Pennsylvania Intergovernmental Cooperation Authority

Staff Report
on the
City of Philadelphia's
Five-Year Financial Plan
for
Fiscal Year 1997 - Fiscal Year 2001

April 30, 1996

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INTRODUCTION AND STAFF RECOMMENDATION

The City of Philadelphia's Five-Year Financial Plan, Fiscal Year 1997-Fiscal Year 2001 (including Fiscal Year 1996), submitted to the Pennsylvania Intergovernmental Cooperation Authority (PICA) as of April 1, 1996 (the FY97-FY2001 Plan or the Plan) presents a reasonable prospect for balanced budgets in each year of its term. Even more than in recent years, however, this year's Plan is dependent on a variety of circumstances beyond the City's control.

Three items in particular have yet to be resolved:

- Collective bargaining and arbitration processes now underway will result in new labor contracts to be effective during the initial four years of the Plan. The results of such new contracts, and containment of labor costs within the parameters of the Plan, are critical to the overall success of the Plan.

- Federal and State government revenue streams, which support City programs, other Philadelphia public agencies, and residents in need, may be radically altered over the next two years.

- The Plan relies on the realization of tax revenues from riverboat gambling, a highly speculative revenue source, commencing in FY99.

Additionally, the Plan's success will depend greatly on economic trends. PICA Staff believes that the City's projections of these trends are highly optimistic.

Even though many of the Plan's assumptions have a high degree of uncertainty, the Rendell Administration has shown willingness both to control expenditures throughout the fiscal year and impose extraordinary measures when necessary to balance the budget. PICA Staff has no reason to believe that the City will not do so again if such actions are required. However, extraordinary measures, if required, could have a severely adverse impact on municipal services and, resultantly, on Philadephia's future.

General Fund Stability

The City has been successful in achieving operating surpluses each of the past three years. Yet, there is little indication that the City has achieved a long-term structural balance between revenues and expenditures. Indeed, a major reason the City has an $80.5 million positive General Fund balance is because PICA borrowings retired a total of $225 million in accumulated deficit in FY91 and FY92.

In its first report four years ago, PICA's stated goal was "to give Philadelphia enough fiscal breathing room to put its revenue collection and spending processes in order, and to reach a consensus on its priorities, assets and limitations in the decade of the

90's." While the City has made impressive strides toward fiscal responsibility and managerial accountability, it still has an enormous distance to travel before its long-term fiscal stability can be taken for granted.

Instituting Change

The City needs to institutionalize the changes made to date, integrate the culture of change and continuous improvement into individual agencies, and impose a system of accountability on all levels of government.

For the second consecutive year, the Plan includes service level measures. While these measures are a major step toward building a system of managerial accountability, they have not significantly evolved or been directly linked to department budgets. The delay is partly due to a budgeting process which does not have the capacity to allocate indirect expenses. However, there is also a significant question as to whether adequate management capacity exists to establish accountability.

PICA Staff is concerned that without a firmly-rooted system that *requires* accountability, the prospects for institutionalization of change are, at best, speculative.

Incremental Tax Reduction Program

The FY97-FY2001 Plan envisions continuance of annual reductions of two of the City's major tax revenue sources, the Wage, Earnings and Net Profits taxes and the Business Privilege Tax. In the opinion of PICA Staff, the Plan's proposed Annual Tax Reduction Program is a vital component of the City's fiscal recovery process. Nonetheless, it is important to recognize that year-by-year determinations will have to be made about the feasibility of implementing the proposed incremental tax reductions.

As PICA Staff has noted in previous reports, while tax reduction is an important factor in halting the deterioration of the City's tax base, a large number of residents and businesses who leave Philadelphia do so as a result of perceived shortfalls in City services, including public education. Improved service levels need to be addressed in conjunction with tax cuts.

Implicitly, the City bases its ability to cut taxes, maintain services, and keep the General Fund balanced on the success of the Economic Stimulus Program and its efforts to stem job loss. PICA Staff would prefer that the tax cuts be explicitly based on definitive expectations of increased revenues or reduced expenditures resulting from service improvements. By not doing so, implementation of the tax cuts could place the entire General Fund at risk.

Projecting annual incremental tax reductions is easy in conjunction with the fairly optimistic assumptions that the Plan makes. If these assumptions are not realized, though, implementing the future tax cuts projected in the Plan may be quite difficult.

Plan Presentation

This year's Plan takes a "hold harmless" approach. With few exceptions, all department spending levels for FY97 are held constant at this year's expected levels, adjusted for the full-year effects of the wage increase which went into effect this month. For the out years (i.e., FY98-FY2001), besides pension and health/medical costs, the Plan projects that growth in benefit and non-personnel costs will be less than inflation. Wage costs are projected to remain constant in all departments except for the Department of Human Services, which expects a growing service demand, and the Police Department, which will gradually assume the costs of police currently funded under 1994 Federal crime legislation.

Unlike the first two Plans, none of the successive Plans has quantified management initiatives or attempted to tie their success to the budget. The latest two Plans, including the current one, describe past accomplishments and future issues that have to be addressed, often without specifically indicating how they will be addressed. As PICA has expressed previously, agencies will feel less of an obligation to meet either performance or spending goals if there is less downward pressure on budgets to force them to do so.

As a result of the change in methodology, Plan projections have come to rely heavily on the reasonableness of the baseline projection growth rates and not on estimated impacts of management initiatives.

The changed Plan structure results to some degree from the improved financial position of the City, relieving the City from having to develop initiatives to balance the budget. The negotiation and arbitration of new labor agreements, as well as possible Federal and State budget cuts, will likely force the City to return to proactive initiative analysis in its five-year planning process.

Report Summary

Unlike previous PICA Staff reports on City Five-Year Plans, this report focuses primarily on significant risks to the Plan and does not review department-specific issues beyond those that could have a severe adverse impact on the General Fund. PICA Staff continues to track departmental progress in numerous areas and will report on those areas as significant issues arise.

The Plan's economic assumptions depend largely on what appeared to be Philadelphia's employment trends as of January. In March, however, the U.S. Bureau of Labor Statistics revised the data used by the Plan. The revised data indicate that employment in Philadelphia has continued to decline and not stabilized as the Plan describes. This changed economic outlook casts a pallor on the Plan's tax revenue projections, most significantly the Wage and Earnings Tax.

The Wage and Earnings Tax projections are based on a highly optimistic prediction of growth in average wage per employee and an even more optimistic employment forecast. Since the projections do not account for growth in the tax base resulting from improved enforcement and compliance, and collections continue to be stronger than certain economic data would indicate, the projections appear achievable, even if uncertain.

After a four year period of zero net growth, Real Property Tax collections are projected to increase gradually over the Plan period. This projection is based on two questionable assumptions: that commercial and industrial property values will reverse their declining trend; and that residential property assessments will increase. Projected collections appear aggressive, although less so than in previous Plans.

The Business Privilege Tax projections appear reasonable based on collections over the past four years. However, the projected growth rate in the tax base is very aggressive.

The other tax projections, together accounting for less than 15% of all tax collections, are reasonable but also at risk from forces beyond the City's control. Sales and Use Tax collections may suffer from increased suburban retail competition. Real Property Transfer Tax collections are fairly volatile and dependent on numerous national and regional economic trends. Finally, the Personal Property Tax may soon be declared unconstitutional.

The General Fund confronts a greater threat from Federal and State funding changes and reductions. Already Title IV-A funding, which reimburses child welfare costs, has been eliminated for juvenile justice services. Even if the State funds part of the resulting shortfall as expected, this change will still cost the City as much as $6 million in FY97. Changes under consideration in Washington to further alter Titles IV-A and IV-E as well as Medicaid and Medicare would also have significant direct effects on General Fund revenues.

State plans for converting Medical Assistance to a managed care system will profoundly alter General Fund revenues to the Public Health and Human Services departments. Ongoing problems with Act 148 funding for child welfare services, as detailed in PICA's December *Staff Report on State Funding of the Philadelphia Department of Human Services*, may eventually cause funding shortfalls to Philadelphia. In addition, the County Health Act funding formula works against Philadelphia because it does not weigh demographic features.

The Plan clearly states that the City will reduce or eliminate programs if it lacks the resources to make up for Federal and/or State funding cuts. While such an event is undesirable, the Mayor affirmed during his budget address that "the City's commitment to a balanced budget is unwavering -- we <u>will</u> make whatever service cuts are required to fulfill this fundamental pledge."

The City is also on the verge of new labor contracts with its four major unions. Affecting close to 60% of all General Fund expenditures, these contracts will likely determine whether the General Fund remains balanced. To provide flexibility in negotiations and not attempt to prejudice the outcome of the negotiations and arbitrations, the Plan's budget projections assume no wage increases after current labor contracts expire on June 30, 1996. The Plan, however, commits the City to providing "modest increases" in compensation. PICA Staff is strongly concerned that any "modest increases" not exceed the City's limited ability to pay; and will closely review the final contracts to determine if they result in a variance with the Five-Year Plan.

As in the past, PICA Staff is concerned about the Capital Program Office. Computer technology does not appear to be fully utilized or compatible among the Office's own systems. While the search for a Capital Project "Czar" proceeds unsuccessfully, the capital program continues to suffer from a lack of vision.

PICA Staff is also concerned about rising indemnity costs. Although the current Plan significantly increases the indemnities budget over last year's Plan, PICA Staff is uncertain whether the increasing number of cases being filed, the impending resolution of Act 111 interest arbitration, and lawsuits resulting from the revelation of police corruption will result in higher than anticipated indemnity costs.

Similarly, the First Judicial District's zero-growth budget agreement with the City expires at the end of FY97. It is unknown how the relationship between the City and the courts will evolve. If the past is any indication, the City may be in danger of being required by the courts to greatly increase their General Fund appropriation. If the State begins to fully fund the courts, as it may soon be required to do, State funding to the City will likely be eliminated elsewhere.

Potential Federal and State budget cuts and changes to non-General Fund programs also bode ill for the General Fund. Federal proposals include cuts to housing and homeless programs, public transportation, and entitlements ranging from Aid to Families with Dependent Children and Medicaid to Social Security and Medicare. The State continues to consider limiting Medical Assistance (MA) eligibility. The creation of a managed care system for MA recipients will affect City Mental Health and Human Services beneficiaries. State cuts will also affect public transportation, the Philadelphia School District, and General Assistance recipients. These changes will likely result in tax revenue losses to the City and increased demand on General Fund services.

Finally, PICA Staff has five other areas of concern: (1) the City confronts an unfunded pension liability of $2.5 billion, which it plans to eliminate by FY2020; (2) the Plan expects that the current General Fund balance will be depleted by FY98, even before taking the new labor contracts into consideration; (3) the methodology for projecting revenues and expenditures is deficient; (4) the target budget process may be losing its effectiveness; and (5) the City's strategic planning process appears ill-defined and lacking in long-term value.

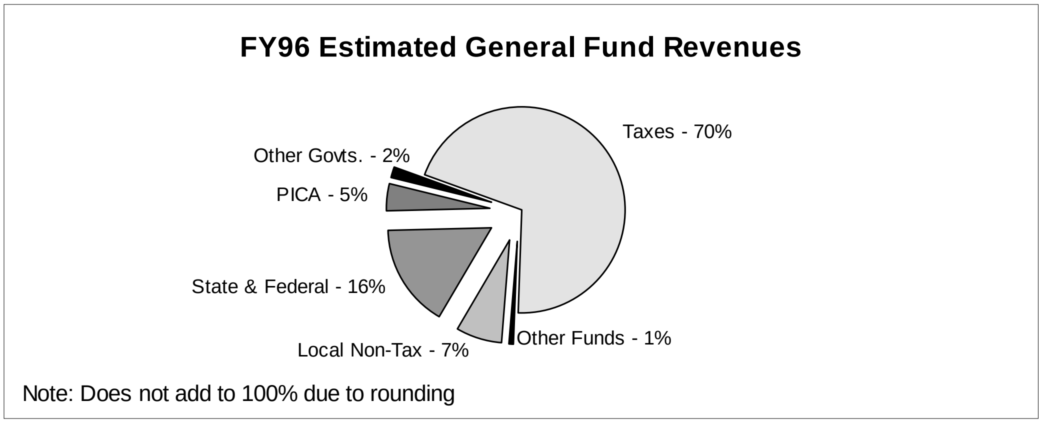
Staff Recommendation

Notwithstanding the potential risks to the General Fund and PICA Staff concerns outlined in this report, the FY97-FY2001 Plan presents a reasonable prospect for balanced budgets in each year of its term.

