Federal Funds, Fiscal Cliffs, and the Philly Fund Balance

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What's the Issue?

Philadelphia, like nearly all local governments, received federal funds to respond to the COVID-19 pandemic and its negative impacts. As a combined city-county, Philadelphia received $1.4 billion from the State and Local Fiscal Recovery Fund (SLFRF) plus funding from federal sources, including Emergency Rental Assistance, the Coronavirus Relief Fund, Emergency Solutions Grants – CV and others. The federal relief was essential to the City, as revenues from local taxes and fees nosedived at the same time new services, like COVID testing and quarantine and isolation spaces, were needed. Without the federal support, Philadelphia would not have been able to sustain existing critical services and support hard-hit households and business over the past few years.

But those dollars weren't granted on a recurring basis, and a deadline for spending is looming – all SLFRF funds must be obligated by December 2024. After that, the City will need to balance its books and provide for City service delivery on its own or face a fiscal cliff (a sudden and severe imbalance in revenues and spending). Because the City issues a Five-Year Financial Plan, as mandated by the PICA Act, the City developed a game plan for avoiding a fiscal cliff – but even with planning ahead to avoid a sudden drop in available resources and services starting on January 1, 2025, the City of Philadelphia isn't quite in the clear. Between FY25 and FY28, the current Five-Year Plan relies on drawing down on the fund balance to make up for the lost revenues and rising costs. With the current projected fund balance for FY28 being a scant $86 million (about $900 million less than recommended by the Government Finance Officers Association), this approach will likely not be sustainable another year in the future.

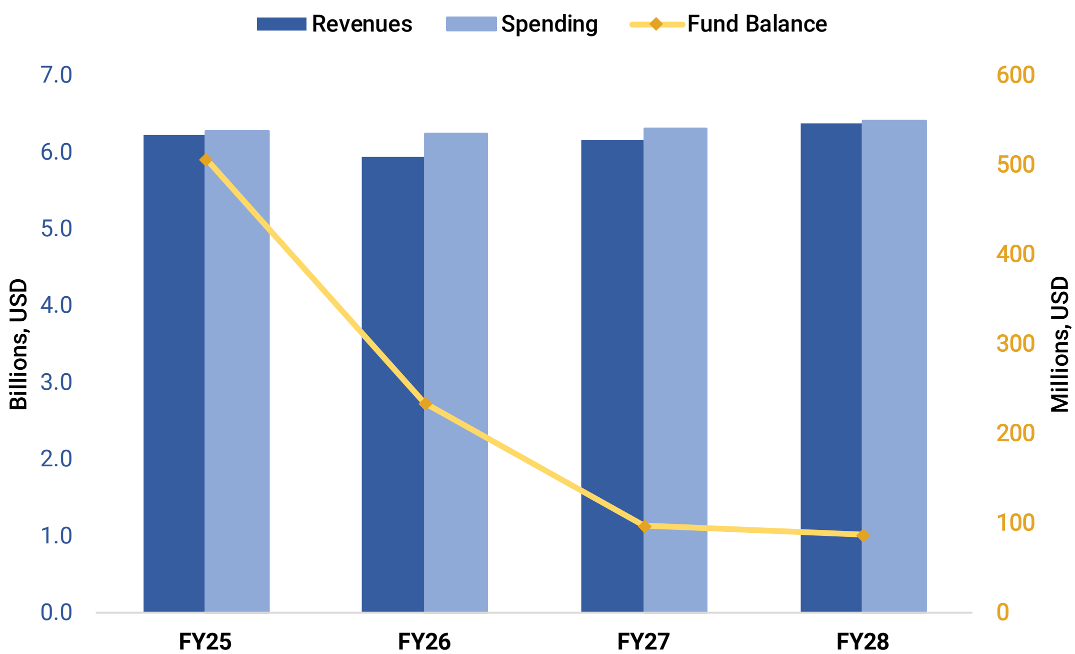
As the Parker Administration proposes its first budget and the FY25-29 Five-Year Plan, it will need to make sure that Philadelphia navigates the end of the federal funds while maintaining an adequate fund balance. If the City runs short on funds, it could face hard choices around raising taxes, reducing services, and laying off employees.

