plan projections. On the other hand, the Office of the City Controller, using the REMI model with minor adjustments, has forecasted long-term employment growth of only 0.4% through the year 2015.[12] Given the Controller's projection, PICA Staff agrees with the City's decision to use job growth projections lower than what the Plan presents as the REMI model projections.

Over the next few years, the Bureau of Labor Statistics plans to revise the way it measures job numbers, potentially resulting in comparative data no longer being available. Any such breaks in comparative data will impede the City's ability to gauge job trends in certain industries. PICA Staff encourages the City to accelerate its efforts to develop its own reliable economic indicators through the use of tax records, in order to better ascertain job trends in the City.

Philadelphia's Population Continues to Decline

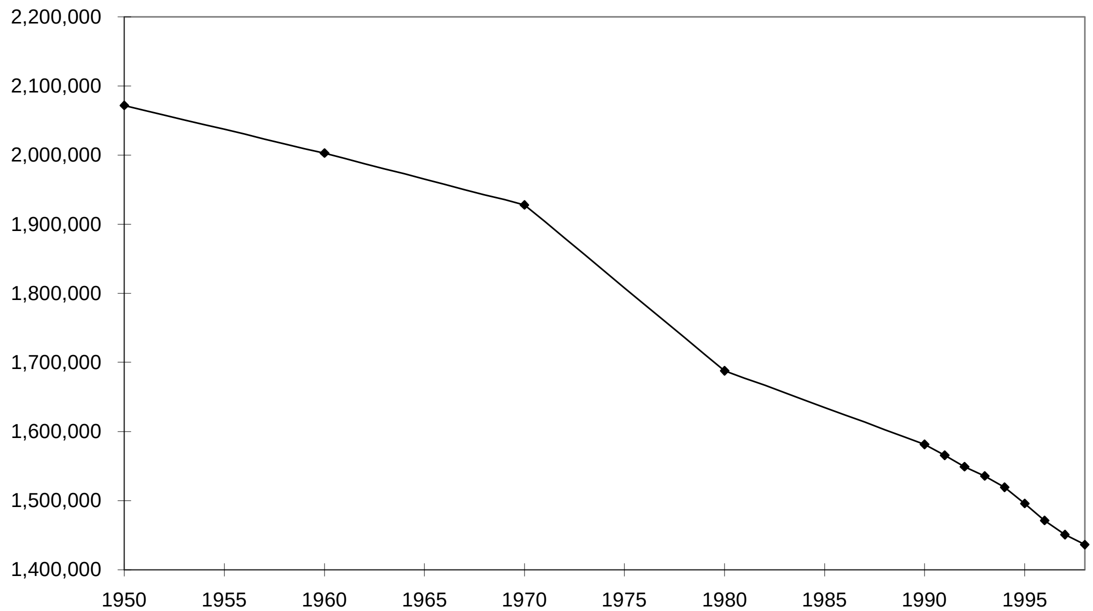
The latest Census Bureau estimate of the City's population shows continuation of almost a half-century of decline. The City has taken exception to the Census Bureau figure this year, claiming that it is based on an undercount from the 1990 Census and that the method used to generate an estimate is biased. However, what is most significant is the undisputed continuing downward trend in population. Both the Delaware Valley Regional Planning Commission and the City Controller's Office project further decline in

[12] *Philadelphia: A New Urban Direction*, Office of the City Controller (Philadelphia, PA: 1999), p. 15.

City population over the next two decades.

The intuitive impression is that the residents moving out of the City are those who can afford to do so (i.e., those with financial resources). Such emigration results in a declining tax base and a growing concentration of poverty, leading to an increased demand for public services. Although there is no data currently available to definitively prove that this is the case, Census Bureau poverty data and State Personal Income Tax data reflect increasing concentrations of poverty in the City.

PHILADELPHIA'S POPULATION CONTINUES TO DECLINE



Note: Annual estimates are included for 1991 through 1998.

Source: U.S. Census Bureau

Real Estate Values Reflect the Job and Population Trends

The most straightforward way to analyze the change in property values over time is by using assessed values as determined by the Board of Revision of Taxes (BRT). BRT assessments are not perfect, as properties are typically underassessed and changes in assessments are based more on reassessment schedules and methodologies than on actual changes in property values. However, assessments are arguably the strongest proxy for changes in market values over time.

Last year, the total taxable assessment for commercial and industrial (C&I) property grew for the first time in six years. Driven mostly by Center City office properties, total assessments for C&I property rebounded in 1999 to a level higher than in 1997.

Commercial and Industrial Taxable Assessments (Dollars in millions)[13]								
	1992	1993	1994	1995	1996	1997	1998	1999
Initial Assess.	$3,543	$3,560	$3,518	$3,442	$3,359	$3,239	$3,202	$3,255
Annual Change	4.0%	0.5%	-1.2%	-2.2%	-2.4%	-3.6%	-1.1%	1.7%

Source: Board of Revision of Taxes

Center City has seen an extraordinary level of real estate activity over the past two years. Over 2,800 new hotel rooms are under construction. At least fifteen proposals have been made to convert non-residential facilities to residential use. Office vacancy rates continue to decline while rental rates rise. Real estate investment trusts and developers have purchased numerous office buildings. This heightened level of activity in Center City's real estate sector indicates a renewed confidence by the private sector in the City's future.

It is unclear how all of this activity will affect Real Property Tax collections. Many of the new developments have been granted tax breaks that will delay by three to ten years any expected increase in tax collections resulting from new buildings or improvements to existing facilities. At a minimum, that delay will help stabilize Real Property Tax collections over the long-term. More significantly, the transition of hospitals from the non-profit Allegheny Health Education and Research Foundation to the for-profit Tenet Healthcare Corporation has already boosted 1999 taxable assessments by over $38 million over their initial level.

Residential property assessments have remained flat over the past two years. Sales data analyzed by the Board of Revision of Taxes (BRT) indicate that market values may have risen during that time, but assessments typically lag changes in market value. Even the sales data, though, indicate that property values have not kept pace with inflation.

Residential Taxable Assessments (Dollars in millions)[2]								
	1992	1993	1994	1995	1996	1997	1998	1999
Initial Assess.	$5,682	$5,746	$5,795	$5,860	$5,832	$5,980	$5,999	$5,985
Annual Change	1.1%	1.1%	0.9%	1.1%	-0.5%	2.5%	0.3%	-0.2%

Source: Board of Revision of Taxes.

The BRT has indicated that it does not currently expect to repeat the 1996 equalization project, which increased total residential taxable assessments in 1997 by 2.5%. That effort had been undertaken as a precautionary measure to protect the City against potential liability for inconsistent residential property assessments. The BRT

[13] For this analysis, condominiums are considered residential property.

believes that residential assessments have been largely equalized and that any further steps toward equalization will be on a much smaller scale.

Given the historical trends in assessments, as well as the job and population trends discussed above, the Plan's projections for growth in assessments (no higher than 1.5% for C&I and 1.6% for residential property annually) appear fairly aggressive, even though they are less than the projected rate of inflation. To meet the combined rate of growth, either commercial and industrial properties as a whole will need to appreciate in value much faster or there will need to be another Citywide round of residential reassessments.

DEPARTMENT OF HUMAN SERVICES

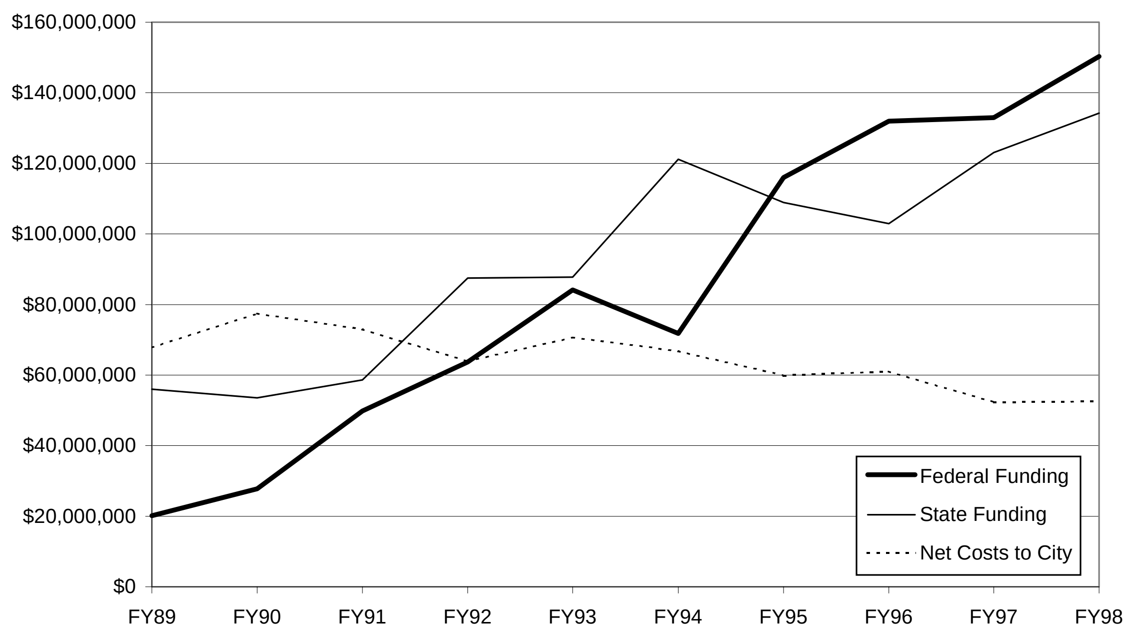
The Department of Human Services (DHS) has successfully and significantly increased its state and federal funding over the past eight years. This increased funding has allowed the City to enhance service levels, while simultaneously reducing net City costs. Programmatic and funding challenges threaten to increase net City costs in the future.

The City must continue working diligently with the state to protect the funding it currently receives and to identify new funding streams. It is also important for the City to closely monitor the costs of unfunded mandates, so that it can best promote its case for continuing and increased state and federal funding.

Increased State and Federal Funding has led to Service Enhancements and Reduced Net City Costs

In the early 1990s, as a result of legal and political pressure, the state initiated a Needs-Based Budget process to determine appropriate levels of state funding for human service functions. While serious problems with the state's Needs-Based Budget Process still need to be addressed, the process has resulted in increased state funding for City-provided Children and Youth and Juvenile Justice Services. Simultaneous to this change, the City and the state also began pursuing additional federal funding for these services.

Increased State and Federal Funding to DHS Has Allowed the City to Expand Services While Reducing Net Costs
(Not Adjusted for Inflation, General Fund Only)



As the above graph illustrates, while the City locally funded 47% of DHS General Fund costs in FY89, by FY98 the City locally funded only 16% of these costs. Over that same time period, the federal government went from the smallest funding source (14%) to the largest (45%). The State's contribution has bounced around between 32% and 47% of total costs over the past ten years, but in FY98 it was again close to its FY89 contribution level of 39% of total costs.

These increased revenues from other governments have allowed DHS to enhance service levels. As an example, the number of dependent children in placement increased from 5,903 in 1990 to 8,016 in 1998. Similarly, the total number of delinquent children served increased from 1,670 in 1991 to 2,445 in 1998.

Increased state and federal revenues have also allowed the City to reduce its local share of DHS costs. On an inflation-adjusted basis, the City's local share of DHS costs in FY98 was less than 60% of what it was in FY89.

Increased State and Federal Funding Creates a Strong Financial Dependency

The City's success at obtaining increased state and federal revenues for DHS services is a double-edged sword. While it has reduced the demand those services place on locally-generated revenues, it has also increased the City's dependence on decision-makers in Harrisburg and Washington, DC.

The City's vulnerability to legislative and regulatory decisions at both the state and federal levels has already been exposed. For example, in January 1996, after having worked with the state Department of Public Welfare to obtain what was then federal Title IV-A reimbursement for broad categories of DHS costs, the federal Department of Health and Human Services stopped reimbursing for some of those categories. This decision significantly reduced the amount of federal funding Philadelphia would be receiving. Fortunately for the City, the state stepped in and kept the City revenue neutral for six months. This change was then preempted by Congress' 1996 creation of Temporary Assistance to Needy Families (TANF), which reduced the amount of such funding available to the state. The state then effectively decided to provide a lump sum of TANF funding to DHS. The method by which the funding level was determined and its method of application then affected other funding streams, resulting in lengthy negotiations between DHS and the state. In the end, DHS experienced a significant decline in Title IV-A/TANF funding.

The City, in conjunction with the state, has managed to identify new sources of available federal funding that have continued to shift DHS costs to the federal level, even after taking into account the changes mentioned above. However, the City cannot take for granted the continuance of these funding streams. It is especially important that the City continue to work closely with the state to maintain current state and federal funding levels and to identify new opportunities for enhanced funding.

Programmatic and Funding Challenges may Affect Net City Costs

Adoption and Safe Families Act of 1997

The City is currently implementing the Adoption and Safe Families Act of 1997 (ASFA). This federal legislation places significant new demands on how DHS must handle its dependency caseload. Perhaps most onerous is the requirement that, after a dependent child has been in foster care for 15 of the most recent 22 months, DHS must file a petition to terminate parental rights, or present to a family court judge a "compelling reason" why such an action would not be in the best interest of the child.

