

Look Before You Leap?
The Fiscal Situation That
Awaits the Next Mayor

A PICA Issues Report

September 14, 2006

Look Before You Leap – The Fiscal Situation That Awaits the Next Mayor

Overview

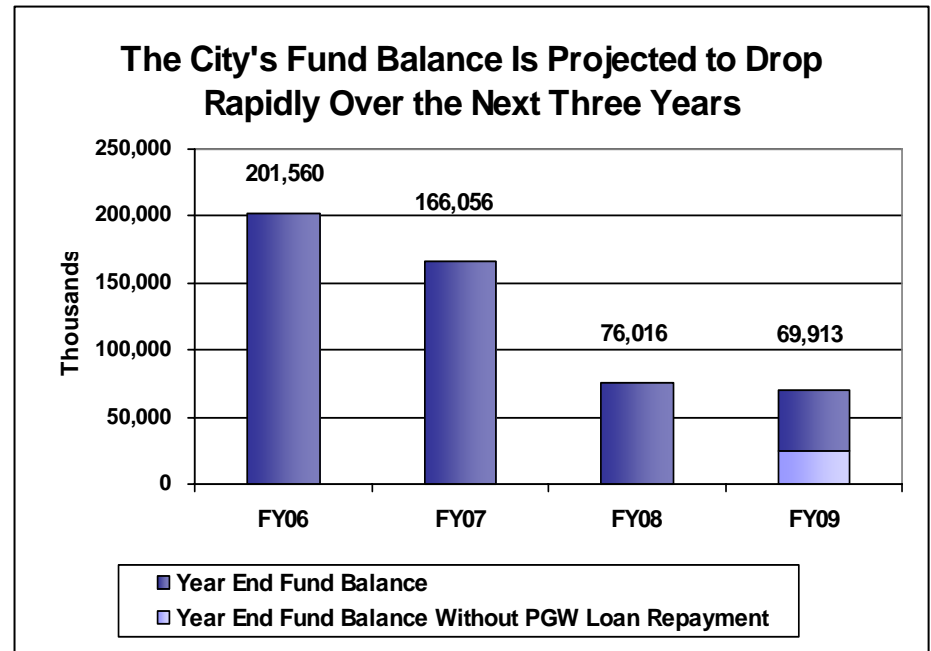
Within six months of taking office, the new mayor will have to construct a new five year plan that lays out his or her agenda for the City and negotiate new contracts with all of the City's unions. At the same time, he or she will need to tackle the long-term issues described in this report's first section, entitled **“What Have I Gotten Myself Into?”**

The financial situation facing the next mayor will be extremely challenging, but it will not be hopeless. There are steps the mayor can take to tackle the issues he or she will confront. This report's second section, entitled **“How Do I Get the City Out of This?”** will discuss options for dealing with each of the issues.

Look Before You Leap – The Fiscal Situation That Awaits the Next Mayor What Have I Gotten Myself Into?

