Translating Philadelphia’s FY2005 Ending Fund Balance: Happy Days Are Not Here Again

PICA Issues Report

November 2, 2005

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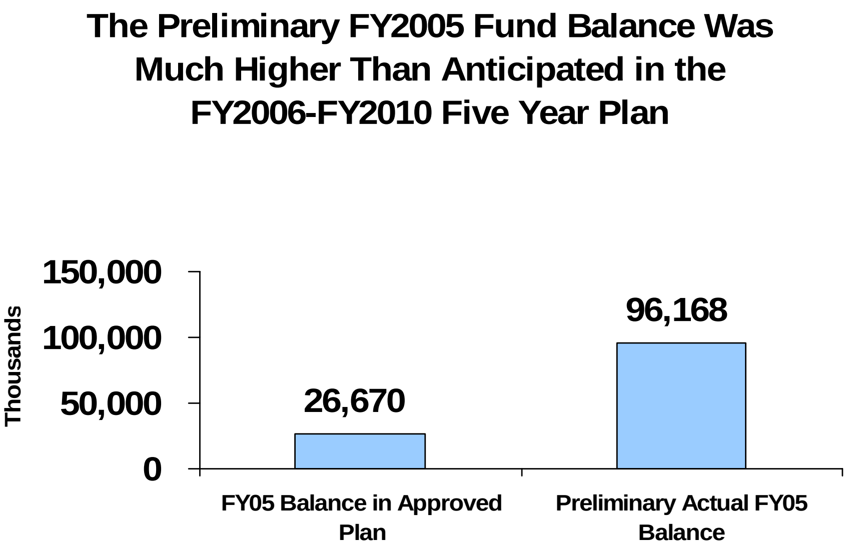
The FY2005 Fund Balance

Preliminary numbers show that the City's actual FY2005 ending fund balance was almost $70 million higher than the amounts included in the PICA approved FY2006-FY2010 Five-Year Plan.



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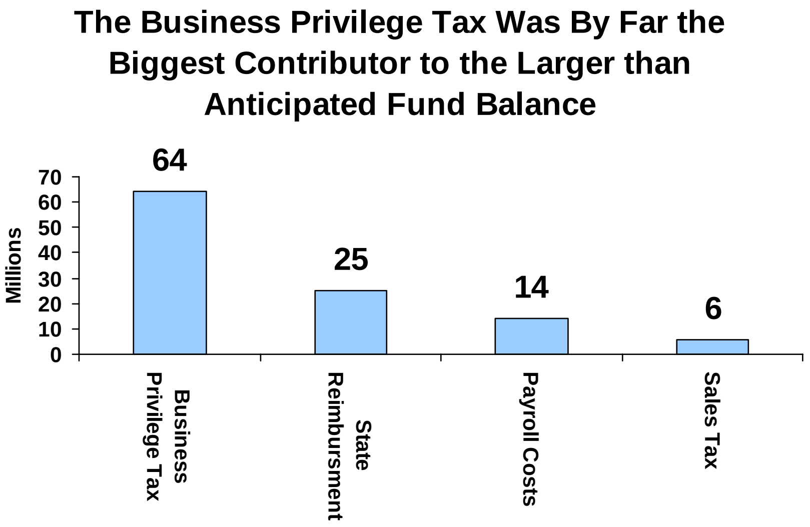
Why Was the Fund Balance So Much Higher than Originally Projected?

1. **Business Privilege Tax collections were $64 million higher than the amount included in the Plan.**
2. **A $25 million state reimbursement for child welfare services was received earlier than anticipated.**
3. **Payroll costs were $14 million lower than projected.**
4. **Sales Tax collections were about $6 million higher than projected.**
5. **The improvements to fund balance were partially offset by the delay of a $19 million convention center payment until after the end of FY05.**



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What Does the Increased Fund Balance Indicate?

- The increased fund balance is a sign that that the City's fiscal health is moderately better than forecast.
- The increases in business privilege and sales tax collections are signs that the City's economy is doing better than anticipated. Strong collections during the first quarter of FY06, particularly for the real estate transfer tax, are another sign that the City's economy is strengthening.
- The decrease in payroll costs is a sign that the continuing decline in the number of City general fund employees is having a positive impact on the City's finances.