DHS estimates that it will need to hire a total of 81 new employees by the end of FY2000 to handle the increase in the workload resulting from the implementation of ASFA. To help fund these new positions, the state has increased the certified level of state funding available to DHS. The City will also be able to bill the federal government for these new positions through the regular funding process. Even so, this new mandate will require the City to provide more local funding to DHS than otherwise required.

Continuing Problems with the Act 30 Needs-Based Budget Amendments to Act 148

As mentioned above, the Needs-Based Budget process continues to suffer from serious inequities and muddled processes. PICA has previously discussed these problems (see *Staff Report on State Funding of the Philadelphia Department of Human Services*, December 15, 1995). As the Plan explains, as a result of the confusion surrounding the process, Philadelphia has repeatedly pressed the state to increase the FY99 certified level of funding for Philadelphia. The certification is still under appeal.

DHS takes major issue with three aspects of the current Needs-Based Budget process. Each one potentially leads to state underfunding. When calculating the appropriate level of state funding for a particular year, the state Department of Public Welfare uses:

(1) Uniform, statewide caps on rates of increases for costs of purchased services without regard to actual costs or differences in costs among counties;
(2) Uniform statewide caps for salaries and benefits which ingore cost of living differences among counties; and
(3) "Certified" funding amounts from the previous year, rather than actual costs or mid-year estimates.[14]

To date, increased federal funding has obscured the flaws in the Needs-Based Budget process. However, these flaws are likely to become more significant if federal funding either levels off or declines.

Conclusion

DHS has been remarkably successful at obtaining much greater levels of state and

[14] See *City of Philadelphia, Annual Plan for Fiscal Year 2000,* Philadelphia Department of Human Services and the First Judicial District of Pennsylvania, August 1, 1998, p. V-1.

federal funding, allowing it to enhance its service levels and reduce net City costs. This success, though, makes it imperative that the City actively protect the gains it has made and seek out new potential revenue streams. DHS also needs to monitor the costs of new mandates, such as the federal Adoption and Safe Families Act of 1997, to be able to continue to make a strong case for continued funding.

REVENUE AND EXPENDITURE PROJECTIONS

Last year, PICA Staff was pleased to note the City's purchase of an econometric forecasting and simulation computer model (the REMI model). The City Revenue Department has used the model to double-check the Plan's underlying economic assumptions. The City has also used the model to estimate the potential economic effects of proposed public investments and policy changes, such as the funding of new sports stadiums and a reduction of the Real Property Transfer Tax rate.

Even after this and other steps to improve its methodology for projecting tax revenues, the City continues to misstate the underlying economic growth assumptions in the Plan. The City has also not ameliorated other persistent problems with its methodology for projecting growth in the real property tax base and projecting delinquent tax collections. The City needs to clearly articulate its assumptions and how those assumptions are applied throughout the Plan. The City also must be more diligent in using consistent data in the Plan and any supporting material.

The Base Obligation Methodology for projecting expenditures other than personnel and debt service costs also continues to be problematic. By presenting each department's budget projections by class for each year covered by the Plan, as it already does for certain departments, the City would make it much more apparent how this methodology is applied.

The Plan Misstates Economic Growth Assumptions

The Plan presents a table "show[ing] the assumptions underlying the City's wage tax forecast."[15] This table is not an accurate presentation of the Plan's assumptions; it merely creates confusion. The "assumptions" in the table are not the ones used to project Wage and Earnings Tax collections. Rather, according to the City, tax collections are calculated using assumptions that are <u>not</u> presented in the Plan. The "assumptions" presented in the table are calculated backward from the Plan's projection of <u>total</u> tax collections.

Contrary to the table's figures, the Wage and Earnings Tax base (a product of the average wage per employee and the level of employment) is projected to grow by between 3% and 3.5% in each year of the Plan. For the second year in a row, this rate of growth exceeds projected inflation in each year of the Plan (2.5% annually through FY2003 and 2.75% in FY2004). While the projected rate of growth does not pose a significant risk to the successful implementation of the Plan, it is not as conservative as the Plan insinuates. It is much closer to the REMI model's baseline prediction of growth in the Wage and Earnings Tax base than the Plan claims.

The Methodology for Projecting Real Property Tax Collections is Suspect

The Plan, on page 10, presents another table that attempts to illustrate the annual

[15] *Five-Year Financial Plan Fiscal Year 2000 – Fiscal Year 2004,* p. 9.

change in real estate assessments both before and after appeals and other adjustments. This table presents incorrect information for 1997 and 1998. Contrary to the table presented, total real estate assessments after adjustments grew by 0.5% in 1997 and by 0.4% in 1998, and not 1.3% and -0.2% respectively.

As in the past, the City has again provided PICA Staff with supporting material demonstrating how tax revenue projections were calculated. As in previous years, the supporting material for projected real estate assessments is incorrect. Not only does it ignore actual figures available from the Bureau of Revision of Taxes and the Department of Revenue, it does not even correspond to the data presented in the faulty table discussed in the above paragraph.

Fortunately, the inconsistent data do not pose a significant risk to meeting the projected Real Property Tax collections over the life of the Plan. Nonetheless, the inconsistencies undermine the credibility of the entire Plan.

The Methodology for Projecting Delinquent Tax Collections is Suspect

The City continues to have a problem in projecting "prior year" (i.e., delinquent) tax collections. The City typically takes actual collections from the previous fiscal year and replicates it over the life of the Plan, with minor adjustments. The City does not explicitly consider how factors such as enacted and proposed tax rate changes or enforcement efforts will affect delinquent collections.

From year to year, this can lead to wide swings in the projection of delinquent collections. For instance, two years ago, based on the collections experience of FY96, the City projected that collections for delinquent Wage and Earnings Taxes would be over $21 million during each year of the then-current Plan. The following year, as a result of its flawed methodology for projecting delinquent collections, the City revised these projections downward to no more than $13 million per year. This year, as a result of FY98 results, projections were again revised, but this time upward by an average of $2 million per year.

Fortunately, due to the unexpectedly strong economy, "current" (i.e., non-delinquent) Wage and Earnings Tax collections after FY97 exceeded projections by more than enough to mask inflated projections for delinquent Wage and Earnings Tax collections.

Problems with Non-Personnel, Non-Debt Service Expenditure Projections

The Plan's underlying obligation growth assumptions once again appear to be optimistic. Excluding personnel and debt service costs, the assumptions include no growth in FY2000 and 1.5% annual growth in each of the out years. These baseline assumptions are identical to previous years' assumptions of no growth in the first year and 1.5% annual growth thereafter.

These assumptions may result in severely underestimated expenditures, particularly in the out years. It is unlikely that costs for contracted services, materials, supplies and equipment will continue to grow at the assumed rate, which is 60% the projected rate of inflation. This point is exacerbated by the fact that 90% of the costs projected in the proposed Plan will be the responsibility of a successor administration.

Since projections for individual departments often differ from the Plan’s underlying obligation growth assumptions based on department specific issues and considerations, the impact of the overall assumptions may be limited. However, the City does not always stipulate where the underlying assumptions are applied and where other considerations are taken into account. Thus, it is difficult to calculate the difference between the City’s assumptions and costs that could be expected if expenditure growth more closely tracks projected inflation.

Expenditure projections must be based on reasonable assumptions and a methodology that is clearly presented. When it is unclear how assumptions are applied, it calls into question the credibility of the entire presentation.

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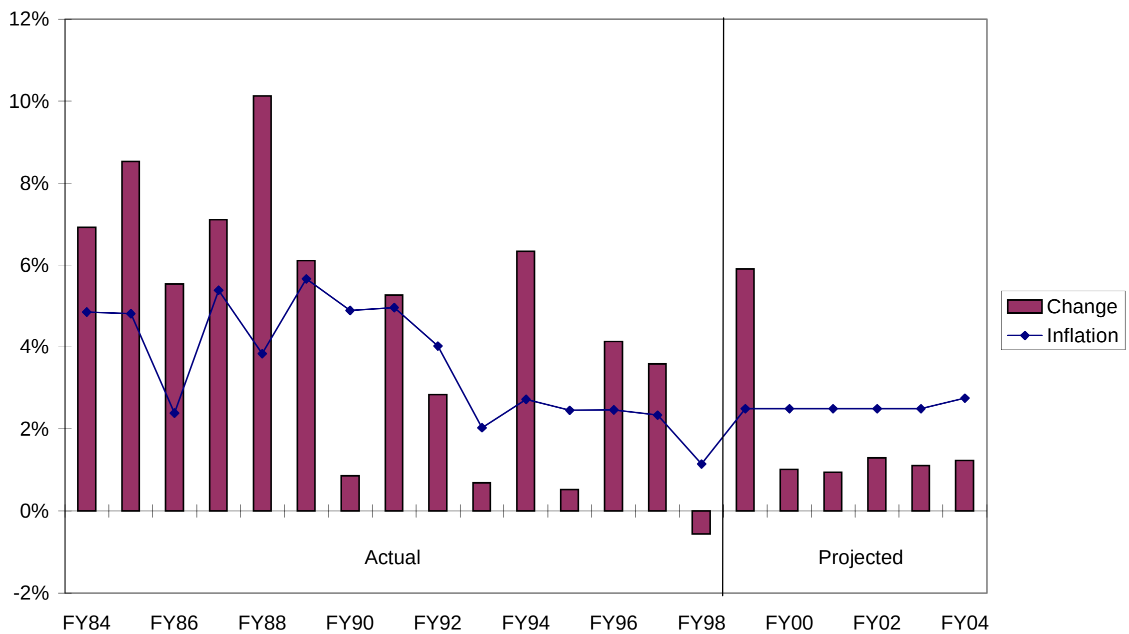
ANALYSIS OF NET CITY COSTS

The City receives a significant amount of state and federal funding for many different activities, including human services, physical health promotion, mental health services, highway maintenance and law enforcement. Almost all of this funding is earmarked for such specific activities and cannot be diverted. Locally-generated revenue, primarily taxes, pays for the rest of the budget.

While the City is required by law to spend some of its locally-generated revenue on specific programs or activities, it has discretionary power over how it spends most of its local revenue. By reducing net costs (General Fund costs not funded with state or federal revenue) in any one area, the City can redirect resultant savings to whatever purpose it determines urgent, whether alternative cost centers or new labor contracts. By reducing total net costs, it can give itself the ability to generate a reserve to protect itself in times of fiscal stress or to enact tax reductions.

FY98 was the first time in at least fifteen years that the City reduced its total net costs (i.e., the locally-funded share of total expenditures). Although not the biggest decline in inflation-adjusted terms, it was still a significant achievement.

In FY98, the City Reduced its Net Costs (i.e., the Locally-Funded Share of Total City Expenditures) for the First Time in 15 Years



Note: Includes PICA debt service as a locally-funded city expenditure.

In general, net City expenditures decline when state and federal revenues increase faster than total City expenditures. Last year, even total General Fund expenditures grew less than 1%. There are three significant dynamics that contributed to this commendable achievement:

1) Payroll costs grew by less than 0.5% from FY97 to FY98, even as 3-4% wage increases went into effect for virtually all City employees.
2) Costs for purchased services barely grew from FY97 to FY98.[16]
3) Debt service costs fell by over 7.5% in FY98, a result of reduced debt service and delayed issuance of new debt.

These three dynamics will be difficult to reproduce, especially as Crime Bill funding expires, libraries, recreation centers and prisons increase staffing and the debt service required for the recent $250 million General Obligation bond issue takes effect.

The Expiration of Crime Bill Funding

Over the past four years, the City has hired 753 police officers with the assistance of $56.5 million in federal Crime Bill funding. The City has been assuming a greater share of the funding for these officers each year since FY97, and by FY2002 it is to fully fund these positions out of local revenues.

According to the Plan, the City will be spending $34.6 million in locally-generated funds for these new officers in FY2000. In FY2002, when these positions are no longer eligible for federal funding, the City will be spending $44.8 million out of its own pocket. Police officers are eligible for longevity and pay step salary increases that, over time, will further increase the costs associated with these new positions.

According to Plan projections, the Police Department will consume 25% of all locally-generated revenues in FY2002, far more than any other City operation. This will make it difficult to reduce net City expenditures again without a special effort to reduce the Police Department's budget, such as by reducing overtime costs related to court appearances.

The Free Library and Recreation and Prisons Departments are Adding 347 Employees

The FY2000 budget calls for increasing the total number of full-time General Fund positions by 417 over the original FY99 budgeted level. Eighty-eight positions are budgeted within the Department of Human Services and will in large part be paid for with state and federal funding. State and federal funding will not appreciably offset the costs related to 347 positions being added to the Free Library and the Recreation and Prisons Departments.

