

# **Pennsylvania Intergovernmental Cooperation Authority**



**Balancing a Budget on about 10 Million Dollars a Day:  
The Fiscal Situation Facing the New Mayor**

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**PENNSYLVANIA INTERGOVERNMENTAL COOPERATION  
AUTHORITY**

1429 Walnut Street, 14<sup>th</sup> floor, Philadelphia, PA 19102

Telephone: (215) 561-9160 – Fax: (215) 563-2570

Email: [pica@picapa.org](mailto:pica@picapa.org)

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## **Balancing a Budget on about 10 Million Dollars a Day: The Fiscal Situation Facing the New Mayor**

“Oh no, it’s gotten worse.” That is the Mayor Nutter’s likely response when he assesses the financial situation facing the City. In 2006, PICA Staff wrote a report that detailed the grim financial condition that the next mayor would inherit. As this report will show, each of the factors that created that financial condition remain and some have gotten far worse since that report was issued.

Based on the approved FY08-FY12 Five-Year Plan and PICA’s analysis, here is how conditions have changed since September 2006:

### **Falling Fund Balance**

*Then:* The general fund’s balance was projected to drop \$130 million – 65 percent in three years.

*Now:* While Mayor Nutter will inherit a near record fund balance of almost \$300 million, the general fund’s balance is projected to drop \$128 million – 38.9 percent in three years. What is more troubling than the projected drop in the fund balance from FY06 to FY09 is what is likely to happen by FY13 -- the end of the final year of the next Mayor’s first five-year plan. By the end of FY13, the fund balance could have become a nearly \$200 million deficit.

### **Ailing Pension Fund**

*Then:* The City’s pension payment was projected to increase by more than \$110 million in just three years, largely driven by the increase in the City’s unfunded pension liability.

*Now:* The City’s pension fund payment in FY09 is projected to be \$154 million higher than it was in FY06, the Administration dropped from its Plan suggestions for changes to help reduce the City’s long-term liability, and the percent of the pension fund’s liabilities that are funded has dropped to under 52 percent.

### **Soaring Health Medical Insurance Costs**

*Then:* Health medical costs were projected to be almost \$80 million higher in FY09 than they were in FY06 –even if the City was successful in appealing police and fire health benefits awards.

*Now:* Health medical costs are projected to be over \$128 million higher in FY09 than they were in FY06, all four unions got at least one year of double digit increases in recent settlements and the fire award included increases that exceeded 45 percent over three years. By FY12, health insurance costs are projected to exceed \$540 million and, when combined with pension costs, are projected to consume one out of every four general fund dollars. As recently as FY01, they accounted for one out of every eight general fund dollars.

### **Increasing Long-Term Obligations**

*Then:* Long-term obligations were projected to be \$140 million higher in FY09 than they were in FY05.

*Now:* Long-term obligations are projected to be \$125 million higher in FY09 than they were in FY05.

### **Insufficient Infrastructure Investment**

*Then:* By FY09, the City would have gone eight years since it had invested even half of the amount that its own City Planning Commission recommended be dedicated towards its capital budget.

*Now:* The City will still have gone eight years without investing even half the amount the City Planning Commission recommended. In addition, the adopted capital program calls for investing less than a third of the Commission's recommended level each year through FY13.

### **Tax Structure**

*Then:* The City had a tax structure that put it at a competitive disadvantage, but had the longest annual wage and business tax reduction program in the country.

*Now:* The City still has an uncompetitive tax structure and will continue its tax reduction program. The FY08-FY12 Five-Year Financial Plan, however, proposes to end the business tax reduction program beginning in FY10.

### **Philadelphia Gas Works**

*Then:* The City included in FY09 – which was the third year of its five-year plan -- repayment by PGW to the City of a \$45 million loan. In the September 2006 report, PICA said it was unlikely that PGW would make that repayment.

*Now:* The City has received about \$22 million of the \$45 million repayment and has budgeted the remaining \$23 million in FY09, which will be the first year of the new mayor's first five year plan. While the repayment of half of the loan is encouraging, a recent Public Utility Commission award gave PGW only a quarter of the rate increase that it requested and makes it much less likely that the company's managers will be able to make the kind of changes that would be necessary to provide long-term stability for the utility.

### **School District of Philadelphia**

*Then:* The School District's financial problems had not yet become public. The District's finances were not even mentioned as a potential threat in the City's FY07-FY11 Plan.

*Now:* The School District faces persistent financial problems that make require it to seek additional funding from the City.

### **Philadelphia Prisons System**

*Then:* Rapid increases in the prisons' census were driving up costs well beyond amounts included in the budget. The Plan appeared to include too little funding to keep pace with the rapid growth in costs.

*Now:* Little has changed since last year. The census and costs are continuing to grow and the City continues to discuss formulating initiatives designed to stem the growth.

### **Rainy Day Fund**

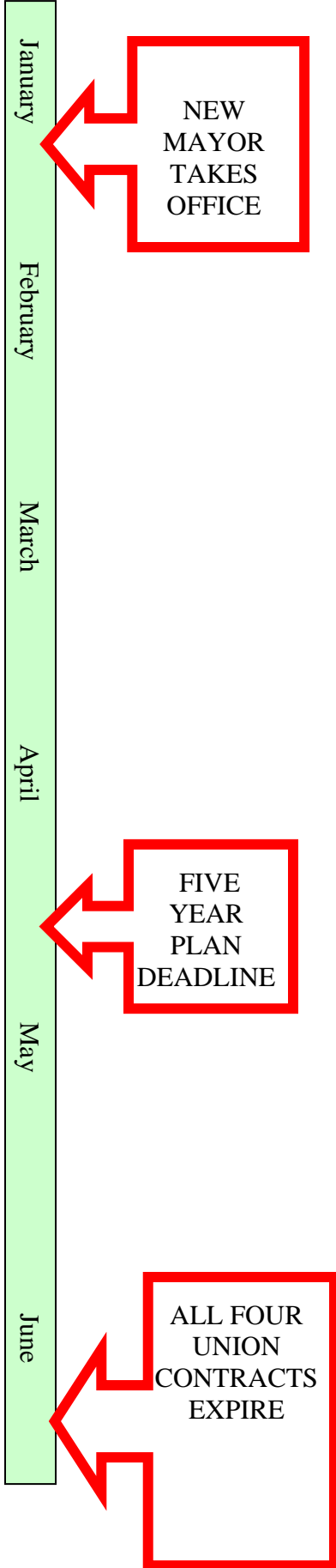
*Then:* The Administration was in the midst of negotiations to establish a rainy day fund.

*Now:* The Administration and Council were unable to agree on the establishment of a fund.

### **There Isn't Much Time**

Unfortunately for the next mayor, he must produce a five-year plan within three months of taking office and faces contract negotiations with all of the City's unions just six months after assuming office. Time will be short; the task will be daunting and the consequences enormous. The task, however, is not hopeless and this paper will explore the options that the City has for confronting these challenges.

# The New Mayor's Timeline



*The New Mayor will have to act quickly upon taking office. He will have 90 days to submit a Plan to PICA. That Plan will have to include strategies for the following:*

- Dealing with the City's increasing pension costs and unfunded liability;
- Slowing or halting the rising cost of health insurance costs for city employees;
- Ensuring the fiscal health of the Philadelphia Gas Works in a way that doesn't require additional funding from the city;
- Increasing investment in the City's crumbling core infrastructure while not accelerating the already rapid growth in the City's long-term obligations;
- Making the City's tax structure more competitive without sacrificing key city services;
- Containing the growth in the prison census;
- Helping to ensure the School District's fiscal stability; and,
- Funding new initiatives the mayor will want to implement.

*On July 1<sup>st</sup>, the collective bargaining agreements with all four of the City's major unions will expire. The Mayor will need to obtain fair and affordable contracts that address the City's pensions and health insurance issues without including excessive raises or giving up management rights that will help with controlling the size of the workforce.*

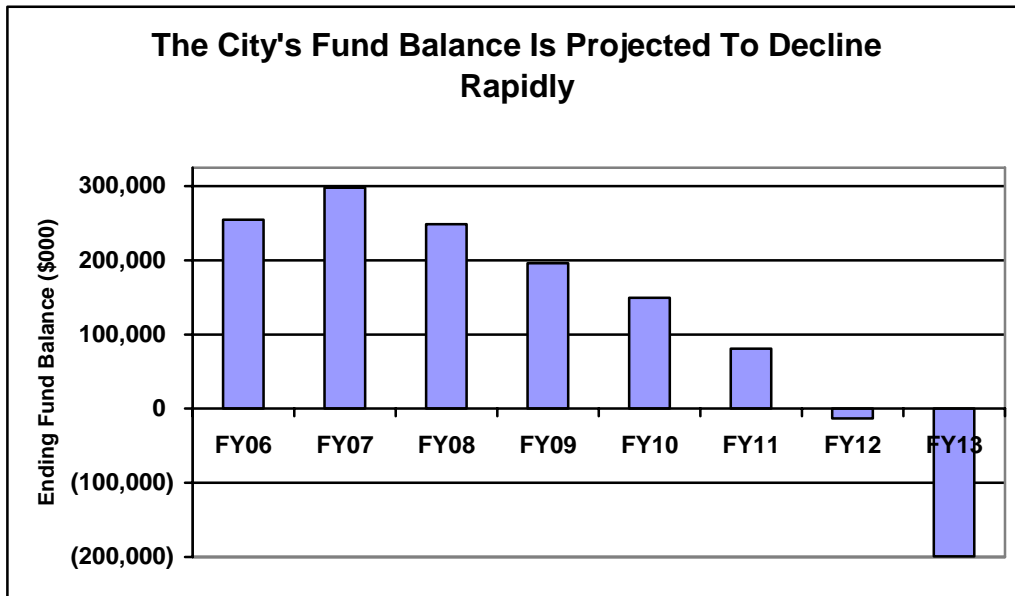
**When You Take Office, Here's What Will Be Waiting For You**

The new mayor has a strong mandate to implement change. Unless the mayor tackles the fiscal challenges facing the city, however, he will be crippled in his attempts to implement his ambitious priorities.

