Pennsylvania Intergovernmental Cooperation Authority

Staff Report
on the
City of Philadelphia's
Five-Year Financial Plan
for
Fiscal Year 2012 - Fiscal Year 2016

July 26, 2011

PENNSYLVANIA INTERGOVERNMENTAL COOPERATION AUTHORITY

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Introduction

"As for the future, your task is not to forsee it, but to enable it.."
- Antoine de Saint-Exupéry

The Five-Year Financial and Strategic Plan has served as an important tool in restoring fiscal stability to the City of Philadelphia. The fiscal crisis in 1991 which led to PICA's creation was precipitated in part by the unwillingness of the City to reasonably project its future revenues and budget its obligation levels accordingly. The creation of a Plan process which demanded that reasonableness of assumptions be verified by a third party established a responsible baseline for City budget decisions. The multi-year aspect of the Plan assured that budgetary decisions were evaluated for both short-term and longer-term impact.

Initial Plans submitted to PICA embodied a relationship between the strategic planning of the City and the financial goals and impacts of that planning. New efficiencies and investments were highlighted in the narrative of the Plan and realization of these goals was contained in the fiscal projections. Over time, as opportunities for "easy fixes" diminished, it became harder to reasonably project the realization of savings from new efficiencies; the financial projections of the Plan evolved into a series of projections rather than a true planning template. Strategic language in the Plan was replaced by lists of past accomplishments.

The Five-Year Plans of the past few years have reinvigorated the strategic nature of the text sections of the Plan. The Nutter Administration, as noted in previous Staff Reports, has placed a new emphasis on strategic planning across the City and has realigned departmental activities to conform to specific goals. Though the Plan narrative reflects this new emphasis there remains a detachment between the strategic language of the text and the fiscal data which makes up the statutorily required elements of the Plan.

Some select elements are reflected in both: the Administration goals for savings in health costs from new labor contracts have been included for the past few years, and were in fact realized for the labor activities completed to date. Other stated strategic goals could be better reflected in the financial documents, particularly if the City moves closer to a performance and/or activity based budget system. At the same time, fiscal plans should not reflect "wishful thinking" but should strive to reflect the attainment of reasonable goals.

As a multi-year fiscal projection, the Plan retains significant value, not just as a predictor of outcomes, but more in its ability to recognize the long-term implications of changes in the City's economy as well as service delivery and policy decisions. This asset should be applauded, while also recognizing the largely unrealized potential it has as a tool for enabling the City to progress.

Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT ON FY2012-FY2016 FIVE-YEAR FINANCIAL PLAN

SECTION I:

EXECUTIVE SUMMARY AND STAFF RECOMMENDATION

I. EXECUTIVE SUMMARY AND STAFF RECOMMENDATION

The FY12-16 Five-Year Financial Plan (Plan) presents the City's attempts to struggle through the halting economic recovery while confronting fiscal challenges at the School District, changing spending priorities at the State and federal level, and its ongoing efforts to control personnel costs. As in the past two Plans, the City utilizes a combination of new revenue initiatives and spending cuts to achieve a schedule of balanced budgets throughout the five years of the Plan. However, the Plan's projected fund balances are dangerously narrow. When coupled with the staggering unfunded Pension liability, continuing uncertainties surrounding labor contracts, fiscal instability and a loss of credibility at the School District, State and federal budget challenges, and the slow economic recovery, these balances accentuate the risks regarding the City's ability to maintain fiscal stability over the next five years.

The FY12 budget cycle is the first to reflect the City's decision (long advocated by PICA) to reflect reimbursable Department of Human Services (DHS) spending in the Grants Revenue Fund rather than in the General Fund. Net of that shift, the City reduced its FY12 spending projection by approximately $23 million (.6%) from last year's Plan projection. The net reduction is due in part to continued management improvements including reducing the prison census. Additional savings were offset by increased City contributions to the School District ($10 million). While the School District real estate tax increase did not impact the General Fund, it continued to exacerbate the uncompetitive tax burden on Philadelphia residents and businesses.

As recommended in several previous PICA reports and Issue Papers, the Administration has continued trying to address some of the long-term fiscal challenges faced by the City, though the success of key initiatives will not be known until the completion of all the unresolved labor contracts. The City has begun the process of creating a Rainy Day Fund despite the narrow fund balance, and is benefiting from continued fiscal stability at the Philadelphia Gas Works.

The Staff Report primarily focuses on those areas which could negatively impact the projections contained in the Plan. Though not discussed in detail below, there are always unexpected positive results which help to mitigate the negative uncertainty. Lower spending levels resulting from increased efficiencies (such as recently witnessed in the Prisons system); a quicker economic recovery; lower staffing levels than anticipated; or lower than projected need in the debt service or indemnities funds, are all scenarios which have occurred in the past, and are taken into account when PICA Staff considers the Plan in its entirety.

Under the PICA Act, the Board is charged with determining whether: "the financial plan projects balanced budgets, based upon reasonable assumptions…for each year of the Plan." In the opinion of PICA Staff, the Plan the Board is now considering meets that test.

Report Summary
The report focuses primarily on six areas:

1. **Substantial risks included in the Plan:** These are items for which a strong possibility exists that the City will not meet its projections; the risks are quantifiable and substantial; or, the potential impacts are unquantifiable, but the risk of the City's missing those projections is not so large that it is unreasonable for the City to include them in the Plan.

2. **Additional risks included in the Plan:** These are qualitatively less substantial risks contained in the Plan where the City may not meet its projections, or the potential negative impact is small enough so as not to upset the Plan's positive fund balances.

3. **Ameliorated risks relative to prior Plans:** These are long standing fiscal challenges highlighted in previous PICA Staff Reports which are deemed to no longer present immediate, substantial risks to the City's ability to achieve balanced budgets throughout the life of the Plan.

4. **Tax revenue and expenditure projections included in the Plan:** The tax collection projections are a key determinant of the level of expenditures that can be included in the Plan and an analysis of expenditure trends demonstrates how the City has responded to the fiscal challenge.

5. **The long-term financial risks that face the City:** These are an array of issues that must be addressed to secure the City's long-term fiscal health whether or not they impact the City's ability to achieve balanced budgets over the Plan years.

6. **Indicators of Financial Health:** A series of measures and statistics which create a snapshot of the City's overall fiscal health and how it is changing over time.

Substantial Risks Included in the Plan

Pension Liability: The pension liability presents the greatest threat to the City's fiscal health for three primary reasons: it is the largest fixed cost in the budget; a large part of the risk is beyond the control of the City; and, over the past few decades, the City has failed to address those areas of the pension liability where it does retain control. In fact, some of the areas under City control have been altered in a manner so as to exacerbate the problem. The City's ability to address the myriad challenges of the pension liability are also challenged by the reality of potential long-term structural fixes having significant short-term costs, and short-term efforts to reduce the impact of large annual pension fund payments worsening long-term structural problems.

Labor Contracts and the Municipal Work Force: Three of the four municipal union employee contracts with the City remain in the negotiation/arbitration process, as employees have been without contracts since 2009. The Plan not only assumes no net increase in costs resulting from new contracts for the life of the Plan, but that the City will realize an annual workforce savings of $11.86 million. While new labor contracts could potentially increase General Fund costs, if the City is successful in achieving its reform objectives, the contracts would positively impact some of the City's long-term fiscal challenges on pensions and health benefits. **Any contracts which increase General Fund costs beyond the City's ability to pay, or fail to realize the savings assumed in the Plan, will require a revision to the Plan. This revision must demonstrate that there are sufficient funds to cover these costs or unrealized savings.**

Property Tax Assessment System: One of the most significant risks facing the FY12-FY16 Plan is the reform of the City's property tax assessment system by the Office of Property Assessment (OPA). From a policy standpoint, this change is clearly desirable and has long been supported by PICA. The move toward a more accurate property valuation system should create a more legitimate basis for one of the City's major tax revenue sources. The OPA assessment reforms should have substantial economic benefits and promote long-term financial stability by helping the City create a more viable tax revenue structure. Nonetheless, the transition to the new assessment system poses short-term financial risks as well as potential serious impacts on specific neighborhood real estate markets.

Intergovernmental Grants: As was the case with the FY11-FY15 Plan, the FY12-FY16 Plan could face risks associated with diminishing levels of grant funding from the State and federal government. These risks are related to the expiration of funding under the federal American Recovery and Reinvestment Act (ARRA), fiscal stress at the State, and the ongoing effort to reduce the federal budget deficit. The City relies on a wide array of formula based and discretionary State and federal grants to support a range of services, particularly those related to health, human services, and housing. Diminished levels of resources for these programs could result in pressure to increase City tax support for these programs over the next five years.

Narrow Fund Balances: For the fourth consecutive year, the proposed Plan includes relatively narrow fund balances, ranging from $28.5 million to $71.4 million. While these figures represent a substantial amount of money, they equate to an average surplus of only 1.4 percent of expected revenues (as opposed to the minimum 5 percent long recommended by the Government Finance Officers Association). That scenario is the equivalent of a family with a household income of $50,000 setting aside $700 per year to cover unexpected emergencies.

<u>Additional Risks in the Plan</u>

Uncertain National Economy - Macroeconomic Trends: An additional area of risk to the Plan is the performance of the city economy over the next five years. The FY12-FY16 Plan generally projects modest growth in all the city's tax bases, based on the assumption that the national and city economy will continue to recover slowly from the deep recession of 2008-2009. These trends are largely consistent with recent economic trends and surveys. Should national and city macroeconomic growth falter over the next five years, however, Plan revenue projections could prove overly optimistic.

School District of Philadelphia: The fiscal problems at the School District of Philadelphia (SDP) present an indirect but serious risk for the City's General Fund and a direct and serious threat to the City's tax base. The failure of the SDP to address publicly identified short-term funding shortfalls, and the failure to timely disclose the extent of the long-term fiscal challenges facing the District and propose remedies to those challenges, underscores the threat the SDP budget presents to the City's fiscal health. Ongoing fiscal challenges at the SDP also impact the City economy insofar as the SDP is one of the largest employers in Philadelphia.

Ameliorated Risks Relative to Prior Plans

It is worth highlighting that two areas of fiscal challenge long cited as a risk to the City by PICA Staff no longer appear as significant areas of concern in this report – the Philadelphia Gas Works and the creation of a Rainy Day Fund.

Tax Revenue and Expenditure Projections

Most City revenues have seen some stabilization and growth over the past year. Overall tax revenues are projected to increase $50.4 million (2.0 percent) from FY11 to FY12. This increase reflects modest percentage increases, ranging from 2.1 percent to 3.6 percent, for all major taxes except the real estate and business privilege tax. City tax revenues are projected to show limited growth over the remainder of the Plan as the City continues to emerge from the recession.

Total FY12 obligations are projected to decline 8.8 percent from FY11, primarily due to the shift of grant funded DHS obligations to the Grants Revenue Fund. Excluding DHS obligations, total FY12 obligations are projected to increase 4.7 percent, primarily driven by increases in School District contributions, debt service, police costs, fleet spending and the first installment of repaying the pension deferment. Few categories change dramatically throughout the remaining years of the Plan. Obligation levels would be greatly impacted, however, by any new labor contracts which increase personnel costs for the City.

Long Term Financial Risks

The PICA Act indicates that the General Assembly intended that the City's Five-Year Financial Plan process should promote both near-term fiscal balance and policy and management changes that would secure the City's long-term fiscal stability. Consistent with these objectives, this section of the report reviews and assesses current City initiatives that address long-term fiscal stability. These initiatives are classified into the following categories: fiscal policies, managerial accountability, tax policy, economic development, and workforce trends.

City Controller's Opinion

As in past years, and as required by the PICA enabling legislation, PICA Staff requested of the City Controller an opinion or certification prepared in accordance with generally accepted auditing standards, with respect to the reasonableness of the assumptions and estimates in the City's FY12-FY16 Five-Year Plan. The City Controller's opinion did find that the assumptions used in the Plan provided a reasonable basis for the City's forecasted statement. However, the report also noted key sensitive assumptions, relating to wage and benefit cost savings as they are dependent on successful labor negotiations; and self-insurance costs which are based on previous premium based costs and are impacted by the uncertainty in the timing and outcome of the appeal of the IAFF arbitration award. The Controller also noted certain uncertainties, including federal funding levels, School District fiscal challenges, and new property tax legislation. A complete copy of the City Controller's transmittal letter and report can be found in Appendix C of this Staff Report.

STAFF RECOMMENDATION

Like many Plans, the Five-Year Plan for FY12-FY16 contains a number of substantial risks. The dramatic changes in public sector benefits necessary to achieve long-term fiscal stability are proceeding haltingly, at times held back by a lack of unified political will among elected City officials that face further challenges in the transition to actual value property assessments. Impacts from ongoing changes in State and federal funding, as well as uncertainty regarding labor contracts and the extent of the fiscal problems at the School District of Philadelphia, present serious fiscal unknowns. The greatest challenge is continuing to balance these risks against very narrow fund balances.

The past three years have established the problems with reliance on too small a reserve. The City has demonstrated the ability to respond to these challenges, but not without two consecutive years of negative end-of-year fund balances and the current estimate of a barely positive balance in FY11. Should significant unexpected problems arise, the City will have little room to maneuver, especially as the number of potential new revenue resources is limited.

Ultimately, in the opinion of PICA Staff, the Plan does present five years of balanced budgets and positive cash balances in each month of the first year of the Plan, using reasonable assumptions, as required by the PICA statute. PICA Staff recommends that the Board of the Pennsylvania Intergovernmental Cooperation Authority approve the revised Five-Year Financial Plan for FY12-FY16 as submitted to the Authority on July 7, 2011.

Pennsylvania Intergovernmental
Cooperation Authority

STAFF REPORT
ON
FY2012-FY2016
FIVE-YEAR FINANCIAL PLAN

SECTION II:

RISKS TO THE PLAN

II. RISKS TO THE PLAN

1. Substantial Risks

A. PENSION LIABILITY

The pension liability presents the greatest threat to the City's fiscal health for three primary reasons: it is the largest fixed cost in the budget; a large part of the risk is beyond the control of the City; and, over the past few decades, the City has failed to address those areas of the pension liability where it does retain control. In fact, some of the areas under City control have been altered in a manner so as to exacerbate the problem. The City's ability to address the myriad challenges of the pension liability are also challenged by the reality of potential long-term structural fixes having short-term costs, and short-term efforts to reduce the impact of large annual pension fund payments worsening long-term structural problems.

Size of the Pension Problem

According to the most recent actuarial valuation of the City's Pension Fund, the Fund should have assets totaling $9.3 billion in order to meet its actuarial liabilities. In fact, the Fund has actuarially valued assets totaling $4.3 billion; the unfunded liability is just over $4.9 billion or 53 percent of the total requirement. These figures represent a rapid decline for a pension fund which had an unfunded liability of 23 percent in FY2001.

This is not just a concern regarding the City's long-term ability to meet its pension obligations. The impact on the General Fund (GF) has been significant. In FY2001, the pension fund contributions from the GF (including fund payments and debt service on Pension Obligation Bonds) totaled $194 million, which equated to 6.7 percent of GF obligations. In FY11, those payments totaled over $492 million or nearly 13 percent of GF obligations, and by FY16 (after contributions deferred in FY10 and FY11 are repaid) those figures are projected by the City's actuary to reach $595 million, or 16.5 percent of GF obligations.

The extent of the Pension Fund deficit may also be somewhat masked by the earnings rate assumptions used in the actuarial analysis, currently set at 8.15 percent (a more detailed discussion of this assumption is found below). A recent government accounting standard proposed by the Governmental Accounting Standards Board (GASB) would require government pension funds to assume an earnings rate equivalent to a 30-year municipal bond rate, or roughly between 3 and 4 percent. Even if this new standard is not utilized in calculating the City's State-mandated annual payment to the Pension Fund, it will still dramatically increase the size of the reported liability with potential consequences for rating agencies and potential investors in City issuances.

For a City with an already high and increasing tax burden, coupled with increasing demand for funding city services and the School District, a single fixed payment which consumes one-sixth of the budget is troubling.

Structural Imbalance in the Pension Fund

PICA has long cited the growing unfunded liability of the Pension Fund as the greatest long-term fiscal challenge facing the City.[1] While a number of challenges have exacerbated the pension problem over the last decade, the fundamental flaw in the current pension system is that contribution levels do not equal benefit levels. This situation led to a pension liability first identified by Mayor Green in 1981, highlighting the need for a $63 million payment in order to fund the system. The slow but steady growth in that liability, which led to the $194 million payment in FY2001, resulted from a pension system with relatively generous benefits, and relatively low contribution levels by active members. With just over 65,000 members, the Philadelphia pension system is one of the largest municipal plans in the country. Employees are eligible to retire at age 60 (50 for uniformed employees) with 10 years of service, at which point they can begin to collect 2.2 percent of the average of their three highest years' earnings times the number of years they work for the first ten years employed (20 years for uniformed employees) and 2 percent of the average of their three highest years' earnings for each additional year worked. These benefits have gravitated toward the more generous among other major city pension plans.

Despite this generous benefit level, non-uniformed City employees contribute less than 2 percent of salary to the Pension Fund, as compared to a national average of over 5 percent, and Commonwealth of Pennsylvania employees who contribute 6.5 percent. Until the recent Police arbitration award, uniformed employees contributed 5 percent of their salary to the fund, as compared to a national average of nearly 8 percent.

From the City side, until FY2003, the city contribution level was based on an actuarially devised funding formula, designed to adequately fund the pension system utilizing a twenty year amortization period. In FY2003, the decision was made to reduce the contribution level from a City determined actuarially derived funding formula to the State's mandated actuarially derived Minimum Municipal Obligation (MMO) payment, utilizing a longer, thirty year amortization period. It should be noted, however, that the City has never taken a "pension holiday" or otherwise reduced its contribution level below its minimum State-mandated payment to fund the Pension Fund.

The 2004 PICA pension report noted that

> In Philadelphia, employee and employer contributions vary by plan, but the average expected employee contribution was 3.63 percent in FY04 and the City's normal cost

[1] A more comprehensive discussion of the problems facing the Pension Fund and recommendations for changes can be found in the PICA Issues Paper: "An Ounce of Prevention: Managing the Ballooning Liability of Philadelphia's Pension Fund" available on the PICA website at www.picapa.org.

was 5.41 percent of payroll for a combined contribution of 9.04 percent. These rates are far below the median for the cities PICA surveyed. The median contribution across the selected cities was 6.00 percent for members and 8.02 percent for the cities. This puts the combined contribution for Philadelphia's system at nearly 5 percent below the median.

This structural imbalance has left the Pension Fund overly reliant on strong investment returns and their inherent risks. Given the Pension Fund's own history, it is unrealistic to believe that outside earnings can make up that unfunded portion while the structural imbalance remains.

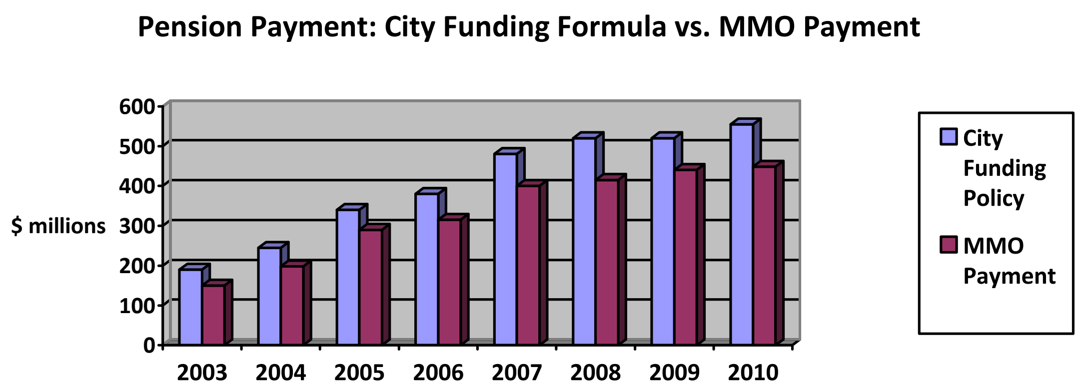
Challenges to the Pension Fund

The dramatic growth in the unfunded liability, and resulting higher GF pension payments resulted from a series of challenges, only some of which were in the City's control. The greatest of these is the risks associated with the dependence on strong investment returns. For the thirty year period from 1981 through 2010, the S&P 500 had an annualized annual return of 10.74 percent; for the period from 1985 through June 30, 2010 the Philadelphia Pension Fund had an annualized annual return of 8.6%.[2] The greater the unfunded liability, the higher the return has to be in order for the fund to achieve asset gains. This risk was most apparent in 2008 and 2009, when sudden and dramatic market losses required sharply higher pension payments, significantly increasing City costs while it was facing a sharp fall-off in revenues.

The City does have some control in this area, as the actuarial valuation includes an assumed earnings rate on the Pension Fund assets. The lower the assumed earnings rate, the lower the risk to the fund from market volatility. At the same time, the higher the assumed earning rate, the lower the minimum General Fund payment required of the City. Until 2005, that assumed rate was 9 percent, among the highest in the country. In part based on the recommendation of PICA and the City Controller, the assumed earning rate has been steadily lowered over time, first to 8.75 percent, then to 8.25 percent in 2009, and now to an 8.15 percent level recommended by the actuary, in 2011. While this change has reduced the Pension Fund's risk profile (though not enough to be considered conservative), it has also increased the City's annual payments in order to make up for the lower rate.

The most dramatic City-controlled impact on the Pension Fund was the decision to switch to the MMO payment in FY03. This change has resulted in the City contributing almost $700 million less over the last eight years, and has required the actuarial valuation to assume that lower contribution level over the thirty-year amortization period. This single decision to free up funds in the short term has placed even larger demands on future generations of Philadelphia taxpayers.

[2] The Pension Board was only able to provide investment return data going back to 1985.



