

# **Pennsylvania Intergovernmental Cooperation Authority**



## **Philadelphia's Fiscal Challenge: Finding A Way To Save**

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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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## **Philadelphia's Fiscal Challenge: Finding a Way to Save**

The City of Philadelphia ended its Fiscal Year 2000 (FY00) with a positive fund balance, for the eighth consecutive year. The Pennsylvania Intergovernmental Cooperation Authority (PICA) has given deserved accolades to the City for this accomplishment, accompanied by warnings, reminders and recommendations. PICA, tasked with the duty to "assist cities in avoiding defaults, eliminating and financing deficits, maintaining sound budgetary practices and avoiding the interruption of municipal services," has consistently stressed the City's need to proactively prepare for identifiable and unknown fiscal threats that may impede continued fiscal stability and prosperity.<sup>1</sup>

The strong national economy has been a major driving force behind the consecutive positive fund balances achieved by the City. Philadelphia, having emerged slowly from the recession of the early 1990s, continues to be in a tenuous financial position that ebbs and flows in accordance with the volatile national economy. Factors such as a high poverty concentration, a high local tax burden, and a shrinking population, make Philadelphia especially vulnerable to a fast adverse hit should a national recession occur. The City can not afford to be caught unprepared should a national recession come to pass; it should be taking measures now to lessen the blow that a national recession would cause.

### **Many States and Municipalities Have Embarked on Saving Initiatives**

Forty-four of the fifty states have responded to the hard lessons learned from the recessions of the early 1980s and 1990s by creating either a rainy day fund or some type of stabilization reserve fund. Pennsylvania's projection for its reserve balance at the end of FY01 exceeds \$1.1 billion dollars. Major cities such as Houston and Washington D.C. have joined the states in proactive recession planning and have created rainy day funds at the local level. In a report jointly published by the Maxwell School of Citizenship and Public Affairs at Syracuse University and *Governing Magazine*, 16 of 35 cities studied were cited as having rainy day funds or reserve surplus funds.

It is not too late for Philadelphia to join those forward thinking government entities and embark upon a planned saving process. Philadelphia must take advantage of the present situation in which unemployment rates remain low, consumer spending is high, inflation remains fairly steady and worker productivity continues to improve. The City will not be a pioneer in such saving endeavors and it can benefit by studying other rainy day fund models.

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<sup>1</sup> Intergovernmental Cooperation Agreement by and between Pennsylvania Intergovernmental Cooperation Authority and The City of Philadelphia. Dated as of January 8, 1992.

## **The Logic Behind the Rainy Day Funds**

A rainy day fund as defined by *Governing Magazine* is, “reserves set aside to be used in the event of a recession or other unpredictable fiscal surprises.”<sup>2</sup> A rainy day fund is a tool used by governments to handle hard to predict economic downturns when they occur. Rainy day funds are created to serve as an alternative to raising taxes, cutting services, or increasing debt, practices that most municipalities resorted to in the past when faced with economic recessions.

Credit agencies look favorably upon rainy day funds and a “spin-off benefit of a fund balance is that it also provides government with funds to invest in order to earn interest income.”<sup>3</sup> When initiating a proposition to form a rainy day fund in the City of Houston proponents offered the following supportive statement from Amy Doppelt of Fitch IBCA, “Fitch would view the establishment of a rainy day fund as a positive action for the City of Houston. It shows evidence of prudent fiscal management, and increases the City’s financial flexibility.”<sup>4</sup>

While the accumulated balance in a rainy day fund could not, in most instances, fully sustain a city’s economy in the event of a national downturn, such funds are a proactive fiscal step towards preparing for the blows that a volatile economy delivers. “The idea is not to insure against a disastrous downturn but to buy time for adjustment when the economy flags.”<sup>5</sup>

## **Set Parameters for a Rainy Day Fund**

Rainy day funds are composed of general fund revenue or tax supported dollars. The annual percentage of general fund dollars to be allocated into the fund, the purposes for which the money can be spent and the maximum amount of money that may accumulate in the fund are issues for which each respective municipality must set strict parameters.

**Allocating Money Into A Rainy Day Fund** - In Philadelphia’s case money could be allocated into a rainy day fund through year to year appropriations or transfer ordinances approved by City Council. A prudent option would be to allocate a certain percentage of total expenditures each year into the fund. States often refer to a five- percent allocation of expenditures as “the reserve level Wall Street bond houses view as prudent.”<sup>6</sup> Some municipalities opt for simply directing each year’s positive fund balance into a rainy day fund reserve.

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<sup>2</sup> “Grading The Cities: A Report Card on Urban Management”. *Governing*. February 2000, p 31.

