

Translating Philadelphia's FY06 Ending Fund
Balance: Happy Days Still Are Not Here Again

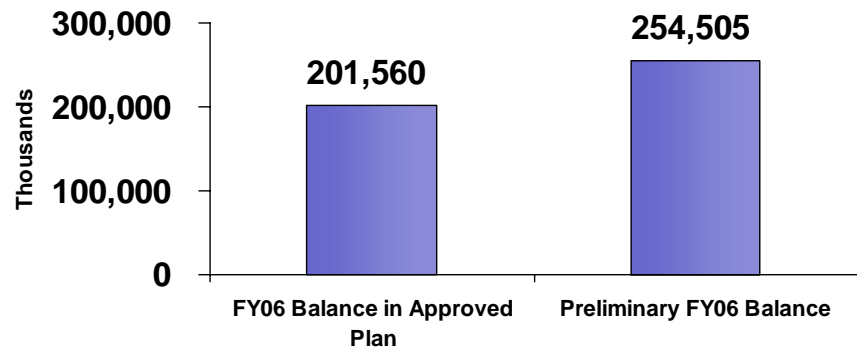
PICA Issues Report
November, 2006

Translating Philadelphia's FY06 Ending Fund Balance: Happy Days Still Are Not Here Again

The FY06 Fund Balance

- Preliminary numbers show that the City's actual FY2006 ending fund balance was more than \$50 million higher than the amount included in the PICA approved FY2007-FY2011 Five-Year Plan.

The Preliminary FY06 Fund Balance Was Much Higher Than Anticipated in the FY07-FY11 Five Year Plan

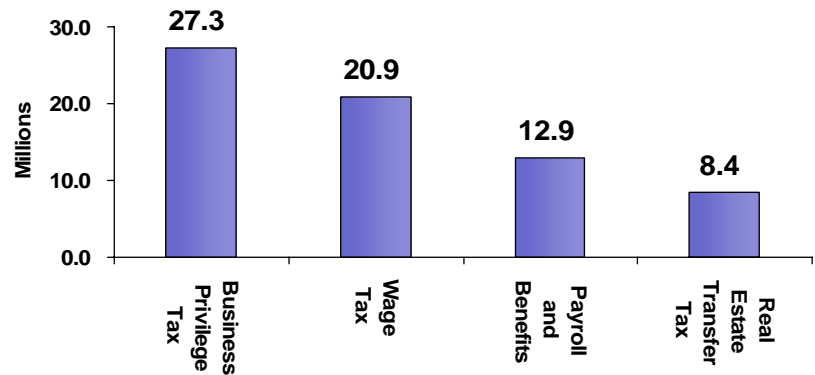


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Why Was the Fund Balance So Much Higher than Originally Projected?

1. Business Privilege Tax collections were \$27 million higher than the amount included in the Plan.
2. Wage and net profits taxes were almost \$21 million higher than anticipated.
3. Payroll and benefits costs were almost \$13 million lower than projected.
4. Real Estate Transfer Tax collections were more than \$8 million higher than projected.

The Business Privilege Tax Was By Far the Biggest Contributor to the Larger than Anticipated Fund Balance



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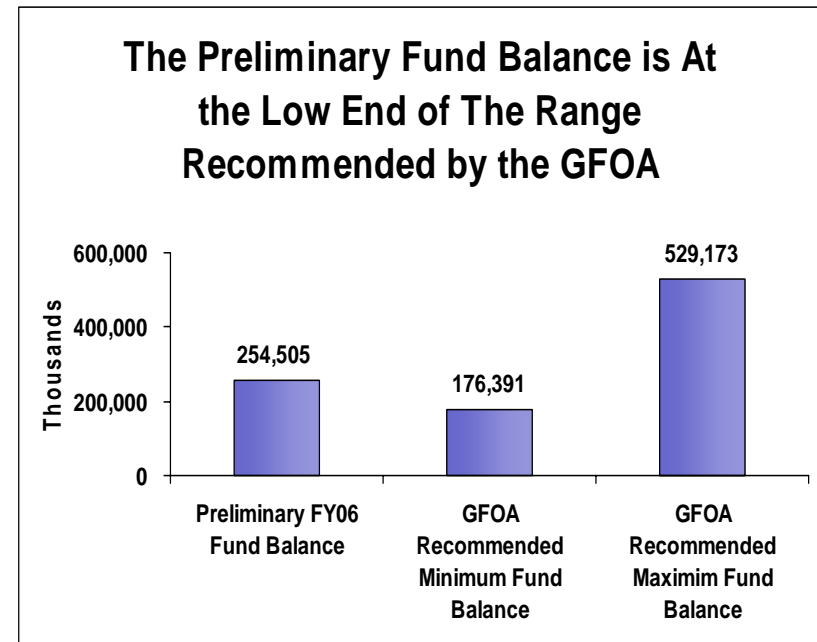
What Does the Increased Fund Balance Indicate?