Plummeting Fund Balance

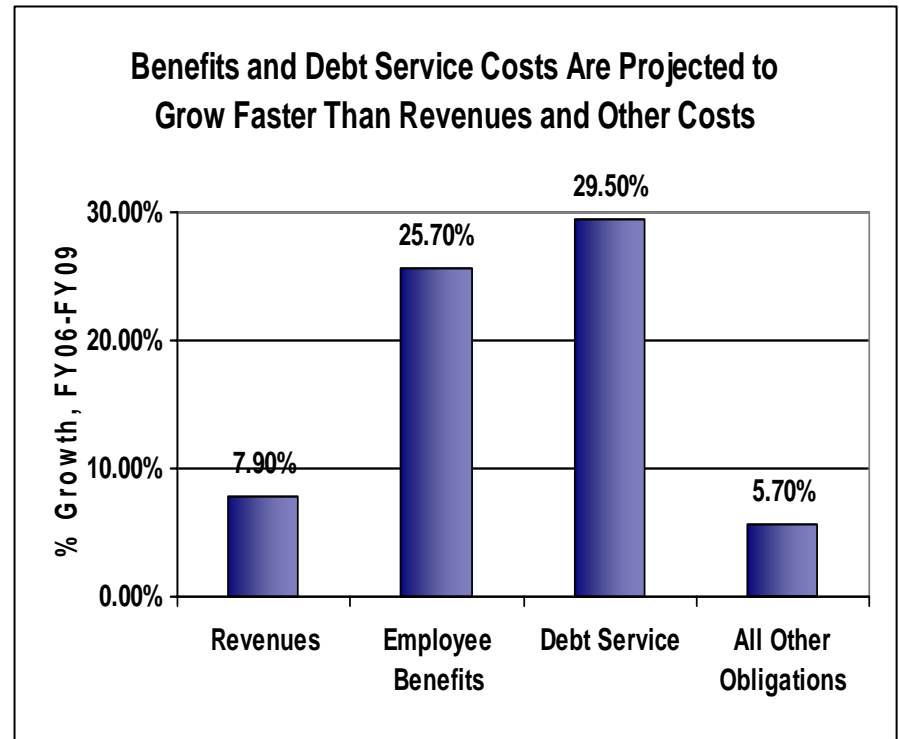
- The new mayor will be faced with a rapidly declining fund balance. The Five -Year Plan projects that the fund balance will drop \$130M (65%) in 3 years.
- The Plan's projections assume that PGW will repay its \$45M loan, which is one of the most speculative items included in the Plan. Even if every other assumption in the Plan is correct, if PGW does not repay its loan, the fund balance will drop to \$25M in FY09. The new mayor's margin for error will be gone.



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Skyrocketing Benefits and Debt Service Costs

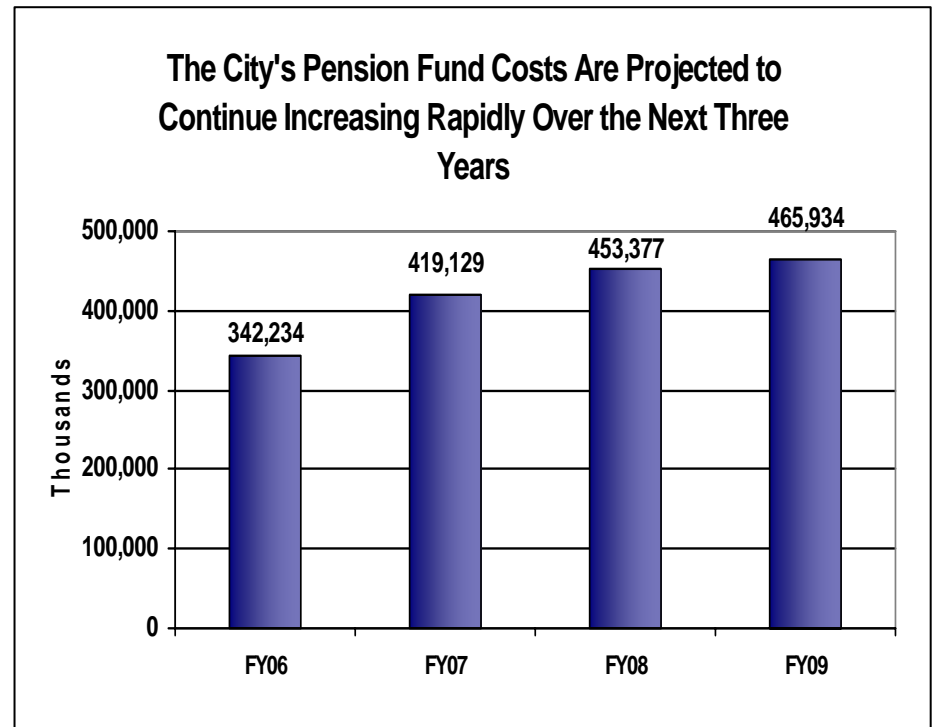
- The fund balance will drop in large part because of rapid increases in the costs of employee benefits and debt service.
- If, instead of being projected to grow almost five times as fast as other costs, employee benefits and debt service were projected to grow at the same rate as other costs, total revenues would be projected to grow faster than total obligations and the fund balance would not be projected to drop by \$130M.