In FY2000, the Free Library will be completing its six-year project to renovate and upgrade each of its branch and regional facilities, with two or three exceptions. Library officials believe that this project will obviate the need for closing down facilities for renovations or repair work over the next few years. They expect all of the facilities to be operational beginning next year, with the added potential of a new branch opening in East Center City. To fully staff the library system, the FY2000 General Fund budget

[16] This was due in significant part to a one-time, $30 million "economic stimulus" grant to PIDC in FY97. Adjusting for this grant, the FY98 decline in the preceding chart becomes an increase, although both the FY97 and FY98 resultant increases are below inflation.

provides $1,820,694 more than the original FY99 appropriation for salary costs associated with 58 additional staff.

The Recreation Department is to hire 54 additional full-time employees in FY2000, at a salary cost of $1,367,238. Most of these new employees are expected to provide full-time custodial coverage to mid-size recreation centers, while 8 are building and trades positions for recreation center repair.

The Prisons Department is planning on constructing and opening a new women's facility in FY2000. This facility is budgeted for 232 full-time positions, costing over $7 million in salary alone. Other changes in staffing have a net effect of adding 3 more positions. The opening of the Curran-Fromhold Correctional Facility in FY96 resulted in an increase in the Prisons Department use of locally-generated revenue, from about 6.1% to 6.7%. After the new facility is opened, the Prisons Department portion of such revenue will increase to 7.5%.

Debt Service for the Recent New General Obligation Bond Issue will Begin in FY2000

The City issued $250 million in General Obligation Bonds last fall. The debt service on this issuance will begin in FY2000 at $17.8 million and generally remain flat at $17.2 million through FY2028. The Plan has typically budgeted for $125 million of new General Obligation Debt per year. By delaying such issuance in FY98, the City was able to reap significant one-time savings. By issuing two years' worth of debt this past fall, the savings associated with the FY98 delay will not be repeated.[17]

Meeting Plan Projections for Net City Expenditures will be Challenging

The prior chart illustrates in part how the Rendell Administration is budgeting for the out years of the Plan. The FY99 projections as of mid-year conservatively project that net City costs will grow at more than twice the rate of inflation. This unfavorable outcome is rather unlikely, but provides the City with a cushion for unforeseen circumstances.

For FY2000 through FY2004, the City projects that obligations will grow at no more than half the rate of inflation each year. While this assumption is fairly aggressive, it builds on the Plan-projected FY99 obligation level, which, again, is likely to prove to be above the actual result.

More troubling is the implicit assumption in the Plan that there will be no wage increases after FY2000, when the current labor contracts with the four major collective bargaining units expire. The pay increases included in the current contracts, as low as they may be historically, will likely exceed inflation in total. It is therefore rather aggressive to anticipate that the new labor contracts will not increase total net City costs at more than half the rate of inflation. In order for that to occur, the next administration must fund any future wage increases through further improvements to efficiency or

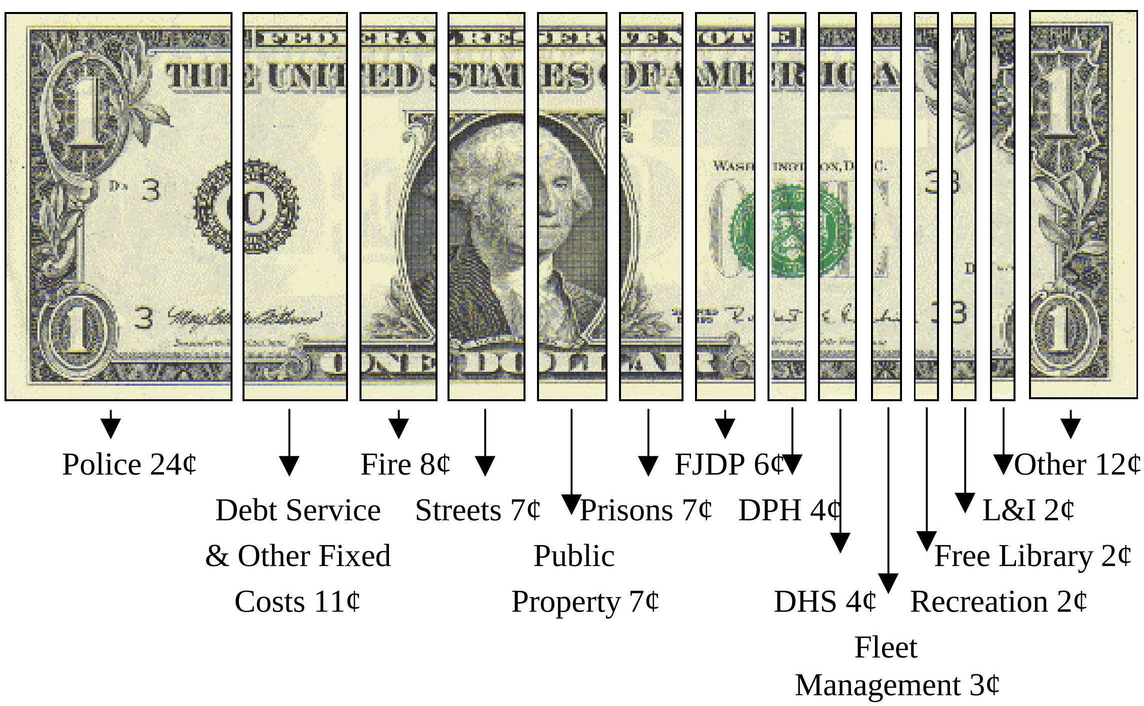
[17] By delaying its debt issue, the City fortuitously benefited from lower interest rates this past fall. There was no way for the City to know in advance that interests rates were going to drop.

service reductions. (For a more detailed discussion of the upcoming labor contract negotiations, please see the Labor Contracts section of this report.)

Trends in how the City Spends its Locally-Generated Revenue

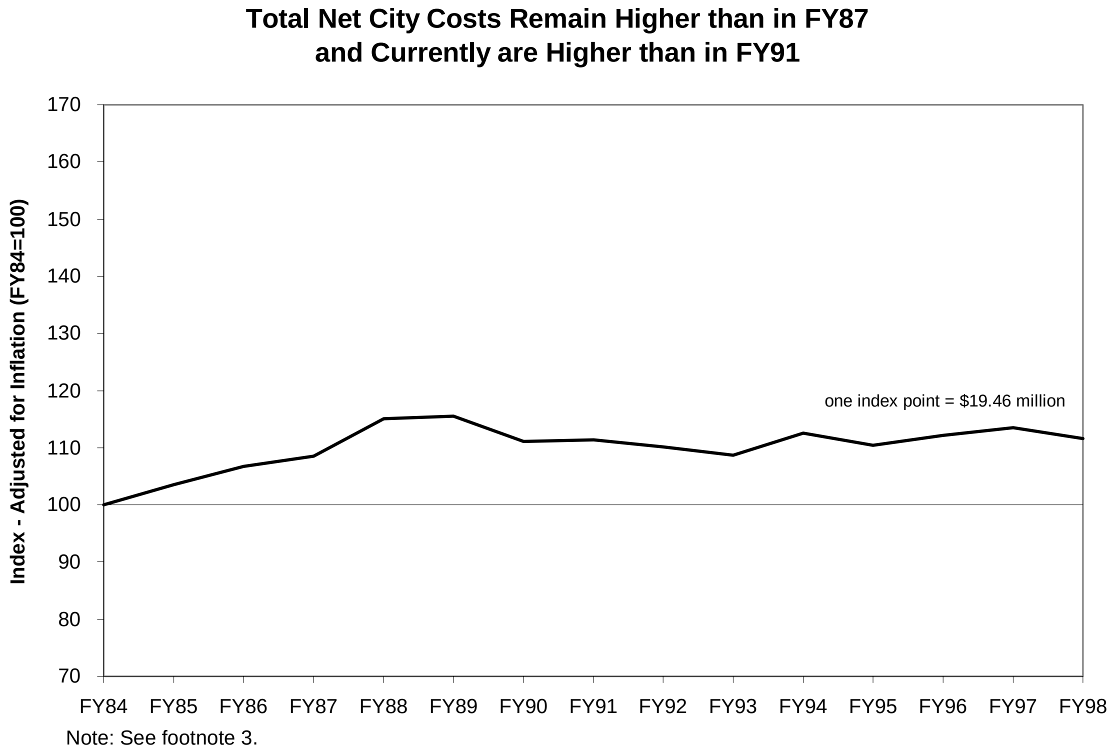
The following chart provides a guide to where the City spends its locally-generated revenues, most of which are tax revenues. By focusing on the areas where it spends its discretionary funds, the City can continue to produce savings to redirect to new funding demands and tax reductions.

Use of Locally-Generated Dollar
Fiscal Year 1998[3]



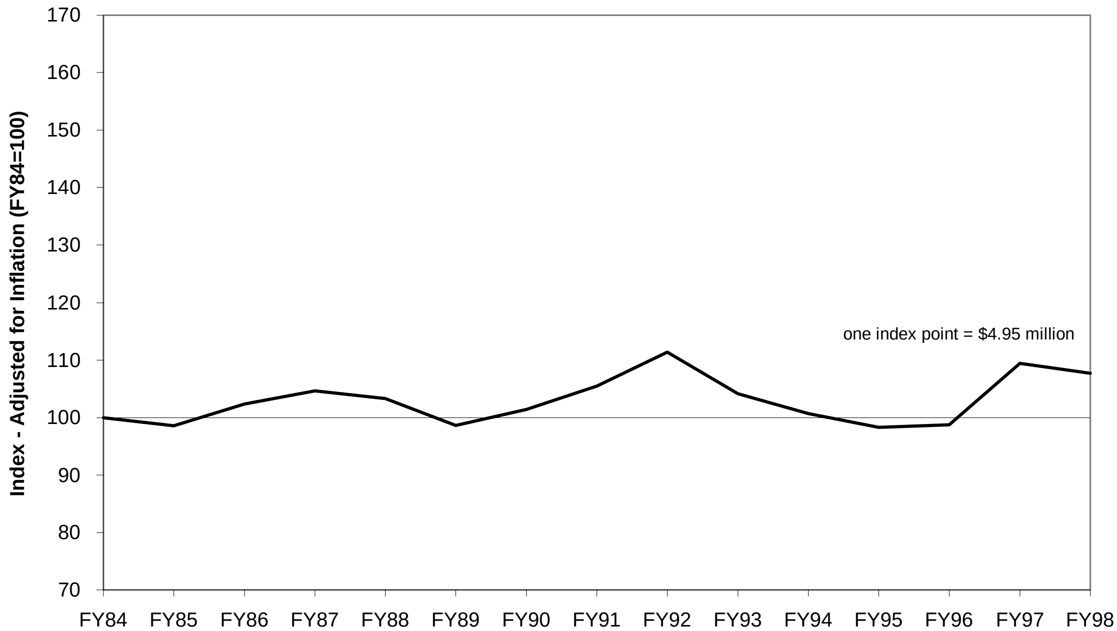
[18] Figures are based on budget results as presented in the City's annual *Supplemental Report of Revenues and Obligations*. Estimated fringe benefits are charged back to departments. Fixed Costs include General Obligation and PICA debt service, long-term leases and the net subsidy to the Pennsylvania Convention Center. Public Property includes utility, space rental and telecommunication costs, most of which are attributable to other departments, and the City's annual contribution to SEPTA.

The Rendell Administration has managed to achieve fiscal stability by controlling net City costs. However, in inflation-adjusted terms, the City spent more locally-generated revenue in FY98 than it did in FY91.



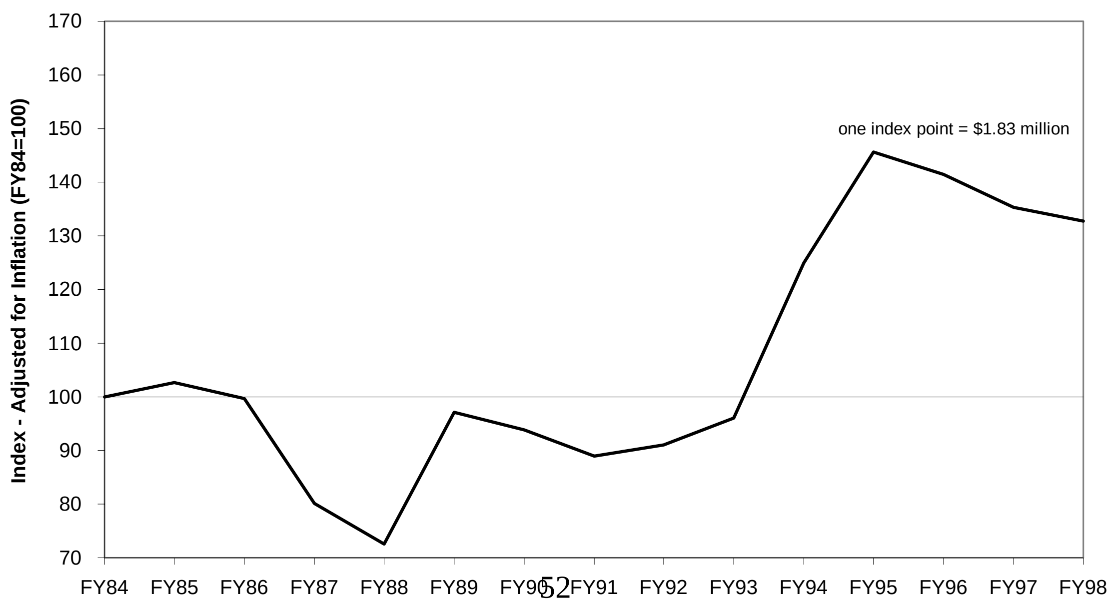
The charts on the following pages illustrate how much locally-generated revenue the City has spent on most of its major cost centers over the past 15 years. In many areas, the City's spending habits are not much different from what they were fifteen years ago.