Other direct pension related changes by the City have impacted the system. The Deferred Retirement Option Program (DROP) has had a short term cost of at least $10 million per year, and has had a negative impact on Pension Fund cash flows. In June, City Council passed legislation to make some changes to the DROP program which would reduce its costs to the Pension Fund, but the Mayor vetoed those bills while pressing for complete elimination of the DROP, citing its ongoing cost to the Pension Fund. While City Council could still override the Mayor's veto, failure to eliminate the DROP will continue to have a negative fiscal impact on the Pension Fund and reinforce a widely held sense that some policy makers have failed to comprehend the fiscal consequences of the City's pension fund crisis.

The City code contains a provision for a Pension Adjustment Fund (PAF) which would allow for cost-of-living increases for retiree benefits. If the Pension Fund had returns more than 1 percent greater than the assumed earnings rate, then a formula allocates some of those excess funds to a PAF. When it was created , the PAF allowed for automatic contributions only if the fund was over 70 percent funded, so as to prevent taking resources from a grossly underfunded system. In 2007, City Council passed a bill (over the Mayor's veto) which allowed for automatic contributions to the PAF based solely on rates of return, regardless of the funding status of the Pension Fund.

While the reduction in the City workforce has had fiscal benefits in some areas, its impact on the Pension Fund has been negative in the short term. In particular, as more senior employees have retired and begun receiving benefits, and since many positions have not been replaced, fewer employees are making contributions to the Pension Fund. During this period, the Pension Fund reached a point where more than 50 percent of the participants in the pension system are already retired, so more employees are drawing benefits than are contributing to the system. Among ten of the largest local government defined benefit pension plans in the United States included in a recent study, Philadelphia's retirement system, along with the New York City Police Pension Fund, had the lowest percentage of members who were active workers, at 44 percent.[3]

In the cases of the decision to reduce the contribution level to the MMO, the continuation of the DROP, and the changes to the PAF formula, the City has demonstrated an unwillingness to mitigate the risks and challenges to the Pension Fund which are within its sole control.

Structural Changes to the Pension Fund

The current Administration has taken several steps to address the long-term structural problems with the Pension Fund. In its opening proposals for labor negotiations, and in public comments, it has called for realigning contributions and benefit levels, and consideration of a "hybrid pension plan" which would include a defined benefit option with lower benefit levels then the current plan and higher employee contribution rates, and a defined contribution option, with a partial City match of employee contributions.

It is interesting to note that when these proposals were first made, they were at the vanguard of proposed public pension changes across the nation. Since that time, however, many states and municipalities have moved far beyond the original Administration proposals, as they have grasped that the current systems were unsustainable. Wisconsin, Massachusetts, New York and New Jersey are among those states which have enacted dramatic pension plan reforms, including capping retirement benefits, raising the retirement age, changing pension benefit calculations, eliminating the inclusion of overtime in pension calculations, and raising contribution levels for new hires and current employees. Recent court rulings in Colorado and Minnesota have affirmed the legality of States making changes to certain retiree benefits.

At the municipal level, several cities have proposed or begun to enact changes which go far beyond Philadelphia's proposals, led by Atlanta which lowered the pension multiplier to 1 percent, dramatically increased contribution rates for current and former employees, and capped cost-of-living adjustments for future retirees. The implementation of any similar proposals in Philadelphia would considerably improve the health of the Pension Fund and decrease the risk currently borne by taxpayers.

The Police arbitration award in December 2009 made the first attempt at structural changes, including a hybrid pension option with both a defined-benefit and a defined-contribution plan (the first of its kind in the nation for uniformed employees), and an increase in member contribution levels. These changes only applied to new hires, however, and entering the defined contribution plan was at the employee's option; to date, no employee has chosen to enter the defined-contribution plan which bears the least

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[3] "Robert Novy-Marx and Joshua Rauh, "The Crisis in Local Government Pensions in the United States," in Yasuyuki Fuchita, Richard J. Herring and Robert E. Litan, eds., *Growing Old: Paying for Retirement and Institutional Money Management after the Financial Crisis (Washington, DC:* Brookings Institution Press and Nomura Institute Of Capital Markets Research, 2011), p. 51.

risk to the taxpayer. The October 12, 2010 Fire arbitration award contained similar pension change provisions. Portions of that award have been appealed by the City although the pension changes were not appealed by the City.

In June of 2011, arbitration awards were handed down for the Sheriff's Office Deputies and the Register of Wills employees who are represented by the FOP bargaining unit. Though these units are relatively small, they do demonstrate additional progress on pension issues. Sheriff's Office Deputies will have the choice of maintaining the defined benefit plan while increased contribution levels from 30% of normal cost to 50% of normal cost, or entering into a hybrid plan with a defined contribution element. Register of Wills employees will be required to enter a hybrid pension plan.

Although recent and proposed structural changes are an important step to lowering long-term costs, more medium-term and long-term change is needed then was realized in the uniformed arbitration awards. The City's decision to lengthen the pension amortization period of the Pension Fund and defer a portion of the required payments in FY10 and FY11 only make sense as part of a comprehensive strategy to fix this problem. In such a scenario, these short-term fixes provide temporary relief to the General Fund allowing time for long-term structural changes to take effect. If the short-term measures are not accompanied by changes in the existing structure of Pension Fund benefits, or employee contribution rates, they will not solve the long-term problem. If changes are not made during the current employee contract negotiations, then the City has failed to properly mitigate the risks in the Pension Plan.

B. LABOR CONTRACTS AND THE MUNICIPAL WORK FORCE

Three of the four municipal union employee contracts with the City remain in the negotiation/arbitration process, as employees have been without contracts since 2009. The Plan not only assumes no net increase in costs resulting from new contracts for the life of the Plan, but that the City will realize an annual workforce savings of $11.86 million. While new labor contracts could potentially increase General Fund costs, if the City is successful in achieving its reform objectives, the contracts would positively impact some of the City's long-term fiscal challenges on pensions and health benefits. **Any contracts which increase General Fund costs beyond the City's ability to pay, or fail to realize the savings assumed in the Plan, will require a revision to the Plan. This revision must demonstrate that there are sufficient funds to cover these costs or unrealized savings.**

By far, the City's largest General Fund cost is for personnel. For FY11, projections show that of every dollar City government spends, about 60 cents goes to labor costs. Changes in labor costs can, as a result, have a major impact on the City's finances. Often during budget debates, the focus is on the "choice" between increasing revenues or reducing services. In truth there is another answer – reducing the cost of delivering the service. For the City of Philadelphia, reducing labor costs, whether wage or benefit costs, represents a major opportunity to reduce the cost of service delivery.

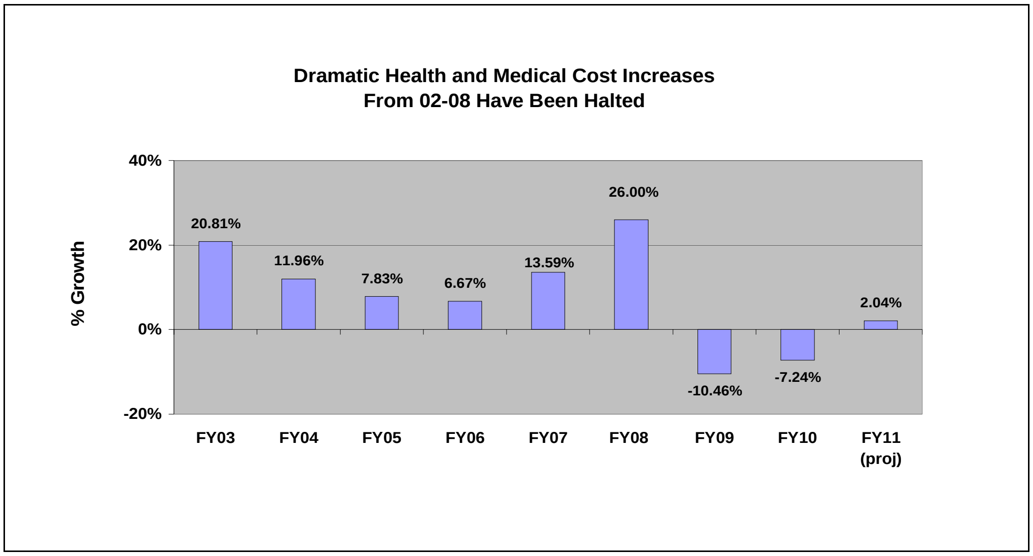
All four labor contracts expired on June 30, 2009. While the City has already reached a contract settlement with the Fraternal Order of Police through the arbitration process, the remaining unions remain in negotiations (with the unions representing non-uniformed employees), and the arbitration process (with the International Association of Fire Fighters). A Fire arbitration award was issued on October 12, 2010 which included some similar provisions to the Police awards, but fewer management tools for the City. The pension provisions (discussed in detail in the first highlighted risk above) were not appealed, but other portions of that award have been appealed by the City and it is unclear when resolution of that appeal will occur. Little progress has been reported in completing negotiations with the unions representing non-uniformed employees.

In June of 2011, the City finalized labor agreements with the Sheriff's Office Deputies and the Register of Wills employees who are represented by the FOP bargaining unit. Though these units are relatively small, they could present harbingers of the larger contracts to follow. The contracts are for five years. Sheriff's Office Deputies' contract includes wage increases of 0, 2.5, 2.5 in the first three years, with a reopener for the last two years; a defined benefit pension plan with higher contribution levels or a hybrid pension plan; a self-insurance health plan similar to the Police contract, and retroactive step and longevity increases Register of Wills employees will have raises commensurate with contracts for the non-uniformed employees when they are settled; will continue in the City administered health plan which has already moved to self-insurance; new employees will be required to enter a hybrid pension plan; and will receive step and longevity increases going forward from the implementation date of the award. The total five year cost of the award is estimated at $2.2 million, which is not included in the Plan projections.

The Plan has significant assumptions about the end result of this process, including no net increase in costs resulting from new contracts for the life of the Plan, but rather that the City will realize an annual workforce savings of $11.86 million per year of the Plan for a total Plan savings of $59.3 million. The Plan also faces the risk of retroactive costs from new labor agreements, a risk which grows in size the longer contracts remain uncompleted. Actual results from FY11 on reduced benefit costs suggest that the City has a reasonable expectation of achieving its target for workforce savings. Work rule changes alone could lead to significant savings, particularly in the City's overtime costs. Benefit changes would have the most significant positive impact on the City's short-term costs while also ameliorating two of the City's most pressing long-term fiscal challenges.

Health Benefits

Over the past decade, health benefit costs have risen dramatically. The labor contracts agreed to in FY09 were the first in a decade to lower the health care costs for the City. In FY02, City health care costs totaled $187.5 million; by FY08, they were $421 million, or more than 11 percent of the total City budget. From FY02 to FY08 these costs rose an astounding 124%;[4] national health care spending for the same period rose an estimated 82%.



The FY09 contracts, for the first time in ten years, reduced health payments by nearly 11 percent and recognized that more could and should be done to control health costs. A Joint Labor-Management Healthcare Evaluation Committee was formed with representatives of all employees to explore various opportunities for efficiencies and savings while preserving a competitive level of benefits. The Police arbitration award in December 2009 made substantial changes to the health/medical plans, including an increase in member co-pays and a switch to self-insurance. The early results from the overall health/medical changes resulted in a decrease in costs of over 7 percent for FY10 and low growth of just over 2 percent estimated for FY11. However, it is unclear what if any changes will be implemented in the remaining contracts currently being negotiated or arbitrated.

These changes over the past several years are having a significant impact. The FY11 budgeted amount for health/medical costs was nearly $369 million, $51 million below the FY08 actual spending figure. Changes in the Police arbitration award and changes instituted by the City for its exempt and non-represented employees are resulting in concrete savings, with the City now expected to have ended FY11 with health/medical costs of about $357 million, or a savings of about $12 million relative to the original projection. This level of savings represents a significant portion of the projected $25 million in annual savings projected in last year's Five-Year Plan, and suggests that the current Plan's savings goal is attainable.

[4] The FY08 health care increase was impacted somewhat by one-time payments associated with renegotiated labor contracts. However, the increase from FY02 to FY07 alone was over 70 percent.

Work Rule Changes

For many years, City managers have highlighted the need for increased management flexibility in administering their workforce. The current labor contracts include many examples of inflexible requirements which prevent the City from functioning in a cost-effective manner. Many of the rules surrounding overtime usage, including the ability to earn overtime when not working a full week, and the ability to make use of flexible schedules, lead to significant costs for the City.

Many of the desired changes in work rules have been proposed by the City in labor negotiations and if implemented could result in better management of City resources and significant savings. The Police arbitration award did increase some management controls over summer vacations, shift rules, and court-related notifications, but it also relaxed the City's residency requirements. The fiscal impact of these changes is not yet quantifiable.

Any contracts that increase General Fund costs above the amounts included in the Plan will require a revision to the Plan that demonstrates sufficient revenues to cover the increased costs.

C. Property Tax Reform

One of the most significant risks facing the FY12-FY16 Plan is the reform of the City's property tax assessment system by the Office of Property Assessment (OPA). From a policy standpoint, this change is clearly desirable and has long been supported by PICA. The new assessment system, the Actual Value Initiative (AVI) is designed to produce property assessments that accurately reflect market value. This change should result in a more legitimate basis for one of the City's major tax revenue sources. Moreover, it should set the stage for a long-term transition toward greater reliance on the property tax as a local tax revenue source by the City, a policy goal advocated by the 2003 Tax Reform Commission and the 2009 Task Force on Tax Policy and Economic Competitiveness. The OPA assessment reforms should have substantial economic benefits and promote long-term financial stability by helping the City create a more viable tax revenue structure. Nonetheless, the transition to the new assessment system poses short-term financial risks.

In the fall of 2012, OPA plans to release new assessed values for the City's approximately 563,000 taxable properties which will be the basis of the 2013 real estate tax. These values are expected to track more closely the actual market value of property. They should improve the overall accuracy and equity of city property assessments, as measured by such standard measures as the coefficient of dispersion and the price related differential.[5] In addition, the new assessment processes should allow assessments to rise

[5] See International Association of Assessing Officers, "IAAO Standard on Ratio Studies," (Kansas City, MO: IAAO, 2007) for definitions of these industry standard measures of assessment accuracy and equity.

and fall over time in a manner consistent with actual trends in the real estate market. City policy-makers, in turn, will be required to set annual tax rates for the City and School District based on the new assessed values, with tax rates set based on anticipated revenue needs. Accountability for tax burdens will be appropriately lodged with elected officials, and fiscal stability will be promoted to the extent that lawmakers are willing to set tax rates consistent with the annual financial requirements of a balanced budget for both the City and the School District.

Unfortunately, the transition to AVI has been muddied as it occurs during a period of consecutive years of property tax increases. The City has already indicated that when it transitions to AVI, it will set the new rate so as to capture the previously unrealized increase in valuations over the last decade. Outside experts have estimated the value of this increase at over 25 percent, but the City will effectively capture about 20 percent based on its estimated revenue figures for FY13, or the same total tax as what residents are currently paying. The unknown[6] is what will happen with the School District portion of the real estate tax, since the School District does not publish revenue estimates beyond one year. If the Mayor and City Council choose to follow a similar model when setting the new AVI based School District property tax rate, the School District would increase collections in FY13 by $120 million over FY11 levels, or $83 million above the new higher tax rate for FY12, again increasing the burden on City taxpayers.

The transition to the new system of assessments has associated with it two major risks: one associated with the timing of the implementation of the system, and the other with the short term effects on property values and taxpayers. Another issue is the relationship between Plan-projected revenues and real estate tax rates projected under current law, and State requirements relative to School District funding under Act 46 of 1998.

Plan Projected Revenues, Tax Rates, and Obligations to the School District

In a letter to the PICA Board,[7] Mayor Nutter, Council President Verna, and Council Members Tasco and Clarke indicated that they planned to levy a FY13 tax rate sufficient to generate the levels of revenue for the real estate tax projected in the FY12-FY16 Plan. The letter highlights that although the tax rate currently in law for FY13 is lower than that of FY12, (.03305 vs. .04123), the lower rate will be more than sufficient to provide the projected real estate tax revenues in FY13 assuming AVI is implemented as planned. The letter provides three possible scenarios for the total aggregate assessments resulting from AVI, and identifies the new tax rate that would be associated with each total assessment scenario. All three scenarios result in tax rates which are far below the tax rate currently in law, thereby making the Plan estimates more conservative than current

[6] Although School District officials have not discussed their estimates for FY13 and beyond, during City Council testimony the City Finance Director and several members of City Council projected that the School District would capture the increase in property values in a manner similar to the City's approach.

[7] A copy of the letter can be found in Appendix A of this report.

law. The City also included a table laying out the three scenarios as an appendix to the final Plan submission to PICA.[8]

The other concern regarding consistency with current law is the increase of 3.85 percent in the School District portion of the real estate tax in FY12, providing an additional $37 million to the School District. Current City law provides that this increase will be only for FY12, with the rate reverting to the FY11 level beginning in FY13. Ordinarily this change would not cause a challenge for the City General Fund. However, under Act 46 of 1998, the State legislation which authorized State governance of the School District, the City cannot reduce tax rates for taxes that support the School District. While the City has applied for a waiver from the State regarding this maintenance of effort requirement (in part due to the need to reset a lower millage rate in conjunction with the transition to AVI), it has not yet been granted.

While it could appear that current law (a lack of a waiver and the lower City tax rate) would require the City to make up the funds elsewhere, that is not the case. If the waiver is granted, the millage will either be reset to the FY11 rate, or under the more likely scenario of the successful transition to AVI, be set to a much lower rate. If no waiver is granted, State law supersedes City law in this matter, and the City will be required to continue the higher FY12 rate. In any of these scenarios, the Five-Year Plan General Fund projections are not affected.

Timing of AVI Transition

In terms of timing, there is uncertainty how policymakers will be able to determine tax rates for FY13, the initial year of the new assessed values, so that revenue generated will be consistent with the City's Five-Year Plan and the School District's FY13 budget. These tax rates will have to be determined before July 1, 2012, while the actual values that these tax rates will be applied to will not be publicized by OPA until fall of 2012. Thus, lawmakers will have to set tax rates based on an estimate of the overall assessed value of City property that OPA will determine. If this estimate is low, an unexpected revenue windfall could result. While this is not a problem for financial stability, it could create political or legal problems for the process of assessment reform which could negatively impact City finances. If City Council's estimate of the aggregate assessed value is substantially higher than the actual OPA-determined value, then their FY13 tax rate will not generate revenue sufficient to meet budgetary targets, which could pose a substantial problem for both the City and School District.

In future years, the Administration has indicated to PICA Staff that the timing of the public release of annual certified assessed values by OPA will occur in the spring, during the annual budget process, allowing elected officials to determine tax rates based upon actual assessments, and allowing the City to project the revenue such tax rates will generate with some degree of certainty. But these values will not be available in time for the initial fiscal year under the new assessment system, FY13. So this timing issue is a one-time problem for the City and School District.

[8] The final Plan submitted by the City on July 7, 2011 is available at PICA's website, www.picapa.org.

Impact on Collection Rates and Values

The second financial risk generated by the move to the new assessment system is the potential effects of the new system on tax collection rates and property values. Past research has suggested that the current assessment system tends to overestimate the value of lower-value properties located in weaker real estate market areas of the city, while underestimating the value of higher-value properties located in stronger markets. In general, the move to more accurate assessments is expected to shift the burden of the real estate tax away from lower valued properties toward higher valued properties. In other words, the percentage of taxes levied on higher value properties is expected to increase. This overall shift could result in substantial increases in tax liability for some taxpayers. The impact of this shift on taxpayers' ability to pay real estate taxes and overall collection rates is unknown. Particularly for taxpayers on fixed incomes, the increase in tax liability associated with the new assessment system could be a problem. To date, the City has not indicated if it has any plans to expand programs to address property tax affordability, such as a property tax circuit breaker policy which would limit property tax liability to a percentage of income.

Another concern is how the new assessment system will affect property values. Changing assessments, according to economic theory, should be capitalized into property values. In other words, property values should increase for those properties with a relatively lower tax burden under the new system, while property values should decrease for those properties that face relatively higher tax burdens under the new system. The magnitude and timing of these effects is unknown. It is also unknown how these changes will affect the real estate market, and the economic viability of neighborhoods that face generally higher tax burdens.

In summary, the transition to a modern, professionalized assessment system under OPA does pose a serious short-term financial risk for the City. However, once completed, the transition should have long-term benefits for the City's economic health and financial stability.

D. State and Federal Funding

As was the case with the FY11-FY15 Plan, the FY12-FY16 Plan could face risks associated with diminishing levels of grant funding from the State and federal government. These risks are related to the expiration of funding under the American Recovery and Reinvestment Act (ARRA), fiscal stress at the State, and the ongoing effort to reduce the federal budget deficit. The City relies on a wide array of formula based and discretionary State and federal grants to support a range of services, particularly those related to health, human services, and housing. Diminished levels of resources for these programs could result in pressure to increase City tax support for these programs over the next five years.

For programs such as services to the homeless that meet basic needs, but are not generally subject to State mandates, the City will be faced with a basic policy choice of whether to continue to support levels of service that have been maintained in recent years largely through federal and state grants. This choice is even difficult against the backdrop of high fixed costs such as pension funding, health benefits, and high debt service. ARRA funding, for instance, has been utilized to fund homeless prevention programs, with $7.2 million budgeted in FY12 for this purpose. With the expiration of these funds, the City will face the choice of whether or not to fund these programs to continue to make progress at addressing the needs of the homeless and implementing its long term strategies for ending chronic homelessness.

Funding reductions could also affect various other areas, including the Police Department, court system, economic development, and housing programs. The City recently announced $16.5 million in reductions in housing programs across a number of agencies due to federal and State funding cuts.[9] Other reductions of this nature are possible in the future given the fiscal pressures facing federal and State government. How this will impact City finances remains to be seen.

