Pennsylvania Intergovernmental Cooperation Authority

Staff Report
on the
City of Philadelphia's
Five-Year Financial Plan
for
Fiscal Year 2002 - Fiscal Year 2006

May 15, 2001

PENNSYLVANIA INTERGOVERNMENTAL COOPERATION AUTHORITY

1429 Walnut Street, 14th floor, Philadelphia, PA 19102
Telephone: (215) 561-9160 – Fax: (215) 563-2570
Email: pica@picapa.org

Board of Directors

Chairperson
Lauri A. Kavulich, Esquire

Vice Chairperson
William J. Leonard, Esquire

Secretary/Treasurer
Gregg R. Melinson, Esquire

Member
Stephanie A. Middleton, Esquire

Member
Michael A. Karp

Ex-Officio Members

Representative of the
Commonwealth of Pennsylvania
Robert A. Bittenbender
Secretary of the Budget

Representative of the
City of Philadelphia
Janice D. Davis
Director of Finance

Staff

Joseph C. Vignola .... Executive Director

Peter Geleta .... Deputy Executive Director

Uri Z. Monson .... Director of Budgetary Analysis

John J. Daly .... Director of Capital Analysis

Harvey M. Rice, Esquire .... Assistant to the Executive Director

Lisa W. Gallagher .... Administrative Assistant

Deidre A. Morgenstern .... Special Assistant

Kim Richardson .... Secretary/Receptionist

Professional Advisors

Authority Counsel
Reed Smith LLP

Independent Auditors
Deloitte & Touche LLP

TABLE OF CONTENTS

This page intentionally left blank

Pennsylvania Intergovernmental Cooperation Authority

**STAFF REPORT
ON
FY2002-FY2006
FIVE-YEAR FINANCIAL PLAN**

SECTION I:

INTRODUCTION

EXECUTIVE SUMMARY AND STAFF RECOMMENDATION

The City of Philadelphia (City) submitted its *Five-Year Financial Plan, Fiscal Year 2002-Fiscal Year 2006* (the Plan) to the Pennsylvania Intergovernmental Cooperation Authority (PICA) on May 1, 2001. This Plan represents a change in structure from previous Five-Year Plans, with an increased focus on overall strategic goals for the City as well as better, though still limited, use of performance measures throughout. PICA Staff applauds the changes and hopes that the City will continue to incorporate performance measures as part of its planning process.

Expenditures and revenues are projected utilizing realistic assumptions. The Plan presents a reasonable prospect for balanced budgets over the life of the Plan, and anticipates ending FY2006 with a surplus of just over $21 million.

As in the past, there are a number of risks, both quantifiable and qualitative, which threaten the fiscal health of the City over the life of the Plan. While some of these threats emerge from new Administration proposals, many are ongoing issues previously documented by PICA Staff. These risks are dependent on a variety of circumstances, some of which are beyond the City's control. While the Plan often acknowledges these risks, few precautionary strategies are offered.

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

- Inclusion of unidentified "Future Target Reductions" in each of the final four years of the Plan ($60 million risk).
- Loss of PGW's annual $18 million payment to the City as well as possible failure to repay a loan to the City ($135 million risk).
- Additional City support for the School District of Philadelphia, which faces a possible $1.6 billion deficit by the end of FY2006.
- No explicit funding in the Plan for any costs associated with new labor contracts for uniformed employees after FY2002 and non-uniformed employees after FY2004.
- An increase in the percentage of General Fund revenues that are subject to long-term commitments and the City's fast approach to its allowable debt limit, which jeopardizes the infrastructure maintenance goals of the overall capital program.
- Continued phase-in of welfare reform, including the looming Federal deadline for cessation of welfare benefits, with unpredictable effects on the City's economy and demands on its General Fund.

Additionally, the Plan's success will depend greatly on a national economy that avoids a significant slowdown. PICA Staff believes that the City's economic projections are reasonable in the current economic climate, but the City continues to show little preparedness for a general economic decline.

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 FY2002-FY2006 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, as well as continuing to produce White Papers to provoke discussion on areas of concern to the fiscal health of the City.

City's Revenue Assumptions

Other than the specific risks to the revenue side (PGW) discussed in detail below, PICA Staff found the assumptions underlying the City's revenue projections to be reasonable. In addition to the PICA Staff review, PICA convened a group of regional economists to comment on the revenue assumptions. The group's consensus was that the estimates used in the Plan were reasonable in light of the current economic outlook.

Quantifiable Risks

As mentioned earlier, the Plan confronts six significant risks to its successful implementation. The first two of those risks are quantifiable and are included in the Chart of Quantifiable Risks at the end of this executive summary.

The FY2002-FY2006 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 and future target reductions. This is the fifth 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 unforeseen expenditures within a budget year, PICA Staff has reservations about the ability of the target budget process to generate significant savings over time.

The Philadelphia Gas Works (PGW) continues to pose a significant threat to the fiscal health of the City's General Fund. PGW's financial situation appears to be much worse than its management group and the City Administration is willing to publicly admit. PGW's ability to continue making its annual $18 million payment to the City's General Fund as well as repay the $45 million loan it received from that Fund should be considered uncertain. Also, PGW's large outstanding debt situation is a very significant negative factor to the City's overall financial well being. Whether the City is willing to sell PGW is unclear. PICA Staff's concerns as to the potential negative impact of PGW's financial problems on the City's Five-Year Financial Plan and overall financial health are expected to result in the issuance of a follow-up report later in this calendar year.

Other Significant Risks

Fiscal difficulties at the School District of Philadelphia pose a considerable threat to the fiscal health of the City's General Fund. Preliminary budget estimates by the School District project a cumulative deficit of $785.9 million by the end of FY2004, the third year of the City's Five-Year Financial Plan. PICA Staff projects the cumulative deficit could reach $1.6 billion by FY2006, the end of the Plan period. PICA Staff's concerns as to the potential negative impact of the School District's financial problems on the City's Five-Year Financial Plan and overall financial health are expected to result in the issuance of a follow-up report later in this calendar year.

The largest unknown variable in the Plan is personnel costs. The collective bargaining agreements between the City and its police and fire employees expire at the end of FY2002; the other municipal employee contracts expire at the end of FY2004. As is standard procedure, the Plan assumes no increases in wages or benefit costs after these expiration dates. Personnel costs account for 56 percent of the FY2001 budget; thus even a minimal increase in wages and benefit costs will have a significant impact on the City's expenditures throughout the life of the Plan.

Over the first few years of the Plan, the City will increase the percentage of General Fund revenue dollars that are subject to long-term commitments. The risk inherent in these long-term commitments is compounded by the City's fast approach to its legal debt limit, which jeopardizes the infrastructure maintenance goals of the overall Capital Program. These risks are further heightened by the anticipated start of the Neighborhood Transformation Initiative that is certain to add to the City's long-term debt.

State and Federal welfare reform continues to phase in, although few sanctions have as yet been imposed. 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. As the Federal deadline for benefits is reached in March 2002, these effects are likely to grow. PICA Staff is pleased to note that the City has improved its level of preparedness for the coming deadline.

Other General Fund Concerns

According to data released by the Bureau of Labor Statistics (BLS), the number of jobs in Philadelphia has increased from year to year since 1997, although increases have slowed in recent quarters. Unlike past national economic slowdowns, the City has not been at the forefront of a national recession. The potential impact of welfare reform has yet to bear a fiscal burden on the City, and the City seems better prepared for this matter than in past years. The hospitality and service sectors have grown stronger in Philadelphia, though slowing recently. Mergers and insecurity in the financial and healthcare sectors continue to foreshadow a decline in some of the industries that are Philadelphia's largest non-governmental employers.

The Neighborhood Transformation Initiative was designed by the Administration to end suburban flight and stabilize the City's neighborhoods. While applauding the City for undertaking a much needed project, PICA Staff has concerns regarding the lack of specificity surrounding a project which is expected to add at least $250 million to the City's debt obligations. There is also little detail regarding the likelihood and sources of private investment, and very little information on accountability and performance standards for this effort.

A key element of the City's economic policy lacks any meaningful method for measuring its effectiveness. The City is unable to show that the Economic Stimulus Program (ESP) has resulted in a more effective outcome than putting the money towards other initiatives, such as tax reduction, since there are no reliable performance measures in place for the ESP. The City does not provide performance standards or expectations for the input of dollars prior to the allocation or money, and the City does not evaluate the results after the money has been used.

The City remains somewhat at the mercy of the health of the national economy. The recent national economic slowdown only enhances the argument for greater preparedness for the unforeseen. Although these are factors mainly beyond the City's control, the City has made little effort to prepare for such an eventuality. The City needs to move ahead with the creation of a "Rainy Day" fund that can be utilized in a fiscal emergency.

The Department of Human Services has successfully and significantly increased its State and Federal funding over the past nine years. This increased "outside" 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 other governments to protect the funding it currently receives from them and to identify new funding streams.

In past PICA Staff reports, as well as in numerous press reports and independent studies, much has been made of the dramatic growth in the size of the City's budget over the past decade, despite the equally dramatic loss in population. The most common explanation offered by the City has been the growing services required by the remaining population, as well as increasing demands on the criminal justice system. A brief review of the budget growth in a number of key cost centers reveals that while some growth may be attributable to those factors, other increases are exponentially higher than inflation with no apparent justification.

Staff Recommendation

The identified potential risks to the General Fund in the FY2002-FY2006 Plan constitute a real threat to the fiscal health of the City. However, the Plan is also predicated on a continuation of the previous Administration's program of small and steady cuts to the wage and business privilege taxes. PICA Staff will continue to closely monitor the City's fiscal situation throughout the coming year, with particular attention to the threats posed by PGW and the School District of Philadelphia. PICA Staff is further encouraged by the strong performance of the City's economy at the close of FY2001. With these caveats in mind, the FY2002-FY2006 Plan presents a reasonable prospect for balanced budgets in each year of its term.

PICA Staff recommends that the Board of the Pennsylvania Intergovernmental Cooperation Authority approve the Plan as submitted to the Authority on May 1, 2001.

This page intentionally left blank

Chart of Quantifiable Risks to the FY2002-FY2006 Plan

($ in thousands; totals may vary slightly due to rounding)

	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006	TOTALS
Quantifiable Risks							
Unidentified Reductions			(12,000)	(12,000)	(18,000)	(18,000)	(60,000)
Annual PGW Payment		(18,000)	(18,000)	(18,000)	(18,000)	(18,000)	(90,000)
PGW Loan Repayment				(45,000)			(45,000)
Other Significant Risks							
School District of Philadelphia							
Labor Contracts							
Long-Term Debt							
Welfare Reform							
Total Risks		(18,000)	(30,000)	(75,000)	(36,000)	(36,000)	(195,000)
Cumulative Total Risks		(18,000)	(48,000)	(123,000)	(159,000)	(195,000)	
City's Projections as of December 31, 2000							
Total Revenue	2,793,096	2,898,476	3,020,042	3,033,874	3,090,672	3,157,659	
Total Obligations	2,963,405	2,951,818	3,028,024	3,112,239 [1]	3,163,420	3,216,887	
Prior Year Adjustments	28,000	(99,487)	75,487	68,000	68,000	28,000	
Prior Year Fund Balance	295,138	152,829	0	67,505	57,140	52,392	
Plan Projected Fund Balance	152,829	0	67,505	57,140	52,392	21,164	
Fund Balance if All Risks Realized	152,829	(18,000)	19,505	(65,860)	(106,608)	(173,836)	
Value of Wage Tax Rate Reductions *		7,082	18,598	30,834	43,998	57,495	
Value of BPT Rate Reductions *		5,420	4,534	2,419	2,550	2,688	
Net Fund Balance if All Risks Realized Without Making Cuts in Tax Rates (cumulative)		(5,498)	55,140	3,028	8,828	1,782	

(1) PICA Staff did note that the City ended all funding for Veteran's Stadium as of June 30, 2003. The Phillies are currently expected to still be playing through October 2003. PICA Staff estimates that the Recreation – Stadium budget is short a little over $1 million.