Net City Costs for the Police Department have Grown as Crime Bill Funding Ends



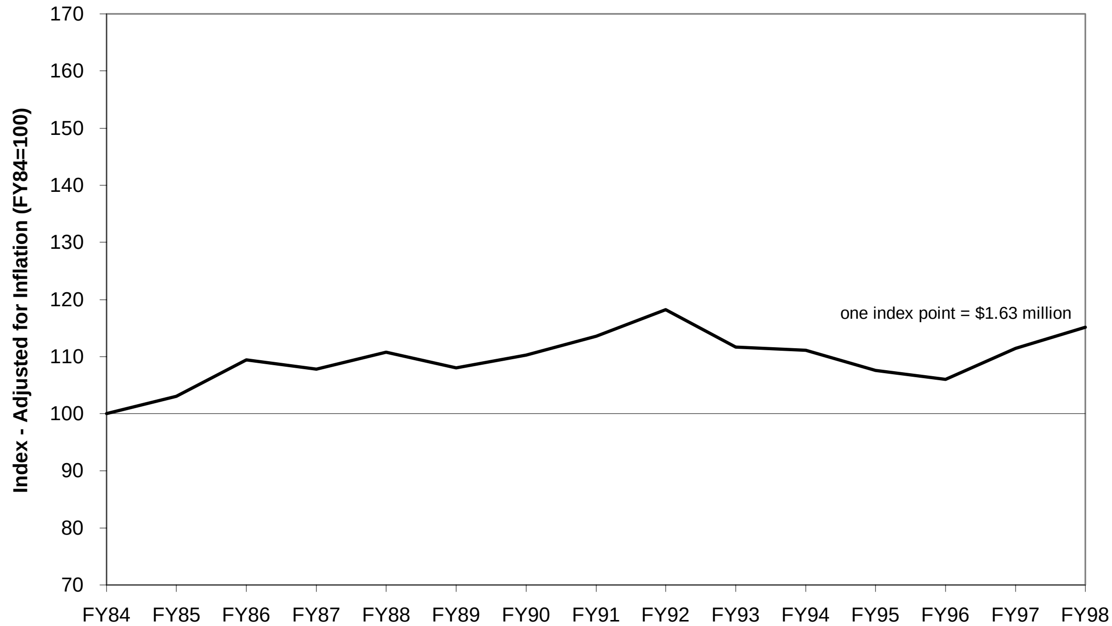
Note: Adjusted for loss of Fleet Management function in FY94. See Footnote 3.

Net City Costs for Debt Service & Other Fixed Costs have Increased as a Result of PICA Debt, the New Prison, the Rehabilitated MSB and New General Obligation Debt



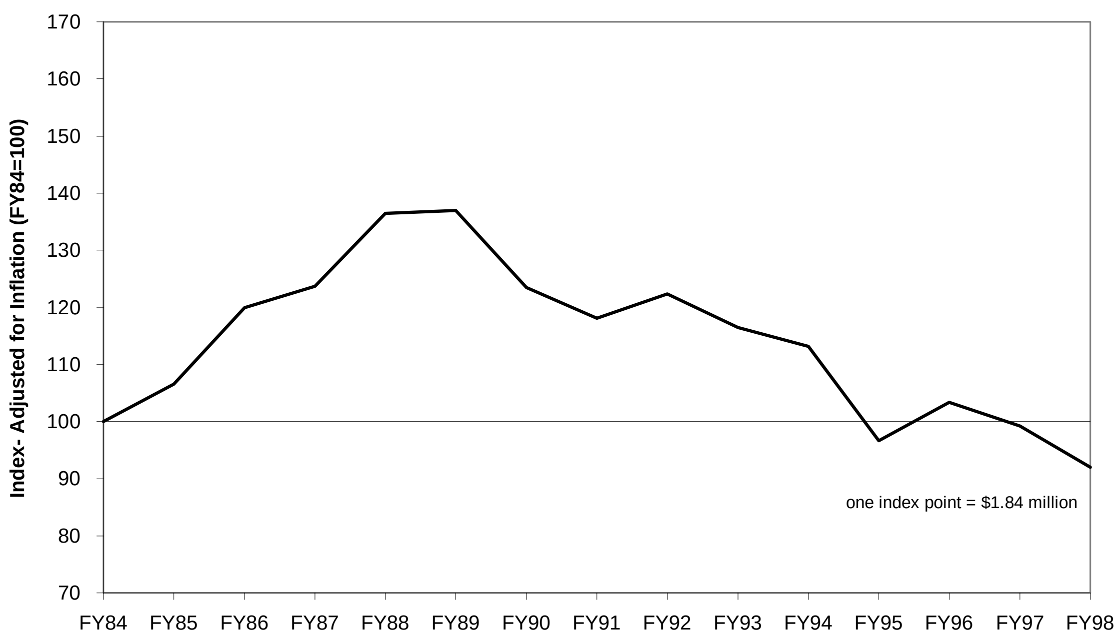
Note: See footnote 3.

Net City Costs for the Fire Department have Grown as the City has Increased the Number of EMS Squads



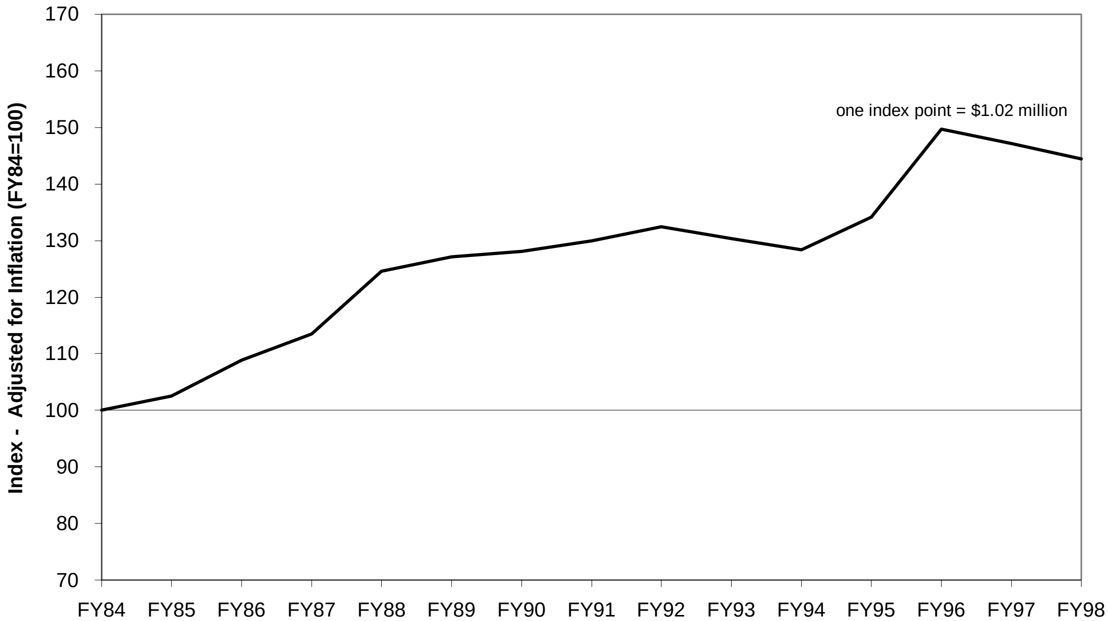
Note: See footnote 3.

Net City Costs for the Streets Department have Fallen as the City has Reduced Disposal Costs and Staffing Levels



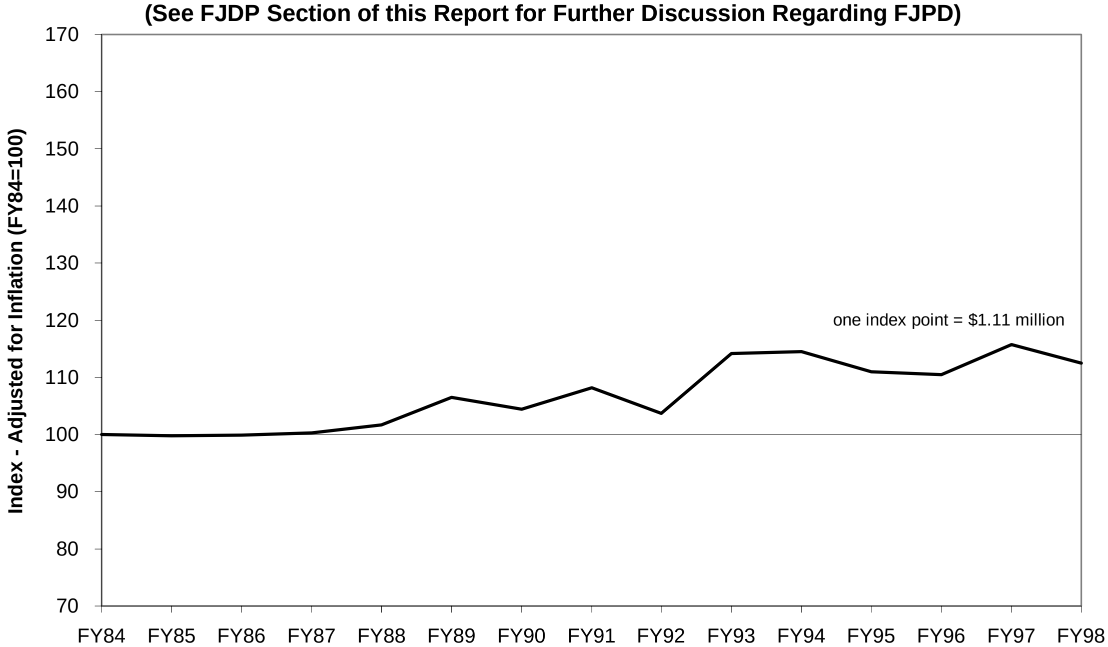
Note: Adjusted for loss of Fleet Management function in FY94. See footnote 3.

Net City Costs for the Prisons Department has Increased as Inmate Population has Grown and the New Prison Opened



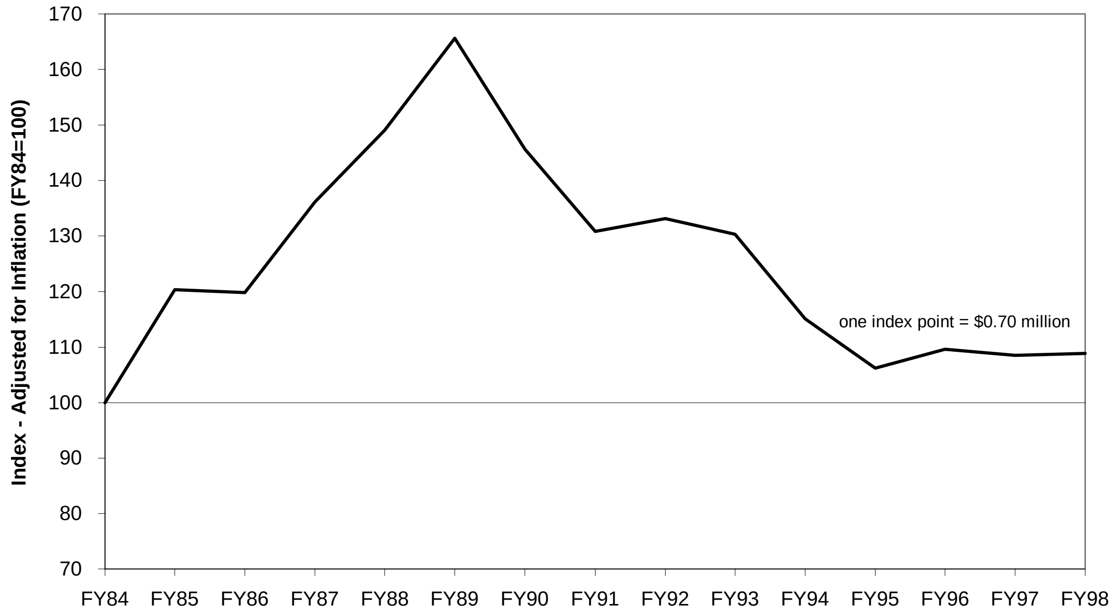
Note: Adjusted to include Prison Health Services, which were part of DPH prior to FY96. See footnote 3.