**Where Did All The Fund Balance Go?**

**The City's Fund Balance Is Projected to Drop Quickly**

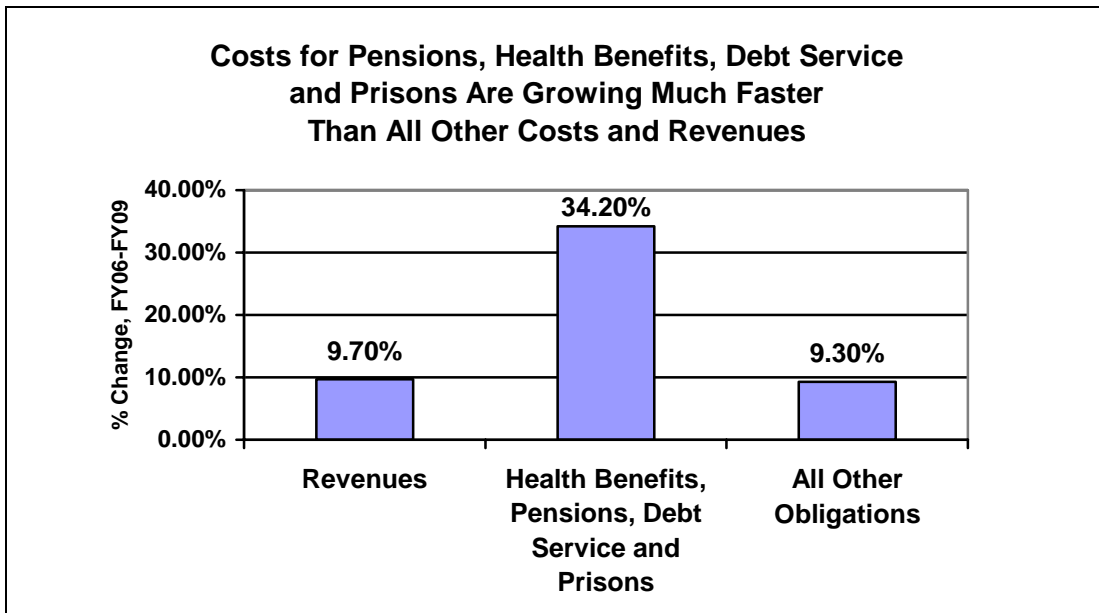
The next mayor's ability to implement his policies will depend on a number of factors, but one of the most important of those factors will be how much money the City's general fund has and how much flexibility the City has to spend that money. As of the end of FY07, the City had a \$297 million fund balance; the Plan projects that the fund balance will drop to just \$127 million in FY12. A PICA analysis, however, shows that making only minor, reasonable, adjustments to the Plan's projections and including a one percent annual increase in employee salaries, would produce a deficit of nearly \$200 million by the end of the new mayor's first plan. Each one percent increase in salaries would add \$207 million in costs to the Plan.



The numbers in the above chart make only the following changes to the Plan's assumptions: adding a one percent annual increase in wages; including the impact of the bill that provides credits against the wage tax for low-income payers and becomes effective in FY13; and, eliminating the Plan's projected FY08 indemnities and benefits savings because the City did not present clear strategies for how they would be achieved. If the City does not receive its remaining \$23 million loan repayment from PGW the numbers in the above chart would be \$23 million worse each year beginning in FY09 and the projected FY13 deficit would be nearly \$222 million.

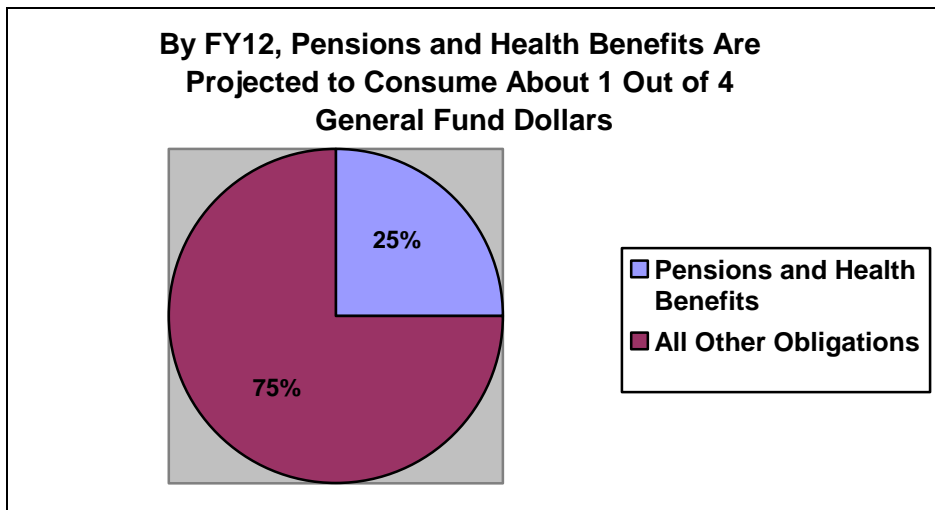
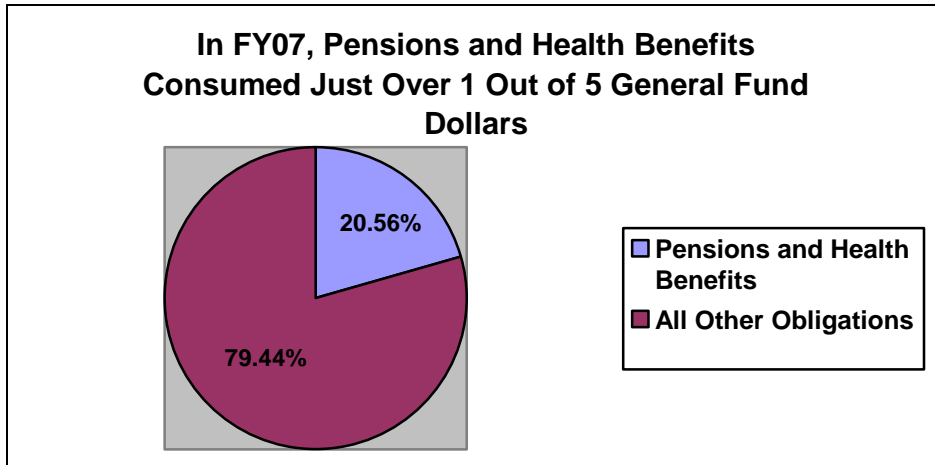
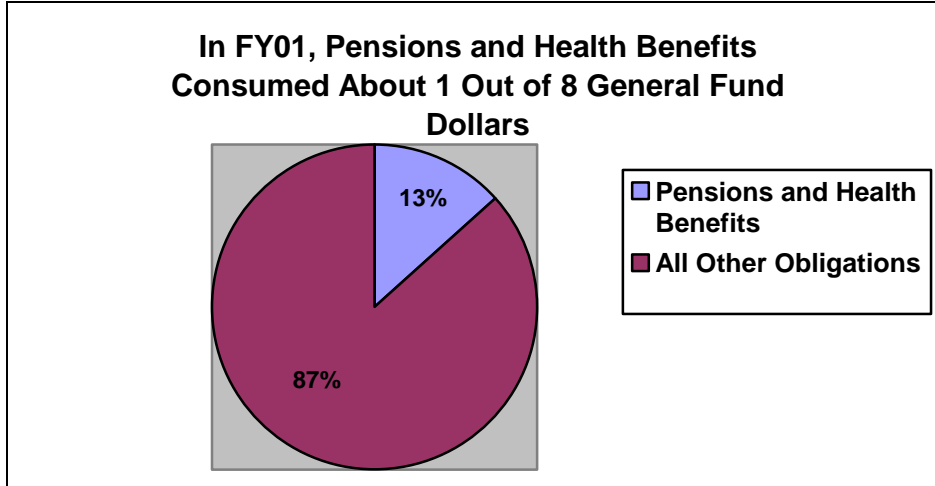
Whether the City's finances look like the graph above will depend in large part on the strength of the City's economy and the next mayor's ability to reduce the City's cost of doing business. The strength of the economy has enabled the City to continue to have steadily increasing fund balances, but the recent weakening in the national economy may mean that revenue growth will begin to slow.