* Value of Wage Tax reduction estimated by PICA Staff; value of BPT reduction estimates provided by Office of Budget and Program Evaluation.

This page intentionally left blank

Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT
ON
FY2002-FY2006
FIVE-YEAR FINANCIAL PLAN

SECTION II:

QUANTIFIABLE RISKS

This page intentionally left blank

TARGET BUDGETS AND "FUTURE TARGET REDUCTIONS"

The FY2002-FY2006 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 fifth consecutive year that the Plan has projected significant monetary savings resulting from the use of this management tool and the implementation of new management and productivity initiatives.

While applauding the City's continued use of target budgets to better manage unforeseen expenditures within a budget year, PICA Staff has reservations about the ability of the target budget process to generate significant savings over time. Significantly, the FY2001 target budget is **higher** than the original adopted budget.

While the Administration has a stated goal of reducing costs, its commitment level is too nascent to gauge at this writing.

This year's Plan anticipates a $21 million General Fund balance at the end of FY2006, allowing no opportunity 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 previous Administration as a way to constrain spending below budgetary levels. Following City Council's adoption of a budget, the Administration adopts target budgets for each department and cost center, typically 1.5 percent below the appropriated level. Each department and cost center is then given the opportunity to explain extenuating circumstances for a change in their assigned target budget. 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.

Target Budgeting Results in the Short-Term

Target budgets do provide a valuable cushion for unexpected costs that may arise during the year. At a minimum, when they are properly used, target budgets force departments to justify their expenditure needs to the Administration during the fiscal year. The Administration can then push departments to find offsetting efficiencies or savings elsewhere in their budget.

It is difficult to gauge the effectiveness of the target budget process and how it affects the City's overall 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. However, the evidence indicates that the use of target budgets has not resulted in large amounts of savings.

Target Budgeting Results in the Long-Term

Beyond the single budget year, target budgeting seems to have little impact on the overall amount of City obligations. According to the stated goal, carrying over the previous year's target budget amounts as a baseline for the following year's budget should lead to an overall reduction in spending; in fact the opposite has been true. In seven of the past eight years, both the original budget, and the target budget have exceeded the previous year's actual obligations.

Original and Targeted Budget Levels have Exceeded the Previous Year's Actual Obligations all but once in the Past Seven Years
(Amounts in Thousands)

Period	Original Budget	Target Budget	Year-End Actual	Original Over Previous Year-End?	Target Over Previous Year-End?
FY1993			$2,337,303		
FY1994	$2,384,579	$2,346,741	$2,346,033	Y	Y
FY1995	$2,295,907	$2,261,845	$2,267,211	N	N
FY1996	$2,366,917	$2,353,679	$2,370,971	Y	Y
FY1997	$2,416,797	$2,378,257	$2,463,930	Y	Y
FY1998	$2,510,072	$2,473,635	$2,479,617	Y	Y
FY1999	$2,632,731	$2,607,350	$2,616,583	Y	Y
FY2000	$2,759,553	$2,748,491	$2,711,245	Y	Y
FY2001	$2,830,456	$2,957,878		Y	Y

Source: *Quarterly City Managers Reports*, First Quarter FY1993, and First and Fourth Quarters FY1994 – FY2000 and First Quarter FY2001.

While the continued rise in the City's spending is not attributable to any one factor (i.e. increase in services, higher labor costs, etc.), it is clear that any savings realized by the target budget process is more than outweighed by other factors. As discussed in PICA's White Paper No. 7 "Philadelphia Must Reduce its Need for Tax Revenues," not only has the City's obligation level continued to increase over the past eight years, it has maintained its dependence on local tax revenues. The City must reduce tax-supported expenditures, and target budgeting is not an effective means to that end.

The City has not ably demonstrated that target budgeting has a direct relationship with long-term productivity. In order to institutionalize long-term efficiency in the City's budget process, the City must better tie its year-to-year budgeting to specific service delivery and performance goals.

Projected Savings from Efficiencies Instead of Target Budgets

Given the history of target budgets outlined above, it is questionable, or at least difficult to determine, whether they will produce the level of savings the City projects in the Plan. 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.

Further, the Administration's commitment to finding and implementing efficiencies is open to question. The city department ostensibly overseeing these efforts, the Office of Management and Productivity (OMP), has seen its staffing reduced significantly. The Administration has formed a new "Service Provider Evaluation Group" which may be a source for some new initiatives to help meet the target reductions. As the group's first meeting was in late April, the impact of this effort is impossible to gauge.

It is unknown whether this Administration will be able to generate the $60 million in savings anticipated in the Plan. Although it is a relatively small amount of money in relation to total five-year costs, with the Plan projecting only a $21 million surplus at the end of the Plan period, any inability to realize these savings could result in a budget deficit at the end of FY2006.

Target Budgets are a Management Tool Subject to Political Pressures

PICA Staff also has concerns as to whether this Administration will be able to continue to use target budgets to maintain departmental expenditures below budgeted levels. Due to its appropriation power, City Council has a significant say in the total dollars appropriated to individual City departments. 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 non-mandated management tool, and are subject to ever changing political realities. City Council may in the future look unfavorably upon a mayor who systematically does not spend money as it has been budgeted, and could use its political will and public pressure to encourage spending of all appropriated funds.

Conclusion

PICA Staff recognizes that target budgets are an innovative and effective management tool which provide the Administration with extra leverage to ensure department accountability, and short-term flexibility. Not only are the "Future Target Reductions" unspecified, the Administration's commitment to finding these efficiencies is unsupported. The proposed Plan projects an ending General Fund balance of $21 million in FY2005. This amount is insufficient to cover the $60 million in "Future Target Reductions" should those reductions not materialize.

PHILADELPHIA GAS WORKS

The Philadelphia Gas Works (PGW) continues to pose a significant threat to the fiscal health of the City's General Fund. PGW's financial situation appears to be much worse than its management group and the City Administration is willing to publicly admit. PGW's ability to continue making its annual $18 million payment to the City's General Fund as well as repay the $45 million loan it received from that Fund must be considered uncertain. Also, PGW's large outstanding debt situation is a very significant negative factor to the City's overall financial well being.

Long-term, this City owned utility faces the prospect of deregulation and serious competition. It faces a pressing need to dramatically improve its operations, while continuing to be burdened by the City's requirements that it also serve as a social service delivery operation. It is still unclear whether the City is willing to sell PGW. The probability that PGW can remain an economically viable entity in a competitive environment is subject to serious question.

PICA Staff's concerns as to the potential negative impact of PGW's financial problems on the City's Five-Year Financial Plan and overall financial health are expected to result in the issuance of a follow-up report later in this calendar year.

PGW's Assertions

In it meetings with PICA Staff, PGW presented a new management structure and claims of a rosier future. This was the fourth such presentation and assertion in PICA's ten-year existence. Earlier efforts included the introduction of an independent management service; the hiring of heavily recruited chief officers; and, the close watch of the City's Finance Director. Each of those earlier presentations touted a realistic evaluation of the dire straits facing PGW, a new planning process, and a better outlook.

This year's presentation was no different, with the interim PGW management team once again claiming a new era in PGW oversight. With operations now being regulated by the Commonwealth's Public Utility Commission and with claims of strong Mayoral support, PGW management asserts that it will be running a fiscally efficient operation by the third year of its proposed five-year financial plan. Recently approved rate increases, as well as the fine-tuning of the new computer system and improved customer responsiveness will ostensibly pave the way to a model public utility. Operational efficiency will supposedly be vastly improved once employee work rules are rewritten.

The Reality Facing PGW

PGW's true situation is far from the optimistic outlook most recently presented to PICA Staff. PGW has not received all of the rate increases requested to date. At the same time, the percent of dollars collected has dropped as customer bills have increased, with many PGW customers unable or unwilling to pay the new rates. The new "super" computer system, though improving, continues to send out incorrect bills. Normal management reporting, such as providing reports detailing what percentage of customers are paying their bills, is not presently available.

Customer service continues to fall short, with phone queues of nearly two hours for callers with billing questions. Little public discussion has emerged regarding changes in work rules while senior management awards itself significant raises.

PGW's long-term planning process is highly suspect. PGW's plan assumes that costs will drop over the life of their plan despite a record of steady expense increases. Undeterred by falling collection rates, PGW's five-year financial plan assumes steady revenue increases after years of continued revenue decrease. If PGW's five-year financial plan were subject to PICA supervision, PICA Staff would recommend disapproval of the plan as it has little basis in reality.

Short-term Risk: The $18 Million Payment to the City's General Fund; $45 Million Loan Repayment by FY03

Due to past mild winters, mismanagement, and rising fuel costs, PGW has experienced four 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 a delay in making its annual $18 million payment to the City. Debt service costs, as well as the high cost of continued short-term debt strategies, will further strain PGW's finances beginning this summer.

PGW's current leadership team has verbally committed to PICA Staff that it will meet the utility's financial obligation to the City General Fund. At the same time, PGW's Chief Financial Officer (CFO) has been quoted as saying that without receiving the necessary rate increases, the City can "forget about" getting the payment.[1] It remains uncertain whether PGW can make the payment, and how keeping that commitment would affect the utility's financial stability and credit rating.

As it did in FY1999 and FY2000, PGW anticipates it will be making the FY2001 payment later than stipulated by the Agreement for the Management of PGW. In accordance with that agreement, the FY2000 late payment included just over $203,000 in interest. No commitment has as yet been made to include interest with the FY2001 late payment.

The possible negative impact on the City is further increased by the $45 million loan approved by City Council last year. The loan exists as a revolving credit that PGW can draw

---

[1] Philadelphia Daily News, December 12, 2000. "PGW Sees Bleak Future."

on as it needs help with cash flow issues. The loan is expected to be paid back by the end of FY2003. The combination of the loan and the annual payments constitute a possible net negative impact of $135 million over the life of the City's Five-Year Financial Plan.

Given the overall state of PGW's financial situation, as well as the difficulties detailed in this section, the future of these payments to the City is considered questionable. The only factor preventing PICA Staff from discounting this money altogether is PGW's past record of making such payments as well as the assurances of PGW's CFO and the City's Finance Director that this year's payment will be made. PICA Staff believes that there is a strong likelihood that City revenues will be short up to the $135 million over the five years covered in the Plan.