PICA Staff recommends that the Pennsylvania Intergovernmental Cooperation Authority approve the Plan as submitted to the Authority on April 1, 1996.

GENERAL FUND REVENUES

General Fund revenues consist primarily of tax revenues, locally generated non-tax revenues, and revenue from other governments. There are also revenues from other City funds, primarily reimbursements from the Water and Aviation funds for costs borne by the General Fund. These latter payments are based on calculated estimates negotiated between the City and its applicable authorities and are relatively small. They are not reviewed in this report.



The Five-Year Plan includes an extensive discussion of the employment situation in Philadelphia. Since the assumptions derived from that discussion affect tax revenue projections, the critique is presented here.

Employment Growth Assumptions

The employment data utilized in the preparation of the Plan is no longer valid. New data suggest that the employment trend in Philadelphia has been significantly worse than the Plan presents.

The Plan bases much of its economic development discussion on employment data from the U.S. Bureau of Labor Statistics (BLS). Every March the BLS reconciles its data, through a process called "benchmarking," to State Unemployment Insurance data for the previous two calendar years. Since the Plan was written in January, before the revised data were released, the City used preliminary BLS data.

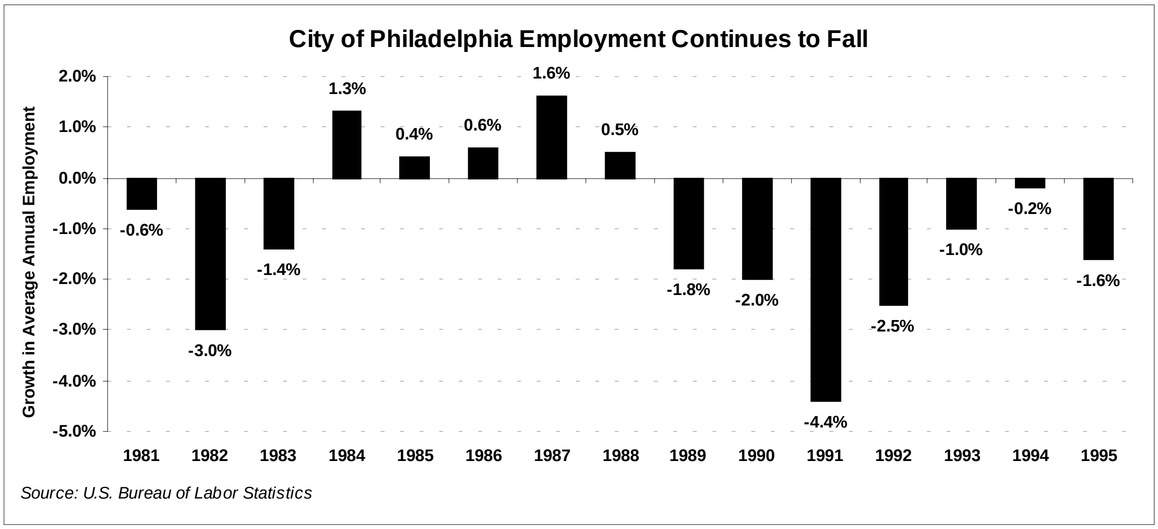
The Plan notes that the data it presents are preliminary. It also notes that the benchmarking process the previous two years resulted in "substantial increases in Philadelphia employment totals." The Plan goes on to say:

> If rebenchmarking revisions for the 1995 figures result in revisions similar to those made with respect to the 1993 and 1994 employment figures, the revised 1995 data may actually indicate a continuing, albeit modest, increase in employment. [Plan, p. 19]

However, BLS benchmarking this year resulted not in an increase of the employment figures but in a decrease for both 1994 and 1995.

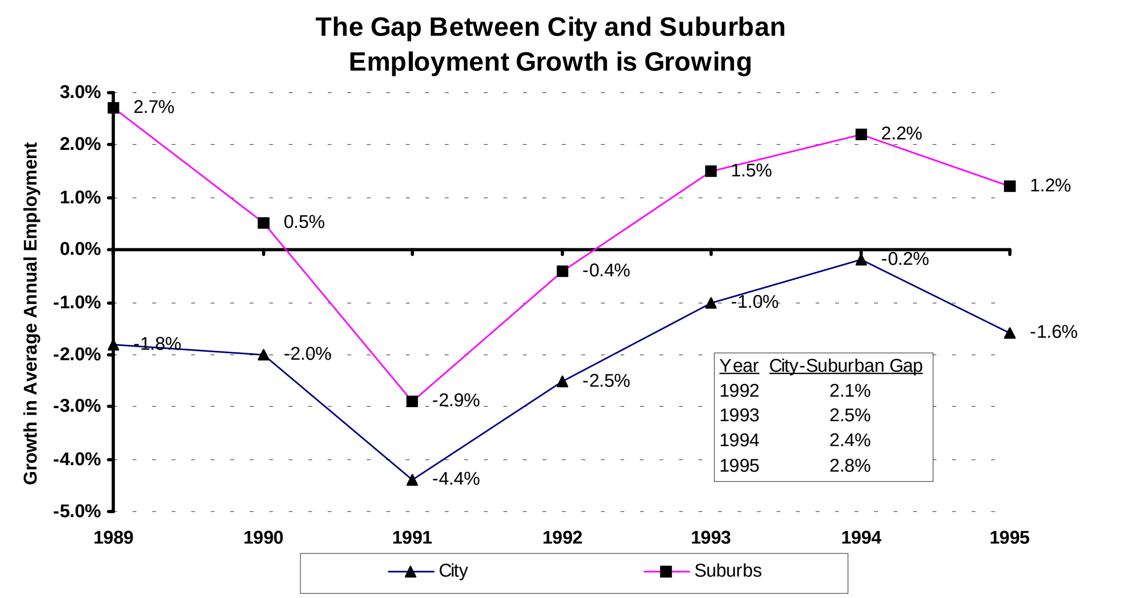
Previous to the March revision, BLS data showed employment in Philadelphia increasing in 1994 by 1,200 jobs (0.2%) and decreasing in 1995 by 3,380 jobs (-0.5%). The revised data show employment **decreasing** in 1994 by 1,500 jobs (-0.2%) and decreasing again in 1995 by 11,100 jobs (-1.6%).

The data indicate that Philadelphia's job base did not get any reprieve in 1994 from its continuing decline and that Philadelphia's seven year job loss pattern is continuing.



The Plan attempts to portray a stabilized private job market, attributing the 1995 job loss to Federal cutbacks, particularly the final closing of the Philadelphia Naval Shipyard. However, the new BLS data reveal that the greatest job loss occurred in the transportation and public utilities sector (3,700 jobs) and not in the Federal government (3,400 jobs). In total, private sector employment declined by 8,500 jobs.

Worse yet, using the revised data, and correcting for faulty 1993 data used in the Plan, the city-suburban gap in employment growth has increased over the past few years and not decreased as stated in the Plan.



Note: Suburbs include Bucks, Chester, Delaware, and Montgomery counties in Pennsylvania, and Burlington, Camden, Gloucester, and Salem counties in New Jersey.

Source: U.S. Bureau of Labor Statistics

Job growth for the region as a whole continued to be positive in 1995, even if just slightly so (0.3%). The fact that Philadelphia continues to lose jobs in a region of steady or growing employment indicates that Philadelphia has unique problems that are not only driving jobs out of the city but inhibiting new jobs from being created.

For the first time in over a decade, Philadelphia lost health service jobs in 1995 - 2,400 according to the latest BLS figures. As consolidation and cost cutting in the health care industry continue and both the Federal and State governments further scale back health care funding for the poor and unemployed, the health care industry, which employed an average of 88,900 in 1995, will likely eliminate even more jobs.

The Pennsylvania Economy League estimates that the nine-county Philadelphia region will lose on average between 2,000 and 4,000 health services jobs annually over the next five years.[1] Since Philadelphia is home to 38% of all health services jobs in the region, a large number of these job losses will be in Philadelphia.

The Rendell Administration continues to concentrate on these job growth issues, as the Plan makes clear in its discussion of what the City expects to accomplish during the third and final year of its Economic Stimulus Package. While there is no definitive way to know whether the City's efforts have been successful at slowing the job decline, it is apparent that the City has a long road ahead to economic recovery.

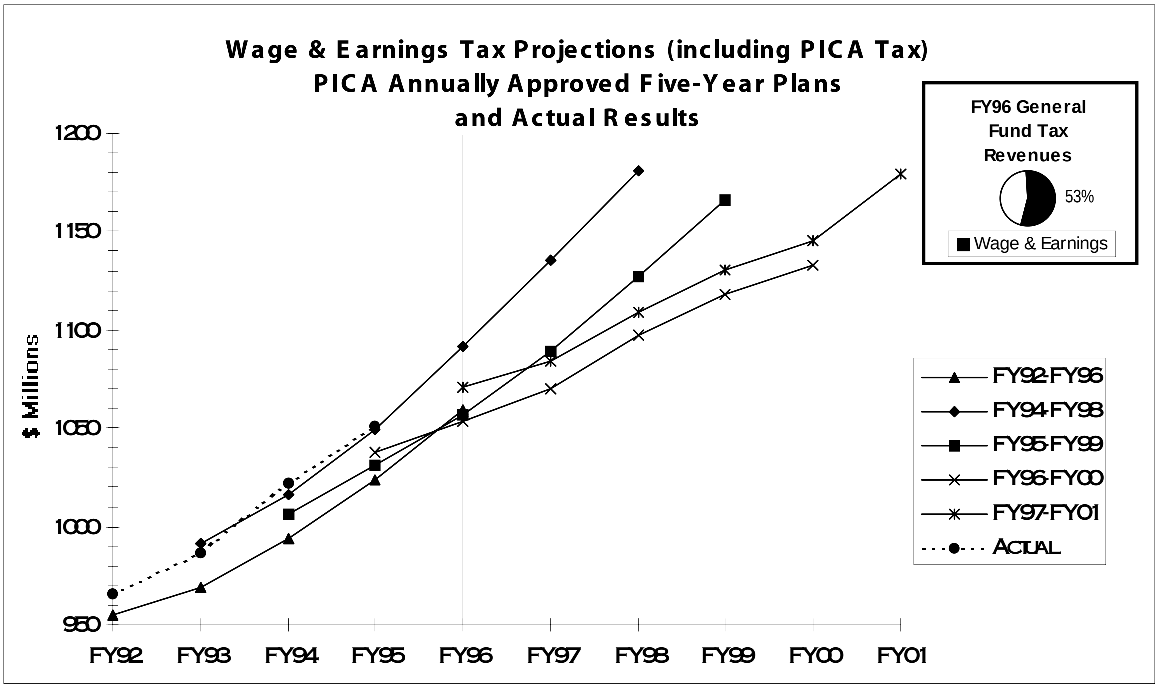
[1] See Pennsylvania Economy League, *Greater Philadelphia's Challenge: Capitalizing on Change in the Regional Health Care Economy*, February 1996.

Tax Revenues

Fiscal Year 1996, which ends June 30, 1996, marks the end of the time frame covered by the City's first Five-Year Plan, approved by PICA in the Spring of 1992.

In the interest of seeing how Plan projections have changed over the past five years, a graph of the five Five-Year Plan projections, along with actual results, is included with each discussion of the five major taxes. Each Plan has had projections for the fiscal year in which it was published and, except for the first Plan, the following five fiscal years. The first Plan included projections for only the following four fiscal years.

