Pennsylvania Intergovernmental Cooperation Authority

Revenue Stress in the City of Philadelphia

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PENNSYLVANIA INTERGOVERNMENTAL COOPERATION AUTHORITY

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Revenue Stress in the City of Philadelphia

After four years of growing General Fund surpluses, one might conclude that Philadelphia's budget is *structurally balanced* - that the revenue structure is sufficient to maintain city services. However, such a conclusion would be incorrect and dangerous.

The continuing decline in Philadelphia's economy, resulting from job and population loss (as documented in PICA's White Paper No. 1), seriously limits the city's ability to generate tax revenues, which presently pay for approximately two-thirds of the city's basic services. Locally generated non-tax revenues (e.g., fees and fines) and federal and state funding have increased significantly over the past five years. Nonetheless, basic city services are primarily reliant on revenues emanating from a shrinking tax base. Additionally, even the non-tax revenues are at considerable risk.

Ignoring flat revenue trends and the potential for their decline will only ensure future deficits and a return to fiscal instability.

Structural Balance

Structural balance has been defined as achieving a balance "between the services that are provided and the local economy's ability to pay for these services."[1] It refers to a situation in which revenues cover expenditures and where both revenues and expenditures can be reasonably expected to grow or decline at similar rates, ensuring a balanced budget into the future.

Achieving structural balance limits the potential for a budget deficit or the need for drastic action to balance the budget in any one year. Budgets in such a situation may not balance each and every year, but the potential for a significant negative balance is substantially reduced. A significant negative balance, defined as 5% of total revenues in any one year, or a negative balance that persists over two years and grows the second year is considered indicative of a long-term budgetary problem.[2] PICA's definition of a "budget variance", at which point PICA can require immediate city corrective action, is even more narrow – a budget gap greater than 1% of budgeted revenues in any one year.[3]

Structural balance in Philadelphia is based on the fiscal status of the General Fund. All other city funds rely on revenues dedicated to providing specific services and are

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[1] "Structural Balance," New York State Financial Control Board, July 1992, p. 1.

[2] *City Financial Emergencies*, Advisory Commission on Intergovernmental Relations, 1973.

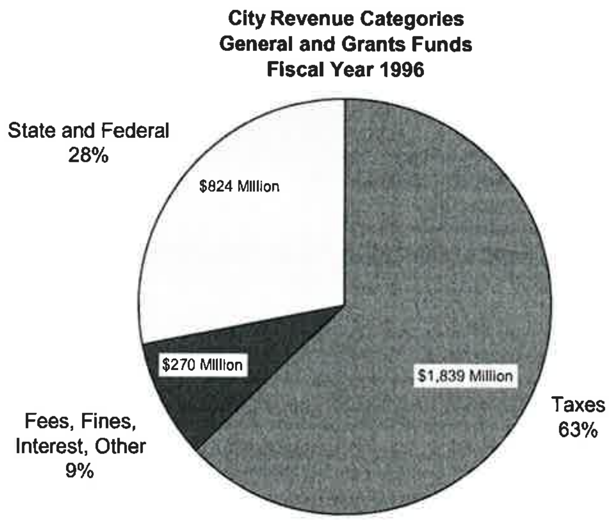
[3] Intergovernmental Cooperation Agreement by and between the Pennsylvania Intergovernmental Cooperation Authority and the City of Philadelphia, Section 4.10. The Cooperation Agreement also stipulates that a projected cash flow shortfall of more than 5% of the original forecast is considered a variance.

effectively self-balancing.[4] Non-General Fund dedicated revenues are most typically provided by the state and federal governments, or, in the case of utilities, are generated through service charges. Although non-General Fund transactions do not directly impact structural balance, they ultimately relieve the need for the General Fund to provide certain services and also contribute to the economic activity in the city, thus assisting in generating General Fund tax revenue.

For consistency purposes, this report combines the General and Grants Funds. Over the years, various programs and funding streams have been shifted between these two funds to such a degree that adjusting the General Fund for the impact of such shifts is nearly impossible.

Revenue Categories

Philadelphia (i.e., the General and Grants Funds) has three main revenue sources. The largest and most significant is taxes. Tax revenues are largely dependent on local economic circumstances. They fund most municipal functions and a substantial amount of county functions, such as courts, prisons, and health and human services. For purposes of this paper, PICA tax revenues are considered to be city tax revenues.



Note: Assumes all Grants Fund revenue is state and federal revenue.