If the City does begin to incur deficits it will be in large part because of rapid increases in employee benefits, prisons and debt service costs. As the following graph shows, the combined increases in those three areas from FY06 through FY09 are projected to be much faster than the growth in revenues and the growth in other obligations. The Plan projects that revenues will grow by 9.7 percent from FY06 through FY09, slightly faster than all obligations *except* health benefits, pensions, debt service and prisons. In other words, if the City were able to lower the cost of those four fast growing areas to the same rate of growth as other obligations, it would be incurring surpluses instead of deficits and could be making choices about how to invest those surpluses.



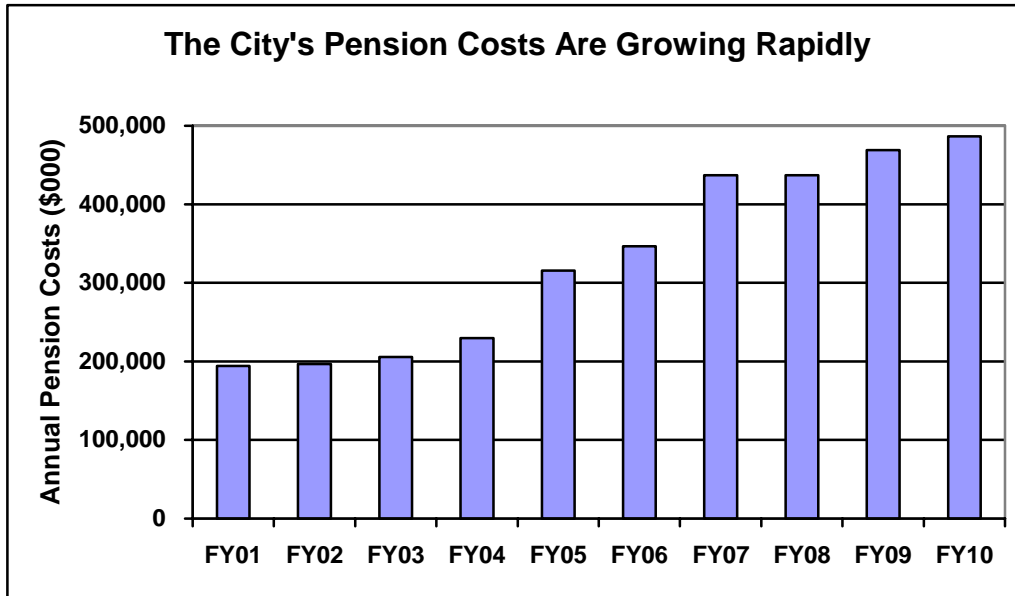
**Up, Up and Away: Employee Benefits Costs Soar Ever Higher**

As the following pie charts show, pensions and health benefits are continuing to devour more and more of the City's budget.



Pension Costs

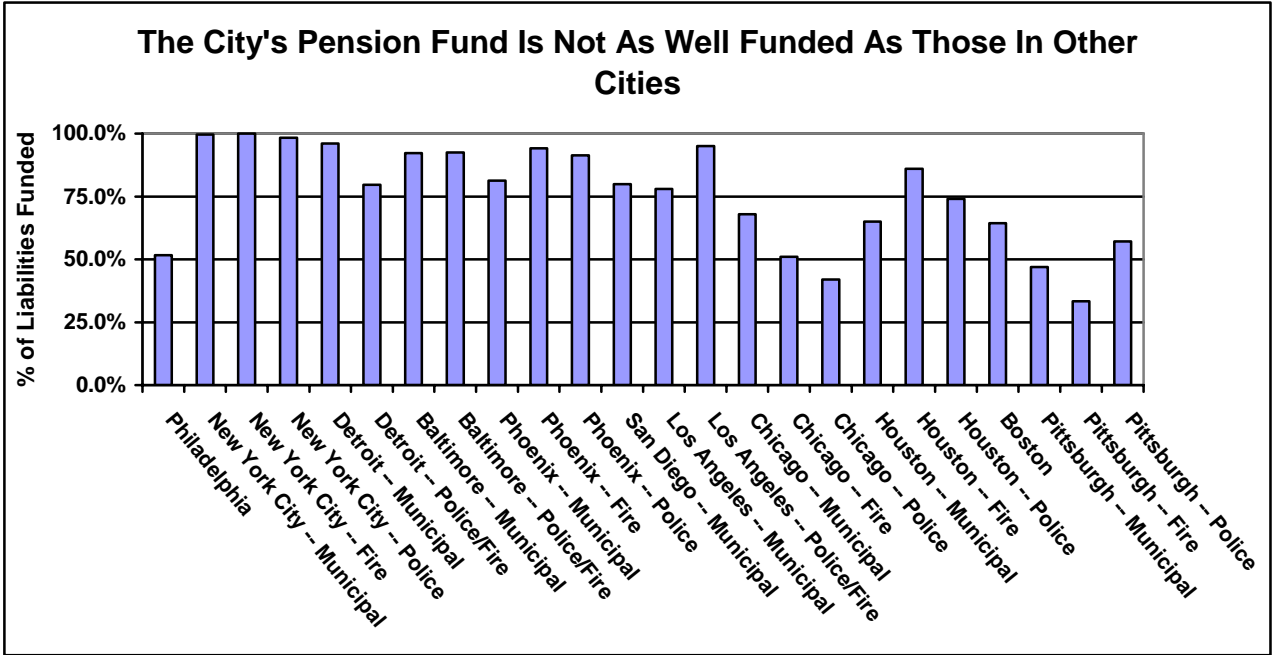
In reports, letters, and testimony, PICA has documented the financial challenges posed by the City’s pension fund. This report will focus on what those increases mean for the City’s budget. As the following graph shows, those costs more than doubled from FY01 to FY07.



Pension costs have gone up for a number of reasons including to compensate for investment losses during the stock market’s downturn and to pay for increases in the amount of time retirees receive pension benefits as employees enter retirement status earlier and live longer.

Unfortunately at the same time that the City’s pension costs have increased, the health of the fund has deteriorated. In FY01, when the City was paying under \$200 million annually, the fund was able to meet almost 80 percent of its liabilities. By FY07, when the City was paying over \$400 million, the fund was able to meet only about 50 percent of its liabilities.

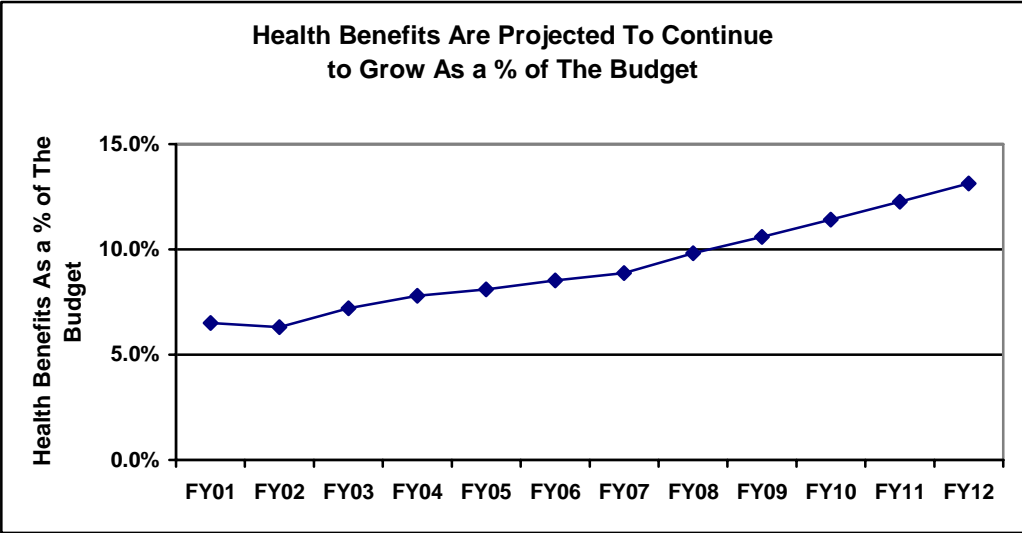
While other cities face pension challenges that are similar to Philadelphia’s, most other large cities are able to meet a higher percent of their liabilities. Because the health of its fund is worse than the health of those in other cities, the City is likely to have to take more dramatic action than other cities would have to take.



Of the 23 other funds included in the chart, 20 have better funding ratios than the City's pension fund, most by substantial percentages.

Health Medical Insurance Costs

Like governments and businesses around the country, Philadelphia's city government has seen its health medical insurance costs soar. That growth is projected to continue. From FY01 to FY07, the City's healthcare costs grew by \$140 million. From FY07 to FY13, those costs are projected to jump another \$258 million. The relentless increase in costs will mean that healthcare benefits will increase significantly as a percent of the budget – from 8.9 percent to 14.1 percent.

