Reversing the Trend of Doing Too Little with Too Much: Maintaining the City's Infrastructure While Reducing Its Dangerously High Debt Load

PICA Issues Report

January 23, 2006

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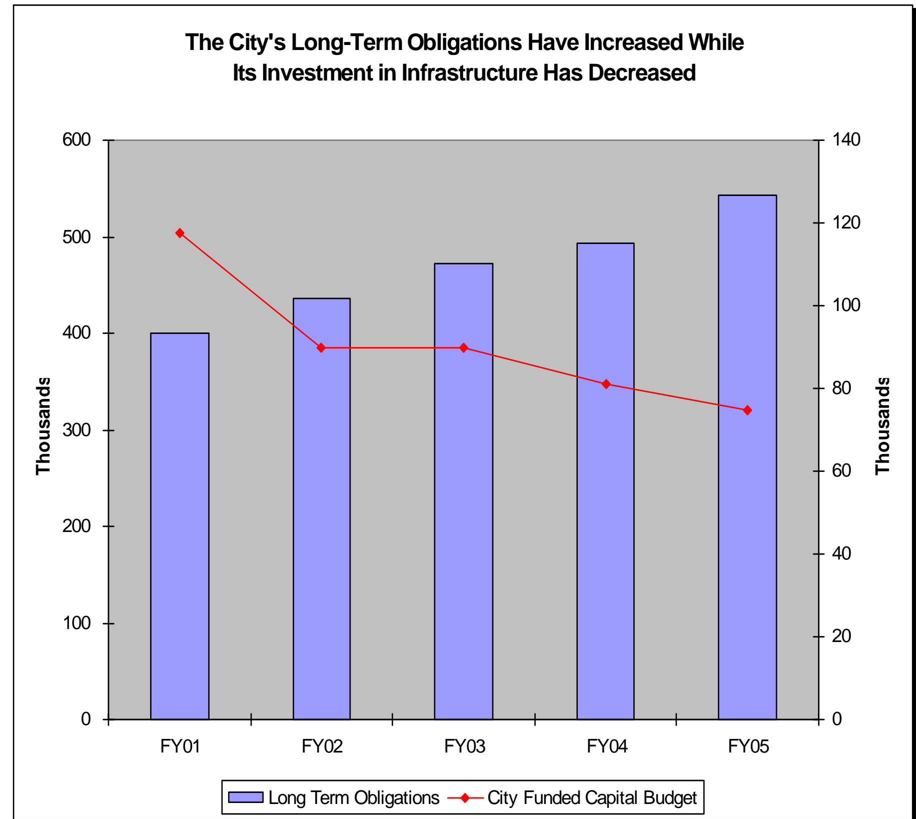
Extent of the Long-Term Obligations and Infrastructure Problem - History

- The City should be increasing investment in its aging infrastructure while reducing long-term obligations as a percent of the budget. Instead, long-term obligations have increased rapidly while investments in the City's infrastructure have shrunk.

- The fixed costs are approaching a level at which they threaten the City's budgetary flexibility and the declining infrastructure investment threatens to lead to a rapid deterioration in the condition of city assets.



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Extent of the Long-Term Obligations and Infrastructure Problem - History

Facing these two problems at the same time makes them particularly challenging. Having a high long-term obligations burden means that the City cannot prudently simply ramp up its borrowing to increase its infrastructure investment and having insufficient investment in its infrastructure means the City cannot reduce its long-term obligations by simply cutting back its level of investment. This report will describe the long-term obligations and infrastructure investment challenges facing the City and provide some recommendations for ameliorating the problems they create.

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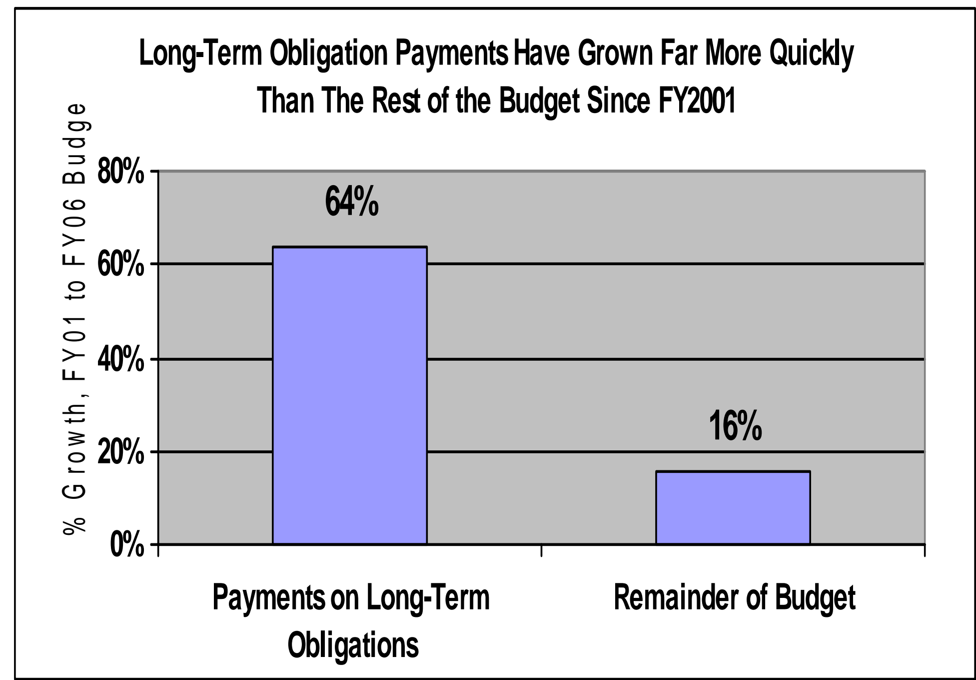
Extent of the Long-Term Obligations Problem - History