Wage and Earnings Tax



The Wage and Earnings Tax projection in the current Plan is aggressive, but, barring any radical economic upheaval, appears achievable.

The method the City uses for calculating the projection is questionable. To simplify what can be a complex calculation, the City estimates an average wage per employee growth, adds a projection for job growth (or more accurately, subtracts a projection for job loss), and subtracts the effect of the proposed tax cut to come up with a net forecast growth.

Wage Tax Forecast - Key Assumptions						
		FY97	**FY98**	**FY99**	**FY00**	**FY01**
	Avg. Wage/Employee Growth	3.2%	3.5%	3.5%	3.5%	4.0%
+	Employment Growth	-0.5%	-0.2%	0.0%	0.0%	0.0%
=	Gross Forecast Growth	2.7%	3.3%	3.5%	3.5%	4.0%
-	Effect of Tax Cut	-1.8%	-1.3%	-1.9%	-2.7%	-1.3%
=	**Net Forecast Growth**	0.9%	2.0%	1.6%	0.8%	2.7%
	Projected Inflation	3.0%	3.0%	3.5%	3.5%	3.5%

Source: *City of Philadelphia Five-Year Financial Plan, Fiscal Year 1997 - Fiscal Year 2001*, pp. 2, 7.

The projected growth in average wage per employee exceeds projected inflation for three of the five years covered by the Plan, including Fiscal Years 1997 and 1998, and is unlikely to be achieved. The growth in average wage per employee in Philadelphia has not exceeded inflation since 1992. There is little reason to expect that it will do so over the time frame of the Plan. High-wage industrial jobs continue to be replaced with low-wage service jobs. The decline in unionization in the northeast United States will also likely lead to lower wage jobs. Even the City Wage Tax rate cuts will deflate average wages since the premium employers must pay their employees for working in the City will decrease and any new jobs created as a result of the tax cuts will likely have below average salaries.

The employment growth forecast is also aggressive, especially when considering the newest data released by the Bureau of Labor Statistics (see Employment Growth discussion above). Employment in Philadelphia will likely continue its seven-year downward trend unless there is a major reversal in the City's economy. Even the Five-Year Plan notes that Philadelphia's employment levels are primarily due to factors beyond the City's control, such as the national economy and Federal and State government funding of programs such as Medicare and Medicaid.

The Plan's omission of certain growth factors at least partially compensates for these overly optimistic forecasts. The City continues to identify new taxpayers through compliance with mandated suburban withholding and the use of professional collection agencies to pursue individuals who conduct business in Philadelphia but do not pay required taxes. Also, the Revenue Department again plans to use Federal tax return information to identify Philadelphia residents who owe Earnings Tax and are not subject to suburban withholding, such as residents who work in New Jersey.

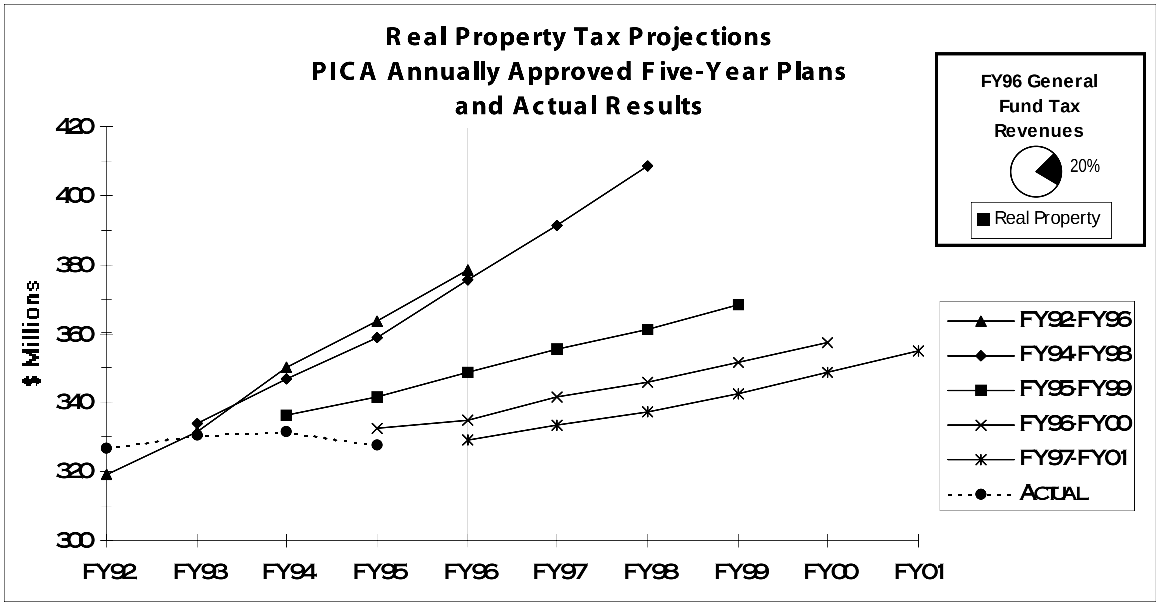
However, these and other planned enforcement measures are unlikely to continue to be as successful as they have been the past four years. These enforcement programs typically identify individuals and businesses who have not paid taxes in a number of years. As delinquent taxes are paid and newly identified taxpayers are added to the tax rolls, the revenue growth attributable to these efforts will drop. Additionally, if newly identified taxpayers move out of the city for tax purposes, the City's tax base will diminish.

For example, the City estimates that suburban withholding legislation resulted in an increase of $8.3 million in non-delinquent City and PICA Wage and Earnings Tax revenue in FY95 and will likely produce $16.3 million in FY96. (This figure does not include revenue from suburban companies that had been withholding for some of their Philadelphia residents prior to the State legislation and are now withholding for them all.) As taxpayers have been identified through compliance with suburban withholding, the City has attempted to collect on delinquent Earnings Taxes. These delinquent Earnings Tax collections will wane as suburban withholding is fully implemented. Additionally, these new taxpayers have become part of the tax base. Non-delinquent Wage Tax growth due to suburban withholding has stabilized and will no longer differ significantly from growth in the rest of the Wage Tax base. Finally, if city residents who were affected by suburban withholding legislation decide to move to the suburbs to avoid the Wage Tax, which they are now forced to pay, revenues from suburban withholding will begin to fall.

The forecast of the effect of the tax cut on Wage and Earnings Tax growth is reasonable but omits an important aspect. The forecast is based on the difference between the projected non-delinquent collections at the new rate and what would have been collected at the previous year's rate. It does not take into account the effect of the rate changes on collections of delinquent taxes. Delinquent taxes are assessed at the rate as of when the taxes are due. The Plan's projections implicitly assume that those taxes will be assessed at 1995 rates (4.96% for residents and 4.3125% for non-residents) regardless of when during the Plan period they are due. This omission inflates annual collection projections by as much as $1 million.

During FY96 to date, Wage and Earnings Tax collections have been stronger than in the recent past. Combined City and PICA non-delinquent Wage and Earnings Taxes for the first seven months of FY96 increased 4.2% over the same period in the prior fiscal year. Excluding the estimated effects of suburban withholding and the tax cut, the growth rate is 2.8%. This compares to next year's projection of 2.7% (see table above). Part of this growth is attributable to enforcement efforts. If enforcement efforts begin to recognize less revenue, employment levels continue to decline, high-wage jobs continue to leave the city, and only low-wage jobs are created, all likely events, Wage and Earnings Tax revenue will not be able to maintain this rate of growth.

Real Property Tax



The projection for real property tax collections appears aggressive.

Projecting real property tax collections beyond one year is difficult due to the volatile nature of real estate value, particularly in Philadelphia. However, the City's projection is based on two questionable assumptions: that commercial and industrial property values will reverse their declining trend; and that residential property assessments will increase.

The City assumes that commercial and industrial property values will stop declining and begin to increase again by 1998. As the chart below demonstrates, the total taxable assessment for commercial and industrial property at billing time declined over 5% between 1993 and 1996. (This trend is worse if tax abated properties which returned to the tax rolls during these years are excluded.) This downward trend has resulted primarily from the decline in market value of Center City office space.

Commercial and Industrial Taxable Assessments (Dollars in millions)							
	1990	1991	1992	1993	1994	1995	1996
Initial Assessments	$3,489	$3,763	$3,902	$3,920	$3,898	$3,813	$3,726
Percentage Change	N/A	7.9%	3.7%	0.5%	-0.6%	-2.2%	-2.3%

Source: Board of Revision of Taxes

According to the CB Commercial Real Estate Group, Inc., the office market vacancy rate in Center City has declined over the past two years from 16.10% to 14.20%.[2] However, the current rate is still above the 1990 level of 11.00%, just before the greatest amount of new office space ever (including the second phase of Liberty Place) came onto

[2] CB Commercial Real Estate Group, Inc., *Philadelphia Downtown Office Market*, Fourth Quarter 1995.

the market. As a result of this overabundance, rental rates on Center City office space have fallen and there has been no new construction of office space in Center City since the end of 1992.

There is little evidence to indicate that Center City office space will soon begin to reverse its decline in assessed value. Although modern high rises will likely continue to experience high demand, older, smaller office buildings are likely to continue to experience sluggish demand, thereby driving down their property values.

The hotel industry in Philadelphia appears on the verge of growth, both in the number of businesses and the total assessed value of such property. However, large new hotels are likely to be granted tax abatements for three years, as was the Convention Center Marriott.

Excluding hotels, there is little evidence to suggest that commercial and industrial property in Philadelphia will experience a growth in total assessed value in the next few years.

The second assumption, that residential assessments will increase, is based on the following rationale. A property's assessment is calculated by multiplying the common level ratio of 32% to the market value as determined by the Board of Revision of Taxes (BRT). The BRT currently sets market value at 71% of estimated sale price, based on an average of recently completed sales of similar structures in the same census tract.

Currently, there are many properties with market values less than 71% of their estimated sale prices. The City plans to incrementally bring all properties up to the 71% market value ratio level and then increase the ratio over the next few years from 71% so that it approaches 80%.

Whether such a strategy can be successful is unknown. While the BRT pursued such a strategy for its 1995 assessments, initial assessments at billing time increased by only 1.4%. The BRT attributes this small growth to the fact that, during the market value readjustment project, residential properties with assigned market values more than 80% of estimated sale prices were lowered to the 80% level. The BRT believes that the next round of market value adjustments will be more successful since few, if any, properties will fall into the category of assessments to be automatically lowered.