Net City Costs for the First Judicial District have Fluctuated Even Though a Zero-Growth/Reduction Agreement is Still in Place
(See FJDP Section of this Report for Further Discussion Regarding FJPD)



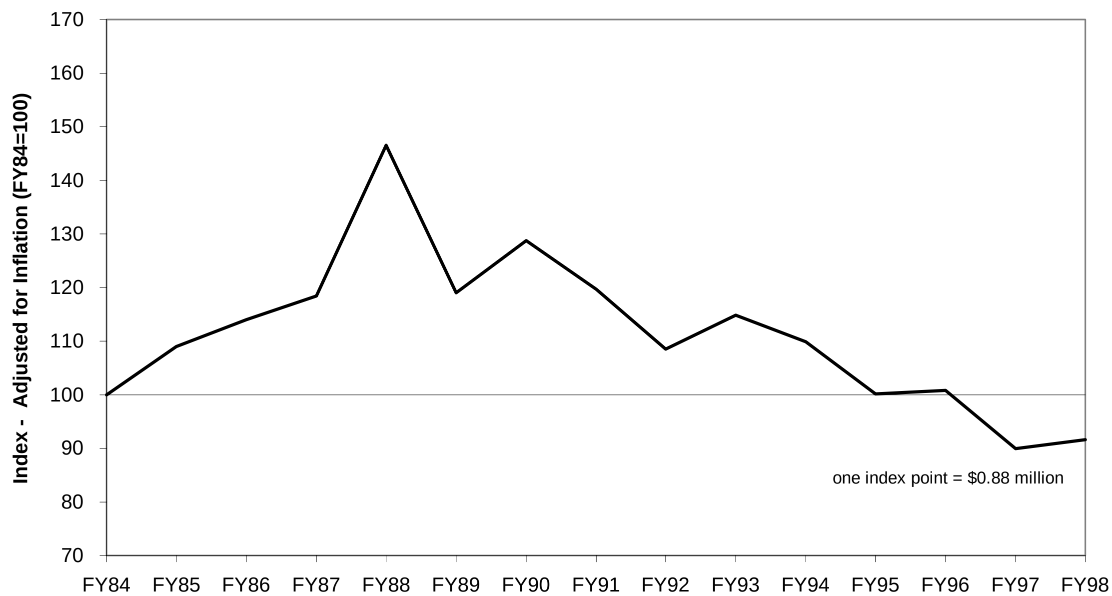
Note: See footnote 3.

Net City Costs for the Department of Public Health Fell as the City Successfully Pursued Increased State and Federal Funding



Note: Adjusted to exclude Prison Health Services, which were transerred to the Prisons Department in FY96, and to account for an FY97 change in how the City accounts for Medical Assistance. See footnote 3.

Net City Costs for the Department of Human Services have Fallen as the City has Pursued Increased State and Federal Funding
(See DHS Section of this Report for Further Discussion Regarding DHS)



Note: See footnote 3.

Reducing Net City Costs is Vital if the City is to Further Reduce the Local Tax Burden

The City has successfully obtained additional revenue from the state and federal governments over the past few years, particularly for DHS.[19] This success has alleviated some of the budgetary pressure on locally-generated revenue. Yet even with this success, out-of-pocket City costs for many basic municipal and county services have continued to grow.

By reducing net City costs in certain departments, such as Streets, the City has been able to absorb the costs of enhanced services elsewhere, such as Police. The past seven years have also demonstrated that with strict fiscal discipline, the City can control departmental spending to a level sufficient to absorb certain new costs, such as wage increases, without realizing corresponding jumps in total net City costs.

Nonetheless, the analysis in this section demonstrates that strict fiscal discipline alone is not enough to put the City on track to meet the challenge of providing enhanced services at reduced costs. Even with all of the City's success over the past few years, total net City costs adjusted for inflation were higher in FY98 than in FY91. The combined effects of the expiration of Crime Bill funding, the proposed increased staffing at the libraries, recreation centers and the prisons, and the cost of debt service for last fall's debt issuance will place new pressures on the General Fund budget that will make it more difficult to further reduce net City costs.

Only by reducing <u>total</u> net City costs will the City be able to provide more than marginal tax relief to its residents and make Philadelphia a more competitive place to live, work and visit.

[19] See the section on DHS in this report for a more detailed discussion of DHS funding.

NEW SPORTS STADIUMS

In February 1999, the state legislature appropriated approximately $773 million in state funding for local capital projects, including $320 million to house the four major league baseball and football franchises located in the state.

State funding for sports stadiums is limited to approximately $80 million per team--but in no circumstance will the Commonwealth contribute more than one-third of the total cost of each new stadium. The remaining costs, at least two-thirds of the total cost of each stadium, are expected to come from equal contributions by the respective teams and local government. Estimates for the costs associated with constructing two new stadiums in Philadelphia vary considerably. It is conceivable that, after including costs for site acquisition, preparation and infrastructure, such costs could reach or exceed $600 million.

Also, Pennsylvania, in a move unprecedented in any other state, included a provision in its legislation requiring that each team guarantee a “return on state taxpayers investment”. Tax and fee revenue are required to equal or exceed the state's cost of issuing the debt to pay for its share of each stadium. In the event that such revenues fall short, the teams are to be held liable for the difference.

Philadelphia sports stadium construction details have yet to be finalized and thus the full cost to City taxpayers cannot yet be calculated. With no agreement in place to spell out the funding mechanism, it is too early to predict how much the City will contribute to stadium costs or what form the City's aid may take. It is nonetheless appropriate to point out some areas of concern:

- Site Selection - Stadium location will have a dramatic impact upon both construction costs and new revenues to be generated.
- The City's Share - Numerous options exist for funding the City's share. Some which have been publicly discussed include a ticket surcharge, a tax on auto rentals, a new regional lottery, infrastructure improvements in lieu of money, contributions equivalent to what the City currently pays for the maintenance of Veterans Stadium and stadium naming rights. Certain options could have a dramatic impact on General Fund revenues and expenditures.
- Ownership and Revenues - Who owns the facilities and therefore the naming, concession and parking rights will have a dramatic impact on how the teams' and City's shares will be calculated.

As Veterans Stadium is City-owned and operated, the General Fund recognizes numerous direct, as well as indirect, revenues and obligations associated with the use of that facility. Revenues include, but are not limited to, rents, stadium concessions, taxes (both direct and indirect) and other assorted fees. Obligations include costs for stadium maintenance, operations and debt costs associated with capital improvements. PICA staff will closely evaluate the effects any new stadiums will have on the City's General Fund.

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STRATEGIC PLANNING

The City of Philadelphia issued a Citywide strategic plan in 1995 as an appendix to that year's Plan. It stated that all operating departments would be expected to complete their own strategic plans by the end of September 1995 and indicated that copies would be provided to PICA Staff as they were completed. Since that time, only five departments have provided PICA Staff with copies of their departmental strategic plans--or a report as to the reasons for their delay in executing the planning process. With the exception of those put forth by the Mayor's Office of Information Services (MOIS) and the Water Department, the departmental strategic plans provided to date have not demonstrated a commitment to fundamental change and improvement. However, they do provide *some* focus to the City's broad range of activities and a guide for proceeding with improvements.

PICA Staff understands that the City has numerous priorities and that focusing on a strategic planning process can be challenging and seemingly superfluous. However, such a process is vital to preparing for future challenges. As the City has already demonstrated, proper strategic planning can surface creative, service enhancing and money saving ideas and help to build a dedicated and enthusiastic workforce. Unfortunately, based on the actions to date, PICA Staff can only conclude that the City has not made the strategic planning process a serious priority.

The Process behind the Citywide Strategic Plan was Top-Down

The 1995 Citywide strategic plan was developed primarily with the input of senior City officials. There was some representation from the private sector and from a handful of community organizations. However, as PICA Staff has previously noted, the process failed to include sufficient representation from the City's numerous neighborhood groups, town watch groups, local foundations, businesses or city residents at large. This resulted in a strategic planning process that focused on the basic mainstays of the Rendell Administration but did not build a constituency with an investment in its outcome.

The City primarily operates under what PICA Staff has previously described as an intuitive, top-down management style. During the period of the City's dire fiscal crisis this style proved necessary and useful. However, PICA Staff believes the next administration needs to shift to a more inclusive, bottom-up management style. It remains vitally important that the central administration provide a unified vision and that it keep a handle on the financial and service level operations of each department. However, where possible, decision-making should be shifted down the hierarchical ladder to enable front-line employees to more efficiently and effectively identify service needs and handle job demands.

A strategic planning process incorporating the input of a wide range of employees would provide a more diverse range of perspectives and ideas, as well garner the support and commitment of a greater number of City employees.

There has been no Formal Follow-up to the Citywide Strategic Plan

According to the City administration, the City attempted to document the progress made toward the goals of the Citywide strategic plan. The final report ended up looking very much like the Five-Year Financial Plan. What is needed is not a recital of the City accomplishments to date. What is needed is an inventory of what still needs to be done, not only from the goals of the original strategic plan but also from an ongoing process that evaluates the changing demands on City government.

The City needs to ensure that it is continuously focused on its long-term goals. The only way to do this, and to show the public that it is doing so, is to report on a regular basis (even if only every two or three years) that its goals are still appropriate and that it is making progress toward them.

The Failure to Fully Commit to Strategic Planning has Set a Poor Precedent for Future Administrations

As a result of its lack of commitment to a full-fledged strategic planning process, the City has lost an opportunity to focus its employees and policy makers on a prioritized agenda for improvement. Its ability to identify and implement changes that will improve service delivery has been hindered. The process failed to institute a mindset with City managers and the general workforce that could benefit Philadelphians for many years beyond the tenure of the current administration.

The lack of an adequate commitment to strategic planning is a poor precedent for any future strategic planning effort. PICA Staff will continue to scrutinize the City's efforts and hopes for a renewed emphasis on strategic planning both now and in the next millenium.

Conclusion

PICA Staff can only conclude what is painfully obvious. The City continues to view its strategic planning process as a low priority. This lack of attention limits the City’s ability to plan for the future and diminishes the value of efforts that have been made on both the Citywide and departmental strategic plans. Continuing to view the process as less than a high priority will impede any future strategic planning effort and potential benefits derived from such an effort.

CAPITAL PROGRAM OFFICE

PICA Staff has in the past been an aggressive, vocal critic of the operation and performance of the Capital Program Office (CPO). PICA Staff is now encouraged about the CPO's future prospects. We are pleased to acknowledge the major strides taken by the CPO to improve both its structure and the management of its projects and groups, but we will continue to closely monitor the Office's progress as it takes the next steps in providing the City with a leaner, more efficient Citywide capital infrastructure operation.

PICA Staff is pleased that the CPO appears to be meeting its stated Plan goals of completing projects "faster and [potentially] cheaper…." The CPO has been assessing project costs better and taking advantage of processing efficiencies. The CPO has also demonstrated both upgraded information reporting and improved general management of capital projects. These developments were highlighted during PICA Staff's annual review of the CPO.

Some of the current major accomplishments of the CPO include:

- Decreasing the project backlog at a rate equivalent to stated goals;
- Introducing project and administrative efficiencies;
- Adopting improved tracking and management systems; and
- Continuing efforts to implement a plan to disqualify non-performing contractors.

It is important to acknowledge the progress that the City has made over the last several years in its efforts to professionalize its overall execution of capital projects. However, it is also necessary to note that most of the recent success is tied to the decision to undertake a major organizational restructuring of capital program functions under the broad direction of a Capital Program Director. Thus, the improvements are largely the product of the will of the current administration. This success could be undermined if the next administration does not maintain a commitment to the current direction of the CPO.

However, in spite of major progress in improving on structural and procedural aspects of the CPO, PICA Staff continues to monitor with disappointment the City's failure to act upon several key projects that it repeatedly identifies as necessary for the sake of safety and/or to provide much needed economic benefits. Examples include:

- *The creation of a central fleet maintenance facility.* This would eliminate the need for high expenses resulting from multiple facilities. The City has failed to move beyond the proposal stage on this vital project; and
- *Replacement of the severely outmoded Youth Study Center (YSC).* In addition to providing a healthy and safe state of the art facility, completion of this project would also free up the valuable plot of land the YSC currently occupies on the Ben Franklin Parkway for private purposes, thus generating taxable economic activity; and

- *The now scaled back renovations to City Hall.* In addition to restoring a historic tourist destination, this project would improve safety for municipal workers and generate tax producing economic activity. Instead of executing the full scope of the ambitious original project proposal, the City adopted a scaled back piece-meal approach.

PICA Staff intends to strongly encourage the next mayoral administration to continue to build and improve upon the recent success of the CPO. Given that more than $458 million in PICA-funded capital programs are currently in various stages of development, any deviation from the current path of progress or a continuing failure to complete critical projects would be considered detrimental to PICA Staff's opinion regarding the viability of future capital budgets and the approval of future PICA-financed capital project funding.