<sup>3</sup> Shelton, Michael and Tyer, Charlie. “Benchmarking and Municipal Reserve Funds: Theory Versus Practice”. p 3.

<sup>4</sup> News Release Office of the City Controller City of Houston, June 1999.

<sup>5</sup> Petersen, John E. “Don’t Forget Your Umbrella”. *Governing*. October 1998, p 70.

<sup>6</sup> Berube, Alan and Lav, Iris. “When It Rains It Pours”. Center on Budget and Policy Priorities: March 1999, p 7.

Allocating money into a rainy day fund as a percentage of total expenditures is the surest way to guarantee that money is being put away each year to alleviate the impact of a future recession. Depositing positive fund balances into a rainy day fund also provides assurance that year to year surpluses would contribute to allaying future fiscal emergencies. With many diverse interests pushing and pulling on the City's funding capabilities contributing to a rainy day fund may be sidetracked if year to year appropriations must be made through City Council. Philadelphia will be tested to remain dedicated to the stated purpose of the rainy day fund and must be prepared to insist that the rainy day fund be utilized to compensate for a downturn in the economy, unknown risks and emergencies and revenue shortfalls.

**Placing Caps on the Rainy Day Fund** - "About three-fifth of the states have a limit on the size of the budget reserve fund, with limits ranging from 3 percent to 10 percent of appropriations...Typically, funds above the budget stabilization fund limit would remain in the state's ending balance."<sup>7</sup> Since debates and criticisms sometimes surround the utilization of rainy day funds, most municipalities decide to set a maximum limit on the amount of dollars in the rainy day fund. Each respective municipality must find its own balance and comfort level, so that levels in the rainy day fund are justifiable over such decisions as reducing taxes, or directing dollars towards other operating expenses.

**Withdrawing from the Rainy Day Fund** - Withdrawals from the rainy day fund should be structured to ensure that the intent for establishing the fund is maintained. Exacting limitations should be placed on withdrawals to assure use only in time of emergencies, economic downturns or revenue shortfalls.

Some municipalities require appropriation through a majority vote of the legislative body before funds may be withdrawn from the rainy day fund. Other municipalities have devised formulas that determine when a rainy day fund may be utilized. "Maryland's rainy day fund can be used only if the state unemployment rate is greater than 6.5 percent and is greater than in the previous year. In Indiana, the rainy day fund can be used only if the state experiences an economic decline as measured by changes in total state personal income. In particular, the fund can be used only if aggregate personal income in the previous year fell by more than two percent...."<sup>8</sup> Another option might allow the fund to be tapped only after a certain number of consecutive quarters of revenue decline.

Philadelphia's task would be to create parameters that provide an appropriate cushion in times of fiscal emergencies and economic decline. Using a specific formula to stipulate when dollars can be withdrawn from the rainy day fund will more effectively ensure that the rainy day fund is used only in recessionary periods. Also, a neutral party might be utilized to operate the rainy day fund. Use of a neutral party can often alleviate the political and sometimes public pressures to avert fund parameters.

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<sup>7</sup> National Association of State Budget Officers. "The Fiscal Survey of States: June 1999". p 12.

<sup>8</sup> Sjoquist, David L. "Georgia's Shortfall Reserve: An Analysis of Its Role, Size and Structure". Fiscal Research Program School of Policy Studies. Georgia State University. Atlanta, Georgia. FRP Report/ Brief No. 5 March 1998

## **Pennsylvania's Act 32 - Session of 1985**

The "Tax Stabilization Reserve Fund" (analogous to a rainy day fund) was created in Pennsylvania through Act 32 of 1985. Findings reported in the law concluded that, "It is a valid and proper public function to set aside a reserve fund in order to minimize future revenue shortfalls and deficits, provide greater continuity and predictability in the funding of vital government services and minimize the need to increase taxes to balance the budget of the commonwealth during periods of economic distress."<sup>9</sup> The Commonwealth accumulates dollars into the rainy day fund through General Assembly appropriation.

The Commonwealth has established a procedure whereby the Governor may request withdrawal from the rainy day fund in a written proposal to the General Assembly. Two-thirds of both the House and the Senate must approve a bill to authorize the release of funds from the rainy day fund. This helps to assure that the Governor's proposal will be scrutinized so that the purpose of the rainy day fund is maintained. According to the legislation enacted, "It is the intent of the General Assembly that these funds be appropriated only when the emergency or downturn in the economy cannot be dealt with through the normal budget process and that the moneys in the tax stabilization reserve fund not be used to begin new programs but provide for the continuation of vital public programs in danger of being cut off due to financial problems resulting from the economy."<sup>10</sup> The legislation adopted by the General Assembly of Pennsylvania could serve as a starting point for Philadelphia's consideration of similar legislation.