As shown in Table 2.1, across most programmatic areas of City government, total spending across all operating funds is projected to increase modestly or decline from FY08 through FY11. With the exception of the other citizen services category, General Fund obligations are estimated to make up a smaller proportion of total obligations in FY11 than in FY08. Since spending outside the General Fund is supported primarily by federal and State grants, this trend indicates how grant funding has been increasingly important to the City in recent years. Despite significant reductions in some local tax revenues since FY08, the City has generally been able to maintain service levels, or avoid significant service reductions, due to increases in grant funding.

The risk for the FY12-FY16 Plan is that should the level of funding from State and federal government continue to decline over the next five years, the City may need to consider using locally generated funds to support these programs.

[9] "Philadelphia Proposes $16.5 Million Cuts to Housing Agencies," Marcia Gelbart and Jeff Shields, *Philadelphia Inquirer* (May 20, 2011).

Table 2.1. Obligations for Major Program Categories, General Fund and All Operating Funds, FY08-FY11 ($ in millions)

Program and Fund	FY08 Actual	FY09 Actual	FY10 Actual	FY11 Est.	Percent Change, FY08-FY10	Percent Change, FY08-FY11
Public Safety						
General Fund	944.9	978.0	972.2	954.2	2.9	1.0
All Funds	972.7	1,009.2	1,006.4	997.3	3.5	2.5
Court System						
General Fund	213.2	208.9	196.9	194.9	(7.6)	(8.6)
All Funds	261.2	257.2	248.2	255.0	(5.0)	(2.4)
Health and Human Services						
General Fund	779.3	762.6	717.2	703.5	(8.0)	(9.7)
All Funds	1,056.5	1,098.1	1,127.5	1,272.2	6.7	20.4
Economic Development						
General Fund	81.2	63.7	59.5	44.8	(26.7)	(44.8)
All Funds	265.2	231.4	229.2	301.4	(13.6)	13.7
Education						
General Fund	61.7	65.2	65.0	64.2	5.4	4.1
Other Citizen Services						
General Fund	586.7	526.1	513.2	490.3	(12.5)	(16.4)
All Funds	721.9	580.2	583.6	575.5	(19.2)	(20.3)
Administrative Services						
General Fund	407.9	402.6	371.7	403.3	(8.9)	(1.1)
All Funds	508.4	606.0	479.7	571.5	(5.6)	12.4

Note:

1. FY11 figures are estimates from the *Mayor's Operating Budget for Fiscal 2012*, while the FY08-FY10 figures are actual obligations from the annual *Supplemental Report of Revenues and Obligations*.

2. Because of the need to budget sufficient appropriation authority to allow for expenditure of unanticipated grants, estimated figures, which typically reflect budgeted amounts for grants, are likely to be higher than actual amounts.

E. NARROW FUND BALANCES

For the fourth consecutive year, the proposed Plan includes relatively narrow fund balances, ranging from $28.5 million to $71.4 million. While these figures represent a substantial amount of money, they equate to an average surplus of only 1.4% of expected General Fund revenues. That scenario is the equivalent of a family with a household income of $50,000 setting aside $700 per year to cover unexpected emergencies.

The Government Finance Officers Association (GFOA) has long recommended that municipalities should plan for a fund balance that ranges from five to fifteen percent of revenues in order to properly hedge against short-term fiscal risks. Philadelphia would need to budget for a fund balance of $175 million in order to achieve the minimum fund balance recommended by the GFOA.

The last three years have demonstrated the dangers of relying on such a narrow reserve. In FY09 and FY10, the City ended the year with a negative fund balance. Even though the City made hundreds of millions of dollars in expenditure cuts and revenue increases over the FY09-FY10 period, the City was unable to end either year with a positive fund balance.[10] FY11 is currently projected to end the year with a mere $3.4 million positive balance, and could ultimately turn negative if State reimbursements are received after August 30.

In light of the numerous fiscal risks highlighted in this report, and two years of negative fund balances, the narrow fund balances in the Plan present one of the most significant risks to the short-term fiscal health of the City. However, while they do not represent prudent fiscal policy, these narrow balances do not, in of themselves, provide a rationale for concluding the likelihood of imbalance in the City's financial operations during the Plan period.

3. Additional Risks

A. MACROECONOMIC TRENDS

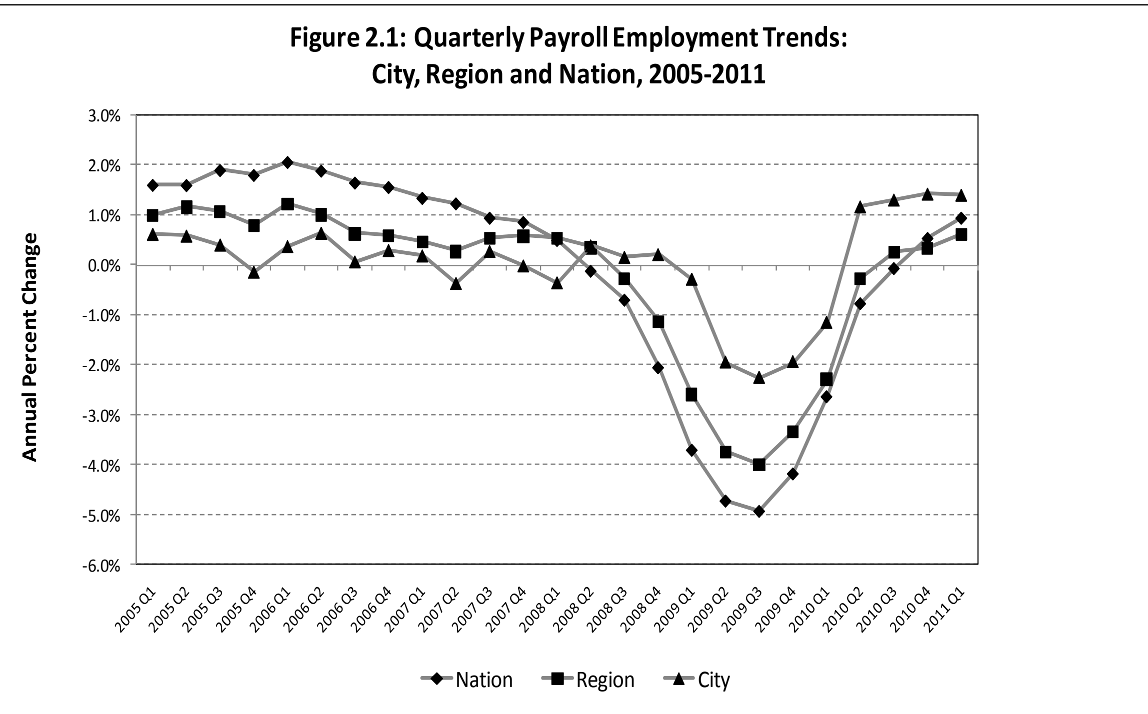
An additional area of risk to the Plan is the performance of the city economy over the next five years. The primary source of the financial crisis of 2008-2010 was the deterioration of the national economy and real estate market which had significant effects on growth in major city tax revenues, particularly in the real estate transfer tax, wage and earnings tax, sales tax, and business privilege taxes. The financial stability that has been achieved in the past year has resulted from short term and recurring tax increases, expenditure cuts, and, importantly, the return to modest growth in the city's major tax bases. The FY12-FY16 Plan generally projects modest growth in all the city's tax bases,

[10] The FY09 fund balance of negative $137 million was artificially low as it includes a delayed payment from the state for DHS reimbursements of $45 million. If those funds had been received on time, the FY09 ending balance would have been negative $92 million.

based on the assumption that the national and city economy will continue to recover from the deep recession of 2008-2009. Should national and city macroeconomic growth falter over the next five years, Plan revenue projections could prove overly optimistic.

The city's economic performance during the recession of 2008 and 2009 was somewhat stronger than the region and the nation. Figure 2.1 presents quarterly payroll growth trends from 2005 through the first quarter of 2011 for the nation, the Philadelphia-Wilmington-Camden metropolitan area, and the city. While city employment growth generally lagged that of the region and nation through the first half of calendar 2008, since that time city employment has outperformed that of the region and nation. This apparently reflects the high concentration of the city economy in education and health services, two large economic sectors that are relatively stable over the business cycle. In fact, city payroll employment returned to positive growth in the second quarter of 2010, two quarters before national employment began to increase.

Relative to other cities during the recession, Philadelphia saw less volatility in its overall tax base because of its concentration in relatively recession-proof economic sectors which resulted in the relative stability of the wage and earnings tax, the major source of tax revenue for the General Fund. From a fiscal year perspective, the wage and earnings tax base had its worst year in FY10, declining 0.4 percent in nominal terms, before increasing 3.2 percent in FY11. This relative stability in the wage tax base was a major factor that mitigated the impact of the recession on City finances.



Source: U. S. Department of Labor, Bureau of Labor Statistics, Current Employment Statistics, Non-Farm Payroll Employment, Not Seasonally Adjusted

The economic assumptions underlying Plan revenue projections are indicated by the FY12-FY16 Plan projected annual rates of tax base growth for the City's major General Fund taxes. These growth rates are presented in Table 2.1. These rates are base growth rates prior to any adjustments for rate changes or collection level changes. Base growth rates for the wage, earnings, and sales taxes range from 3.1 to 4.0 percent over the Plan period. These growth rates are generally consistent with actual growth in FY11, which was 3.2 percent for the wage and earnings tax and 4.2 percent for the sales tax. The Plan assumes that these tax bases will continue their recent pattern of modest growth over the next five years. Should economic growth slow over the next five years, revenues could drop significantly below projections.

The annual base growth for the business privilege, net profits, parking, and amusement taxes are generally projected at 2.5 percent. The real estate transfer tax base is projected to increase 3 percent in FY12, 5 percent in FY13 and FY14, and 4 percent in FY15 and FY16. The relatively high rate of growth projected in FY13 and FY14 reflects the assumption that this tax base will grow relatively rapidly in the near term as the market recovers from recent declines.

Table 2.1. Annual Projected Tax Base Growth, Major General Fund Taxes, FY12-FY16

Tax	**FY12 Est.**	**FY13 Est.**	**FY14 Est.**	**FY15 Est.**	**FY16 Est.**
Wage and Earnings	3.4	4.0	3.4	3.2	3.1
Real Estate	0.0	--[1]	1.3	1.3	1.3
Business Privilege	(0.4)	2.5	2.5	2.5	2.5
Net Profits	2.5	2.5	2.5	2.5	2.5
Sales	3.5	4.0	3.4	3.2	3.1
Real Property Transfer	3.0	5.0	5.0	4.0	4.0
Parking	2.5	2.5	2.5	2.5	2.5
Amusement	2.5	2.5	2.5	2.5	2.5

Notes:

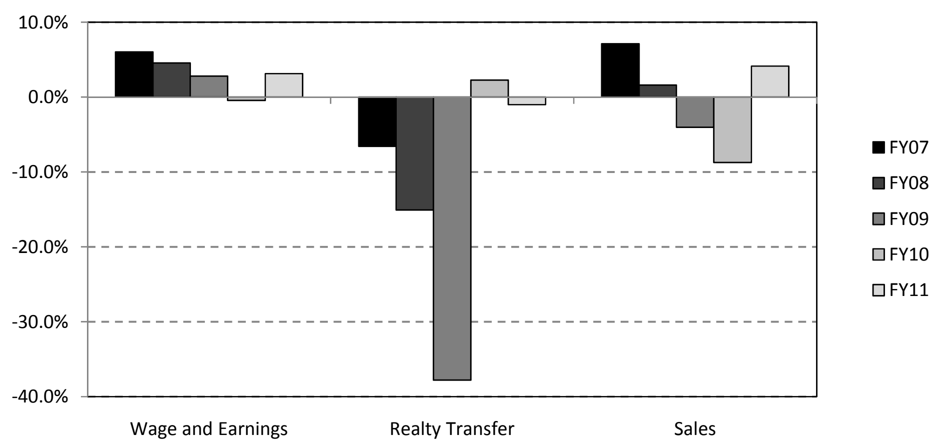
1. Because of the implementation of the Actual Value Initiative in FY13, it is not possible to calculate the growth of the real estate tax base in this year. Actual real estate assessment growth in this year will depend on market trends and the extent to which assessments under AVI reflect actual market values of property in the city.

The base of the real estate tax is the aggregate assessed value of taxable real estate in the city. This value is projected to be unchanged in FY12, due to a moratorium on assessment changes by the Office of Property Assessment (OPA) for 2012. The projected base change in FY13 cannot be calculated because the assessed values for the 2013 tax year will reflect the new higher values as a result of OPA's Actual Value Initiative (AVI). These values will be significantly higher than the 2012 values, and more reflective of market value. At this time, the magnitude of the increase is unknown. The City indicates that the aggregate assessments could range from $36 to $43 billion, a level that is 3 to 3.6 times the FY12 level.

Aggregate assessments, after taking account for the impact of successful appeals, are projected to increase 1.3 percent annually from FY14 through FY16. Under AVI, the City plans to annually revalue all taxable properties citywide and make adjustments based on actual market trends. The assumption of 1.3 percent growth beginning in FY14 reflects an assumption of a modest recovery in the housing market.

The risk implicit in the Plan's tax revenue projections is apparent from the contrast between the stable base growth projected for the FY12-FY16 period and the trends of the past five years, as shown in Figure 2.2. The City's major tax revenue sources are clearly linked to economic trends. This will be true to an even greater extent with the implementation of AVI, which will ensure that real estate assessments follow market trends more closely than in the past. Should the economy return to a period of slower growth or recession over the FY12-FY16 period, the Plan's projections of tax revenues may not be realized.

Figure 2.2: Annual Tax Base Growth, Major General Fund Taxes, FY07-FY11 (Estimated)



B. SCHOOL DISTRICT OF PHILADELPHIA

The fiscal problems at the School District of Philadelphia (SDP) present an indirect but serious risk for the City's General Fund. Improved educational achievement is a stated priority of the Administration, and is clearly supported by other City officials based on their actions this spring to increase funding by increasing the tax burden for City residents. The failure of the SDP to address publicly identified short-term funding short falls, and the failure to publicly present either the extent of the long-term fiscal challenges facing the District or make timely proposals to remedy those challenges, underscores the threat the SDP budget presents to the City's fiscal health. Ongoing fiscal challenges at the SDP also impact the City economy insofar as the SDP is one of the largest employers in Philadelphia.

There is no question that a functional public education system plays a significant role in the vibrancy of any municipality. In Mayor Nutter's own report on achieving his key educational goals, it states that "Philadelphia's young people and adults must be well-educated to support a safe, economically vibrant, thriving city."[11] While improving and sustaining an educational system which meets this need requires certain funding levels, the SDP has been faced with several challenges to its funding stream in the past year, in particular due to changing funding formulas of the State and the completion of certain federal stimulus education grants.

Of greatest concern is the failure of the SDP to anticipate obvious changes in intergovernmental funding policies and to take corrective actions to its fiscal challenges in a timely fashion. The City had announced its assessment freeze related to the AVI transition in 2009, effectively freezing real estate tax growth. In the fall of 2010, prior to the release of new state funding levels, the SDP was already warning of projected budget deficits of several hundred million dollars. Despite these warnings, the SDP had no public discussions regarding opportunities to reduce expenditure levels, made no changes in its current year obligations, and did not prepare contingency plans to handle the projected deficit. Even though the changes in state funding were anticipated to some degree, the SDP failed to present viable options for addressing the over $600 million projected deficit until the beginning of May, well after the state funding levels had been released and leaving little time for corrective actions.

This approach contrasts with the City's approach to addressing the challenges that arose from the recession in 2008. Due in large part to the requirements of PICA's Five-Year Plan process, within months of the fiscal collapse, the City presented a rebalancing Plan which addressed the projected deficit for FY09 through FY13 through a combination of revenue and obligation changes. The extent of the deficit and the necessary spending cuts were publicly identified and debated, allowing for community participation and input. Most importantly, the City began implementing those changes immediately, rather than letting the problem grow unchecked.

The greatest challenge is that what will be required ultimately to achieve the long-term fiscal stability of the SDP is unknown. The SDP has failed to produce a balanced long-term fiscal plan, though one is expected in September, as required under the accountability agreement signed between the SDP, the City and the State. Until those challenges are identified, the extent of the risk to the City's fiscal health remains a question mark.

[11] "Shaping an Educated City: Two-Year Report on the Mayor's Education Goals, January 2008-December 2009," Mayor's Office of Education.

A. Ameliorated Risks From Prior Plans

It is worth highlighting that two areas of fiscal challenge long cited as a risk to the City by PICA Staff no longer appear as significant areas of concern – the Philadelphia Gas Works and the creation of a Rainy Day Fund.

A. PHILADELPHIA GAS WORKS

The Philadelphia Gas Works (PGW) has been cited as a significant risk to City finances since 2000. The combination of high debt levels, annual structural deficits, low collection rates, elevated personnel costs and insufficient capital investment all contributed to a dangerous risk profile for PGW. Perhaps of greatest concern was that PGW's annual financial plans were often based on uncertain propositions ranging from dramatic rate increases granted by the Pennsylvania Public Utility Commission, to new federal funding, to the implementation of new technologies. A precarious fiscal situation was coupled with unrealistic proposals for improvement.

PGW's present fiscal situation is drastically different. Although still high, PGW's $1.2 billion in outstanding debt is nearly $80 million below 2008 levels, and continues to undergo restructuring to reduce its risk profile. PGW is able to fund $24 million in annual capital improvements from operating funds and has improved its cash liquidity from negative $88.6 million in 2000 to positive $80 million in 2011. Collection rates are at industry standards and consistent, and the utility has been able to restore its annual $18 million payment to the City. Staffing levels, employee costs, and company management controls continue to improve. As in the last several years, PGW has established a series of initiatives aimed at gaining fiscal security. Unlike the recent past, not only do these initiatives have some likelihood of success, the fiscal stability of PGW is not predicated on the success of these initiatives.

On August 3, 2010, Standard & Poors increased PGW's bond ratings from BBB- to BBB, not only recognizing that PGW's fiscal situation is improving, but also resulting in significant interest savings for PGW as it accesses the capital market. The progress is significant but not complete; PGW continues to suffer from its treatment by some as a social service agency, with discounts for low-income and senior clients which shift the burden to the remaining customers, leading to rates that are among the highest in the nation. Structural challenges, an expensive workforce, and an outstanding $1.2 billion in debt continue to require attention, but PGW is far more fiscally stable than at any point in the last eleven years.

B. RAINY DAY FUND

The establishment of a Rainy Day Fund has been one of the key long-term fiscal concerns for PICA since the November 2000 release of its issues paper "Philadelphia's Fiscal Challenge: Finding A Way To Save." As that paper noted, Rainy Day Funds provide an important tool for governments to handle hard to predict economic downturns. They serve as an alternative to raising taxes, cutting services, or incurring debt. Additionally, emergency reserve funds are perceived favorably by credit agencies, and have been cited by rating agencies as examples of prudent financial management and increased financial flexibility.

The advantages of such an emergency fund are even more evident today than they were ten years ago. The economic challenges of the past few years engendered budget crises which forced municipalities and states across the nation to face sudden service cuts and/or tax increases. Those entities which had reserve funds were not only better able to weather the storm, but also had more time to identify the best means for making revenue and expenditure decisions going forward. For Philadelphia, the need for emergency reserves is even more acute. Unlike the situation in 2000, the City's Five-Year Plan contains very narrow projected fund balances - less than 2 percent of projected revenues in every year of the Plan. The City has little room to adjust to sudden changes in revenues or unexpected expenditure needs.

In PICA's 2000 report, we noted the key characteristics of a successful emergency fund – a clear mechanism for making contributions, goals for the size of the fund, and strict limitations on withdrawal procedures from the fund. Best practices dictate that the fund rely not just on optional contributions on an annual basis, but also that specified percentages of either a year end fund balance, or excess revenues, trigger an automatic contribution to the fund.

In April, City Council unanimously passed a bill which would put the creation of a Rainy Day Fund (formally called the Budget Stabilization Reserve), on the ballot for voter consideration in November 2011. If approved, the city will have to put 0.75 percent of its unrestricted local General Fund into the reserve each year. The city would not have to put money in during difficult years - payments are required only if at least 3 percent of the previous year's budget carries over. The fund would be capped at 5 percent of general-fund appropriations, about $190 million. The reserve includes strict parameters for when the funds can be tapped. Assuming voter approval, the City will finally have its long needed Rainy Day Fund.

Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT ON FY2012-FY2016 FIVE-YEAR FINANCIAL PLAN

SECTION III:

REVENUE AND EXPENDITURE PROJECTIONS IN THE PLAN

III. PLAN REVENUE AND EXPENDITURE PROJECTIONS

A. Changes in the Plan from Proposed to Final: Overview

Between the Administration's original Five-Year Plan presented to City Council on March 3 and the final Five-Year Plan (Plan) submitted to PICA on July 7, there were some changes to revenues and obligations. These changes are summarized in Table 4.1.