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Skyrocketing Pension Costs

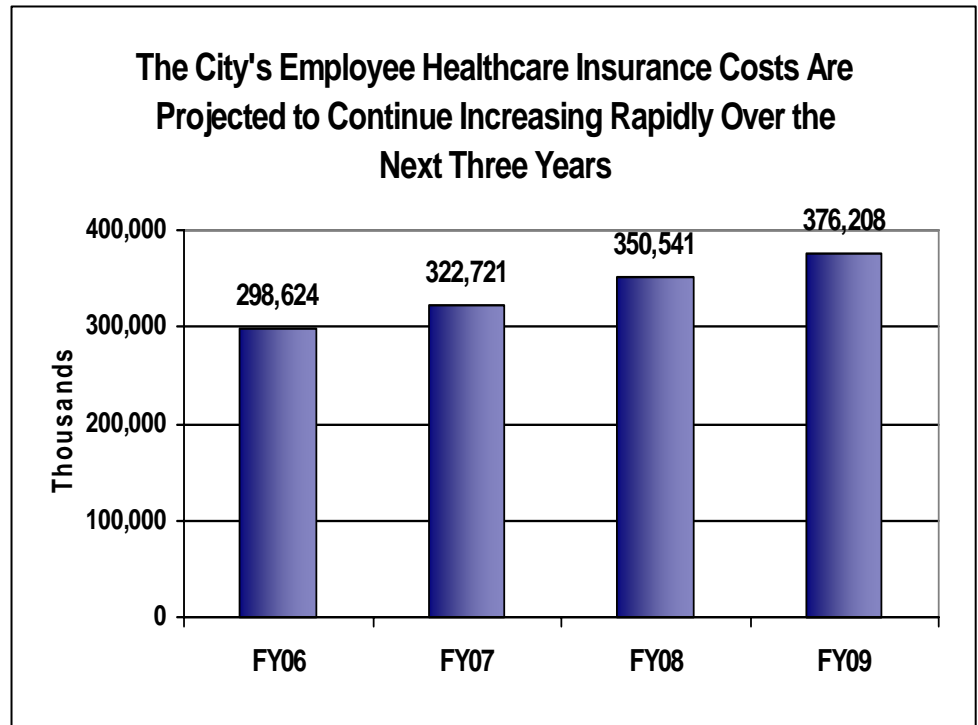
- The combined costs of the City's pension fund contribution and debt service on its pension obligation bonds is projected to increase by over \$120M in 3 years.
- By FY09, pension costs are projected to equal 12% of the City's budget, up from less than 7% in FY01.
- Costs have gone up because the fund's earnings plummeted when the stock market fell and because employees are retiring earlier and living longer, which means that they receive their pensions for a longer period.



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Skyrocketing Healthcare Benefits Costs

