Pennsylvania Intergovernmental Cooperation Authority

Staff Report
on the
City of Philadelphia's
Five-Year Financial Plan
for
Fiscal Year 1998 - Fiscal Year 2002

May 20, 1997

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EXECUTIVE SUMMARY AND STAFF RECOMMENDATION

The City of Philadelphia's Five-Year Financial Plan, Fiscal Year 1998-Fiscal Year 2002 (including Fiscal Year 1997), submitted to the Pennsylvania Intergovernmental Cooperation Authority (PICA) on April 30, 1997 (the FY98-FY2002 Plan or the Plan) presents a reasonable prospect for balanced budgets in each year of its term. As in previous years, however, the Plan is dependent on a variety of circumstances beyond the City's control.

There are three major risks to the successful realization of the Plan's projections:

- Outstanding legal challenges to the State-authorized Personal Property Tax may be successful, and the City's imposition of a substitute tax may be challenged, possibly resulting in the termination of the tax revenue and the City's being held liable for the refund of such taxes paid since 1993 ($162 million risk).

- The Plan relies on the realization of tax revenues from riverboat gambling, a highly speculative revenue source, commencing in FY2000 ($89 million risk).

- The City includes unidentified Future Target Spending Reductions in each of the last four years of the Plan ($70 million risk).

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

The City's Ability to Weather Risks is Unknown

Even though many of the Plan's assumptions have a high degree of uncertainty, the Rendell Administration has shown a 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 current administration will not do so again if such actions are required.

However, half of the time period covered by the current Plan will occur under the watch of a successor administration. Of the $321 million in risks noted above, at least $203 million (63% of the total) will not affect the City until after Mayor Rendell leaves office.

PICA Staff is wary of the Plan's reliance on a currently non-existent tax revenue and unspecified expenditure reductions. Given the timing of the current Plan, the current administration has some time to affect the need to continue to rely on such uncertain elements in order project balanced budgets into the next decade. However, the current administration will need to leave its successor with a reasonable prospect for balanced budgets in the future. Accordingly, PICA Staff will be even more skeptical next year about underlying assumptions (particularly the implementation of riverboat gambling) in the City's next Five-Year Plan, as 70% of that Plan's time frame will be during the tenure of a new administration.

Report Summary

Similar to last year's PICA Staff Report on the Five-Year Plan, this report focuses primarily on significant risks to the Plan and does not review department-specific issues beyond those that could have a severely adverse impact on the General Fund. A Chart of Quantifiable Risks to the Five-Year Plan appears at the end of this executive summary. PICA Staff continues to track departmental progress in numerous areas and will report on those areas as significant issues arise.

<u>Major Risks to the Plan</u>

The State-authorized Personal Property Tax is currently being challenged in the State Supreme Court on constitutional grounds. The City has taken action to limit its exposure to revenue loss and refunds by enacting a substitute Personal Property Tax that will take effect if and when the State-authorized tax is found unconstitutional. PICA Staff questions whether the City's action can withstand legal challenge, whether the new tax undermines Philadelphia's own economic development goals, and whether the new tax, as enacted, unfairly penalizes certain taxpayers.

The Plan once again includes income from riverboat gambling as a future revenue source. The present Plan recognizes revenue from riverboat gambling beginning in FY2000, only one-half of which will be during the tenure of the current administration. Projected annual revenue collections in the Plan's out years remain unchanged from projections in prior Plans. Given current political realities, PICA Staff will be much more reluctant in the future to recommend Plan approval if riverboat gambling tax revenue is included.

The Five-Year Plan anticipates a total of $70 million in unspecified expenditure reductions over its final four years as a result of the continued use of target budgets. PICA Staff has previously expressed its reservations as to the amount of savings that can be anticipated from future use of the target budget process. PICA Staff's concerns about the use of target budgets are more relevant this year in light of the current Plan's anticipation of substantial monetary savings resulting from the continued use of this management tool.

PICA Staff cannot overstress the importance of improving the underlying economic trends in Philadelphia. If the City's economy does not soon begin growing, the City will continue to suffer from a declining tax base concurrent with an increasing demand for public services. PICA Staff strongly encourages the City to intensively address the economic state of the City primarily by lowering the costs of living and doing business in Philadelphia. The tax reduction program and the economic development activities of the City and its affiliated agencies are an excellent beginning, but the City continues to lack a comprehensive approach to economic development and its efforts remain largely reactive.

Other Significant Risks

The First Judicial District of Pennsylvania (FJDP) is a cost center of significant concern to PICA Staff. The State Supreme Court has directed the Commonwealth of Pennsylvania to assume financial responsibility for the State courts on or before January 1, 1998. However, there has been little indication that the legislature will act and that the Commonwealth will assume responsibility for statewide funding of a unified court system in a timely manner. If the City is forced to maintain funding beyond the first six months of FY98, and the "zero-growth" budget agreement is not renewed, the City may be required to provide funding to the FJDP above and beyond what the City may be holding in reserve in the Plan.

The Rendell Administration successfully concluded labor agreements and arbitration negotiations with all four of the City's major collective bargaining units in 1996. Except for the contract with the Fraternal Order of Police, Lodge 5 (FOP), which expires at the end of FY98, the new agreements cover three of the five years in the Plan. Since the Plan's Police Department expenditure projections provide no increase in police personnel costs that may result from the upcoming contract process, the Plan probably underestimates such costs.

Federal welfare reform turned Social Security Act Title IV-A funding into a block grant, affecting how states and counties will now pay for child welfare services. To PICA Staff's disappointment, the State has not used this opportunity to reevaluate its overall child welfare funding system and produce a rational and comprehensive approach to funding the children and youth program in the State. The major change is that what was previously Title IV-A Emergency Assistance entitlement funding will now be capped for each county. These capped levels have not yet been determined, but the State expects to announce its decision soon. As the State has not certified funding allocation levels since FY95, the City continues to operate in an uncertain funding environment.

Last year, both the State and Federal governments enacted dramatic welfare reform legislation that has already altered eligibility and the level of support provided to those in need. The enacted changes will continue to be phased in over the next few years. These reforms will lead to increased demands on City services, most particularly emergency shelter, homeless prevention, child welfare, and primary health care.

Other General Fund Concerns

PICA Staff has numerous concerns about the City Sales and Use Tax. Foremost is the relationship between the City and the State, which collects the tax on the City's behalf. The State remains reluctant both to provide information to the City regarding collections and to coordinate with the City on audits. The initially enacted collection agreement provided the City with minimal leverage to be an effective advocate for its own interests. PICA Staff also has continuing concerns as to the City's projections of future revenues from this tax source, particularly with respect to the City's retail sector and its ability to successfully compete against the growing competition in the suburbs.

The City remains burdened by a $2.7 billion unfunded pension liability. The payment schedule for eliminating the liability requires gradually increasing annual General Fund payments to more than $243 million in FY2002, the final year of the Five-Year Plan, and more than double that in FY2019, the last year of the liability reduction schedule. The City proposes instituting a 15-year rolling amortization program once the Pension Fund reaches a 70% funded level, projected to be in the year 2010, in effect stretching out payments beyond 2019. PICA Staff is pleased that the City is pursuing potential solutions to a problem that threatens to be a budget buster early in the next millennium. However, PICA Staff strongly urges that the City seriously consider other solutions, including bond issuance, to fully eliminate the current unfunded Pension Fund liability.

PICA Staff does not believe that the Plan's indemnity projections are reliable. Estimates in previous Plans have consistently been less than actual final costs. The City's past inability to project indemnity costs results in obvious concerns about the projections in this year's Plan. PICA Staff believes that the City should increase the indemnities budget, improve its methodology for estimating and budgeting for indemnities, and align its indemnities budget with its CAFR-projected aggregate loss deemed "probable" and "reasonably possible."

PICA Staff continues to be concerned that the inmate population often exceeds the Philadelphia Prison System's capacity of 5,600. The City appears to be doing everything presently prudent to keep the inmate population below the system's capacity. Consistently exceeding the Prison System's population capacity could become an extremely expensive proposition and represent a threat to the financial stability of the City in FY98 and beyond.

After over a year of promises and activity, the City of Philadelphia finally issued a citywide strategic plan in 1995 as an appendix to that year's Five-Year Financial Plan. After many more months of promises and commitments, the City finally provided PICA Staff with three departmental strategic plans just this past February. The plans provided so far have not necessarily been ideal models of a strategic plan, but they have provided some focus to the City's broad range of activities and provided a guidepost for how to proceed. Based on the actions of the Rendell Administration to date, PICA Staff can only conclude that the City is not utilizing the strategic planning process to its full potential.

The City's ability to project revenues and expenditures has improved over the past few years. However, its methodology for projecting tax revenues and non-personnel, non-debt service expenditures remains imprecise.

PICA Staff continues to be disappointed by the lack of progress shown by the City's Capital Program Office. PICA Staff has patiently and continuously argued that the Capital Program Office should receive more attention from the City Administration to maximize the positive economic impact of the expenditure of capital project dollars. The City has only recently begun to give the Capital Program Office the attention it deserves. With the reorganization of the capital program structure and the hiring of a Capital Program Director, PICA Staff hopes that the City will be able to achieve its stated aim "...to manage and complete capital projects with the ultimate goal of carrying out our responsibilities faster, cheaper, and with greater quality."

The City and the School District of Philadelphia continue to move forward on securitizing (i.e., selling) a large portion of their property tax liens. This initiative, which has been postponed until June, is expected to both accelerate and increase collections on outstanding liens. It is also expected to significantly reduce the backlog of delinquent properties on the tax rolls and increase future taxpayer compliance. While not directly related to the City's Five-Year Plan, PICA Staff is concerned about how the School District is using its securitization proceeds.

Non-General Fund Concerns

As a result of a stagnant tax base and a 9% increase in student enrollment, the School District of Philadelphia, in conjunction with the City, has filed a lawsuit against the State for increased State funding. For FY98, the District has proposed a zero-growth budget that, given the limitations on funding sources, relies on significantly more funding from the State than was allocated in the State budget approved earlier this month. Unless the State provides more funding or the District cuts costs more than currently planned, the District will end the year with a significant deficit.

SEPTA plays an integral role in Philadelphia's economy, providing transportation to large numbers of commuters and to residents without alternative methods of transportation. SEPTA also employs approximately 9,600 individuals and spends millions of dollars locally each year on infrastructure investments. SEPTA's viability is crucial to the City's future, particularly as welfare reform requires more individuals without private transportation to look for and find work. Future funding for SEPTA is uncertain, although not as desperate as it appeared it would be last year at this time.

The Philadelphia Gas Works (PGW) also has an important place in the City's economic future. The most significant challenge confronting PGW is preparing for private market competition. The debt-laden municipal utility could very likely be outmaneuvered in a free market. Although the current management is confident that they can operate effectively in a private market, PICA Staff is not convinced. PGW is subject to political pressure, union challenges, a high debt load, and significant numbers of delinquent accounts. As a publicly owned utility, PGW does not have the flexibility that its private market competitors have.

Staff Recommendation

Notwithstanding the potential risks to the General Fund and PICA Staff concerns outlined in this report, the FY98-FY2002 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 30, 1997.

Chart of Quantifiable Risks to the Five-Year Plan

($ in thousands)

	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002	TOTALS
Major Risks							
Personal Property Tax[1]	(16,000)	(16,474)	(16,962)	(17,549)	(18,156)	(18,785)	(103,926)
Riverboat Gambling				(17,500)	(35,000)	(36,050)	(88,550)
Unidentified Reductions			(10,000)	(15,000)	(20,000)	(25,000)	(70,000)
Other Significant Risks							
Potential FOP Labor Contract[2]			(6,900)	(19,044)	(22,881)	(23,578)	(72,404)
Other General Fund Concerns							
Sales and Use Tax[3]				(456)	(942)	(1,459)	(2,858)
City's Revised Projections as of March 31, 1997							
Total Revenue	4,916						
Total Obligations	(3,712)						
Prior Year Adjustments	11,000						
Total Risks for Each Year	(3,796)	(16,474)	(33,862)	(69,549)	(96,980)	(104,873)	(325,534)
Cumulative Total Risks	(3,796)	(20,270)	(54,132)	(123,682)	(220,661)	(325,534)	
Plan-Projected Fund Balance	112,267	-	52,826	44,294	26,105	34,210	
Fund Balance if All Risks Realized	108,471	(20,270)	(1,306)	(79,388)	(194,556)	(291,324)	
Fund Balance if All Risks Realized as a Percent of:							
Individual Year	4.5%	-0.8%	-0.1%	-3.0%	-7.2%	-10.6%	
Cumulative Plan	4.5%	-0.4%	0.0%	-0.8%	-1.5%	-1.9%	

[1] Does not include a potential $58 million the City may be required to refund if this tax is successfully challenged.
[2] Projected Class 100 (personal costs) impact if the next FOP contract runs from July 1, 1998 to June 30, 2000 and matches the 3% and 4% raises in FY99 and FY2000, respectively, as provided for in the IAFF, AFSCME District Council 33, and AFSCME District Council 47 contracts.
[3] Assumes that growth tracks inflation rather than exceeding it.

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Pennsylvania Intergovernmental Cooperation Authority

**STAFF REPORT
ON
FY1998-FY2002
FIVE-YEAR FINANCIAL PLAN**

MAJOR RISKS TO THE PLAN

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PERSONAL PROPERTY TAX

In reaction to a constitutional challenge to the Personal Property Tax, Philadelphia recently enacted legislation designed to enable the City to continue to levy a tax on personal property and to concurrently protect itself against any losses resulting from refunds if the current Personal Property Tax is determined to be unconstitutional. PICA Staff questions whether the City's action will be able to withstand legal challenge, whether the new provisionally enacted tax undermines Philadelphia's own economic development goals, and whether the new tax unfairly penalizes certain taxpayers.

Background

The Personal Property Tax is currently levied against the value of certain intangible assets, primarily stocks of companies that are not subject to the Pennsylvania Capital Stock and Franchise Tax (i.e., companies that do not have any presence in Pennsylvania).

In February 1996, the U.S. Supreme Court ruled the Personal Property Tax in North Carolina unconstitutional because it discriminated against out-of-state corporations, interfering with interstate commerce. As the North Carolina tax was modeled on Pennsylvania's Personal Property Tax, a number of constitutional challenges were subsequently made to the tax in Pennsylvania.

Although the Personal Property Tax is authorized by the State, counties levy the tax at their own discretion. Therefore, the legal challenges to the tax have been filed against certain counties that levy the tax. The most prominent of these cases was brought by Walter H. Annenberg against Montgomery County and is currently pending before the State Supreme Court. Interestingly, no case was filed against Philadelphia.

Philadelphia, in a preemptive move to protect itself against the loss of this revenue stream and the potential for being required to refund as much as $58 million in collections from previous years, approved a new Personal Property Tax intended to replicate the net revenue stream the City now enjoys and cover any refunds that would be required.

PICA Staff is concerned whether the City's rationale for enacting this tax complies with the mandates of the Sterling Act.

The New Tax Undermines the City's Goal to Cut the Cost of Living and Doing Business in Philadelphia

The Rendell Administration has made a concerted effort to cut the costs of living and doing business in Philadelphia by reducing taxes. Indeed, one of the ten primary strategic objectives of the City as laid out in the City's strategic plan is:

- **Cut the Cost of Doing Business** by reducing taxes; by rationalizing and simplifying the tax structure;...and by working for business cost reductions.

In the instance of the Personal Property Tax, the City is actually creating a new tax and will be the only county in Pennsylvania to levy such a tax. Indeed, as of this year Philadelphia is one of only two counties in Pennsylvania that still levies the Personal Property Tax.

There are many large trusts still held in Philadelphia that may be able to avoid the tax by relocating outside of the City. While the trusts are not necessarily huge employers, any shifting of assets out of Philadelphia will result in a diminished City economy. Additionally, residents who are subject to the Personal Property Tax are being given one more incentive to relocate outside of the City, since the suburban counties that used to levy a Personal Property Tax, such as Montgomery County, no longer do.

For a City striving to reduce the tax burden, retain jobs, and retain residents who can afford to move elsewhere, it seems counter-intuitive to continue to levy a tax and particularly to create a new tax that no other county in the State levies.

The New Tax Penalizes Certain Taxpayers the First Year it is in Effect

The new City-authorized Personal Property Tax, which is to take effect if the current Personal Property Tax is determined to be unconstitutional, will levy a one-time five mill tax on assets held on January 1, 1996. Credit will be given for any Personal Property Taxes paid that calendar year or the previous three. The intent of this provision is to protect the City from any refunds it may have to make to taxpayers who previously paid Personal Property Tax under the levy currently in effect.

For some taxpayers, the end result may be that they continue to pay the same amount in Personal Property Taxes under the new system as under the current one being challenged. However, taxpayers who paid little or no Personal Property Taxes prior to last year, either because they had no intangible property or because their assets included no personal property subject to the tax as it currently exists, may end up receiving little or no refunds and paying the full 5 mills on assets as of January 1, 1996. Alternatively, taxpayers who had more intangible property prior to January 1, 1996 than on that date may end up getting a refund simply because they reduced their intangible property holdings before that date.

It is impossible at this point to predict how many taxpayers will end up paying a penalty and how many will receive a refund simply because of timing issues. It is also not possible to know how many trusts and residents may have structured their investments in an effort to avoid the Personal Property Tax as it currently exists and how many may leave the City as a result of the planned changes.

RIVERBOAT GAMBLING

The Plan, for the third consecutive year, includes income from riverboat gambling as a future revenue source. For the second consecutive year, revenue anticipated from this source has been pushed one year further into the future. The present Plan recognizes revenue from riverboat gambling beginning in FY2000. Only one-half of that fiscal year will be the current administration's responsibility. Projected annual revenue collections in the out years remain unchanged from projections in prior Plans.