Table 4.1. Summary of Changes in from Initial Proposed to Final FY12-FY16 Five-Year Financial Plan ($ in Millions)

Category	FY10 Actual	FY11 Est.	FY12 Est.	FY13 Est.	FY14 Est.	FY15 Est.	FY16 Est.	FY12-FY16 Total
Initial Plan								
Revenues	3,654.3	3,933.5	3,470.0	3,586.7	3,616.4	3,527.1	3,584.9	17,785.1
Obligations	3,653.7	3,830.4	3,457.0	3,599.3	3,634.6	3,578.8	3,604.9	17,874.7
Prior-Year Adjustments	22.6	24.5	24.5	24.5	24.5	24.5	24.5	122.5
Operating Surplus/(Deficit)	23.2	127.6	37.4	11.9	6.3	(27.2)	4.5	32.9
Prior-Year Fund Balance	(137.2)	(114.0)	13.5	51.0	62.9	69.2	42.0	
Year-End Fund Balance	(114.0)	13.5	51.0	62.9	69.2	42.0	46.4	
Final Plan								
Revenues	3,654.3	3,895.9	3,502.7	3,597.9	3,616.1	3,530.1	3,593.0	17,839.8
Obligations	3,653.7	3,802.9	3,470.1	3,611.6	3,646.9	3,591.1	3,617.2	17,936.8
Prior-Year Adjustments	22.6	24.5	24.5	24.5	24.5	24.5	24.5	122.5
Operating Surplus/(Deficit)	23.2	117.5	57.1	10.8	(6.3)	(36.5)	0.3	25.5
Prior-Year Fund Balance	(137.2)	(114.0)	3.5	60.6	71.4	65.1	28.6	
Year-End Fund Balance	(114.0)	3.5	60.6	71.4	65.1	28.6	28.9	
Change from Initial to Final Plan								
Revenues	--	(37.6)	32.7	11.2	(0.4)	3.0	8.1	54.7
Obligations	--	(27.5)	13.1	12.3	12.3	12.3	12.3	62.1
Prior-Year Adjustments	--	--	--	--	--	--	--	--
Operating Surplus/(Deficit)	--	(10.1)	19.7	(1.0)	(12.6)	(9.3)	(4.1)	(7.4)
Prior-Year Fund Balance	--	--	(10.1)	9.6	8.6	(4.0)	(13.4)	
Year-End Fund Balance	--	(10.1)	9.6	8.6	(4.0)	(13.4)	(17.5)	

The Plan includes reduced revenue estimates of $37.6 million in FY11, but a total increase of $54.7 million over the FY12-FY16 period. The FY11 reduction occurs primarily as a result of reductions in revenues from other governments associated with later than anticipated reimbursements for Department of Human Services (DHS) expenditures. The revenue increase over the FY12-FY16 period occurs primarily in the first two years of the Plan, and primarily reflects increases in revenue from other governments associated with DHS reimbursements. These increases are the result of the delayed reimbursements that resulted in decreases in FY11 estimated revenues.

Estimated FY11 obligations are reduced by $27.5 million in the Plan, reflecting lower debt service requirements and a number of smaller reductions across purchase of services. Obligations over the FY12-FY16 period are increased by $62.1 million, reflecting a $50 increase in the City's subsidy to the School District of Philadelphia (SDP) and modest increases in other departments. The net result of the changes in revenues and obligations is to decrease the FY11 estimated operating surplus by $10.1 million, and the combined FY12-FY16 operating surplus by $7.4 million. In the final Plan, the year end fund balance decreases by $10.1 million in FY11. The estimated year-end balance increases by $9.6 million and $8.6 million in FY12 and FY13, respectively, and decreases by $4.0 million in FY14, $13.4 million in FY15, and $17.5 million in FY16.

The Plan projects the year-end fund balance will increase from $3.5 million in FY11 to $71.4 million in FY13, before declining to $28.6 million in FY15 and $28.9 million in FY16. As was the case with the approved FY11-FY15 Five-Year Plan, the year end balances are very small in relation to the overall General Fund budget, representing 0.8 percent of revenues in FY16. The final Plan includes little provision for events that could decrease revenues or increase obligations from Plan-projected levels over the next five years. Given the magnitude of the potential risks facing the Plan, this is again cause for concern.

B. *Changes in the Plan from Proposed to Final: Revenues*

Table 4.2 presents details of the changes in revenues from the initial to the final Plan. Total General Fund revenues are projected to be $37.6 million lower in FY11 in the final Plan, and $54.7 million higher in the FY12-FY16 period.

The Plan projects cuts in the wage, earnings, and net profits tax rates that are smaller than those in the originally proposed Plan. The impact of this change is to increase wage and earnings tax revenues by $21.2 million and net profits tax revenues by $0.2 million over the FY12-FY16 period. For a resident making $50,000 this equates to $4.75 less in tax reductions in FY16. The Plan also reflects a $10.0 million increase in estimated FY11 revenue from the business privilege tax (BPT). However, the Plan does not increase the estimate of BPT revenue over the FY12-FY16 period, despite the higher FY11 projection, because of the volatility of business net profits which are a prime determinant of revenues from this tax. In tax year 2009, approximately 74 percent of BPT revenues derived from the portion of the tax levied on net income, and the remainder from the gross receipts tax.

The Plan includes a $2.5 million downward revision in the estimate for real estate transfer tax revenues in FY11, due to weaker than anticipated collections. This revision is carried forward into the FY12-FY16 projections, with total revenue from this tax projected to be $14.1 million lower over the life of the Plan. Overall, tax revenues in the Plan are projected to be $7.2 million higher than in the initial Plan, primarily because of the additional wage, earnings, and net profits tax collections projected from the more modest tax rate decreases projected in FY14 through FY16.

Table 4.2. Changes in Projected Revenues from March 3 Proposed Plan to July 7 Final Plan, FY12-FY16 ($ in Millions)

Category	FY11 Est.	FY12 Est.	FY13 Est.	FY14 Est.	FY15 Est.	FY16 Est.	FY12-FY16 Total
Taxes							
Wage and Earnings	--	--	--	3.3	6.7	11.1	21.2
Business Privilege	10.0	--	--	--	--	--	--
Net Profits	--	--	--	--	0.1	0.1	0.2
Real Property Transfer	(2.5)	(2.6)	(2.7)	(2.8)	(3.0)	(3.1)	(14.1)
Total	7.5	(2.6)	(2.7)	0.5	3.8	8.2	7.2
Locally Generated Non-Tax							
Division of Technology	(1.9)	--	--	--	--	--	--
Police	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)	(5.0)
Streets	(11.3)	--	--	--	--	--	--
Fire	(1.8)	--	--	--	--	--	--
Recreation	0.1	--	--	--	--	--	--
Public Property	2.0	--	--	--	--	--	--
Fleet Management	1.0	--	--	--	--	--	--
Licenses and Inspections	2.8	1.0	--	0.1	--	--	1.2
Records	(1.8)	(1.9)	(1.0)	--	--	--	(2.9)
Finance	1.4	--	--	--	--	--	--
Revenue	(2.3)	(8.8)	(10.8)	(10.8)	(10.8)	(10.8)	(52.0)
City Treasurer	0.5	--	--	--	--	0.8	0.8
City Representative	--	0.1	0.1	0.1	0.1	0.1	0.4
Clerk of Quarter Sessions	8.0	--	--	--	--	--	--
Register of Wills	(0.5)	--	--	--	--	--	--
Sheriff	(4.0)	--	--	--	--	--	--
Total	(8.7)	(10.6)	(12.6)	(11.6)	(11.7)	(10.9)	(57.4)
Revenues from Other							
Police	(1.0)	--	--	--	--	--	--
Human Services	(59.9)	37.1	15.8	--	--	--	52.9
Finance	1.0	8.8	10.8	10.8	10.8	10.8	52.0
City Treasurer	11.5	--	--	--	--	--	--
Total	(48.4)	45.9	26.6	10.8	10.8	10.8	104.9
Revenues from Other Funds	12.0	--	--	--	--	--	--
Total	(37.6)	32.7	11.2	(0.4)	3.0	8.1	54.7

In the local non-tax revenue category, Police Department reimbursements are projected to be $5 million lower over the FY12-FY16 period. The Plan categorizes the City share of gaming revenue as revenue from other governments received by the Office of the

Director of Finance rather than locally-generated non-tax revenue received by the Revenue Department, resulting in a shift of $52 million from local non-tax revenue to revenue from other governments. As a result of these changes, and other minor changes in other agencies, the Plan projects total locally-generated non-tax revenue to be $8.7 million lower in FY11 and $57.4 million lower over FY12-FY16.

The Plan also reflects a delay in the federal Title IV-E and State Act 148 reimbursement in the Department of Human Services (DHS). This delay reduces FY11 projected DHS revenues by $59.9 million, while increasing revenues by $52.9 million over FY12-FY16. Overall revenues from other governments are projected to be $104.9 million higher in the Plan. Revenues from other funds are projected $12 million higher in FY11due to higher than anticipated reimbursements for 911 costs from the Grants Revenue Fund.

C. Changes in the Plan from Proposed to Final: Obligations

Obligation changes between the proposed and final Plan are presented in Table 4.3. The Plan reflects a $10 million annual increase in the City's subsidy to the School District of Philadelphia (SDP), which was proposed by City Council and agreed to by the Administration, in order to address the SDP's FY12 budget deficit. Because the City cannot reduce its annual contributions to SDP under State Act 46 of 1998, the decision to increase the City's FY12 appropriation to SDP will require it to maintain that level in FY13 and beyond. The Plan reflects this requirement.

The Plan transfers $14 million in obligations over the FY12-FY16 period from the Prisons to the First Judicial District. This funding will be used to support an expansion of the electronic monitoring program financed through the court budget. This initiative is expected to result in reduced Prisons obligations. The Plan also increases projected obligations for the Office of Housing and Community Development (OHCD) by $500,000 annually to allow expansion of the OHCD vacant lot cleaning program. The projected obligations for Legal Services are increased by $500,000 from FY12 to FY16, to reflect increased contributions to the Defenders' Association of Philadelphia. In addition, the Plan reflects an increase in projected Streets Department obligations of $1.0 million in FY12 and $0.7 million in FY13-FY16 to provide additional support for City-owned alley lights.

There are a number of other relatively small changes in projected obligations in the Plan. Compared to the initial Plan, the final Plan projects FY11 obligations to be lower by $27.6 million, and combined FY12-FY16 obligations to be higher by $62.2 million.

Table 4.3. Changes in Projected Obligations from Initial to Final Plan, FY11-FY16 ($ in Millions)

Agency/Cost Center	FY11 Est.	FY12 Est.	FY13 Est.	FY14 Est.	FY15 Est.	FY16 Est.	FY12-FY16 Total
City Controller's Office	0.1	--	--	--	--	--	--
City Commissioners' Office	0.4	0.3	0.2	0.2	0.2	0.2	1.3
Commerce	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.4)
Debt Service	(13.1)	--	--	--	--	--	--
District Attorney's Office	0.1	--	--	--	--	--	--
Fire	--	0.3	--	--	--	--	0.3
First Judicial District	--	4.0	2.5	2.5	2.5	2.5	14.0
Fleet Management	1.5	--	--	--	--	--	--
Free Library	--	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.5)
Fringe Benefits	--	0.1	0.1	0.1	0.1	0.1	0.5
Housing and Community	--	0.5	0.5	0.5	0.5	0.5	2.5
Human Services	(15.0)	--	--	--	--	--	--
Indemnities	(1.8)	--	--	--	--	--	--
Legal Services	--	0.5	0.5	0.5	0.5	0.5	2.5
Licenses and Inspections	(3.0)	--	--	--	--	--	--
Managing Director's Office	--	0.1	0.1	0.1	0.1	0.1	0.4
Mural Arts Program	--	0.1	--	--	--	--	0.1
Office of the Director of Finance	1.9	--	--	--	--	--	--
Office of the Mayor	--	0.1	0.1	0.1	0.1	0.1	0.7
Parks and Recreation	--	0.2	0.2	0.2	0.2	0.2	1.1
Prisons	--	(4.0)	(2.5)	(2.5)	(2.5)	(2.5)	(14.0)
Refunds	(0.1)	--	--	--	--	--	--
School District Subsidy	--	10.0	10.0	10.0	10.0	10.0	50.0
Streets	1.6	1.0	0.7	0.7	0.7	0.7	3.6
Total	(27.6)	13.1	12.3	12.3	12.3	12.3	62.2

D. Revenues: FY12-16 Assumptions

The projected revenues in the Plan reflect estimated revenues in FY12, the initial year of the Plan, as well as projected growth rates in FY13 to FY16, the out years of the Plan. This section discusses the major assumptions that underlie the Plan's projected revenues, beginning with a discussion of the FY12 revenue estimates, followed by a discussion of projected growth rates in the out years. Table 4.4 presents the FY12 revenue estimates in relation to FY10 actual revenues and FY11 estimated revenues by category. Total FY12 General Fund revenues are projected at $3,502.7 million, a decline of 10.1 percent from FY11, primarily due to an accounting change relating to Department of Human Services revenues.

Table 4.4. General Fund Revenues, FY10 Actual through FY12 Estimated ($ in Millions)

Revenue Category	FY10 Actual	FY11 Est.	FY12 Est.	Percent Change, FY11-FY12	Average Annual Percent Change, FY10-FY12
Taxes					
Real Estate	402.2	488.7	486.7	(0.4)	10.0
Wage and Earnings	1,114.2	1,149.9	1,188.6	3.4	3.3
Business Privilege	364.7	370.8	369.3	(0.4)	0.6
Net Profits	14.5	17.1	17.5	2.1	9.7
Sales	207.1	247.5	256.5	3.6	11.3
Real Property Transfer	119.2	117.3	120.9	3.0	0.7
Parking	70.5	72.5	74.3	2.5	2.7
Amusement	21.9	21.1	21.6	2.5	(0.5)
Smokeless Tobacco	--	1.0	1.0	--	NA
Other	2.4	3.1	3.1	1.0	14.0
Total	2,316.6	2,489.0	2,539.5	2.0	4.7
Locally-Generated Non Tax					
Division of Technology	13.8	20.8	18.7	(9.8)	(16.5)
Streets	6.4	16.8	24.0	43.2	94.3
Fire	34.6	35.4	37.2	5.1	3.6
Licenses and Inspections	44.5	46.0	46.5	1.0	2.3
Records	16.0	16.2	17.1	5.2	3.4
First Judicial District[1]	39.6	50.1	42.6	(15.0)	3.7
Other	74.5	80.8	73.9	(8.6)	(0.4)
Total	229.4	266.1	260.0	(2.3)	6.5
Revenue from Other					
Public Health	50.6	58.8	58.8	--	7.8
Human Services	487.3	486.6	59.8	(87.7)	(65.0)
Finance	147.6	151.2	157.1	4.0	3.2
PICA City Account[2]	300.8	293.2	290.9	(0.8)	(1.7)
Other	90.1	86.8	85.1	(1.9)	(2.8)
Total	1,076.4	1,076.6	651.8	(39.5)	(22.2)
Revenue from Other Funds	31.9	64.2	51.5	(19.8)	27.0
Total General Fund Revenues	3,654.3	3,895.9	3,502.7	(10.1)	(2.1)

Notes:

1. Includes Clerk of Courts and Traffic Court, and Clerk of Quarter Sessions in FY10 and FY11. The Clerk of Quarter Sessions was merged with the First Judicial District during FY11.
2. Includes PICA excess interest earnings.

Overall tax revenues are projected to increase $50.4 million (2.0 percent) from FY11 to FY12. This increase reflects modest percentage increases, ranging from 2.1 percent to 3.6 percent, for all major taxes except the real estate and business privilege tax. Real estate tax collections are projected to decline 0.4 percent in FY12, reflecting a moratorium on assessment increases in 2012, combined with expected losses in assessed value resulting from successful appeals. Business privilege tax (BPT) revenues are also projected to decline 0.4 percent in FY12, reflecting the City's assessment that 2010 was an unusually strong year for corporate profits, and that somewhat lower corporate profits in 2011will be reflected in lower FY12 BPT collections.

Locally-generated non-tax revenues are projected to decline 2.3 percent in FY12 reflecting declines in revenues from the Division of Technology and First Judicial District. FY11 revenues for the First Judicial District in this category reflected an unusually high level of forfeited bail collections associated with the merger of the Clerk of Quarter Sessions with the First Judicial District. Revenue from other governments is projected to decline 39.5 percent in FY12, reflecting a shift of DHS revenues from the General Fund to the Grants Revenue Fund, an accounting change that should improve the City's financial reporting.

All state and federal reimbursements for DHS costs incurred in FY12 and future years will be recognized in the Grants Revenue Fund, which should increase the level of transparency of financial results reported for DHS. In recent years, delays in the reimbursement process have resulted in substantial variations in General Fund financial results that are unrelated to the underlying operations of DHS and its revenue structure. With the recognition of all intergovernmental funding to DHS in the Grants Revenue Fund, variations in timing of reimbursements should no long have such a pronounced effect on the year end General Fund balance.

Revenue from other funds is projected to decline 19.8 percent in FY12, reflecting a $12.0 million reduction in Grants Revenue Fund reimbursement of costs related to the 911 system.

Table 4.5 presents the annual growth rates for revenues by category in the out years of the Plan, FY13 through FY16. Overall revenues are projected to increase 2.7 percent in FY13 and 0.5 percent in FY14, and to decline 2.4 percent in FY15 and increase 1.8 percent in FY16. The decline in FY15 reflects the planned reduction in the sales tax rate to 1 percent when the City's authority to levy a 2 percent sales tax rate under State Act 44 of 2009 expires.

Real estate tax revenue is projected to remain unchanged in FY13, consistent with the City's approach to setting rates after the implementation of the Actual Value Initiative (AVI) in 2013. This issue is discussed in Section II of this report. After FY13, real estate tax revenue is projected to increase 1.0 percent in FY14, 1.7 percent in FY15, and 1.4 percent in FY16. These modest growth rates are a reflection of the City's assumption that assessments after 2013 will track trends in the real estate market, but that the market value of real property will grow only modestly through 2016. This assumption is reasonable given current economic forecasts.

Wage and earnings tax collections are projected to increase 4.0 percent in FY13, and at more modest rates afterward, ranging from 2.3 to 2.1 percent. The lower growth in FY14 through FY16 reflects the assumption of slower growth in the tax base, coupled with an annual reduction in the resident and non-resident tax rates which is scheduled to begin in FY14. The tax base is projected to increase 4 percent in FY13, 3.4 percent in FY14, 3.2 percent in FY15, and 3.1 percent in FY16. The resident tax rate is projected to decline from its current 3.928 percent to 3.8364 percent in FY16, while the non-resident rate is projected to decline from 3.4985 percent to 3.4169 percent over the same period.

Business privilege tax collections are projected to increase modestly over the Plan period, reflecting modest growth in the tax base, combined with tax rate reductions beginning in FY14. Tax rates for the real property transfer tax, parking tax, and amusement tax are projected to be unchanged over the Plan period, and the base of these taxes is projected to grow at annual rates ranging from 2.5 to 5.0 percent.

Most categories of locally-generated non-tax revenue are projected to remain constant or increase at only modest rates over the FY13 to FY16 period. In the revenue from other governments category, DHS revenue is expected to fall to zero beginning in FY14, reflecting the shift of reimbursements for DHS programs to the Grants Revenue Fund. PICA City Account revenue is projected to increase at rates ranging from 4.9 percent to 3.7 percent from FY13 to FY16, reflecting the City’s assumptions about growth in the base of the wage, earnings and net profits taxes, as well as projected PICA debt service.

Table 4.5. Projected Percentage Growth in Revenues, FY12-FY16

Category	FY13 Est.	FY14 Est.	FY15 Est.	FY16 Est.
Taxes				
Real Estate	--	1.0	1.7	1.4
Wage and Earnings	4.0	2.3	2.1	2.1
Business Privilege	2.4	1.3	(0.6)	0.9
Net Profits	2.1	1.3	1.3	1.4
Sales	3.9	3.4	(48.4)	3.1
Real Property Transfer	5.0	5.0	4.0	4.0
Parking	2.5	2.5	2.5	2.5
Amusement	2.5	2.5	2.5	2.5
Smokeless Tobacco	--	--	--	--
Other	1.0	1.0	1.0	1.0
Total	2.9	2.2	(3.5)	1.9
Locally-Generated Non Tax				
Division of Technology	4.8	9.7	1.9	--
Streets	(4.2)	--	--	--
Fire	--	--	--	--
Licenses and Inspections	3.5	3.2	3.0	--
Records	5.6	5.3	--	--
First Judicial District[1]	1.2	--	--	--
Other	4.1	3.8	0.3	0.7
Total	2.3	2.7	0.8	0.2
Revenue from Other Governments				
Public Health	--	--	--	--
Human Services	(1.5)	(100.0)	NA	NA
Finance	1.3	--	--	--
PICA City Account	4.9	4.1	3.9	3.7
Other	--	--	--	--
Total	2.4	(6.9)	2.0	1.9
Revenue from Other Funds	(1.4)	0.9	(15.2)	0.7
Total General Fund Revenues	2.7	0.5	(2.4)	1.8

Notes:
1. Includes Clerk of Courts and Traffic Court.

E. Obligations: FY12-16 Assumptions

The FY12-16 Plan obligation projections reflect various programmatic assumptions that are embedded in the Council-approved FY12 budget, as well as additional assumptions for obligation growth in the out years, FY13-FY16. The obligation projections in the FY12 budget are discussed first, followed by the out year assumptions.

Table 4.6 presents actual obligations for FY10, and estimated obligations for FY11 and FY12, for major General Fund cost centers, along with growth rates from FY11 to FY12 and the average annual growth rate from FY10 to FY12.

Total FY12 obligations are projected to decline 8.8 percent from FY11, primarily due to the shift of grant funded DHS obligations to the Grants Revenue Fund. Excluding DHS obligations, total FY12 obligations are projected to increase 4.7 percent. Few categories are projected to change dramatically from FY11 to FY12. Notable exceptions include: the Board of Revisions of Taxes (65.3 percent decrease) and the Office of Property Assessment (92.2 percent increase), reflecting the transfer of the assessment function to OPA beginning in FY11; Fleet Management (5.1 percent increase), reflecting increased costs for a new vehicle lease/purchase program; Fringe Benefits (4.4 percent increase), reflecting a $58.4 million increase in City contributions to the pension fund resulting from the end of the City's authorization to defer State-mandated pension contributions; Licenses and Inspections (13.8 percent increase), reflecting a return to normal levels General Fund support for demolitions; City contribution to the School District of Philadelphia (26.8 percent increase), reflecting the decision to provide increased funding to reduce the SDP's FY12 deficit; and Sinking Fund Commission (13.1 percent increase), reflecting higher scheduled debt service payments.