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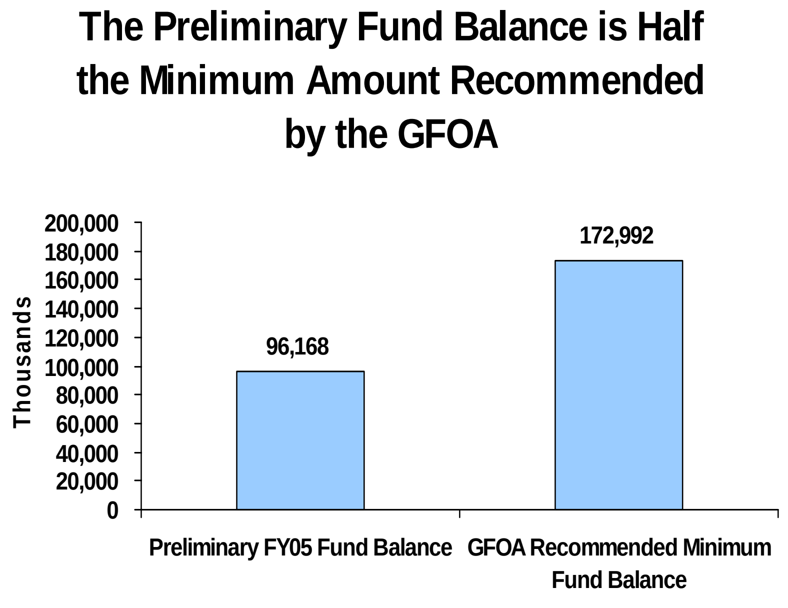
Why Isn't The Increased Fund Balance A Sign that Happy Days are Here Again: Benchmarking

Even at $96 million, the fund balance is barely half of the 5% of revenues that the Government Finance Officers' Association says is the minimum 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: One-Time vs. Recurring Revenues

In addition to being far smaller than recommended by the Government Finance Officers' Association, the fund balance was built, in part, on one time or volatile revenue sources.

- The $25 million state reimbursement for child welfare services that boosted FY05's ending fund balance was already included in the approved Five-Year Plan for FY2006, which will reduce revenue in FY06 and is revenue neutral over the life of the Plan.
- Business Privilege Tax collections are historically volatile with sometimes dramatic year-over-year increases and decreases. For example, business privilege tax collections declined in both FY02 and FY03.
- The proposed changes to the property assessment system in Philadelphia make it difficult to project Real Estate Tax revenues over the life of the Five-Year Plan. In its report titled "From Virtual Realty to Full Value Realty: Preparing for Reassessment," PICA called on the City to ensure that the changes to the real estate assessment process are revenue neutral after accounting for natural growth.

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

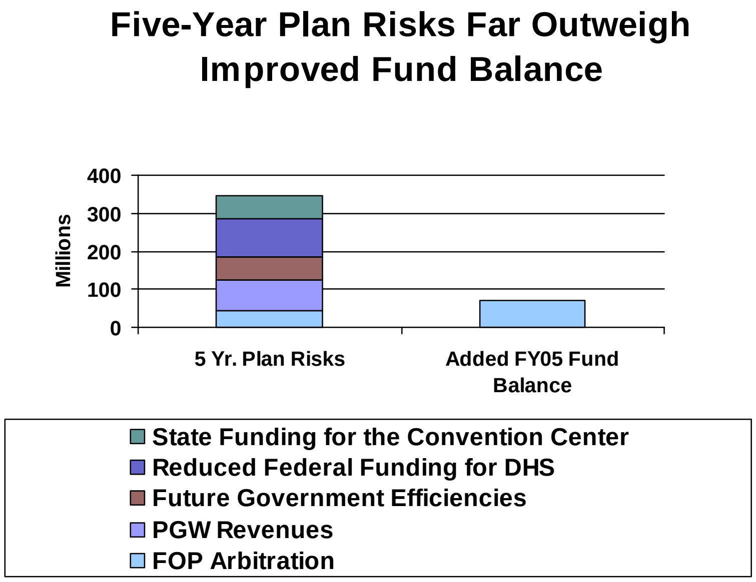
- **Labor agreements and awards**. The FOP health/medical benefits arbitration award alone would cost $45 million over 5 years if the City's appeal is not successful. The City also faces an IAFF arbitration and a renegotiation of health/medical benefits with nonuniformed employees within the next year.

- The Five Year Plan still includes $81 million in revenues from **PGW** that the City might not receive.

- The Five-Year Plan continues to include $60 million in **unspecified future government efficiencies** that the Plan acknowledges will be hard to achieve.

- **Reductions in federal funding** have created a substantial risk that funding for the Department of Human Services will have to increase or services will have to be reduced. If services are not reduced, the added cost could be over $100 million over five years.

- The Plan assumes that the State will take full responsibility for funding **the convention center** in FY07, but there is a substantial risk that state funding will be lowered than planned and will be received later than the Plan anticipates. The added cost over the life of the Plan could be about $60 million.



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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 FY07-FY11 Plan will be balanced. 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 City's goal should be to have a reserve that is at least equal to the five percent of revenues that the GFOA says is the minimum a government should have.
- **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 The City's annual long term obligations, including its unfunded pension liability, equal almost 16 percent of its revenues. In FY01, those long term obligations equaled less than 13 percent of revenues.
- **Make the City's tax structure more competitive.** Philadelphia's taxes, particularly the business privilege and wage taxes, should be lowered. As has been repeatedly documented, the City's tax structure is a deterrent to job growth.
- **Reduce the City's unfunded pension liability.** The pension fund's liability is only 59 percent funded, down from 77 percent five years ago; 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.