A Difficult Environment for Introducing Change

The possibility of improved fiscal stability for PGW is unlikely in the face of myriad internal problems. Although mild winters have been harmful to PGW's finances, well-chronicled technology problems have also been a major problem. PGW has been unable to produce accurate financial information since August 1999. The billing system indicates that as many as 5,000 accounts may have been unbilled for years. It is impossible to estimate how much of that unbilled revenue will ever be recovered.

In addition, the ongoing implementation of the new billing system has resulted in many accounts going unbilled for as long as eight months, and in a multitude of inaccurate bills. PGW presently acknowledges that as much as two percent of its customers either receive no bills or receive inaccurate bills. Anecdotal evidence suggests that an even larger number of customers are presently not being billed or are receiving erroneous bills. These realities diminish PGW's revenue collection opportunities.

Even beyond its fiscal difficulties, PGW faces additional management and productivity difficulties. Its human resources department is unable to provide employee attendance records. The lack of an internal training program coupled with inadequate succession planning will further exacerbate its staffing as more employees take advantage of early retirement programs. Customer service departments are severely overburdened. The new management team's goal to implement meaningful performance and productivity measures can best be considered a distant possibility.

PGW is also hampered by City Council imposed requirements that it function as a social services agency as well as a public utility. These requirements include significant discount programs for the elderly and the indigent, as well as regulations preventing winter shut-offs. These rules, often abused by customers, hamper PGW's efforts to run as an efficient business. There has been no indication from the Administration or City Council of any willingness to amend these rules.

Long-term Risk: The City's Liability for PGW Bonds

There are significant capital expenditures looming for PGW, particularly in regard to its Liquefied Natural Gas Plant. PGW is in the process of prioritizing its limited capital dollars, but numerous infrastructure improvement requirements have reached the critical stage. PGW currently has over $900 million in outstanding debt. It is conceivable that the combination of increasing capital demands combined with the continued loss in revenue could render PGW unable to meet its debt obligations. This scenario could occur as early as January 2003.

According to the City, there has been no official legal opinion on whether the City is contractually liable for repayment of PGW's debt should PGW be unable to meet those obligations. However, considering that nearly all Philadelphia commercial and residential gas users are served by PGW, and given the City's history of coming to the aid of its citizenry even when not legally liable, the likelihood of the City assuming such liability is strong.

Competition in the Natural Gas Industry

Since July 2000, PGW's operations have been regulated by the Commonwealth's Public Utility Commission. The General Assembly is still considering a number of proposals for allowing customers to choose a natural gas supplier. 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.

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. A great deal of uncertainty remains about how the industry, and how PGW itself, will look in the future. PGW's current leadership team has promised to keep PICA Staff informed as it explores options for the utility, including privatization of certain operations.

Selling PGW

In Mayor Street's budget address, he forcefully raised the notion of selling PGW. Since that declaration however, the Administration has continued to release ambiguous statements regarding future plans for PGW. Options have included selling the utility to the first serious bidder; improving the utility to make it more attractive to prospective buyers; or, improving the utility and maintaining City control. Until a clear goal is established, PICA Staff cannot evaluate the impact of selling PGW.

Future Report

At this writing, it is too early to discern the impact of recent changes and rate hikes. PGW management has informed PICA Staff that the first benchmark for projecting the continued fiscal health of the utility will be the rate at which dollars billed are collected by the end of the summer; and that such information will be available in September. At the same time, PGW's fiscal year will have ended, and its year-end financial statements should be completed by the end of October.

When this information is available, PICA Staff will be better able to evaluate the fiscal health of PGW and the potential impact on the City's General Fund. PICA Staff plans to issue a future report re-evaluating the two greatest threats to the City's fiscal health – PGW and the School District of Philadelphia (see School District section for further discussion).

This page intentionally left blank

Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT ON FY2002-FY2006 FIVE-YEAR FINANCIAL PLAN

SECTION III:

OTHER SIGNIFICANT RISKS

This page intentionally left blank

SCHOOL DISTRICT OF PHILADELPHIA

Fiscal difficulties at the School District of Philadelphia (School District) pose a dire threat to the fiscal health of the City's General Fund. Preliminary budget estimates by the School District project a cumulative deficit of $785.9 million by the end of FY2004, the third year of the City's Five-Year Financial Plan.

As of this writing, few plans have been offered by the City, the Commonwealth, or the School District regarding expenditure cuts or additional revenues to close the deficit. PICA Staff's concerns as to the potential negative impact of the School District's financial problems on the City's Five-Year Financial Plan and overall financial health are expected to result in the issuance of a follow-up report later in this calendar year.

Background

Due to a variety of factors including (though not limited to) the City's limited real estate tax base, education spending caps by the Commonwealth, increased School District costs, and the high-needs population of the School District, the School District faces significant deficits over the next few years. Neither the Commonwealth nor the City have as yet proposed increased funding sufficient to eliminate such deficits.

The presence of Act 46, the legislation that would permit takeover of the School District by the Commonwealth discourages the City from providing one-time funding to the School District. Under Act 46, in the event of a takeover, the City would be required to continue all of the previous year's funding commitments.[2]

A Burgeoning Deficit

If current projections of the School District prove accurate, it will be facing an operating deficit of over $305 million in FY2004, and a cumulative deficit of nearly $786 million. PICA Staff estimates that without additional cuts or additional funding, by the end of FY2006, the last year of the City's Five-Year Financial Plan, the School District will be facing an operating deficit of nearly $450 million, and a cumulative deficit of **over $1.6 billion**.

[2] In the event of a takeover, if the proposed $45 million payment for use of School District facilities by the City were to be passed by City Council this year, it is possible that the City would be obligated to maintain that level of funding throughout the life of the Plan. The uncertainty regarding this payment and the untested legal issues surrounding Act 46 do not warrant this possibility being considered as a significant risk at this time.

Who will Cover the Gap?

At the present time, future School District funding is unclear. Governor Ridge proposed an additional $67 million dollars in funding for the School District, but the Commonwealth's budget situation is far from settled. City Council has yet to act on the City Administration's request for an additional $45 million for the School District in the current fiscal year. The Five-Year Plan contains no additional funding beyond the annual $15 million contribution already accounted for in the School District's budget.

While it is expected that some of the projected deficit will be eliminated via expenditure cuts by the School District, the major portion of the projected deficit will need to be covered by additional funding. The School District announced that it will eliminate the "cluster" system, resulting in $60 million in savings over the next five years. Newspaper reports also indicated that the School District will implement additional administrative savings of $140 million over the next five years for a total of $200 million.[3] As yet, no budget including these cuts has been presented. Assuming one-quarter of the projected cumulative deficit ($400 million) could be eliminated through expenditure cuts, that would still leave the Commonwealth and the City responsible for funding a $1.2 billion cumulative deficit by the end of FY2006.

It is impossible to predict how that responsibility would be shared. However, with the City projecting a fund balance of just over $21 million by the end of FY2006, even taking on responsibility for one-third of the additional needed revenues would devastate the City's General Fund.

Future Report

At this writing, it is impossible to predict the funding schemes that will be devised to close the School District's deficit. By the end of the summer, it is expected that the Commonwealth's budget will be set, and more will be known regarding the efforts to cut the School District's expenditures. The School District advised PICA Staff that more reliable projections will be available by the end of the summer.

When this information is available, PICA Staff will be better able to evaluate the fiscal health of the School District and its potential impact on the City's General Fund. PICA Staff plans to issue a future report re-evaluating the two greatest threats to the City's fiscal health – the School District of Philadelphia and the Philadelphia Gas Works (see PGW section for further discussion).

[3] *Philadelphia Inquirer*. "Schools to Disband 22 Clusters for Savings," May 1, 2001, p.1.

LABOR CONTRACTS AND THE MUNICIPAL WORK FORCE

During the course of the FY2002-2006 Five-Year Plan, all of the collective bargaining agreements between the City and its unionized workers will expire; it is impossible to assess the impact of any future wage and benefit related cost increases over the life of the Plan.

Despite the fact that personnel costs account for more than half of the FY2001 budget, the Plan pays little attention to the need to rightsize the City's workforce. PICA Staff's concerns include the significant increase in the number of exempt employees over the past decade, and the lack of a comprehensive human resource information system.

Municipal Union Contracts

The largest unknown variable in the Plan is personnel costs. The collective bargaining agreements between the City and its Police and Fire employees expire at the end of FY2002; the other municipal employee contracts expire at the end of FY2004. As is standard procedure, the Plan assumes no increases in wages or benefit costs after these expiration dates. Personnel costs account for 56 percent of the FY2001 budget; thus even a minimal increase in wages and benefit costs will have a significant impact on the City's expenditures throughout the life of the Plan.

Rightsizing the City Workforce

Despite the forecast of an operating deficit in each of the five years covered in the Plan, there is scant attention paid to the need to rightsize the City's workforce. The Plan correctly notes that across the board layoffs and early retirement programs will only serve to shrink the workforce without regard to the City's actual needs. It is interesting to note, that while the number of Civil Service employees has barely increased from FY1991 to FY2001, the number of exempt employees has jumped by over 31 percent.

However, the projected size of the FY2001 workforce is equal to the size of the workforce in FY1990, despite the loss of nearly 10 percent of the City's population during the same period (see discussion in Controlling Local Spending section). This period saw unprecedented increases in productivity and investments in technology, with seeming little impact on the size of the City's workforce. Further, the size and structure of the workforce are not very different from the 1950's, when the City's population was nearly *25 percent* larger than it is today.

In order to truly control its operating costs, the City must focus on determining the right size and makeup of a City workforce to meet the needs of Philadelphia in FY2002-2006. It is therefore disappointing that the Plan makes no effort to identify this effort as a priority.

Human Resource Information System is Needed

Despite the City's enormous personnel costs, the Personnel Office functions without a comprehensive Human Resource Information System (HRIS). The absence of such a system results in significant costs through non-automated paper processing, duplication of effort, and an inability to properly manage personnel needs throughout the City.

According to a City Personnel Department report, the City employs 160 clerks to complete and route over 70 paper forms used to establish and maintain employee status. At an estimate of $33,000 per employee (salary and benefits), the City pays $5 million every year to support this function. Updates on employee status take an average of 27 days resulting in delays in information availability and hampering City departmental management of personnel.

The Personnel Department estimates that a comprehensive system would cost $5-7 million. Obvious savings generated would include the reduction in staff support by half. The system would be largely paperless, reducing staff time currently spent filing documents in the operating departments and in Central Personnel. Personnel related time delays would be eliminated with the advent of real-time information updates allowing for better human resource management.

A HRIS system also provides new tools for programs such as employee development and training, and compensation support. It can provide logistical support for running training programs, such as automatically posting employees to class lists, generating notices and tracking attendance. Data on employee performance can be collected and used to support performance-based pay initiatives. In short, to best manage the largest piece of its budget, the City needs to strongly examine the implementation of a HRIS.

INCREASING DEBT SERVICE COSTS

The City again anticipates increasing the percentage of General Fund revenue dollars that are subject to long-term debt commitments. The inherent risk in continuing this trend is the speed at which the City is approaching its allowable debt limit. As stated in the Plan, this jeopardizes the infrastructure maintenance goals of the overall Capital Program. These risks are further heightened by the issuance of debt related to the construction of two new sports stadiums, the implementation of the Neighborhood Transformation Initiative (NTI) and the proposed expansion of the Pennsylvania Convention Center. While the debt associated with these projects in all probability may be exempt from the City's allowable debt limit, nonetheless, these projects add to the City's annual debt burdens on the local taxpayers.