The second revenue source is locally-generated non-tax revenue (i.e., fees, fines, interest earnings, and payments from other city funds) and revenue from governments other than PICA and the state and federal governments. Fees and fines help to recoup costs of specific services while interest earnings are available for discretionary use. Revenues

4 Examples of city funds other than the General Fund are Capital Improvement, Community Development (i.e., CDBG money), Grants, Philadelphia Gas Works, and the Philadelphia Water Department.

from other city funds (such as Water and Aviation) are generally reimbursements to the General Fund for services rendered. The revenues from other governments included in this category (such as SEPTA and the Convention Center Authority) also are generally reimbursements.

The third source of revenue is funding received from the state and federal governments. These monies are significant in their magnitude and arguably are more at risk than tax revenue, since Harrisburg and Washington have ultimate control over them. Due to a lack of sufficiently detailed data, this paper assumes that all Grants Fund revenues come from the state and federal governments, although up to 10% of such funding ($46 million or 2% of total revenues in Fiscal Year 1996) may be attributable to the "Fees, Fines, Interest, Other" category.

Tax Revenue Trends

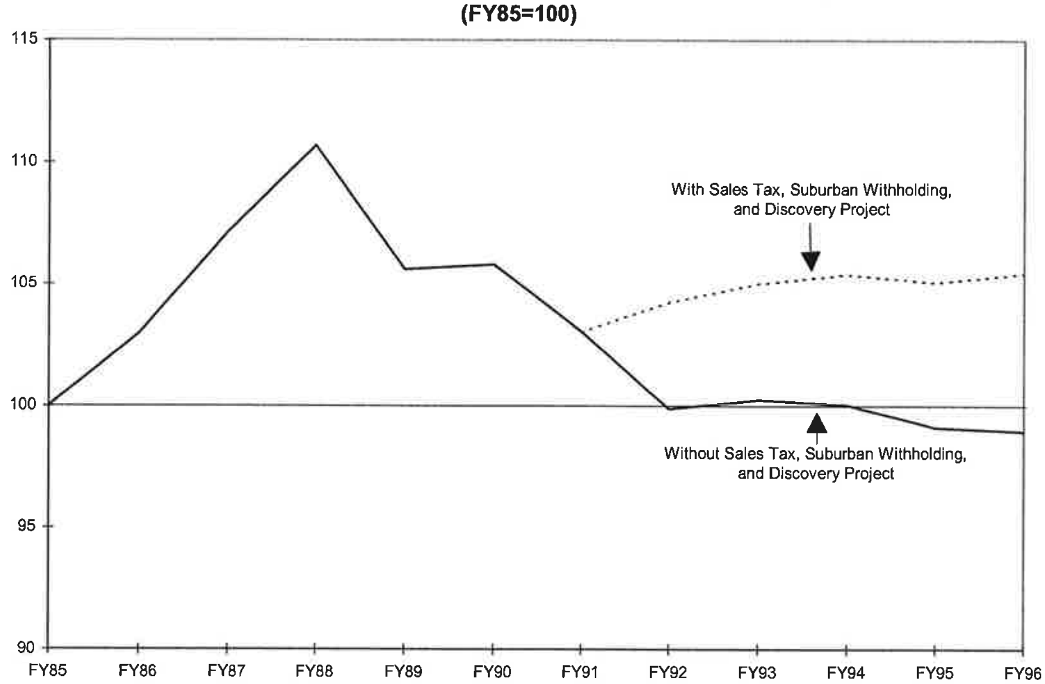
Philadelphia's tax revenues are heavily dependent on the city's economy. Wage and Earnings, Business Privilege, Net Profits, and Sales taxes all depend on economic activity and productivity in the city. The first three of these taxes also depend on the larger regional economy, as many city residents are employed in the suburbs and numerous city businesses conduct business in the suburbs.

The Real Estate Property Tax is second to the Wage and Earnings Tax in the amount of revenue it generates. During the real estate boom of the 1980s, this tax revenue stream grew much faster than the rate of inflation. Revenues from this source have begun to fall as Philadelphia real estate market values have become depressed, particularly in the commercial and industrial sectors. Through the early 1990s, revenues from this source did not decline as fast as the real estate market, a result of expiring tax abatements and the return to the tax rolls of commercial properties built during the boom period. Since virtually all of these large abatements have expired, the effect of returning abatements will no longer be as significant.

The tax base, absent the effects of the Sales Tax, mandated suburban Wage Tax withholding, and the Discovery Project (i.e., identifying previously unknown tax delinquents), has tracked the city's economic decline since 1988. As the chart below shows, the city's overall tax base grew faster than inflation from Fiscal Year 1985 through Fiscal Year 1988. Since then, the tax base has been shrinking, a result of the dramatic loss of population and jobs during this time.