Table 4.6. General Fund Obligations, FY10 Actual through FY12 Estimated ($ in Millions)

Agency/Cost Center	FY10 Actual	FY11 Est.	FY12 Est.	Percent Change, FY11-FY12	Average Annual Percent Change, FY10-FY12
Board of Revision of Taxes	7.5	2.1	0.7	(65.3)	(68.9)
Community College Subsidy	26.5	25.4	25.4	--	(2.0)
Convention Center Subsidy	24.2	15.0	15.0	--	(21.2)
District Attorney	30.2	30.5	31.1	1.7	1.5
Division of Technology	38.5	63.6	63.9	0.6	28.8
Fire	190.1	191.0	190.0	(0.5)	0.0
First Judicial District[1]	111.9	110.1	110.8	0.6	(0.5)
Fleet Management	47.3	51.0	53.7	5.1	6.5
Free Library	32.8	33.0	33.9	2.7	1.7
Fringe Benefits	829.9	979.9	1,022.6	4.4	11.0
Human Services	562.7	549.4	111.9	(79.6)	(55.4)
Indemnities	0.0	35.0	33.1	(5.5)	NA
Legal Services	35.9	36.6	37.6	2.6	2.2
Licenses and Inspections	23.1	19.1	21.8	13.8	(2.8)
Parks and Recreation	46.9	44.8	46.3	3.4	(0.7)
Police	541.6	530.0	550.7	3.9	0.8
Prisons	240.6	233.1	227.2	(2.6)	(2.8)
Property Assessment	--	6.1	11.7	92.2	NA
Public Health	111.2	113.7	110.4	(2.9)	(0.3)
Public Property	164.8	167.4	168.8	0.8	1.2
School District Contribution	38.5	38.6	48.9	26.8	12.7
Sinking Fund Commission	185.4	197.9	223.9	13.1	9.9
Streets	134.9	125.7	121.4	(3.5)	(5.2)
Supportive Housing	38.4	36.5	36.5	--	(2.5)
Other	190.9	167.3	172.7	3.2	(4.9)
Total General Fund Obligations	3,653.7	3,802.9	3,470.1	(8.8)	(2.5)

Notes:

1. Includes Clerk of Quarter Sessions in FY10 and FY11. The Clerk of Quarter Sessions was merged with the First Judicial District during FY11.

Table 4.7 shows those categories of spending within major expenditure class and by cost center that are projected to increase over the Plan period. All other categories are projected to remain unchanged after FY12. Because the City's contracts with the major non-uniformed unions and the International Association of Fire Fighters remain unresolved, the City generally projects zero wage increases for each year of the Plan for departments other than Police. The Police Department salary and wages projection (Class 100) shows modest growth in each year of the Plan to reflect normal step increases. Other agencies reflect modest wage and salary declines in FY13, followed by zero growth.

Table 4.7. Projected Percentage Growth in Obligations (Other than Fringe Benefits), FY13-FY16

Agency and Fund	FY13 Est.	FY14 Est.	FY15 Est.	FY16 Est.
Personal Services				
City Controller's Office	(2.8)	--	--	--
Office of the Director of Finance	(1.7)	--	--	--
Office of the Inspector General	(6.2)	--	--	--
Police Department	0.2	0.1	0.1	0.1
Department of Public Health	2.1	--	--	--
Department of Streets	(0.1)	--	--	--
Purchase of Services				
Commerce/City Representative	(6.3)	--	--	--
Division of Technology	--	--	(19.9)	--
Office of the Director of Finance	(1.3)	--	--	--
Office of Property Assessment	(9.4)	--	--	--
Office of Human Resources	(30.4)	--	--	--
Police Department	0.8	--	--	--
Department of Public Health	1.8	--	--	--
Department of Public Property	1.5	1.2	1.9	1.9
Department of Revenue	(6.1)	--	--	--
Sinking Fund Commission	5.8	1.1	(0.1)	(3.4)
Department of Streets	2.5	2.5	2.5	2.5
Materials, Supplies, and Equipment				
Fire Department	(21.5)	--	--	--
Office of Fleet Management	3.5	6.8	--	--
Police Department	(2.4)	(6.7)	--	--
Department of Public Health	1.1	--	--	--
Department of Streets	(4.8)	--	--	--
Contributions, Indemnities and Taxes				
School District Subsidy	0.2	0.2	0.2	0.2
Office of the Director of Finance	(66.7)	--	200.0	(66.7)
Debt Service				
Sinking Fund Commission	3.0	11.3	(0.1)	1.8
Payments to Other Funds				
Fire	7.2	6.7	6.3	--
Department of Public Property	18.2	2.5	2.4	--

Note: Zoning Code Commission also shows changes in obligations, specifically a reduction to zero beginning in FY13.

Within the purchase of services category (Class 200), there are some significant declines in FY13, reflecting non-recurring FY12 costs associated with unusual contractual services. The Division of Technology Class 200 obligations decline 19.9 percent in FY15, due to the expiration of the Motorola 911 wire line lease payments. Department of

Public Property purchase of services obligations increase between 1.2 percent and 1.9 percent annually during the FY13-FY16 period, reflecting expected increases in the cost of space rentals, utilities, and the City's subsidy to the Southeastern Pennsylvania Transportation Authority (SEPTA). Streets Department purchase of service obligations reflects the assumption of 2.5 percent annual increases in the cost of waste disposal.

Materials, supplies, and equipment expenditures within the Fire Department are projected to decline $1.8 million in FY13 due to a return to normal expenditure levels. Office of Fleet Management Class 400 expenditures are projected to increase due to the increased projected cost of the vehicle lease-purchase program in FY13 and FY14.

F. Growth in Fringe Benefits: FY12-16 Assumptions

Table 4.8 presents projected growth rates after FY12 for employee fringe benefit programs. Pension costs are projected at $554.7 million in FY13, a growth rate of 22.6 over the prior year. This significant cost increase reflects the repayment of the deferred FY10 and FY11 payments to the Pension Fund. After FY14, pension costs are projected to moderate, as the repayment of the FY10 and FY11 deferred amounts is phased out. Pension costs are projected to decline 0.8 percent in FY14 and 13.2 percent in FY15, before increasing 0.8 percent in FY16. The Plan's projected pension costs are based on assumptions and calculations by the City's actuary. To the extent that actual experience is different from the assumptions – with respect to factors such investment returns, employee wage growth, employee retirement behavior, and retiree longevity – the actual costs will differ from the projections.

The City also presents the costs of debt service on pension obligation bonds issued in 1999 as a separate category. These bonds were issued to provide funds to reduce the unfunded liability of the pension fund, and render the City's annual pension costs more predictable. The debt service on these bonds is projected to increase moderately over the life of the Plan: 4.2 percent in FY13, 1.0 percent in FY14, 4.0 percent in FY15, and 2.8 percent in FY16.

Health and medical costs are projected at 357.9 million in FY13, an increase of 3.4 percent over the FY12 level. The City is undertaking a number of initiatives to contain the cost of employee health benefits, including adopting self-insurance for the City-administered and Police and Fire union health plans, implementing a disease management program for the City-administered plan, increasing co-payments, and competitive bidding. These initiatives resulted in cost savings in FY11. The Plan projects annual growth rates for employee health benefits ranging from 3.4 percent to 4.1 percent over the FY12-FY16 period. Maintaining cost growth within the Plan projections will require continued success at initiatives to reduce cost growth through changes in plan administration and creating new programs to improve the health and wellness of City employees.

Employee disability programs, which include workers compensation, Heart and Lung Act programs, and the City's Regulation 32 program, are projected to increase 7.6 percent in FY13, followed by moderate increases of 3.2 percent in FY14 and 1.6 percent in FY15. Maintaining costs within these limits will require success at efforts to increase the safety of employee work environments, as well as reform the structure of disability programs, in particular the Heart and Lung program and workers compensation. The projected FICA costs reflect the projected overall payroll costs in the Plan. FICA costs are projected to increase 4.4 percent in FY13, 2.2 percent in FY14, and zero in FY15 and FY16. The zero growth in the final two years of the Plan reflects the assumption of no wage increases that is consistent with current labor contracts.

Table 4.8. Projected Percentage Growth in Fringe Benefits, FY13-FY16

Category	FY13 Est.	FY14 Est.	FY15 Est.	FY16 Est.
Pension	22.6	(0.8)	(13.2)	0.8
Pension Obligation Bonds	4.2	1.0	4.0	2.8
Health/Medical	3.4	3.6	3.8	4.1
FICA	4.4	2.2	--	--
Employee Disability	7.6	3.2	1.6	--
Other[1]	--	--	--	--
Total	12.3	1.1	(4.6)	2.0

Note:

1. Includes unemployment compensation, group life, group legal, tool allowance, flex cash payments, and anticipated workforce savings.

**Pennsylvania Intergovernmental
Cooperation Authority**

**STAFF REPORT
ON
FY2012-FY2016
FIVE-YEAR FINANCIAL PLAN**

SECTION IV:

LONG-TERM FINANCIAL ISSUES FACING THE CITY

IV. LONG-TERM FINANCIAL ISSUES FACING THE CITY

The intent of the General Assembly in enacting the PICA Act was to “foster sound financial planning and budgetary practices that will address the underlying problems which result in…deficits for cities of the first class” and that the City of Philadelphia “shall be charged with the responsibility to exercise efficient and accountable fiscal practices…” The Act gives eight examples of such “efficient and accountable” practices, including: “increased managerial accountability…consolidation or elimination of inefficient city programs…privatization of appropriate city services…sale of city assets as appropriate…[and] review of compensation and benefits of city employees…”[12]

This section of the PICA Act indicates that the legislature intended that the City’s Five-Year Financial Plan process should promote both near-term fiscal balance and policy and management changes that would secure the City’s long-term fiscal stability. Consistent with these objectives, Section IV of this report reviews and assesses current City initiatives that address long-term fiscal stability. These initiatives are classified into the following categories: fiscal policies, managerial accountability, tax policy, economic development, and workforce trends.

A. FISCAL POLICIES

I. Unfunded Pension Liability

The problems in the Pension Fund are discussed in detail in Section II of this report. At the beginning of FY2009, the Pension Fund was only 55 percent funded; at the end of FY10 that figure was at 47 percent. The City has proposed a two-pronged approach to dealing with the pension problems – one short-term, one long-term. While the short-term fixes (reamortization and payment deferrals) eased pressure on the General Fund, they will ultimately be meaningless without implementation of the long-term fixes proposed by the City.

The City’s long-term proposals include increasing the level of employee contributions and implementing a new pension plan. The new plan would be a hybrid with a defined benefit option with a lower level of benefits than the current plan, and an optional defined contribution plan which will function like a 401(k) including a City match of a portion of each employee’s contributions. Failure to achieve changes which align contribution levels with benefit levels will leave the Pension Fund in worse condition than before, as the liability will have been exacerbated by the short-term fixes.

II. Debt and Long-Term Obligations

The Plan projects total debt service and lease payments will increase from $226.4 million in FY11 to $267.2 million in FY16, an average annual increase of 3.6 percent, above the

[12] The Pennsylvania Intergovernmental Cooperation Authority Act for Cities of the First Class, Act of 1991, P. L. 9, No. 6 at § 102(b)(1)(iii).

2.5 percent annual increase for total General Fund obligations. Combined debt and lease obligations under the Plan projections will increase from 6.5 percent of General Fund obligations in FY12 to 7.4 percent in FY16. The substantial increase in debt service reflects higher scheduled payments on outstanding debt and an assumption that the City will issue new General Obligation debt totaling $398.5 million over the next five years.

The level of fixed costs relating to debt service and long-term obligations in the General Fund budget continues to impose a significant constraint on the City's financial flexibility. Debt service includes debt service on City general obligation (GO) and pension obligation bonds, and required payments for lease-backed debt issued by City-related entities. Long-term obligations reflect payments for the unfunded liability of the Pension Fund, and payments to the Pennsylvania Convention Center Authority (PCCA) to support its debt service obligations. These payments directly impact the General Fund, and all of them are outside the City's immediate control.[13]

There are two primary problems associated with debt and long-term obligations. The first is that if these costs exceed a certain percentage of total General Fund costs, they can substantially lower financial flexibility. While the rationale for debt financing of capital assets is that the benefits of these assets accrue over long periods, nonetheless, debt service costs represent a cost paid by current taxpayers for facilities and projects that were authorized in the past. When these payments form too large a percentage of the budget, they can unduly constrain the City's ability to finance ongoing expenses for current services.

The City has utilized debt financing to pay for a number of major capital projects over the last decade, all of which took place prior to the current Administration. This financing has supported two stadiums, neighborhood revitalization, and cultural facility and commercial corridor improvements. The debt service associated with the bonds issued for these projects was not evenly spread over the life of the bonds. In some cases, annual payments were more heavily weighted to periods beyond the life of the then current Five-Year Plan. The result has been a substantial increase in overall general obligation and lease debt cost for the General Fund. These costs have increased from $172.2 million in FY08 to a projected $197.9 million in FY11, a 14.9 percent increase during a period in which overall General Fund obligations are projected to *decline* 3 percent. Moreover, debt service is projected to increase further to $248.7 million in FY16.

The City Treasurer's Office took an important step toward addressing this issue by issuing an updated debt policy in December 2009. This policy includes various benchmarks for debt issuance procedures and policies, and for the city's debt portfolio. The policy sets as a goal that City tax-supported debt service plus long-term obligations not exceed 15 percent of total General Fund and debt service fund expenditures. The

[13] The City also has long-term obligations associated with health and certain other benefits for retirees. These costs are paid on a pay as you go basis. The unfunded actuarial accrued liability associated with these benefits was $1.1 billion as of July 1, 2009. See *Comprehensive Annual Financial Report*, FY10, City of Philadelphia, pp. 104-105.

current ratio achieved that goal, at 14.7 percent in FY10.[14] If the City is successful in maintaining this goal, debt service will no longer consume an increasing part of the General Fund budget, and the City will have increased flexibility to meet other priorities.

Another problem associated with the City's long-term obligations relates to the ability of the City to finance ongoing infrastructure needs (discussed in the next item below). Numerous assessments of the conditions of City facilities have suggested that the City needs to make substantial investments in its capital facilities to bring them up to an adequate level of safety and functionality. For years, the level of capital investment in the City's infrastructure has been inadequate. The FY12-FY16 Plan does propose a significant increase in the level of capital investment. The Plan states that the City will allocate $110.3 million in City-supported capital funding in FY12, of which $107 million will be financed through new General Obligation bonds. The proposed FY12 allocation of City funds is a substantial increase from capital spending prior to FY08, when City-financed capital spending was closer to $60 million annually. While this is a movement in the right direction, substantial additional resources will be needed over the long term.

However, these additional resources should be allocated only on the basis of a comprehensive assessment of infrastructure needs, and the City's service priorities. The City needs to develop a set of criteria for determining what level of facility infrastructure it will maintain, taking into account the needs of city residents, the strategic objectives of the City government and its various agencies, and its financial means to pay for ongoing maintenance and new investment.

Another major component of the City's long-term obligations is the unfunded pension liability (discussed in detail in the risks section of this report). The payment to the Pension Fund is projected at $452.3 million in FY12, and will increase to $480.9 million in FY16. The growth of these costs represents a major long-term financial problem for the City. Without significant restructuring of the City's pension program, these costs will continue to grow as a percentage of the budget, thus preventing the City from continuing to provide adequate current service levels at an affordable tax cost. Reform of the pension system is of the greatest importance for the City's viability as a competitive city over the long-term.

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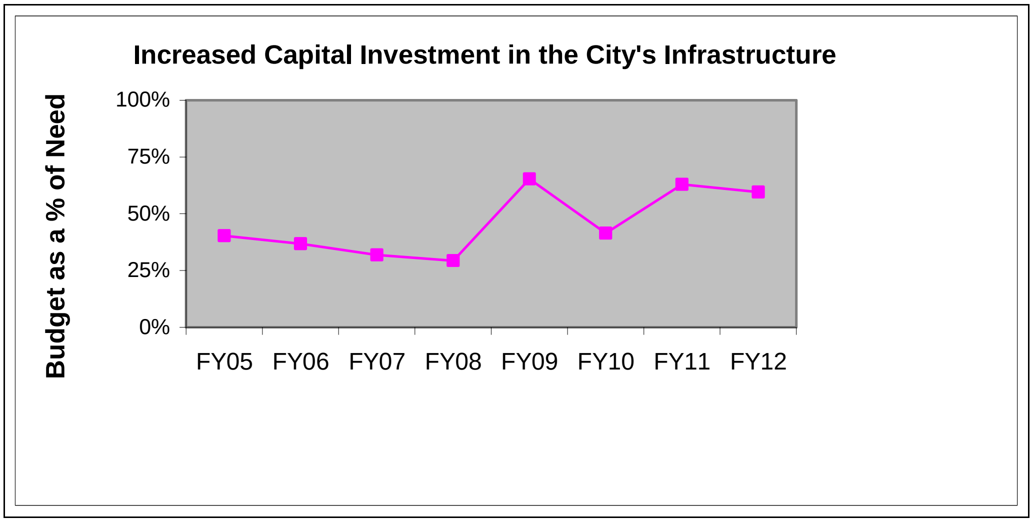
[14] *Debt Management Policy*, Office of the City Treasurer, City of Philadelphia, December 2009, p. 4.

III. Infrastructure Investment

After years of under-investing in the City's infrastructure, the Nutter Administration has pledged to invest $110.3 million in FY12 of City-supported capital funding. In 2001 the City Planning Commission found that the City needed to invest $185 million annually to keep its infrastructure in good condition. From FY03 to FY08 the City invested less than half of that amount each year; an average of $53 million per year of new loans was invested in the city's infrastructure. FY09 marked the first significant increase in infrastructure investment in a decade, and the FY12-FY16 Plan increases the level of investment slightly over the FY10 level.



Because of the historical lack of investment, in early 2007, PICA funded a Facility Assessment Project. This project assessed the physical condition of each of the facilities in the Prisons System, City Hall and the Police, Fire and Health Departments. The project was completed in October of 2007 and it provided the City with a working tool to prioritize and allocate adequate capital funding. The City also received an ongoing maintenance schedule for the facilities covered by the project as well as an IT system to track the condition of its infrastructure.

Over the past few years, PICA has recommended that the City institute pay-as-you go funding for certain capital projects. Starting in FY09 the city attempted to tackle the ever-growing backlog of streets resurfacing by utilizing $10 million per year of this type of funding. The funds were generated by a twenty percent increase in the Parking Tax.

Request for PICA Funds

In July 2008, PICA approved the City's request to utilize $27.5 million in existing PICA capital funds for improvements to Police and Fire facilities and projects at the Free Library. The City has continued to utilize those funds. Much of the requested funding for departmental facilities is as a result of the PICA Assessment Project that was completed in the fall of 2007.

IV. Rainy Day Fund

The City has made substantial progress in the establishment of a Rainy Day Fund, which is discussed in detail in section III of this report. A rainy day fund would have enabled the City to cover some portion of the budget shortfalls which resulted from the dramatic economic downturn of 2008 and 2009. Also important, rating agencies use the existence and structure of a rainy day fund in deciding cities' bond ratings. By establishing a fund, the City would be able to reduce its borrowing costs, creating cost savings in the long run. According to a paper published in 2004 in the *National Tax Journal*, government entities can expect a ten basis point reduction in bond yields after the creation of a reserve fund.

The narrow fund balances maintained by the City, which are discussed in Section II of this report, further highlight the need for the City to establish and maintain a well-structured rainy day fund. While such a fund would not have prevented the City from the need to take actions to increase revenues and decrease spending in the 2008-2009 recession, it would have provided another tool to help smooth the impacts of those changes.

B. MANAGERIAL ACCOUNTABILITY

The City has in recent years taken a significant step to adopt performance management practices, including establishing a regular process of public reporting and discussion on performance for particular agencies. This process, known as PhillyStat, recently resumed after a year-long hiatus. The City has also since the 1990s developed and reported on quantifiable performance indicators for various agencies. Further, certain City agencies, such as the Police Department and the Department of Human Services, have developed their own performance management processes which appear to be contributing to improved results within those agencies.

As PICA Staff stated in its report on the FY10-FY14 Five-Year Financial Plan, adoption of performance management practices by the City is a very positive development in terms of the long-term ability of the City to manage toward positive outcomes. For a government the size of the City, with the level of social and economic challenges faced by its population, systematic processes to measure and analyze trends in outcomes, and the relationship between resources, programs, and these outcomes, is important. The recent reestablishment of the public PhillyStat process indicates that the City continues to assign a high priority to adoption of performance management practices. Nonetheless, additional progress is needed to adopt other elements of performance management throughout the government.

Performance management is a series of practices that are interrelated, and that collectively are designed to increase the capacity of government to deliver services that are of value to the public at minimal cost. These practices include strategic planning, budgeting, management, performance measurement, and reporting. It is the combination and interrelationship of these activities, and their basic orientation to delivering results that makes them valuable and has the potential to dramatically improve the operations of the public sector.[15]

The City has made progress toward implementing a performance oriented management process through PhillyStat. This, however, is only one element of performance management. The City also needs to develop more systematic planning processes, relate the budget and Five-Year Financial Plan process to performance goals and strategies, to systematize and broaden the process of performance measurement, and greatly increase the comprehensiveness and timeliness of its reporting, both with respect to public objectives and strategies, and performance measures. It can be hoped that the recent reinvigoration of the PhillyStat process is only the next step on a long-term process of implementing these other elements of performance management and institutionalizing these processes at a bureaucratic level, within both internal and citizen service agencies.