- The increased fund balance is a sign that the City's fiscal health continues to be moderately better than forecast.
- The increases in business privilege, wage and real estate transfer tax collections are signs that the City's economy is doing better than anticipated.
- While overall collections during the first quarter of FY07 continued to be strong, real estate transfer tax collections declined after years of rapid growth.
- The lower than anticipated payroll costs are a sign that the continuing controls on the number of City general fund employees are having a positive impact on the City's finances. The FY07 budget, however, appears to undo some of those controls as it includes over 700 new positions.

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Why Isn't The Increased Fund Balance A Sign that Happy Days are Here Again?: Benchmarking

- Even at almost \$255 million, the fund balance is at the lower end of the 5% to 15% of revenues that the Government Finance Officers' Association says is the appropriate balance for a local government. The GFOA says having an adequate fund balance is an essential hedge against long-term and short-term risks.

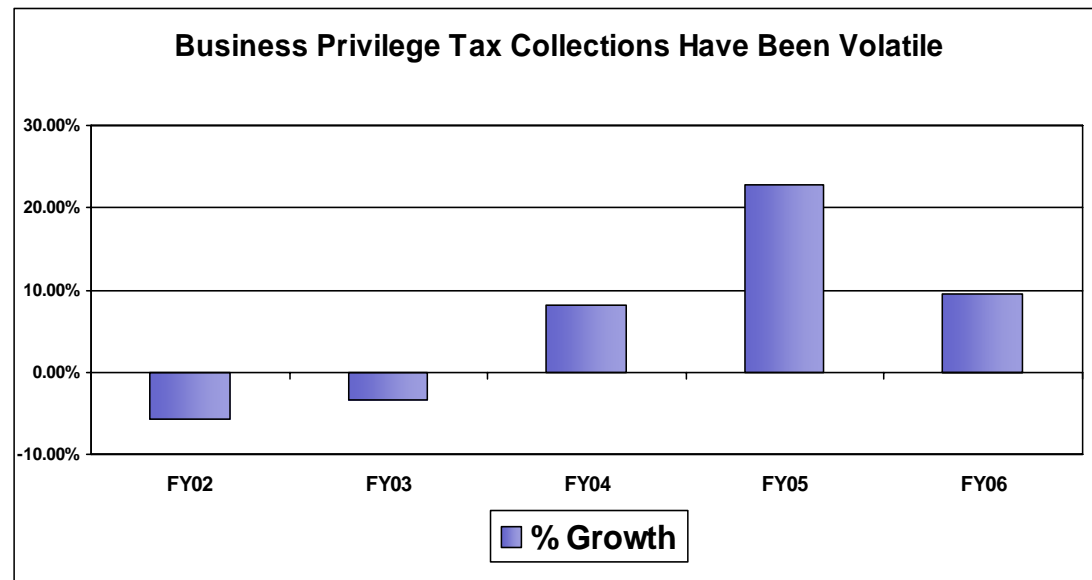


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Why Isn't The Increased Fund Balance A Sign that Happy Days are Here Again?: Volatile Revenues

- The City's fund balance increases in FY05 and FY06 were built in large on growth in the business privilege and real estate transfer taxes, both of which are extremely volatile.

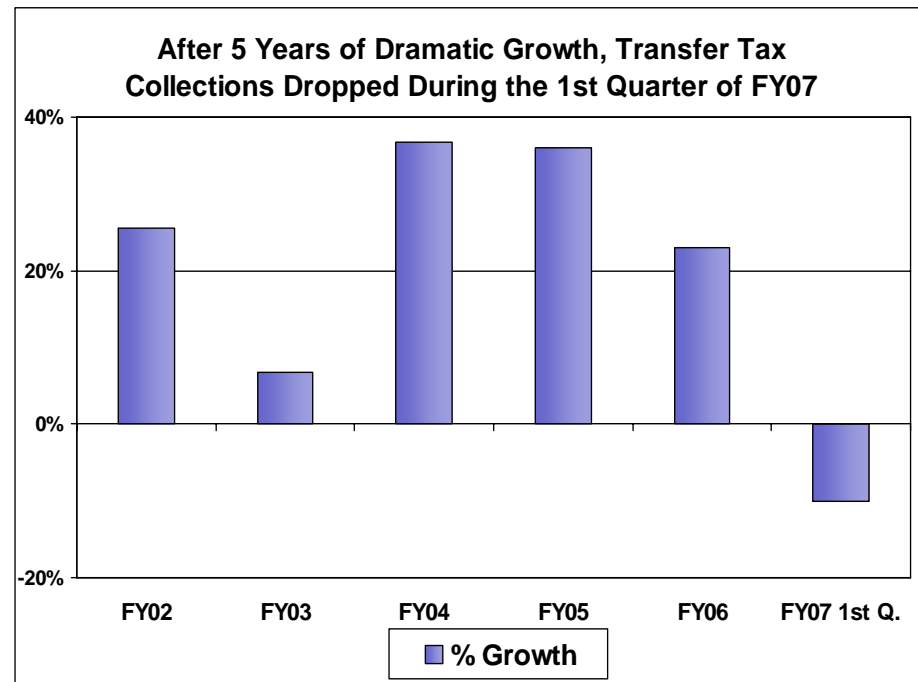
Business Privilege Tax collections, which have increased by \$113 million in the last two fiscal years, declined in both FY02 and FY03.