## **Philadelphia's Short-Term Savings Plan**

In its Five-Year Financial Plan, Fiscal Year 2001 – Fiscal Year 2005, the City indicated an intent to save \$80,843,000 through the end of FY01. The City designated this saving as a "Funding for Contingencies". This measure by the City is a short term saving plan which proposed expending the \$80.8 million through FY04. There is no guarantee that the \$80.8 million will be either initially saved or utilized across three fiscal years as proposed in the Plan.

The \$80.8 million is a proposed small cushion over three years which will most likely be used for operating expenses; it is not structured to provide for a downturn in the economy and there are no restraints which would restrict the money to be used only in emergency situations, revenue shortfall or a downturn in the economy. This planned saving to be expended over three years can be viewed as a plan for a short term reserve fund, which may or may not evolve as designed. As such the \$80.8 million sharply contrasts with the concept of a rainy day fund.

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<sup>9</sup> Commonwealth of Pennsylvania. Act 32 - Session of 1985. Chapter 2, Section 202, subsection B.

<sup>10</sup> Commonwealth of Pennsylvania. Act 32 - Session of 1985. Chapter 2, Section 202, subsection B.

Though the \$80.8 million is not termed a reserve fund or rainy day fund and though the money is not extracted and placed into a separate account, the similarities of the City planning for a “Funding for Contingencies” and the concept of a reserve fund are nonetheless striking. The noted similarity actually lends to a significant distinction. It is important to note the difference between planning for a short-term reserve and the creation of a rainy day fund. “Contingency and rainy day funds do share some similarities...But, and this is the key distinction, a reserve fund is not necessarily a contingency or rainy day fund. Rather, reserve funds can be for any number of purposes while rainy day funds are for unexpected contingencies, emergencies, or revenue shortfalls...”<sup>11</sup>

### **The Home Rule Charter: Philadelphia’s Balancing Act**

An often-cited obstacle to the creation of a rainy day fund in Philadelphia is the Home Rule Charter. Section 2-302 of the Philadelphia Home Rule Charter stipulates that, “The annual operating budget ordinance shall not become effective and the City Controller shall not approve any order for any expenditure thereunder until the Council has balanced the budget.” Philadelphia is bound by law to produce a balanced budget every year. This has been interpreted to preclude creation of a rainy day fund without first amending the City Charter, which is regarded as an arduous process.

PICA Staff strongly recommends that the City reinvestigate the legal potential for creating a rainy day fund as a component of a balanced budget. The Five-Year Plan, mandated by the PICA Act, might well be the catalyst for creation of such a fund. The savings process implied by the Plan’s “Funding for Contingencies” presumes that such monies will in fact be made available.

If it is feasible for the City to plan to save money in the Five-Year Plan then it is within the City’s means to create a saving plan with the same intent as a rainy day fund. The City in conjunction with City Council could develop legislation to guarantee that funds are carried over from year to year and that parameters are constructed so that funds would be used only in the event of an economic recession, shortfall of revenues or other emergency situations. As City Council and the Street Administration have already set a precedent for planning to set aside reserves, legislative action may be the key to extending those reserves for a greater period of time and more defined set of circumstances.

**Amending the City Charter** - “Philadelphia can change the Home Rule Charter by either adopting amendments or by adopting an entirely new charter. Charter amendments may be placed on the ballot by two-thirds vote of Council, or by a majority vote of Council if petitioned by at least 20,000 registered voters.”<sup>12</sup> The most recent amendment

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<sup>11</sup> Shelton, Michael and Tyer Charlie, “Benchmarking and Municipal Reserve Funds: Theory Versus Practice”. p 2.

<sup>12</sup> Pennsylvania Economy League. Philadelphia Government. Seventh Edition, p 12.

to the City Charter was adopted in November of 1999. City Council placed an amendment on the November 1999 election ballot and voters passed the amendment allowing the Mayor to appoint and dismiss school board members at will.

The most recent amendment to the charter might be characterized as being of minor difficulty in comparison to earlier failed attempts to amend the charter. Though amending the charter should not be taken lightly, the process may no longer be as daunting as it had been considered to be in the past. City Council might well follow up on its recent success and initiate an amendment to allow for the creation of a rainy day fund. Amending the City Charter is a definitive step that, pending voter approval, would allow for the creation of a rainy day fund.