Planning should be more consistent across the various agencies of the City. In multi-year strategic plans, and shorter-term operational plans, agencies need to articulate their major goals and strategies to achieve them. The plans should be adopted and updated on a regular time schedule, and they should be public. Strategic plans are important as a foundation for performance management because they articulate the results that agencies seek to achieve, and provide the basis for performance measurement, budget allocations, and accountability. The Administration has developed a number of strategic plans, including *Greenworks Philadelphia* for City-wide sustainability efforts, the Water Department's *Green City Clean Water* plan for stormwater management, and *Inclusion Works* for the Office of Economic Opportunity. But too many agencies have not published a strategic plan in recent memory.

Most City agencies have developed some level of performance measurement and reporting. But it does not appear to be comprehensive across all agencies, nor is it reported in a systematic way to the public. Defining measures and reporting them consistently over an appropriate time period is important both for internal management and external accountability. The City should consider adopting and reporting performance measures for every City agency. Measures should be designed and reported in a way that is appropriate for the audience. Measures appropriate for internal management purposes are likely to be more numerous and detailed than measures appropriate for public reports. But it is important that appropriate measures be developed and reported, both internally and publicly, since such measures form the basis of measuring progress toward strategic goals, evaluating the rationality of budgetary allocations in relation to strategic goals, and in providing an orienting framework for discussions of performance in PhillyStat and other venues. These measures could be reported to the public either in separate annual performance reports for each City agency, or the City as a whole, or as part of an annual budget document that contained strategic

[15] See *A Performance Management Framework for State and Local Government: From Measurement and Reporting to Management and Improving* (Chicago: National Performance Management Advisory Commission, 2010) for an overview of various performance management practices and how they are interrelated.

goals, performance measures, and financial allocations for each agency. Publicizing comprehensive and accessible performance information is important because it should increase the incentive for City officials to define realistic annual goals for their agencies, and manage to achieve these goals cost-effectively.

With the availability of routinely reported and meaningful performance measures for every City agency, the City budget process could become more performance oriented. Decisions about financial allocations among and within agencies could be informed, and to a greater degree based upon, accurate information about the relationship between resources and the outcomes they produce for the public. Publishing a budget document that clearly aligns annual financial allocations with actual and projected performance indicators should help structure executive branch decision making about the budget, while also improving the ability of City Council and the public to understand the Administration's priorities and effectively advocate for changes that they believe are desirable.

Philadelphia faces many challenges: slow economic growth, poverty, crime, high taxes, unsustainable pension costs, and inadequate infrastructure. To make progress toward addressing Philadelphia's challenges over the long-term, the City needs to adopt a greater performance or result orientation to its policy-making and management processes. Such a change should improve the quality of decision-making, increase the ability of officials and managers to achieve articulated goals, and increase citizen confidence in the quality of governmental decision-making and the direction of the city.

C. TAX POLICY

The FY12-FY16 Plan, like the FY11-FY15 Plan, contains modest annual reductions in the wage, earnings, net profits, and business privilege taxes, beginning in FY14. It continues the basic tax reform strategy that the City has pursued since 1996, which is to gradually lower the rates of the wage and business taxes, which are viewed as particularly damaging to the City's economic competitiveness and employment base. This view, which is consistent with empirical findings and public finance theory, has been endorsed by the two panels that have examined City tax policy in recent years: the 2003 Tax Reform Commission and the 2009 Mayor's Task Force on Tax Policy and Economic Competitiveness.

However, both these panels recommended a more ambitious approach to tax reform than the FY12-FY16 Plan represents. The 2003 Commission recommended that by 2014 the resident wage tax rate be reduced to 3.0 percent and the non-resident rate to 2.5 percent, assuming the City would receive State aid to support wage tax reduction (which has averaged about $86 million in annual revenue from State gaming proceeds beginning in FY09). The 2009 Task Force recommended reductions of the resident wage tax rate to 2.7 percent and the non-resident tax to 2.4 percent by 2025. By contrast, at the pace of tax reduction in the final three years of the FY12-FY16 Plan, the wage tax reduction goals of the 2009 Task Force will not be achieved until fiscal year 2050.

With respect to the business privilege tax (BPT), the 2003 Commission recommended complete elimination of the BPT by 2015. The 2009 Task Force recommended elimination of the gross receipts portion of the BPT, and reduction of the net income portion of the tax to 6.0 percent, by 2025. Both panels also recommended changes to reduce the impact of the BPT on jobs. The 2003 Commission recommended adoption of single sales factor apportionment for the net income portion of the tax. The 2009 Task Force recommended market based sourcing for service companies, and single sales factor apportionment for all firms.

In its final three years, the FY12-FY16 Plan includes reductions in the BPT gross receipts tax at a rate that would place it on track for elimination by 2030. The Plan also reduces the net income portion modestly, from a rate of 6.45 percent in FY12 and FY13 to 6.34 percent in FY16. The Plan also discusses the City's pilot test of single sales factor apportionment for research and development firms and market-based sourcing for computer systems design firms, first implemented in FY10. The Plan states that the City will study the impact of these changes

Tax reform is a critical issue for the long-term financial stability of the City. Numerous studies have documented that City taxes for residents and businesses are relatively high compared to other cities around the country. What may be an even greater problem is the extent to which City taxes are higher than taxes in surrounding suburbs. The City needs an ambitious approach to redesign its tax structure so as to minimize its economic impact, and to reduce the overall tax burden to competitive levels. With the ongoing reforms of the property tax assessment system by the Office of Property Assessment, the near future would be an appropriate time for the City to clarify its long-term tax reform strategy. The City should not allow uncertainties associated with the financial impact of major tax changes to prevent it from adopting sensible, research-based tax reform strategies, and planning for their financial impact.

Among the questions the City needs to address is to what degree and over what time period should it shift the tax burden away from business and wage taxes toward real estate taxes? How will it ensure that real estate tax levels remain competitive after such a shift is complete? How will the impact of higher real estate taxes on lower-income homeowners be mitigated? How can the BPT be restructured to reduce its economic cost to the city? How can these changes be accomplished within a reasonable time frame? PICA Staff believes that the Five-Year Plan process should facilitate long-term thinking about this important issue, in part through the ongoing incorporation of the financial impacts of tax changes into the Plan's revenue projections. Doing so would help to realize the value of the Plan process as a mechanism to encourage the City to adopt changes that will promote long-term financial stability.

D. ECONOMIC DEVELOPMENT

Planning

In FY11, the City has continued to improve the public policy context for economic growth. In June 2011, the City Planning Commission released *Citywide Vision: Philadelphia 2035*, a comprehensive plan that encompasses goals and strategies designed to promote economic development, quality of life, and more creative use of the City's physical resources. Spanning various policy domains – including housing, transportation, energy, environment, economic development, land use planning, and urban design – the plan goes beyond a traditional land use plan to encompass many of the most important governmental functions of the City. As such, it constitutes not simply a plan for Philadelphia's physical environment, but a strategic plan for key parts of Philadelphia's government. In this regard, *Philadelphia 2035* is admirable. In no time in recent memory, has there been such a comprehensive statement of policy goals for the City. The City government should benefit from the existence of this document, if it is used as a blueprint for action.

Another important aspect of *Philadelphia 2035* is that the City has committed to making planning an ongoing process. The city wide plan will be translated into 18 district level plans which will specify land use in more detail for specific areas. Further, the City expects to update the comprehensive plan and district level plans every five years. Thus, planning will become more of an ongoing process, and should help the City to maintain a sense of strategic direction going forward.

The primary concern with this document relates to implementation. Some of the strategies proposed in the document lack specifics, or appear more aspirational than possible. Moreover, while there are clear fiscal implications for many of the recommendations in Philadelphia 2035, it is not clear how the activities proposed in the plan will be financed. The plan estimates the total cost of its recommendations at $42.8 billion in capital costs and $2.7 billion in operating costs. Averaged over a 25-year period, this represents $1.7 billion in annual capital costs and $106.7 million in annual operating costs. It is far from clear how even a small portion of these costs could be financed within the context of the City's resources and debt capacity, even assuming that other levels of government are able to meet their anticipated contributions.

The comprehensive plan states that the City intends to align short-term projects included within *Philadelphia 2035* with the Capital Program and Five-Year Financial Plan.[16] While this would be welcome, it would represent a departure from past practice with respect to the Five-Year Financial Plan, which has generally included few specifics about the relationship between policy and program priorities and financial projections beyond its initial year. PICA Staff would welcome a more program-oriented Five-Year Plan, and looks forward to the incorporation of the financial implications of Philadelphia 2035 in the FY13-FY17 Five-Year Financial Plan.

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[16] *Citywide Vision: Philadelphia 2035* (Philadelphia: Philadelphia City Planning Commission, June 2011), p. 190.

More broadly, the City needs to integrate into its Five-Year Financial Plan not only the programmatic goals articulated in *Philadelphia 2035*, but other policy goals of the City contained in various other official policy and planning documents.

Vacant Land Strategies

Another key economic priority for the City is redevelopment of vacant land. There has been considerable attention to this problem over the past year. A 2010 study by Econsult Corporation found that there are 40,000 vacant parcels in the city, and that these vacant properties result in significant fiscal costs to the City and economic costs to its residents. The existence of these properties reduces the value of city real estate by 6.5 percent citywide, resulting in a loss of $3.6 billion in wealth to households. The report also estimates that City-owned vacant property costs $20 million annually to maintain, and that vacant property results in the loss of $2 million annually in uncollected property taxes.[17]

The problem partly reflects the weak real estate market in some parts of the city. But it has been exacerbated by the City's approach, or lack of it, to dealing with the problem. One significant problem is that no single agency is empowered to develop and implement strategies to acquire, hold, and dispose of vacant property in a way that maximizes property values, and promotes economic development and quality of life. The City also needs to address various related problems such as code enforcement and tax foreclosure. Because of the many agencies involved in these issues – the Redevelopment Authority, Housing Authority, Office of Housing and Community Development, Department of Public Property, Office of the Sheriff, among others – coordination is clearly needed. Cities around the country have tackled these problems in innovative ways.[18] Philadelphia needs to adapt these models in a manner appropriate for local conditions..

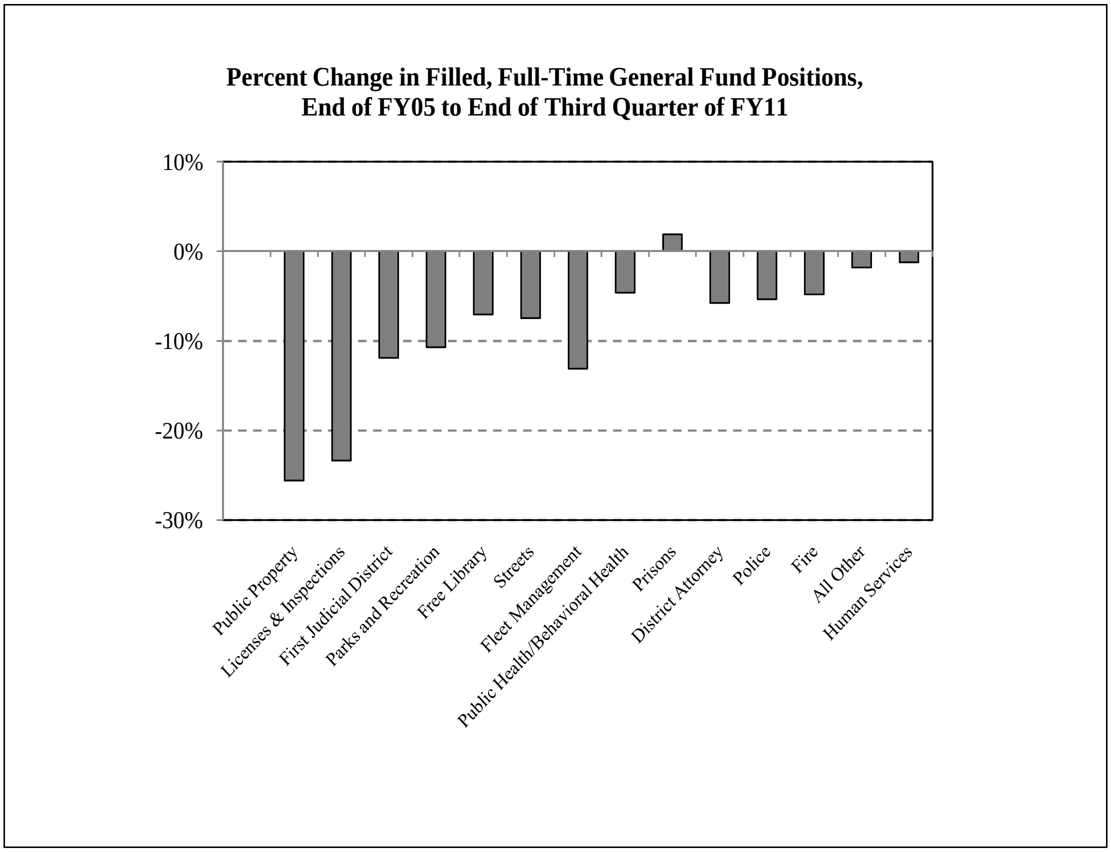
The Mayor has appointed a working committee to address vacant property issues. City agencies have also made progress in recent years toward improving the process of marketing City-owned properties to private developers. PICA Staff looks forward to the development of new policies and procedures for dealing with vacant land resulting from the City working committee.

[17] Econsult Corporation, Penn Institute for Urban Research, and May 8 Consulting, *Vacant Land Management in Philadelphia: The Costs of the Current System and the Benefits of Reform*. Prepared for the Redevelopment Authority of the City of Philadelphia and the Philadelphia Association of Community Development Corporations, November 2010.

[18] Alan Mallach, *Bringing Buildings Back: From Abandoned Properties to Community Assets* (Montclair, NJ: National Housing Institute, 2006) provides an excellent discussion of the practical steps required to take control of abandoned properties and facilitate their productive reuse.

E. WORKFORCE TRENDS

The number of filled full-time positions in the General Fund continued to fall through the end of the third quarter of FY11, the most recent quarter for which data are available. As shown in the figure below, from the end of FY05 through the end of the third quarter of FY11, position levels declined significantly in the Department of Public Property (25.6 percent), the Department of Licenses and Inspections (23.4 percent), the First Judicial District (11.9 percent)[19], Parks and Recreation (10.7 percent), the Free Library (7 percent), the Streets Department (7.4 percent), and the Office of Fleet Management (13.1 percent). Among major agencies, only the Prisons Department saw an increase (1.9 percent) in personnel levels from the end of FY05 through the third quarter of FY11, and this trend was coupled with a reduction in Prisons related overtime. Overall filled General Fund positions were 22,029 at the end of the third quarter of FY11, a decrease of 1,161 (5 percent) from the end of FY05.



Some of these personnel reductions have resulted in service reductions, but most reflect more efficient service provision. For instance, Streets Department personnel have declined in part through increases in recycling and reductions in waste disposal. Reductions in Fleet Management reflect reductions in the City fleet.

[19] Figures for the First Judicial District include the Clerk of Quarter Sessions, which was merged with the First Judicial District in FY11.

The Plan does not explicitly assume reductions in personnel levels. In fact, filled General Fund positions are projected to change little, going from 22,297 at the end of FY10 to 22,277 at the end of FY16. Position declines are nonetheless possible, and most likely will be necessary if arbitration awards or negotiated contracts with the major municipal unions require salary increases over the life of the Plan. Because of the Plan's assumption of zero salary growth for all major unions other than that already awarded to the Fraternal Order of Police for FY11 and FY12, any additional salary increases will have to be funded through savings in employee benefits, personnel reductions or other efficiencies.

Personnel reductions can occur without negatively impacting the public if the City continues to be successful at its efforts to reform the operation of its criminal justice and social service systems. If DHS continues to reduce the number of children in placement, and the duration of placements, it may be able to accelerate reducing personnel. If the City's criminal justice system reforms continue to drive down the prison population, additional personnel reductions may be possible at the Prisons System. The major investments in information technology included in the FY12-FY17 Capital Program, and the significant increase in the operating budget for the Division of Technology beginning in FY11, should also result in personnel savings over the Plan period.

One shortcoming of this Plan is that it makes no assumptions about the likely personnel reductions that will occur over the Plan period. It is important to use the Plan to set goals, with respect to costs, services, and taxes. This Plan falls somewhat short in this regard because it does not recognize the potential for savings that exist as a result of the various initiatives of the City. Future Plans should incorporate reasonable estimates of the impact of management initiatives on personnel levels and costs. Such a change would allow the Plan to be a clearer statement of policy priorities, an instrument for clarifying financial and management goals, and a mechanism for holding City agencies and the City as a whole accountable for progress toward those goals.

Pennsylvania Intergovernmental
Cooperation Authority

STAFF REPORT
ON
FY2012-FY2016
FIVE-YEAR FINANCIAL PLAN

SECTION V:

INDICATORS OF FINANCIAL HEALTH

V. INDICATORS OF FINANCIAL HEALTH

A recent trend in the business and government spheres is to identify a series of indicators which can be presented in a brief format so as to provide a snapshot of performance. This section identifies a series of indicators in a number of areas which describe the fiscal status of the City overall, as well as the City budget specifically. Some of these areas are directly under City influence; others represent the long-standing economic realities of the City overall.

Depending on the specific measure, data includes comparisons with national trends and peers, past City performance, or performance levels defined by the City.

Economic Demographics

Median Household Income [20]		2006	2009
	Philadelphia	$33,368	$36,959
	US	$48,451	$50,221
	Philadelphia as a % of US	**68.9%**	**73.6%**

Poverty Rate [21]		2006	2009
	Philadelphia	24.9	24.5
	US	13.3	14.3
	Philadelphia as a % of US	**187.2%**	**171.3%**

Unemployment Rate [22]		2006	2010
	Philadelphia	6.2	10.9
	US	4.6	9.3
	Philadelphia as a % of US	**134.8%**	**113.5%**

[20] Source: US Census Bureau, Small Area Income and Poverty Estimates

[21] Source: US Census Bureau, Small Area Income and Poverty Estimates

[22] Source: US Bureau of Labor Statistics

City Budget Indicators

General Fund Balance as a % of Revenue	2006	2010	2016 (proj)
Philadelphia	**7.2%**	**-3.1%**	**0.8%**
GFOA Recommended Minimum	5%	5%	5%

Pension Fund Liability	2006	2010
Unfunded Liability	**$3.9 billion**	**$4.9 billion**
Funding Ratio	**51.6%**	**47.0%**

Indebtedness	2006	2010
Primary government debt ($millions) [23]	6,906.5	7,062.1
Ratio of debt outstanding to personal income [24]	**14.5%**	**13.3%**

City Operating Flexibility - Debt	2006	2010	City Debt Policy Target
Debt service (inc PICA and Pension Bonds) plus long term obligations as a percent of total expenditures	**15.8%**	**14.7%**	**15%**
Debt service (inc PICA) plus long term obligations as a percent of total expenditures	**8.6%**	**9.2%**	**12%**

[23] Source: FY10 City of Philadelphia Comprehensive Annual Financial Report Statistical Section, table 12

[24] Calculated utilizing personal income data from the US Department of Commerce, Bureau of Economic Analysis

City Operating Flexibility – Personnel costs	2006	2010
Wages and Benefits as a percentage of total obligations	**58.7%**	**59.9%**
Benefits as a percentage of total employee compensation	**37.8%**	**37.9%**
Benefits as a percentage of total obligations	**22.2%**	**22.7%**

Tax Competitiveness	2006	2009
State and local taxes for a family of three in Philadelphia, at income of $50,000 [25]	**$6,839**	**$6,859**
Median state and local taxes for family of three in fifty largest US cities, at income of $50,000 [26]	**$4,214**	**$4,182**
Philadelphia as a percent of median	**162.3%**	**164%**
	1997	2004
Philadelphia local taxes per $100 of city taxable resources [27]	**$6.84**	**$7.16**
Philadelphia tax effort as a percent of median of large cities [28]	**155.3%**	**114.6%**

[25] Source: Tax Rates and Tax Burdens in the District of Columbia --A Nationwide Comparison, Government of the District of Columbia

[26] Source: Tax Rates and Tax Burdens in the District of Columbia --A Nationwide Comparison, Government of the District of Columbia

[27] Source: New York City Independent Budget Office

[28] Source: New York City Independent Budget Office

Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT ON FY2012-FY2016 FIVE-YEAR FINANCIAL PLAN

SECTION VI:

APPENDICES

APPENDIX A

CITY OF PHILADELPHIA

June 24, 2011

Mr. Sam Katz
Chair, Pennsylvania Intergovernmental Cooperation Authority
1500 Walnut Street, 16th Floor
Philadelphia, PA 19102

Dear Mr. Katz:

This letter is in response to questions raised about the property tax revenue projections in the City's proposed Fiscal 2012-2016 Five Year Plan. While the two year 9.9% property tax increase expires at the end of fiscal 2012, property tax revenues are projected at the higher levels through fiscal 2016. The Administration and City Council believe this to be a conservative projection because the City's assessed valuation is expected to at least triple when the Actual Value Initiative (AVI) is complete in the fall 2012 for the fiscal 2013 budget. At that point, the tax rate will need to be substantially lowered or significant excess revenues beyond those shown in the Five Year Plan would be generated.

A property tax ordinance was passed by City Council and signed by the Mayor in June 2010 which raised the property tax rates for fiscal 2011 and fiscal 2012. The ordinance specifically set forth real estate tax rates of $3.305 for fiscal 2008-2010, $4.123 in fiscal 2011 and fiscal 2012 and then back to $3.305 in fiscal 2013. Assuming that the tax rate of $3.305 is left in place when AVI is complete in fiscal 2013 and assuming that the City's assessed value increases from $12 billion to $36 billion, an extra $2.5 billion would be generated over the life of the plan - $622 million in fiscal 2013, $630 million in fiscal 2014, $638 million in fiscal 2015, and $647 million in fiscal 2016. While we do not know exactly what assessed values will be when AVI is complete, we believe $36 billion to be on the low end of the projected assessed value. The high end is estimated to be $43 billion. It is the Administration's plan to reduce the tax rate when AVI is complete to generate at least the amount of revenues needed to meet the property tax revenue projections in the Five Year Plan. To give a sense of the magnitude of the planned tax reduction, if the assessed value is $36 billion when AVI is complete, the tax rate would be reduced to about $1.357. If the assessed value is on the higher end at $43 billion when AVI is complete, the tax rate would be reduced to about $1.137. Information on the property tax revenue projections will be included as part of the Appendices in the Five Year Plan submission to PICA.