- In FY2001, long-term obligations – debt service, long term leases and payments to eliminate the City's unfunded pension liability – totaled about $400 million. In FY2006, they are budgeted to be just under $540 million – a $140 million or 35 percent increase.
- Payments on long-term obligations have increased by 64% since FY2001, while the remainder of the budget has grown 16%.



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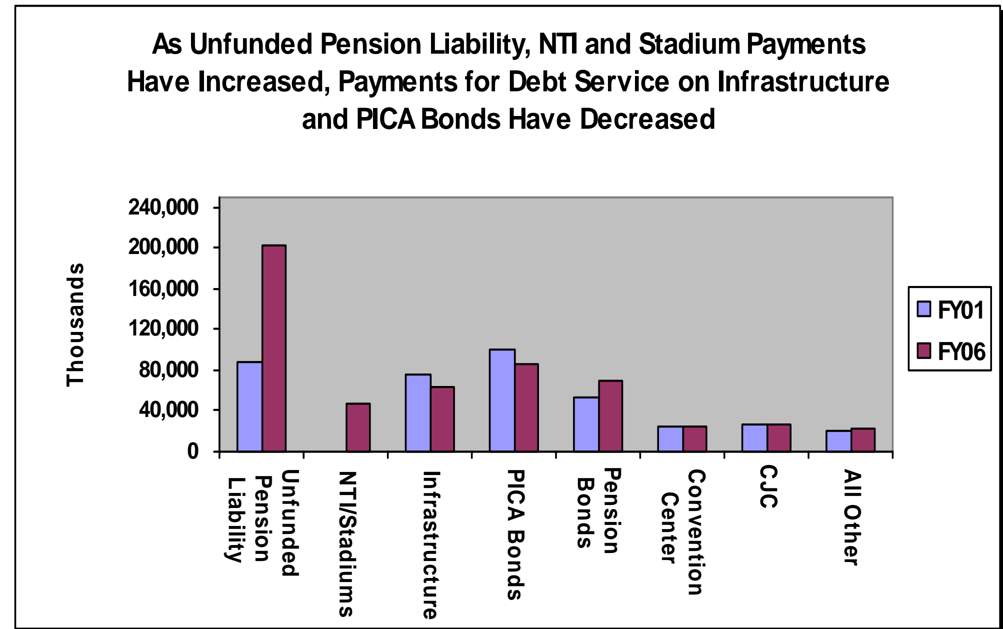
Extent of the Long-Term Obligations Problem - History

- Even as long-term obligation costs increased, funding for infrastructure decreased.
- The reduction in infrastructure investment came at the same time as payments to amortize the City's unfunded pension liability increased and the City began making payments on bonds issued for the Neighborhood Transformation Initiative and the Eagles and Phillies Stadiums.



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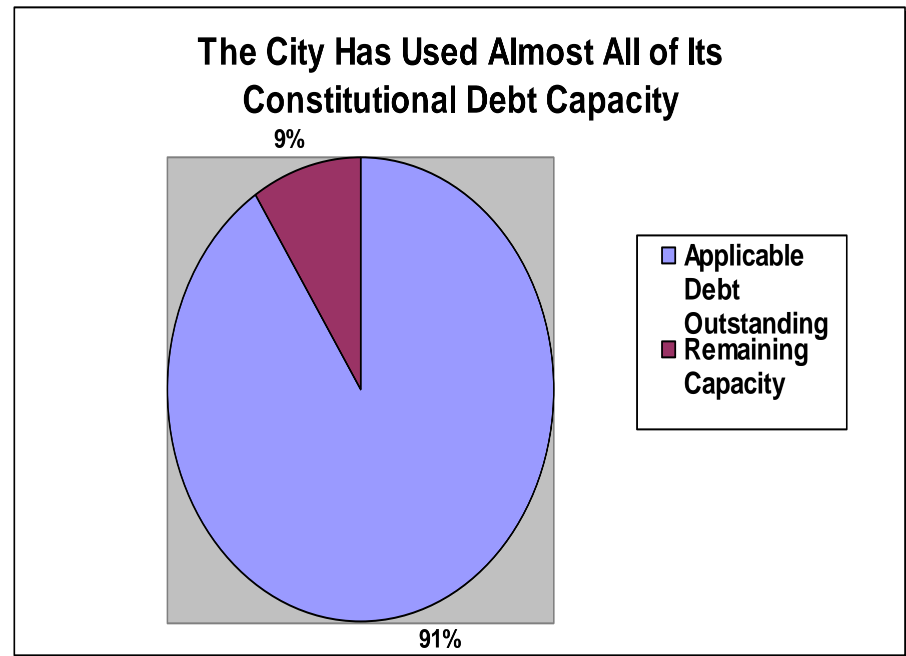
What are the Limits on the City's Debt?