Increasing Reliance on Long-Term Debt

During the last few years of the Rendell Administration, the City was able to slowly reduce the percentage of General Fund revenue dollars that were devoted to long-term debt costs. As the chart below details, the Street Administration's Plan reverses that trend. In fact, by the first year of the Plan, this percentage will be above 11 percent, higher than at any point since FY1995.

Fiscal Year	General Fund Revenues	Total Fixed Costs[1]	Fixed costs as a % of General Fund Revenues
1995	2,275,734,000	256,919,307	11.29%
1996	2,364,834,000	259,989,423	10.99%
1997	2,424,778,000	258,893,561	10.68%
1998	2,497,235,000	253,322,174	10.14%
1999	2,628,107,000	254,263,652	9.67%
2000	2,755,500,000	263,588,374	9.57%
2001 (Target/ Revised Estimate)	2,793,096,000	282,958,700	10.13%
2002	2,898,476,000	324,128,133	11.18%

[1] Total Fixed Costs includes Debt Service payments, PICA Debt payments, Long Term Leases, and the Convention Center Subsidy.

The increasing reliance on long-term debt is a concern in light of the other risks highlighted within the Plan and in this report. The cost of long-term obligations are dedicated monies that cannot be rebudgeted. Should there be a national economic downturn, revenues will not increase as projected; should welfare reform lead to an increased need for services, additional monies will be required in the appropriate service agencies; if revenues fall short of projections, if new administrations at the State or federal level choose to reduce funding to the City, or if other unbudgeted costs arise, the City will be forced to reallocate from among a smaller pool of funds.

While it is true that after FY2002 the percentage of General Fund revenue dollars that are subject to long-term commitments will begin to fall, that is due in large part to PICA's refinancing of past loans on behalf of the City, and not as a result of the City's management of its other long-term debt. In addition, the farther ahead the projection (in this case, the last few years of the Plan), the greater the likelihood that the economic landscape will differ from the outlook today. The result is an increased risk of a probable downturn in the City or national economy, as well as the potential for increased pressure on General Fund revenue dollars.

It is a generally accepted sound budgeting axiom that the time for a municipality to pay down debt is when that municipality has surplus funds. This Plan takes the opposite approach, by increasing the City's reliance on long-term debt during a period of relative fiscal health. Following eight straight years of balanced budgets and another record surplus, the City should be using this opportunity to put its financial house in order, reduce its long-term obligations, and attain the fiscal flexibility needed to meet unforeseen challenges.

The City is Quickly Approaching its Legal Debt Limit

At the end of FY2000, the City's general obligation debt borrowing capacity was down to $342 million. As a result, the City's Capital Budget for FY2006 is expected to be under $46 million, less than one-third of the average Capital Program from FY1993-FY2001. This shrinking of the Capital Program places at risk the routine construction and renovation necessary to maintain the City's buildings, facilities, and infrastructure. Additionally, much of the State and Federal construction monies that the City receives is dependent on the local matching of funds. Without the availability of capital fund dollars to provide these matching funds, the City risks losing tens of millions of dollars in State and Federal funds for SEPTA infrastructure, highway repair, etc. The City will also be unable to make commitments to long-term projects (City Hall, the Art Museum, etc.), commitments which are often used to gain private funding to complete a project.

Although the Plan acknowledges the approaching debt limit constraint, there is no defined approach to solving the problem. While the Plan states that "the City is reviewing ways to expand its debt incurring capacity or fund capital projects through other financing sources, so that the Capital Program is efficiently maintained through the term of this Five-Year Plan," the City has not even updated its own Debt Policy Statement, published most recently in December 1997. As an example, a stated policy is that the debt service on Net Direct Debt of the City of Philadelphia will not exceed 6.9 percent of the total General Fund obligations of the City. Yet in FY1997, the very first year of the policy, this ratio was 7 percent.

PICA Staff does agree with the City that the formula for determining the City's debt limit is not equitable with other municipalities in the State. However, before putting itself within danger of reaching the current debt limit, the City should observe the directive found in the introduction to the most recent Debt Policy Statement: “This Debt Policy is intended to be a dynamic, not a static document. Therefore it should be annually reviewed and updated.”

PICA Staff is pleased to note that the City heeded our recommendation from last year’s Staff Report and improved the balancing of the remaining debt capacity over the life of the FY 2002-2007 Capital Program.

General Fund Revenue Dollars Further Burdened by Large-Scale Projects

Three large-scale City projects will involve significant long-term debt obligations. The $250 million “Blight Remediation Bonds” scheduled to be issued by the Redevelopment Authority (RDA) on behalf of the City for the Neighborhood Transformation Initiative (NTI) will cost the City approximately $20 million annually in debt service over the life of the Plan.[4] (See NTI section) Assuming the City is able to achieve its stated goal and fill the funding gap of almost $30 million without City funds[5], the stadia project will add nearly $400 million in long-term debt.

In addition to these projects, there have been ongoing discussions regarding the proposed expansion of the Pennsylvania Convention Center. Plans to expand the current facility are estimated to cost upwards of $464 million with the Convention Center expected to ask the City to contribute 50 percent of the costs, or $232 million.[6]

Although these projects do not count against the City’s debt limit, these projects represent an ever-increasing debt burden on local taxpayers. PICA Staff is concerned City debt payments could simply overwhelm the City’s budget in the future.

---

[4] Five-Year Financial Plan, Fiscal Year 2002-Fiscal Year 2006, p. 32
[5] PICA Staff was extremely concerned by a report in the May 10, 2001 Philadelphia Daily News (p.3) that the City may be funding the $29 million funding gap, despite assurances to the contrary by City officials. PICA Staff will continue to monitor stadia related expenditures for long-term fiscal impacts on the City as well as inclusion of sufficient debt service repayment funds in the Five-Year Plan.
[6] Gelbart, Marcia, “In D.C., Mayor Makes a Convention Pitch,” *The Philadelphia Inquirer*, March 3, 2001

This page intentionally left blank

WELFARE REFORM

Since the passage of the Personal Responsibility and Work Opportunity Reconciliation Act in 1996 and the subsequent implementation of the Commonwealth's Act 35, the potential impact of welfare reform on the City of Philadelphia has been a significant issue. PICA Staff has previously commented on the need for the City to assess the impact of welfare reform on the fiscal health of the City. We note with pleasure the City's improved preparedness for the approaching welfare reform deadline.

Temporary Assistance to Needy Families

In 1996, the Personal Responsibility and Work Opportunity Reconciliation Act radically altered the resource allocations that the federal government utilized to fund welfare services. Aid to Families with Dependent Children (AFDC), the cornerstone of the 60 year-old federal program was replaced by Temporary Assistance to Needy Families (TANF). Under the TANF guidelines, each State is charged with the planning and implementation of its own welfare program through a block grant from the Federal Government.

Pennsylvania's welfare legislation, Act 35, went into effect March 1997. Act 35 requires that after 24 months recipients of TANF cash assistance must work at least 20 hours per week to retain the TANF cash assistance. The Commonwealth determines specific exemptions from work such as mental illness or the birth of a child. If non-exempt recipients do not comply with the work requirements, the State may deem recipients ineligible for TANF benefits and an entire family may lose cash assistance.

The portion of the legislation that might most adversely impact the City is the five-year lifetime limit on a recipient's ability to collect TANF benefits. Once a recipient has received continuous TANF benefits for five years, that recipient will be sanctioned and face the possibility of losing cash assistance. The five-year deadline is scheduled for March 2002.

Change in Commonwealth Sanctions

In meetings with PICA Staff, Department of Human Services (DHS) officials stated that the Commonwealth was in the process of re-evaluating the sanctioning process under Act 35. Subsequently the State Department of Public Welfare (DPW), revised Act 35 to allow recipients who meet certain requirements to gain an extra year on the previously imposed five year lifetime limit on receiving TANF cash assistance. These requirements include those recipients:

- working 30 hours per week
- working 20 hours per week and enrolled in a state approved training programming for 10 hours per week

- composed of two-parent families in which both parents are working a combined 55 hours per week
- who are domestic-violence victims receiving counseling[7]

City Preparedness

According to Commonwealth statistics, the City is home to more than half of Pennsylvania's welfare recipients. In January of 2001, there were 122,580 welfare recipients in Philadelphia. This is a reduction of 72,711 since Act 35 was implemented in March 1997. During this time period the City has responded to welfare changes by working in a collaborative manner with local and state agencies, and by establishing employment and training programs, outreach campaigns, childcare services and other resources for welfare recipients. Over 13,000 former welfare recipients have been placed in jobs through the efforts of the City and its partners.[8]

DHS has partnered with the Commonwealth to develop and implement a web-based case management system, PACWIS (Pennsylvania Automated Child Welfare Information System), that will enable DHS Staff to match TANF recipients with clients being served by DHS. PACWIS will marry the need of caseworkers to have information about the children and families they serve with the need of managers to understand the characteristics of the families being served at the county level and across the state. This system also allows DHS Staff to provide proactive intervention with families that are not meeting the requirements of ACT 35. This web-based system will also alleviate the need to rely on untimely data provided by DPW.

Given the current circumstances, the City is better prepared than at any other time to manage the fiscal impact of TANF.

[7] Wiggins, Ovetta, "PA., NJ, Officials Offer More Time to Get Off Welfare" The Philadelphia Inquirer, March 29, 2001.
[8] Philadelphia Workforce Development Corporation Annual Report, 1999-2000, p. 8-12

Pennsylvania Intergovernmental
Cooperation Authority

STAFF REPORT
ON
FY2002-FY2006
FIVE-YEAR FINANCIAL PLAN

SECTION IV:

OTHER GENERAL FUND CONCERNS

This page intentionally left blank

ANALYSIS OF THE CITY'S ECONOMY

Data released by the Bureau of Labor Statistics (BLS), indicates the number of jobs in Philadelphia has increased from year to year since 1997. The rate of increase has slowed in recent quarters. The job increases come on the heels of wage and business privilege tax cuts begun in FY1996 and continued through FY2001. Concurrently, the City can boast of a stabilized property tax assessment base and a FY2000 General Fund balance of $295.1 million. Recent Census figures indicate that the City continues to suffer significant population losses, though not as bad as originally feared.

Unlike past national economic slowdowns, the City has not been at the forefront of the current downturn. The City's decreased presence in the manufacturing sector has reduced its job losses during the current slowdown, although recent data indicates that the job losses may be moving to other sectors of the economy. The potential impact of welfare reform has not yet imposed a fiscal burden on the City. The City seems better prepared to handle that problem now then it was in past years. The hospitality and service sectors have grown stronger in Philadelphia, albeit that such growth has recently slowed. Mergers and insecurity in the financial and healthcare sectors continue to foreshadow a possible decline in some of the industries that are Philadelphia's largest non-governmental employers.