The primary factor that has kept the city's tax base above its Fiscal Year 1985 level has been the city Sales Tax ($82 million in Fiscal Year 1996), which was authorized as part of the PICA statute and has mostly assisted in maintaining prior tax revenue levels as opposed to adding growth. Mandated suburban Wage Tax withholding ($20 million) and enhanced tax collection enforcement through the Discovery Project ($11 million) has also helped maintain tax revenues.

Indexed Philadelphia Tax Base Growth Adjusted for Inflation (FY85=100)



The total tax base including the Sales Tax, mandated suburban withholding, and the Discovery Project has experienced an upward trend since Fiscal Year 1991, primarily as a result of increasing taxpayer compliance with these new levies and enforcement programs. There is evidence, however, that compliance with the Sales Tax has peaked and that Sales Tax revenues will begin to track falling retail sales activity in the city. Additionally, the proximity to full compliance by employers subject to suburban withholding and the probable reduced number of remaining unidentified tax delinquents will likely lead to a reversal of the upward trend in collections resulting from these two programs.

Separate from these issues, the city's Personal Property Tax, a tax on residents' non-Pennsylvania stock and bond holdings, faces an unresolved threat. A recent U.S. Supreme Court ruling that North Carolina's Personal Property Tax, which was modeled on Pennsylvania's, is unconstitutional has engendered litigation in several suburban Philadelphia counties to void the tax. Accounting for $17 million in collections in Fiscal Year 1996, the loss of this revenue would be significant, although not insurmountable. The larger problem is that an unfavorable court ruling could require refunds of prior year collections.

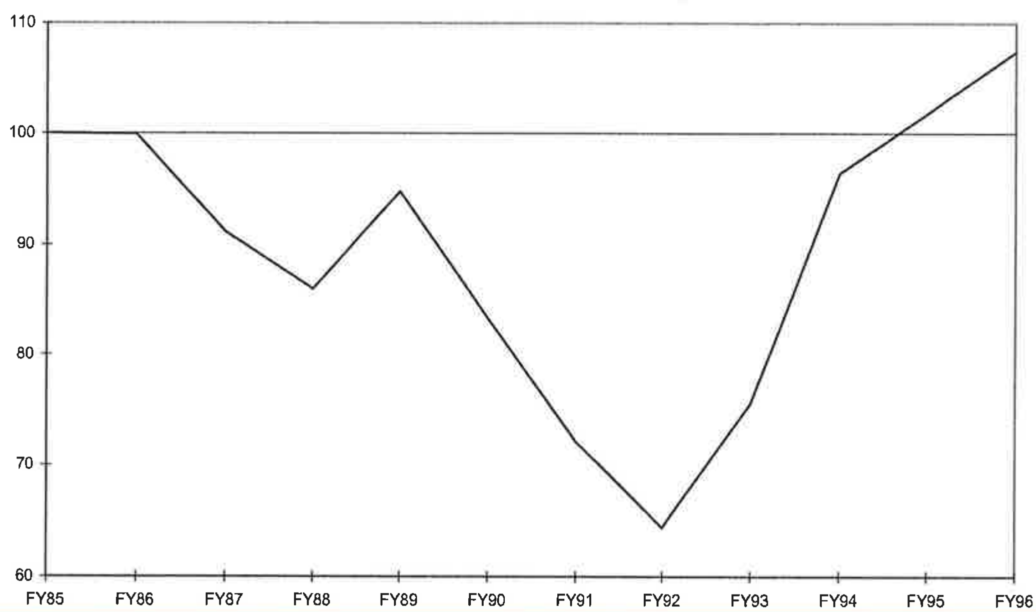
The tax base trend demonstrates that the national recovery over the past four years has benefited the city only to the degree that its economic decline, which started in 1988, has slowed dramatically. PICA is concerned not only about the city's continuing tax base erosion and the unresolved threat to the Personal Property Tax, but also that the city is unprepared for an eventual national economic decline, a situation in which contraction of the city tax base will accelerate.

Fees, Fines, Interest, Other

Locally generated non-tax collections and revenues from governments other than PICA and the state and federal governments fluctuate depending on the vigor of collection activity and interest rates. This category of revenues grew from Fiscal Year 1992 through Fiscal Year 1995 largely as a result of increased fee and fine collections by the Department of Licenses and Inspections, the enactment of the 911 telephone line surcharge, and greatly increased interest earnings (due to higher interest rates and larger investable cash balances).

There are a few net revenue generators in the fee and fines category, including net parking violation fines from the Parking Authority ($16 million), and fees from Licenses and Inspections ($12 million from non-demolition activity). As a general rule, however, revenue from this category does not cover the full cost of the activity for which the charge is made.