Residential Taxable Assessments (Dollars in millions)

	1990	1991	1992	1993	1994	1995	1996
Initial Assessments	$5,137	$5,263	$5,323	$5,386	$5,416	$5,489	$5,465
Percentage Change	N/A	2.5%	1.1%	1.2%	0.5%	1.4%	-0.4%

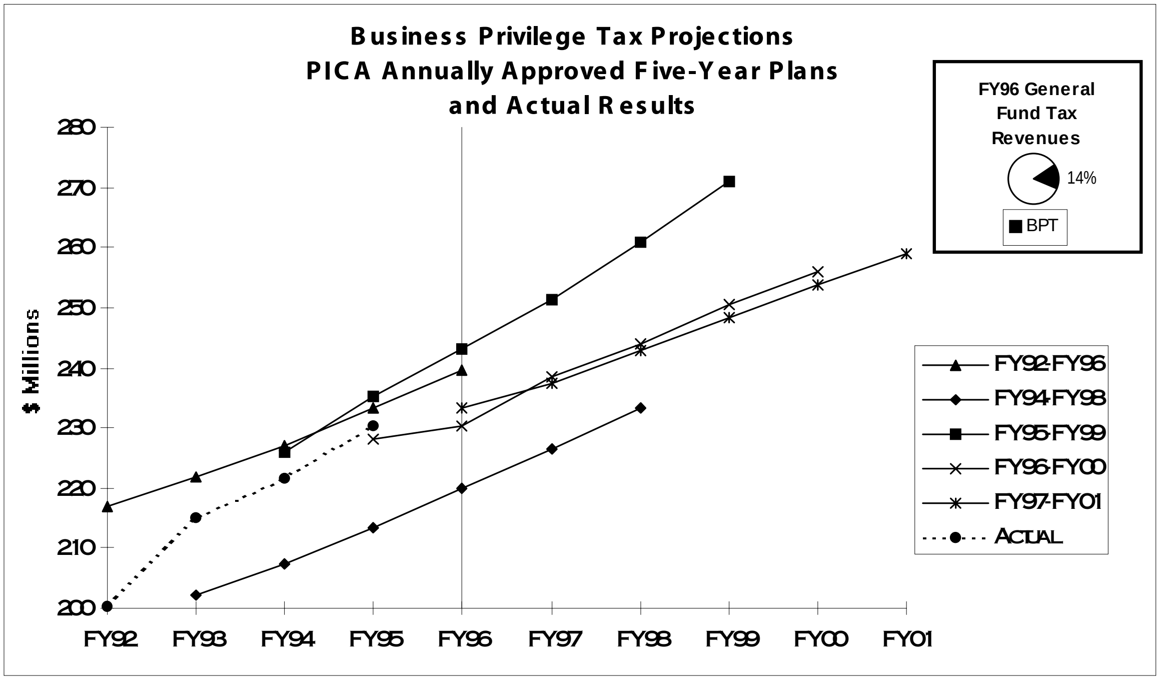
Source: Board of Revision of Taxes

A risk of reassessing this way is that if sale prices have fallen since the last time this was done, which certain data indicate, market values may also need to be adjusted downward. The BRT believes that this risk is not significant since a property's market value will be lowered only if its market value is more than 80% of its sale price. Since most properties have market values which are significantly less than 80% of their sale prices, it would take a large drop in sale price (typically over 10%) before a property's market value needed to be adjusted downward.

A second risk is that the planned reassessments may increase the number of appeals and the total amount of appeal losses. The BRT acknowledges that the total number of assessment inquiries went up as a result of the 1995 effort. Yet apparently, most inquiries were not pursued as appeals once the logic behind the reassessment was explained. Based on data supplied by BRT, it does not appear that there was a significant growth in residential appeal losses as a result of the 1995 reassessments.

There are also long-term risks to successful implementation of this strategy. As assessments increase, property values are likely to decrease, as residing in the city begins to cost more. As property values decrease, so will assessments, diluting the effect of raising the market value ratio, although not totally negating it. Additionally, increased assessments will likely accelerate population loss and property abandonment, although not dramatically.

Business Privilege Tax



The Business Privilege Tax (BPT) projection appears reasonable based on collections over the past four years. However, the projected growth rate in the tax base is very aggressive and unlikely to be met. Additionally, the calculation has two minor problems, as detailed below.

As the Plan notes, "of all the City's taxes, the BPT is probably the most volatile and difficult to predict."[3] The BPT is sensitive to national economic trends, corporate profits, and use of the net loss carry forward to offset profits. Even so, the Plan projects that the BPT tax base will grow 1% more than inflation each year of the Plan.

BPT Tax Base Growth Versus Inflation (Plan Projections)						
	1996	1997	1998	1999	2000	2001
BPT Tax Base Growth	4.0%	4.0%	4.0%	4.5%	4.5%	4.5%
Inflation	3.0%	3.0%	3.0%	3.5%	3.5%	3.5%

Source: *City of Philadelphia Five-Year Financial Plan, Fiscal Year 1997 - Fiscal Year 2001*, pp. 2, 10.

The Plan notes that since the BPT tax was first assessed in FY85, the average annual growth rate has been close to 4.0%. However, this includes the first two years of the tax which experienced growth rates of 26.2% and 15.9%, respectively. Over the past six years, annual tax growth has averaged closer to 2.4%. The City believes that future growth will exceed the ten-year average as a result of the tax cuts and the Economic

[3] *City of Philadelphia Five-Year Financial Plan, Fiscal Year 1997 - Fiscal Year 2001*, p. 10.

Stimulus Program. However, the BPT tax base is unlikely to maintain such a high growth rate in comparison to inflation.

The BPT is generally filed on April 15 of the tax year, based on business activity during the previous year (as opposed to the Federal income tax which is filed on April 15 of the year following the tax year). In FY92, BPT revenues dropped $17 million (7.8%) from the previous year due to the 1991 recession. There was no recession in 1995 to negatively affect revenues for FY96. However, a recession similar to the one in 1991 during the next two years would prevent the City from meeting its BPT projections.

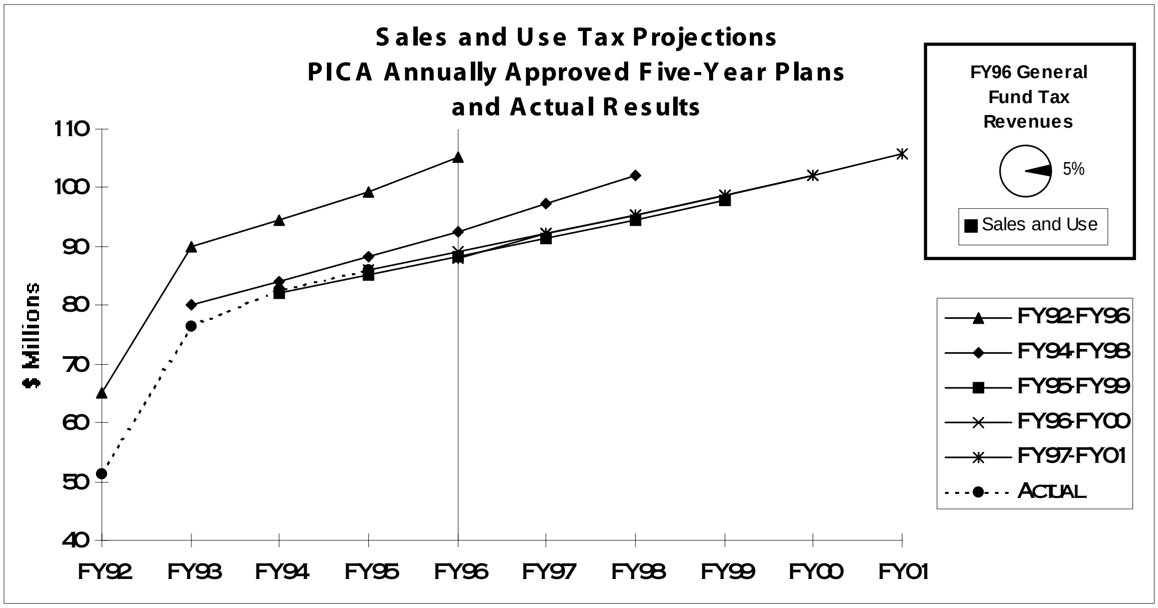
The first minor problem with the calculated projection relates to the effect of double weighting the gross receipts factor when companies apportion the amount of their income to Philadelphia. The impact of this change is estimated to be an annual loss of $700,000 in tax revenues. While this estimate was calculated based on returns for tax year 1993, the apportionment change creates major swings in how much is paid by individual filers, resulting in an unpredictable net effect.

Large businesses based in Philadelphia can end up paying tens of thousands of dollars less and large businesses located outside of Philadelphia but conducting much of their business in the city can end up paying thousands of dollars more. While the net of those two effects in tax year 1993 would have been a loss of $700,000, it is likely that the net effect in tax year 1996 will be substantially different.

The second problem is that an extra $200,000 is included in the total estimate based on changing the delinquent filer interest rate from a flat 6% to a floating rate similar to the State's. However, the State General Assembly has not yet acted on the City's request to change its rate structure, as is required by law. For the foreseeable future, the City is unlikely to realize revenue from this initiative.

The City's projection of the effect of the Gross Receipts tax cut is reasonable based on its steady tax base growth assumptions. As with the Wage Tax projections, though, there is no impact estimated on "prior year" (e.g., delinquent) collections. Even though "prior year" collections are projected to shrink over the life of the Plan, they may still be inflated by as much as $2 million annually.

Sales and Use Tax

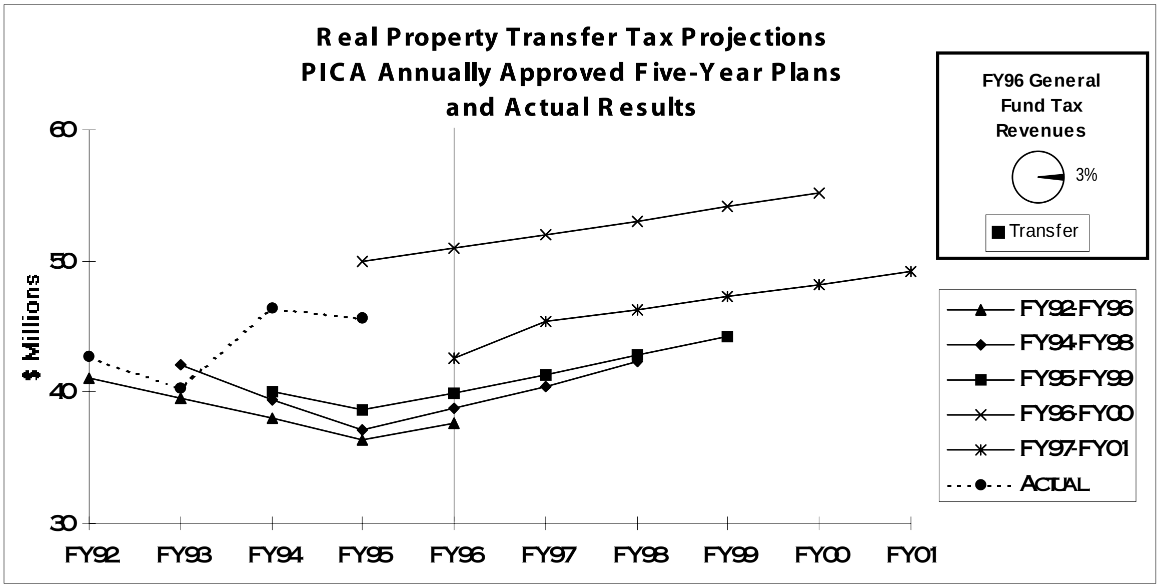


Projected collections for the Sales and Use Tax are fairly close to inflation projections and are reasonable based on collections experience to date.

After adjusting for a special monthly payment made out of sales tax revenue in most of FY95, all of FY96, and half of FY97 to the Pennsylvania Department of Revenue, which collects the tax on the City's behalf, sales tax revenues are projected to increase at a rate of 3.5% in FY97, higher than the Plan's projected inflation for that year.

Collections to date for FY96 appear to be meeting projections. However, with increasing retail competition, particularly from Philadelphia's suburbs, sales tax revenues may not continue to meet projections. Any shortfall, however, is unlikely to be significant during the first two years of the Plan period.

Real Property Transfer Tax



The City's projections for Transfer Tax collections are reasonable but somewhat aggressive considering the unpredictable nature of this tax revenue stream.

As the above graph demonstrates, predicting Real Property Transfer Tax collections is difficult. Transfer Tax revenues are highly dependent on uncontrollable factors such as the real estate market, mortgage rates, and the regional economy. Additionally, one or two significant sales of commercial property can boost tax revenues by a noticeable amount.

Since the end of the building boom of the late 1980s, Transfer Tax collections have remained between $40 million and $47 million annually. The City projects a significant jump in FY97 of 6.8% (to $45.4 million). This would follow a projected decline of 6.8% in FY96. The City believes that sometime during 1996 the real estate market will rebound from its decline this year. Considering the apparent decline in both residential and commercial real estate values, discussed in the Real Property Tax section above, and the likely prospect of stabilizing or even rising mortgage rates, the City's FY97 projection is somewhat aggressive.

The projection for the out years is for an annual increase of 2.0%. Given the aggressiveness and uncertainty of the FY97 projection, the projections for the out years are even more so.

Riverboat Gambling Wagering Tax

The City began including this revenue source in last year's Plan. The original projection was that steps to legalize riverboat gambling would be made during 1995 and that riverboats would be operating by the end of 1996. Since that is no longer likely, the Plan has pushed out the recognition of these revenues from FY97 to FY99.