Given current political realities, PICA Staff will be much more reluctant in the future to recommend Plan approval if riverboat gambling tax revenue is included.

Riverboat Gambling Proceeds as a "Reasonable and Appropriate" Revenue Source

According to the agreement between PICA and the City, the Plan is only to include revenues "based on assumptions and methods of estimation determined to be reasonable and appropriate by the Authority."[1] For the current Plan, as was done with the previous two, PICA Staff is willing to give the City the benefit of the doubt when it comes to the appropriateness of including this revenue in its Plan.

To mitigate PICA Staff concern that the successful implementation of the Plan is dependent upon this speculative new revenue source, the City continues to link the successful recognition of Riverboat Gambling Taxes to the continuation of the Wage Tax reduction program, which is of a similar magnitude.

> The Current Plan assumes that the progressive year-by-year reductions in wage tax rates ... will not be instituted if riverboat gambling is not legalized, unless a determination is made in future Five-Year Plans that the City can maintain a balanced General Fund budget on a long-term basis and sustain necessary City service levels if these rate reductions are carried out, even in the absence of legalized riverboat gambling.[2]

PICA Staff is becoming more wary of this arrangement as the years pass with no strong indication that riverboat gambling will be legalized in Pennsylvania.

Half of the time frame of the current Plan will be during the governance of a successor administration. The Plan creates an expectation that the tax reduction program will continue past the tenure of the current administration. However, by including an unproven and potentially nonexistent revenue stream to keep the budget balanced in the last three years of the Plan, the current administration is not truly budgeting for the tax

[1] *Intergovernmental Cooperation Agreement by and between Pennsylvania Intergovernmental Cooperation Authority and the City of Philadelphia Dated as of January 8, 1992,* Section 4.02(a).
[2] *City of Philadelphia Five-Year Financial Plan, Fiscal Year 1998-Fiscal Year 2002*, p. 6.

reductions in those years. Rather it is budgeting for those reductions based on a "wish list."

For the current Plan, PICA Staff has decided that since the budget becomes dependent on riverboat gambling in FY2000, the final year of the Rendell Administration, it is once again "reasonable and appropriate" for the resulting taxes to be included. However, without a change in sentiment in Harrisburg on this issue (see discussion below), PICA Staff will be much more skeptical about including this anticipated revenue source in any future Plan. Indeed, if the City pushed the recognition of such revenues out another year, as it did this year, the implementation of riverboat gambling would become dependent on a successor administration, an unreasonable political assumption.

Likelihood of State Enactment

PICA Staff is unable to predict whether or not riverboat gambling will become legal in Pennsylvania. However, given the vocalized sentiment of the current governor and legislative leadership in Harrisburg, such an outcome presently seems unlikely.

Governor Ridge pledged during the 1994 gubernatorial race that he would not consider enacting riverboat gambling unless the voters approved it in a statewide referendum. Given the political characteristics of Pennsylvania, it is commonly considered an insurmountable obstacle to enactment. Additionally, since there is no State constitutional provision for such a course of action, such a referendum would be open to constitutional challenge and would be non-binding, leaving the State legislature responsible for final enactment.

Legislatively, the efforts at enactment have been unsuccessful. The chairman of the General Assembly's State Government Committee, whose purview extends to placing a statewide referendum on the ballot, has stated that he will not allow any such bill to leave his committee. As the governor has not made this issue a priority item on his legislative agenda, it would appear that enactment will be difficult if not unlikely.

The City argues that the State will need to turn to legalized gambling as a way to generate needed State revenues for what will soon be court-mandated funding for local courts and school districts statewide. Although it may well be true that the State will need to find additional revenue for these funding mandates over the next few years, it is not inevitable that such a source will be the gambling industry.

TARGET BUDGETS AND UNIDENTIFIED "FUTURE TARGET SPENDING REDUCTIONS"

The Five-Year Plan anticipates a total of $70 million in unspecified expenditure reductions over its final four years as a result of the continued use of target budgets. PICA Staff has previously expressed reservations as to the amount of savings that can be anticipated from future use of the target budget process. PICA Staff's concerns about the use of target budgets are more relevant this year in light of the current Plan's anticipation of substantial monetary savings resulting from the continued use of this management tool.

Target Budgets have been Vital to the City's Financial Recovery

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

The Rendell Administration has successfully used target budgets to keep departmental spending below budgeted levels and keep departments focused on continuously identifying and implementing new efficiencies. PICA Staff believes target budgets to be one of the most innovative and successful management changes implemented by the current administration and hopes that they outlive future mayoral transitions.

It is Unknown Whether Target Budgets will Continue to be Effective

Last year, PICA Staff noted a reduction in the size of the cushion created by the target budget process. This year, the target budget cushion returned to a level commensurate with previous years.

Cushion Created by Target Budget		
Period	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
FY97	1.59%	$38,540,321

Source: *Quarterly City Managers Reports*, First Quarter FY93, FY94, FY95, FY96, FY97.

In response to PICA Staff's expressed concern last year, the City indicated that target budget levels are based on circumstances unique to each year. Accordingly, PICA Staff has requested a list of the items under consideration for the years FY99 through

FY2002 that could result in net obligation reductions of the magnitude specified. The City has yet to provide such a list.

There is a Lack of Explanation Regarding "Future Target Spending Reductions"

The Plan's projection of a positive General Fund balance after FY98 relies in part on significant savings anticipated to be achieved as a result of "Target Spending Reductions." While the Rendell Administration has demonstrated that savings can be derived from the use of target budgets, it has never before included a projection in a Five-Year Plan of amounts to be saved through the use of this management tool.

Without any explanation of how the projected "Future Target Spending Reductions" might be achieved or any attribution of reductions to particular departments, it is difficult for PICA Staff to gauge whether the Plan's projected savings are reasonable.

Although hampered by a lack of sufficient information, PICA Staff believes that it is possible, although in no way certain, that the Rendell Administration can continue to achieve savings from the use of target budgets during its tenure. The Rendell Administration may even be able to implement the Plan projected savings over the next year or two by implementing initiatives with recurring savings of the magnitude projected in the Plan.

However it is important to remember that, halfway through FY2000, a new administration will take control of City government. PICA Staff necessarily is less certain whether a future administration will be able to deliver on projected savings based on the current administration's expectation. PICA Staff would prefer to see specific initiatives that can produce the needed savings and to which a future administration can be held responsible.

Target Budgets vs. Appropriations

PICA Staff also has concerns as to whether any City administration will be able to continue to use target budgets to maintain departmental expenditures below budgeted levels. City Council has ultimate budgetary authority through its appropriation power. While the mayor can exercise managerial discretion over how money is spent, he is limited to departmental budgets as they are approved by City Council.

Target budgets are a currently effective management tool which have a direct impact on expenditure levels. Despite the administration's effort to focus on service levels instead of monetary levels, City Council may in the future look unfavorably upon a mayor who systematically does not spend money as it has been budgeted.

ECONOMIC DEVELOPMENT

PICA Staff cannot overstress the importance of improving the underlying economic trends in Philadelphia. If the City's economy does not soon begin growing, the City will continue to suffer from a declining tax base concurrent with an increasing demand for public services. PICA Staff strongly encourages the City to intensively address the economic state of the City, with the public schools as a central focus.

The City has temporarily stayed the challenge of reconciling a shrinking revenue base with growing expenditures. During this respite, the City must pointedly address the underlying economic problems that led to its recent fiscal crisis otherwise these problems will again present crushing budgetary challenges in the future. The tax reduction program and the economic development activities of the City and its affiliated agencies are an excellent beginning, but by themselves are insufficient to reverse the long-term decline of the City.

The City's Economic Realities

The City's economic state is inextricably linked to the nation's, but with a consistently unfavorable lag. For example, the latest national recession began in July 1990 and ended in April 1991. According to the City Controller's Philadelphia Coincident Index, the City entered a recessionary period in April 1988 and came out only this past June. As the national unemployment rate has fallen, so has the City's, although it was not until April 1996 that the City's fell below 7% for the first time since 1990, whereas the national unemployment rate has exceeded 6% only twice since mid-1994.

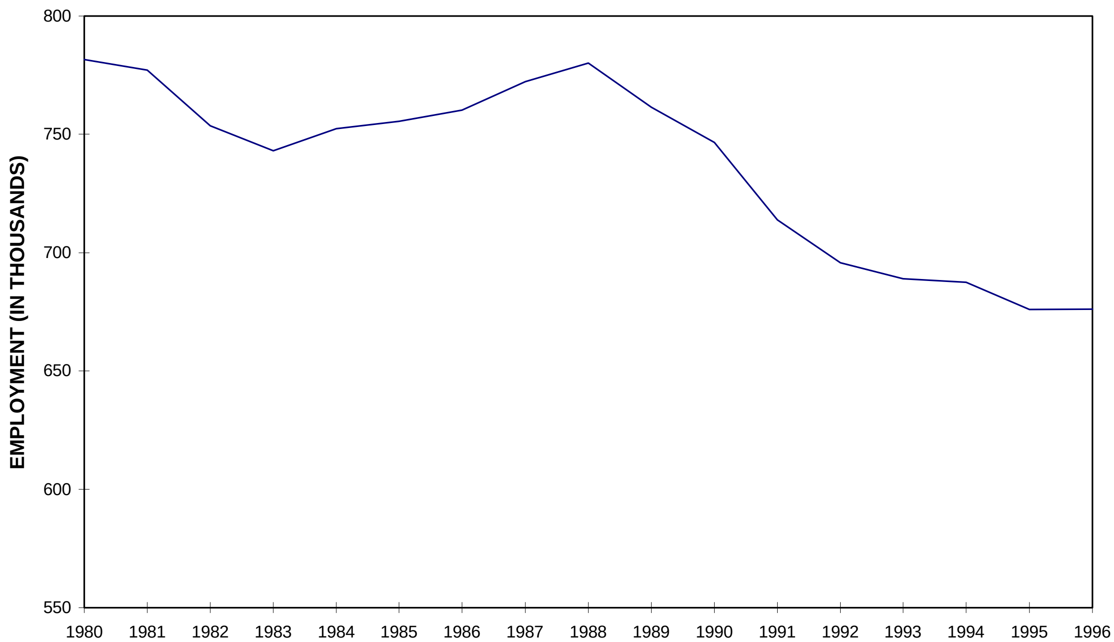
The City has inarguably benefited from the current national economic expansion. Similarly, it is expected that if and when the national economy slows, the City's will also slow, although in a more pronounced way.

The Federal Reserve Bank's recent action to restrain growth in the national economy by raising the interest rate charged to banks on overnight loans was taken in the hope of preempting inflationary pressures which could result from faster national economic growth. For Philadelphia, higher interest rates will put a damper on economic growth, potentially pushing the City back into the red on job growth.

Job Loss Appears to have Abated but is Projected to Continue

National economic growth has resulted in an increase in the number of jobs nationally. Philadelphia, however, continued to experience job loss up through the beginning of 1996. As the graph below demonstrates, the annualized number of jobs in Philadelphia stayed flat in 1996.

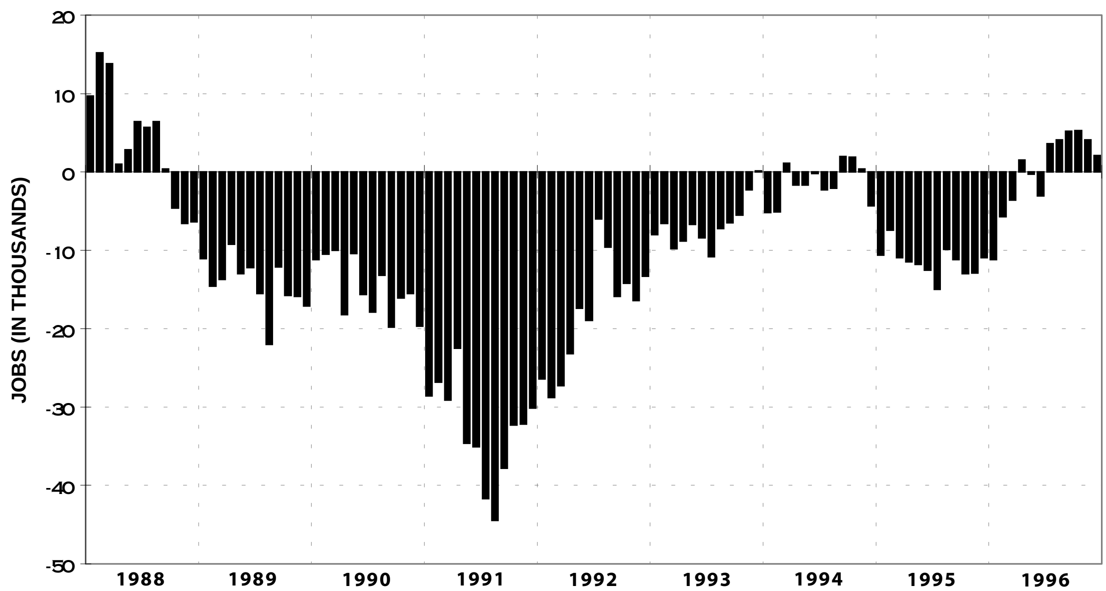
THE NUMBER OF JOBS IN PHILADELPHIA APPEARS TO HAVE STABILIZED



Source: U.S. Bureau of Labor Statistics

Alternatively, monthly job estimates indicate that, since the end of the City's recessionary period in June, the number of jobs has been growing compared to the same month in the previous year. The current spate of job growth is the longest Philadelphia has experienced since 1988.

City of Philadelphia, Monthly Job Losses and Gains
(Net Change versus 12 months Earlier)
1988-1996



Source: U.S. Bureau of Labor Statistics

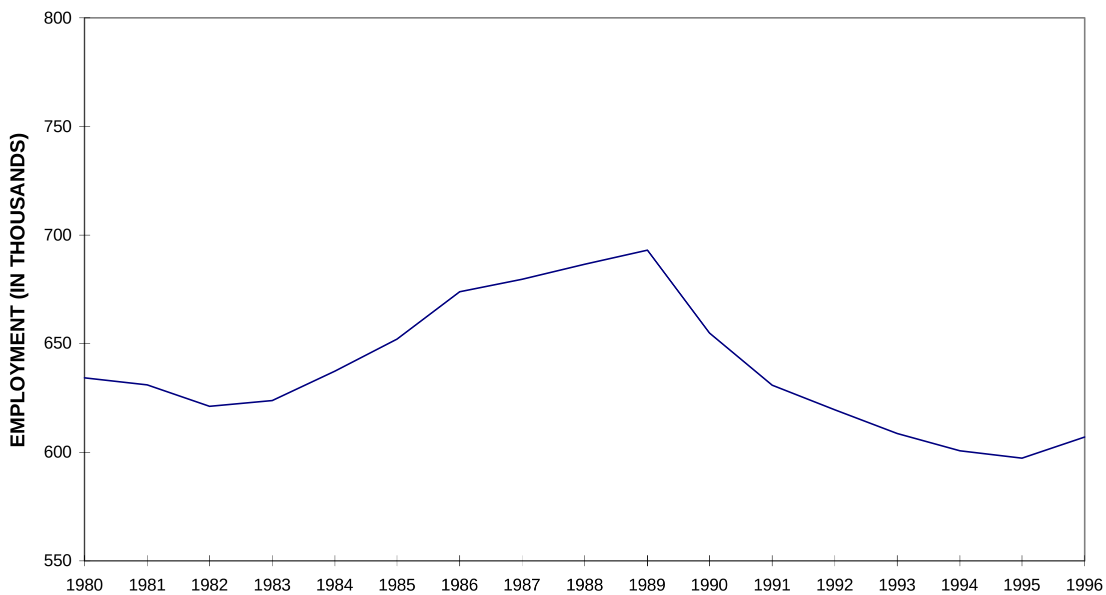
As the 1996 data are subject to one final revision in March 1998, the City's claim that there was no job loss in 1996 is still preliminary. Given the experience of past benchmarks, it is possible that the final 1996 job numbers could show a loss in jobs. Indeed, regional economists project continued slight job loss over the next couple of years. However, given the magnitude of past declines, the 1996 preliminary results are encouraging.

The City Controller's Office has found that the industries which experienced job growth in the City between 1993 and 1995 fall into four clusters. The most significant (accounting for 63% of all City job growth, or 4,088 jobs) is the Local Government and Related Support Services cluster, which includes private sector social and educational services. This does not bode well for Philadelphia's economy, which direly needs to expand in industries besides government and human services. The other clusters are High-Tech Production and Related Services (22% or 1,428 jobs), Hospitality and Retailing Services (13% or 852 jobs), and Building and Construction (2% or 125 jobs). The growth in Hospitality and Retailing Services is not surprising given the opening of the Pennsylvania Convention Center, the new Center City Marriott Hotel, and the City's continued emphasis on tourism. However, the growth in High-Tech Production and Related Services, while relatively small, is encouraging. It is a private industry sector with a history of creating high paying jobs.

Job growth in these four clusters has been outweighed by job loss in other industries, particularly Federal Government, Petroleum and Coal, Food and Kindred, and Paper and Allied Products. Some of these losses can be attributed to general "downsizing" in these industries.

In addition to the growth in the number of jobs in the City, the number of City residents employed also appears to be growing (see graph below). Faster growth in the number of residents employed compared to the number of jobs in the City may indicate that a larger number of residents are commuting to work in the suburbs. However, there is no data to prove definitively that this is the case.