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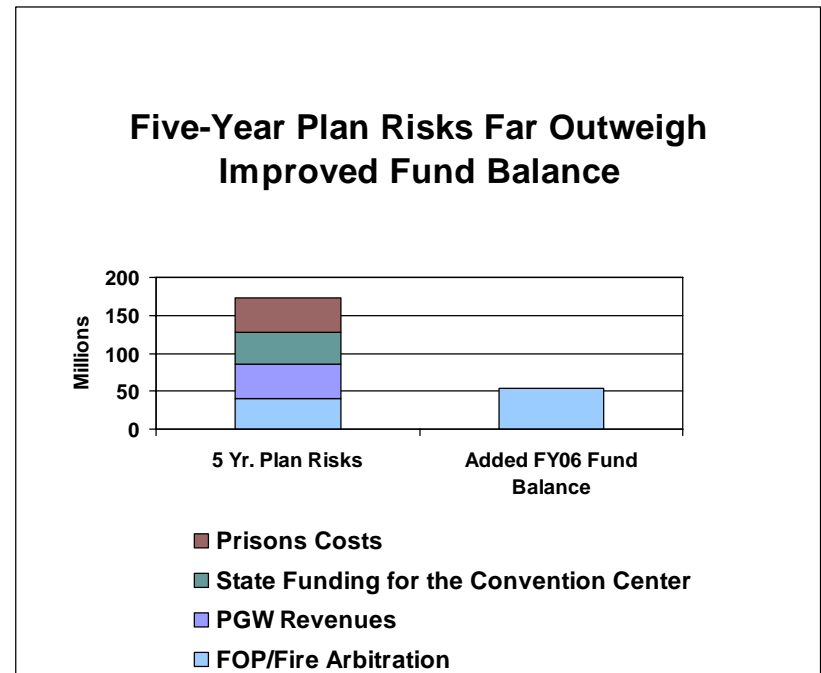
- Real estate transfer tax collections have begun to slow. After growing by just under 200 percent over the last five years, collections declined during the first quarter of FY07.



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Why Isn't The Increased Fund Balance A Sign that Happy Days are Here Again?: Risks

- **Labor agreements and awards.** The City has lost appeals of awards for both police and firefighters. If those awards are not overturned, it will add tens of millions of dollars of costs to the FY07-FY11 Plan.
- The Five Year Plan still includes \$45 million in revenues from **PGW** that the City might not receive.
- **The potential for continued reductions in federal funding** creates a substantial risk that City funding for the Department of Human Services will have to increase or services will have to be reduced.

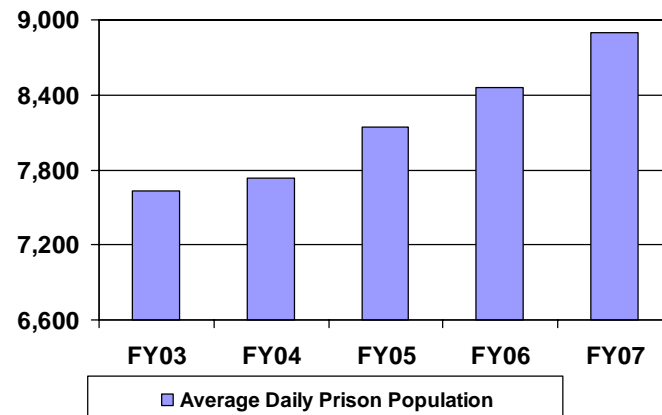


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Why Isn't The Increased Fund Balance A Sign that Happy Days are Here Again?: Risks

- The Plan assumes that the State will take full financial responsibility for **the convention center** beginning in FY10, but there is a substantial risk that state funding will never be received, will be lower than projected or will be received later than the Plan anticipates. The added cost over the life of the Plan could be about \$45 million.
- Continuing growth in the **prison system's population**. The average daily prison census has grown 19% since FY01 and the system's costs have grown 33% -- \$47 million dollars. The FY07-FY11 Plan projects another 5% growth in the census in FY07, but projects that obligations will grow by less than inflation. The increased population is likely to cause increases in obligations for both contracts and overtime well beyond the amounts included in the Plan.