The projected revenue collections from this tax are the same as last year's.

The probability of riverboat gambling being legalized is unknown. The Governor is still committed to holding a statewide referendum, which would by law not be binding. The Rendell Administration hopes to use the results of such a referendum to argue that the decision to legalize riverboat gambling should be made locally and that the State legislature should enact enabling legislation.

If riverboat gambling is legalized in Philadelphia, the tax revenues it would generate are hard to predict since it will depend primarily on the tax rate structure, which presumably would be developed by the State legislature.

As it did last year, the Plan ties the tax cut proposal for the last three fiscal years covered by the Plan to the implementation of riverboat gambling so that the successful outcome of the Plan, and the ability of the City to maintain a balanced budget, does not ride exclusively on the decisions of the State legislature. If riverboat gambling is not legalized, and the City is unable to identify other ways to pay for the tax cut, the tax cut will not take effect.

Other Taxes

The other major taxes, together accounting for about $60 million in projected FY96 revenue, are the Net Profits Tax ($10 million), Personal Property Tax ($16 million), Parking Tax ($26 million), and Amusement Tax ($8 million).

Net Profits Tax growth is projected at zero since the tax is fairly volatile depending on the economy and business profits. The projection does not consider the effects of the tax rate cut, which is tied to the Wage and Earnings Tax rate cut, or how the change in calculating the net income portion of the BPT will affect collections. (The Net Profits Tax allows for a 60% tax credit for what is paid in the Net Income Tax portion of the BPT tax.)

Personal Property Tax collections are projected to grow dramatically in FY96 (31%) as a result of the unprecedented growth in stock values during calendar year 1995. Since it is doubtful that such growth will continue, the City projects no growth for FY97 and then 3.5% annual growth beginning in FY98. Although this growth rate exceeds projected inflation for FY98, it exceeds by only 0.5% and follows an FY97 projection of zero growth. While there is a likelihood that stock market values will drop over the next few months, it is not certain. Even if they drop back to their December 31, 1994 value, though, it would result in a loss of less than $4 million for this tax.

A greater threat to the Personal Property Tax exists in a number of lawsuits that have been filed against some of the suburban counties following a U.S. Supreme Court decision declaring a similar tax in North Carolina unconstitutional. If the lawsuits are successful, Philadelphia may not only lose this revenue stream but be held liable for a significant portion of past collections.

The Parking and Amusement taxes are projected to grow at 3.5% annually beginning in FY97. Although the inflation rate for FY97 and FY98 is only 3.0%, the growth is achievable given the success to date of the Convention Center and the hopeful success of the professional sport franchises.

Locally Generated Non-Tax

The City plans to increase various fees and fines “to keep pace with inflation” in FY99. The projected total impact of these changes is $4 million. Additionally, the Voluntary Contribution Program (formerly known as PILOTS/SILOTS) has identified 50 non-profit organizations to date which are now annually providing a total of $6.2 million ($2.8 million to the General Fund and $3.4 million to the School District) in cash and $6 million in direct services.

Besides these two programs, there are no significant changes expected in how much the City will receive from specific local non-tax revenue sources. There are two small changes of note, however.

Beginning in FY97, the City will recognize 911 surcharge revenue in the Grants Revenue Fund and not in the General Fund. This change is due to State accounting requirements that could not be met in the General Fund. The General Fund portion of the 911 surcharge will be transferred from the Grants Fund as Revenue from Other Funds.

The greatest drop in Locally Generated Non-Tax revenue in FY97, besides the 911 surcharge change, is the rent the Phillies pay for Veterans’ Stadium - a $1.5 million drop due to the liability partially paid off in FY96 for back rent that had been in dispute with the City over other issues.

Revenue from Other Governments

With the political changes in Washington and in Harrisburg, Federal and State government funding streams have begun to experience fundamental changes. These changes, and proposed further reforms, affect the amount and type of funding available both to the City and to Philadelphia residents who depend on government assistance.

This section concentrates on funding streams to the City's General Fund. Later in this report is a discussion of the indirect effects funding changes to other City funds and entities, as well as to entitlements, will have on the General Fund.

Department of Human Services

Federal and State funding for the Department of Human Services (DHS) will account for an estimated $238 million in FY96, almost two-thirds of all Federal and State funding recognized in the General Fund. More than half of this amount comes from two Federal funding streams, Title IV-A and Title IV-E, and the rest comes from the State under Act 148. In addition, the City has successfully diverted over $20 million in medical costs annually to Medical Assistance (Medicaid). Since this funding stream does not appear in the General Fund, it is discussed later in this report.

Projections for Federal and State funding are based on caseload projections, which are developed for each service category. Therefore, financial growth rates are not based directly on inflationary factors.

The Plan makes clear that reduced services will result from any reduction in Federal or State funding that the City cannot make up otherwise without jeopardizing the stability of the General Fund.

<u>Title IV-A</u>

The greatest impact so far on the City's General Fund from cuts in human services funding has been the result of a Clinton Administration decision to cut Title IV-A funding for juvenile justice services.

In conjunction with Philadelphia and other counties, the State successfully applied to the Federal government for Title IV-A "Emergency Assistance" funding, beginning in FY95. Under this Social Security Act program, the City, via the State, can receive 50% reimbursement for children in emergency situations whose families are eligible for Aid to Families with Dependent Children (AFDC). DHS and the State Department of Public Welfare (DPW) defines emergency situations broadly so that almost all served children can be eligible for this funding.

Originally, Title IV-A funding was to be available for both child protective and juvenile justice services. It provided the City with over $34 million in FY95 and, as of the beginning of FY96, was projected to account for close to $55 million this fiscal year.

However, the Federal Department of Health and Human Services (HHS) notified the State last year that, as of January 1, 1996, Title IV-A would no longer fund juvenile justice services (JJS). This portion of the Title IV-A funding stream was to account for close to $18.8 million in FY97 for the City. The City estimates that the loss in Federal funding for FY96 will be $9.4 million.

The State appears to be honoring its commitment to hold counties "harmless" from Title IV-A shortfalls by providing extra Title 148 funding (see below). Currently it appears that the State will fully fund the FY96 shortfall so that the City will feel no budgetary impact this fiscal year. For the out years of the Plan, the State appears prepared to provide its share of the Title IV-A JJS funding shortfall as determined by the Act 148 funding formula.

Remaining Title IV-A funding, that for non-juvenile justice services, may also be at risk. According to the Plan, Congress has considered reforming this program by reducing funding to its FY95 level. The Plan estimates that the impact of such a change could reach $20 million.

Since Congress has not yet acted on any reform proposals, Title IV-A funding for non-juvenile justice services is projected to grow by almost 11% ($4 million) in FY97, while for the out years the City expects more gradual growth. The large growth in FY97 is driven by expected increases in caseload and costs.

<u>Title IV-E</u>

Title IV-E funding is expected to grow at a stable rate, not exceeding 4% in any one year.

Title IV-E is a Social Security Act program that provides funding for services to youth meeting certain income-eligibility requirements. It reimburses a fixed percentage of allowable state or local costs for placement services, adoption assistance, training, and administration and does not fund non-placement services or services provided by for-profit agencies.

Congress has considered replacing Title IV-E with block grants to states so that states can determine how to distribute the funding. Part of a block grant proposal would likely be a reduction in funding.

<u>Act 148</u>

Act 148 funding includes Federal Social Security Act Title IV-B funding and is projected to grow gradually over the Plan period, after a large increase in FY97 to make up for the Title IV-A shortfall discussed above. As detailed in PICA's December *Staff Report on State Funding of the Philadelphia Department of Human Services*, the State's Act 148 needs-based budget funding mechanism may eventually place an increasing financial burden on Philadelphia.

As discussed above, the Federal government is no longer providing Title IV-A revenue for juvenile justice services. Previous to the receipt of this revenue in FY95, the State and City jointly funded these services through Act 148 formulas. When the State and its counties decided to pursue Title IV-A funding as a new revenue source, the State agreed to hold the counties harmless from any future shortfall in Title IV-A funding.

It appears that the State will be honoring its commitment and providing an extra $9.4 million in FY96 and around $13 or $14 million in FY97.

The Act 148 needs-based budget process has a number of weaknesses. Potentially the most significant in relation to the City's General Fund is that the funding level is based on applying cost of living adjustments (COLAs) to the previous year's State-certified DHS budget. If actual cost increases ever exceed the State developed COLAs, the City's Act 148 allocation will begin to fall behind actual costs.

One final aspect of Act 148 funding is the "Overmatch Recovery" of approximately $1.5 million per year that the State has been providing the City since FY93. This provision, part of the 1990 settlement agreement which established the needs based budgeting process, is an effort to pay back the City for the shortfall in Act 148 funding in the past. The last payment is scheduled for FY96.

Department of Public Health

The Department of Public Health (DPH) also receives significant Federal and State funding, an estimated $47.4 million in the General Fund in FY96. This funding comes in three categories: Medical Assistance (MA) and Medicare funding for the Philadelphia Nursing Home, MA and Medicare funding for the City's health centers, and County Health Act funding for general health related activities.

DPH also expects to receive $369 million in Federal and State funding in the Grants Revenue Fund, primarily for mental health, mental retardation, and drug abuse programs. These Grants Fund-funded programs are primarily provided by contractors so that a loss in funds would likely result in a loss of service and not a direct burden on the General Fund.

<u>Philadelphia Nursing Home</u>

MA and Medicare funding for the Philadelphia Nursing Home (PNH) is pass-through reimbursement funding based on how many patients are served. Funding projections are based on PNH population projections. Any deviation from MA and Medicare projections would be counterbalanced by an equal reduction on the expenditure side.

<u>District Health Centers</u>

The City's district health centers receive reimbursements for services provided to MA and Medicare-eligible patients. Revenue projections are based on projected service demands. Any deviation from MA and Medicare projections will be counterbalanced by an equal reduction on the expenditure side of services to MA and Medicare recipients.

However, since the health centers serve uninsured patients, a reduction in MA and Medicare funding will likely result in higher City costs for two reasons: a smaller percentage of paying consumers places a greater burden for overhead costs on the City and the centers may experience greater demand if fewer residents are insured.

As the State has moved toward a managed care system for MA recipients, DPH has improved its facilities and services and become a provider for five HMOs that serve MA recipients. The City is committed to serving in the role of primary care provider to the uninsured and underinsured and will work to maximize MA and Medicare funding.

County Health Act

County Health Act funding is based on population. As Philadelphia's population continues to diminish, the amount of County Health Act funding it receives does the same.

DPH is working to change the State's funding formula so that it will take into consideration other factors besides population, such as health and poverty indicators. The potential of changing the funding formula is slim since there are only nine counties and cities that receive this funding and competition for this funding would likely be fierce.

Other Major Sources

There are four other funding streams from other governments that each account for over $10 million in FY96. These include the PICA City Account ($105.6 million), Pension Aid from the State ($34.5 million), the State Utility Tax Refund ($24 million), and the "rental payment" ($18 million) from the Philadelphia Gas Works (PGW) .

The PICA City Account primarily consists of what remains from the PICA Wage, Earnings, and Net Profit Tax collections after PICA debt service costs. The projection for this revenue stream is consistent with the Plan's tax growth assumptions. The Wage, Earnings, and Net Profits Tax rate reduction has no direct effect on PICA's collections. The PICA tax remains 1.5% and the City absorbs the entire impact of the rate cut.

The State provides pension aid to the City in an effort to assist the City in eliminating its unfunded pension liability. This amount is regulated by Act 205.

The State Utility Tax Refund is based on special tax collections from utilities that are exempt from local property taxation. Revenues from this tax are allocated to local governments.

PGW's annual "rental payment" is set at $18 million and is considered payment on capital the City has invested in the utility. The City and PGW have begun considering alternative methods for calculating what the payment should be. PGW's ability to continue making this payment may be adversely affected by proposed cuts to the Low-Income Home Energy Assistance Program (LIHEAP), which enables PGW to recover costs for gas service to low-income customers (see section on Federal and State Government Cuts to Non-General Fund Programs for discussion of LIHEAP). Additionally, the $18 million payment is currently under court challenge. Even so, the City has little concern that this payment is threatened.