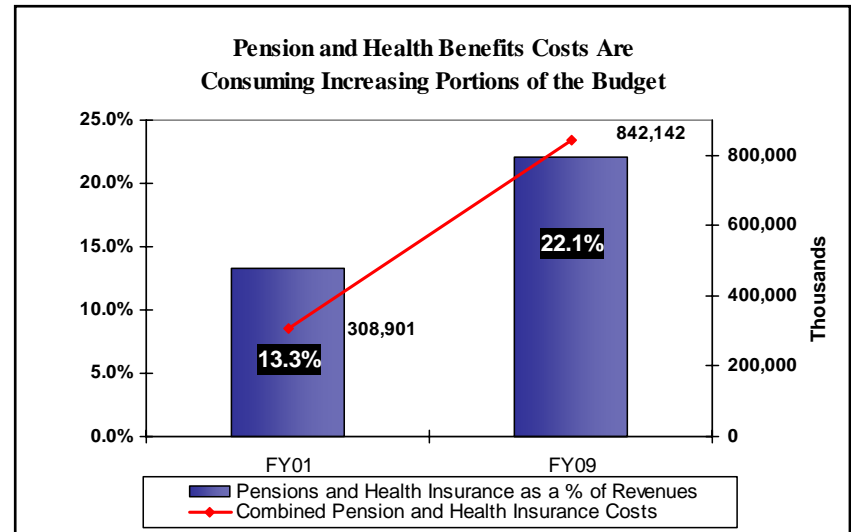
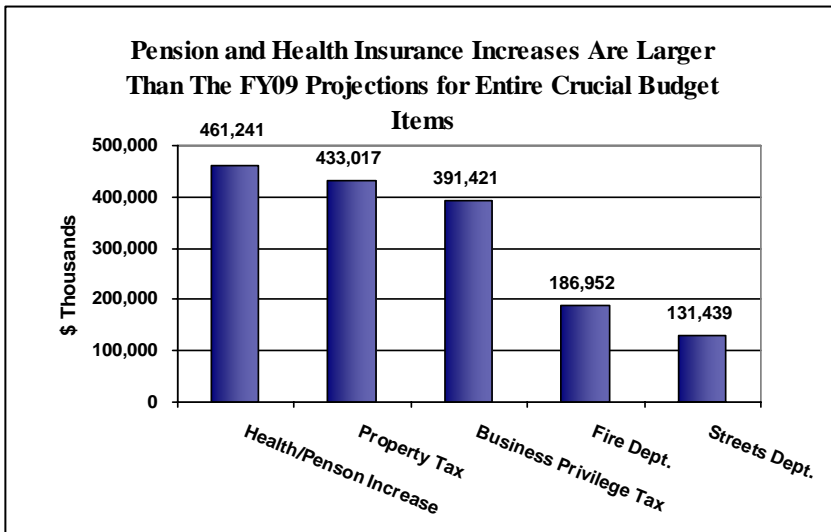
- Consistent with national trends, the City's employee health care insurance costs have risen quickly and are projected to grow another \$80M (26%) over the next three years.
- The increases will be even larger than the Plan projects if the City is unsuccessful in its appeals of recent police and fire arbitration awards.



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Skyrocketing Pensions and Healthcare Benefits

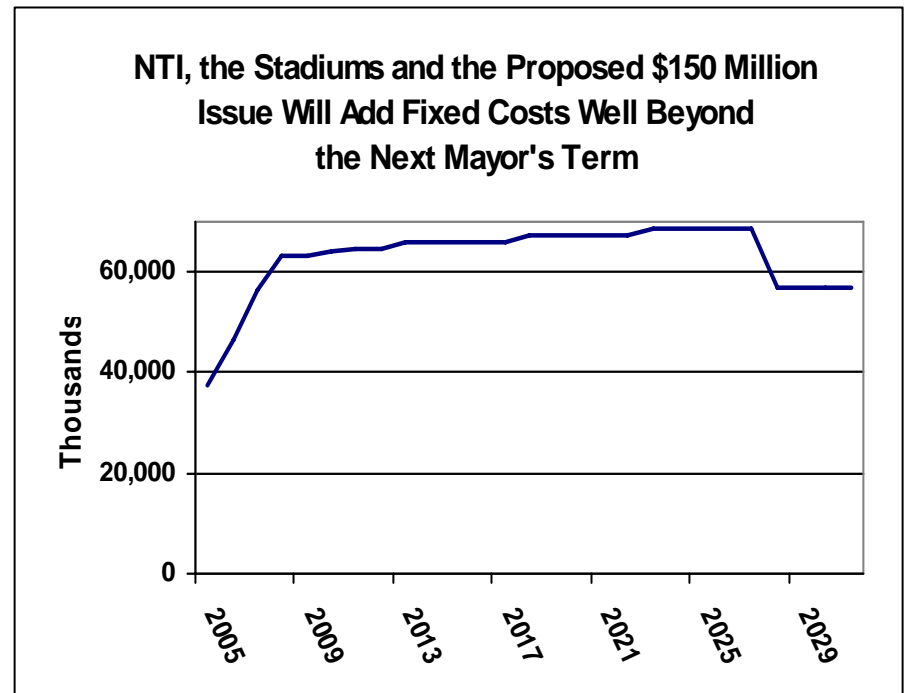
- Pensions and health benefits are consuming more and more of the budget, which leaves less room for everything else.