PHILADELPHIA RESIDENT EMPLOYMENT APPEARS TO HAVE INCREASED FOR THE FIRST TIME SINCE 1989



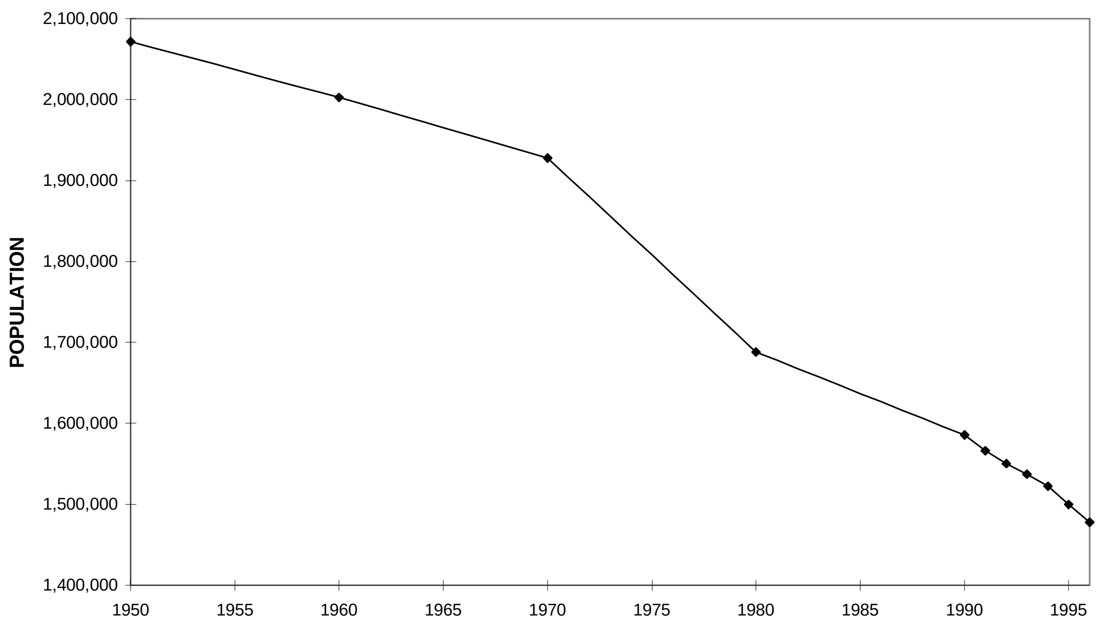
Note: Data beginning in 1994 uses a revised survey method.

Source: Pennsylvania Department of Labor and Industry, Bureau of Research and Statistics

Population Continues to Shift Out of the City

The latest Census Bureau estimate of the City's population shows a continuation of almost a half-century of decline. The intuitive impression is that the residents moving out of the City are those who can afford to do so (i.e., those who have financial resources). Such emigration results in a declining tax base and in a growing concentration of poverty, leading to an increased demand for public services. As in the case of reverse commuting discussed above, there is no data currently available to prove definitively that this is the actual situation.

PHILADELPHIA'S POPULATION CONTINUES TO DECLINE



Note: Annual estimates are included for 1991 through 1996.

Source: U.S. Census Bureau

A Declining Economy and Population is Reflected in Declining Property Values

As businesses and residents leave the City, there is a smaller demand for real estate. A declining demand leads to a decline in value. Changes in property values are an indicator of the City's economic state, and it is important to note that as property values decline, City and School District property tax collections directly suffer.

The most straightforward way to analyze the change in property values over time is by using assessed values as determined by the City's Board of Revision of Taxes (BRT). BRT assessments are not perfect as, historically, properties are underassessed and changes in assessments are more based on reassessment schedules and methodologies than on actual changes in property values. However, assessments are arguably the strongest proxy for changes in market values over time.

Since 1993, the total taxable assessment for commercial and industrial buildings in Philadelphia fell by over 9%. This trend is even worse if adjusted for tax abated properties which returned to the tax rolls during these years. 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)[3]

	1990	1991	1992	1993	1994	1995	1996	1997
Initial Assess.	$3,162	$3,407	$3,543	$3,560	$3,518	$3,442	$3,359	$3,239
Annual Change	18.5%	7.7%	4.0%	0.5%	-1.2%	-2.2%	-2.4%	-3.6%

Source: Board of Revision of Taxes

According to an annual survey done by Jackson-Cross Oncor International, the office market vacancy rate in Center City has declined over the past four years from over 17% to 13.6%. Vacancy rates vary widely depending on building quality or "class", with Class "AA" buildings having a 4% vacancy rate and Class "B" buildings having a 23% vacancy rate.[4] Additionally, the vacancy rate does not take into account abandoned space, which, if included, would drive the Center City vacancy rate to well over 20%.[5] The abundance of space caused rental rates on Center City office space to fall through 1995. The Jackson-Cross survey found that, during the past year, rental rates rose. Even so, there has been no new construction of office space in Center City since the end of 1992.

Over the past year, there have been a number of major real estate announcements, including the sale of certain major buildings and the change in site of certain major law firms. A result of this activity is that improvements are planned for many Center City buildings, perhaps the most significant being the refurbishment and reopening of the mothballed Six Penn Center building at 17th and Market Streets. This activity does not of itself indicate a greater demand for office space. It merely proves that commercial leasees continue to demand prime property and improvements from building owners. Indeed, with the announced departure of 1000 jobs at Raytheon (located at 30 South 17th Street) and the potential loss of a large number of jobs at Conrail (located at Two Commerce Square), it is possible that prime real estate will continue to be readily available.

Another result of the real estate activity is that more Class "B" and other office properties are becoming vacant. Perhaps the most significant current example of the shift to higher quality office space is the move of PNC Bank's regional headquarters from the Land Title Building at Broad and Chestnut Streets to 1600 Market Street.

It is unclear what all this activity will mean for the City's tax collections. Over the coming year, the tax-abated Convention Center Marriott Hotel on Market Street comes onto the tax rolls, while the City's purchase of the Bell Telephone Building at 16th

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3 For this analysis, condominiums are considered residential property.

4 Jackson-Cross Company, "1997 Real Estate Market Report," January 1997, p. 12.

5 Nathan Gorenstein, "Commercial center shifts west: New Center City buildings are the lure. Much space remains empty." *Philadelphia Inquirer*, January 12, 1997, p. D1.

and Arch Streets will move that building out of taxable assessments. If any new building or improvements happen, including hotels, the resulting increase in property value will not be taxable for anywhere from three to ten years.

What is clear, however, is that while the activity in the commercial real estate sector may not definitively reflect a growing demand for office space, it does indicate a certain level of private sector confidence in the City's future.

On the residential side, taxable assessments grew significantly last year compared to the previous five. This resulted primarily from a citywide, systematic reassessment which helped raise total residential assessments over 2.5%, an amount close to inflation for 1996. This reassessment was part of an attempt to close the gap between sales values and assessed market values, which have lagged since the real estate boom of the 1980s. Therefore, this inflationary growth in assessments does not reflect actual market value growth for the last year. It also does not make up for the sluggish cumulative growth to date this decade. Since the City does not plan on doing these citywide reassessments annually, last year's growth is unlikely to be repeated next year.

Residential Taxable Assessments (Dollars in millions)

	1990	1991	1992	1993	1994	1995	1996	1997
Initial Assess.	$5,464	$5,620	$5,682	$5,746	$5,795	$5,860	$5,832	$5,980
Annual Change	9.4%	2.9%	1.1%	1.1%	0.9%	1.1%	-0.5%	2.5%

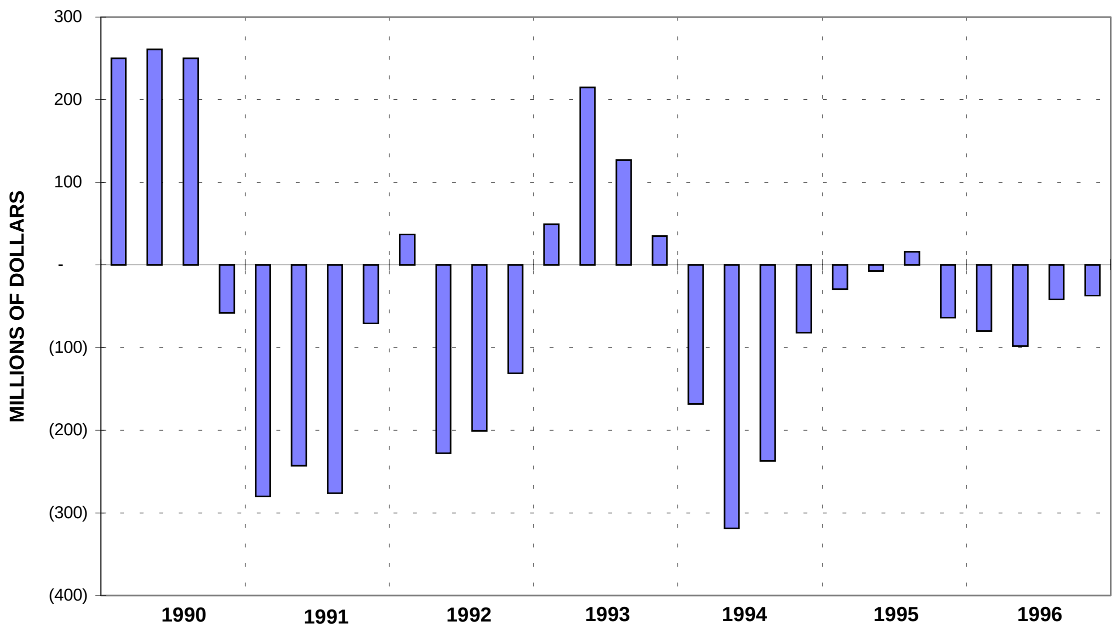
Source: Board of Revision of Taxes. See footnote 3.

The decline in residential property values is at least partially a product of an outmigration of the City's population. This outflux of residents also results in a growing number of abandoned properties, many of which the City ends up adding to the list of dangerous properties that the Department of Licenses and Inspections needs to handle, either through its Clean and Seal Program or by demolition. Licenses and Inspections projects that the continuing flow of abandoned properties through its inventory will be of such a degree that it will not be able to reduce the City's backlog of dangerous abandoned buildings.

Retail Sales in the City are also Declining

Figures show that through the last quarter of 1996, retail sales in Philadelphia continued to decline. There are a number of factors that contribute to this trend. Competition from suburban malls, closure of major retail chains, including Wanamaker's, Strawbridge and Clothier's, Clover, and BEST, continuing consolidation, a move toward discount outlets, and the job and population shift to the suburbs all result in less retail activity in the City.

City of Philadelphia, Change in Retail Activity Compared to Same Quarter in Previous Year



Source: U.S. Census Bureau

Regional economists believe that the City's retail sector has gone through a major one-time restructuring over the past couple of years. They project that retail sales in the City will now more closely track inflation, perhaps even exceeding it, over the next couple of years.

Unfortunately for economic monitors, the data used for the graph above is no longer produced as of the beginning of 1997. Using City Sales and Use Tax collections as a substitute indicator of retail sales activity will not be a reliable option for some time as the discussion in the Sales and Use Tax section of this report makes clear.

The City's Economic Development Activities

This year's Five-Year Plan extends the City's Economic Stimulus Program through 1997, making it in total a four-year, $3.7 billion program that appears to be guiding the City down the right track toward economic growth. Taxes have been reduced, critical investments have been made, and organizational changes have been implemented. However, PICA Staff continues to harbor reservations about the City's economic development efforts.

Several of the City's individual economic development agencies are moving slowly but successfully toward facilitating greater levels of business growth. The Philadelphia Industrial Development Corporation (PIDC) has won awards from the Council of Developmental Finance Agencies and Business Facilities Magazine. The Empowerment Zone Performance Report 1995-1996 published by the U.S. Department of Housing and Urban Development describes the Philadelphia Empowerment Zone as "making good progress toward achieving the goals of the [zone's] Strategic Plan."

Even given these successes, PICA Staff has concerns regarding the Economic Stimulus Program and Philadelphia's economic development activities in general. The City lacks a comprehensive approach toward economic development, making it difficult for businesses and individuals to access services and leading to inconsistent levels of service. The complicated nature of the City's economic development efforts is demonstrated by an article last year in the *Philadelphia Daily News* that called into question the City's reporting of economic development figures.[6] In addition, the lack of timely reporting on progress casts doubt on the reported success of the program. The lack of clear and complete information forces reliance on anecdotal information to evaluate success.

PICA Staff believes that the City's economic development activities continue to be too structured toward assisting large corporations and too focused on real estate and large-scale financing arrangements. Anecdotal evidence suggests that the City is often unresponsive and ensnares small businesses and residents in excessive red tape. The City's economic development activities are also largely reactive.

The Rendell Administration must focus foremost on proactive measures that make the City more competitive overall, both regionally and nationally, by lowering the costs of living and doing business in Philadelphia. Simultaneously, the City must provide small businesses and individual residents with the services they need.

The City Lacks a Comprehensive Approach to Economic Development

The City has numerous offices that focus almost exclusively on economic development, including the Commerce Department, which also houses the Mayor's

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[6] Anthony S. Twyman, "Can Job Numbers Be Counted On?" *Philadelphia Daily News*, June 24, 1996, p. 24.

Business Action Team, PIDC, which also houses the Office of Defense Conversion, the Philadelphia Commercial Development Corporation (PCDC), the Philadelphia Redevelopment Authority (RDA), and the Office of the Deputy Mayor for Economic Development.

In an effort to coordinate these agencies, as well as the numerous other departments and quasi-public agencies with a role in economic development, the Rendell Administration created the Economic Development Executive Committee and the Economic Development Cabinet. Yet even with this effort at coordination, and the creation of an overarching Economic Stimulus Program which aimed to focus the City's economic development investments, there is a persistent lack of a comprehensive approach.

The City has numerous site-based economic development programs, most significantly the Empowerment Zone (spread out in two separate areas of the City) and the Philadelphia Naval Complex. There are also four State Enterprise Zones, two of which overlap the Empowerment Zone, and numerous CDCs, which focus on economic development in specific City neighborhoods. PICA Staff continues to be concerned that each of these efforts may compete against each other. For businesses looking to locate in the City, navigating through all of these different programs can also be challenging, as each has a different staff.

In addition to a lack of coordination among economic development programs, City departments that have significant impacts on quality of life issues or regulatory oversight are often not in sync with economic development efforts. All City departments need to be included in the development of a comprehensive approach to economic development. Last year, the Empowerment Zone received significant negative press coverage when two businessmen being given a tour of the zone along with their Commerce Department tour guides were robbed. Given the importance of the Empowerment Zone, it is disappointing that the police presence is not sufficient to deter such a crime in broad daylight, particularly when a potential client is receiving a tour.

PICA Staff observed first-hand another example of the lack of a comprehensive approach to economic development during a tour of the Empowerment Zone. Directly across the street from an Empowerment Zone project (the clearing of a long-time abandoned factory) are abandoned houses now home to squatters and illegal activities. The City should be coordinating its policing and Licenses and Inspections activities with its economic development activities to ensure that client tours and potential development sites are not marred by such circumstances.

Alternatively, PICA Staff was pleased to note the successful removal of substantial amounts of graffiti and abandoned buildings along the main thoroughfares of the Empowerment Zone. More of this type of coordination is needed to make the Empowerment Zone, as well as the rest of the City, attractive enough for businesses and residents to locate and remain there.

There are a multitude of other economic development organizations in the City with whom the City government needs to coordinate. These include Greater Philadelphia First, which is developing a regional perspective on economic development, the Greater Philadelphia Chamber of Commerce, the Private Industry Council, Philadelphia Community College, Wharton's, Temple's, and LaSalle's Small Business Development Councils, the Ben Franklin Technology Center, the University City Science Center, and numerous others.

The City's Economic Development Efforts are Largely Reactive

Anecdotal evidence indicates that the City is often not involved in helping businesses through their problems on a day-to-day basis. However, once Philadelphia is notified of a business's plans to move out of the City, the requisite economic development agencies leap into action. Yet, at this point, it is usually too late and the business has already made its decision to relocate.

A few years ago, the Rendell Administration set up with the Greater Philadelphia Chamber of Commerce meetings around the City with small business owners in an effort to provide local businesses with the assistance they may need and to alter the perception of the City as an unfriendly place to do business. Unfortunately, after only one round of these meetings, they never happened again. There has also been talk in the past of setting up a support network for City businesses, with a system of continuous outreach, such as through regular phone calls to every City business owner on a regular basis. However, this too has never crystallized.

Philadelphia needs to be proactive in its attempt to retain businesses in Philadelphia. It needs to give reasons for businesses to stay and convert them into boosters for the City. Only by building a supportive business environment can this happen.

The Lack of Timely and Reliable Reports

The City does not produce timely and reliable reports regarding the Economic Stimulus Program or any of the City's economic development efforts. The Five-Year Plan's discussion of the Economic Stimulus Program is not a sufficient substitute. PICA has been promised progress reports on the Economic Stimulus Program on numerous occasions, yet it has never received any on a regular basis.

PICA Staff understands that producing reports can be cumbersome. However, it is vital to ensuring productive efforts. A potential model for reporting on progress is PIDC's 1996 year-end report. Such reporting on a quarterly basis would be appropriate. The quarterly report should concisely discuss goals, current performance, and pending issues related to economic development.

The need for reliable reports is highlighted by an article last year in the *Philadelphia Daily News* which called into question the veracity of the City's reporting on the Economic Stimulus Program. It pointed out that the City's figures are misleading if not inaccurate because they double count jobs that have been created and count jobs as created even though no one has yet been hired.[7]

The City attempted to justify the highlighted figures by noting that there is no standard national methodology for counting jobs resulting from economic development programs. The general response was that the economic development figures are "in the ballpark."[8] PICA Staff believes that the City should be more accurate in its reporting on job creation figures.