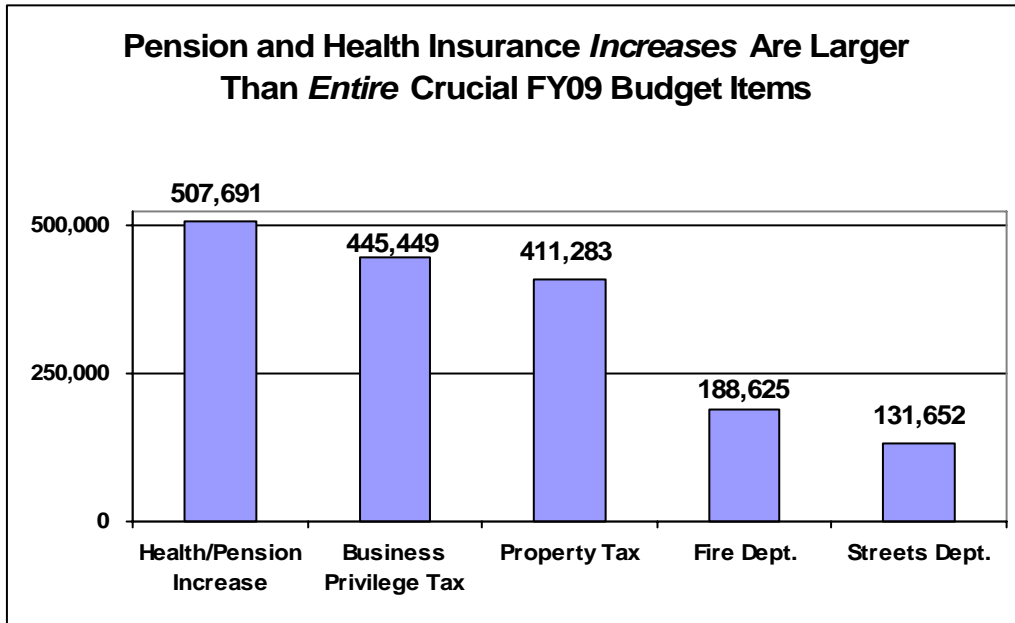


Unfortunately, the projections may be optimistic. The projections assume that the City will hold the growth in its costs to nine percent annually. That nine percent, however, would be much slower growth than the City has recently experienced. Without action to slow the growth of health benefits costs, those costs are likely to be tens of millions of dollars higher than the amounts included in the Plan.

*What Do The Increases In Pensions and Health Benefits Costs Mean for the Rest of the Budget?*

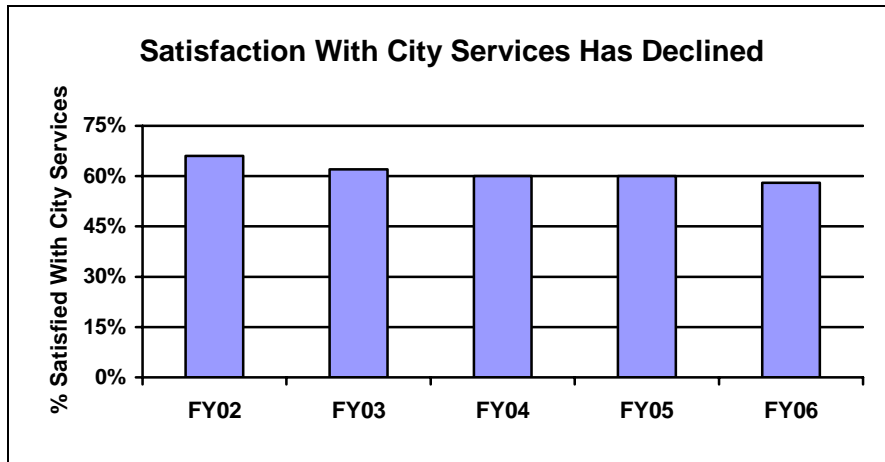
The rapid increases in pension and health insurance costs mean that less money is available for the rest of the budget. By FY09, the City will be dedicating over \$500 million more in funding to pensions and health benefits than it did in FY01. By FY12, that number will have risen to over \$650 million. To put those numbers in context, the \$500 million *increase* in health benefits and pensions costs will be more than the *entire* FY09 budgets of every City department except for the Department of Human Services and the Police Department. By FY12, the \$650 million *increase* in health benefits and pensions costs will have surpassed the size of the DHS and Police budgets and will be larger than the *entire* budget of each City department.

The following graph compares the FY01 to FY09 *increase* in pension and benefits costs to *totals* for other components of the FY09 budget.



The graph shows that all of the revenues collected from either the business privilege tax or the property tax are not sufficient to cover the costs of the FY01 to FY09 *increase* in the City’s health benefits and pensions. If those costs had been contained, the City would have had more money to make crucial investments, improve services or reduce taxes. Until the City successfully implements initiatives to curtail the growth in these two areas, the City will be unable to address successfully its long-term problems.

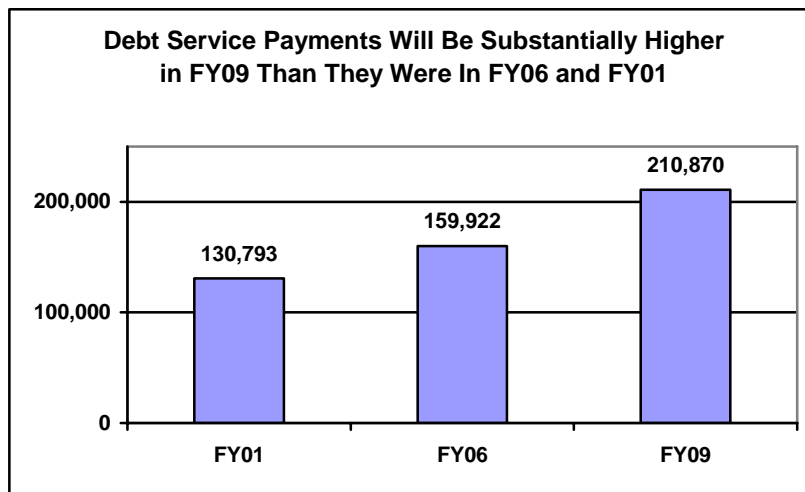
The redirection of City expenditures appears to have had an impact on citizens' perception of government services. Satisfaction with government services has decreased in all but one year since FY02.



While many City departments did show improvements in satisfaction with services in FY06, there were some areas with large decreases. The percent of respondents satisfied with police protection fell from over 72 percent to 65 percent; the percent who were satisfied with the City's efforts to demolish building dropped from 70 percent to 52 percent; and the percent who were satisfied with the neighborhood transformation initiative sank from 53 percent to 47 percent.

### **Runaway Debt: Increasing Debt Service Costs**

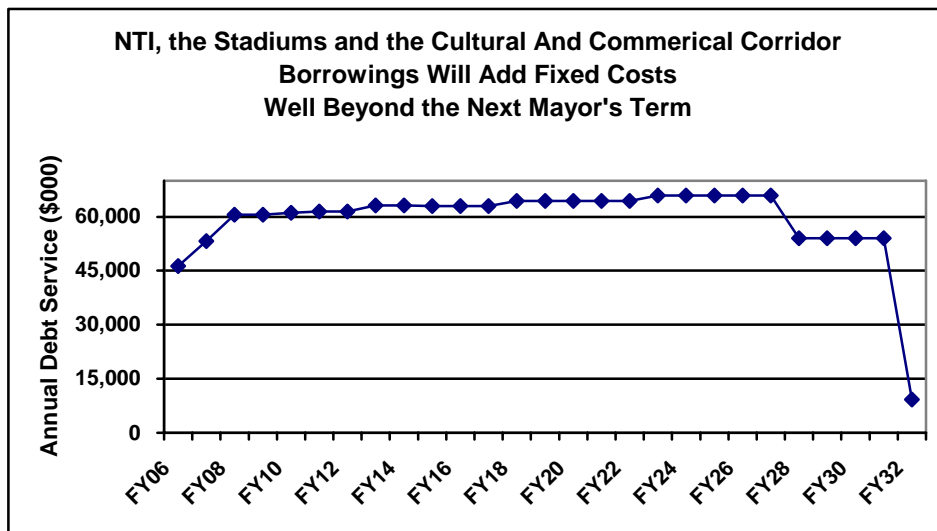
As the City struggles to find ways to keep its budget balanced and to make crucial investments, it will be constrained by the rapid growth in its fixed costs. By FY09, the City's debt service payments will be over \$55 million higher than they were in FY06 and over \$85 million higher than they were in FY01.



The reason for the increase is easy to identify: the City has radically increased its borrowing through authorities. As the City's ability to issue its own debt has declined because of limits imposed by the Pennsylvania Constitution, the City has increasingly turned to authorities to issue its debt.