LABOR CONTRACT NEGOTIATIONS

The City's labor agreements with its four major unions -- the American Federation of State, County, and Municipal Employees (AFSCME), District Council 33 (DC 33); AFSCME, District Council 47 (DC 47); the Fraternal Order of Police, Lodge 5 (FOP); and the International Association of Firefighters, Local 22 (IAFF) -- expire on July 1, 1996.

Negotiations have begun on all of the agreements, the FOP having already moved toward binding arbitration. With potentially contentious union elections scheduled for DC 33, the largest of the four unions, on May 14, it is uncertain if any new agreements will be in place prior to the expiration of the current ones.

The City uses 40 pages in the 400 page main body of the Plan to discuss issues related to the current labor negotiations and to set forth the City's approach to such negotiations.

Impact of Labor Negotiations on Plan Compliance

Both the mayor and the Plan have committed the City to providing employees with some sort of "net increase" in compensation. However, the Plan opts not to detail the City's full bargaining position in public.

Projected General Fund surpluses through FY2001 appear to be available to assist in providing modest increases in compensation. Barring contract negotiation or arbitration results which fail to require that increases primarily be funded from savings within such contracts, the General Fund appears secure for the out years.

Even so, the Plan does not project how increases in compensation might affect expenditures. Therefore, final contracts with the unions will be carefully reviewed by PICA Staff to determine if they result in a variance with the Five-Year Plan.

The Five-Year Plan's Argument

The Plan presents the argument that, even after the expiration of the current agreements, which were considered frugal in comparison to past agreements, compensation for City employees is competitive with the private sector. It argues that not only are benefits generous but that salaries and negotiated wage increases, even taking into account the current agreements, are competitive.

The City's Negotiation Strategy

The Plan lays out the groundwork for the City's negotiating strategy, making no projection of what the results of the labor negotiations may be. It documents that the City has little available funding for compensation increases and describes what the City's negotiating stance is.

Since the City would undermine its position by building in assumed pay raises, the Plan assumes no across-the-board wage growth. Besides the Department of Human Services, which projects a slow growth in personnel levels, departmental sections of the Plan reflect no increases in personnel levels or costs after FY97, when the FY96 pay raise becomes annualized. The Police Department, which in FY98 will begin to phase into its General Fund costs the salaries of Federal Crime Bill-funded officers hired between FY95 and FY97, has a separate "Crime Bill Match" line item making the Plan presentation consistent.

Nevertheless, the Plan appears to indicate that because locally generated revenues are expected to average 1.9% annual growth between fiscal years 1996 and 2001, the City should be able to afford an annual increase in the total employee compensation package of an equivalent amount over the four years of the labor agreement.

The Plan recognizes that this growth rate is less than what the Plan projects to be inflation over the same time period. However, it also notes that this is the limit on how much the City believes it can afford to increase **total compensation**. By negotiating benefit, pay structure, work rule and other such changes that the City claims would not materially affect the quality of life for employees, the City would be able to redirect at least some resulting savings to salaries or to other benefits.

The Plan lists eight categories of "shared-savings opportunities," describing in over twenty pages specific ways to realize compensation savings.

The Plan's section on the labor agreement negotiations ends with a description of the scale of action that would be necessary to close a budget gap caused by an agreement or arbitration award requiring the City to pay more than the City believes is available.

CAPITAL PROGRAM OFFICE

Longstanding and previously reported PICA Staff concerns regarding City capital program administration capabilities have yet to be quelled. Signs of improvement are slowly becoming evident and proposals for further improvement abound; but a centralized administration that utilizes presently available technology and provides vitally needed guidance is sorely lacking. The City, in the Capital Program section of the Plan, cites numerous capital program accomplishments since 1992 -- all perfectly valid -- and has thus effectively shown that even an impeded capital program management group can show improvement when provided with a massive infusion of capital funds.

The emerging/anticipated use of management and accounting computer systems, the future projected use of an on-line contracting program, and proposed future links to City geographic information systems to track facilities and projects, are not equivalent to currently employing top-of-the-line procedures.

It is disquieting to be advised that, while the Capital Program Office has access to City-wide accounting and management systems, such systems do not correlate with that Office's own contracting and project management data bases. The record to date does not engender optimism that the proposed upgrade to a FAMIS 4.2 accounting system, and a soon to be installed construction contract management system coupled with Geographic Information System tie-ins, will lead to significant Capital Program Office administrative efficiencies or improvements.

PICA Staff was initially heartened to learn of the City's search for a Capital Project "Czar" and also that the Department of Public Property has implemented a policy to contract out management of complex construction projects to private firms.

The "Czar" has not yet been employed despite a lengthy search. Qualified and interested candidates have been identified, but for various reasons, have eventually excluded themselves from consideration. The need for a qualified and focused individual to oversee capital programs cannot be overemphasized. Policies and planning to optimize the productivity of capital dollars; prioritization of capital projects to produce increased operational revenues by either directly improving existing services or reducing operational hindrances; and focused maximization of Economic Stimulus Program opportunities through judicious capital funding can and must be utilized to benefit Philadelphia.

PICA Staff recommends that outside management contracts to supervise complex major projects be seriously considered for all City departments, not just those under the auspices of the Department of Public Property.

A forward step by the Departments of Recreation and Public Property toward reducing the size of their excess land and facilities inventories, and ridding themselves of the cost of maintenance (and of potential liabilities from results of required maintenance having been deferred) is applauded. PICA Staff continues to believe it is vital that the City institute an all-inclusive program to review the need for and condition of its many facilities. Recommendations as to use/closure, location/relocation, consolidation and disposition of surplus facilities are vital to the successful use of capital to most efficiently serve the needs of the citizenry.

FIRST JUDICIAL DISTRICT COSTS

The City, in the Plan, properly continues to rail against the fact that the General Assembly of the Commonwealth of Pennsylvania continues to take advantage of an indefinite stay granted it by the Supreme Court of Pennsylvania, of that Court's holding "that the statutory scheme for county funding of the judicial system is in conflict with the intent clearly expressed in the constitution that the judicial system be unified." The stay granted by the Court was as follows:

> "However because this order entails that present statutory funding for the judicial system is now void as offending the constitutional mandate for a unified system, we stay our judgment to afford the General Assembly an opportunity to enact appropriate funding legislation consistent with this holding. Until this is done, the prior system of county funding shall remain in place."

The City's frustration in being required to fund most of the expenses of the First Judicial District of Pennsylvania (FJDP), "an agency ultimately under the direction and control of the Pennsylvania Supreme Court", without having "direct authority to manage, control expenses, or set budgetary levels" is understandable but not unique among Pennsylvania counties. What has been unique is the degree of cooperation between the FJDP and the current City administration. The remarkable achievements of the FJDP since FY92 in dramatically improving its financial operations under a zero-growth budget agreement have greatly assisted the City in its own dramatic financial achievements.

The Pennsylvania Supreme Court committed the FJDP to a zero-growth, zero-reduction budget beginning in FY92, after having appointed the first Executive Court Administrator in December 1991. Under that operational scenario, the FJDP has saved the City an estimated $89 million in expenditures over the period FY92 through FY95 while instituting numerous reforms and improvements in its operations. Cost savings achieved within the zero-growth/zero-reduction format totaling more than $8.1 million in that same four year period were allocated to technological improvements and training of FJDP personnel. The budget limitation agreement between the City and the FJDP, originally for a three year term and extended for an additional three years, expires at the close of FY97. The Plan projects that FJDP costs for fiscal years FY98 through FY2001 will be unchanged from those of FY97, which increases nominally from FY96 in recognition of a sharing of increased civil fees as provided in the budget limitation agreement.

PICA Staff is very concerned that, absent a prompt takeover of Court funding costs by the legislature, recent Supreme Court of Pennsylvania actions resulting in a dilution of the power of the Executive Administrator and installation of a new governing board format for the FJDP could substantially increase post-FY97 costs to the City. Justification for the recently instituted FJDP changes included the plethora of improvements which have been made in court operations to date and the desire that FJDP oversight once again be similar to that in all other counties in Pennsylvania. PICA Staff's concern is that an ongoing non-conciliatory stance on the part of the City, engendered by the perceived unfairness of continuing to be required to fund an autonomously administered FJDP, coupled with the judiciary's recollections of perceived sacrifices made by them during the current zero-growth budget program could obviate the possibility of agreement on a continuance of a similarly workable and productive agreement.

The FJDP does have mandamus power to command the funding it deems appropriate. While its use of that power at this juncture seems unlikely, it is nonetheless a potential threat to the reasonable stability of costs to the City of the operations of the FJDP until such time (hopefully within the life of this Plan) as the State is required to assume full court funding.

INDEMNITIES

PICA Staff has previously expressed its concerns as to a perceived substantial risk on the part of the City, as a self-insured entity, for indemnity costs from both unresolved and potential lawsuits. Accordingly, it would normally applaud the City's caution in increasing the amount provided for the cost of indemnities in the FY97-FY2001 Plan. The Plan provides 42% more for indemnities resolution in the upcoming five-year period than was provided for in the FY96-FY2000 Plan five-year period.

However, increasing indemnity costs; the phase-out of day-backward program settlements and the probability of higher settlement amounts with regard thereto (cases taking the longest to resolve are generally the cases with the greatest potential exposure for the City); anticipated increases in special litigation costs; and the increasing annual costs of risk-management claims (pre-lawsuit claims) all continue to bode ill for the City in this difficult to predict cost area. PICA Staff has significant concerns relative to the following specific matters which could adversely impact this area of the FY97-FY2001 Plan.

Ongoing Inventory

The City's Comprehensive Annual Financial Report (CAFR) for the Fiscal Year Ended June 30, 1995 (in footnote number 28 relative to claims, litigation and contingencies) indicated the following General Fund loss liability estimates at such date:

	Amount (Millions)
Aggregate estimate of loss deemed to be probable	$84.3
Additional aggregate estimate of loss which could result if unfavorable legal determinations were rendered against the City - pertinent to cases in which some amount of loss is reasonably probable	97.1
TOTAL	$181.4

While the CAFR disclosure bears a reasonable relationship to the Plan proposed Indemnity Budget, the following disclosures within the Plan indicate a potential for cost increases beyond the Plan's estimates:

> The City's 20 percent anticipated increase in case filings as a result primarily of the Court of Common Pleas "Day Forward Program" designed to resolve new complaints within a year.

The City's anticipated 19 percent increase in Federal Court filings against it during FY96. (The City does not enjoy liability limitation in Federal Court).

Act 111 Interest Arbitration Engendered Litigation

The City has yet to be successful in any part of its appeals to date of an arbitration award against the City Police Department won by the Fraternal Order of Police, Lodge No. 5 ("FOP") pertinent to a City-instituted schedule change which became effective January 5, 1990. The FOP asserted that police officers became entitled to 15 minutes additional overtime pay per day as a result of the schedule change. The FOP's grievance was sustained by an arbitration award issued in February 1995. The City appealed the arbitration decision to the Court of Common Pleas. That Court affirmed the award in June 1995. The City has indicated an intent to appeal to the Commonwealth Court and if unsuccessful there, to seek review by the Pennsylvania Supreme Court.

A suit was filed in Federal Court in August 1992 by a group of current and retired police officers challenging the City's pay practices as a result of the failure to pay the overtime discussed above, alleging that, together with other practices, such actions violate the Fair Labor Standards Act. Motions for summary judgment were denied and the case, which was to be scheduled for trial, was placed on hold awaiting the result of the State Court appeal.

The FOP has claimed that the City's liability will ultimately be determined to be $10 million per year since January 1990.