Excessive Red Tape

Anecdotal evidence indicates that small businesses continue to feel that the City is unresponsive and slow to respond to their needs. Disputes can take months or even years to resolve, often adding costs that small business cannot afford. In addition, there is an apparent bias toward larger projects, such as hotels or the Philadelphia Naval Base rather than a focus on resolving the multi-faceted problems faced by Philadelphia's small businesses.

There is example after example of businesses running into excessive red tape. Everything from excessive time delays for project approvals to disputes with City departments results in making Philadelphia appear to be an inhospitable business environment. Indeed, according to the City Controller's Office, a recent survey of City businesses indicated that a substantial number of them found City "red tape" to be a significant burden to doing business in Philadelphia.

In one recent instance, an excessive "time and bureaucracy" delay almost cost the City 175 jobs and potentially 1,000 jobs. In this instance, the business needed to expand quickly, yet the City's response was delayed. A City official explained, "any responsible governmental agency will need two or three months to do research and to do due diligence and to get any board approval."[9] In today's fast-paced business environment, the City needs to react much faster to business requests and complaints.

Once the above situation had become a crisis, the mayor stepped in and said, "We've agreed to see if, in the <u>next 24 hours</u>, we can hammer out a final [offer] to them which they will evaluate and weigh against the New Jersey offer."[10] Only by adjusting to the business's needs and schedule was the mayor able to prevent the company from leaving.

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[7] Ibid.
[8] Ibid.
[9] Anthony S. Twyman, "City loses another biz," *Philadelphia Daily News*, February 28, 1996, p. 16. This firm ended up remaining in Philadelphia.
[10] Ibid.

The City Needs to Focus on Taxes and Costs

The Economic Stimulus Program is divided into four areas: neighborhood economic development, business retention and attraction, defense conversion, and tourism and hospitality. While these are excellent areas on which to focus, the City's primary goal for economic development must be to lower the cost of living and doing business in Philadelphia. Even with the tax reduction plan, the primary angst of Philadelphia business owners continues to be taxes.

Study after study indicates that businesses gravitate toward lower cost environments. Businesses born in the City will often move to the suburbs, where the cost of doing business is lower. As the Five-Year Plan notes, Philadelphia taxes can be almost twice as high as neighboring local counties.

While the mayor has once again extended the tax reduction plan through all five years of the current Plan, two of those additional years take place during another mayor's administration. There is no guarantee that a future administration will carry through with the tax reduction schedule.

At a recent meeting with members of the Greater Philadelphia Chamber of Commerce, the mayor indicated that if the Commonwealth assumes funding for the courts as of January 1, 1998, he would cut the much disliked Wage Tax even further than currently proposed. PICA Staff supports this proposed action. An immediate reduction in taxes will lower costs, reduce the incentive for jobs and residents to relocate out of the City, and increase the wealth of all Philadelphians.

Conclusion

It is increasingly clear that, generally, each of Philadelphia's economic development agencies carries out its mission well. However, coordination among City departments and agencies, as well as between the City and private sector organizations involved in economic development, remains a serious weak point. Additionally, activities tend to be reactive, with too little effort placed in reaching out to businesses earlier.

The City must instill a proactive drive to ensure that all relevant agencies are involved in getting problems remedied quickly. If businesses cannot afford the luxury of waiting for months for action or of paying more in taxes than what can be justified based on the level of service received, then neither can the City.

Most importantly, while individual economic development agencies may be successful in their individual projects, their efforts are all for naught if businesses continue to move to "greener pastures" outside the City to avoid dealing with the City altogether. The primary focus of the City must be on reducing the cost of living and doing business in Philadelphia. Only then will the City be in a position for growth.

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Pennsylvania Intergovernmental Cooperation Authority

**STAFF REPORT
ON
FY1998-FY2002
FIVE-YEAR FINANCIAL PLAN**

OTHER SIGNIFICANT RISKS

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THE FIRST JUDICIAL DISTRICT OF PENNSYLVANIA

The First Judicial District of Pennsylvania (FJDP) is a cost center of significant concern to PICA Staff. The State Supreme Court has directed the Commonwealth of Pennsylvania to assume financial responsibility for the State courts on or before January 1, 1998. However, there has been little indication that the legislature will act and that the Commonwealth will assume responsibility for statewide funding of a unified court system in a timely manner.

The City is at Risk of not Realizing or Even Losing State Funding

The conundrum of future funding of the courts does not auger well for the City. Should the State fail to assume court funding by January 1, 1998, the City will be obligated to continue FJDP funding. There is precedent for PICA Staff's concern that the State will not assume court funding in a timely manner. The State legislature ignored the Pennsylvania Supreme Court's original 1987 funding order (which did not include a deadline) for over nine years.

Should the Commonwealth assume responsibility for funding the courts, it may possibly cut State funding for other programs in an effort to at least partially recover the cost of court funding. If the State eliminates or reduces funding for programs with rapidly growing service demands, substituting support for the courts in their stead, the result could be State assumption of a relatively slow growth obligation at the expense of a rapidly growing one, reducing the total amount of State assistance in the Plan's out years.

The City has Redirected Local FJDP Funding

The City has budgeted only six months of expenditures for the FJDP for FY98, reallocating the rest of what it would have budgeted to two new line items: "Contribution to School District/Tax Cuts" and "Director of Commerce - Economic Stimulus." For the Plan's out years, the FJDP General Fund appropriation is zero, with the two new line items receiving an appropriation equal to the projected net City obligation for the FJDP.

The Administration verbally describes the two new line items as "reserve funds" for expected FJDP obligations if the State does not provide any new funding. If new funding is realized, the City will be able to use these funds for their appropriated purpose.

PICA Staff is concerned that the "reserve funds" are allocated for purposes other than FJDP funding. If the State does not provide full court funding, these appropriations will need to be shifted back to the FJDP through Councilmanic action. There is no guarantee that this appropriation power will not be exercised during the interim period or that such a reappropriation will be possible.

PICA Staff is also concerned that the "reserve funds" may not be of sufficient size.

The FJDP may not Agree to Extend the "Zero-Growth" Budget Agreement

In FY91, the State Supreme Court intervened in a confrontation between the City and the local courts resulting from a disagreement over court funding. The Supreme Court appointed an Executive Court Administrator to oversee the unification of the Court of Common Pleas, Municipal Court, and Traffic Court into the FJDP. The Supreme Court also ordered the FJDP to enter into what has been termed a "zero-growth" budget agreement.

During FY97 the State Supreme Court approved a reorganization of the leadership of the FJDP, returning leadership to the Judges. Under the new structure, the FJDP is overseen by a seven-member Administrative Governing Board, and the FJDP Executive Court Administrator has been replaced by a new Administrator of the City Court System.

The FJDP has worked under a "zero-growth" budget agreement since FY92. The "zero-growth" budget agreement significantly benefited both the City, which maintained relatively constant court expenses during its financial crisis, and the FJDP, which has had access to funding for improvements. The "zero-growth" budget agreement is estimated to have "saved" the City $106 million over five years. The agreement between the City and the FJDP ends on January 1, 1998. Since both the City and the FJDP expect the State to assume a greater portion of court funding as of that date, there has been no extension of this formal agreement.

If the City must maintain funding beyond the first six months of FY98 and the "zero-growth" budget agreement is not renewed, the City may be required to provide funding to the FJDP beyond what the City may be holding in reserve in the Plan.

State Supreme Court Appointment of Special Master

With its most recent decision (i.e., Allegheny II), the State Supreme Court has made it clear that it intends to see responsibility for court funding transferred from the counties to the State. It has appointed former Supreme Court Justice Frank Montemuro Jr. as a special master to study the transition. He is serving primarily to determine which costs the State is obligated to assume and the administrative scope of the State's responsibilities. Complex issues are involved which may well cause prolonged delays before the Commonwealth's final implementation of unified court funding.

The Position of the Commonwealth on State Funding

The Ridge Administration and State legislative leaders have agreed to work together with Judge Montemuro. This cooperative relationship of the executive, legislative, and judicial branches is integral to ensuring a workable transition. The transition group consists of four legislators, four gubernatorial appointees, and Judge Montemuro and his staff.

The Results of the Transfer of Court Funding in Other States

Other states have confronted the issue of the transfer of court funding from the counties to the state. The results have been mixed. Massachusetts was not adequately prepared, and initial state funding proved to be unnecessarily expensive. New Jersey, on the other hand, assumed the responsibility with limited difficulty. At this point it appears that adequate preparation and cooperation, such as occurred in New Jersey, is being devoted to an eventual successful transition.

The Position of the Mayor and Local County Officials on State Funding

In a proactive move, Mayor Rendell and the county commissioners of Bucks, Chester, Delaware, and Montgomery counties, which together represent 33% of the State population, submitted their collective recommendations to Judge Montemuro. They recommended that "[t]he court unification model ultimately adopted should be based on broad-as opposed to narrow-definitions of categories of court related costs. . ." They included all personnel and other costs associated with the courts, including counsel and arbitration fees, facility costs, and juror expenses.

In addition, the Mayor and the local county officials advocated an equitable allocation of court funding across the State. They also distinguished between the responsibility of administering the courts and the responsibility of funding the unified court system.

Montgomery County Commissioner Joseph Hoeffel has described the joint recommendations as "a wish list." He also clearly expressed that it was "a stretch" to expect the State to pick up the cost without extending its administrative control over the courts.

The Statewide Cost of Unified Court Funding

The burden of unifying the courts is an issue that pertains to the entire State, not just the City of Philadelphia. Currently this new financial obligation to the Commonwealth is estimated at as much as $1 billion for the entire State. The funding for the FJDP alone is anticipated to exceed $108.5 million annually, 10% of the Commonwealth's total. The statewide total is more than 5% of the State's $19 billion 1997-98 budget.

Conclusion

PICA Staff is significantly concerned that the Commonwealth will not commence funding for the unified court system on January 1, 1998. The funding cost is substantial, the issues are broad, and the potential for disagreements high. Should the State fail to fund the courts, the City may be left with the obligation to provide additional funding.

As noted above, the City has budgeted in two "reserve" line items what would be the FJDP's full share of local funding given no movement toward greater State funding and the continuation of the "zero-growth" budget agreement. PICA Staff acknowledges this cautious approach. However, given that this funding is not legally allocated to the FJDP, should the Commonwealth fail to provide appropriate funding for the FJDP, the City is at potential risk for more than $440 million dollars over the life of the Plan.

Additionally, the "reserve" funding may prove to be insufficient if the State does not provide additional funding and the "zero-growth" budget agreement is not renewed, potentially costing the City many more millions of dollars.

LABOR CONTRACTS

The Rendell Administration successfully concluded labor agreements and arbitration negotiations with all four of the City's major collective bargaining units in 1996. Except for the contract with the Fraternal Order of Police, Lodge 5 (FOP), which expires at the end of FY98, the new agreements cover three of the five years in the Plan.

Paying for the New Contracts

PICA Staff applauds the City's attempt to identify sources of anticipated ongoing savings to help fund the cost of the labor contracts. In addition to savings resulting from the new contracts themselves, reductions in PICA debt service payments as a result of a PICA debt refunding and reduced electricity costs resulting from a newly negotiated arrangement with Peco Energy are earmarked to be applied to the increased costs of the new labor contracts. Nonetheless, the bulk of the newly incurred labor costs will have to be borne by the General Fund without specific savings or new revenues identified to pay for them.

To help cover the costs of the new contracts in FY99 and FY2000, the City anticipates utilizing a projected FY98 surplus of $99.7 million. Once the accumulated surplus is spent down, however, the Plan relies on questionable revenues (Riverboat Gambling Taxes and the Personal Property Tax) as well as unidentified Target Spending Reductions, to maintain budget balance under the new labor contracts. PICA Staff is concerned that the City may not be able to pay for the continuing costs of its labor contracts once its accumulated surplus is spent down.

The Uncertainty of the Next FOP Award

In discussing the cumulative costs of the new labor contracts, the City Workforce chapter of the Plan assumes that the FY98-FY2000 FOP negotiated settlement or arbitration award will follow the International Association of Firefighters, Local 22 (IAFF) contract for FY99 and FY2000. However, the Plan's Police Department expenditure projections provide no increase in police personnel costs that may result from the upcoming contract process.

PICA Staff recognizes the City's concern that budgeting for an unknown labor contract outcome will compromise the City's ability to negotiate. However, it is important to remain aware that the current administration has an obligation both to be prepared for the upcoming negotiation/arbitration and to ensure that the next administration is not burdened with insupportable labor costs.

Redesigning Government Initiative

As part of the new labor contracts, the City agreed to a two-year moratorium on new competitive contracting initiatives that would result in either layoffs or demotions of existing City employees. In its place, a labor-management initiative was established with AFSCME District Councils 33 and 47 that aims to improve services and minimize costs for selected City functions.

The newly created Office of Labor Relations will be the coordinating City office for this initiative, which is also benefiting from the assistance of Harvard University's John F. Kennedy School of Government. The City will concentrate this new effort on areas it had previously identified for its competitive contracting initiative. Other areas for improvement may also be identified during this process.

PICA Staff is disappointed that the City has given up the unlimited ability to contract out activities, even if for only two years. On the other hand, since the people who serve on the front-line in unionized positions often know best how to improve City government, there is great potential for labor-management cooperation on improving City government. Given the lack of progress to date, though, as well as the fact that the pilot period for this initiative is already almost half over, PICA Staff is not optimistic that this innovative approach will be productive in the immediate future.

DEPARTMENT OF HUMAN SERVICES FUNDING UNDER FEDERAL WELFARE REFORM

Federal welfare reform and the challenges it poses have received much attention in the press over the past few months. One area that has not received much attention, however, is how the block granting of Federal Social Security Act Title IV-A funding will affect how states and counties pay for child welfare services.

Background

In April 1994, Pennsylvania and its counties began filing for Federal Title IV-A reimbursements for "emergency assistance" child welfare services. Much of this new funding was used to replace the need for State funding. Counties also benefited since this new funding stream increased the effective reimbursement rate for eligible service costs. In FY95, Title IV-A funding decreased the demand that would otherwise have been placed on City funds by an estimated $14 million.

On January 1, 1996, the Federal Government stopped providing Title IV-A funding for services to delinquent youth, although it continued to provide funding for dependent children. Pennsylvania identified "one-time only" funds that it used to hold counties harmless from the Title IV-A change for the remainder of that fiscal year, the result being that Philadelphia did not experience a net change in reimbursements for FY96 as a result of the Federal decision.[11] For the first quarter of FY97, though, services to delinquent youth that had been eligible for Title IV-A funding reverted to the previous funding formulas, reducing the effective reimbursement rate to the City for these service costs.

The Federal welfare reform act, known as the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, converted all Title IV-A funding, including cash assistance (i.e., AFDC) and child welfare Emergency Assistance, into a single block grant provided to states based on previous Title IV-A funding levels. This block grant is titled the Temporary Assistance for Needy Families (TANF) Block Grant and took effect on October 1, 1996. Pennsylvania has decided to appropriate $120 million of its $719.5 million block grant to child welfare Emergency Assistance services, including, once again, services to delinquent youth. The State has also decided not to fund county administrative costs for these services with TANF funding, even though such administrative costs had been reimbursable under Title IV-A. These administrative costs, however, can now be billed under Title IV-E.

TANF Block Grant Funding is Capped

Pennsylvania will continue budgeting for child welfare services in the same way as previously, using its established "needs-based budget process". As PICA Staff has

[11] The Five-Year Plan incorrectly states otherwise.

noted in the past, the needs-based budget process is flawed and confusing, to the detriment of Philadelphia. PICA Staff had hoped that Pennsylvania would use this opportunity to reevaluate its overall child welfare funding system and produce a rational and comprehensive approach to funding the children and youth program in the State. (See PICA Staff Report on State Funding of the Philadelphia Department of Human Services, December 15, 1995.)

Instead, Pennsylvania has made only one change to the needs-based budget process. What was previously Title IV-A Emergency Assistance funding will now be capped for each county. These capped levels have not yet been determined, but the State expects to announce its decision soon.

Under the capped system, Philadelphia will invoice the State under the pre-TANF formulas (except for the above-noted funding change for administrative costs) until it reaches its capped TANF Emergency Assistance allocation. The City will then invoice the State under the remaining funding streams for the rest of the fiscal year, as if no Federal Emergency Assistance funding is available, effectively lowering its reimbursement rate for that part of the year. State caps as a result of the needs-based budget process also limit the amount of State funding the City can receive. The City may begin to feel an even greater financial burden for the provision of these services if State funding proves insufficient.[12]

TANF-Mandated Work Requirements and Time Limits

The Federal welfare reform legislation enacted certain work requirements and time limits on adults in households receiving TANF benefits. For children in institutional settings, these requirements and limits will have no effect since children are exempt. However, for children receiving in-home services or in foster family settings, these requirements may apply to their parents or guardians. It is unclear at this time whether all such services will be subject to the Federal requirements since defining regulations have yet to be issued.

If households are not compliant with the new requirements, the City will likely have to continue to provide services to these children. Without the ability to use TANF funding, net City costs will increase.

TANF Cap, Work Requirements, and Time Limits Create Financial Incentives to use more Expensive Services

With the TANF time limits and statewide cap, the only Federal child welfare funding stream left as an entitlement is Title IV-E, which reimburses costs only for placement services. Both this and the fact that children in institutional settings will not

[12] In response to the capping of federal Emergency Assistance, Pennsylvania has increased its FY98 Act 148 budget by approximately $18 million more than what it would have been otherwise. It is uncertain whether this amount will be sufficient.

be affected by TANF Emergency Assistance time limits create an incentive for local governments to place children out of their homes rather than provide them with in-home services. By avoiding in-home services, local governments can access greater Federal and State funding and reduce their net costs. Given the emphasis both statewide and nationally to preserve and strengthen families, this incentive appears contrary to fundamental service goals.