Unlike general obligation debt that it borrows by itself, the debt that the City has authorities issue does not require approval from the voters. Like that voter-approved debt, however, the borrowings through authorities create a long-term financial commitment for the City's taxpayers. The payments for that authority debt have increased from \$42.5 million in FY01 to \$84.6 million in FY06 and are projected to reach \$97.3 million in FY09.

Three borrowings produced the increase in debt service costs: to fund new stadiums, the Neighborhood Transformation Initiative, and commercial and cultural corridors. While there were debates about the economic benefits of each of the three borrowings, there is no question that they created a recurring obligation that will cut into the City's financial flexibility and diminish its ability to address its infrastructure or service needs.

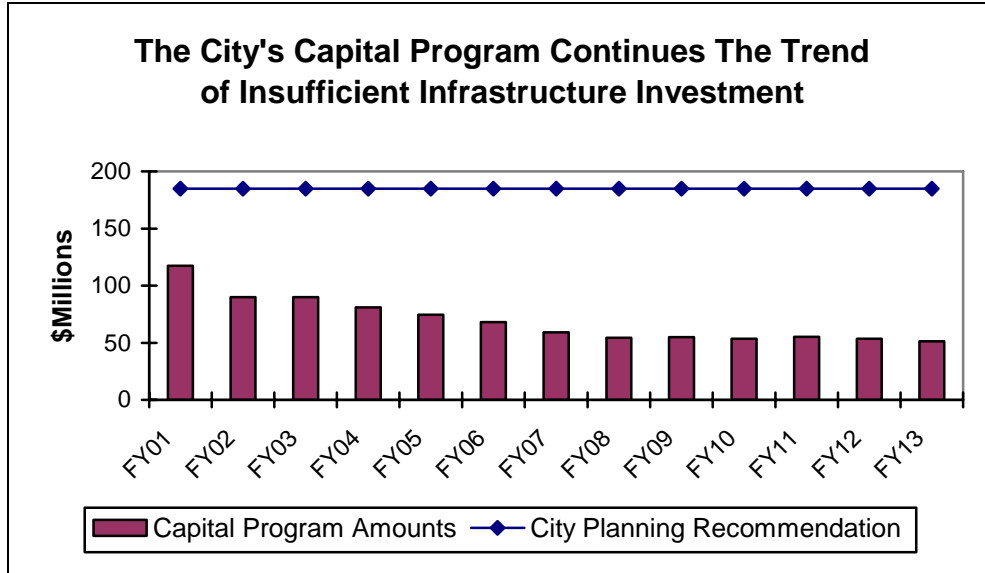


As the graph shows, the costs of the borrowings will be at least \$60 million each year until FY28 and will stay above \$50 million through FY31. Even if the next three mayors all serve two full-terms, they will all be paying debt service on at least one of these three bonds for their entire terms.

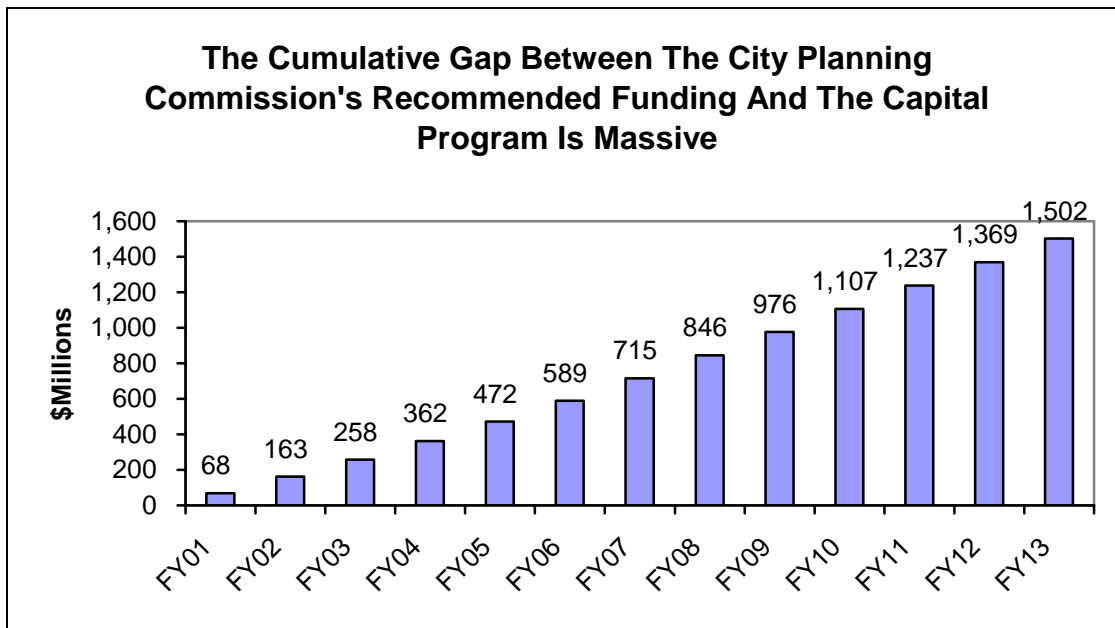
**Where The Money Doesn't Go: Insufficient Infrastructure Investment**

The City has been investing far too little in its core infrastructure – its roads, health centers, police and fire stations – and has no plans to increase its spending. The City Planning Commission opined in FY00 that the City should be spending \$185 million on infrastructure. Instead, the City has not invested more than \$90 million in any year since FY01 and the FY08-FY13 capital program includes less than \$60 million in each of its years. The insufficient level of proposed funding would only serve to exacerbate the

problems that years of underinvestment have already created in city facilities. The inevitable result of this chronic underinvestment is that facilities will deteriorate to the point at which they will need costly emergency repairs. The cost in the future of those emergencies is likely to far outweigh any short term savings the City is achieving by starving its capital budget.



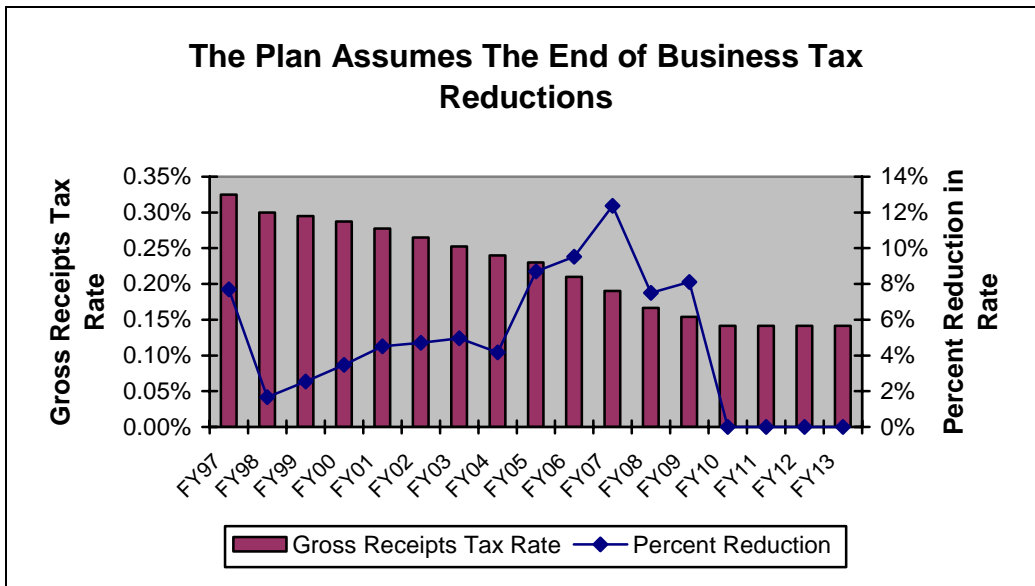
If the City had followed its planning commission’s recommendations, it would have invested almost \$1.7 billion in its infrastructure from FY01 through FY09. Under the current capital program, however, the City will have instead invested under \$700 million – a difference of \$975 million. By FY13, the gap between the amount the commission recommended and the amount that the City will have invested since FY01 under its capital program will have grown to \$1.5 billion.



**An Uncompetitive Tax Structure**

Recognizing that its tax structure put it at a competitive disadvantage, the City began a tax reduction program in FY96. The program was aimed at the wage tax and the gross receipts portion of the business privilege tax – two taxes that countless analyses have shown hurt Philadelphia’s economy. The tax reduction program has helped improve the city’s competitiveness, but Philadelphia is still a relatively high tax jurisdiction and more needs to be done.

The current fiscal year is the tax reduction program’s 13<sup>th</sup> year. The FY08-FY12 five-year plan, however, proposes to make FY09 the last year of the business privilege tax reduction program. While the rate of the gross receipts tax will have been cut by well over 50 percent by FY09, ending the program would send the damaging message that reducing the cost of doing business in the city is no longer as high a priority of city government.



The Plan does propose to continue to reduce the rate of the wage tax. In addition, the Plan also proposes to accelerate the reductions in the wage tax when gaming revenue is received. Under the Plan’s proposals, by FY12 the wage tax would drop to 3.7094 percent for residents – 25 percent below the FY95 rate – and 3.4569 percent for nonresidents – almost 20 percent below FY95’s rate. Gaming revenues would take those reductions from the FY95 rate to 32.5 percent for residents and 22.1 percent for nonresidents.