The Five-Year Plan Projects That The Prisons Population Will Continue to Grow in FY07

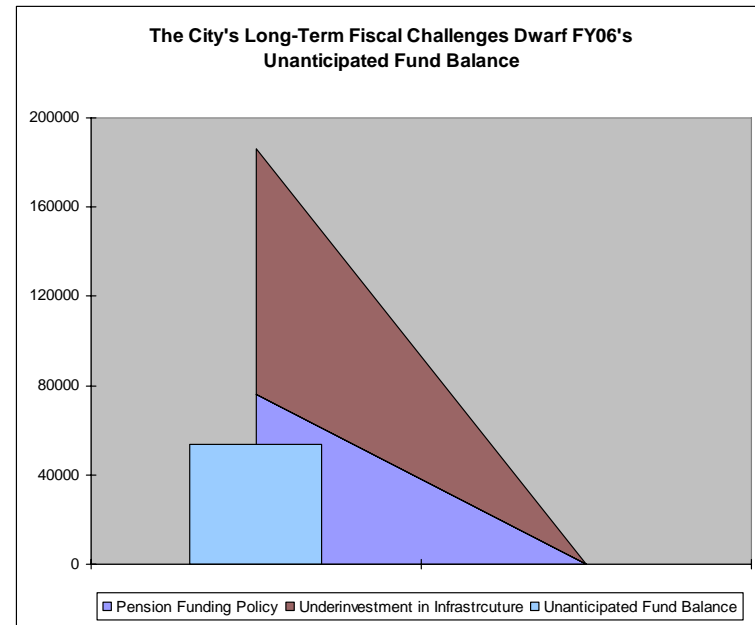


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Why Isn't The Increased Fund Balance A Sign that Happy Days are Here Again?: Long-Term Financial Challenges

The Cost of Addressing the long-term financial issues facing the City dwarves the added FY06 fund balance.

- **Unfunded Pension Liability.** In addition to having a large unfunded pension liability, the City makes the minimum pension payment required under state law. If instead of paying that minimum, the City paid the amount required under its funding policy, it would pay about \$80 million more annually.
- **Crumbling Core Infrastructure.** The Plan includes substantially less than half of the amount that the City Planning Commission says is required to maintain the City's core infrastructure. If the City paid the amount the Commission said is required, it would cost over \$100 million annually.
- Even if the City made the financial commitment to address these two long-term financial issues, it would still need to take steps to establish a rainy day fund, make the City's tax structure more competitive and lessen its long-term obligation burden.



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What is the Fiscally Prudent Response to the Higher Than Anticipated Fund Balance?

The City's first step should be to ensure that, even after accounting for all substantial risks, the FY08-FY12 Plan will be balanced using reasonable assumptions. If the City clears this hurdle, it should use any projected fund balance to begin to cure some of the key structural challenges facing the general fund:

- **Build a rainy day fund.** The Administration is working with City Council on the establishment of a fund.
- **Reduce the City's debt burden.** The City's high level of fixed obligations threatens its fiscal health. As more and more of the budget is dedicated to the kinds of costs that cannot be cut during the year, the City will have fewer and fewer choices when it is faced with making mid-year budgetary corrections. By FY11, the City's debt service costs alone are projected to be \$90 million higher than they were in FY01.
- **Make the City's tax structure more competitive.** Philadelphia's tax rates, particularly for the business privilege and wage taxes, should be lowered further. As has been repeatedly documented, the City's tax structure is a deterrent to job growth.
- **Reduce the City's unfunded pension liability.** The latest actuarial report shows that the pension fund's liability is only 53 percent funded, down from 77 percent five years ago. The FY07-FY11 Plan says the Administration will explore strategies to decrease pension obligations including increasing the minimum retirement age, decreasing the benefit multiplier, increasing the period to determine average final compensation and increasing the employee contribution; and
- **Invest in the City's Infrastructure.** The City has failed to invest adequately in its infrastructure including its physical facilities, fleet and information technology. This deferred investment will likely lead to the need for much larger investment in the future.