Ironically, in an effort to partially compensate for time-limited eligibility for Emergency Assistance, the Federal government has expanded Title IV-E eligibility to include for-profit service providers, making it even easier to place children in reimbursable placement services. Previously, Title IV-E reimbursed costs for services provided by non-profit service providers only.

The State has not Certified Allocation Levels since FY95

As part of the needs-based budget process, the State annually issues to each county specific fiscal year allocations for each revenue stream. As mentioned above, there are many weaknesses to this process which PICA Staff has addressed previously. However, one of the more urgent concerns is that the State has not issued final allocations to any county in over two years.

This leads to multiple problems, not the least of which is that the City cannot be certain of how to invoice the State for reimbursements appropriately. To date, the State has honored Philadelphia's invoicing without any regard to certified levels of funding. This is probably because the City has managed to stay under the State's "preliminary" allocation levels for State funding. Even though the City has exceeded the allocation levels for Federal funding, the State benefits financially from allowing the City to access as much Federal funding as it can. It remains uncertain whether the State will cover all appropriate service costs if and when the City exceeds its Act 148 allocation.

Without final, certified allocations, the City's needs-based budget request last year was tentative, since it is always based on the previous year's certified allocations. The lack of a definitive commitment by the State just adds to the uncertainty of whether costs are going to be reimbursed as the City anticipates. For its part, the State claims that the inability to issue final allocations is due, at least in part, to the lack of resolution over a dispute with the City described below.

Outstanding Dispute between the State and the City

When the State originally applied to the Federal government for reimbursement under Title IV-A for emergency assistance child welfare programs, the Federal Department of Health and Human Services approved the State's plan much faster than the State had expected. This resulted in a much sooner start-up than had been planned.

In the Fall of 1994, the State requested counties to begin invoicing for Title IV-A services as of April 1, 1994. The City, along with other counties, was given the impression that, since the State's 1994 fiscal year had ended June 30, the State would allow the counties to keep any and all Federal money for which the counties could successfully invoice from the three-month period. In April 1996, the City received notice that the State wanted to be reimbursed for the difference between what it had actually provided the City for those three months and what it would have paid had the funding formulas been revised as of April 1, 1994 rather than July 1, 1994. For Philadelphia, the contested amount is between $3 million and $6 million.

The City asserts that the State is reneging on its commitment. However, the State plans to withhold an equivalent amount of money out of future reimbursements regardless of the City's assertion. PICA Staff is concerned about this particular disagreement as well as what it may indicate about the underlying relationship between the City and the State.

THE EFFECTS OF WELFARE REFORM ON SERVICE DEMANDS

Last year, both the State and Federal governments enacted dramatic welfare reform legislation that has already altered eligibility and the level of support provided to those in need. The enacted changes will continue to be phased in over the next few years. These changes are expected to increase the demand on City services and may pose a significant risk to the Plan.

Welfare Reform Described

Numerous financial supports have been and are being taken away from low-income City residents. As many as 18,000 legal immigrants residing in Philadelphia may lose their Supplemental Security Income, Food Stamp benefits, and/or Medical Assistance under the new Federal legislation. An additional 352,000 residents will see a reduction in Food Stamp benefits. Eighteen thousand residents will become ineligible for General Assistance under the State's new eligibility guidelines, adding to the 25,900 who lost General Assistance over the previous two years as a result of other caseload reductions. The State has also eliminated Medical Assistance coverage to an estimated 62,000 Philadelphians considered "able-bodied adults" who do not work at least 100 hours per month.[13]

The State's new welfare plan eliminates the $50 child support pass-through to custodial parents, reducing the cash income of many families in need. The plan also enacts Federally mandated work requirements and lifetime limits of five years. These latter two elements will, over the long term, reduce the number of families eligible for assistance with no guarantee that those who lose it will no longer be in need of such assistance.

Federal welfare reform mandates that Food Stamp eligibility for childless "able-bodied adults" be limited to three months out of every three years, unless the individual is working 80 hours per month. Pennsylvania successfully requested a waiver of this mandate for a number of "surplus labor" vicinities, including Philadelphia. The waiver covers only one year, though, and there is no guarantee that it will be renewed each year thereafter.

The City estimates that in the next City fiscal year, its citizens may lose as much as $374 million in benefits. The loss of this income within the City will have multiplier effects throughout the City's economy, lowering the flow of money and probably resulting in a loss of jobs and City tax revenues. More directly, as individuals lose cash and health care benefits, they will turn to the City in greater numbers for assistance.

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[13] *City of Philadelphia Five-Year Financial Plan, Fiscal Year 1998-Fiscal Year 2002*, pp. 246-7.

These Reforms will Lead to Increased Demands on City Services

As depicted in the Economic Development section of this report, Philadelphia has lost over 100,000 jobs since 1988. Yet thousands of government assistant recipients are being required to find jobs. In addition to an insufficient number of jobs, there is often a disparity between the educational level of government assistance recipients and employer requirements. Without a realistic opportunity for most of these individuals to find work to support themselves, they will begin to turn elsewhere for the support they need.

As described by one State Department of Public Welfare regional administrator, "[Welfare reform] has nothing to do with saving money. It doesn't save any money at all. It's about shifting costs."[14] The City, under existing law and political realities, is the provider of last resort for many social services and will probably attempt to meet the increased need, notwithstanding the City's rhetoric to the contrary.

The Office of Emergency Shelter and Services (OESS) and the Departments of Human Services (DHS) and Public Health (DPH) are the City entities that will have to absorb the greatest burdens resulting from welfare reform.

<u>OESS</u>

OESS provides emergency shelter and homeless prevention services. Demands for these services are expected to increase as greater numbers of people lose resources they depend on to maintain a home. In fact, evidence indicates that the number of homeless individuals has already increased over the past few months, not only as a result of last year's welfare reform measures but due to the cumulative effects of the State General Assistance reductions from the previous two years. Simultaneous to this increased demand is the expectation that State and Federal funding for these services will continue to be scarce.

<u>DHS</u>

Based only on the State welfare reform legislation, DHS projected last summer that demands on child welfare services will increase. Part of the anticipated increase is attributed to extended family households (aunts, uncles, grandparents) that provide care for other family members' children that, to date, have relied on cash assistance and are now expected to turn to foster care payments because of the work requirements and time limits associated with cash assistance. The rest of the anticipated increase is attributed to cuts in public assistance that are expected to increase service demand as the result of increased poverty and its associated sociological problems.

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[14] Bill Hangley, Jr. and Erin Mooney, "Health Care and Welfare: A Brief Assessment of the Impact of Welfare Devolution on Medicaid, Medical Assistance and the Greater Philadelphia Region," 21st Century League, March 1997, p. 20.

Due to the vagaries of the State's needs-based budget process, DHS did not project any effect resulting from the State changes for the current fiscal year in the Annual Plan it presented to the State last summer. However, for Fiscal Year 1998, DHS has projected that referrals would increase by 10% (1,398) and caseload would increase by 1,500 (a 13% increase from the current caseload of approximately 11,500). The Federal welfare changes are expected to increase caseload projections even further.

<u>DPH</u>

The elimination of Medical Assistance benefits to legal immigrants, certain disabled children, drug and alcohol addicts, former General Assistance recipients, and those who do not meet work requirements is not expected to result in a decreased need for health care. Indeed, it is projected that without primary preventative care, those who need medical attention will wait until their situation worsens, leading to higher costs for individual cases. In those situations, hospital emergency rooms will probably be called upon to absorb the demand and the associated costs for those services.

For primary care services, however, many residents who lose their benefits will turn to the City's district health centers, which historically have served all comers regardless of insurance status. Already the district health centers have seen an increase in the number and proportion of visits that are not covered by insurance. In addition to greater numbers of citizens lacking primary care health insurance, the declining state of health of the City's population as a result of a loss of other public assistance is likely to increase service demands on the health centers.

Simultaneous to eligibility changes, the Medical Assistance (MA) population is being shifted to a managed care system. With all of the changeover confusion, it is expected that many individuals will not properly register for MA benefits, or will not designate the district health centers as their primary care facility, but that they will still use the health centers for primary care needs. DPH is implementing systems to keep such instances to a minimum. It is unknown how successful the department will be. Additionally, given the competitive nature of the managed care arrangement, the district health centers will be challenged to retain enough insured patients to continue to support services for the uninsured.

The Future Effects of Welfare Reform are Unknown

The effects of welfare reform will grow over the next several years, even if there is no further narrowing of eligibility or funding reductions. Unless the Federal or State governments reverse course, the City will continue to face a growing challenge to balance an increasing demand for social services with decreased revenue for those services. The City will need to be vigilant not to spend beyond its means in these areas. The current administration has made clear its commitment to financial responsibility. However, given the emotional and political aspect of these services, and the political climate in both Washington and Harrisburg, it will be difficult to maintain such a commitment.

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Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT ON FY1998-FY2002 FIVE-YEAR FINANCIAL PLAN

OTHER GENERAL FUND CONCERNS

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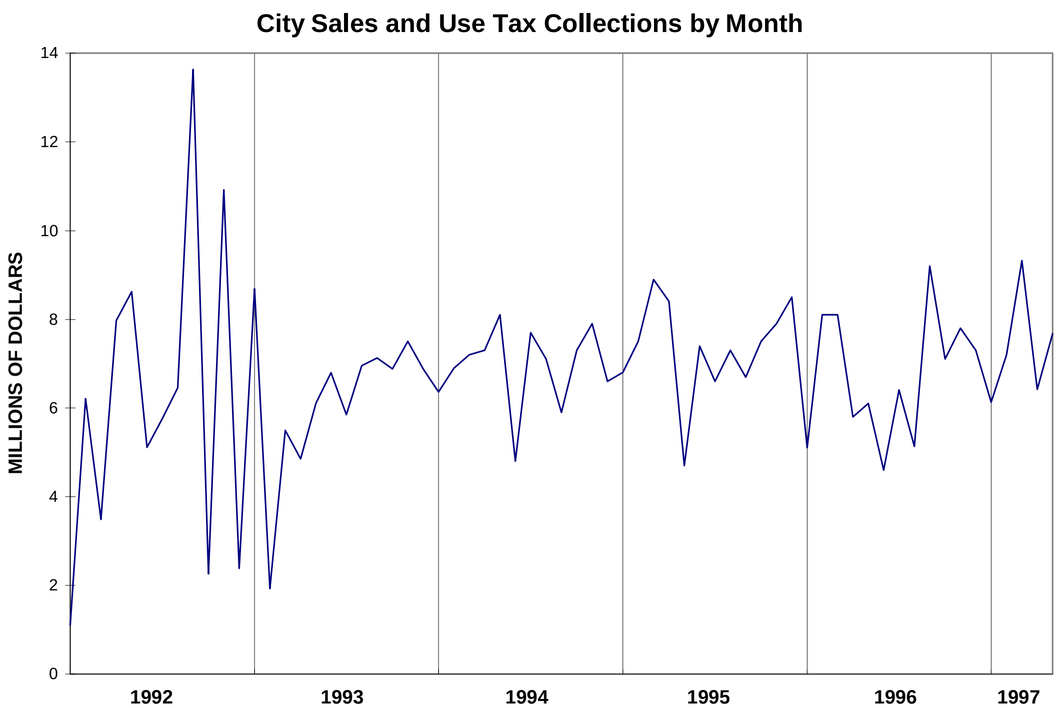
SALES AND USE TAX

PICA Staff has numerous concerns about the City's Sales and Use Tax. Foremost is the relationship between the City and the State, which collects the tax on the City's behalf. The State remains reluctant both to provide information to the City regarding collections and to coordinate with the City on audits. The initially enacted collection agreement provided the City with minimal leverage to be an effective advocate for its own interests. PICA Staff also has continuing concerns as to the City's projections of future revenues from this tax source, particularly with respect to the City's retail sector and its ability to successfully compete against the growing competition in the suburbs.

Relationship with the State Department of Revenue

The City Sales and Use Tax was authorized as part of the PICA Act legislation. Enacted in October 1991, the tax is collected by the State simultaneous to the State's collection of its own Sales and Use Tax. Collections are then allocated to the City on a monthly basis.

Collections got off to a rocky start, as can be seen in the graph below, with monthly fluctuations that defy reasonable expectations. There were numerous complications with collecting the tax, not the least of which was the lack of clarity in the tax forms. As the State became more effective in collecting the tax, it installed a new computer system which again caused a number of collection problems in the spring of 1996, which the State claims were corrected for during the fall of 1996.



The collection agreement between the City and the State leaves the City with little recourse or ability to be an advocate for its interests. As an example, the State recently notified the City by mail of a sizable amount of overpayments that needed to be refunded. Without any prior warning or solicited input, the State explained in the letter how it planned to refund the $700,000 in overpayments out of the City's future proceeds. As the State has complete control over the collection and allocation processes, it has wide discretion in how it operates.

The State also has not been particularly forthcoming in providing backup information to the City, requiring that the City rely on the State to appropriately credit the City for the taxes that are due it. The City also has not been able to access the State's collection data to be able to compare it to its own tax rolls for tax compliance purposes.

In pursuing its interests, the City has found that the State's Department of Revenue is somewhat limited by the law in how much it can cooperate with the City, particularly in the case of sharing taxpayer information. However, it has also found that the State prefers to keep sole control over its operations, expressing reluctance in allowing the City to conduct sales tax audits as a part of regularly conducted general business tax audits. The City hopes to continue working with the State to overcome these problems.

Collection Projections

Growth in Sales and Use Tax collections during the first few years of the tax was fueled in large part by increasing compliance with the tax. It appears that compliance has now peaked and that growth in tax collections will now more closely track retail activity.

Based on discussions with regional economists, the City projects that that the City's Sales and Use Tax collections will increase at or slightly above inflation over the life of the Plan. Given the technical problems with the collections process discussed above, it is possible that continuing collections may not accurately reflect the economic realities of the City's retail sector. Even absent the collections problems though, PICA Staff remains doubtful that the sales growth in the City will meet the City's projections. Given the seven month closure of a major Center City retail establishment, the consolidation of other major retail outlets, the move toward discount chains, the continued growth of suburban malls, and the City's continued loss of residents, PICA Staff believes it possible that retail activity in the City will not reverse its declining trend as quickly as the current Plan projects.

Earlier this month, in conjunction with its budget adoption, the State exempted computer services from all Sales and Use Taxes. This new exemption also contributes to the City's likely inability to reach its projection for Sales and Use Tax collections.

UNFUNDED PENSION FUND LIABILITY

The City remains burdened by a significant unfunded pension liability. Approximately 45% of the actuarially determined Pension Fund liability has been funded. The unfunded benefit obligation presently exceeds $2.7 billion.

This shortfall may in fact be underestimated as a result of the City's aggressive assumption that the Pension Fund will earn a 9% annual rate of return. However, utilizing that assumption, the City is following a schedule which purports to eliminate the unfunded liability by Fiscal Year 2019.

The payment schedule for eliminating the current, actuarially determined liability requires gradually increasing annual General Fund payments to more than $243 million, $36.6 million of which will be State funded, by FY2002, the final year of the Five-Year Plan. The payment required at the end of the liability reduction schedule will be more than double the FY2002 amount.

The present pension obligation funding methodology is based on State and Court mandates. In an effort to reduce the impact which this growing annual payment will have on the City's budget, the City has proposed amendments to State legislation. Currently, the City is required to increase contributions annually at an actuarially-determined rate which will result in the unfunded current pension liability being eliminated by the year 2019. The City-proposed amendments would allow it to institute a 15-year rolling amortization program once the Pension Fund reaches a 70% funded level, projected to be in the year 2010, in effect stretching out payments beyond 2019.

The City's actuaries project that 70% funding would provide sufficient assets to cover all current or accrued benefits. (In layman's terms, if the City went out of business at that point, its pension liabilities would be covered.) Pension funds typically try to accumulate funding in excess of actuarially-projected current benefit accruals to partially mitigate increases resulting from future pay increases and plan changes. Such additional funding acts as a cushion to reduce the future need for increased contributions.

The proposed legislation stipulates that, once the Pension Fund is at the 70% funded level, the City can calculate subsequent Pension Fund contributions based on an annual determination of the amount required to eliminate the remaining liability over the following 15 years. Each year's payment would thus be based on a 15-year pay-out schedule. While the Pension Fund would never be fully funded, it presumably would always be approaching a fully-funded state.

PICA Staff is pleased that the City is pursuing potential solutions to a pension liability problem that threatens to be a budget buster early in the next millennium. However, given the inherent difficulties of successfully initiating legislative action to change State-mandated pension funding, relying solely on such State action to solve this problem seems imprudent. PICA Staff strongly urges that the City seriously consider other solutions, including bond issuance, to fully eliminate the current unfunded Pension Fund liability.