If the next Plan fails to absorb the loss of federal funds while maintaining a positive fund balance using reasonable assumptions, an even more immediate fiscal cliff would appear. Without PICA Board approval for the Five-Year Plan, almost all Commonwealth of Pennsylvania funds for Philadelphia would be withheld until the Plan gets back into balance, including nearly $700 million from the PICA Tax plus many state grants.

Current Plan to Avoid a Fiscal Cliff

While other cities may be kicking the can on figuring out how to avoid a fiscal cliff, the PICA Act requirement that Philadelphia produce a balanced Five-Year Plan meant that the City developed a game plan shortly after the funds were awarded. First, the City reviewed the rules for how the funds could be used and opted to claim all $1.4 billion as revenue replacement. This approach maximized the City's flexibility in how to use funds. With very few exceptions, it could use the SLFRF dollars in the same manner it might use local tax collections. The City also decided to stagger the use of the funds over multiple fiscal years, right up until the December 2024 expenditure deadline. By spreading out the use of the funds, paired with targeted spending decreases, anticipation of a revenue rebound over time, and utilization of the fund balance, the City of Philadelphia planned for a gentler transition following the end of federal support.

FIGURE 1 | **The fund balance is expected to drop from FY25 to FY28 as spending outpaces revenues.**



Source: City of Philadelphia FY24-28 Five-Year Plan

An alternative approach would have been to spend all the funds as soon as they were received to maximize immediate community impact but necessitating dramatic service reductions and/or sharp tax increases shortly thereafter.

Revenue Growth

The City's plan to transition to lower levels of federal government support once the COVID grants end relies in part on a rebounding of the City's tax revenue streams. Overall, tax revenues are expected to increase each year through the end of the FY24-28 Plan. The Plan assumes that every tax type will grow every year between FY25 and FY28, with two exceptions. The Business Income and Receipts Tax base, a historically volatile tax stream, is projected to shrink by 2.34% in FY26 followed by 6.84% growth in FY27. The Philadelphia Beverage Tax base is expected to decline by 1% in FY26 and about half that rate in both FY27 and FY28 due to an expected continuing shift in consumer behavior away from sweetened beverages.

For the City's two largest tax streams, Wage and Real Estate, steady growth is expected (see Table 1).

Based on collections through the first quarter of FY24, Wage Tax collections remain on track. It's too early in the year to evaluate Real Estate tax collections, which are due this coming March. There are signs of trouble with another significant revenue source, the Realty Transfer Tax (RTT). The PICA-approved FY24-28 Plan anticipated FY24 collections from the RTT of $389 million. Unfortunately, after seeing how collections have gone in the first quarter of FY24, the City downwardly revised its RTT projection by more than $100 million, to $265M. This decline likely stems from higher interest rates that are driving down prices and/or the volume of transactions, although mortgage rates have recently begun to drop. How long these conditions linger may have a material impact on the City's total revenue collections over the course of the Five-Year Plan.

TABLE 1 | COMPARING WAGE AND REAL ESTATE TAX GROWTH RATES

Fiscal Year	Base Growth Rate Wage Tax	Base Growth Rate Real Estate
FY24	3.74%	0.0%
FY25	4.75%	4.5%
FY26	4.55%	3.0%
FY27	4.06%	3.0%
FY28	3.88%	3.0%

Targeted Spending Reductions

Although the overall General Fund budget is expected to grow from $6.2 billion in FY24 to $6.4 billion in FY28, there are areas of the budget that are slated to shrink for at least one year in the current plan. While some of these reductions may reflect purchases designed to be one-time/ infrequent (for example, a new Case Management System for the Law Department, or a bulk purchase of electric vehicles for L&I inspectors), other reductions may result in lower service levels in outyears compared to what was provided in FY24.

Fund Balance

Owing to higher-than-expected revenues and unplanned savings due to ongoing hiring challenges, the City's General Fund balance for FY23 was $300 million higher than projected in the FY24-28 Plan. This adds to a cushion that the City built up in anticipation of the need to absorb continuing spending growth before the revenue growth could rebound and catch up. Between FY25 and FY28, the current Plan requires using up more than $400 million in fund balance to address the imbalance between revenues and spending. In the last year of the current Plan, this leaves the City projecting just $86 million left over – not much wiggle room to navigate potential deviations from planned collections or spending, like new labor contracts that increase costs more than the amount set aside in the Labor Reserve, significant climate events or public health disruptions that require emergency responses and disrupt the local economy, or broader economic deterioration. For the unexpected and unavoidable, the City's Budget Stabilization Reserve can provide a safety net, but $86 million is far below the City's target fund balance between 6% and 8% of revenues (about $400 to $500 million). The Government Finance Officers Association recommends a more robust fund balance equal to 2-months spending (a bit over $1 billion).