The City cautiously projects flattening employment growth while appropriately estimating moderate growth in property assessments. These assumptions seem to be a reasonable, if slightly conservative, short-term forecast for the City's economy, with (as must be expected) greater uncertainty over the last three years of the Plan.

Job Growth Continues in Philadelphia

According to the BLS, the total number of jobs in Philadelphia steadily declined from 1990 to 1997. From 1990 through 1997, the City lost 79,200 jobs, 32,900 of which were lost from 1990 to 1991. The average change in employment over the seven-year period was at a rate of 1.6 percent.[9] In 1998 the figures reported by the BLS indicated the first job growth of the decade in the City, and the 2000 figures show continued job growth above 1999. The BLS reported that the average annual total number of nonagricultural jobs in the City for calendar year 2000 stood at 698,300, which is an increase of 13,100 jobs from 1999 representing a growth rate of about 1.9 percent. This was an increase from the growth rate of 1.4 percent between calendar year 1998 and 1999, and the 1.2 percent growth rate between calendar year 1997 and 1998.

Although the annual average job growth is strong, a quarterly breakdown indicates that the growth rate has been slowing. Most of the year 2000 increase occurred in the first quarter of the year. While the City's quarterly job growth had ranged from 1.2 to 3.2 percent over the previous three years, the fourth quarter of 2000 was flat, with a growth rate of just .3 percent. Additionally, preliminary statistics from the first quarter of 2001 show a decline in job growth

[9] U.S. Bureau of Labor Statistics

for the first time since 1997. Accordingly, despite the job growth of the past three years, continued population loss and a weakening national economy have led the City to forecast flat job growth through FY2006.[10]

The City is not Leading the way to an Economic Recession

The national and regional economies appear to be slowing. Recent data has indicated increased unemployment, uncertain consumer confidence, and decreasing corporate earnings. At the same time, the unemployment rate remains historically low and the gross domestic product continues to grow at a steady rate. Although Philadelphia has seen some signs of slowdown, such as in job growth, it is not nearly as drastic as in prior periods of national and regional downturns.

Philadelphia has a history of leading the region into periods of economic slowdown, and lagging the region in rebounding from such slowdowns. The City's first sign in the 1990's that the bleeding of jobs had stopped and was rebounding slightly was at the end of calendar year 1998 when the City realized a growth of 7,800 jobs from 1997. The Philadelphia Primary Metropolitan Statistical Area (PMSA) started to pull out of job loss in calendar year 1992.[11] BLS data reveals that the Philadelphia PMSA showed the first job growth from 1992 to 1993 and growth in the region as a whole has continued consistently through 1999. The City did not share in the region's rebound until a good five years later, when its first job growth occurred.

One explanation offered for the current ahistorical trend is that Philadelphia has gone through a significant economic restructuring during the past two decades, and is now better positioned to weather this economic slowdown. The manufacturing sector is bearing the brunt of the current economic weakness, and the City's "under-dependence on manufacturing may finally be working to [the City's] advantage." [12] The City did so poorly in the past, that it is feeling the effects of the current slowdown to a much lesser degree.

Late April unemployment data does not bode well for the region. Record number of layoffs are beginning to infiltrate beyond the manufacturing sector. Many economists are noting slowing of corporate profits across a broad range of sectors. "As a result, the job losses, which once were mainly in the manufacturing-heavy Midwest and the Southeast, are reaching the West Coast and the Northeast." [13]

Despite the current slowdown, City Wage Tax receipts have continued to grow at a steady pace. Through the third quarter of FY2001, wage tax receipts are up 4.06 percent; if last year's wage tax reductions are factored in, the growth rate would be over 5 percent. Just the

---

[10] *Five-Year Financial Plan, Fiscal Year 2002 - Fiscal Year 2006*, p. 14.

[11] The Philadelphia PMSA consists of Bucks, Chester, Delaware and Montgomery Counties in Pennsylvania and Burlington, Camden, Gloucester and Salem Counties in New Jersey.

[12] Joel L. Naroff, "*Philadelphia: Ground Zero for a Recession?*" The Philadelphia Inquirer, March 4, 2001. p. E7.

[13] Philadelphia Inquirer, "More lose jobs as slowdown spreads in U.S." May 4, 2001, p. 19.

third quarter alone, which would most likely demonstrate a slowing of the economy, had a growth rate of 5.24 percent; with the wage tax reductions factored in, the growth rate would be over 6 percent. Though easing in some areas, the City's economy appears to be weathering the current slowdown well. Looking ahead, however, if job losses do reach the Northeast, the impact will be most apparent in falling City Wage Tax receipts in FY2002.

Philadelphia's Largest Non-Governmental Employers and the Impact of Mergers, Acquisitions and Downsizing on the City's Economy

Government employment plays a major role in Philadelphia's economy, but non-governmental employment is a driving force in the final result. Eight of the top twenty-five non-governmental employers in the City are hospitals, two are financial institutions and two are insurance companies. Though the City still maintains a presence in the manufacturing sector, the dominance of that sector has declined; in its place the City has increased its reliance on the service sector and tourism and marketing.

The healthcare sector is a crucial part of Philadelphia's economy, as demonstrated by its dominance in the top twenty-five largest non-governmental employers. Downsizing in the healthcare sector has had a direct impact on the City in terms of job losses and lost Wage Tax revenue. Recent press reports seem to indicate a leveling off in the health sector's contraction. Many of the Philadelphia area health systems have stabilized revenues, and the Tenet system showed a small profit in the last quarter. Instability in the sector remains however, and must be watched closely due to its potential impact on the local economy.

The finance, insurance and real estate sector (FIRE) showed a significant job decline in Philadelphia between 1990 and 1997; "declining by 10.9 percent in Philadelphia while simultaneously growing by 6.6 percent in the suburbs".[14] First Union National Bank (First Union), the largest financial services institution in the City, continues its upheaval with dramatic losses and the recent acquisition of Wachovia. First Union's struggles, as well as other mergers and acquisitions in the financial sector and the likelihood of mergers in the insurance sector present continuing challenges to the City. The financial sector in Philadelphia provides a significant amount of Wage Tax revenue to the City. Lost jobs through financial consolidations place a burden on the City's economy. PICA Staff encourages the City to devise a proactive plan, in conjunction with the current reactive efforts, directed at improving the underlying economic trends in Philadelphia.

[14] *Five-Year Financial Plan, Fiscal Year 2000 - Fiscal Year 2004,* p. 51.

The City's Projections for Property Tax Assessments are Reasonable

The estimates for the real property tax revenue are significant since the property tax is the second largest source of City tax revenue. Property assessments determine the amount of revenue to be realized. Real estate tax assessments for commercial, industrial and residential properties have grown for each respective year since 1997. The average annual rate of growth since 1997 has been .79 percent.[15]

The pattern of slight but consistent growth in real property assessments can be expected to continue. The Philadelphia real estate market continues to be healthy. The center city market has rebounded; occupancy rates for business class space in 1998 was 87.3 percent and currently rests above 90.5 percent.[16] Small increases in residential assessments, the addition of taxable property from Tenet Healthcare's acquisition of previously tax exempt healthcare facilities, and a lower rate of adjusted assessments gives strong indication that property assessments have stabilized and will continue the growth pattern evidenced over the past three years.

The City projects that commercial assessments will grow by 1.1 percent annually and residential assessments will grow by 1.4 percent annually through 2006.[17] Based on the past three years of property assessment growth and property tax revenue, and after discussions with regional economists, the Board of Revision of Taxes, and local real estate industry leaders, PICA Staff feels that the City's projections throughout the life of the Plan are justified.

---

15 *Five-Year Financial Plan, Fiscal Year 2002 - Fiscal Year 2006,* p. 15.
16 *Five-Year Financial Plan, Fiscal Year 2002 - Fiscal Year 2006,* p. 16.
17 *Five-Year Plan, Fiscal Year 2001 - Fiscal Year 2005,* p. 16.

NEIGHBORHOOD TRANSFORMATION INITIATIVES

Since 1950, the City's population has declined by approximately 25 percent. The Neighborhood Transformation Initiative (NTI) was designed by the Administration to end suburban flight and stabilize the City's neighborhoods. The issuance of $250 million of Blight Remediation Bonds to fund NTI services is the major component of the project. While applauding the City for undertaking the much-needed project, PICA Staff has major concerns regarding the details of NTI.

Background and Goals of NTI

In order to stem the tide of the City's physical decline and in an attempt to reverse its fifty-year decline in population, the Administration created the Office of Neighborhood Transformation. This office is responsible for developing and implementing the Neighborhood Transformation Initiative. NTI is an unprecedented, multifaceted, multi-agency project that is the most ambitious urban-renewal program in the City's history.

Over the life of the Plan, the City is projecting that $1.63 billion will be invested in order to accomplish the goals of NTI. Much of these funds will be state and federal dollars diverted from other programs; some will emanate from private investment. The core of the City's portion of the project cost is $250 million of "Blight Remediation Bonds" that will be will issued by the Redevelopment Authority (RDA) on behalf of the City.[18]

The goals of NTI are:

- Demolish 14,000 abandoned homes and buildings
- Stimulate the construction of 16,000 housing units
- Encapsulate 2,500 vacant buildings
- Increase the coordination among various City agencies and departments with respect to housing and development activities
- Keep existing vacant lots clean
- Remove the backlog of immediately dangerous street trees approaching 8,500
- Develop a web based computer tracking system to be utilized by the participating city departments and agencies

[18] Five-Year Financial Plan, Fiscal Year 2002-Fiscal Year 2006, p. 32

Fiscal Elements of NTI

As of this writing the implementation and financial strategies have not been detailed in the Plan. According to the Plan, the City, through the RDA, is anticipating issuing two different types of bonds.

Over a period of five years approximately $195 million of governmental purpose (tax-exempt) bonds will be issued to fund the demolition of abandoned residential and commercial buildings, encapsulate vacant homes and improve streetscapes. An estimated $55 million of private activity (taxable) bonds will be issued to finance non-traditional neighborhood investment programs and thus avoid being hamstrung by federal regulations.

The dates of issuance and amounts of proposed bond issuance are not currently available. According to the Five-Year Plan, the City has budgeted just under $20 million annually to pay the debt service on the NTI bonds over the life of the plan.

PICA Staff Concerns

While recognizing the imposing tasks of implementation of such a large project, the on-going lack of budgetary detail is troubling to PICA Staff. The project has been in the planning stages for sixteen months and the limited fiscal information that has been made public continues to change on a daily basis. There is scant detail regarding the sources of private funding on which the success of this project depends. The lack of pertinent details regarding NTI is also a troubling fact to City Council. As of this writing, Council has refused to introduce the necessary financing legislation for the project. Basic information such as the specifics and the sequence of the demolitions has been requested by City Council to no avail.[19]

The lack of a schedule for bond issuance is also problematic. The increase in City's fixed annual costs will further raise the percentage of locally generated revenue dedicated to long-term obligations (see the Increasing Debt Service Costs section of this report).

NTI requires the coordination and consolidation of City departments and agencies but the plan neither defines nor discusses how these goals would be accomplished. Perhaps most troubling is the overall lack of accountability and performance standards (not presently evident in the Plan). Despite a fairly long planning process, the NTI has few specific outcome measures, and little beyond broad policy goals. PICA Staff has great concern about the ongoing evaluation of the success of NTI beyond counting the number of buildings demolished and lots cleared.