Mr. Sam Katz
June 24, 2011
Page 2

Significant additional funds have been put into the Office of Property Assessment's fiscal 2012 budget to enable the Office to fully reassess all properties in the City by the fall of 2012. The City has had meetings with PICA staff and one board member to demonstrate that this process will be completed on time. Because of the much higher assessed value expected beginning in fiscal 2013, the projection for relatively constant property tax revenues from fiscal 2012 to fiscal 2013 is conservative. Please let us know if you have any additional questions about this matter.

Sincerely,

Michael A. Nutter
Mayor

Anna C. Verna

Honorable Anna C. Verna
City Council President

MB Tasco

Honorable Marian B. Tasco
Councilwoman

Darrell Clarke

Honorable Darrell Clarke
Councilman

cc: Michael Karp, PICA Board
Joseph DiAngelo, PICA Board
Gregory Rost, PICA Board
Uri Monson, Executive Director, PICA
Suzanne Biemiller, Chief of Staff
Rob Dubow, Finance Director
Rebecca Rhynhart, Budget Director

APPENDIX B

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 percent) 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 was submitted to PICA by the Mayor on July 7, 2011 and the PICA Act provides a 30 day period for review. 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 March 3, 2011 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 July 25, 2011.

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, revisions mandated by conditions of Plan approval, 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, 2012 (100 days prior to the end of FY2012). At that time, the City is required to add its Fiscal Year 2017 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 $1,200 million in funding to assist the City, allocated to the following purposes:

Purpose	Amount (thousands)
Deficit Elimination/Indemnities Funding	$ 269,000
Productivity Bank	20,000
Capital Projects	468,500
Retirement of Certain High Interest City Debt	384,300
TOTAL	**$1,141,800**

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 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.

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 2012. 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:

> <u>Quarterly Plan Reports</u> 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 FY2011 is August 15, 2011. Quarterly reporting deadlines for FY2011 are November 15, 2011, February 15, 2012, May 15, 2012 and August 15, 2012. 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.
>
> <u>Grants Revenue Fund Contingency Account Report</u>. 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. For FY2012, the reporting dates are October 20, 2011, January 20, 2012, April 20, 2012 and July 20, 2012. The report details the receipt 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.
>
> <u>Prospective Debt Service Requirements Reports</u> 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 FY2012 are August 1, 2011, October 31, 2011, January 31, 2012 and May 1, 2012.

APPENDIX C

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, 2012 through June 30, 2016, 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. PICA Staff is grateful for the assistance provided by the Controller's Staff in evaluating this Plan.

The Independent Auditor's Report of the Controller's Office resulting from its work with respect to the Plan, formally reported to PICA on July 21, 2011, is reproduced in this Appendix as well as the transmittal letter from the City Controller highlighting concerns and risks. Certain 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 City Controller's perspective on such matters.

CITY OF PHILADELPHIA

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ALAN BUTKOVITZ
City Controller
www.philadelphiacontroller.org

July 21, 2011

Mr. Uri Monson
Executive Director
Pennsylvania Intergovernmental Cooperation Authority
1500 Walnut Street, Suite 1600
Philadelphia, PA 19102

Dear Mr. Monson:

In accordance with Section 12720.209(f)(1) of the Pennsylvania Intergovernmental Cooperation Authority Act, my office conducted an examination of the Forecasted General Fund Statement of Operations With Budget Revisions for the fiscal years ending June 30, 2012 through June 30, 2016 (the forecasted statement). The forecasted statement was prepared by the Office of the Director of Finance and submitted to the Pennsylvania Intergovernmental Cooperation Authority (PICA) on July 7, 2011.

My staff conducted its examination of the forecasted statement in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we evaluate whether the assumptions used by the City of Philadelphia's management at the time the plan was submitted provide a reasonable basis for management's forecasted statement. Attached is the independent auditor's report signed by my deputy who is a Certified Public Accountant.

Although the independent auditor's report indicates that the assumptions used in the plan were reasonable, the forecasted statement includes particularly sensitive assumptions which PICA should consider when assessing the plan. These particularly sensitive assumptions include:

- The city has assumed wage and benefit savings totaling $11.9 million in fiscal year 2012 and $47.6 million over the remaining years of the forecast. However, these savings are dependent upon the successful completion of civilian labor negotiations and a favorable outcome to the appeal of the arbitration award to the International Association of Firefighters Local 22(IAFF).

- The city estimated savings related to self-insurance of $40.5 million in fiscal year 2012 and $162 million over the remaining years of the forecast. These savings are based on previous premium-based amounts due to the uncertainty in the timing and outcome of the appeal of the IAFF arbitration award.

In addition, several uncertainties exist which could dramatically impact the plan's effectiveness. These uncertainties, which PICA should also weigh when reviewing the plan, include:

- The effect that the eventual passage of the federal budget will have on city revenues. While the budget debate in Washington rages on, it would be naïve to believe that the city would be unaffected by any reductions in the current level of federal financial assistance provided to states and municipalities. However, due to the uncertainty surrounding both the extent of any cuts in federal funding and the programs that may be affected, the forecasted statement does not include assumptions to identify and quantify any potential revenue reductions. The Director of Finance, in his transmittal letter to PICA acknowledged the City's inability to plan for this contingency:

  > *"The City will feel the impact of state and federal cuts in FY12 and throughout the Five Year Plan...The City plans to handle these cuts by reducing spending in certain areas or shifting funds from one area to another...Additional general fund budget support to compensate for these cuts is not included in the FY12-16 Plan."*

  Because of the potential severity of these cuts, I strongly urge PICA to be vigilant in analyzing and evaluating the impact of this uncertainty upon the plan.

- The possibility of additional funding requests by the School District (District) in future years. The city has recently agreed to provide the District with $10 million in additional contributions from its General Fund for fiscal year 2012 and beyond, as well as $43 million in tax and fee increases. Given the current political and economic climate in Harrisburg, there can be no assurances that the District will not seek further increases in city contributions in later years of the plan. As City Controller, I have repeatedly called for the District to prepare a five year plan of its own, which would require the approval of an independent authority. I believe this additional level of oversight is necessary to halt the District's pattern of recurring fiscal crises of escalating proportions which we have witnessed in recent years. Unless the District takes the necessary steps to operate within its budgetary constraints and eliminate the uncertainty regarding its future funding requirements, the possibility of further financial shortfalls will remain, placing additional strains on the city's finances.

- The impact of any new legislation affecting property tax. Current plan assumptions do not provide for the possibility of future legislation by the state or City Council to ease the additional real estate tax burden on senior citizens and low-income taxpayers that will result from the implementation of the Actual Value Initiative. Nor does the plan account for returning property tax rates back to 2010 levels. Any such legislation or rollback of property tax rates may result in property tax revenue falling short of the amounts projected in the plan. In evaluating the assumptions used to forecast property tax revenues, the economist who assisted us in our examination considered the possible tax rate rollback in his economic model, and determined that the assumptions fell within an acceptable range of reasonableness.

Again, I urge PICA to be cautious when using the forecast because of the unpredictability of the assumptions and uncertainties described above, because as with any forecast, events and circumstances frequently do not occur as expected.

Finally, I would like to express our thanks to the management and staff of the city's Office of Budget and Program Evaluation for their courtesy and cooperation in the conduct of our examination.

Respectfully submitted,

ALAN BUTKOVITZ
City Controller

cc: Chair and Board Members of the
Pennsylvania Intergovernmental Cooperation Authority
Michael A. Nutter, Mayor
Rob Dubow, Director of Finance
Rebecca Rhynhart, Budget Director

CITY OF PHILADELPHIA
PENNSYLVANIA

OFFICE OF THE CONTROLLER

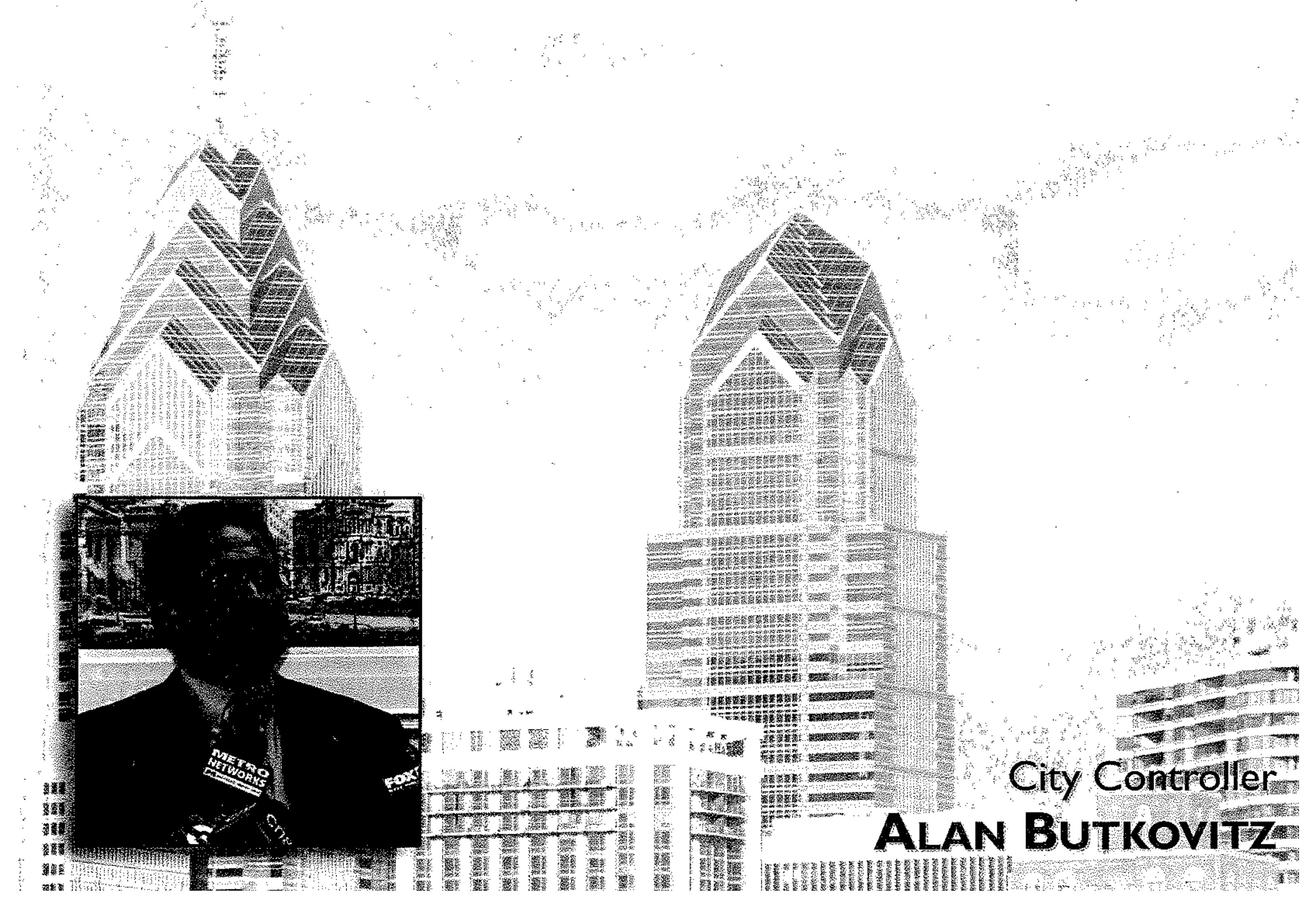
Promoting honest, efficient, and fully accountable government

FORECASTED GENERAL FUND
STATEMENTS OF OPERATIONS

CITY OF PHILADELPHIA

ACCOUNTANT'S REPORT

FISCAL YEARS 2012 – 2016



City Controller
ALAN BUTKOVITZ

CONTENTS

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ALAN BUTKOVITZ
City Controller

GERALD V. MICCIULLA
Deputy City Controller

INDEPENDENT ACCOUNTANT'S REPORT

To the Chair and Board Members of the
Pennsylvania Intergovermental Cooperation Authority

We have examined the accompanying Forecasted General Fund Statements of Operations for the fiscal years ending June 30, 2012 through June 30, 2016 (the forecasted statements). The City of Philadelphia's management is responsible for the forecasted statements, which were prepared for the purpose of complying with the provisions of the Pennsylvania Intergovermental Cooperation Authority (PICA) Act. Our responsibility is to express an opinion on the forecasted statements based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by the City of Philadelphia's management and the preparation and presentation of the forecasted statements. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, the accompanying forecasted statements are presented in conformity with guidelines for presentation of forecasted information established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's forecasted statements. However, there will usually be differences between the forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

The forecasted statements referred to in the preceding paragraph include assumptions that are particularly sensitive relating to wage and benefit cost savings and self-insurance costs. The assumptions relating to wage and benefit savings totaling $59.5 million ($11.9 million per year) are considered particularly sensitive because they are dependent on successful labor negotiations and are described in Note B.6 (a). The assumptions relating to self – insurance costs totaling $202.5 million ($40.5 million per year) are based on previous premium based costs due to the uncertainty in the timing and outcome of the appeal of the IAFF arbitration award as described in Note B.6 (b) and, accordingly, are considered particularly sensitive.

The accompanying forecasted statements and our report are intended solely for the information and use of the management of the City of Philadelphia and PICA and are not intended to be used and should not be used by anyone other than these specified parties.

Gerald V. Micciulla

July 20, 2011

GERALD V. MICCIULLA, CPA
Deputy City Controller

City of Philadelphia - Office of the Director of Finance

Forecasted General Fund Statements of Operations

Fiscal Years Ending June 30, 2012 through June 30, 2016

(Amounts in Thousands)

NO.	ITEM	FY 2012 Estimate	FY 2013 Estimate	FY 2014 Estimate	FY 2015 Estimate	FY 2016 Estimate
(1)	(2)	(3)	(4)	(5)	(6)	(7)
	OPERATIONS OF FISCAL YEAR					
	REVENUES					
1	Taxes	2,539,452	2,614,063	2,670,726	2,578,109	2,627,820
2	Locally Generated Non-Tax Revenues	259,959	265,951	273,252	275,383	275,981
3	Revenue from Other Governments	651,800	667,137	620,838	633,140	645,453
4	Sub-Total (1)+(2)+(3)	**3,451,211**	**3,547,151**	**3,564,816**	**3,486,632**	**3,549,254**
5	Revenue from Other Funds of City	51,510	50,773	51,244	43,453	43,745
6	Total - Revenue (4)+(5)	**3,502,721**	**3,597,924**	**3,616,060**	**3,530,085**	**3,592,999**
7	Other	0	0	0	0	0
8	**Total Revenue and Other Sources (6)+(7)**	**3,502,721**	**3,597,924**	**3,616,060**	**3,530,085**	**3,592,999**
	OBLIGATIONS/APPROPRIATIONS					
9	Personal Services	1,330,088	1,331,929	1,332,627	1,333,117	1,333,482
10	Personal Services-Pensions	554,325	661,009	657,416	588,930	595,786
11	Personal Services-Other Employee Benefits	468,378	487,158	503,433	518,691	534,365
12	**Sub-Total Employee Compensation**	**2,352,791**	**2,480,096**	**2,493,476**	**2,440,738**	**2,463,633**
13	Purchase of Services	758,994	768,395	772,573	768,054	768,902
14	Materials, Supplies and Equipment	78,960	76,164	77,594	77,594	77,594
15	Contributions, Indemnities, and Taxes	117,544	117,104	117,165	117,726	117,288
16	Debt Service	130,739	134,682	149,835	149,708	152,465
17	Capital Budget Financing	0	0	0	0	0
18	Advances and Miscellaneous Payments	4,000	4,000	4,000	4,000	4,000
19	Sub-Total (12 thru 18)	3,443,028	3,580,441	3,614,643	3,557,820	3,583,882
20	Payments to Other Funds	27,066	31,138	32,219	33,291	33,291
21	**Total - Obligations (19+20)**	**3,470,094**	**3,611,579**	**3,646,862**	**3,591,111**	**3,617,173**
22	Oper.Surplus (Deficit) for Fiscal Year (8-21)	32,627	(13,655)	(30,802)	(61,026)	(24,174)
23	**Prior Year Adjustments:**					
24	Revenue Adjustments	0	0	0	0	0
25	Other Adjustments	24,500	24,500	24,500	24,500	24,500
27	Total Prior Year Adjustments	24,500	24,500	24,500	24,500	24,500
28	**Adjusted Oper. Surplus/ (Deficit) (22+27)**	**57,127**	**10,845**	**(6,302)**	**(36,526)**	**326**
	OPERATIONS IN RESPECT TO					
	PRIOR FISCAL YEARS					
	Fund Balance Available for Appropriation					
29	June 30 of Prior Fiscal Year	3,454	60,581	71,426	65,124	28,598
30	Residual Equity Transfer	0	0	0	0	0
31	Fund Balance Available for Appropriation June 30 (28)+(29)+(30)	**60,581**	**71,426**	**65,124**	**28,598**	**28,924**

See accompanying summaries of significant accounting policies and assumptions and accountant's report.

A. Nature of the Forecast

The City of Philadelphia Office of Budget and Program Evaluation (OBPE) is responsible for providing revenue and obligation estimates to the Director of Finance and the Mayor for discussion and inclusion in the FY2012 budget and the FY2012-2016 Five Year Financial Plan (FYP) submitted by the Mayor to the Pennsylvania Intergovernmental Cooperation Authority (PICA) on July 7, 2011. These financial forecasts present, to the best of management's knowledge and belief, the City's expected results of operations for the forecast periods. Accordingly, the forecasts reflect the City's judgment as of July 7, 2011, the date of these forecasts, of the expected conditions and its expected course of action. The assumptions disclosed herein are those that management believes are significant to the forecasts. There may be differences between the forecasted and actual results because events and circumstances frequently do not occur as forecasted or expected.

B. Summary of Significant Accounting Policies

The Forecasted General Fund Statement of Operations is presented on the budgetary basis of accounting. The budgetary basis of accounting differs from the modified accrual (Generally Accepted Accounting Principles) basis used in the preparation of the city's governmental fund financial statements in that both expenditures and encumbrances are applied against the current budget, adjustments affecting activity budgeted in prior years are accounted for through fund balance or as a reduction of expenditures and certain interfund transfers and reimbursements are budgeted as revenues and expenditures.

C. Summary of Significant Forecast Assumptions

1. Approach to Revenue Forecasting

The city's estimated general fund revenues for FY12 total $3.503 billion. Approximately 72% of the city's budget comes from local taxes, and 19% comes from other governments. Locally generated non-tax revenues, which include fees, fines and permits, account for 7% of revenues.

OBPE provides forecasts of the six major taxes, totaling over $2.5 billion in the adopted FY12 budget, as well as $260.0 million of Locally Generated Non-Tax revenues, and $651.8 million in Revenue from Other Governments. These three sources comprise 98% of the revenues anticipated for the FY12 budget.

OBPE employs a number of approaches to developing its forecasts of local revenues:

a. Forecasts of economic activity provided by several sources including the Congressional Budget Office and the Blue Chip Economic Indicators;

b. Continuous evaluation of national and local economic data on employment, inflation, interest rates, and economic growth;

c. Ongoing examination of the city's current tax receipts;

d. Economic forecasting of tax revenues provided by a revenue forecasting consultant;

e. Discussions with economists at the Federal Reserve Bank of Philadelphia; and

f. The extensive experience of its staff.

OPBE's tax projections for the FYP were developed in conjunction with a revenue forecasting consultant, IHS Global Insight, Inc (IHS). IHS created econometric models which included variables such as wage and salary disbursements in the metropolitan statistical area (MSA) and the county, personal income in the county, the unemployment rate, home prices in the county, real estate transaction growth, and national corporate profits. These models, together with their forecast of the Philadelphia economy, were used by IHS to project tax revenues for the City. IHS focused on four taxes – Wage and Earnings Tax, Business Privilege Tax, Real Estate Transfer Tax, and Sales Tax. These projections were refined by OBPE after discussions with leading economists at the Federal Reserve Bank of Philadelphia.

2. The National and Local Economic Context

Although its effects did not begin to be felt by the City until the summer of 2008, according to the National Bureau of Economic Research, the recession officially took place between December 2007 and June 2009. Governments and businesses across the globe have had to grapple with a world economy beset by a profound financial crisis, large declines in residential housing markets, a global contraction in economic activity, and a weak job market characterized by high unemployment. While the recession may be officially over, the recovery has been slow and particularly slow for employment and real estate.

Growth in the United States' output since the middle of 2009 has been very weak compared to previous economic recoveries. This type of weak growth tends to occur following recessions brought on by financial crises like the one just experienced.[1] U.S. gross domestic product (GDP) increased 2.9% in 2010 after a decline of 2.6% in 2009. Consensus forecasts of economic growth have tempered somewhat over the last few months and U.S. GDP growth is projected to be 2.6% in 2011. The housing sector remains troubled -- the consensus estimate of projected housing starts continues to decline and is now estimated to be only slightly higher in 2011 than 2010.[2]

National unemployment remains high and is not expected to decline significantly over the next year. According to the Blue Chip consensus, unemployment is expected to be 8.8% in 2011, declining to a still high 8.2% in 2012. All of this taken together signifies that while continued modest growth is expected, the recovery will be slow and economists do not expect a return to pre-recession levels in the near future.