Examples of Planned Spending Reductions

Managing Director's Office
Planned Reductions in FY25
$12M for Community Partnership Anti-Violence Grants
$5M for CLIP
$5M for Clearing Criminal Justice Debts
$2M for Abandoned vehicles

Managing Director's Office
Planned Reduction in FY26
$31M for Free Transit Passes for Low-Income Philadelphians

Fleet Planned Reduction in FY25
$2.9M for Fuel Purchases

Commerce Planned Reduction in FY25
$3M for Workforce Solutions Grants and Incentives

Finance Planned Reduction in FY25
$24M for the Recession, Inflation, and Reopening Reserve

Office of Homeless Services
Planned Reductions in FY25
$3.5M for support of Opioid-Related Programs
$3.2M for Non-Congregate Shelter
$2.3M for Security and Food at Emergency Shelters

Chief Administrative Officer
Planned Reduction in FY26
$9M for Free Transit Passes for City Employees

Building a Balanced FY25-29 Five-Year Financial Plan

FY25 will be the last opportunity for the City to rely on American Rescue Plan dollars, with the remaining $449 million already built into the current Five-Year Plan. As Mayor Parker and her team swiftly formulate their first budget and the FY25-29 Five-Year Plan, they will need to revisit the assumptions and decisions in the FY24-28 Plan to determine:

1. Are the planned reductions, like discontinuing free transit passes and support for CLIP, aligned with the Parker Administration intentions – or will other choices and trade-offs need to be made?

2. Are the revenue growth expectations for the out years of the Plan still reasonable? Might they be lower or higher?

3. Will the planned rates for taxes and fees still generate the needed amount of funds to sustain planned expenditure levels?

4. How will the Parker Administration's priorities for how funds are raised and spent be reflected in the FY25-29 Plan?

What Will PICA Be Looking for in the FY25-29 Plan?

Once the FY25 budget is adopted by City Council and signed by the Mayor, the Administration will update its proposed FY25-29 Plan and make a final submission to PICA. PICA staff will evaluate the Plan for alignment with the requirements laid out in the PICA Act and make a recommendation to the PICA Board on whether to approve the Plan, a necessary step to ensuring that state dollars, including close to $700 million from the PICA tax, flow into the City's coffers in FY25. PICA will be looking for:

- **Balanced Budgets**

  -The City is running out of runway to use the fund balance to close the gap between revenues and spending each year in the General Fund, as the FY28 fund balance is currently projected to be $86 million. The upcoming Plan will not be able to sustain spending growth that outpaces revenue growth by more than $86M.

  -Per the Intergovernmental Cooperation Agreement between the City and PICA, all Covered Funds must be balanced -- including the General Fund, the General Capital Fund, the Grants Revenue Fund, the Housing Trust Fund, the Hospital Assessment Fund, Transportation Fund, and any other principal operating fund of the City which becomes a member of the City's Consolidated Cash Account.

- **Reasonable Revenue Estimates**

  -Taxes – Growth rates need to be revisited, especially in light of the weaker than expected performance of the Realty Transfer Tax during the first quarter of FY24. Revenue projections will need to be calculated using updated tax bases.

  -Federal Funds – While the Intergovernmental Cooperation Agreement between PICA and the City identify past levels of federal grant funds to estimate future federal funding levels, the unique context of the pandemic and the CARES Act and American Rescue Plan Funds will necessitate using other approaches to estimate potential federal funding levels.

- **Realistic Operational Expectations**

  -FY25-29 Plan will need to be clear which services will be sustained throughout the Plan and what the winddown looks like for those that will not continue at current levels.

  -Ongoing challenges with filling positions will need to be reflected in spending expectations as well as performance targets.

  -Clear statements of the City's financial goals and the plans to achieve them. This may mean communicating existing goals (like achieving 80% funding of the Pension Fund by FY29 and having a fund balance of at least 6% to 8% of revenues) and identifying others (ex. achieving structural balance or reducing the share of the budget dedicated to fixed costs) in a consolidated format along with the strategies that will be used to achieve them.

About This Brief
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