### **The City of New York: Example of a Rolling Surplus**

The City of New York is required under State law to balance its budget annually. At the end of FY98 New York established a budget stabilization account. In order to abide by Generally Accepted Accounting Principles (GAAP) guidelines the budget stabilization account is a short term saving plan from which expenditures of the surplus are planned within the few years of the current fiscal year end.

The New York State Financial Control Board estimated that the year-end balance in New York's budget stabilization account in FY00 would reach \$2.9 billion. According to the New York State Financial Control Board's Staff Report the city planned to, "use more than half of these resources to reduce the projected gap in FY01 and the remainder for budget relief in FYs 02 and 03."<sup>13</sup> The Control Board noted that the, "city regularly uses its end-year surpluses to prepay certain future-year obligations, such as debt service prior to the close of the fiscal year."<sup>14</sup>

In April of 1998, in a letter to Mayor Giuliani, the Citizens Budget Commission urged the City of New York to call upon the Governor to amend State law so that New York City would be able to create a rainy day fund. The Commission's alternative suggestion was to commit the end of the year surplus in its entirety to making prepayments on future debt. According to the Commission, "If the Mayor and Council were diligent about maintaining and building the size of the budget stabilization account, and refrained from drawing down its resources until the state of the local economy required it, then the City would effectively have a viable rainy day fund. In essence, the City would "roll" the surplus from one year to the next by using it each year to prepay debt service expenditures from the following year. When the economy sours and those resources are needed, the amount of debt service prepayment would decline; in an economic recovery the prepayment amount would be increased again."<sup>15</sup> The Control Board warned that this

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<sup>13</sup> New York State Fiscal Control Board. *Staff Report Review of FY 2000*. May 23, 2000.

<sup>14</sup> New York State Fiscal Control Board. *Staff Report Review of FY 2000*. May 23, 2000.

<sup>15</sup> Public letter dated April 1, 1998 from the Citizens Budget Commission of New York to the Honorable Mayor Rudolph W. Giuliani.

latter approach to saving is not preferred over a rainy day fund but is their choice of method to save rather than planning to expend the surplus in the manner in which the city is currently operating.

The city of Philadelphia can draw on many different municipal models that have averted violating balanced budget requirements while accumulating surpluses to be used in the event of a recession. Philadelphia must be creative in its thinking and capitalize on the current strong national economy.

### **The Unknown: The Volatile Economy**

The City of Philadelphia quickly found itself battling to survive the recession of the early 1990s. The impact was dramatic and the toll on the City was severe. The City lost thousands of jobs that it is still attempting to recoup, and found itself facing a possible operating deficit of over \$200 million at the end of FY92. As other municipalities were emerging from the recession after about a two year time span, Philadelphia continued to stagger in comparison and took roughly five years to stem job loss and unemployment. Philadelphia quickly felt the blow of the national recession and was slow to emerge from its aftermath.

The story has been told time and time again. The City readily recognizes its vulnerability; even after eight consecutive years of positive fund balances its survival outlook is bleak in the face of a national recession. Even so, the City has not initiated action to combat a recession. Economic development efforts and the small tax cuts do not constitute an effective financial cushion in for a future recessionary period.

In its White Paper No. 5, "Caution: Severe Threats to Philadelphia's Fund Balance Ahead", PICA noted that, "Although Philadelphia's positive General Fund balance is large by historical standards, it does not compare as favorably to other cities positive balances. According to the National League of Cities' survey cited above, cities with populations greater than 300,000 ended FY97 with fund balances equal to 11.7% of expenditures. Philadelphia's currently projected General Fund balance for FY99 is less than 5% of expenditures."

The verdict is still out on where the national economy is headed. The stock market has been volatile in the wake of lower than expected earnings reports, high energy prices and rising consumer prices. The national economy may very well be moderating to a more sustainable pace or the beginning of a national recession may be in the offing. In the latter situation the City may again find itself raising taxes, cutting services, and increasing debt as reactive measures to a national recession. It could again find itself losing thousands of jobs and inching slowly along through a painful economic recession because appropriate lessons were not learned from the last such event.

## **Conclusion**

The City of Philadelphia is currently benefiting from a strong national economy as evidenced by its eighth consecutive positive fund balance. Having said that, Philadelphia remains vulnerable to the national economic shifts. Past history has shown the City to be quick to fall into a recession and late to come out from one. Learning from the past and preparing for the future must be more than just words; it requires positive action. Philadelphia can prepare for future fiscal uncertainties by creating a rainy day fund. Other municipalities under the same charter constraints as Philadelphia have found ways to put funds aside for the seeming inevitable future downturn in the economy. The question for Philadelphia is not can this be done but does the City want to take the strides to get it done in a timely manner.