PHILADELPHIA PRISON SYSTEM

PICA Staff continues to be concerned that the inmate population at the Philadelphia Prison System (PPS) often exceeds the population management goal of 5,600. Since the end of FY96, when the Curran-Fromhold Correctional Facility was opened, the prison population has almost always exceeded the management goal, which coincides with the previously court-mandated prison cap.

Stepped up enforcement efforts by the Police Department combined with recent criminal justice trends have placed a significant strain on PPS resources. Consistently exceeding the prison population management goal has become an expensive practice and could worsen, threatening the fiscal stability of the City in FY2000 and beyond.

At the same time, the City appears to be doing everything prudent to keep the inmate population below the system's management goal.

History of Overcrowding in the Prison System

In compliance with court consent decrees of 1986 and 1991, the City of Philadelphia implemented a comprehensive prison planning process and instituted a maximum allowable population (MAP) also known as the "prison cap." When the prison cap was exceeded, the City would not admit certain offenders into the PPS.

In FY96, after both opening the new prison and completing the required comprehensive prison planning under the guidance of Federal District Judge Norma Shapiro, the prison cap was lifted. The inmate population subsequently jumped 18% in nine months from 5,114 to 6,021, 421 more inmates than the previously court-enforced prison cap. Between March 1997 and March 1998 the City managed to lower and maintain the population at approximately 5,700 inmates. However, in the subsequent nine months of 1998, the PPS has seen its average monthly inmate census rise up to and exceed 6,000. The City projects that in FY2000 that trend will continue, seeing the population rise to 6,500, or 900 inmates over the MAP.

The rapid growth in prison population and its impact on the City is staggering when viewed in fiscal terms. In the six fiscal years between FY94 and FY2000, the Prison System's adjusted General Fund obligations will have grown more than twice as fast as total General Fund expenditures. As the Plan indicates, the continuing increase in Prison spending may necessitate reductions in spending elsewhere in the City's budget. The only fiscal alternative, albeit a dubious one, is to seek additional funding elsewhere, including the already depleted tax base.

Factors Contributing to the Increase in Prison Population

Inmate population has significantly increased since the arrival of the current Police Commissioner as a result of increased police enforcement such as Operation

Sunrise. Adjudicative trends such as longer sentences, more crimes being subject to imprisonment, movement of juveniles to adult facilities and increasingly serious juvenile crimes are also contributing to the growth in inmate population. Special needs associated with growing numbers of incarcerated women and juveniles are compounding the fiscal and operational strains on the PPS. It is also possible that crime rates may be increasing.

In 1994, the Federal Bureau of Investigations (FBI) rated Philadelphia the safest of the ten largest cities based upon what the City has acknowledged was tainted and fraudulent reporting practices. Following extensive and critical press coverage, the Police Commissioner is attempting to restore the credibility of the Police Department and the quality of its crime data. The City now ranks sixth in safety according to FBI statistics.

Philadelphia continues, for the seventh consecutive year, to be ranked among the safest of the ten largest cities in the nation. At a time when crime dropped 7% among the nation's largest cities, prior Philadelphia Police Department practices have not only damaged the credibility of the department, but have also made it impossible to determine if crime in Philadelphia has risen.

Aggressive Action to Curb Overcrowding

The City continues to attempt to address prison overcrowding in several ways.

1. The City is using pretrial release guidelines, which carefully evaluate individuals for risk of flight or threat to the community.
2. The City has implemented a special release mechanism for "recommended" inmates when the population exceeds certain levels. The Trial Commissioner and District Attorney's Office approve all candidates selected for special release.
3. The City has sought to house prisoners outside of Philadelphia. Housing inmates in other jurisdictions is extremely expensive. In February, the City executed a contract with Delaware County to house up to 200 inmates in its facilities costing up to $1.3 million in FY99.
4. In September 1998, the City announced plans to construct a new female facility that is expected to increase PPS capacity by over 500 beds.
5. Coincidentally, the opening of the new downtown federal prison in FY2000 will free up 35 PPS beds which are currently occupied or available for federal inmates.

Conclusion

The City is attempting to resolve the problem of prison overcrowding in diverse and innovative ways. However, the growth of the inmate population continues. Short-term solutions such as pretrial release guidelines and selective release mechanisms must obviously be used conservatively as they can be costly and do not reduce the demand for prison space.

An unresolved threat to a sound prison system budget is the increasing cost of housing prisoners outside of the PPS. Should the prison population grow appreciably, the cost could become prohibitively expensive and could represent a significant threat to the Plan. An integrated, long-term criminal justice solution could aid in avoiding future potential threats to Plan balance resulting from overcrowding in the Philadelphia Prison System.

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TOBACCO SETTLEMENT

On January 13, 1999, a Philadelphia Common Pleas Court judge approved Pennsylvania's involvement in the landmark $206 billion national tobacco settlement--pending an appeals process. As a result of its participation, the Commonwealth could potentially receive $11.3 billion over 25 years.

The Commonwealth has not yet determined how it would use the funds. This is a challenging prospect considering that there are many stakeholders statewide who are interested in being compensated for, among other things, anti-smoking advocacy, smoking-related health research and various other tobacco-related costs.

If Pennsylvania manages to mitigate the single remaining legal challenge to its participation, and the requisite number of other states and U.S. territories likewise clear the same hurdles, Pennsylvania and Philadelphia stand to be significant beneficiaries.

Unlike Allegheny County, which chose to litigate in order to clarify its legal standing and rights as a result of Pennsylvania's participation, the Rendell Administration chose to negotiate with the Commonwealth to protect Philadelphia's interests. The City has accordingly begun to attempt to tally the financial costs that it incurs as a result of smoking-related service demands. For example, the City calculated that $35 million of the City's costs of fighting fires last year--29% of the total--were attributable to fires associated with cigarettes or other smoking materials.

In one scenario, if the Commonwealth was to distribute its share of the tobacco settlement, approximately $450 million annually, to counties on a per capita basis, Philadelphia could realize a new revenue source of approximately $58 million annually over the twenty-five years covered by the settlement.

Another scenario would be for the Commonwealth to use the proceeds of the tobacco settlement to offset statewide costs associated with treating smoking-related illnesses and forego any direct fiscal subsidy to counties. In such a scenario, the best that Philadelphians could hope for would be the trickle-down benefits of state revenue relief either in the form of reduced state taxes or the economic benefits of increased state spending in Philadelphia.

While it is not yet clear if and how Philadelphia will share in the tobacco settlement proceeds, it is important for the City to continue to advocate its interests and rights to a "fair share" of the proceeds. The City cannot plan on receiving any revenue from the settlement until, at a minimum, the state formulates a plan for spending the proceeds and the settlement is honored. Any future Plan dependent upon revenues from a tobacco settlement which were not actually included in the Commonwealth budget would be viewed as unsuitable for recommendation for PICA Board approval.

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Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT
ON
FY2000-FY2004
FIVE-YEAR FINANCIAL PLAN

SECTION V:

NON-GENERAL FUND CONCERNS

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PHILADELPHIA GAS WORKS

The Philadelphia Gas Works (PGW) continues to confront numerous financial and managerial challenges. A second consecutive mild winter has stretched its financial resources thin and, over the past twelve months, the municipal utility has lost most of its senior management.

The most immediate threat to the City's General Fund is whether PGW will be able to continue to make its annual $18 million payment. The City has agreed to allow PGW to delay its FY99 payment until June, when it will be due with interest. The acting CEO of the utility, who is also the City's Finance Director, has verbally committed the utility to making its payment in full.

In the long-term, the utility still faces the prospect of deregulation and competition and has again been evaluating various options for improving operations. It remains to be seen if PGW can remain an economically viable entity in a competitive environment.

Financial Challenges and the $18 Million Payment to the City's General Fund

Due to mild weather, PGW has experienced two years of below average revenues and poor cash flow. Efforts to lower staffing levels and improve collections have helped it to stay solvent in the short term. Yet, even with these efforts, PGW has maintained a positive cash balance only through the use of short-term debt and the delay in making its $18 million payment to the City. Debt service costs from a new bond issue last year will further strain PGW's finances beginning this summer.

PGW, currently under the interim leadership of the City's Finance Director, has verbally committed to meeting the utility's financial obligation to the City General Fund. Yet, it remains uncertain whether it can do so and how keeping that commitment would affect the utility's financial stability and credit rating.

Competition in the Natural Gas Industry

The state legislature is still considering a number of proposals for deregulating the natural gas industry. Although PGW, with a legally limited service area, expects to avoid full-fledged competition, it is likely to be included in some way in the movement toward natural gas deregulation. For its part, the City has again been exploring what options it has for the utility, including privatization of certain operations.

PICA Staff has previously reported on the challenges PGW would face in a competitive environment, particularly as a result of its high debt load, City Council-mandated discount programs and significant number of delinquent accounts. Significant uncertainty remains about how the industry, and how PGW itself, will look in the future.

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Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT ON FY2000-FY2004 FIVE-YEAR FINANCIAL PLAN

SECTION VI:

APPENDICES

APPENDIX A

Statutory Background, Plan Review Methodology and Summary of Events

Overview

The General Assembly created PICA in June of 1991 by its approval of The Pennsylvania Intergovernmental Cooperation Authority Act for Cities of the First Class (Act of June 5, 1991, P.L. 9, No. 6). As in previous PICA Staff reports concerning the City's prior five-year financial plans, rather than re-state in the body of this Staff Report the principal provisions of the PICA Act and the Intergovernmental Cooperation Agreement, PICA Staff has included such information in this Appendix.

A brief summary of events to date including comments as to PICA's future focus, a summary of PICA Staff's Plan review methodology and a compilation of required future City reporting to PICA is also included herein.

Statutory Basis -- The PICA Act

The mission of the Authority, as stated in the PICA Act (Section 102), is as follows:

> Policy.--It is hereby declared to be a public policy of the Commonwealth to exercise its retained sovereign powers with regard to taxation, debt issuance and matters of Statewide concern in a manner calculated to foster the fiscal integrity of cities of the first class to assure that these cities provide for the health, safety and welfare of their citizens; pay principal and interest owed on their debt obligations when due; meet financial obligations to their employees, vendors and suppliers; and provide for proper financial planning procedures and budgeting practices. The inability of a city of the first class to provide essential services to its citizens as a result of a fiscal emergency is hereby determined to affect adversely the health, safety and welfare not only of the citizens of that municipality but also of other citizens in this Commonwealth.
>
> Legislative intent.--
>
> (1) It is the intent of the General Assembly to:
>
> (i) provide cities of the first class with the legal tools with which such cities can eliminate budget deficits that render them unable to perform essential municipal services;
>
> (ii) create an authority that will enable cities of the first class to access capital markets for deficit elimination and seasonal borrowings to

avoid default on existing obligations and chronic cash shortages that will disrupt the delivery of municipal services;

(iii) foster sound financial planning and budgetary practices that will address the underlying problems which result in such deficits for cities of the first class, which city shall be charged with the responsibility to exercise efficient and accountable fiscal practices, such as:

(A) increased managerial accountability;

(B) consolidation or elimination of inefficient city programs;

(C) recertification of tax-exempt properties;

(D) increased collection of existing tax revenues;

(E) privatization of appropriate city services;

(F) sale of city assets as appropriate;

(G) improvement of procurement practices including competitive bidding procedures;

(H) review of compensation and benefits of city employees; and

(iv) exercise its powers consistent with the rights of citizens to home rule and self government.

(2) The General Assembly further declares that this legislation is intended to remedy the fiscal emergency confronting cities of the first class through the implementation of sovereign powers of the Commonwealth with respect to taxation, indebtedness and matters of Statewide concern. To safeguard the rights of the citizens to the electoral process and home rule, the General Assembly intends to exercise its power in an appropriate manner with the elected officers of cities of the first class.

(3) The General Assembly further declares that this legislation is intended to authorize the imposition of a tax or taxes to provide a source of funding for an intergovernmental cooperation authority to enable it to assist cities of the first class and to incur debt of such authority for such purposes; however, the General Assembly intends that such debt shall not be a debt or liability of the Commonwealth or a city of the first class nor shall debt of the authority payable from and secured by such source of funding create a charge directly or indirectly against revenues of the

Commonwealth or city of the first class.

The PICA Act establishes requirements for the content of a five year financial plan, and Sections 209 (b)-(d) of the statute and the Cooperation Agreement provide:

(b) Elements of plan. -- The financial plan shall include:

(1) Projected revenues and expenditures of the principal operating fund or funds of the city for five fiscal years consisting of the current fiscal year and the next four fiscal years.

(2) Plan components that will:

(i) eliminate any projected deficit for the current fiscal year and for subsequent years;

(ii) restore to special fund accounts money from those accounts used for purposes other than those specifically authorized;

(iii) balance the current fiscal year budget and subsequent budgets in the financial plan through sound budgetary practices, including, but not limited to, reductions in expenditures, improvements in productivity, increases in revenues, or a combination of these steps;

(iv) provide procedures to avoid a fiscal emergency condition in the future; and

(v) enhance the ability of the city to regain access to the short-term and long-term credit markets.