Thirty-Ninth Police District Cases

The eventual cost of claims recently filed and possibly yet to be filed against the City by citizens who have alleged civil rights violations and false imprisonment in conjunction with the arrest and convictions of certain Philadelphia police officers and an ongoing Federal Bureau of Investigation probe and Federal Grand Jury investigation of such matters, although not yet determinable, could be severe. The City has acknowledged receipt of notice of 19 pre-suit claims and 8 lawsuits and indicates that one of the lawsuits seeks certification as a class action suit. It should be noted that, after careful review by the District Attorney's Office, 115 persons who had been convicted in this matter have had their convictions overturned. The cases filed have been initiated in Federal Court and some have been stayed pending the conclusion of the criminal investigation.

School District Reform

While not technically an indemnity matter, PICA Staff also has significant concerns as to potential future costs to the City which may emanate from a November 1995 Commonwealth Court ruling naming both the Commonwealth of Pennsylvania and the City as additional defendants in an action mandating reforms to be undertaken by the School District of Philadelphia, and ordering them to explain why they should not be forced to pay more to help improve the school system. There is thus a possibility of a court supervised, City funded school reform program of as yet unknown proportions.

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FEDERAL AND STATE FUNDING CUTS TO NON-GENERAL FUND PROGRAMS

There are three program categories besides General Fund services where the Federal and State governments may make funding changes and cuts: non-General Fund City activities, other public sector entities which serve Philadelphians, and entitlement programs upon which many residents rely. These changes and cuts, if enacted, will indirectly affect General Fund tax revenues and demand for General Fund-provided services.

Funding Cuts to non-General Fund City Activities

The City of Philadelphia receives significant funding from both the Federal and State governments that is recognized outside of the General Fund. Examples of City programs funded this way include Mental Health/Mental Retardation services ($250 million in FY96), the Federal Empowerment Zone ($100 million in total), Community Development Block Grant programs ($84 million across two City funds in FY96), Section 108 housing loans ($24 million in FY96), the Healthy Start Initiative ($25 million over five years), Department of Human Services medical placements (over $20 million annually), and Crime Bill police officers ($10 million in FY96).

These funding streams fluctuate annually since many of them are created for short duration. However, they are also vulnerable to programmatic changes and annual appropriation negotiations. In the cases of the Empowerment Zone and Crime Bill police, the City has been virtually guaranteed that this funding will remain available. The future of other funding streams is not so certain.

Generally, a reduction of funding in any of these areas would be counterbalanced by a reduction in services and not result in a direct burden on the General Fund. However, a reduction in services would probably result in an increased demand on General Fund services, such as district health center and homeless services, and therefore higher General Fund expenditures.

Mental Health services

The Mental Health/Mental Retardation system is the largest recipient of non-General Fund revenue. Through FY94, much of this funding was recognized in the General Fund. However, for budgetary and tracking purposes, this revenue is now recognized in the Grants Fund.

This funding stream would be significantly altered under the State's proposal to place all Medical Assistance (MA) recipients into managed care programs. Since Mental Retardation is considered a disability, only Mental Health services would be covered under the proposed managed care system.

The City has decided to maintain its mental health services infrastructure and has already prepared itself for the proposed change by creating a behavioral health managed care private, nonprofit entity, Community Behavior Health. However, it is uncertain whether funding under the new State system would be equivalent to current funding. How the funding mechanism will work is also undecided. While the managed care proposal has been postponed for over two years already, it is likely to be enacted in the near future.

Housing and Homeless Programs

The City's housing agencies, working in conjunction with nonprofit housing organizations city-wide, have managed to more than quadruple the amount of Federal grants flowing into Philadelphia for homeless housing assistance, to over $16.5 million in FY96. This success can easily be overwhelmed by significant Federal or State reductions in housing program funding. Programmatic success which has resulted from increased Federal funding also could be condemned by entitlement reductions that would dramatically increase homeless and housing service demands. This latter possibility is discussed in the section on entitlement cuts.

The Plan discusses in broad terms changes and cuts in homeless and housing assistance programs that are being considered in Washington and in Harrisburg. Changes consist of block-granting various funding streams to allow for greater State and local flexibility. Program cuts are potentially drastic, including one-third of public housing renovation funds.

One aspect of the reduced funding this year for the Low-Income Home Energy Assistance Program (LIHEAP) is that Housing and Emergency Assistance, a State-funded, City-administered program to maintain persons in their own residences, was used disproportionately for utility bill payments, leaving fewer funds for rental and security deposit assistance. This shifting of funds from one program to replace reduced funding in another program can result in cuts in assistance or service reductions across a broader range of the population than the initial program cuts may imply.

Department of Human Services Medical Assistance Diversion

Over the past four years, the City has been working with the State to divert medical costs for children served by DHS to Medical Assistance (MA) through the Early and Periodic Screening, Diagnosis and Treatment (EPSDT) expansion of Medicaid. The City projects that in FY97, over $22 million of treatment costs will be covered by MA. DHS still funds non-medical costs associated with these children in non-State licensed facilities, but these costs are eligible for other funding streams, including Act 148.

Previous to diversion, these services were covered under Act 148 funding formulas. Over the past few years, DHS has worked with its in-state contractor agencies to license them with the State. State licensing guarantees MA funding eligibility.

The State has been moving toward a mandated managed care plan for MA recipients for almost two years. DHS is concerned about how such a plan will affect the population it serves and its own efforts at cost diversion. Because a court often orders DHS to provide certain medical treatment to children in its care and DHS wants to ensure a continuity of care as a child moves from one type of environment to another (e.g., from institutional treatment to treatment at home), the City may get stuck with medical costs that MA managed care providers are unwilling and not mandated to bear.

DHS has requested that the State delay phasing into the proposed MA managed care system the population it serves until these and other issues are addressed. In the interim, DHS continues to meet with DPW and other concerned counties.

Other Areas

The areas discussed above are just three examples of what Federal and State programmatic changes and funding cuts to the City's non-General Fund coffers may do. Other significant areas that could be similarly affected include Community Development Block Grant programs, drug and alcohol services, and assistance for HIV-positive individuals.

Funding Cuts to Other Philadelphia Entities

In addition to the City, a number of large public sector agencies in Philadelphia rely on funding from the Federal and State governments. If that funding is not maintained at a sufficient level, Philadelphia's quality of life may suffer and the City government may need to, or in at least one case be compelled to, fill in the funding gap. Additionally, funding cuts that diminish service quality will result in accelerated population and job loss.

SEPTA

SEPTA has been actively campaigning against proposed Federal and State public transit funding reductions.

The Federal government may reduce its operating subsidy to $8 million in FY97, one-third the amount provided in FY95. The Governor has proposed in his budget to keep the State operating subsidy at its FY96 level of $177 million. Additionally, Act 26 funding, which comes from specific State tax revenue streams, is projected to fall by almost $30 million in FY97.

On SEPTA's capital side, the State will not be following through on the previous Governor's plan to provide $100 million annually over the next three years from Intermodal Surface Transportation Efficiency Act (ISTEA) "flexible" federal transportation aid. The State is also no longer providing $60 million annually for vehicle overhaul and safety programs.

Overall, SEPTA projects that the $33 million Federal and State operating subsidy shortfall will contribute to a operating budget deficit of $75 million in FY97. The capital budget is expected to be cut by a cumulative $369 million over FY96 and FY97. If no Federal or State action is taken to compensate for these cuts, Philadelphia will likely suffer from fare raises and service cuts. Even if the City is willing and able to provide a greater subsidy to SEPTA, the City will not be able to compensate for such a great loss in funding.

<u>Philadelphia School District</u>

State funding for the Philadelphia School District is expected to decline slightly in FY97. Additionally, the District's local funding, which relies primarily on real estate taxes, continues to fall. Even with the new liquor by the drink tax, which went into effect and generated $7.8 million during FY95, tax revenues to the District fell in the last fiscal year. The City Controller, in his "Mid-Year Economic and Financial Report," estimates that School District tax revenue will be the same in FY97 as in FY93.

Both the State and the City have been added as defendants to the District's ongoing desegregation court case (see Indemnities section). Although the City is unlikely to provide significant funding to the School District through its General Fund (it currently pays for crossing guards through the Police Department), without additional State funding, the City may be compelled to raise tax rates on the taxes that flow to the District. A tax rate hike would further worsen the City's economic competitiveness.

<u>Philadelphia Gas Works</u>

The Philadelphia Gas Works (PGW) is a self-supporting entity. However, its revenue stream includes a substantial amount of money ($12 million in FY95) accessed by customers from the Low-Income Home Energy Assistance Program (LIHEAP).

With a substantial Federal reduction in funding this fiscal year, LIHEAP will not serve as many consumers as previously. Additionally, the State placed new restrictions on the use of LIHEAP funds forcing PGW to write-off over $37 million in noncollectable bills.

To compensate for losses in revenue that could prevent PGW from meeting its bond holder rate covenant, the utility might either raise charges or not meet its $18 million annual payment to the City. PGW's plans to reduce its non-fuel base rates by 10% over the next five years by reducing operational expenses and expanding its customer base may help to counterbalance any loss in LIHEAP revenue.

Funding Cuts to Entitlement Programs

Perhaps the most significant concern of Philadelphia residents who rely on government assistance is potential funding cuts to entitlement programs. These programs include the State's largest welfare programs, General Assistance and Medical Assistance.

<u>General Assistance</u>

In 1994, the State cut General Assistance (GA) to able-bodied recipients between 45 and 64 years of age to one month annually. While original projections were that 15,000 residents would lose benefits, an estimated 5,500 did. In 1995, a second GA cut eliminated another approximately 15,500 individuals. The Governor has proposed further cuts in eligibility and a lifetime limit on aid of 24 months, unless a recipient who cannot find work does volunteer work 20 hours per week.

Additionally, the State Department of Public Welfare (DPW) is beginning to require certain recipients of Aid to Families with Dependent Children (AFDC) to enroll in job readiness and placement programs. Those deemed eligible will risk a reduction in benefits if they do not participate.

The City estimates that 200-300 individuals have spent some time in the City's shelters as a result of the enacted GA cuts. The City also believes that more effected individuals will look to the City for assistance as they use up their other resources. With more cuts being considered, the demand on City homeless and housing assistance is likely to continue to grow.

<u>Medical Assistance</u>

Approximately 490,000 Philadelphia residents receive Medical Assistance (MA), between 300,000 and 320,000 of them through a managed care plan. Statewide, approximately 88% of MA recipients have medical benefits funded by both the Federal and State governments while the rest are funded exclusively by the State.

The Governor's recently defeated proposal to limit MA eligibility would have taken an estimated 64,000 low-income Philadelphia residents off MA. General Assistance (GA) recipients are automatically eligible for a certain level of MA benefits, so that proposals to cut GA usually results in effected individuals losing certain MA coverage, if not all MA coverage.

State cuts in MA would have multiple negative effects on the City in addition to burdening the District Health Centers (see section on General Fund Revenues from Other Governments). The State Department of Public Welfare estimated that Philadelphia hospitals would lose $127.5 million annually under the Governor's proposal. This would cause some institutions to close, requiring the City to handle a greater number of patients.

Less revenue to the region would shrink the City's economy, eliminating hundreds of jobs. All of this would result in tax revenue losses for the City.

Federal Programs

Congress is considering cuts in its major entitlement programs such as Aid to Families with Dependent Children (AFDC) and Medicaid. Social Security and Medicare may also be considered for changes over the next few years. Any reduction in these programs will have similar effects as the items discussed above.

Funding for job training programs may also be reduced, limiting job retraining opportunities for welfare recipients just as they are being required to find work.

OTHER MAJOR AREAS OF PICA STAFF CONCERN

PICA Staff has a number of other concerns besides the ones noted previously in this report. These include the unfunded pension liability, the planned consumption of the positive General Fund balance, the City's methodology for projecting tax revenues and certain expenditures, the continued usefulness of target budgets, and the value of the City-wide and individual departments' strategic plans.

Unfunded Pension Liability

The City confronts a significant unfunded pension liability. As of the end of FY94, the Pension Fund was only 45% funded. This is the highest level of funding that it has achieved in over ten years. Yet it still has a shortfall of approximately $2.5 billion.