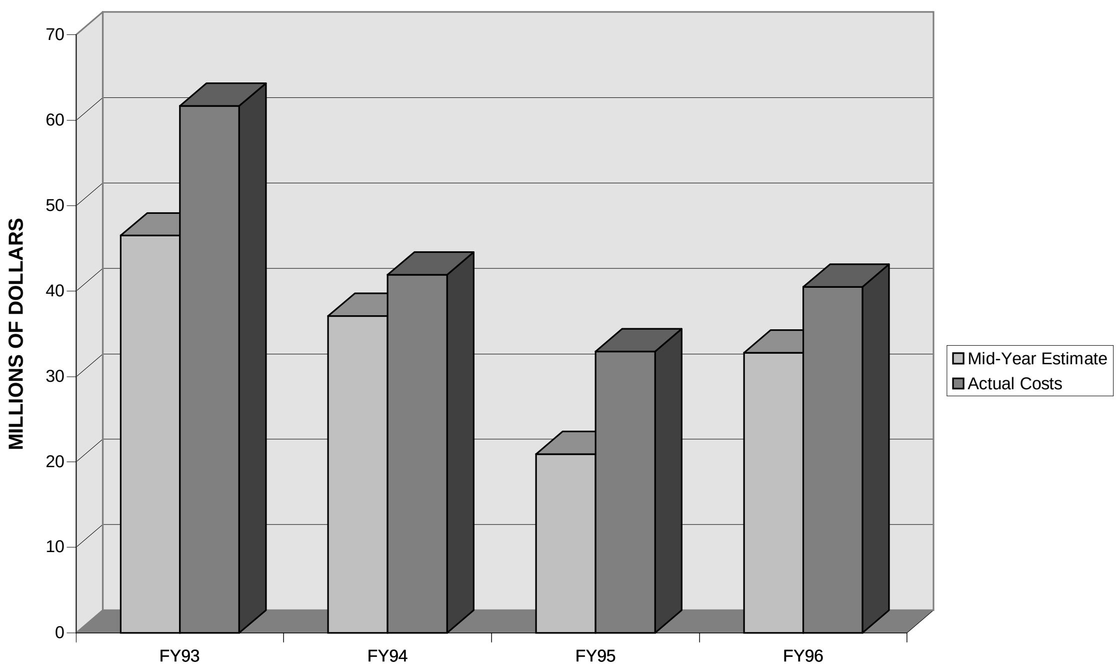
INDEMNITIES

PICA Staff does not believe that the Plan's indemnity projections are reliable. Estimates in previous Plans have consistently been less than actual final costs. The City's past inability to project indemnity costs results in obvious concerns about the projections in this year's Plan.

Historically, the Plan has had Low Estimates

The FY96 indemnity estimate in last year's Plan was $32.8 million. However the actual final cost was $40.2 million or 23% more than estimated. A one-time underestimate would not raise serious concerns, but this deviation is part of an historical pattern.

Comparison of Estimated and Actual Indemnity Costs



Note: Mid-year estimate is as presented in the respective Five-Year Plan.

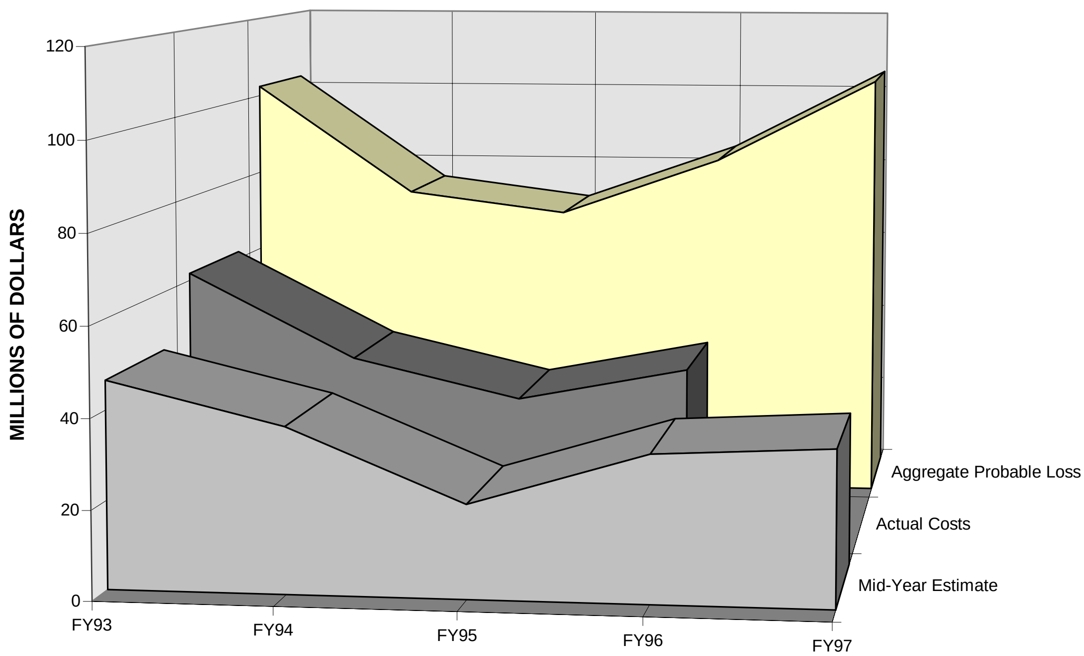
Actual costs have consistently exceeded Plan estimates over the past four years. The chart above demonstrates the difference between estimated and actual costs. Halfway through FY93, the City estimated that indemnities would cost $46.5 million that year. That estimate was 33% below the actual cost of $61.7 million. In FY94, the estimated cost of indemnities was $37.1 million, but actual costs were $41.9 million, 13% above the estimated amount. Halfway through FY95, the estimated cost was $20.9 million. However, the actual cost was $32.9 million, 57% above the estimated cost. The City's track record with respect to projecting indemnity costs shows a clear pattern of underestimating final costs.

The City currently estimates that FY98 indemnity costs will be $34.6 million, less than the current FY97 mid-year estimate of $34.9 million and 16% less than the FY96 actual cost of $40.2 million. At current settlement levels, both the FY97 and the FY98 estimates will likely prove to be low.

The City Faces an Increased Aggregate Risk

The fear of an underestimate is further aggravated by the fact that the "aggregate estimate of loss deemed to be probable" as presented in the City's Comprehensive Annual Financial Report (CAFR) has increased over the past two years.

Comparison of Estimated and Actual Indemnity Costs and Aggregate Probable Loss



Note: Mid-year estimate is as presented in the respective Five-Year Plan.

The mid-year FY97 estimate of indemnity costs is incongruent with the increased aggregate probable loss. The CAFR estimate of aggregate probable loss increased 24%, from $84.3 million as of the beginning of FY96 to $104.8 million as of the beginning of FY97. The chart above demonstrates the divergent trends of the FY97 estimate and the CAFR-estimated aggregate probable loss.

In addition, the aggregate estimate of loss deemed to be "reasonably possible" has increased 26%, from $97.1 million as of the beginning of FY96 to $122.4 million as of the beginning of FY97. PICA Staff is concerned that the increases in CAFR estimates have not been taken into account in the Plan.

Conclusion

PICA Staff is fully cognizant of the difficulty inherent in budgeting for indemnities. Nonetheless, we believe that the City should increase the indemnities budget, improve its methodology for estimating and budgeting for indemnities, and align its indemnities budget with its CAFR-projected aggregate loss deemed “probable” and “reasonably possible.” The consistent disparity between Plan estimates and final costs is a disquieting trend that should be promptly ameliorated.

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PHILADELPHIA PRISON SYSTEM OVERCROWDING

PICA Staff continues to be concerned that the inmate population often exceeds the Philadelphia Prison System's intended population capacity. Since the end of FY96, the prison population has almost always exceeded the maximum intended capacity of 5,600. The City appears to be doing everything presently prudent to keep the inmate population below the system's capacity. Consistently exceeding the prison population capacity could become an extremely expensive proposition and represent a threat to the financial stability of the City in FY98 and beyond.

In compliance with court consent decrees of 1986 and 1991, the City of Philadelphia implemented a comprehensive prison planning process and instituted a maximum allowable population (MAP) also known as the "prison cap." When the prison cap was exceeded, the City would not admit certain offenders into the Philadelphia Prison System (PPS).

In FY96, after both opening a new prison and completing the required comprehensive prison planning under the guidance of Judge Norma Shapiro, the prison cap was lifted. The inmate population subsequently jumped 18% in nine months from 5,114 to 6,021, 421 more inmates than the City's capacity. As of March 31, the City has managed to bring the population down to 5,741 inmates, or 141 inmates over the MAP.

Aggressive Action to Curb Overcrowding

The City continues to address prison overcrowding in three ways. First, it is using pretrial release guidelines, which carefully evaluate individuals for risk of flight or threat to the community. Second, it has implemented a special release mechanism for "recommended" inmates when the population exceeds certain levels. All candidates selected for special release are approved by the Trial Commissioner and District Attorney's Office. Third, the City has sought to house prisoners outside of the Philadelphia System. However, housing inmates in other jurisdictions is extremely expensive. The original FY97 projection for such costs was $385,000 and has since risen to $1.1 million, an increase of 186%.

Current Crime Trends

Whether the result of increased police presence, new policing methods such as community policing, or social factors such as aging baby boomers, crime in the City appears to be dropping. Philadelphia continues, for the fifth consecutive year, to be ranked among the safest of the ten largest cities. In 1995, the City was rated the third safest of the ten largest cities by the FBI. With continued trends in crime reduction, there is the potential for the Philadelphia prison population to decrease.

Conclusion

The City is attempting to resolve the problem of prison overcrowding in diverse and innovative ways. However, the growth of the inmate population continues. Short-term solutions such as pretrial release guidelines and selective release mechanisms must obviously be used conservatively. An unresolved threat to a sound prison system budget is the increasing cost of housing prisoners outside of the PPS. Should the prison population grow appreciably, the cost would become prohibitively expensive and could represent a significant threat to the Plan.

STRATEGIC PLANNING

After over a year of promises and activity, the City of Philadelphia finally issued a citywide strategic plan in 1995 as an appendix to that year's Five-Year Financial Plan. While not necessarily an ideal model of a strategic plan, it provided some focus to the City's broad range of activities and provided a guidepost for how to proceed. It stated that departments would be expected to complete their own strategic plans by the end of September 1995. After many more months of promises and commitments, the City finally provided PICA Staff with three departmental strategic plans just this past February.

PICA Staff understands that the City has numerous priorities and that focusing on a strategic planning process can be challenging and seemingly superfluous. However, such a process is vital to preparing for the multitudinous challenges the City will face in the future. As the City has already discovered, it can also be a useful management tool that surfaces creative service-enhancing and money-saving ideas as well as helps build a dedicated and enthusiastic workforce.

Based on the actions of the Rendell Administration to date, PICA Staff can only conclude that the City is not utilizing the strategic planning process to its full potential.

The Process Behind the Citywide Strategic Plan was Top-Down

The citywide strategic plan was developed with the input of primarily senior City officials. This resulted in a Strategic Plan which focused on the basic mainstays of the Rendell Administration and did not build a constituency interested in the planning process or its outcome.

The City continues to operate with an intuitive, top-down management style. During the period of the City's fiscal crisis this style proved necessary and useful. However, the administration needs to shift its management style to a more inclusive, bottom-up structure. It remains vitally important that the central administration provide a unified vision and that it keep a handle on the financial and service level operations of each department. However, where possible, decision-making needs to be shifted down the hierarchical ladder so that front-line employees can more efficiently and effectively identify service needs and handle job demands.

A strategic planning process that incorporates a wider range of employees at different levels of the City, or even of individual departments, would incorporate a more diverse range of perspectives and ideas, as well as win the buy-in of a greater number of City employees.

The Strategic Plan Itself is Weak

The strategic plan, a 42-page compilation of graphs, charts, and narrative, has no overarching mission statement for the City. The 140-word vision statement includes at least six distinct areas of focus. Each of the ten primary strategic objectives has three to five strategies. The City has never formally reported on either these strategies or on the 63 Measures for Progress.

According to one source on strategic planning in the public sector:

> A formal strategic planning process has the following results...:
>
> 1. A mission statement for the organization
> 2. An environmental scan and conclusions about future scenarios in a three- to five-year period
> 3. Basic goals for the time period in the scan, and goals for the coming one-year period
> 4. Strategies and action steps that will move the organization toward the goals
> 5. Implementation plans that assign responsibilities for action steps."[15]

This source also points out that "[a]s a process, strategic planning is not a one-time endeavor. It must be constant and ongoing."[16]

The City needs a succinct mission statement. It should then spell out specific and measurable goals and objectives that should be tracked to ensure that the mission is being pursued. Departments can then develop strategies and action plans that explain how they are going to contribute to the overall City goals and objectives, in addition to any goals and objectives the departments may have beyond the citywide ones. The Administration and City Council can then measure departmental progress in implementing strategies and action plans and see whether they are helping attain citywide goals and objectives. This process then needs to begin over again, with a reevaluation of the City's mission, goals, and objectives, making sure that they are still relevant and comprehensive.

Obviously, the City's strategic plan of two years ago did not have all of these results, perhaps most importantly a mission statement and implementation plans with assigned responsible parties. Even a statement as simple as "City government must do all it can to create the environment for a working economy that will provide good jobs and real opportunity for its citizens"[17] would be appropriate for a mission statement.

There has been no Formal Follow-up to the Citywide Strategic Plan

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[15] Gerald L. Gordon, Strategic Planning for Local Government, Washington, D.C.: International City/County Management Association, 1993, p. 9.
[16] Ibid., p. 11.
[17] *Philadelphia 2000 - Strategic Plan*, City of Philadelphia, January 1995, p. 3.

According to the City administration, the City attempted to document the progress made toward the goals of the citywide strategic plan. The final report ended up looking very much like the Five-Year Plan. However, what is needed is not a repetition of what the City accomplishments have been to date. What is needed is an inventory of what still needs to be done, not only from the goals of the original strategic plan but also from an ongoing process that evaluates the changing demands on City government.

The point in following up the goals of the strategic plan is not to make busy work or to make PICA Staff happy. The City needs to ensure that it is continuously focusing on its long-term goals. The only way to do this, and to show the public that it is doing so, is to report on a regular basis (even if only every two or three years) that its goals are still appropriate and that it is making progress toward them.

PICA Staff is not Impressed with the Departmental Strategic Plans Provided to Date

After repeated requests from PICA Staff, the City finally provided PICA with copies of strategic plans for just three departments, even though the City claims that most departments have completed one. One of the three provided was dated February 1995, two years prior to it being provided to PICA. Another was dated October 1995. When the three plans were provided in February, the City promised that it would continue to provide PICA with departmental strategic plans in a constant flow over the next several months. To date, no more have been received.

The Free Library strategic plan that has been provided to PICA provides clear links to the citywide plan, providing specific operational goals for the libraries that match the City's ten objectives. It also explains the service level measures it currently reports to the City's Budget Office and provides projections of what those measures will be through the year 2000.

The Free Library plan is not actually a strategic plan, however. Rather, it is a centrally developed report that attempts to link the Library's 1991-1996 Long Range Service Plan to the City's strategic plan. The six-year old Long Range Service Plan is actually a good example of how to develop a departmental strategic plan, with specific goals and objectives developed through a process including surveys of Library users. It is unclear from the information provided to PICA Staff whether the old Library plan included action plans with individuals assigned responsibility for each step required.

The Recreation Department's strategic plan, another of the three provided to PICA, is also a strong document that outlines goals and strategic actions that need to be taken to achieve noted goals. However, again no responsible parties are named. Additionally, although the plan notes that it needs to "be evaluated at the end of each fiscal year....includ[ing] a review of both completed strategic actions and the actions scheduled for the following year,"[18] PICA Staff has not been provided with any evidence that such a review has been made, even though the plan is over two years old.

The third departmental strategic plan is by the Mayor's Office of Information Services (MOIS) and demonstrates the most thorough understanding of the value of a strategic plan, how to keep it relevant, and how to measure progress toward its goals. The original plan in 1994 has been updated annually and has been linked to a regularly produced Score Card which tracks each project through six generic phases. Unfortunately, the plan is somewhat voluminous (70 pages), lacks clear lines of responsibility, and at times contains more discussion of past success than current plans.

Conclusion

PICA Staff can only conclude that the City is less than enthusiastic about its strategic planning process. The perception that this process lacks importance will impede any future strategic planning effort.

[18] *Building Youth, Building Neighborhoods, Strategic Action Master Plan*, Philadelphia Department of Recreation, February 1995, p. 54.

METHODOLOGY FOR PROJECTING REVENUES AND EXPENDITURES

The City's ability to project revenues and expenditures has improved over the past few years. However, its methodology for projecting tax revenues and non-personnel, non-debt service expenditures remains imprecise.

Tax Revenues

In calculating 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 current 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 the projected success of collection enforcement activities.

The City also has a problem in projecting "prior year" (i.e., delinquent) collections. Projections plug in the same amount shown for expected current fiscal year collections, with minor adjustments in the out years. 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. In the past, tax revenues have often been attributed to the wrong tax year due to technical deficiencies and human error. The scale of this problem may be significant enough to render prior year collection data unreliable. The City has begun to address this issue, most significantly as it relates to Business Privilege Tax payments for new business starts.

As in the past, the City provided PICA Staff with supporting material demonstrating how tax revenue projections were calculated this year. This material was at times 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.

Non-Personnel Expenditures

The Plan's underlying obligation growth assumptions appear too optimistic. The assumptions include no growth in FY98 for all classes of expenditures other than personnel and debt service and 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 at the assumed rate, which is less than half the projected rate of inflation.

Since projections for individual departments often differ from the Plan's underlying obligation growth assumptions based on specific issues and considerations, the impact of the assumptions is limited. However, the City does not stipulate where the underlying assumptions are applied and where other considerations are taken into account. Thus, it is difficult to calculate the difference between the City's optimistic assumptions and what would occur if expenditure growth more closely tracked inflation.

CAPITAL PROGRAM OFFICE

PICA Staff continues to be disappointed by the lack of progress shown by the City's Capital Program Office. PICA Staff has patiently and continuously argued that the Capital Program Office should receive more attention from the City Administration to maximize the positive economic impact of the expenditure of capital project dollars. The City has only recently begun to give the Capital Program Office the attention it deserves.

Reorganization

Finally recognizing the long-standing need for dramatic improvement within the Capital Program Office, the Mayor, in August of 1996, signed an executive order that fundamentally reorganized the City's capital program. The capital program structure, which was previously divided between departments has now been unified. Expectations for substantive improvement are high, but results have yet to be seen.