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Increasing Debt Service

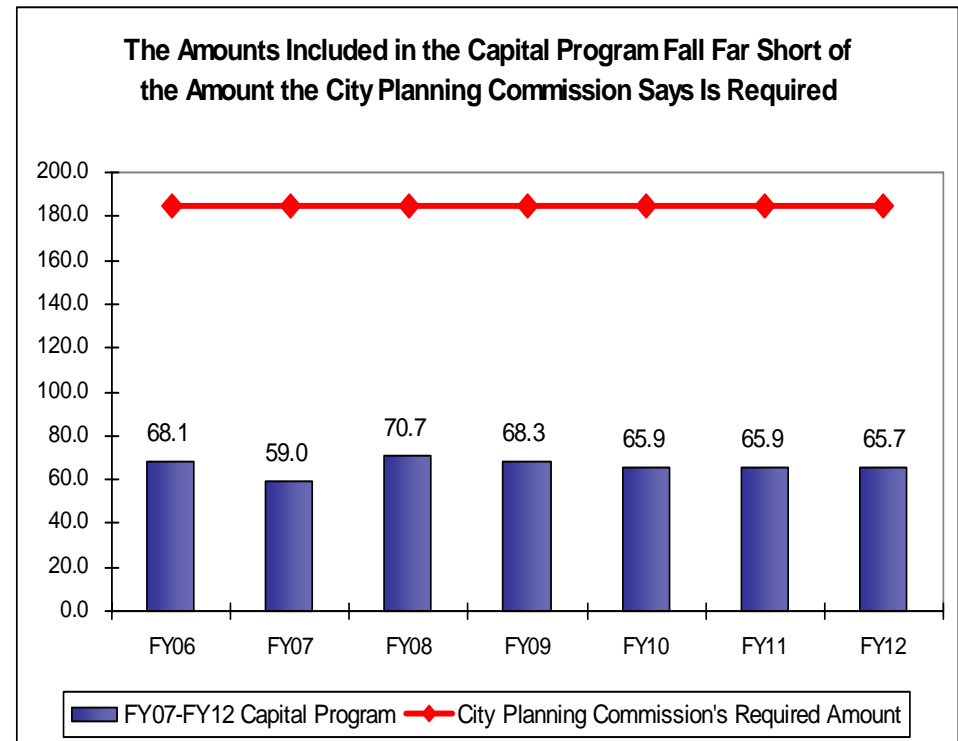
- By FY09, the cost of the City's debt will be almost \$50M higher than it was in FY06.
- The increase has been driven not by borrowings for the City's crumbling core infrastructure, but by issues for stadiums, the Neighborhood Transformation Initiative and the proposed borrowing for cultural assets and commercial corridors. By FY09, the debt service for those three issues is scheduled to be \$63M.



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Crumbling Core Infrastructure

- In 2000, the City's planning commission did an analysis that found that the City should be investing \$185M annually into its core infrastructure.
- The City has not budgeted more than \$71M for core infrastructure in any year of the FY07-FY12 capital program.
- Based on the amounts included in the capital program, the City will fall over \$110M short of its planning commission's recommendations each year through at least FY12.



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An Uncompetitive Tax Structure

- Countless analyses have shown that the City's tax structure puts it at a competitive disadvantage.
- The City's wage tax is higher than income based taxes in other large cities.
- Studies continue to rank Philadelphia as having one of the highest tax burdens for business.

No Rainy Day Fund to Provide a Cushion

- The FY07-FY11 Five-Year Plan does not include any provision for a rainy day fund, which would provide a cushion against an emergency. The Administration, however, has said it would support the creation of a budget stabilization fund.