[19] McDonald, Mark, "Blight Plan Still Stalled," The Philadelphia Daily News, May 2, 2001 p. 11

THE CITY'S ECONOMIC DEVELOPMENT POLICY LACKS MEANINGFUL PERFORMANCE MEASURES

For the first time since its inception in FY1994, the City's economic development strategy has altered some of its priorities. While applauding the Administration's recognition that economic development should be an evolving effort, PICA Staff remains concerned that the Plan does not have a clear, comprehensive performance measurement system in place to measure its effectiveness. Given the massive public investment and the City's decision to continue the program throughout the life of the Plan, PICA Staff feels compelled to reiterate the issues discussed in PICA's White Paper No. 8 entitled "Good Policy Demands Better Measurement: Philadelphia's Economic Development Program."

Revised Focus for Economic Development

During the economic development program of the previous administration, the stated goal was to jump-start the economy and reverse the growing population loss of the City. The areas of focus for the program were: business retention and attraction through dismantling the City's debilitating tax structure and easing administrative and regulatory costs of doing business; expanding the hospitality and tourism industry; neighborhood economic development; and defense conversion.

In the 2002-2006 Five-Year Plan, the stated goal of the economic development strategy is to "create and maintain jobs within the City of Philadelphia."[20] While maintaining the priorities of neighborhood development, tourism, and reducing the cost of doing business, the new strategy has added spotlights on the information technology sector, and workforce development.

With numerous regional economists commenting on the need for a skilled workforce and the continued upside potential of the technology industry, these revised aims seem appropriate to increasing the strength of the local economy. It is interesting to note that the focus on taxes has changed to reducing the high taxes as opposed to reforming the tax structure overall. The Administration sees continued incremental tax reductions, as well as targeted tax incentives as the best means to create and maintain jobs.

Opportunity Cost

The City's decision to allocate General Fund dollars to economic development leaves open the discussion of the opportunity cost and alternative uses of the General Fund dollars. The City has yet to publicly demonstrate that the economic strategies undertaken to date have been the most effective use of public dollars mainly because there are no performance measures in place for these strategies. While the City claims that the economic development tools produced a positive outcome in terms of retained and increased wage tax revenue, the City

[20] *Five-Year Plan, Fiscal Year 2002-Fiscal Year 2006, p. 34.*

also notes the impact of wage tax reduction on retaining residents and employers and attracting businesses, thereby retaining and increasing wage tax revenue. The strong national economy also played a significant role during this period.

It is impossible to determine the best use of funds without a clear, verifiable, accurate system of measuring outcomes. The City does not provide performance standards or expectations for the input of dollars prior to the allocation of money, and the City does not evaluate the results after the money has been used. While the City does have defined criteria for some loan programs (only one piece of a total performance measurement system), Philadelphia Industrial Development Corporation (PIDC) and Commerce Department officials in meetings with PICA Staff, stated that there are currently no standardized expectations for the outcomes from General Fund expenditures for economic development. They also indicated no need to develop such measures in the future. Simply put, it is impossible to determine the value gained by the citizens of Philadelphia for dollars invested in economic development.

Current Economic Development Reporting Tools

In White Paper No. 8, PICA Staff focused on the City's Economic Stimulus Program (ESP) that had evolved into a seven year, roughly $7.5 billion program, without a comprehensive evaluative tool. PICA Staff reviewed the *Economic Stimulus Report* and the Economic Development chapter of the Five-Year Plan (for each respective year since FY1995). The quarterly *Economic Stimulus Report* is published by the Philadelphia Commerce Department in cooperation with the PIDC. The stated objective of the *Economic Stimulus Report* is that it is "designed to both illustrate and measure the specific efforts and effectiveness of the Economic Stimulus Program."[21] The report as presented was ineffectual as a management tool because each report differed in the type of information reported, the data was inconsistent from report to report, and often, the numbers within a quarterly report contained mathematical errors.

During meetings with PICA Staff, the economic development staff of the City indicated that the Economic Stimulus Report would no longer be issued as it was designed for the economic development programs of the previous administration. It should be noted that although the economic development efforts carry a new name, many of the previously utilized strategies will continue. The Neighborhood Transformation Initiative, a centerpiece for this Administration, plans to make full use of “tax increment financing; tax-free Keystone Opportunity Zones; federal Empowerment Zones; historic and low-income housing tax credits; and the 10-year real estate tax abatement program.”[22]

Leadership of PIDC and the Commerce Department further indicated that the other reporting tools currently utilized are sufficient to measure the City’s new economic development strategy. PIDC issues a year end report describing its activities for the year. While the report details a number of funded projects that were initiated or came to fruition during 2000, there is

---

[21] *City of Philadelphia Economic Stimulus Report for the Calendar Year 1994,* p. 3.
[22] Neighborhood Transformation Initiative brochure, revised 4/01, p.4.

no quantitative analysis of the success of PIDC's efforts. The report contains no summary of total dollars spent in any area and makes no effort to link investment dollars to end results. There is simply no means to evaluate the relative merits of PIDC's efforts on a program-by-program basis, or a comprehensive fashion.

PICA Staff urges the City to reevaluate its reporting procedures and in conjunction with the institution of a performance measurement system, create an economic development reporting mechanism that meets the objectives outlined in this section.

Creating an Efficient Performance Measurement System for Economic Development

Performance measurement systems extend beyond simple tracking of outputs. Performance measurement systems are a comprehensive approach to measuring programs and services. Leadership, a defined focus and strategic plan, expected outcomes prior to implementation of resources, defined criteria, follow up upon implementation of input of resources, tracking of outputs and outcomes, a comparison of expected and final results, and possible adjustments made upon those results are each integral parts of a complete performance measurement system. The City of Philadelphia does not have such a comprehensive system for its economic development strategy.

The City may choose to turn to other large cities for ideas on establishing performance measurements. The City of Indianapolis serves as a pioneer in holding companies to job creation, retention and wage standards in exchange for economic development incentives. In a program called "Tax Abatements with Accountability," Indianapolis will revoke a tax abatement or put a company on probation if a company fails to achieve stated job creations or wage levels. Indianapolis requires every company receiving a tax abatement to file an annual survey documenting the activity of the company.

Conclusion

The Street Administration has decided to continue funding an economic development strategy despite the fact that the program has not demonstrated specific quantifiable results. The fiscal implications of the decision to extend the program are unclear since the Five-Year Plan, Fiscal Year 2002 - Fiscal Year 2006 (which includes Fiscal Year 2001) fails to document the funding sources and levels of the new economic development strategy. The Administration does offer some insight into proposed changes in the effort but does not state any intentions to establish a process of performance measurement for the program. There remains no promise of accountability for the tax supported dollars allocated to economic development.

Given the significant public investment in this effort, the lack of performance measurements and established expectations for spending should no longer be tolerated. Inadequate evaluations of the efficiency and effectiveness of economic development investments raise serious questions as to the relative value of the program in comparison to other uses of the General Fund dollars involved in its continuance.

This page intentionally left blank

LACK OF PREPARATION FOR FISCAL RISKS IN THE EVENT OF A DOWNTURN IN THE ECONOMY

As discussed in the “Analysis of the City’s Economy” section of this report, the City has thus far been only mildly affected by the current downturn in the national economy. However, factors such as a high poverty concentration, a high local tax burden and a shrinking population, continue to make Philadelphia vulnerable should the economy slow further. Though the threat of a national recession is mentioned throughout the Plan, the City bases all revenue projections and future assumptions on a strong national economy. Based on the City’s slow recovery from previous recessions and the City’s admission to its own weakness should a national recession occur, the City is placing itself in a tenuous position if it does not prepare for a possible downturn in the local economy.

At the end of FY2000, the City had accumulated a $295.2 million fund balance, even after the tax reduction program begun in FY1995. Though management and productivity initiatives are to be credited with reducing costs, the strong national economy was a major factor driving the positive fund balance. Despite the City's known dependence on a strong national economy the City has failed to make any preparations for a possible downturn.

While the economy is hard to predict, the City can be taking measures that would at least lessen the blow that a national recession would have on Philadelphia. This past winter, City Council held hearings regarding the creation of a Rainy Day Fund for the City. Although the Administration expressed limited support for such a fund, there has yet been no legislation presented by either City Council or the Administration to create it.

Use of a Rainy Day Fund

A Rainy Day Fund as defined by *Governing* magazine is, "reserves set aside to be used in the event of a recession or other unpredictable fiscal surprises."[23] Many municipalities resorted to utilization of a Rainy Day Fund after learning hard lessons from recessions in the early 1980s and the early 1990s. The creation of a Rainy Day Fund is one option for the City of Philadelphia, though not necessarily an easily achieved option. The most often-cited obstacle to the creation of a rainy day fund in Philadelphia is the Home Rule Charter, which has been interpreted to require a balanced budget.

The Plan, mandated by the PICA Act, might well be the catalyst for creation of a rainy day fund as a component of a balanced budget. In the Plan, the City indicated an intent to save $127.5 million through the end of FY2002. The City designated this saving as a “Funding for Future Obligations” (in previous plans titled “Funding for Contingencies”). This process presumes that a short-term emergency fund is legal. If it is feasible for the City to plan to save money in the Five-Year Plan then it is within the City’s means to create a savings plan with the same intent and restrictions as a rainy day fund. The City in conjunction with City Council could develop legislation to guarantee that funds are carried over from year to year.

---

[23] "Grading The Cities: A Report Card on Urban Management". *Governing.* February 2000, p. 31.

Set Parameters for a Rainy Day Fund

Rainy day funds are composed of General Fund revenue or tax supported dollars. The annual percentage of General Fund dollars to be allocated into the fund, the purposes for which the money can be spent and the maximum amount of money that may accumulate in the fund are issues for which each respective municipality must set strict parameters. Debates and criticisms usually arise such as suggesting that balances be used instead to reduce taxes, pay off long-term liabilities, and pay other operating expenses. Cities are forced to remain insistent that the funds are for a downturn in the economy or unknown risks. The City may set a parameter such that after four consecutive quarters of revenue decline the rainy day fund may be tapped to ensure continuation of City services. Also, a neutral party may be utilized to operate the rainy day fund.

Local Municipalities Across the Country Utilize a Rainy Day Fund

There are currently 45 states with rainy day funds or some type of stabilization fund. Pennsylvania is projecting a balance exceeding $1.1 billion in its rainy day fund in FY2000 - FY2001. In the February 2000 issue of *Governing* magazine, in a report published by the Maxwell School of Citizenship and Public Affairs at Syracuse University and *Governing* magazine, 16 of the 35 cities were cited as having rainy day funds or reserve surplus funds. Though most of the accumulated balances in the rainy day funds could not fully sustain a city's economy in the event of a national downturn, the funds are thought to be a proactive fiscal step towards preparing for the blows that a volatile economy delivers.

The rainy day fund is a reserve that can serve as source of revenue that will minimize the likelihood that a city would be forced to raise taxes, increase debt, or cut services in order to survive a downturn in the economy. As these municipalities have discovered, and as Bond Rating Agency representatives discussed during City Council testimony, rating agencies look favorably upon municipalities with rainy day funds.