Philadelphia has been substantially impacted by the economic crises described above. The number of people employed dropped from 592,000 in April 2009 to a low of 575,100 in July 2010, rebounding slightly to 579,800 in May 2011, a decline of 2.1% since 2009. Unemployment has had a sizable

[1] Congressional Budget Office "The Budget and Economic Outlook: An Update" August 2010
[2] Blue Chip Economic Indicators June 10, 2011

increase, from 6.0% in August 2007 to a high of 11.2% in November 2010 and has improved somewhat to 10.1% in May 2011. [3] Employment levels are particularly important for Philadelphia's budget because it is heavily reliant on the Wage Tax.

3. The City's Major Taxes

The city receives revenue to fund its services and programs from six major taxes (contributing to 72% of the expected General Fund revenue in FY12). These include:

1. Wage and Earnings and Net Profit Tax (Wage),
2. Property Tax,
3. Business Privilege Tax (BPT),
4. Real Estate Transfer Tax (RTT),
5. Sales Tax, and
6. Parking Tax.

The remaining taxes, including the amusement tax, provide less than 1% of General Fund revenue. Philadelphia's reliance on the Wage Tax (34% of the General Fund) and the BPT (11%) places the city at risk from economic trends and employment fluctuations of the local economy. Other cities and counties that rely more heavily on property tax revenues are more susceptible to dramatic shifts in the housing market.

a. Wage Tax

The largest tax revenue source (comprising 47% of tax revenues) is the Wage, Earnings, and Net Profits (Wage) tax. The Wage Tax is collected from all employees working within city limits, and all city residents regardless of work location. Currently, the Wage Tax rate is 3.9280% for residents and 3.4985% for non-residents. The resident rate includes 1.5% that is reserved for the Pennsylvania Intergovernmental Cooperation Authority (PICA). PICA has overseen the city's finances since 1992, when the State Oversight Board was first established. The PICA statute permits the Authority to a "first dollar" claim on its portion of Wage Tax proceeds, which is used to pay debt service on bonds issued by PICA for the benefit of the city. Excluding the PICA portion, the Wage Tax is projected to bring in $1.206 billion in FY12. This projection includes a 3.4% growth rate in the Wage and Earnings Tax and a 2.5% expected growth rate in the Net Profits Tax. [4] In FY14, assuming that the city's fund balances remains consistent

[3] Pennsylvania Department of Labor and Industry, Monthly Seasonally Adjusted Unemployment Rates
[4] Growth rates referenced throughout these notes are applied to the current portion of the tax base.

with or higher than those in the FYP, the city plans to resume previously planned wage tax reductions that were suspended in FY10.

b. Property Tax

The Real Property Tax (Property) is the city's second largest source of tax revenue (19%), estimated to contribute $486.7 million of the FY12 tax revenues. This tax is levied on the assessed value of residential and commercial property in the city. The two year 9.9% property tax increase is in effect through the end of FY12. FY12 projected revenues are slightly lower than FY11 revenues due to the expectation of some appeals and because of a lack of reassessments as the city prepares for the Actual Value Initiative (AVI) to take place. In the fall of 2012, the AVI is scheduled to be completed which will result in a substantial increase in assessed value. At this point, the tax rate will need to be substantially lowered for FY13 or significant excess revenues beyond those shown in the FYP would be generated. It is the Administration's plan to reduce the tax rate when AVI is complete to generate at least the amount of revenues needed to meet the property tax revenue projections in the FYP. Included in the FY12 – FY16 projected revenues are the return of abated properties to the tax roll. In addition, although AVI will adjust real property assessments to approximate current market value, we believe real estate tax growth will remain relatively modest over the life of the plan because of the slow recovery of the real estate market to the pre-recessionary level.

c. Business Privilege Tax (BPT)

The Business Privilege Tax (BPT) is projected to produce $369.3 million in FY12, 15% of total tax revenue. The majority of the BPT is derived from corporate profits which had a strong year in calendar year 2010 but are volatile and dependent on economic conditions within the city.

d. Sales Tax

Sales Tax revenues are projected to generate $256.5 million in FY12, 10% of tax revenues. As part of its response to projected budget deficits in 2009, the city passed new legislation which was approved by the Commonwealth of Pennsylvania (the Commonwealth) to temporarily increase the Sales Tax rate from 1% to 2%. This raised the total Sales Tax rate to 8%, with 6% going to the Commonwealth and 2% to the city. The increased rate is scheduled to be in effect through FY14 and return to 7% in FY15. Growth rates projected for Sales Tax are 3.5% for FY12, then peaking at 4.0% in FY13 as the economy rebounds, and tapering off to a low of 3.1% in FY16.

e. Real Estate Transfer Tax

Economic conditions have negatively affected the Real Estate Transfer Tax (RTT) since the housing market decline began in 2007. FY11 RTT revenues are anticipated to be slightly lower than FY10 RTT revenues. The RTT is projected to provide $120.9 million in FY12; a growth rate of 3.0% over FY11 anticipated collections. A growth rate of 5.0% is projected for FY13 and FY14 and a lower growth rate of 4.0% is projected for FY15 and FY16. The city imposes a 3% tax on real property sales and an additional 1% is charged by the Commonwealth for a 4% total RTT.

f. Parking Tax

The parking tax is levied on the gross receipts from all parking transactions. Parking tax revenue is projected to generate $74.3 million in FY12, 3% of tax revenues.

Major Taxes ($ in Millions)
with Percentage Change from Previous Year

Tax	FY10 Actual	FY11 Estimate	FY12 Estimate	FY13 Estimate	FY14 Estimate	FY15 Estimate	FY16 Estimate
Wage & Net Profits - Current & Prior	1,128.7	1,167.0	1,206.0	1,253.5	1,282.2	1,309.0	1,336.0
% change from prior year	n.a.	3.4%	3.3%	3.9%	2.3%	2.1%	2.1%
Real Property - Current & Prior	402.2	488.7	486.7	486.7	491.8	500.2	507.0
% change from prior year	n.a.	21.5%	-0.4%	0.0%	1.0%	1.7%	1.4%
Business Privilege - Current & Prior	364.7	370.8	369.3	378.1	383.1	380.7	384.1
% change from prior year	n.a.	1.7%	-0.4%	2.4%	1.3%	-0.6%	0.9%
Sales	207.1	247.5	256.5	266.4	275.4	142.1	146.4
% change from prior year	n.a.	19.5%	3.6%	3.9%	3.4%	-48.4%	3.1%
Real Property Transfer	119.2	117.3	120.9	126.9	133.2	138.6	144.1
% change from prior year	n.a.	-1.6%	3.0%	5.0%	5.0%	4.0%	4.0%
Parking	70.5	72.5	74.3	76.2	78.1	80.0	82.0
% change from prior year	n.a.	2.9%	2.5%	2.5%	2.5%	2.5%	2.5%
Other Taxes	24.2	25.2	25.7	26.3	26.9	27.5	28.1
% change from prior year	n.a.	3.9%	2.2%	2.2%	2.2%	2.2%	2.2%
Total Taxes	**2,316.6**	**2,489.0**	**2,539.5**	**2,614.1**	**2,670.7**	**2,578.1**	**2,627.8**
% Change from prior year	**n.a.**	**7.4%**	**2.0%**	**2.9%**	**2.2%**	**-3.5%**	**1.9%**

Note: Property Taxes were increased in FY11. Wage and Business Taxes incorporate rate reductions that will resume in FY14. The reduced estimate for the Sales Tax in FY15 is due to the sunsetting of the temporary 1% increase that began in FY10. Other Taxes include the Amusement Tax and miscellaneous taxes. Wage tax does not include the PICA tax.

4. Locally Generated Non-Tax Revenues

Locally Generated Non-Tax revenues are estimated based on historical trends, rate changes, and current collection patterns. Certain revenues such as interest earnings, licenses and permits and recording fees are subject to economic contractions and are estimated accordingly.

5. Revenue from Other Governments

Revenue from Other Governments is estimated based on historical trends and state and federal budget information. The PICA city account which represents 45% of Revenue from Other Governments is estimated using Wage Tax variables.

Revenue from Other Governments in the FY12 budget is significantly lower than that of FY11 because of the move of the Department of Human Services' reimbursed costs and corresponding revenues to the grants fund beginning in FY12. As a result of this change, the City's general fund balance will better reflect the City's financial condition. For the past several years, the financial position of the City's general fund has been distorted by the timing of the receipt of reimbursements from the Commonwealth of Pennsylvania for DHS services. For a variety of reasons, some of those reimbursements have not been recognized in the same year as the costs were incurred. As a result, the costs have been reflected in the City's fund balances, but the reimbursements are not, leading to fund balances that are distorted and artificially low. Removing reimbursed DHS costs and their corresponding revenues from the general fund will remove this distortion from the City's general fund finances.

6. Obligation Estimates

The City of Philadelphia OBPE is responsible for providing obligation estimates to the Director of Finance and the Mayor for discussion and inclusion in the revised annual FY2012 budget and FY2012-2016 Five-Year Financial Plan (FYP) submitted by the Mayor to the Pennsylvania Intergovernmental Cooperation Authority (PICA) on July 7, 2011. OBPE provides forecasts of all major expenditure categories.

A major change to the FY 2012 – 2016 Five Year Plan is the shift of the Department of Human Services' reimbursed costs of $495 million from the General Fund to the Grants Revenue Fund. Making this change will add transparency to the City's finances as the General Fund balances will better reflect the City's financial condition.

The FY 2012- 2016 Five Year Plan also includes departmental spending reductions of $6.9 million in FY 2012 and $5.4 million in FY 2013 through FY 2016 and $47.3 million in increases in FY 2012 and $46.3 million in FY 2013 through FY 2016.

FY12 Expenditure Reductions:

- Building off the successful efforts to lower the inmate census, almost $2 million will be removed from the Prison's budget. In addition, City Council cut an additional $4 million from the Prisons budget to fund electronic monitoring in the First Judicial District's budget. The Administration is still reviewing this budget change by City Council to determine if funding will be provided, but has conservatively put this change into the Five Year Plan.
- $200,000 will be saved in the Law Department, through elimination of unfilled vacancies. Likewise, the Department of Licenses and Inspections will also save $200,000 through the elimination of unfilled vacancies.
- $100,000 will be saved in the Office of the Director of Finance, through the elimination of a vacant position, and contract savings.
- The Office of Fleet Management shows cost reductions of $388,000 through savings in heavy equipment repair.

FY 12 Expenditure Increases:

The largest single increase in the FY12 Adopted Budget is an additional $10 million contribution to the School District of Philadelphia to help reduce a projected $629 million deficit. Due to the provisions of the Commonwealth of Pennsylvania's Act 46, these additional funds are now a permanent part of the City's contribution.

Almost half of the additional funding is for public safety. The Adopted Budget includes an investment of about $20 million in this area as listed below:

- $6.4 million for the Police Department will fund a new class of 120. This new class will allow the Department to build off the successes in crime fighting and prevention over the last three years.
- The Fire Department's budget increased by $4.7 million. This funding will pay for firefighters' personal escape systems, which were mandated in a previous Arbitration Award, and replacement for firefighters' oxygen bottles, which are coming to the end of their useful life. Also funded is

an increase in uniform overtime which will bridge the gap until a new class of firefighters can be brought on board and additional funds for grant matching requirements.

- $4 million in the First Judicial District for electronic monitoring of prisoners. The Administration is still reviewing this change to the budget ordinance made by City Council to determine if funding will be provided, but has conservatively put this change into the Five Year Plan. In addition, the Administration added $2.4 million for the restoration of probation positions funded by a Recovery Act grant that is expiring.
- $1.9 million for the District Attorney to allow the office to maintain needed initiatives.
- $450,000 for the Defender Association for health benefit cost increases. In addition, City Council added $500,000 for the Defender Association for the representation of indigent defendants. The Administration is still reviewing this change by City Council to determine if funding will be provided, but has conservatively put this change into the Five Year Plan.

The remaining investments include:

- $4.4 million is included for the Office of Property Assessment to allow it to complete overhauling the property assessment system, in order to provide fair and accurate property evaluations.
- The Streets Department is increased by $5 million. $4 million is to pay for snow removal. Using the past five years' average expenditures for contracted snow costs, this funding will help to ensure that the City is better able to manage in case of large snow storms. In addition, $1 million is included for alley lighting throughout the City.
- $1 million to increase funding to the Mayor's Commission on Literacy for an Adult Literacy program.
- $573,000 for the newly created PhillyRising program run out of the Managing Director's Office.
- $500,000 for lot cleaning in the Office of Housing and Community Development. The Administration is still reviewing this proposal by City Council to determine if funding will be provided, but has conservatively put this change into the Five Year Plan.
- $310,000 to adequately fund election workers pay in the City Commissioners.
- $220,000 for an increase to the Recreation and Activities Fund in the Department of Parks and Recreation. The Administration is still reviewing this proposal by City Council to determine if funding will be provided, but has conservatively put this change into the Five Year Plan.
- $180,000 to ensure that swimming pools will be open all summer long.

a. Labor Agreements

The City's labor agreements with its four major bargaining units – FOP Lodge No. 5, IAFF Local 22, DC 33 and DC 47 – expired on June 30, 2009. An interest arbitration award to the FOP was made in FY 10. Contracts with DC 33 and DC 47 remain outstanding; and except for its pension provisions, the interest arbitration award granted to the IAFF on October 12, 2010 is under appeal by the City.

F.O.P. Lodge 5

On December 18, 2009, a five year interest arbitration award with the FOP, Lodge No. 5 was issued to cover FY10 through FY14. Important financial components of the award that affect FY12 through FY16 include:

- Three percent wage increase for FY12. Funding for the wage increase is included in the FY 2012 – 2016 Five Year Plan. The award will be reopened for FY13 and FY14 for a determination by the arbitration panel as to what salary changes, if any, will be awarded for those two years.
- In FY11, the FOP's health plan moved to self insurance. Instead of paying a carrier for insurance, the FOP began paying the actual cost of services provided to members. This health insurance change followed a similar change made by the City in FY10 to the plan it administers for non-union employees. The FYP includes an estimate for these costs based on an average of three months of actual FY11 expenditures increased by 10% per year based on medical cost trends.
- Pension changes for new hires – FOP members will now choose between increasing their pension contribution from 5% to 6% of pay or enrolling in a new hybrid pension plan. The hybrid pension plan reduces the risk to the City of poor market returns and is unprecedented for uniformed employees in any major city in the country. Meanwhile, increased employee pension contributions provide General Fund savings for the City.
- Up to 30 furloughs (days off without pay) in a fiscal year.

I.A.F.F.

On October 12, 2010, a five year interest arbitration award with the IAFF was issued to cover FY10 through FY14. Though the terms of the award are similar to those in the FOP award and takes a crucial step toward reform by establishing a hybrid pension system, it imposes more than $100 million in new costs over the Five Year Plan without giving the City the required tools to manage these costs.

Unlike the award for FOP members this award does not give the City the right to furlough, which could have been used to help fund the added cost of a contract. Because of the exorbitant costs and the absence of fiscal tools to manage those costs, the City has appealed portions of this contract award to the court.

The portion of the award not under appeal and already implemented is the change to the IAFF members' pension plan. Similar to the pension changes made in the arbitration award with the FOP, new IAFF members as October 15, 2010, must choose between increasing their pension contribution from 5% to 6% of pay or enrolling in a new hybrid pension plan.

F.O.P. – Deputy Sheriffs and Register of Wills

On June 21, 2011, a five year interest arbitration award with the FOP, Lodge No. 5 concerning Deputy Sheriffs and Register of Wills employees was issued to cover FY10 through FY14. Important financial components of the award that affect FY12 through FY16 include:

- A 2.5% wage increase in FY12 for Deputy Sheriffs. The award will be reopened for FY13 and FY14 for a determination by the arbitration panel as to what salary changes, if any, will be awarded for those two years. Register of Wills employee wage increases will be based on what is negotiated between DC 33 and the City.
- Restoration of step and longevity increments that were frozen by the City in July 2009. Increments were restored retroactively to July 1, 2009 for employees of the Sheriff's Office and restored as of the date of the award for Register of Wills' employees.
- The FOP's health plan, which includes Deputy Sheriffs, moved to self insurance in FY11. This award continues that arrangement. It also reduced the City's monthly contribution from $1,165 per member to $965 per member for the period January 1, 2010 through June 30, 2010. The City will get a credit for contributions already made. Register of Wills employees will continue to participate in the City Administered plan.
- Pension changes for new hires. Deputy Sheriffs will have to choose between going into the existing municipal Plan 87 and increasing their contribution from 30% of normal cost to 50% of normal cost, or going into the new hybrid plan. Register of Wills employees hired after the date of the award must enter the hybrid plan.

AFSCME District Council 33 and District Council 47

Negotiations continue with the City's other two major municipal unions, DC 33 and DC 47. The City is seeking zero wage increases across the life of the contracts. The City is also seeking similar health and welfare plan changes as awarded to the FOP, as well as hybrid pension plans for new members and increased contributions for existing members. In order to achieve short-term savings without requiring long term layoffs, the City is also seeking the FOP's contract terms for furloughs.

If the IAFF award appeal and the contracts with the City's non-uniformed employees exceed the amounts included in the Five Year Plan, the Administration and Council will need to find other ways to balance the Five Year Plan. Without those savings, the Administration would likely have to turn to service reductions or other revenue increases.

The Administration hopes to resolve all outstanding contract issues as soon as possible. Because the plan assumes savings from employee costs of $11.9 million per year and $59.5 million over the life of the plan, and any savings that will be achieved are dependent on the successful completion of the civilian negotiations, as well as the successful appeal of the arbitration award to the IAFF, these assumptions are of a particularly sensitive nature.

b. Health / Medical

The Administration implemented a self-insured group health plan in 2010 for medical benefits for non-union employees. In FY11, coverage for members of the Fraternal Order of Police (FOP), Lodge No. 5 also switched to self-insurance. For non-union employees, an average of five months of experience was used to determine cost estimates in the FYP. No increases were built in for the life of the plan as the City can change the design of the health plan (increase co-pays and employee contributions for example) to keep costs level. For the FOP three months of actual experience was used. However, because the City has no control over the design of the FOP health plan, an increase of 10% per year based on medical cost trends has been included.

Cost estimates for DC 33 and DC 47 are based on an average of six months of actual expenditures in FY11. Because there are no new contracts for these groups and therefore no change in the per member, per month City contribution, it is assumed costs for FY 2012 – 2016 will approximate the FY11 average expenditure.

As the arbitration award to the IAFF is under appeal, the move to self-insurance included in the award has not been implemented. For that reason, the cost estimate for the IAFF is based on an average of six months of actual expenditures under the provisions of the expired contract ($1,270 per employee, per month) with no increase assumed for the life of the plan. Due to the uncertainty in the timing and outcome of the appeal, the health / medical arrangement with the IAFF cannot be determined and therefore the assumption relating to IAFF medical costs of $40.5 million per year for FY12 – FY16 is particularly sensitive.

c. Pensions

As part of the effort to control major cost drivers and to improve the health of the pension fund, several changes have been made over the past few years and the Administration continues to seek additional changes.

The City of Philadelphia's Act 111 interest arbitration award with the Fraternal Order of Police (FOP), Lodge No. 5 issued on December 18, 2009 requires all FOP employees hired on or after January 1, 2010 to make a one-time irrevocable election between:

1) Participating in the City's current defined benefit pension plan and increasing their contribution by 20%, from 5% to 6%; or

2) Participating in a hybrid plan, containing both a defined benefit and a voluntary defined contribution component.

Similar pension changes were awarded in the October 12, 2010 interest arbitration award with IAFF, Local 22. The award's pension provisions are not part of the appeal and, therefore, have been implemented. New IAFF members hired as of October 15, 2010, must make the same one-time irrevocable election between increasing their pension contribution from 5% to 6% of pay or enrolling in a new hybrid pension plan.

Increasing employee pension contributions and introducing a hybrid pension plan are expected to reduce the costs to the City in the short and long term and help minimize the risk that the City faces from dramatic decreases in the stock market, like the ones suffered in FY09. Philadelphia is one of only a handful of cities in the country to offer a defined contribution plan to its employees and is the only one to offer one to uniformed employees. Similar pension benefit changes are being sought as part of the City's ongoing negotiations with DC 33 and DC 47.

In addition to the changes in pension benefits over the past few years as outlined above, the City's pension fund has undergone the following changes:

- Re-amortized the pension fund's unfunded actuarial accrued liability over a 30-year period using level-dollar amortization payments.
- Deferred payment of a portion of its Minimum Municipal Obligation (MMO) to be repaid by end of the fiscal year ending June 30, 2014 with 8.25% interest, which was the fund's earnings assumption rate when the state law enabling the deferrals was enacted,. The City deferred about 20% of its pension costs, $150 million and $80 million for the fiscal years ending June 30, 2010, and June 30, 2011, respectively.
- Eliminated the eligibility of newly elected city officials to participate in Philadelphia's DROP.
- Reduced the pension fund's earnings assumption from 8.25% to 8.15%. Lower earnings assumptions allow funds to moderate the risk of their investments, which can also reduce the likelihood of losses.
- Increased the smoothing period for actuarial losses and gain from five to ten years. Increasing the smoothing period reduces the impact that any particular year will have on the fund's funded status and on the City's required payments. This, in turn, reduces the volatility of pension payments.

The net impact of all of these changes to the City's pension benefits and fund is to moderate what would have been devastating increases in pension costs over the five year plan and to increase the City's ability to fund existing liabilities in the long term. The specific changes to the pension fund assumptions have been tested by the City's actuary and have been determined to be actuarially sound. Yet despite these proactive changes, pension costs will continue to rise. Costs will be substantially higher each year from FY12 through FY16 than they were in FY11. That increase is caused in part by the deferral of FY10's and FY11's payments to FY13 and FY14. The pension amounts included in the FYP are provided by the City's actuary and are based on the amounts required to be paid under state law.