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A Simmering Crisis at PGW

- The new mayor will quickly be confronted with the strong likelihood that PGW will not make the \$45M loan repayment that is now scheduled to be made in FY09.
- The problem, however, is much more severe than just the \$45M. In fact, PGW's problems are so deep that it is possible that the City will have to make additional financial contributions or even that a PGW financial collapse will damage the entire region.

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Improving the Health of the Pension Fund Without Slashing the Rest of the General Fund

- Offer a defined contribution plan to all employees.
- Change the benefits calculation for new employees as recommended in PICA's report on pensions, "An Ounce of Prevention: Managing the Ballooning Liability of Philadelphia's Pension Fund."

Slowing or Stopping the Growth in Health Care Insurance Costs

- Assign someone the responsibility to be in charge of managing the City's healthcare benefits.
- Promote individual health management.
- Improve vendor management.
- Establish true joint labor-management control of health care funds.
- Aggregate healthcare plans.
- Increase cost sharing with employees.
- If the other steps don't work, change plan design.

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Investing in the City's Core Infrastructure

- PICA will fund an assessment of the City's capital needs.
- Some infrastructure investment should come from operating funds as is done in other cities including New York, Baltimore, and San Francisco

Reducing the Growth in the City's Long-Term Obligations

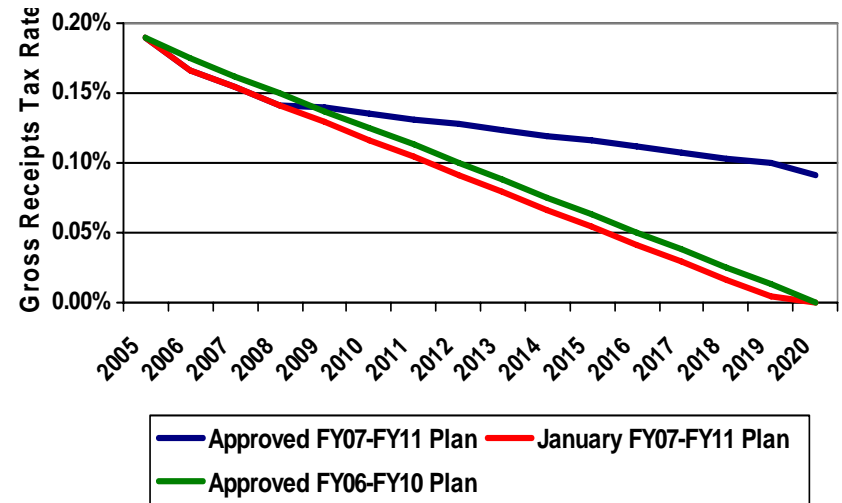
- Issue debt only to fund core infrastructure projects
- Publish a debt policy

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Making the City's Tax Structure More Competitive

- Continue to reduce the wage tax
- Accelerate business privilege tax reductions to hasten the elimination of the gross receipts tax and begin reducing the net income tax.
- The final FY07-FY11 Plan had a slower pace of reductions than did the January version of the FY07-FY11 Plan and the approved FY06-FY10 Plan.

The Approved FY07-FY11 Plan Slows the Pace of Gross Receipts Tax Rate Reductions



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Lowering the Risks at PGW

- PGW's Management Identified Strategies
 - Increase in funding of LIHEAP
 - Improve collection rates
 - Develop the proposed liquefied natural gas plant
- Despite some success in implementing the first two strategies, PGW is still merely treading water.
- There has been speculation About the potential sale of PGW. At a minimum, in any sale, buyer should :
 - Assume the utility's \$1B in debt;
 - Pay back the \$45M loan; and
 - Agree to an annual payment that would help fund social programs.

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Establishing a Rainy Day Fund

- The Administration and Council should continue to work towards reaching an agreement on the establishment of a fund

More Information

For more detailed accounts of the issues and potential solutions addressed in this presentation, please visit us at www.picapa.org.