(c) Standards for formulation of plan:

(1) All projections of revenues and expenditures in a financial plan shall be based on reasonable and appropriate assumptions and methods of estimation, all such assumptions and methods to be consistently applied.

(2) All revenue and appropriation estimates shall be on a modified accrual basis in accordance with generally accepted standards. Revenue estimates shall recognize revenues in the accounting period in which they become both measurable and available. Estimates of city-generated revenues shall be based on current or proposed tax rates, historical collection patterns, and generally recognized econometric models. Estimates of revenues to be received from the state government shall be based on historical patterns, currently available levels, or on levels

proposed in a budget by the governor. Estimates of revenues to be received from the federal government shall be based on historical patterns, currently available levels, or on levels proposed in a budget by the president or in a congressional budget resolution. Non-tax revenues shall be based on current or proposed rates, charges or fees, historical patterns and generally recognized econometric models. Appropriation estimates shall include, at a minimum, all obligations incurred during the fiscal years and estimated to be payable during the fiscal year or in the 24-month period following the close of the current fiscal year, and all obligations of prior fiscal years not covered by encumbered funds from prior fiscal years. Any deviations from these standards of estimating revenues and appropriations proposed to be used by a city shall be specifically disclosed and shall be approved by a qualified majority of the board.

(3) All cash flow projections shall be based upon reasonable and appropriate assumptions as to sources and uses of cash, including, but not limited to, reasonable and appropriate assumptions as to the timing of receipt and expenditure thereof and shall provide for operations of the assisted city to be conducted within the resources so projected. All estimates shall take due account of the past and anticipated collection, expenditure and service demand experience of the assisted city and of current and projected economic conditions.

(d) Form of plan. -- Each financial plan shall, consistent with the requirements of an assisted city's home rule charter or optional plan of government:

(1) be in such form and shall contain:

(i) for each of the first two fiscal years covered by the financial plan such information as shall reflect an assisted city's total expenditures by fund and by lump sum amount for each board, commission, department or office of an assisted city; and

(ii) for the remaining three fiscal years of the financial plan such information as shall reflect an assisted city's total expenditures by fund and by lump sum amount for major object classification;

(2) include projections of all revenues and expenditures for five fiscal years, including, but not limited to, projected capital expenditures and short-term and long-term debt incurrence and cash flow forecasts by fund for the first year of the financial plan;

(3) include a schedule of projected capital commitments of the assisted city and proposed sources of funding for such commitments; and

(4) be accompanied by a statement describing, in reasonable detail, the significant assumptions and methods of estimation used in arriving at the projections contained in such plan.

The Cooperation Agreement (at Section 4.04(a)-(h)), and similar provisions of the PICA Act, also require the following as supporting data for the Plan:

(a) a schedule of debt service payments due or projected to become due in respect of all indebtedness of the City and all indebtedness of others supported in any manner by the City (by guaranty, lease, service agreement, or otherwise) during each fiscal year of the City until the final scheduled maturity of such indebtedness, such schedule to set forth such debt service payments separately according to the general categories of direct general obligation debt, direct revenue debt, lease obligations, service agreement obligations and guaranty obligations.

(b) a schedule of payments for legally mandated services included in the Financial Plan and due or projected to be due during the fiscal years of the City covered by the Financial Plan;

(c) a statement describing, in reasonable detail, the significant assumptions and methods of estimation used in arriving at the projections contained in the Financial Plan;

(d) the Mayor's proposed operating budget and capital budget for each of the Covered Funds for the next (or in the case of the initial Financial Plan, the current) fiscal year of the City, which budgets shall be consistent with the first year of the Financial Plan and which budgets shall be prepared in accordance with the Home Rule Charter;

(e) a statement by the Mayor that the budgets described in section 4.04(d) hereof:

(i) are consistent with the Financial Plan;

(ii) contain funding adequate for debt service payments, legally mandated services and lease payments securing bonds of other government agencies or of any other entities; and

(iii) are based on reasonable and appropriate assumptions and methods of estimation.

(f) a cash flow forecast for the City's consolidated cash account for the first fiscal year of the City covered by the Financial Plan;

(g) an opinion or certification of the City Controller, prepared in accordance with generally accepted auditing standards, with respect to the reasonableness of the assumptions and estimates in the Financial Plan; and

(h) a schedule setting forth the number of authorized employee positions (filled and unfilled) for the first year covered by such Financial Plan for each board, commission, department or office of the City, and an estimate of this information for the later years covered by the Financial Plan. The schedule required under this paragraph (h) shall be accompanied by a report setting forth the City's estimates of wage and benefit levels for various groups of employees, such information to be presented in a manner which will allow the Authority to understand and effectively review the portions of the Financial Plan which reflect the results of the City's labor agreements with its employees, and an analysis of the financial effect on the City and its employees of changes in compensation and benefits, in collective bargaining agreements, and in other terms and conditions of employment, which changes may be appropriate in light of the City's current and forecast financial condition. The parties agree to cooperate such that the form of the report required under this paragraph (h), and the subjects covered, are reasonably satisfactory to the Authority.

City Reporting and Variances

The PICA Act (Section 209) and the Cooperation Agreement (Section 409(b)) require submission of quarterly reports by the City on its compliance with the Plan within 45 days of the end of a fiscal quarter. If a quarterly report indicates that the City is unable to project a balanced Plan and budget for its current fiscal year, the Authority may by the vote of four of its five appointed members declare the occurrence of a "variance", which is defined in Section 4.10 of the Cooperation Agreement as follows:

> (i) a net adverse change in the fund balance of a Covered Fund of more than one percent (1%) of the revenues budgeted for such Covered Fund for that fiscal year is reasonably projected to occur, such projection to be calculated from the beginning of the fiscal year for the entire fiscal year, or (ii) the actual net cash flows of the City for a Covered Fund are reasonably projected to be less than ninety-five percent (95%) of the net cash flows of the City for such Covered Fund for that fiscal year originally forecast at

the time of adoption of the budget, such projection to be calculated from the beginning of the fiscal year for the entire fiscal year.

As defined in Section 1.01 of the Cooperation Agreement, the City's "Covered Funds" are the General Fund, General Capital Fund, Grants Revenue Fund and any other principal operating funds of the City which become part of the City's Consolidated Cash Account.

The statute mandates the submission of monthly reports to PICA by the City after determination by the Authority of the occurrence of a variance.

As provided in Section 210(e) of the PICA Act, there are legal consequences flowing from a determination by the Authority that a variance exists, and in addition to the City's additional reporting responsibilities, it also is required to develop revisions to the Plan necessary to cure the variance. The remedies which PICA has available to it to deal with a continuing uncorrected variance are to direct the withholding of both specific Commonwealth funds due the City, and that portion of the 1.5% tax levied on the wages and income of residents of the City in excess of the amounts necessary to pay debt correction of the variance.

Plan Review Methodology

<u>Staff Report</u> - The Plan, as approved by City Council on March 18, 1999, was submitted to PICA by the Mayor on May 24, 1999 and the PICA Act provides a 30 day period for review which expires June 23, 1999. Authority Staff has consulted with the City, both on the departmental level and otherwise, since the Plan was initially submitted to City Council by the Mayor on January 26, 1999 and has referred to material presented to City Council and the Controller's Office, as well as information included in reports submitted by the City to PICA and other data developed by PICA Staff. This report includes reference to materials received by the Authority through May 14, 1999.

Under Section 5.07 of the Cooperation Agreement, PICA agreed not to disclose information provided to it in confidence by the City with respect to negotiation of collective bargaining agreements and ongoing arbitration proceedings, and the Authority has consistently followed that requirement.

<u>Relationship to Future Plan Revisions</u> - The City is obligated under the both the Cooperation Agreement and the PICA Act to submit a revised Plan in the event it enters into a collective bargaining agreement, or receives a labor arbitration award, at variance with that which was assumed in the Plan. The Cooperation Agreement anticipates that the Plan must be revised to deal with such matters within 45 days after declaration of a "variance" by PICA.

Apart from labor-related revisions, or those required by declaration by PICA of a variance in the Plan in the future, the Plan is subject to mandatory revision on March 23, 2000 (100 days prior to the end of FY2000). At that time, the City is required to add its Fiscal Year 2005 to the Plan and make any other alterations necessary to reflect changed circumstances. Under the PICA Act, the City may determine to revise the Plan at any time and submit the revision to the Authority for its review.

Accounting Concerns - The PICA Act requires that a modified accrual accounting system be used in the preparation and administration of the Plan, in accordance with generally accepted accounting standards. Specifically, the Cooperation Agreement (at Sections 4.02(a) and (b)) provides:

Estimates of revenues shall recognize revenues in the accounting period in which they become both measurable and available...

Appropriation estimates shall include, at a minimum, all obligations incurred during the fiscal year and estimated to be payable during the fiscal year or in the twenty-four (24) month period following the close of the current fiscal year...

The Plan as submitted does not on its face meet the requirements of the PICA Act and Cooperation Agreement inasmuch as it excludes funding specifically earmarked for the FJDP. However, PICA Staff, after both determining that funding is available (budget reallocation required) and that the litigation commenced by the FJDP should resolve the funding issue, has deemed it appropriate to recommend approval.

Summary of Events to Date/Future Focus

PICA's creation was an action taken by the Commonwealth of Pennsylvania in direct reaction to Philadelphia's financial crisis. Accordingly, PICA's primary focus during its initial years of existence has been to assist the City to avoid insolvency; to provide the funds directly required for that purpose and for essential capital programs; and to oversee the City's efforts to lay a sound foundation for its return to fiscal stability. The negotiation of the Cooperation Agreement to set out the basic terms of the City-PICA relationship, the PICA sponsored effort resulting in the establishing of the format and content of the Five-Year Financial Plan process, and the issuance of bonds to provide funds to assist the City to stabilize its finances were all major accomplishments. Successful defense against challenges to the constitutionality of the PICA Act was another vital PICA process component. PICA's annual assessment of Plan progress, successful challenges to overgenerous prior Plan revenue estimates and suspect methodologies, evaluations of City reporting, and analysis of City practices and programs have assisted in the ongoing City improvement as envisioned by the PICA Act.

PICA also provides continuing oversight as to the encumbrance by the City of PICA provided capital funds for capital projects deemed required to rectify emergency conditions or necessary for Plan operational success.

PICA has provided in excess of $1,116 million in funding to assist the City, allocated to the following purposes:

Purpose	Amount (thousands)
Deficit Elimination/Indemnities Funding	$ 256,200
Productivity Bank	20,000
Capital Projects	458,532
Retirement of Certain High Interest City Debt	381,300
TOTAL	**$1,116,032**

PICA's authority to issue new money debt has expired. PICA anticipates that its future activities with respect to the City will focus more closely on oversight on the City's efforts to maintain financial balance, further institutionalize management reforms (both those initiated to date and those still to be made) and to implement ongoing operations changes in accordance with the City Strategic Plan.

The City had taken full advantage of the tools PICA made available to it. It is anticipated that the PICA/City relationship will continue to be a catalyst for further City operational improvements.

Whether PICA will also become involved in the financial oversight of the School District of the City Philadelphia is a matter that presently is in the hands of the Appellate Courts of the Commonwealth.

Future City Reporting to PICA

Absent the occurrence of a variance, receipt of an arbitration award which is at variance with the Plan or a determination by the City that further revisions to the Plan are necessary, the City will not submit a revised Plan to the Authority until March 2000. During future months, the Authority will receive quarterly reports on the City's performance under the Plan, together with other data.

The reporting system established in the Cooperation Agreement and the PICA Act anticipates a regular flow of data to PICA, and the reporting system which has been established by agreement between the City and PICA under the provisions of the PICA

Act is divided into several groups, which are described below:

Quarterly Plan Reports. The Authority receives reports from the City on a quarterly basis (45 days after the end of each fiscal quarter) concerning the status of compliance with the Plan and associated achievement of initiatives. The remaining quarterly reporting deadline for FY99 is August 16, 1999. Quarterly reporting deadlines for FY2000 are November 15, 1999, February 15, 2000, May 15, 2000 and August 15, 2000. The Cooperation Agreement also requires that the City provide reports to PICA concerning Supplemental Funds (*i.e.*, the Water and Aviation Funds) on a quarterly basis.

Grants Revenue Fund Contingency Account Report. The Cooperation Agreement provides that a report on the Grants Revenue Fund Contingency Account be prepared and submitted, by department, not later than 20 days after the close of each fiscal quarter, and still to be received relating to FY99 is the report due July 20, 1999. For FY2000, the reporting dates are October 20, 2000, January 20, 2000, April 20, 2000 and July 20, 2000. This report details the receipt and use of federal and Commonwealth funds by the City, as well as the eligibility for fund withholding by the Commonwealth at PICA's direction in the event the City cannot balance the Plan after an extended period of intensive reporting and PICA review of proposed corrective efforts.

Prospective Debt Service Requirements Reports. The Cooperation Agreement requires submission of a report detailing prospective debt service payments by the City, as well as lease payments, 60 days prior to the beginning of a fiscal quarter. The dates for submission of such reports for FY2000 are August 2, 1999, November 2, 1999, February 2, 2000 and May 3, 2000.