## **Continuing Fiscal Challenges at the Philadelphia Gas Works**

The next mayor's first budget will cover FY09, the year during which PGW is scheduled to repay the second half of the \$45 million loan it received from the City. PGW's ability to make that payment and attain financial stability were put back into question by the PUC's recent decision to only provide PGW with \$25 million of a \$100 million rate increase request. While PGW has repaid \$22 million of the \$45 million loan, its long-term financial issues have not been resolved.

For the last several years, PGW has maintained a positive status quo in its finances. Collection rates continued to increase to a level consistent with those of other public and private utilities. While the utility now has a narrow positive annual operating balance, the nearly \$1 billion debt load and other fiscal constraints make it unlikely it will ever be able to resolve its long-term financial issues assuming a continuation of current conditions. As the utility's capital demands continue to increase, even greater pressure will be exacted on the slender amount of funds available. Effectively, PGW is treading water financially until serious plans for its future can be determined.

PGW has been able to restructure its capital program to meet pressing needs despite its enormous outstanding debt. The combination of increasing capital demands and a loss in revenue, however, could render PGW unable to meet its debt obligations, forcing the City to either further subsidize the utility or allow it to default on its obligations. Either scenario would have dramatic implications on the City's fiscal stability.

The utility had developed a plan to address its financial issues. It put together a \$100 million rate request that, in addition to helping with its cash flow and allowing it to repay the City's \$45 million loan, would have permitted it to address some of its capital needs while reducing its debt burden. By approving only \$25 million of that rate request, however, the PUC has made it much more difficult for PGW to achieve those goals. In an attempt to improve its financial strength despite the PUC's decision, PGW has undertaken a new series of efficiency initiatives. If successful, those initiatives will improve PGW's financial health, but are not likely to provide sufficient benefit to allow the utility to address its longer-term issues.

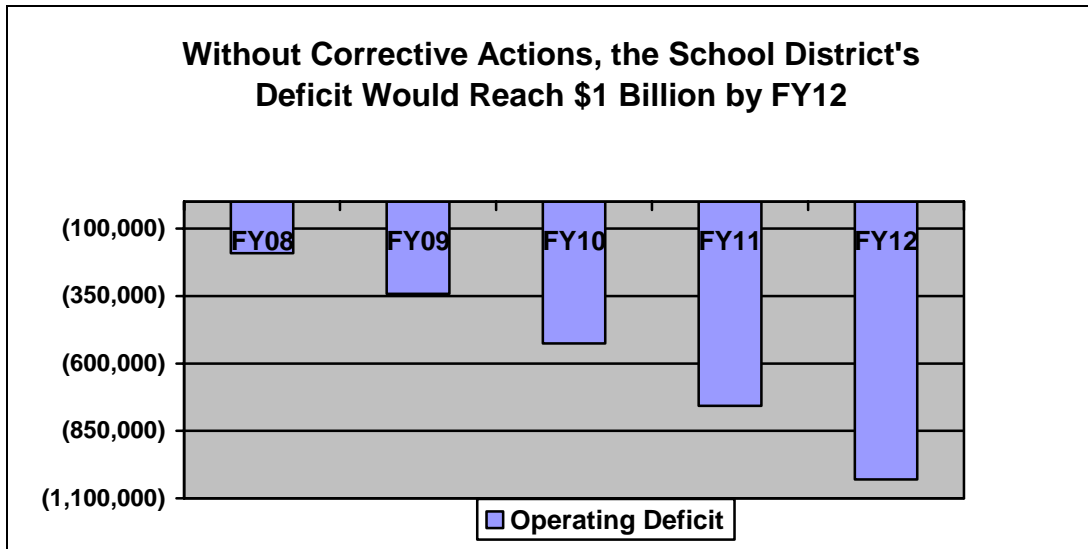
According to the City, there has been no official legal opinion on whether the City is contractually liable to repay PGW's debt should PGW be unable to meet those obligations. However, considering that PGW serves nearly all of Philadelphia's commercial and residential gas users, the City would be forced to deal with the aftermath of a PGW default.

Unlike many of the risks facing the City, the impact of a PGW collapse could be both sudden and dramatic. An abrupt failure would be beyond the City's fiscal capability, and would require help from other governments, putting additional strain on surrounding state and local authorities. Regional businesses and employees who are dependent on the City's economy would be vulnerable, as the main economic driver for the

Commonwealth was disrupted. In short, a PGW failure would have consequences far beyond the City's fiscal stability.

**Potential Deficits At the School District of Philadelphia**

In FY07, the School District revealed that it was facing a severe fiscal crisis. The District said that unless corrective actions were taken, it would have a deficit that reached almost \$200 million in FY08 and over \$1 billion by the end of FY12.



The projected deficits, which came at a time of improving scholastic performance by the District's students, were caused by a number of factors, but by far the largest contributors to the imbalance between revenues and expenditures have been charter schools and debt service. In FY02, charter schools cost the school district \$95 million. By FY06, charter school costs had risen to \$221 million – a 133 percent increase in just five years. Those costs increased as the number of charters in Philadelphia increased from 39 in FY02 to 56 in FY09.

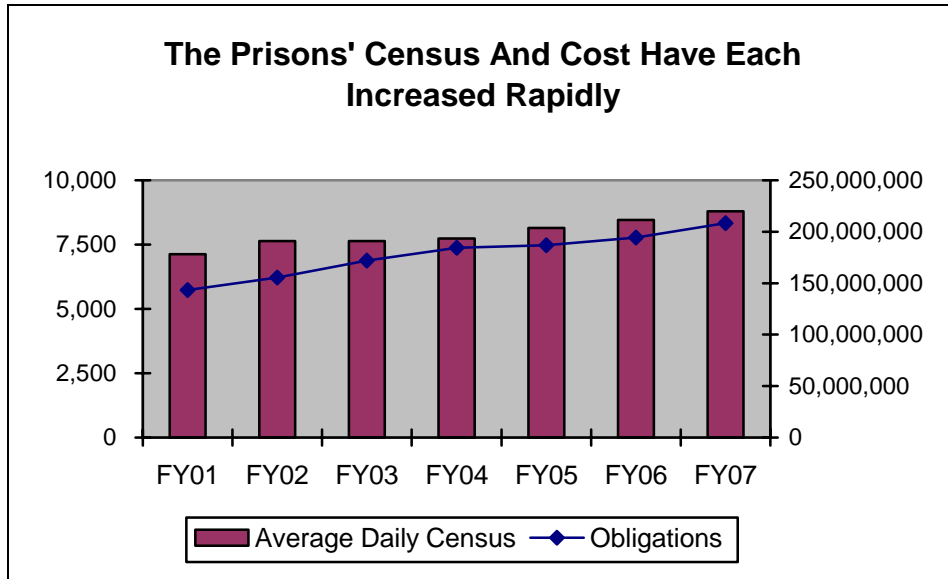
While debt service costs did not grow as quickly as charter school costs, they did jump 73 percent from \$94 million to \$163 million. Costs went up as the School District undertook an aggressive \$1.5 billion capital program to build new facilities and refurbish existing ones. As part of its capital program, the District borrowed over \$800 million in FY04 and over \$300 million in FY07.

There may have been important reasons for the District to increase the number of charters and to issue additional debt, but when combined with other increases in expenditures, they were clearly more than the District could fund without incurring deficits.

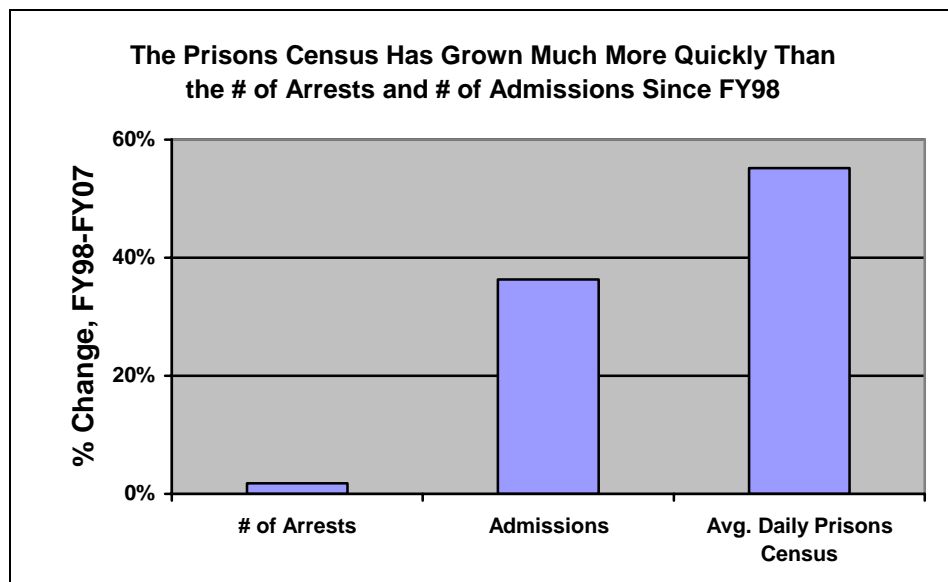
While the State, City and School District have all taken steps to attempt to bring the District's budget back into balance, it is very likely that the District will continue to have financial difficulties and will turn to the City for additional financial assistance.