In last year's Staff Report on the FY97-2001 Five-Year Financial Plan, PICA Staff expressed optimism about the then current improvements underway in the Capital Program Office. It now appears that that optimism was premature. Most of the improvements touted by the Administration in that Plan have yet to be implemented. In addition, the capital program staff still lacks the necessary training to operate systems that were intended to be implemented prior to the submission of the current Five-Year Financial Plan. The few improvements that have been implemented now appear inadequate and in need of modification.

Director of the Capital Program Office

The recent reorganization establishes the post of Capital Program Director and pinpoints that person's responsibility to improve the capital program. PICA Staff believes the director will need to make a Herculean effort to change the culture which currently thwarts improvement at the Capital Program Office. We hope the new director will achieve her stated aims, ". . . to manage and complete capital projects with the ultimate goal of carrying out our responsibilities faster, cheaper, and with greater quality."

Positive actions have, in fact, already occurred. The identification of systems currently failing to measure up to private industry standards and actively seeking to replace them are steps forward. The attempt to shift responsibilities from Capital Program Office employees to private industry, such as with design services, is also a positive step. The focus on increasing the skills of Capital Program Office employees by retraining was overdue, and the cultural change emanating from recruiting consultants from private industry to provide technical expertise for project management teams is applauded.

New Organizational Structure

The restructuring of the office was designed to emphasize accountability. The office is now headed by a Capital Program Director assisted by a First Deputy Capital Program Director. The office is subdivided into Capital Projects and Capital Budgets divisions, each headed by Deputy Directors.

The Deputy Director of Capital Projects is responsible for four Teams that are individually responsible for specific areas. For example, Team 1: Facility Planning & Center City Office Buildings, is responsible for One Parkway, City Hall and Family Court. The Deputy Director of Capital Budgets is responsible for the capital budget bureau, two account management teams, and two capital project coordination teams.

Gauging Performance

The City continues to measure current Capital Program Office performance by comparing it to performance at the time of the City's financial crisis, when the capital program effectively ceased to exist. PICA Staff points out that this is akin to celebrating the health of a severely ill person in comparison to one recently deceased.

PICA Staff recommends measuring the success of the Director and the new Capital Program Office by the speed with which the City deals with its current backlog of 337 projects valued at over $247 million. The Director has indicated that the City anticipates completing 50% of the backlogged projects in FY98 and the remaining balance by the end of FY99. PICA Staff believes that this goal is commendable and achievable and intends to closely monitor performance.

Conclusion

PICA Staff is of the opinion that the reorganization and the appointment of the new Director is a positive step toward improved performance of the capital program. However, the City must continue to support initiatives designed to institutionalize efficiencies. There is now a glimmer of hope that the Capital Program Office will begin to embrace improvements to its processes and procedures and thus share in the managerial successes attained by most other City departments and offices in recent years.

TAX LIEN SALE

The City and the School District of Philadelphia continue to move forward on securitizing (i.e., selling) a large portion of their property tax liens. This initiative, which has been postponed until June, is expected to both accelerate and increase collections on outstanding liens. It is also expected to significantly reduce the backlog of delinquent properties on the tax rolls and increase future taxpayer compliance.

Structure of the Sale

There are $337 million in outstanding property tax liens against delinquent properties in Philadelphia. The City is responsible for collecting on these liens for both the City and the School District. However, the City is unable to adequately pursue collections on these liens given the current size of the backlog. Therefore, the City and School District plan to securitize $190 million of those liens and turn collection responsibility for them over to a private firm.[19]

The City and School District will sell their liens to the Philadelphia Authority for Industrial Development (PAID), a quasi-public City agency, which will purchase them with proceeds from a bond issue. The bonds will be paid off with money generated through the collections process. This way, the City and School District can enjoy the proceeds from what can be considered a liquidation of these assets.

The size of the bond issue is limited to 75% of the face value of the liens. This means that the bond issue should produce $142.5 million in proceeds ($190 million x 75%). As the proposal currently stands, the School District will get all of its share of the bond proceeds up front ($78.4 million) while the City will take only about 47% of its proceeds up front ($29.9 million). The rest of the City's share will be provided to the City over a five-year time period, through a process of Senior Note redemptions, at a rate estimated to be equivalent to what the City would have recognized if it had kept the liens and pursued collections through its standard methods.

The City and the School District will both hold subordinated notes to benefit from any amount collected above the redemption value of the bonds.

There are Risks Involved

PICA Staff is concerned about the risks this sale poses to the City's real estate market, bond rating, and future delinquent property tax collections.

Given the City's economic climate, particularly in the real estate sector, it is unknown whether even a private contractor will be able to collect 75% of the face value

[19] The size of the securitization is subject to change, particularly as delinquent taxpayers hear about the impending effort and voluntarily remit or enter into payment agreements.

of the liens. The City expects that many of the liens will be paid off by the current owners of the respective properties, since, for individual owners, paying the delinquent bill is probably less expensive than losing the property through foreclosure.

If collections do not meet expectations, an outcome possible but considered unlikely by both the City and the Standard and Poor's Corp. bond-rating agency, resulting bond defaults may harm the City's credit rating. Given the City's recent hard-earned rating upgrade, such a result would be unfortunate.

The Five-Year Plan projects delinquent property tax collections to remain at the FY96 level of $30 million, much higher than the $24 million average for the four fiscal years ending FY95. The City claims that this higher rate of collections is reasonable based on the numerous changes it has made to the delinquent collections and sheriff's sale processes. The City has also raised the interest rate charged to delinquent accounts, accelerating the growth of individual account receivables.

The Plan does not take into account the planned securitization. It remains unclear how the securitization will affect the collection of outstanding delinquents and whether it, along with the increased interest charges, will result in greater tax compliance, raising current collections while reducing prior collections in the out years. The City expects total real estate-tax collections to increase as a result of the new efforts.

The School District is Using this One-Time Revenue to Cover an Operating Deficit

While not directly related to the City's Five-Year Plan, PICA Staff is concerned about how the School District is using its securitization proceeds. Unlike the City, which has committed to using its one-time increase in revenues for one-time expenditures related to economic development, the School District is using its one-time revenue as operating revenue, temporarily papering over an operating deficit which will re-appear in the future. In fact, it is planning to use $22 million in proceeds from the securitization to balance this year's operating budget, even though the sale has not yet taken place and has been postponed numerous times. Another $18 million is proposed to be spent in next year's operating budget.

The School District is attempting to copy the City's model of recognizing half of the securitization proceeds over a five-year period, at a rate that it would have recognized those revenues had there not been a securitization. Since it apparently needs to recognize all of the bond proceeds immediately, the School District expects to set up its own reserve using approximately half of its share of the bond proceeds, to be recognized as a budget source over the next five years, thereby achieving the same result the Senior Note redemption process does for the City. Given the fluidity of the School District's arrangement, there appears to be no guarantee that this money will not be used all at once in a time of budgetary pressure, opening up future School District budget holes.

Pennsylvania Intergovernmental Cooperation Authority

**STAFF REPORT
ON
FY1998-FY2002
FIVE-YEAR FINANCIAL PLAN**

NON-GENERAL FUND CONCERNS

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THE SCHOOL DISTRICT OF PHILADELPHIA

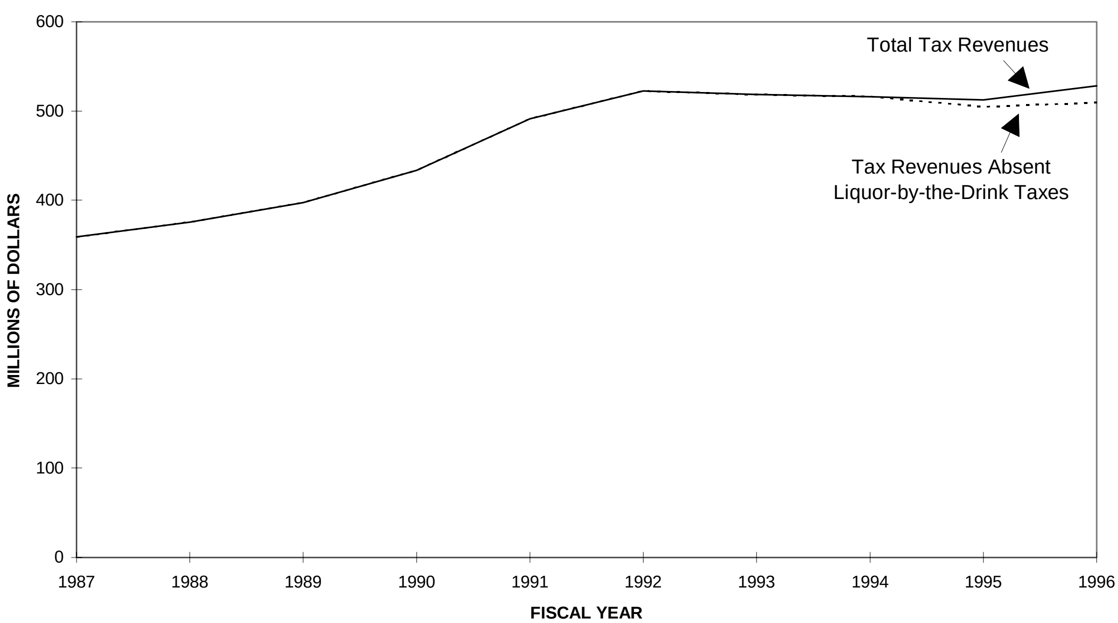
The School District has suffered from a stagnant tax base since 1992, with the exception of the Liquor-by-the-Drink Tax enacted in 1994. During this time, the District has also experienced a 9% increase in student enrollment. As a result of the increased service demand and the decreased local ability to pay for costs, the School District, in conjunction with the City, has filed a lawsuit against the State for increased State funding.

For FY98, the District proposes a zero-growth budget that, given the limitations on funding sources, relies on significantly more funding from the State than was allocated in the State budget approved earlier this month. Unless the State provides more funding or the District cuts costs more than currently planned, the District will end the year with a significant deficit.

The Local Tax Base Remains Flat while Demands on the District Grow

The School District of Philadelphia relies on tax revenues for most of its local funding. The two main sources of tax revenue are the Real Estate Tax and the Use and Occupancy Tax, both of which are calculated based on property assessments. As noted in the Economic Development section of this report, property assessments in Philadelphia have been relatively flat for a number of years, particularly in the commercial and industrial sectors, upon which the Use and Occupancy Tax is levied.

The School District of Philadelphia
Local Tax Revenues Have Been Stagnant Since 1992



As demonstrated by the graph on the previous page, in FY96 the Liquor-by-the-Drink Tax, which generates approximately $20 million annually, helped keep tax revenues above historic lows. However, it did not significantly alter the District's reliance on a shrinking tax base.

Simultaneous to the declining tax base, School District enrollment has been rising, from less than 190,000 students in 1990 to over 210,000 students last year. For next year, over 216,000 students are expected. Additionally, full-day kindergarten has been instituted District-wide. Without significant cuts or savings elsewhere, the District cannot afford these increases next year absent an increase in revenues.

The District is Budgeting for more State Funding than the State Budget Provides

In February, the Superintendent presented a proposed budget to the Board of Education that included $52.8 million more from the State than the governor at that time proposed in his budget. The final State budget approved last week included approximately $12.5 million more for the District than the governor's original proposal, mostly for special education programs. It is unclear how the final State budget affects the amount originally requested by the District. However, the budget gap is still significant.

Even so, the District and the City are pressing ahead with a new lawsuit against the State for equitable funding. This suit joins the desegregation case currently before the State Supreme Court and at least one other major case pending in State court regarding State funding of public education. Given the facts that the desegregation case has continued for so long and that the State is currently attempting to deal with a judicial mandate to fund a unified State court system, it seems highly unlikely that in the near future the State will be forthcoming with as much funding as the District is requesting.

The School District argues that it has cut costs by as much as is reasonable. Indeed, in just the past year, the District has eliminated 200 administrative jobs and claims to have saved $12 million in just the first year following the final report of the Private Sector Task Force on Management and Productivity. On the revenue side, the City has enacted the $20 million Liquor-by-the-Drink Tax and provided two $15 million grants over the past two years. The School District will also be using a total of $40 million in one-time revenue from the Tax Lien Securitization to cover operating deficits in FY97 and FY98. (See this report's section on the Tax Lien Sale for PICA Staff's concerns about how the School District is planning to use its proceeds from this transaction.)

Given the City's financial situation, it is unlikely to provide ongoing support to the School District. Additionally, with the City's need to emphasize reductions in the costs of living and doing business in Philadelphia, the City is unlikely to enact new taxes to support the schools.

If no new funding is forthcoming and the School District is unable to cut costs further, the School District will end the next fiscal year with a significant deficit.

SOUTHEASTERN PENNSYLVANIA TRANSPORTATION AUTHORITY (SEPTA)

SEPTA plays an integral role in Philadelphia's economy, providing transportation to large numbers of commuters and to residents without alternative methods of transportation. SEPTA also employs approximately 9,600 individuals and spends millions of dollars locally each year on infrastructure investments. SEPTA's viability is crucial to the City's future, particularly as welfare reform requires more individuals without private transportation to look for and find work.

The City's direct financial link to SEPTA includes a $55 million annual operating subsidy and a few million dollars more in capital funding.

The PICA Staff Report on last year's Five-Year Plan touched briefly on the known and potential State and Federal funding cuts to SEPTA. Over the past year, a number of funding changes have taken place, leaving SEPTA somewhere between what would have been the worst case funding scenario and where it was previously.

Federal Funding

President Clinton's proposed budget does not include any operating subsidy for mass transit agencies such as SEPTA. SEPTA, however, expects that the final Federal budget will include at least a portion of the $12.5 million in operating money it has received over the past two years.

In place of the operating subsidy cuts, the president's proposed budget increases available capital funding and broadens the scope of expenses that can be covered with Federal mass transit capital funding. In its proposed FY98 budget, SEPTA expects to apply $10 million of such funding to what it now considers operating expenses. It is uncertain whether both the operating subsidy will be continued and the new capital funding will be provided, as SEPTA projects. However, the Federal funding process is not as predictable as the State process.

State Funding

The recently enacted legislation that increased the State gasoline tax had a provision allocating no more than $75 million annually to public transit capital expenditures statewide, through a dedicated portion of State Sales and Use Tax collections. Additionally, the governor committed to provide another $75 million to mass transit annually, as long as he is in office, although he has not specified from where this funding will come or how it will be allocated. It is expected that SEPTA will receive $93 million of the total $150 million being provided through these two measures.

This is good news for SEPTA, which did not see an increase in its basic State-provided operating subsidy in FY97 and lost $200 million in capital funding that had been promised by the previous governor over the FY96 and FY97 budget years. SEPTA may also lose $12.3 million in Act 26 funding for capital-related projects in FY98 as a result of the electric utility deregulation legislation that allows utilities to accelerate the depreciation of certain assets, lowering the tax collections on one of the sources of Act 26 funding. The deregulation bill substituted a compensating tax revenue stream beginning in FY99, so that this loss is not recurring.

Compared to last year's concerns as to serious funding shortfalls and the potential for increased fares, SEPTA is in a stable situation. However, SEPTA continues to suffer from declining ridership and has a continuously growing wish list of service provisions that cannot be met in the near future without greater operating subsidies. SEPTA also has a litany of pressing capital projects it could pursue if it had more capital funding.

SEPTA's Future

With new rail cars and further improvements expected soon for the Market-Frankford Elevated Line, improved track and other infrastructure along some of the Regional Rail lines, a fleet of new buses, and new management, SEPTA appears to be at a decisive point in its history. If it can meet the changing transportation needs of the region, improve the reality and image of low productivity, anticipate the political consequences of its actions, continue to access appropriate levels of subsidies, and maintain competitive fares, SEPTA will prove to be one of the City's and region's strongest assets into the future.

PHILADELPHIA GAS WORKS

The most significant challenge confronting the Philadelphia Gas Works (PGW) is preparing for private market competition. The debt-laden municipal utility could very likely be outmaneuvered in a free market. Although the current management is confident that they can operate effectively in a competitive market, PICA Staff is not convinced. PGW is subject to political pressure, union challenges, a high debt load, and significant numbers of delinquent accounts. As a publicly owned utility, PGW does not have the flexibility that its private market competitors have.

Competition will Require more Competitive Prices

Given the utility's current price structure, PGW may not be able to compete with private providers in the residential market. Currently, PGW's heating customers pay significantly more than suburban Peco Energy gas customers for the same amount of gas.

In an open market, PGW also may not be able to continue its subsidy programs for senior citizens and low-income customers. In 1996 alone, the total cost for these subsidy programs was $58.5 million, more then 10% of PGW's operating revenue. More strikingly, the cost of these subsidies was 86% higher than PGW's net income of $31.5 million.

Competing energy utilities have already moved into the non-residential market and offer lower rates then PGW. *The Philadelphia Inquirer* in 1996 did an extensive three-part series detailing many of the challenges confronting PGW. One of the findings of the series was,

> PGW has already seen much of its industrial load flee for cheaper alternatives. Almost all of its large customers buy their gas from brokers, whose costs are lower than those of regulated utilities such as PGW.[20]

Another telling example of how severe the competition will be is the July 1995 testimony of Harold Connelly, former vice president of PGW, that competition would erode PGW's customer base "within a year or two, if that."[21]

On March 27, 1997 a bipartisan coalition of State legislators proposed introducing competition in the residential natural gas market. Currently, competition is allowed only for non-residential users. The proposal is similar to last year's legislation that deregulated the electric industry. For PGW, this only serves to heighten the level and pace of competition.

PGW's High Debt Load is Debilitating

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[20] Andrew Maykuth, "The heat is on the gas works," *The Philadelphia Inquirer*, February 18, 1996, p. A1.
[21] Ibid.