APPENDIX B

Schedule of Findings, Office of the City Controller

In accordance with Section 4.04(g) of the Intergovernmental Cooperation Agreement between PICA and the City, the City Controller's Office submitted to PICA its report upon the Plan forecasted General Fund financial statements for the fiscal years ending June 30, 2000 and June 30, 2001, including its opinion that the underlying assumptions provide a reasonable basis for City management's forecast and also, at the request of the PICA Board, a report upon the results of agreed upon procedures with respect to the Plan. PICA Staff is grateful for the assistance provided by the Controller's Staff in evaluating this Plan.

The Schedule of Findings of the Controller's Office resulting from its work with respect to the Plan, formally reported to PICA June 4, 1999 (in conjunction with receipt of the Controller's report upon the performance of agreed upon procedures) is reproduced in this Appendix. Certain of such findings have been previously discussed in this report from a PICA Staff perspective. PICA Staff believes the reader will gain added value from a review of the Office of the Controller perspective on such matters.

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ECONOMIC AND GENERAL FUND REVENUE FORECASTS

The Controller's economic and General Fund revenue forecasts are roughly consistent with the Plan's revenue growth estimates. The key underlying assumptions for both projections include (1) continuation of Wage and Business Tax reductions proposed throughout the life of the Plan, and (2) continued strength in the national economy.

Wage and Earnings Tax

City payroll employment will continue to be shaped by forces such as the City's proposed tax cuts, economic development programs, local industry restructuring, and welfare reform. We expect no significant net impact from these forces and a mostly flat pattern in City payroll employment to continue through the next three years. Consistent with the Plan, we expect growth in the average wage paid across City establishments to keep Wage Tax base growth above an inflationary pace over the next three years.

Current Real Estate Tax

The Controller's Office assumes that the Commercial and Industrial real estate markets will continue to be shaped by two patterns. First, industry restructuring and technological improvements in the labor and capital markets will continue to reduce the need (demand) for space. Second, favorable prices generated by the slack demand will induce some modest improvement in the real estate market. The improvement will continue to be concentrated in the hotel sector, condos and rentals. In an effort to be conservative, we assume that the two forces will completely offset one another, yielding flat market values throughout the life of the Plan.

Finding:

- The Plan assumes that there will be modest assessment growth from FY 2000 to FY 2004. Thus, the implicit assumption is that speculative activity will outweigh the disinflationary pressures from technology and industry restructuring. The Plan also assumes that the assessment growth will be met by an extremely low level of appeal losses throughout the life of the Plan. While the Controller's Office agrees with the possibility of modest improvement in real estate market activity, it is likely that the Plan underestimates appeal losses.

Business Privilege Tax

In the past few years, many local establishments in such industries as retailing and wholesaling operated at a competitive disadvantage since their suburban counterparts were able to make transactions inside the City limits without paying the Business Privilege Tax. Starting FY 1999, liability for the BPT was extended to any firm with ongoing activity in the City of Philadelphia in an effort to make the business environment more competitive in the City.

Finding:

- ♦ The Plan assumes that this initiative will garner $6.9 million in FY 2000, then grow steadily to $9.0 million by FY 2002. While the Controller's Office agrees with this initiative from a policy standpoint, to what degree it can be enforced remains an issue. As a testament to this uncertainty, Plan estimates regarding the level and growth drawn from this initiative appear simply arbitrary.

Revenue from Other Governments

Department of Human Services

Title IV-A entitlement spending was rolled into a fixed allocation to the states under the Temporary Aid to Needy Families (TANF) Block Grant last year. The Plan assumes that reduced funding to DHS as a result of the Welfare changes will be met by additional moneys under Title IV-E and the Commonwealth under its Act 148 obligation.

To date, there is a considerable amount of Title IV-E money available due to the strong national economy and its impact on services provided by the Department. As such, most of the Title IV-A shortfall has been compensated for through additional billing under Title IV-E. However, in the event that the IV-E money becomes scarce, there is a high degree of uncertainty regarding the response by the Ridge Administration.

PURTA

The Public Utility Realty Transfer Act (PURTA) enacted in 1968 by an amendment to the State Constitution, exempted public utilities from locally administered property tax and authorized the collection of a similar statewide tax known as Public Utility Realty Tax. The proceeds of the tax are distributed to each local taxing authority that files a report based on the ratio between the total tax receipts of a local taxing authority and the total tax receipts of all reporting tax authorities. This ratio is then applied to the total amount of taxes that reporting authorities could have collected had they been able to directly tax public utility realty. The City receives the amount as Utility Tax Refund under Revenue from Other Governments.

In the past few years, the City has not raised its property tax rate at a rate commensurate with many other local tax authorities within the State. Therefore, the City’s share of the statewide PURTA distribution has compressed slightly. We expect the trend will continue in the Plan’s out years.

We also anticipate that the deregulation of the electricity generation market will mark the ebb of the City's Utility Tax Refund in the Plan's out years. Prior to 1999, the electric utility industry had been regulated as a natural monopoly. This year, the Commonwealth enacted electric deregulation in the electricity generation market to introduce greater competition, which benefits all classes of customers and protects the Commonwealth's ability to compete in the national and international marketplace for industry and jobs. As a part of the electric deregulation, the electric generating plants will become untaxable starting January 1, 2000, and the PURTA tax base will be changed from the depreciated book value of utility realty to market value, which could lead to a lower tax base in both cases.

The statewide budget amount for distribution in FY 2000 is estimated to be $136.7 million, down 16.5 percent from the FY 1999 level of $163.9 million mainly due to the accelerated depreciation of electric generation facilities. Based on projections of statewide PURTA distributions developed by the State Department of Revenue, the impact of the elimination of the electric generating plants from the PURTA tax base will result in statewide PURTA distributions of merely $91.8 million and $62.2 million in FY 2001 and FY 2002, respectively. A two percent increase in the statewide budget amount for distribution is expected in FY 2003 and FY 2004 yielding $63.5 million and $64.8 million for distribution.

Accordingly, the Controller's Office estimates a $4.1 million cutback in the City's PURTA allocation in FY 2000, resulting in a $20.5 million allocation to the City versus the Plan’s estimates of $25 million. We estimate that, as a result of the deregulation alone, the City's PURTA allocation will be reduced proportionally to the State's collection, yielding approximately $13.7 million, $9.3 million, $9.5 million and $9.7 million to the City in FY 2001 to FY 2004, respectively. Thus, the total variance is estimated to be $62.8 million versus the Plan’s estimates for FY 2001 through FY 2004.

Senate Bill 601 regarding the deregulation of the gas utility industry is pending in Harrisburg and its impact on Utility Tax Refund amounts due localities is unknown at this time.

First Judicial District of Pennsylvania
The Plan assumes that the Commonwealth will assume the financial responsibility of funding the First Judicial District throughout the entire Plan forecast horizon.

Findings*:*

- The fact that there is no direct appropriation for the Courts in the City budget is inconsistent with the State Budget. It is also inconsistent with the recent transfer ordinance introduced to fund the Courts through the end of Fiscal Year 1999. As a result, the Other Government and Locally Generated Non-Tax revenues to the First Judicial District reported in the Plan are incorrect. Since monies set aside for economic stimulus and additional tax reduction in the City’s budget are likely to be used to fund the Courts, we expect little net impact on the City’s fund balance in this instance.
- The General Assembly appropriated the necessary funds for transferring a few top-paid court staffers to the State payroll. The Commonwealth’s action will save the City approximately $1.4 million in FY 2000.

GENERAL FUND OBLIGATIONS FORECAST

Base Methodology

The City's General Fund Obligation growth assumptions as presented in Appendix V – Base Methodology for the Five-Year Plan – are deficient and misleading. The projected General Fund Obligations as presented in Appendix III of the Plan increase and decrease at rates different from the obligation growth rates shown in Appendix V.

Finding:

- The projected growth rates for Classes 300 and 400 (Materials, Supplies and Equipment), Class 500 (Contributions and Indemnities), Class 800 (Payments to Other Funds) and Class 900 (Advances and Miscellaneous) are misleading. The base methodology shows Class 300 and 400 obligations to grow by 1.5 percent annually over the life of the Plan. Appendix III however shows these obligations to increase by a smaller amount of approximately 0.8 percent on average over the life of the Plan. The base methodology shows Class 500 obligations increasing by 1.5 percent annually over the life of the Plan. Appendix III shows these obligations to be decreasing at an average rate of over 5 percent annually. In addition, while the base methodology in Appendix V shows Class 800 obligations to grow by 1.5 percent annually over the life of the Plan, Appendix III shows Class 800 obligations decreasing by an average of 1.2 percent over the life of the Plan and Class 900 obligations decreasing by approximately 1.0 percent over the same period.

Payroll

The Plan makes no provision for salary increases for uniformed and non-uniformed employee beyond fiscal year 2000. All unions will receive negotiated salary increases in FY 2000, with uniformed employees receiving raises in September 1999 and non-uniformed employees in March 2000. Even if the unionized employees do not receive a base salary increase in the first year of the new contracts – FY 2001 – it is unlikely that they will not receive salary increases over the life of the Plan.

First Judicial District of Pennsylvania

The Plan does not provide any direct appropriations for the First Judicial District of Pennsylvania (FJDP). As a result, the Governing Board of the First Judicial District has filed a mandamus action against the City. However, the Plan, as it did last year, does include funding in other departmental categories that could be used to fund the FJDP. The Administration and Council have substantial latitude to reallocate funds that have been included in other departmental categories, that may or may not be used to fund the costs related to the FJDP. Should the Administration choose to reallocate these funds prior to the resolution of the Court's mandamus action, the possibility exists that no funding would be available for the FJDP.

Recent information from the Commonwealth shows that the FY 2000 General Appropriation Act failed to include any funding for the First Judicial District other than the $1.4 million appropriation required under the plan developed by retired Supreme Court Justice Frank J. Montemuro.

Debt Service

Findings:

- A comparison of the current General Fund General Obligation Bond maturity registers to the related debt schedules indicates the General Fund Debt Service Obligations to be over-estimated throughout the life of the Plan.

- The Plan estimates short-term borrowings will be $300 million with an interest rate of between 5.5% and 7% over the life of the Plan. The City's last three Total Revenue Anticipation Notes were issued at a premium and had an interest rate of approximately 4.5%, thus, we believe the Plan's estimated short-term interest amounts to be overly aggressive.

- The Plan also includes commitment fee and arbitrage payments related to long-term debt of $1.75 million and $850,000 respectively in each of the next five years. The City has not needed any type of credit enhancement for the last three (3) short-term notes sales, nor are they expected to seek external enhancement for this year's short-term borrowing. Based on this, we believe that the City will not need, or use, any credit enhancement for its short-term borrowings in the future. It is not likely that the City will be subject to any arbitrage payments over the life of the Plan.

Capital Plan

Our agreed-upon procedures applied to the FY 2000 Capital Budget included in the Appendix VI of the City's Five-Year Plan included agreeing the amounts to the City Planning Commission's six-year funding schedule for FY 2000-2005, and verifying the mathematical accuracy of both. In addition, we determined that all projects in the FY 2000 Capital Budget were capital in nature.

We also recomputed the current and future legal debt capacity and compared potential debt service costs associated with the Capital Plan and projected debt service costs shown in the General Fund section of the Plan. Again, as stated in the Debt Service section of this schedule, we believe debt service obligations are over-budgeted throughout the life of the Plan.

OTHER FUNDS

Aviation Fund

Based upon our procedures applied to the Aviation Fund, we continue to see little risk to the City for those cost centers that the City shares risk with the airlines if there is a deficit, namely the Outside Terminal Area (OTA) and the International Gates.

The Division of Aviation continues to achieve surpluses from the OTA. These surpluses are carried in the Aviation Fund Unrestricted Cash Account. For FY 2000 the amount is projected to be $33.6 million. Division of Aviation representatives have stated that these holdings, plus any interest earned, will be used to insulate the General Fund from contributing to the Aviation Fund over the life of the Plan.

Water Fund

Water Department management continues to assure PICA officials that there is little risk that the General Fund will not receive the "annual scoop" transfer of approximately $4.1 million. The Water Department continues to cut costs at both their wastewater treatment and biosolids recycling center. As a result of these continuing cost savings and increased delinquent collections through enforcement of the Utility Services Tenant's Right Act, Water Department management sees no risk in the scoop being eliminated over the life of the Plan.

Philadelphia Gas Works

The General Assembly is currently considering House Bill 937, which would deregulate the purchase of natural gas for Pennsylvania small businesses and residents. This bill could have a significant impact on the Philadelphia Gas Works (PGW), and hence, on PGW's annual $18 million payment to the City.

Cash Flows

The cash flows presented in appendix IV of the Plan for FY 2000 are consistent with the estimates for the General Fund revenues and obligation as presented in Appendix III of the Plan, and forecast for the monthly distribution of revenues and obligations appear reasonable.