**Higher and Higher: The Prisons Census and Budget Each Continue to Increase**

In FY01, the average inmate population for the Philadelphia Prisons System was 7,121 and the general fund cost of the system was \$143 million. Despite years of efforts to control both the census and the system’s costs, both were dramatically higher in FY07 than they had been in FY01 and there is no sign that the growth in either will slow soon.



The census has grown for a number of reasons, but perhaps the most significant is the increase in the length of time that inmates spend in prison. As the following graph shows, because of that lengthening of inmates’ period of incarceration, the prisons census has grown much more quickly than either the number or arrests or the number of admissions.



The increase in inmates' length of stay has been fairly dramatic – 89 percent from 50 days in 1991 to 89 days. By November 2005, almost 40 percent of inmates had been in detention at least 120 days, up from only about a quarter who had been in prison that long in 1995. There are a number of reasons for that increase, including the following:

- The inventory of municipal court cases that are not disposed by the end of the year has grown from under 7,500 in 1995 to over 26,944. As more cases remain open, it becomes more likely that inmates will wait in prison longer before their cases are adjudicated.
- The increases in the number of open cases have coincided with a doubling of the number of inmates held on bail from just under 2,000 in 1995 to over 4,700 in 2005.
- More inmates are being held for more than one reason. In 1995, only 17 percent of inmates were being held for multiple reasons (reasons include bench warrants, serving sentences, probation and parole detainers, and not having paid bail). By 2005, the number of inmates being held for multiple reasons had more than doubled to 43 percent. When inmates have more than one reason for being held, it makes it harder to resolve all of their issues and secure their release.
- Over a quarter of the cases have five or more continuances. If the defendants in those cases are being detained, it means that every one of those continuances has lengthened the amount of time the inmate will be incarcerated before trial.

The increase in the length of stay and the resulting increase in the prison census have led to increased costs in a number of areas including overtime, healthcare, food, maintenance and housing for inmates in non-city run facilities. The growth in medical costs has been particularly rapid since expenses are rising not only because of the increase in the number of inmates, but also because of the escalation in the price of healthcare service.

### **All That and No Cushion: The City Does Not Have a Rainy Day Fund**

While the City faces an array of challenges, one way the new mayor could have a cushion against unanticipated financial setbacks is by funding a rainy day fund. The FY08-FY12 Plan makes no provision for the creation of such a fund, but the Street Administration has been working with City Council on an amendment to the home rule charter to establish the fund. The fund would require approval by voters, but if it were created, it would provide some additional fiscal stability. If, however, the fund is not successfully navigated through the steps that are still required for its implementation, the City will have to rely on what is projected to be a rapidly declining fund balance to provide a cushion against financial downturns.

### **Now That You've Inherited This Mess, What Can You Do About It?**

Clearly, the next mayor will be facing some enormous financial challenges. The solutions to those challenges will not be easy or painless, but they are achievable.

#### **Improving the Health of the Pension Fund.**

The City can improve the health of the pension fund in one of two ways – it can either increase the funds' assets or reduce its liabilities.

The simplest way for the City to increase the funds assets is to simply give it more money. The City's annual contribution to the pension fund is now the minimum amount the City is required to pay under state law. If the City gave an amount above that minimum requirement, it would help slow the growth in the fund's unfunded pension liability. Unfortunately, the City's finances do not often allow it to make extra contributions without sacrificing service. If, however, the City has unexpectedly large fund balances, one of the first actions it should consider taking would be to provide additional funding to the pension fund.

The other major option the City has for increasing the fund's assets would be to increase the interest earnings on the fund's investments. The Pension Board should do everything it can to ensure that the City has the best and most appropriate firms managing its investments and it has already had some success in improving its returns. The fund earned about 15 percent in FY07 and was named medium-sized public plan of the year by Money Management Letter.

The City should also take steps to reduce the pension fund's liabilities. As discussed in PICA's report on pensions, "An Ounce of Prevention: Managing the Ballooning Liability of Philadelphia's Pension Fund," there are a number of ways in which cities have been trying to reduce their costs while at the same time protecting the health of their funds. PICA recommended that the City consider offering a defined contribution plan and making changes to its benefit calculation for new employees.

Several cities including Denver and Detroit and a number of states have also taken action to improve the conditions of their pension funds. Oregon, Alaska and Michigan all now offer defined contribution plans. Jurisdictions that have decided not to offer defined contribution plans, have taken other steps to reduce their liabilities. Colorado's unions agreed to have employees contribute an additional three percent of their salaries to the pension fund and to increase the minimum retirement age rather than go to a defined contribution plan.

There are some advantages to employees in having the option of choosing a defined contribution plan – particularly for employees who plan to stay with the City for a short time and want to have a portable retirement plan. For other employees, the City could consider providing a financial incentive to switch to a defined contribution plan. Even if

the combined cost of that incentive and the City's payment under a defined contribution system were roughly the same as the payment under the City's current defined benefit system, the City would gain because no new unfunded liability would be created for employees participating in a defined contribution plan.

Under the current system, since the City guarantees a benefit to its employees, it incurs an increased liability when the assumptions its actuary uses turn out to be overly optimistic. So, for example, if the pension fund earns less than the actuary projects or employees retire earlier and, as a result, receive their pensions longer, the fund's liability will increase. Under a defined contribution plan, the City only guarantees its contribution, not the level of benefit the employee receives. The risk is transferred to the employee. Unless the city makes changes to its benefits calculation for new employees and gives all employees the option to move to a defined contribution plan, it will not have reduced the risk that it will continue diverting increasing amounts to its pension fund.

### **Containing Health Benefits Costs: We Can Do This The Hard Way or The Easy Way**

The most painful way to control healthcare costs is to reduce the benefits available to employees and to increase the amount that employees have to contribute to their healthcare plans. For example, certain types of procedures could be eliminated from the plan or employees could be forced to pay larger copays or deductibles. The amount of pain that would be required would depend on the level of savings that were needed. Before pursuing those options, the City should make sure that it is taking all necessary steps to control its costs.

Other governmental plans have taken aggressive steps to control costs. They have had their providers track employee usage so that they can target employees who are most likely to require extensive medical care. Since the vast majority of usage in a typical plan comes from a small number of participants who require extensive care, taking steps to ensure that they do not require that care is perhaps the best way to control costs while ensuring the health of city employees. As recommended in PICA's report titled "Health/Medical Benefits: Burning a Hole in The Budget," the City should implement those cost controls as part of a multi-step process that would include the following:

- Dedicating at least one employee full time to managing its health insurance programs. The City employee or employees tasked with managing health insurance costs should work closely with the joint labor-management boards that oversee the health funds.
- Encouraging healthy behavior and avoiding serious illnesses. As discussed above, perhaps the best way for the City to reduce the cost of its programs is to ensure that participants in the programs are healthy and do not require expensive serious medical procedures. In order to achieve that improvement, the City should implement programs that encourage participants to maintain healthy lifestyles,

with particular emphasis on identifying participants at risk of serious illnesses. The programs should be run by an outside consultant who would not share information on individuals with the City or the employees' unions. The consultant's task would be to reduce the incidence of serious illnesses that require surgery, heavy use of medication, and/or extended stays in hospitals.

- In order to ensure that plan members participate in these programs, the City should consider offering financial incentives. For example, the City could offer to reduce required employee contributions for the cost of health insurance if employees participated in wellness programs.
- Continuing to aggressively review insurers' billings to make sure that they are using accurate utilization data and that the City is getting agreed upon rates. In addition, the City should bid out its contracts at least once every three years.
- Ensuring that all of the City's plans have meaningful co-pays and deductibles. While those co-pays and deductibles should not be so large that they dissuade participants from getting necessary care, they should be large enough so that participants understand that there are costs associated with any visit to a doctor or pharmacist.
- Redesigning Plans. If the strategies described above do not lead to reductions in health care costs, the City should consider plan redesign including changes in the number of allowable visits, changes in what procedures are covered and changes in the types of allowable drugs.

### **Managing Debt Service Costs: Stick To The Essentials**

While the new mayor will not be able to undo the borrowings that have led to the ballooning of the City's long-term costs, he can ensure that he does not exacerbate the problem. The simplest first step would be to commit to borrowing only for core infrastructure. A second step would be to look for opportunities to fund capital obligations out of operating expenses. For example, during a year when the City's fund balance exceeds the amount that the City budgeted, it can take a portion of the unanticipated fund balance and use it to invest in infrastructure.