PGW has a high debt load which has severely limited its access to capital. PGW's debt-to-equity ratio remains a severe 3.3 to 1, down from the prior year debt-to-equity ratio of 3.7 to 1. By comparison, Citizen Gas of Indianapolis, a respected municipally owned gas utility company, has a debt-to-equity ratio of 1.8 to 1. The high outstanding debt load and low bond rating have placed serious limits on PGW's ability to access capital.

In 1996, PGW was able to fund 54% of its capital expenditures through internally generated funds. For two years PGW has not entered the capital market, and PICA has been told that PGW does not anticipate entering the capital markets for at least another year.

PGW has a Strategic Plan

PGW's management has enacted a strategic plan with the ultimate goal of creating a competitive private market culture. But changing an institutional culture as ingrained as PGW's takes time. Still, the strategic plan appropriately emphasizes customer service, core business growth, cultural transformation, efficiency and cost reduction, and new business opportunities.

PGW is Aggressively Pursuing New Customers

PGW has also aggressively pursued new customers and business opportunities. One major success is the partnership with Allegheny University to build and operate an energy plant for its Hahnemann campus. After an open bidding process, which included a number of private sector energy suppliers, PGW won the bid. Included in the arrangement is a provision giving PGW options to be a service provider to other Allegheny University sites. PGW won the bid based on its high level of service, even though its price was higher than some of the competitors.

In an effort to win accounts, PGW has also formed a partnership with the American Gas Association to set up a financing mechanism to convert potential customers to natural gas.

PGW has Increased Collections

Another notable recent success is that PGW has increased collections. PGW has stepped-up collection procedures, which include placing liens on property served by PGW on which the customer is delinquent. One PGW official projected a resulting 10% to 20% decrease in delinquent accounts receivable this year alone. This is in addition to a drop in accounts receivable from $228 million in March 1995 to $187 million in March 1996. Even with the progress, though, outstanding delinquent accounts receivable remain high.

Conclusion

Notwithstanding PGW's current success, PGW is structurally at a competitive disadvantage. Given the subsidies it is required to provide, a decreasing captive customer base, a high debt load, and a burdensome structure of governance, PGW cannot easily cut costs or react quickly to a changing market. Even if PGW successfully woos several large commercial accounts, the business practice of subsidizing those costs will work only in the near term.

At this stage, PGW recognizes that it cannot compete in the residential market on price alone and has opted to focus on providing a high level of service. However, natural gas is a commodity and consumers may well seek the lowest price with only transient consideration of service, as many commercial and industrial entities have done.

PICA Staff is concerned that PGW, which as recently as a few years ago was regularly being touted as a potential source of "windfall profits" to the City through sale and privatization, may now have entered an era in which its potential becomes increasingly negative as a significant drain on the City's financial and competitive status.

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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 26, 1997, was submitted to PICA by the Mayor on April 30, 1997 and the PICA Act provides a 30 day period for review which expires May 30, 1997. 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, 1997 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 30, 1997.

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 23, 1998 (100 days prior to the end of FY98). At that time, the City is required to add its Fiscal Year 2003 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 initial years of existence has been to assist the City to avoid insolvency; to provide the funds directly required for that purpose and for essential capital programs; and to oversee the City's efforts to lay a sound foundation for its return to fiscal stability. The negotiation of the Cooperation Agreement to set out the basic terms of the City-PICA relationship, the PICA sponsored effort resulting in the establishing of the format and content of the Five-Year Financial Plan process, and the issuance of bonds to provide funds to assist the City to stabilize its finances were all major accomplishments. Successful defense against challenges to the constitutionality of the PICA Act was another vital PICA process component. PICA's annual assessment of Plan progress, successful challenges to overgenerous prior Plan revenue estimates and suspect methodologies, evaluations of City reporting, and analysis of City practices and programs have assisted in the ongoing City improvement as envisioned by the PICA Act.

PICA also provides continuing oversight as to the encumbrance by the City of PICA provided capital funds for capital projects deemed required to rectify emergency conditions or necessary for Plan operational success.

PICA has provided in excess of $1,102 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	444,593
Retirement of Certain High Interest City Debt	381,300
TOTAL	$1,102,093

PICA's authority to issue new money debt has expired. PICA anticipates that its future activities with respect to the City will focus more closely on oversight on the City's efforts to maintain financial balance, further institutionalize management reforms (both those initiated to date and those still to be made) and to implement ongoing operation changes in accordance with the City Strategic Plan.

The City has 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 improvements.

Whether PICA will also become involved in the financial oversight of the School District of the City Philadelphia is a matter that presently is in the hands of the Supreme Court of Pennsylvania.

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 1998. During future months, the Authority will receive quarterly reports on the City's performance under the Plan, together with other data.

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

> <u>Quarterly Plan Reports</u>. The Authority receives reports from the City on a quarterly basis (45 days after the end of each fiscal quarter) concerning the status of compliance with the Plan and associated achievement of initiatives. The remaining quarterly reporting deadline for FY97 is August 14, 1997. Quarterly reporting deadlines for FY98 are November 14, 1997, February 16, 1998, May 15, 1998 and August 14, 1998. The Cooperation Agreement also requires that the City provide reports to PICA concerning Supplemental Funds (*i.e.*, the Water and Aviation Funds) on a quarterly basis.
>
> <u>Grants Revenue Fund Contingency Account Report</u>. The Cooperation Agreement provides that a report on the Grants Revenue Fund

Contingency Account be prepared and submitted, by department, not later than 20 days after the close of each fiscal quarter, and still to be received relating to FY97 is the report due July 21, 1997. For FY98, the reporting dates are October 20, 1997, January 20, 1998, April 20, 1998 and July 20, 1998. This report details the receipt and use of Federal and Commonwealth Funds by the City, as well as the eligibility for fund withholding by the Commonwealth at PICA's direction in the event the City cannot balance the Plan after an extended period of intensive reporting and PICA review of proposed corrective efforts.

Prospective Debt Service Requirements Reports. The Cooperation Agreement requires submission of a report detailing prospective debt service payments by the City, as well as lease payments, 60 days prior to the beginning of a fiscal quarter. The dates for submission of such reports for FY98 are August 3, 1997, November 2, 1997, February 2, 1998 and May 1, 1998.

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 May 12, 1997 (in conjunction with receipt of the Controller's Opinion on the Plan and report upon the performance of agreed upon procedures) are reproduced in the Appendix. Many 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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GENERAL ECONOMIC FORECASTS

The Controller's forecast of local economic activity is roughly consistent with the assumed growth implicit in the Plan's revenue projections. Our forecast assumptions are predicated upon 1) continuation of the Wage and Business Tax reductions proposed throughout the life of the Plan, and 2) continued strength in the national economy.

Employment and Wages

Over the last year, employment gains made in local service and information producing sectors have offset losses in goods production, yielding a flattening pattern in city payroll employment. Consistent with the Plan, we expect this pattern to continue through the next five years. Uncertainty surrounding local merger and acquisition activity (e.g. Conrail and Bell Atlantic) does pose a potential risk to the improvement in the employment picture. However, to date, the details of such restructuring have not been released.

The Controller is less optimistic than the Plan regarding future wage growth for four reasons. One, average wage growth has generally followed a counter cyclical pattern -- rising during periods of heavy job loss and contracting during periods of growth (or less severe job loss). Given our projection of local employment, we expect average wage growth to falter. Two, local economic development efforts have generally fostered growth in the low wage hospitality sector. Three, consistent with the empirical research which has found that the Wage Tax is capitalized into local wages, future Wage Tax reductions are likely to result in less inflationary pressures on wages. And four, a necessary condition of the Welfare changes will be greater labor force participation, which puts downward pressure on wages.

Retail Sales and Prices

Primarily due to improvements in hospitality related retail sectors offsetting declines in other retail sales activity, we anticipate real trade volume to remain flat through FY 2002. Thus, we expect nominal sales growth to trend consistently with retail price changes, which, due to increasing competition, have remained very low by historical patterns. By contrast, the Plan assumes slightly higher than inflationary growth in the out years.

Real Estate Market

The Commercial and Industrial markets have been impacted by two offsetting patterns. Specifically, technological improvements in the labor and capital markets have continued to reduce the need (demand) for space. By contrast, favorable prices, which were generated by the slack demand, have induced some speculators to jump into the real estate market.

The Plan assumes that the speculation activity will outweigh the disinflationary pressures from technology. In an effort to be more conservative, the Controller's Office is assuming that the two forces will completely offset one another, yielding flat market values throughout the life of the plan.

The residential market is generally driven by employment and income growth in the local area. Thus, our improved outlook in the labor market is likely to be borne out in a bottoming out of residential real estate values over the next few years.

GENERAL FUND REVENUES

Wage & Earnings Tax

The Controller's Forecast of Employment is slightly more optimistic than assumed in the Plan. However, our assumption of wages paid to labor is less aggressive. The product of the two yields base growth estimates that are roughly consistent with Plan assumptions.

Current Real Estate

The Plan assumes that increased assessments driven by improved market conditions and equalization efforts will be met by a moderation in appeal losses throughout the life of the Plan. While the Controller's office agrees with some modest improvement in real estate market activity, it is likely that the Plan's assumption of moderating appeal losses is too aggressive.

Local Economic Revitalization Tax Assistance Act (LERTA) Challenge

A current court challenge to LERTA, which enables the city to provide tax exemptions to property owners making improvements to their property, could dampen tax collections. The Plaintiffs are challenging the timing of the exemptions under LERTA. Under the existing ordinance, exemptions begin the year following the issuance of the building permit. Citing a Commonwealth court decision which invalidated a similar ordinance in Erie County, the plaintiffs argue that the exemptions should begin the year after actual completion of construction.

The Board of Revision of Taxes (BRT) estimates that this challenge, which will likely pass through several lengthy stages of litigation, could cost the city nearly $38 million if upheld.

Personal Property Tax

The constitutionality of the State Personal Property Tax has been challenged on the grounds that the *exemption for Pennsylvania assets* violates interstate commerce issues. Philadelphia has enacted legislation that would impose a tax on intangible personal property without the exemption for Pennsylvania company assets. This new tax legislation, which would leave the city *revenue neutral,* would only take effect if the city's levy of the State Personal Property Tax is ruled unconstitutional.

Riverboat Gambling

The Plan assumes revenues from the Riverboat Gambling and Wagering Tax of $17.5 million in FY 2000, $35 million in FY 2001, and over $36 million in FY 2002. There is a great deal of uncertainty pertaining to the probability of legislative approval of this tax and even more uncertainty regarding the structure this tax will follow if enacted.

First Judicial District of PA
Consistent with the ruling in *Pennsylvania State Ass'n of County Commissioners, et al. v. Commonwealth et al., 681 A.2d 699(1996)*, the Plan assumes that funding for county court costs will be taken over by the Commonwealth in the second half of FY 1998. Since there is a lag between expenditures and revenues, the impact on General Fund revenues will not be felt until FY 1999. The specific line items which would be affected are: reimbursements to the First Judicial District for *Intensive probation* and *Reimbursement for court costs* within Revenue From Other Governments (which totaled over $15 million in FY 1998); and *Court Costs, Fees, and Other Charges* within the Locally Generated Nontax component of the city's General Fund (over $13 million in FY 1998).

The General Appropriations Act of 1997 failed to include any increase in funding for the First Judicial District. Since the Commonwealth has not appropriated the money, the city may be forced to continue with its current financial arrangement. This would cause the Plan to be extremely out of compliance in FY 2000-2002.

Department of Human Services
Federal funding to DHS will be drastically altered under the new Personal Responsibility and Work Opportunity Reconciliation Act. Beginning March 1, 1997, Title IV-A entitlement spending will be rolled into a fixed allocation to the states under the new Temporary Aid to Needy Families (TANF) Block Grant. The Plan assumes that reduced funding to DHS as a result of Welfare changes are *expected* to be met by additional moneys under Title IV-E and the Commonwealth under its Act 148 obligation. To date, a great deal of uncertainty remains as the Ridge Administration has provided little clarity regarding reimbursements to DHS under the new TANF Block Grant and how they would account for any shortfall.

Consistent with Plan assumptions, the Controller's Office assumes that roughly two-thirds of any shortfall in funding under TANF will be picked up by the Commonwealth under its Act 148 obligation. If this *hold harmless* arrangement is not met, the city should be inclined to pursue the additional dollars through litigation.

GENERAL FUND OBLIGATIONS

Base Methodology
The city's General Fund Obligations growth assumptions as presented in Appendix V - Base Methodology - of the Five-Year Plan are deficient and misleading. The obligations as shown in Appendix III of the Plan increase at a greater rate than those presented in Appendix V.

In particular, the 200 Class - Purchase of Services - projected growth rate is the most misleading. The base methodology shows 200 Class obligations increasing by 1.5%

annually over the life of the Plan. However Appendix III shows these obligations to be increasing at an average of approximately 3.4% annually.

Payroll
The Plan makes no provision for police salary increases beyond FY 1998. Given that both the non-uniformed and fire fighter unions have negotiated salary increases through FY 2000, it seems unrealistic to think that police officers will not receive an additional increase in FY 1999. In addition, the Plan does not provide for any salary increases for Non-Uniform and Fire-Fighter Unions beyond FY 2000.

First Judicial District of PA
Consistent with the Supreme Court's 1996 directive, the Plan maintains full funding for the First Judicial District of PA (FJDP) in the proposed operating budget for the first half of FY 1998 only. Effective January 1, 1998, no further appropriations to the FJDP will be provided. From that date forward, the FJDP must look to the General Assembly of PA for funding.

In the Controller's Office *1997 Mid-Year Economic and Financial Report*, we made the assumption that the city would continue funding for the FJDP for the full year. Recent information from the state shows that the General Appropriations Act failed to include any increase in funding for the First Judicial District. As a result, increased state funding of the FJDP remains uncertain.

Debt Service
Based upon our examination of the current General Fund General Obligation Bond maturity registers and the related debt service schedules, we estimate General Fund Debt Service Obligations are over-budgeted throughout the life of the Plan.

The Plan estimates the city's short-term borrowings will be $300 million with an interest rate of 6%, each year through FY 2002. Given that the last short-term note sale had an interest rate of 4.75%, we believe that the estimated 6% rate may be overly aggressive.

The Plan also includes commitment fees of $1.5 million annually over the next five years. The city has not utilized any type of credit enhancement for the last two (2) short term note sales. We question whether the city will utilize credit enhancements for its TRANS in future years.

Indemnities
In 1993, the Association of City Management, a membership organization whose purpose is to represent the interests of non-represented civil service employees filed suit against the city seeking reinstatement of Automatic Flex Credits. In October 1996, the Court of Common Pleas ruled in the plaintiff's favor and ordered the city to reinstate the automatic flex credits and make retroactive payments to all non-represented employees. As written, the order could cost the city $4 million to $14 million.

In 1990, a lawsuit was filed against the city alleging that DHS had violated the constitutional rights of children under its care. The lawsuit claimed that these children were not being provided adequate services and that DHS had continuing systemic deficiencies. According to the Solicitor′s Office, the plaintiffs are not seeking monetary damage awards, but rather the implementation of system-wide changes to insure better care and services. However, there could be costs associated with these changes should the plaintiffs prevail. Some of the changes the plaintiffs are seeking include increased number of social workers, smaller caseloads and an external panel of child advocate lawyers charged with controlling contracted services.

The Plan includes no provision for payment should the city be unsuccessful in defending itself in these cases.

Another unresolved issue, which could ultimately impact the city's Indemnities budget, is the future settlement for attorney's fees from the MOVE trial. Current fee petitions submitted by MOVE's legal counsel are in excess of $10 million. However, the Law Department feels these fees will be settled for a lesser amount.

Capital Plan
We have reviewed the FY 1998 Capital Budget included in Appendix VI of the City's Five-Year Plan. Our review consisted of agreeing the Plan amounts to the City Planning Commission's six year funding schedule for fiscal years 1998-2003, and verifying the mathematical accuracy of both. In addition, we reviewed all projects in the FY 1998 Capital Budget to determine whether or not they were capital in nature.

Included in our Capital Plan review was a computation of current and future legal debt capacity. As well as a comparison of potential debt service costs of the Capital Plan with projected debt service shown in the General Fund section of the Plan.

OTHER FUNDS

Grants Fund
City management has reiterated that if funding for selected Grants Fund programs is eliminated the City will be under no obligation to cover expenditures through the General Fund. Because of constituency pressures, the City may be under great pressure to continue funding certain programs with General Fund support even if these programs lose grant funding.

Aviation Fund
In our review of the Aviation Fund, we continue to see little risk to the City for those costs centers which the City shares risk with the airlines if there is a deficit, namely the Outside Terminal Area (OTA) and the International Gates.

The Division of Aviation continues to achieve operating surpluses resulting from the OTA. These surpluses are carried in the Aviation Fund Unrestricted Cash Account. Division of Aviation representatives have stated that these holdings, plus any interest earned on these holdings, will be used to insulate the General Fund from having to contribute to the Aviation Fund through the course of the Five-Year Plan.

Water Fund

Water Department management continues to reiterate its position that there is minimal risk that the General Fund will not receive the annual “scoop” transfer of approximately $4.1 million. The Water Department continues to cut costs at both their wastewater treatment and sludge processing plants. As a result of these continued cost saving efforts and increased delinquent collections through the enforcement of the Utility Services Tenant′s Rights Act, Water Department management sees no risk in the scoop being eliminated over the life of the Plan.

Cash Flows

The cash flows presented in Appendix IV of the Plan for FY 1997 and FY 1998 are consistent with the estimates for General Fund revenues and obligations as presented in Appendix III of the Plan, and the forecasts for the monthly distribution of revenues and obligations are reasonable.