This shortfall may be underestimated due to the aggressive assumption that it will earn a 9% annual rate of return. However, based on this assumption, the City is on schedule to eliminate the unfunded liability by fiscal year 2020.

The payment schedule for closing the liability requires General Fund payments to gradually increase, exceeding $250 million, $35.5 million of which will be State funded, by FY2001. The payment required at the end of the liability reduction schedule will be approximately double that amount. This item accounts for a significant portion of the General Fund budget and will likely siphon off resources direly needed elsewhere unless action is taken to reduce the future obligation.

General Fund Balance

According to the Plan, the City expects to spend down its current General Fund balance of $80.5 million over the next two years, even before taking into account any compensation changes resulting from the labor negotiations and arbitrations.

A positive General Fund balance provides the City with a cushion for small operating deficits. Using the entire balance, which took three years to accumulate, in such a short period will leave the City vulnerable to General Fund deficits in the out years of the Plan period.

Methodology for Projecting Revenues and Expenditures

The City's methodology for projecting tax revenues and non-personnel, non-debt service expenditures is deficient and imprecise.

<u>Tax Revenues</u>

In developing tax revenue projections, the City does not use either economic modeling or long-term collection trends. Typically, the City reviews collections from the previous fiscal year and the fiscal year-to-date and applies what it believes to be a reasonable growth rate based on a limited number of factors.

Calculations do not incorporate data on employment trends, population shifts, property values, retail and tourism activity, or other economic indicators. While these factors may be considered when projections are developed, relevant data is not used in calculations. Additionally, no accounting is made of collection enforcement activities. The implicit assumption in the current Plan is that the successful collection efforts of the past four years will continue to experience unprecedented levels of success without end, an unlikely prospect.

The City also has a significant problem in projecting "prior year" (i.e., delinquent) collections. In most cases, projections plug in the same amount shown for current fiscal year expected collections. Some taxes have minor adjustments for the first two or three years before flattening out. Even the BPT tax, which recognized $42.7 million in FY95 (approximately 19% of total BPT revenue) as prior year collections, has what appears to be a "plug" number (see BPT tax discussion above). Nowhere does the City calculate how factors such as the enacted and proposed tax changes or enforcement efforts will affect prior year collections.

This methodological weakness in developing prior year collection projections is partially attributable to data shortfalls. The Revenue Department believes that tax revenues are often attributed to the wrong tax year due to technical deficiencies. The scale of this problem may be significant enough to render prior year collection data unreliable. The Department has begun to address this issue.

As in the past, the City provided PICA Staff with supporting material demonstrating how tax revenue projections were calculated this year. This material was often unclear and inconsistent. In the case of the Real Property Tax, the supporting data was incorrect.

Projections can be improved by explicitly considering economic and collection trends in addition to the specific factors of rate changes, new collection efforts, or accrual changes. While the net impact of the methodological deficiencies may not be significant over a one year period, the Plan's out years are vulnerable.

<u>Non-Personnel Expenditures</u>

The Plan's underlying obligation growth assumptions appear too optimistic. Since projections for individual departments often differ from these assumptions based on specific issues and considerations, the impact of these assumptions is limited.

The Plan assumes no growth in FY97 for all classes of expenditures besides personnel and debt service. The Plan assumes 1.5% annual growth for the out years. These baseline assumptions are identical to previous years' assumptions of no growth the first year and 1.5% annual growth thereafter.

These assumptions may severely underestimate expenditure increases, particularly in the out years, since it is unlikely that costs for contracted services, materials, supplies, and equipment will grow as projected, which is less than half the rate of inflation.

Target Budgets

PICA Staff has reservations about how effective the target budget process will be during the out years of the Plan in helping the City balance its budget.

The target budget process was developed by the Rendell Administration as a way to control spending beyond the budgetary limits set by City Council. Following City Council's adoption of a budget, the Administration develops a target budget for each department and cost center, often below the appropriated level. The savings generated by keeping to the target budget provides a cushion for unexpected revenue shortfalls or expenditure needs.

The ability to continue using target budgets may be diminishing. For the first three years target budgets were used, they provided a cushion of over $30 million. This current fiscal year, however, the Administration was apparently unable to develop as large a cushion (see chart below). The Administration continually emphasizes how important target budgets have been to controlling expenditures. It appears, though, that the Administration may be losing its ability to restrain expenditures below appropriated levels.

Cushion Created by Target Budget		
	Percent of Original Budget	Dollar Amount
FY93	1.35%	$30,975,746
FY94	1.48%	$34,062,475
FY95	1.59%	$37,838,312
FY96	.56%	$13,237,876

Source: *Quarterly City Managers Report*, First Quarter FY93, FY94, FY95, FY96

Comparing the first two *Quarterly City Managers Reports* from this fiscal year illustrates how important this cushion can be. Even though the Indemnities, Prisons, and Office of Emergency Services (formerly the Office of Services to the Homeless and Adults) budgets are expected to exceed their appropriations by a combined $16.6 million, this difference will not result in a budget overrun primarily because of the target budget cushion. However, as a result of these and other cost overruns, the target budget cushion has been reduced to under $3 million.

Strategic Plans

PICA Staff is not convinced that the City's current strategic planning process will help shape program, financial, and budgetary decision-making.

The Administration maintains that most departments have virtually completed their strategic plans and that the drafts were used in writing the Five-Year Plan. However, PICA Staff has yet to see any departmental strategic plan or explicit ties between the City-wide Strategic Plan and either the budget or the Five-Year Plan.

Additionally, the City has provided no evidence of definitive plans to keep the strategic planning process alive. The annual development of the Five-Year Plan and the quarterly tracking of service delivery levels work toward similar ends. However, they do not provide all departments with a vision or with measures of progress toward that vision (i.e., regularly gauged quality of life indicators that departments are trying to affect).

As one part of the strategic planning process, the City should consider its infrastructure needs. Conducting a centralized and systematic evaluation of the condition of the City's infrastructure and the impact it has on all aspects and elements of municipal government would enable the City to plan its infrastructure investments more logically.

APPENDIX A

Statutory Background, Plan Review Methodology and Summary of Events

Overview

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

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

Statutory Basis -- The PICA Act

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

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

(ii) create an authority that will enable cities of the first class to access capital markets for deficit elimination and seasonal borrowings to avoid default on existing obligations and chronic cash shortages that will disrupt the delivery of municipal services;

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

(A) increased managerial accountability;

(B) consolidation or elimination of inefficient city programs;

(C) recertification of tax-exempt properties;

(D) increased collection of existing tax revenues;

(E) privatization of appropriate city services;

(F) sale of city assets as appropriate;

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

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

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

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

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

charge directly or indirectly against revenues of the Commonwealth or city of the first class.

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

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

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

(2) Plan components that will:

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

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

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

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

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

(c) Standards for formulation of plan:

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

(2) All revenue and appropriation estimates shall be on a modified accrual basis in accordance with generally accepted standards. Revenue estimates shall recognize revenues in the accounting period in which they become both measurable and available. Estimates of city-generated revenues shall be based on current or proposed tax rates, historical collection patterns, and generally recognized econometric models. Estimates of revenues to be received from the state government shall be based on historical patterns, currently available levels, or on levels proposed in a budget by the governor. Estimates of revenues to be received from the federal government shall be based on historical patterns, currently available levels, or on levels proposed in a budget by the president or in a congressional budget resolution. Non-tax revenues shall be based on current or proposed rates, charges or fees, historical patterns and generally recognized econometric models. Appropriation estimates shall include, at a minimum, all obligations incurred during the fiscal years and estimated to be payable during the fiscal year or in the 24-month period following the close of the current fiscal year, and all obligations of prior fiscal years not covered by encumbered funds from prior fiscal years. Any deviations from these standards of estimating revenues and appropriations proposed to be used by a city shall be specifically disclosed and shall be approved by a qualified majority of the board.

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

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

(1) be in such form and shall contain:

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

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

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

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

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

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

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

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

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

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

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

(i) are consistent with the Financial Plan;

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

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

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

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

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

City Reporting and Variances

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

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

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

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

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

Plan Review Methodology

Staff Report - The Plan, as approved by City Council on March 21, 1996, was submitted to PICA by the Mayor on April 1, 1996 and the PICA Act provides a 30 day period for review which expires May 1, 1996. Authority Staff has consulted with the

City, both on the departmental level and otherwise, since the Plan was initially submitted to City Council by the Mayor on January 23, 1996 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 April 16, 1996.

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

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

Apart from labor-related revisions, or those required by declaration by PICA of a variance in the Plan in the future, the Plan is subject to mandatory revision on March 24, 1997 (100 days prior to the end of FY97). At that time, the City is required to add its Fiscal Year 2002 to the Plan and make any other alterations necessary to reflect changed circumstances. Under the PICA Act, the City may determine to revise the Plan at any time and submit the revision to the Authority for its review.

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

Estimated 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 almost five 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 $1,082 million in funding to assist the City, allocated to the following purposes:

Purpose	Amount (thousands)
Deficit Elimination/Indemnities Funding	$ 256,200
Productivity Bank	20,000
Capital Projects	424,632
Retirement of Certain High Interest City Debt	381,300
TOTAL	$1,082,132

PICA's authority to issue new money debt for purposes other than financing a City cash flow deficit has expired. PICA anticipates that its future activities 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 yet to be completed City Strategic Plan.

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

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 of 1997.

During future months, the Authority will receive quarterly reports on the City's performance under the Plan, together with other data.

The reporting system established in the Cooperation Agreement and the PICA Act anticipates a regular flow of data to PICA, and the reporting system which has been established by agreement between the City and PICA under the provisions of the PICA Act is divided into several groups, which are described below:

> Quarterly Plan Reports. The Authority receives reports from the City on a quarterly basis (45 days after the end of each fiscal quarter) concerning the status of compliance with the Plan and associated achievement of initiatives. The remaining quarterly reporting deadlines for FY96 are May 15, 1996 and August 14, 1996. Quarterly reporting deadlines for FY97 are November 14, 1996, February 14, 1997, May 15, 1997 and August 14, 1997. The Cooperation Agreement also requires that the City provide reports to PICA concerning Supplemental Funds (*i.e.*, the Water and Aviation Funds) on a quarterly basis.

> Grants Revenue Fund Contingency Account Report. The Cooperation Agreement provides that a report on the Grants Revenue Fund Contingency Account be prepared and submitted, by department, not later than 20 days after the close of each fiscal quarter, and those to be received relating to FY96 are: April 22, 1996 and July 22, 1996. For FY97, the reporting dates are October 21, 1996, January 20, 1997, April 21, 1997 and July 21, 1997. This report details the receipt and use of Federal and Commonwealth Funds by the City, as well as the eligibility for fund withholding by the Commonwealth at PICA's direction in the event the City cannot balance the Plan after an extended period of intensive reporting and PICA review of proposed corrective efforts.

> Prospective Debt Service Requirements Reports. The Cooperation Agreement requires submission of a report detailing prospective debt service payments by the City, as well as lease payments, 60 days prior to the beginning of a fiscal quarter. The remaining report in this category for FY96 is to be received on May 1, 1996. The dates for submission of such reports for FY97 are August 1, 1996, November 1, 1996, January 30, 1997 and May 1, 1997.

APPENDIX B

Schedule of Findings, Office of the City Controller

In accordance with Section 4.04(g) of the Intergovernmental Cooperation Agreement between PICA and the City, the City Controller's Office submitted to PICA its opinion with respect to the reasonableness of the assumptions and estimates in the Plan and also, at the request of the PICA Board, a report upon the results of agreed upon procedures with respect to the Plan. PICA Staff is grateful for the assistance provided by the Controller's Staff in evaluating this Plan.

Major findings of the Controller's Office resulting from its review of the Plan, formally reported to PICA on April 16, 1996 (in conjunction with receipt of the Controller's Opinion on the Plan and report upon the performance of agreed upon procedures) are reproduced in this Appendix. Most of such findings have been previously discussed in this report from a PICA Staff perspective. PICA Staff believes the reader will gain added value from a review of the Office of the Controller perspective on such matters.

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