DEPARTMENT OF HUMAN SERVICES

In FY2001 the Division of Social Services (DSS) was created to improve the planning, integration, coordination and delivery of social services to the residents of Philadelphia. The Director of Social Services now manages the programs and services that had previously been implemented by various agencies and departments. The Department of Human Services (DHS) is one of ten Departments that is a component of this new service delivery structure.

Over the last decade, the DHS has significantly increased its State and Federal funding levels. This has allowed the City to increase service levels, while simultaneously reducing net City costs to provide these services. While the City should be congratulated for increasing "outside" funding levels, challenges that could negatively affect the net City costs still remain in the future. It is imperative that the City continues to be vigilant in obtaining other sources of funding in order to adequately serve the ever-increasing needs of its population.

Increase in State and Federal Funding Levels

In the early 1990's the Commonwealth of Pennsylvania instituted a Needs Based Budget process to determine the appropriate levels of State funding for human service functions. Simultaneous to this change, the City started to aggressively pursue additional funding opportunities for these services. When meeting with PICA Staff, DHS staff provided a historical analysis of the City share of costs by fiscal year.

Analysis of City Share of Department of Human Services Costs

(amounts in thousands)

Fiscal Year	City Costs	State/Federal	Total	City % of Costs
'93	61.5	180.9	242.4	25%
'94	64.6	195.1	259.7	24%
'95	48.5	235.5	284.0	17%
'96	38.5	256.7	295.2	13%
'97	44.7	263.2	307.9	14%
'98	48.2	288.7	336.9	14%
'99	45.7	318.3	364.0	12%
'00	39.2	368.7	407.9	9%
'01	51.8	392.0	443.8	11%

As the above information illustrates, City funded costs for DHS services decreased from 25 percent in FY1993 to 11 percent in FY2001, while simultaneously the total costs of the department services rose from $242,400,000 in FY1993 to $443,800,000 in FY2001.

Throughout the life of the Plan, the City share of costs is projected to remain consistent, between nine and ten percent.[24] Given the changes at the national and state levels, PICA Staff has concerns about the likelihood of maintaining these percentages.

Projected City Share of Department of Human Services Costs

(amounts in 000's)

Fiscal Year	City Costs	State/Federal	Total	City % of Costs
'02	47.1	432.1	479.2	9%
'03	49.2	445.1	494.3	9%
'04	51.6	455.8	512.5	10%
'05	54.1	467.6	526.9	10%
'06	56.5	479.0	540.8	10%

Needs-Based Budgeting

The Commonwealth's system of Needs-Based Budgeting continues to hamper the efforts of the Department to effectively plan and allocate expenditures. PICA Staff remains concerned about the absence of a clear and equitable reimbursement process. The criteria utilized by the Commonwealth to determine county-funding allocations continues to remain confusing and more importantly at odds with the realities that face human service departments across the State.

As in previous years the City has appealed its "certified" funding allocation for FY2001 to the Department of Public Welfare (DPW). The Plan states DPW's approved budget for Philadelphia is based solely on historical trends, not the number of children in need of service, nor service trends. Demographic factors are also not taken into consideration when the Commonwealth determines funding levels for DHS. According to the 1999 publication of the *State of the Child in Pennsylvania*, the rate of children living in poverty in the City is 37.4 percent. The average for the rest of the Commonwealth is 17.3 percent.[25]

[24] *Five Year Financial Plan, Fiscal Year 2002-Fiscal Year 2006, p. 127-135*
[25] *Five Year Financial Plan, Fiscal Year 2002 Fiscal Year 2006, p. 133*

DHS takes issue with the following tenets regarding funding process that the Department of Public Welfare utilizes:

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 ignore the cost of living differences among counties;

3. “Certified” funding amounts from the previous year rather than actual costs or mid-year estimates;

4. Cap on administrative costs and exclusion of certain services from reimbursement.

Equally disconcerting is the Commonwealth projected amount of funding the City will receive from federal Title IV-E reimbursements. The anticipated $160.7 million in federal funding includes a probable overstatement that will ultimately reduce the amount of funding that the Commonwealth provides to the City. The Commonwealth bases its allocation of funds on the amount of federal funds that it expects the City to receive. The City believes that the aforementioned federal funding is overstated by 30 million dollars.[26]

Conclusion

The consistent annual increase in non-City funding for DHS services has been exceptional over the last decade. This has allowed the department to increase service levels for its needy clients and look to the future for implementing systemic reform based on accountability, accessibility and prevention. In order to continue the past successes, the City must be proactive in working collaboratively with its State and federal partners and it must also seek out new funding sources.

[26] *Five year Financial Plan, Fiscal Year 2002-Fiscal Year 2006, p. 133*

This page intentionally left blank

CONTROLLING LOCAL SPENDING

In past PICA Staff reports, as well as in numerous press reports and independent studies, much has been made of the dramatic growth in the size of the City's budget over the past decade, despite the equally dramatic loss in population. The most common explanation offered by the City has been the growing services required by the remaining population, as well as increasing demands on the criminal justice system.

A brief review of the budget growth in a number of key cost centers reveals that while some growth may be attributable to those factors, other increases are exponentially higher than inflation with no apparent justification. PICA Staff strongly recommends that the City review the rationale for these budget increases.

Background

During the last mayoral election, much of the local press examined the apparent conundrum between large declines in the City's population in the 1990's, and the steadily increasing City budget. Further studies showed that while the City had lost an estimated 500,000 people since 1950, the size of the government was almost unchanged. While the 2000 census revealed that the City's population loss was not as great as initially feared (losing "only" 70,000 residents from 1990-2000), the City budget during that same period grew at a rate greater than inflation.

Much of the growth can be attributed to increasing demands on the social service delivery agencies of the City. This need, combined with tremendous leveraging of State and federal dollars (see the Department of Human Services section of this report) has resulted in dramatic new spending in the Health and Human Services Departments, although requiring fewer locally generated dollars. The criminal justice system also saw tremendous growth with the large increases in prison populations and the influx of federal dollars for new police hires eventually absorbed by the City's General Fund.

Cost Center Comparison

While some areas of increase can be explained, and have demonstrable benefit (needed services provided, falling crime rates), other areas have increased budgets with no corresponding increase in performance.

The following table shows the rate of growth in select cost centers (General Fund) from 1990 through 2001 (estimated). Average annual growth is provided for the periods from 1990-1995, 1995-2000, and 2000-2001 for the cost centers as well as national inflation rates (CPI).

General Fund Expenditure Growth in Select Cost Centers, FY1990 – FY2001

(amounts in thousands)

Cost Center	1990	1995	2000	2001 (est.)	Annual rate of increase 90-95	Annual rate of increase 95-00	Annual rate of increase 90-00	Annual rate of increase 00-01
City Council	6,504	7,821	10,702	13,065	4.05%	7.37%	6.45%	22.08%
DHS	181,310	284,027	407,891	443,875	11.33%	8.72%	12.50%	8.82%
L&I	20,761	28,031	33,166	38,009	7.00%	3.66%	5.98%	14.60%
Mayor's Office	1,915	2,126	3,035	4,692	2.20%	8.55%	5.85%	54.60%
MDO	2,770	5,330	6,404	7,636	18.48%	4.03%	13.12%	19.24%
Police	312,953	307,978	408,155	425,951	-0.32%	6.51%	3.04%	4.36%
Prisons	76,280	83,614	131,356	138,315	1.92%	11.42%	7.22%	5.30%
CPI					3.32%	2.59%	3.18%	

Due to factors discussed above, it is not surprising that DHS and Prisons saw such dramatic growth over the last decade. In fact, it is somewhat surprising that the Police Department did not show a similar level of growth over the same period.

Other cost centers are less easily explained. Although some of the dramatic increase in the budgets for Licenses and Inspections (L&I), the Managing Director's Office (MDO) and the Mayor' Office between 2000 and 2001 are due to the preparation for the Neighborhood Transformation Program, the NTI will not be implemented until FY2002. While it is difficult to estimate how much of the growth is due to laying the groundwork for this effort, it certainly cannot account for all of a 54 percent increase. Some MDO increase is also due to the implementation of new snow removal efforts and the abandoned car removal efforts over the past year.

However, these factors do not account for the growth during the last decade in these areas. Not including the increases from 2000 to 2001, there seems little justification for a Mayor's Office and City Council budget increase averaging twice the rate of inflation, and the MDO at four times the inflation rate. The dramatic growth in City Council's budget, mostly attributable to a growing staff complement and dramatically increasing salaries, begs explicit justification.

PICA Staff encourages the Administration and City Council to review those cost centers that seem to be growing unjustifiably at an exponential rate.

Pennsylvania Intergovernmental Cooperation Authority

**STAFF REPORT
ON
FY2002-FY2006
FIVE-YEAR FINANCIAL PLAN**

SECTION V:

APPENDICES

This page intentionally left blank

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 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 percent 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

Staff Report - The Plan, as approved by City Council on March 22, 2001, was submitted to PICA by the Mayor on May 1, 2001 and the PICA Act provides a 30 day period for review which expires May 31, 2001. 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 23, 2001 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 4, 2001.

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.

Relationship to Future Plan Revisions - 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 22, 2002 (100 days prior to the end of FY2002). At that time, the City is required to add its Fiscal Year 2007 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 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 meets the requirements of the PICA Act and Cooperation Agreement.

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 $1,127 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	469,870
Retirement of Certain High Interest City Debt	381,300
TOTAL	**$1,127,370**

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 2002. 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 FY2001 is August 15, 2001. Quarterly reporting deadlines for FY2002 are November 15, 2001, February 15, 2001, May 15, 2002 and August 15, 2002. 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 FY2001 is the report due June 20, 2001. For FY2002, the reporting dates are October 22, 2001, January 21, 2002, April 22, 2002 and July 22, 2002. 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 FY2002 are August 2, 2001, November 1, 2001, January 31, 2002 and May 2, 2002.

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 Forecasted Statements of General Fund Revenues, Obligations and Changes in Fund Balance for the Fiscal Years Ending June 30, 2002 and June 30, 2003, included in the Plan. That report included the Controller's Office opinion that the underlying assumptions provide a reasonable basis for City management's forecast. At the request of the PICA Board, the City Controller's Office also prepared 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 May 16, 2001 (as a component 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.

This page intentionally left blank

CITY CONTROLLER'S OFFICE
REVIEW OF THE FIVE - YEAR FINANCIAL PLAN
FOR THE FISCAL YEARS 2004 THROUGH 2006
SCHEDULE OF FINDINGS

Economic and General Fund Revenue Forecasts

The Controller's comparative economic and General Fund revenue forecasts appear to be consistent with the Plan's 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 growth in the national economy but at a slower pace than in recent years. It has been assumed that the City will maintain a relatively stable economic base throughout the life of the Plan.