As PICA wrote in its September 2006 report and its January 2006 report on infrastructure and debt service, it is also important that the City have a public comprehensive debt policy. The last public debt policy statement was issued in December, 1995. An updated debt policy could provide guiding principals for the City's debt incurrence. For example, the policy should set an upper limit for debt service as a percent of the City's locally generated revenues. With such a policy the City would be able to provide a rationale for why it is or is not issuing debt.

## **Investing in Infrastructure: Keeping Facilities From Crumbling**

The first step towards improving the condition of the City's core infrastructure is understanding of the magnitude of the underinvestment. The last estimate of the level of annual investment required to keep the City's infrastructure in good shape was done by the City Planning Commission in 2000 and, as written above, it determined that the City should invest \$185 million annually.

In order to provide a more current determination of the appropriate level of investment, PICA used a portion of its operating funds to pay for an updated assessment of the condition of a number of key City facilities, including police, fire, public health and prison facilities and the interior of City Hall. PICA's goal was to have the analysis completed early enough so that it could be used as a resource for the next mayor's first capital budget and program.

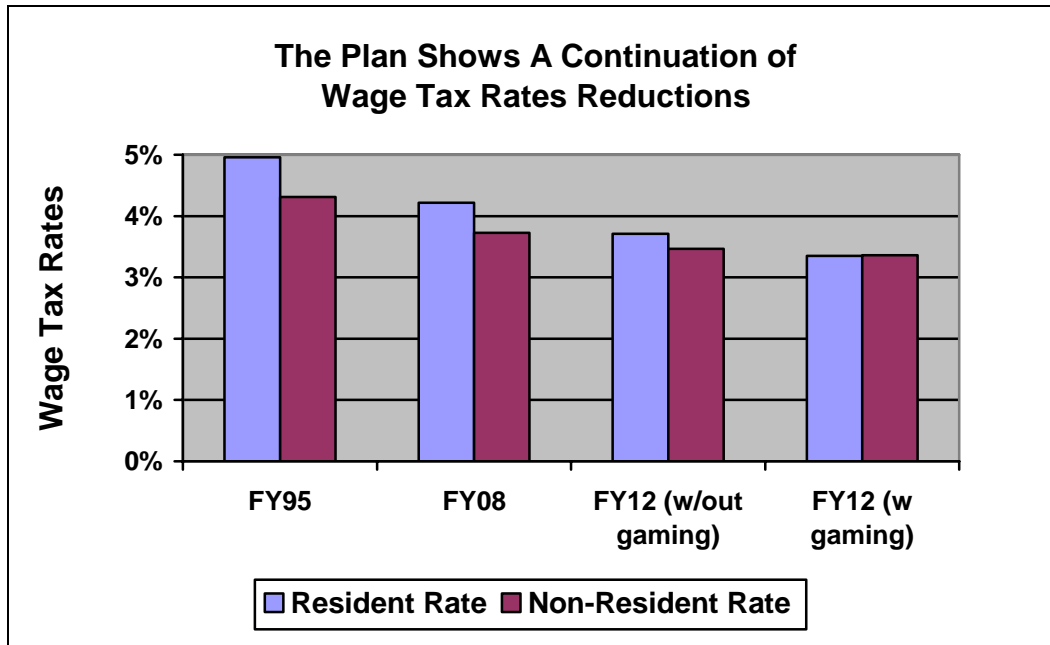
The assessment, which was made public at the end of October, confirmed that the City's capital needs far outstrip the amount included in its capital budget. For the facilities studied, the assessment team found that the City should be investing \$143 million in capital funding over five years. Instead, the City's capital program includes only \$91 million.

Clearly, the City must identify additional funding sources for its infrastructure. PICA has recommended that some of the infrastructure spending come from operating funds. By using operating funds, the City will meet a portion of its infrastructure needs without increasing its long-term obligations. Other cities, including New York, Baltimore, San Diego, Los Angeles and San Francisco use operating funds for capital investments.

The City should also do a thorough analysis of its facilities to determine whether it could reduce the number that it operates and provide service more efficiently. PICA's analysis made it clear that the City has more facilities than it has resources to maintain. Unless the City either dramatically increases the resources it dedicates to facilities maintenance or reduces the number of facilities it has, its facilities will continue to deteriorate.

## **Fixing The Tax Structure: Making Philadelphia More Competitive**

The City must continue both its wage tax and business privilege tax reductions. On the wage tax side, the Administration took an appropriate approach in the FY08-FY12 Plan; it continued the reductions that had already been in place and showed the potential for more cuts if the City receives gaming revenue. With the gaming revenue, the wage tax rate could be 3.35 percent for both residents and nonresidents. Even without the gaming revenue, wage tax rates would drop to 3.7094 percent for residents and 3.4659 percent for nonresidents – a full percent below the resident rate before the reduction program began and almost a full percent lower than FY05's nonresident rate. The City should continue to take this approach in future five year plans.



The City should not, however, continue the approach that the Plan took to the business privilege tax. Instead, the City should resume and accelerate the reductions that were included in the FY07-FY11 Plan. The City should target elimination of the gross receipts portion of the business privilege tax no later than FY20 and should begin reducing the net income portion of the tax – if it can make those reductions without endangering services.

**Lowering the Risks at PGW**

PGW has already taken a number of steps to improve its operations and earlier proposals for stabilizing its fiscal condition – including developing the liquefied natural gas facility and seeking a sale – have not materialized. Assuming that none of those strategies are implemented, PGW must focus on seeking more efficiencies and must appeal the PUC’s decision.

**School District**

The District, the City and the State have all taken steps to reduce the deficit. Those steps included the following:

The City: The City transferred millage worth about \$18 million annually to the District and agreed to provide an additional \$2 million in grants. The District now gets 60 percent of real estate tax collections (up from just under 55 percent as recently as FY02) and receives a \$37 million annual contribution. The City has also said that it will assume the costs of \$8 million in School District contracts and that a new tax delinquency collection program will provide additional revenues to the District.

The State: The State increased funding for the District by over \$30 million in the FY08 budget and then provided additional funding to ensure that every student who lived more than a mile and a half from school received free transportation.

The School District: The District has identified almost \$50 million in cuts and is still looking for additional ways to reduce its costs.

School District officials say that even with all of those actions, the District still faces a deficit of over \$30 million. If, however, the City does assume the cost of School District contracts and the tax delinquency program is successful, the School District may have a balanced FY08 budget.

Even with a balanced FY08 budget, however, it is not clear the District's revenues will be able to keep pace with its fastest growing costs. In order to ensure that the District maintains its fiscal balance going forward, the City, State and District must continue to work together to find ways to control the District's costs, increase its revenues and preserve and accelerate its educational improvements.

### **Controlling the Prisons Census**

In its report entitled "City Budget Behind Bars: Increasing Prison Population Drives Rapidly Escalating Costs," PICA made a number of suggestions for controlling the growth in the prisons census and the resulting costs, including the following:

- Provide alternatives to incarceration where appropriate. Among the alternates that are used by jurisdictions are electronic monitoring, psychological treatment, and drug and alcohol counseling.
- Ensure that cases are processed through the criminal justice system as quickly as possible. In addition to moving cases through the system quickly, the participants in the criminal justice system should seek ways to lessen the amount of time that non-violent offenders are incarcerated only because they cannot pay their bail.
- Prepare inmates for reentry into society. Jurisdictions, including Philadelphia, offer a wide variety of programs to inmates including high school equivalency courses, employment training and drug treatment. Steps should be taken to ensure that the programs Philadelphia offers are sufficient to meet the needs of its inmates.
- Enhance probation and parole. Jurisdictions have taken a variety of actions including increasing the number of parole officers and ensuring that inmates are not returned to custody for technical violations of parole. Philadelphia should pursue both of these actions.

- Review sentencing to ensure that guidelines are appropriate and are followed.

In addition to implementing those changes, all members of the criminal justice system should commit to tracking data including not just the rate of recidivism, but also:

- Inmates' success at finding and maintaining employment;
- The average daily population in correctional facilities;
- The average length of stay for inmates in correctional facilities;
- The number of admissions to and releases from correctional facilities;
- The number and percent of accused offenders detained at bail hearings;
- The number and outcome of bail reduction petitions filed by the public defender;
- The number and percent sentenced to jail compared to the number and percent receiving probation and the number and percent sentenced to state prison by common pleas court judges; and
- The number of probation and parole revocation petitions.

That data would allow the participants in the criminal justice system to understand and anticipate trends and see whether changes have their anticipated impact on the prisons system's population.

### **Establish a Rainy Day Fund**

The Administration and City Council appear to be in serious discussions about the establishment of a rainy day fund. They should conclude those negotiations and agree on the fund.

### **Conclusion**

Mayor Nutter faces a series of daunting challenges. The fiscal situation that he inherits will make it harder, not easier, to make the kind of investments that are necessary to ensure that the City thrives. As this paper makes clear, however, there are steps that he can take to tackle each of the issues that he will confront. PICA understands that accomplishing some of the changes recommended in this paper will not be easy, but these changes are essential for the success of the next mayor and the City of Philadelphia.