Indexed Non-Tax Collections
Excluding Revenues from PICA and the State and Federal Governments
Adjusted for Inflation (FY85=100)



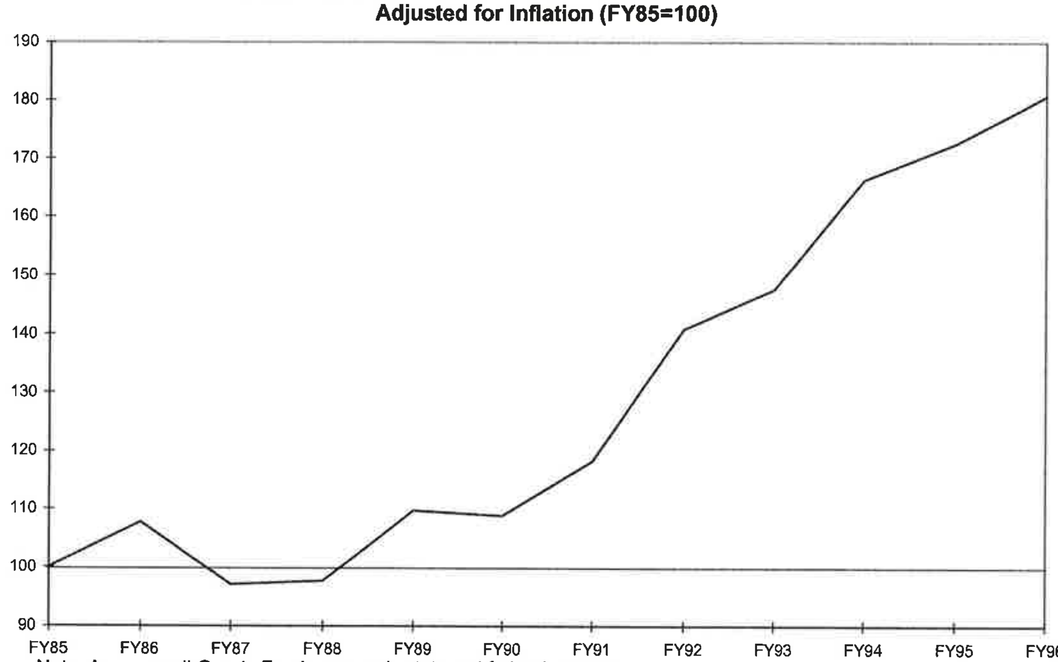
It behooves the city to compile accurate net cost figures for individual departments and certain activities so that policy makers can better understand the net cost of specific activities and services. Such information would allow for better cost/benefit analysis for the purposes of budgeting and setting fees.

State and Federal Revenues

State and federal funding of certain city services began increasing dramatically in Fiscal Year 1991 and has continued to grow much faster than the rate of inflation (see chart below). Most of this growth results from increased state funding for Children and Youth services and for Mental Health/Mental Retardation services.

While the state has provided a greater amount of funding for these areas, this money has not significantly reduced the amount of net city funding devoted to these services. Instead, much of this increased funding has been used to expand services. Advocates in the health and welfare communities claim that the increased funding has helped meet a previously unmet need. Health and human service caseload data would seem to support such a claim.

Indexed Revenues from the State and Federal Governments Adjusted for Inflation (FY85=100)



Note: Assumes all Grants Fund revenue is state and federal revenue.

With programmatic changes in Harrisburg and Washington, it is unclear how these funding streams will be changed in the future. It is clear, though, that the city depends greatly on state and federal funding to provide certain services, particularly health and human services. If funding is reduced, the city will need to either find an alternate funding source, further enhance efficiencies, or terminate certain services.

CONCLUSION

Philadelphia, while currently living within its means, has not achieved structural balance. Although the city has managed to balance its budget and increase its General Fund surplus balance in each of the past four years, its tax base continues to erode. Greater levels of state and federal funds for health and human services and improved revenues from fees, fines, interest, and other entities have not offset dependence on locally-generated tax revenues to provide basic services. Revenues thus remain in jeopardy of severe contraction in the eventuality of a declining national economy.

The greatest challenge confronting the city remains halting the decline of its tax base. As businesses leave the city, it becomes more difficult to maintain an employed population. Economic activity and tax revenue, once lost, is not easily regained. Thus the burden of maintaining city services falls onto fewer and poorer taxpaying citizens.

Budgetary balance at present expenditure levels cannot be maintained in a declining economy. While a structural balance would be best guaranteed in a growing economy, achieving structural balance will require at a minimum that Philadelphia's economic decline be halted. This should be the foremost goal of all policy makers, city, state, and federal, with a role in Philadelphia's future.