Wage and Earnings Tax
City payroll employment will continue to be shaped by forces such as the City's proposed tax reduction, City's economic development programs, local industry restructuring, and welfare reform. Although the City's non-farm payroll employment increased in 2000, this momentum may not carry through the out years. In fact, trends over the past several months indicate stagnant job growth in Philadelphia and a slowing rate of growth throughout the country and the region. Additionally, it remains difficult to discern whether the recent incremental tax cuts led to the past few years of job growth or whether Philadelphia was simply reaping the benefits of a strong national economy. Regardless, the pressure from nationwide mergers and consolidations, as well as the local pressure resulting from population loss and middle-class tax base erosion will continue to hamper Philadelphia's economic health during the whole Plan. As there is little evidence that the City's tax structure or the skill-level of Philadelphia's workforce will improve dramatically in the next few years, the relatively conservative revenue estimates in the Plan are reasonable and wage rates that increase faster than employment will continue to drive revenue growth that slightly outpaces inflation.

Real Property 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 demand for space. However, this may be somewhat mitigated by a recent trend showing a rebounding appreciation for the amenities and central location provided by an urban location. Second, favorable prices, especially in comparison to increasingly expensive suburban space, may induce some modest improvement in the market for commercial office space. Recent

conjecture about the construction of one or more new office towers and the success of several new apartment buildings and condominiums supports this reasoning. However, the sudden oversupply of hotel rooms and uncertainty surrounding bookings at the Convention Center suggests that the hotel sector will not grow appreciably. To remain conservative, and because, historically, the City is very slow to increase assessments, we believe that the demand reduction and favorable price patterns will offset each other, leaving sub-inflation level growth in Real Property Tax revenue, as projected in the Plan.

Business Privilege Tax

By nature, the Business Privilege Tax (BPT), which comprises the gross receipts and net income components, is volatile and contingent upon economic conditions. As the City continues to reduce the gross receipts portion of the tax, the proportion of BPT revenue derived from net income is likely to continue increasing. While the continued reduction makes Philadelphia more competitive, especially to new companies and small companies working with low profit margins, the higher dependence on the net income portion makes overall BPT revenue increasingly more sensitive to trends in profitability. By reflecting this trend, the Plan's conservative BPT revenue estimates appear reasonable.

Revenue from Other Governments

Department of Human Services (DHS)

DHS receives a considerable amount of State and Federal funding, especially from Federal program Title IV-E and State program Act 148. The Plan assumes a 3.1-percent average annual growth rate for Title IV-E and a 4.1-percent average annual growth rate for Act 148. Assuming continued State and Federal surpluses, these funding levels appear reasonable. DHS also receives significant funding from the federal TANF program. For FY 2002, the Plan assumes a one-time 45.6-percent increase over FY 2001 funding and then continued funding at the new level for the remaining years, resulting in an assumed average annual growth rate of 9.1 percent. This may be optimistic.

Public Utility Realty Transfer Act (PURTA)

The Plan assumes that, in FY 2002, the City will experience the final reduction in revenue resulting from Pennsylvania's 1996 electricity deregulation act. For the remaining years, the Plan assumes that funding will hold steady at $5.5 million. This represents a significant reduction from the FY 1999 funding of $24.8 million, but seems reasonable in light of the regulatory changes.

Philadelphia Gas Works (PGW)

As a result of recent warm winters, structural inefficiencies, and computer implementation failures, PGW has developed financial difficulties, resulting in a, to date, unpaid FY2001 dividend to the City and the need to take a $45 million loan. Despite the colder winter during FY 2001, the dramatically increased wholesale price of gas forced PGW to pass the cost to consumers. Consequently, the already fragile collection rate is likely to erode further, compromising PGW's recovery options. With wholesale prices expected to remain high, few real structural changes, and the possibility of a sale, the City may not receive the $18 million annual dividend payments or the $45 million loan repayment cited in the Plan. The Plan, may be overestimating revenues by as much as $135 million over its five year span.

Locally Generated Non-Tax

Stadium

The Plan shows approximately $16.5 million dollars in annual Veterans Stadium related revenue for FY 2002 and FY 2003 with a drop to $4.4 million in FY 2004 and negligible revenues for the remainder of the Plan. This reasonably reflects the revenue impacts of the newly negotiated stadium agreements with the Phillies and the Eagles.

GENERAL FUND OBLIGATIONS

Base Methodology

The City's General Fund Obligation growth assumptions as presented in Appendix V – Base Methodology of the Five-Year Plan – appear to be deficient and may be misleading. The projected General Fund obligations as presented in Appendix III of the Plan are at variance with the obligation growth rates shown in Appendix V.

In particular, the projected growth rates for Class 500 (Contributions and Indemnities), Class 800 (Payments to Other Funds), and Class 900 (Advances and Miscellaneous Payments) are inconsistent. The base methodology shows Class 500 obligations increasing by 1.5 percent annually over the life of the Plan. However, Appendix III shows these obligations decreasing by 10 percent over the life of the Plan. Additionally, the base methodology in Appendix V shows Class 800 and 900 obligations to grow at 1.5 percent annually over the life of the Plan; Appendix III shows the Class 800 obligations to decrease by approximately 1.46 percent on average over the life of the plan, while Class 900 obligations are dropping by 1.0 percent over the life of the Plan.

Payroll

Uniformed unionized employee contracts expire on June 30, 2002. However, the Plan makes no provision for salary increases for uniformed employees. The Street administration continues to state that the unionized work force deserves fair contracts. Given that the non-uniformed employees have a negotiated contract through FY 2004 calling for 3.0-percent increases in each of the last two years, it is likely that the uniformed forces will receive some salary increase beginning in FY 2003. Additionally, there is no provision in the Plan for any salary increases beyond FY 2004 for any organized labor group. Again, it seems highly unlikely that unionized employees will forego wage increases in FY 2005 or FY 2006. While we are not able to predict the outcome of the future labor negotiations, any salary increases for employees will have significant financial impact on the City's budget over the life of the Plan.

Debt Service

Based upon our review of the current General Fund General Obligation Bond maturity registers and related debt service schedules, the General Fund Debt Service Obligations may be over-estimated throughout the life of the Plan.

Debt Service obligations include principal and interest payments for General Obligations Bonds issued in each year of the Plan, as well as the Blight Removal Bonds. While it is possible that the Administration will authorize and sell General Obligation (GO) bonds during the life of this Plan, it is highly unlikely that they will sell GO bonds each year. As for the Blight Removal bonds, it is unlikely the City will market these bonds. Instead, one of the City's quasi-governmental agencies will likely issue this debt and the City will be responsible for some type of service agreement payment. However, we believe that the amounts budgeted may exceed the actual costs.

As we stated in our *FY 2001 Mid-Year Economic and Financial Report*, the City continues to expand its debt burden, borrowing money for infrastructure repairs and new capital assets. In recent years, the City has expanded it long-term debt burden with traditional borrowing as well as more-complex lease and service agreements with quasi-governmental agencies. After falling for years, the City's debt service-to-revenue ratio is increasing. By the end of FY 2003 we project that nearly 16 cents of every general fund revenue dollar will spent on debt-service payments. While this increasing debt has allowed the City to address many capital needs, it places a heavy burden on the City budget. The debt will be a fixed cost that must be paid in the future. If revenues continue to expand, the City will be able to pay its debt-related costs as well as its ongoing service-related costs. But if these debt-related costs grow too high, or if revenue growth declines, the City may have to face the prospects of service cuts or tax increases to remain fiscally stable.

The Plan includes commitment fees and arbitrage payments of $1.75 million and $850,000, respectively, over the next five years. The City has not utilized any type of credit enhancement for the last four short-term note sales. It appears the City will not need, or use, any credit enhancement for its short-term borrowings in the future. Furthermore, it is unlikely the City will be subject to any arbitrage payments over the life of the Plan. In addition, the Plan budgets $1.3 million for Sinking Fund Reserve Payments. For the last two fiscal years this payment has been less than $500,000.

Blight Removal

The Street Administration included a $250 million Blight Removal initiative in the Plan. This initiative, as is stated in the debt service section above, is to be funded through a bond sale. Consequently, the Street Administration has made no direct appropriation for building demolitions. According to Administration officials, these costs are to be funded through the blight initiative.

Unspecified Future Target Reductions

As the Rendell Administration did in the past, the Street Administration continues to include $60 million in unspecified future spending cuts over the life of the Plan. However, the Plan makes no mention of how or where these cuts will be made. Failure to attain these cuts will put the City's budget at a risk equal to the amount of the cuts.

School District of Philadelphia

As of the time of writing, City Council had not yet approved the Administration's request for a $45 million addition to the $15 million FY 2001 School District appropriation. If approved, the spending could represent the beginning of a trend toward increased City funding of the schools. As the Plan only includes the annual $15 million contribution, regular or even irregular additions represent unbudgeted spending that could pose significant financial impact during the life of the Plan. Even more worrisome is the uncertainty surrounding Act 46, which allows the State to take over the School District and requires that the City continue funding at the previous year's level. It is currently unclear whether the proposed $45 million payment for use of School District facilities would be included in the prior year's total. However, it is a risk, that could result in as much as a $225 million shortfall over the life of the Plan.

CAPITAL PLAN

Capital Budget

We reviewed the FY 2002 Capital Budget included in Appendix VI of the City's Five-Year Plan. Our review consisted of agreeing the Plan amounts to the City Planning Commission's six-year funding schedule for FY 2002-2007 and verifying the mathematical accuracy of both. In addition, we reviewed all projects in the FY 2002 Capital Budget to determine whether they were capital in nature.

Included in our review was a computation of the current and future legal debt capacity. We also compared potential debt service costs associated with the Capital Plan with projected debt service costs shown in the General Fund section of the Plan. Again, as stated in the Debt Service section of this schedule, it appears that debt service obligations are over-budgeted throughout the life of the Plan.

The City is fast approaching its legal debt limit. As FY 2001 draws to a close, the City has slightly more than $180 million in debt capacity remaining. At a time when the City is struggling to stay within its legal debt margin, the Plan offers no solution to how the City will combat this problem. The FY 2002 and FY 2003 capital budgets are seeking funding of $88.6 million and $89.3 million respectively. With the Capital Plan burgeoning in the first two years, and dwindling to $37 million in FY 2005, the City is at risk of being unable match state and federal dollars available for projects in the out years. As a result, millions of dollars for capital improvements from outside agencies may be lost.

OTHER FUNDS

Aviation Fund

Based upon the assurances from Aviation Fund officials, it appears unlikely the City will be required to make a General Fund subsidy payment for 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. Division of Aviation representatives stated that these holdings plus any interest earned, may be sufficient to prevent the General Fund from contributing to the Aviation Fund over the life of the Plan.

Water Fund

Water Department officials continue to assure PICA officials that there is minimal risk that the General Fund will not receive the annual transfer of approximately $4 million. The Water Department continues to cut costs at both their wastewater treatment and biosolids recycling center. In addition, the Water Department realized significant cost savings in its energy bill through successful implementation of multiple energy savings initiatives. As a result of these cost cutting measures, energy initiatives, and increased delinquent collections through the enforcement of the Utility Services Tenant’s Rights Act, Water Department management believes that the $4 million annual transfer to the General Fund will continue over the life of the Plan.

CASH FLOWS

The cash flows presented in Appendix IV of the Plan for FY 2001 and FY 2002 agreed with the estimates for General Fund revenues and obligations as presented in Appendix III of the Plan. The forecast for the monthly distribution of revenues and obligations were materially consistent with historical patterns.