Under the Pennsylvania Constitution, the City's debt is limited to 13.5% of the 10 year moving average of the assessed value of property in the City. The City's FY2005 financial statements show that its legal debt limit is now $1.3 billion, but that the City has $1.19 billion of outstanding debt applicable to that debt limit. The City's remaining legal debt margin is just $119 million.



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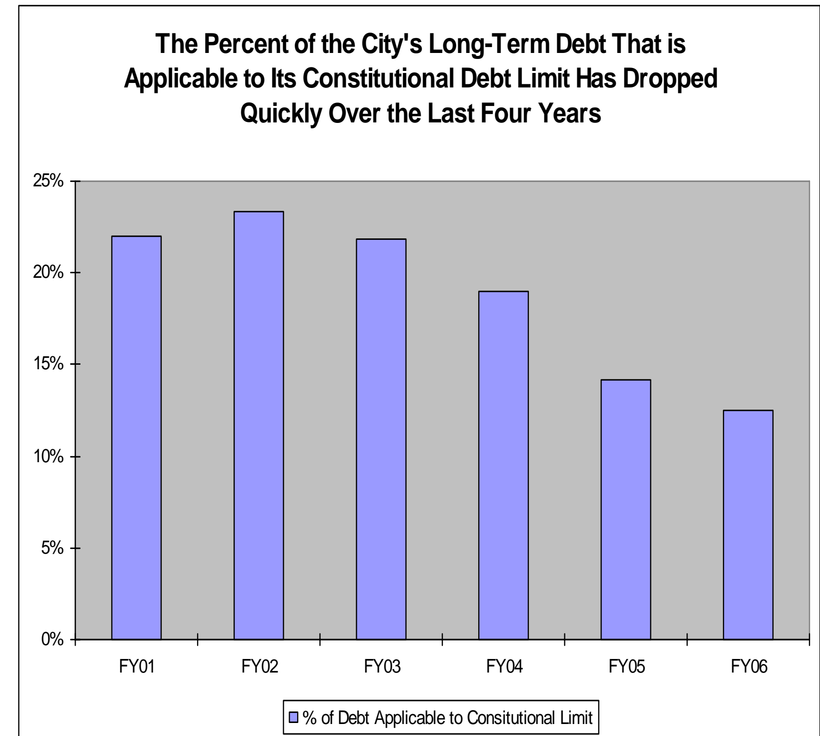
What are the Limits on the City's Debt?

While the City is close to it Constitutional debt limit, that limit's importance is lessened by several factors, including:

- **The City has gotten around the debt limit by using authorities to borrow.** Unlike debt issued directly by the City, borrowings by authorities do not count against the City's debt limit. Almost 85% of the City's long-term obligations do not count against the City's debt limit.

- **The Constitutional debt limit calculation includes only assessed values**, but property taxes account for only a little more than one tenth of the City's general fund revenues.

- **When the Board of Revision of Taxes' full value project is completed, assessed values in the City will increase** because the BRT will be moving from a system that assesses properties at roughly a quarter of their value to one that values properties at 100 percent of their value. That change in the BRT's process will mean that the City's debt limit under the state constitution will roughly quadruple, but there will have been no change in the City's financial ability to support that borrowing.



What Do Other Cities Do?

Cities employ a variety of measures to determine whether their debt levels are too high including limits based on:

- The value of property
- Total revenues
- Total expenditures
- A combination of factors

Virginia Beach, which was one of only five cities that got at least an A- minus from the Government Performance Project, is an example of a City that uses a combination of factors. Even though Virginia Beach is limited by both its state constitution and city charter to having debt that equals no more than 10% of the assessed value of real estate, it takes additional steps to make sure that it does not over borrow. The city has identified the following four indicators of debt affordability: (1) Annual debt service as a % of general government expenditures; (2) Overall net debt should as a % of estimated full value; (3) overall debt per capita; and the ratio of overall debt per capita to per capita income.

While the indicators Virginia Beach uses might not be the right set for Philadelphia, the policy of using indicators in addition to a legal debt limit to determine how much debt a local government can issue is one that Philadelphia should pursue.

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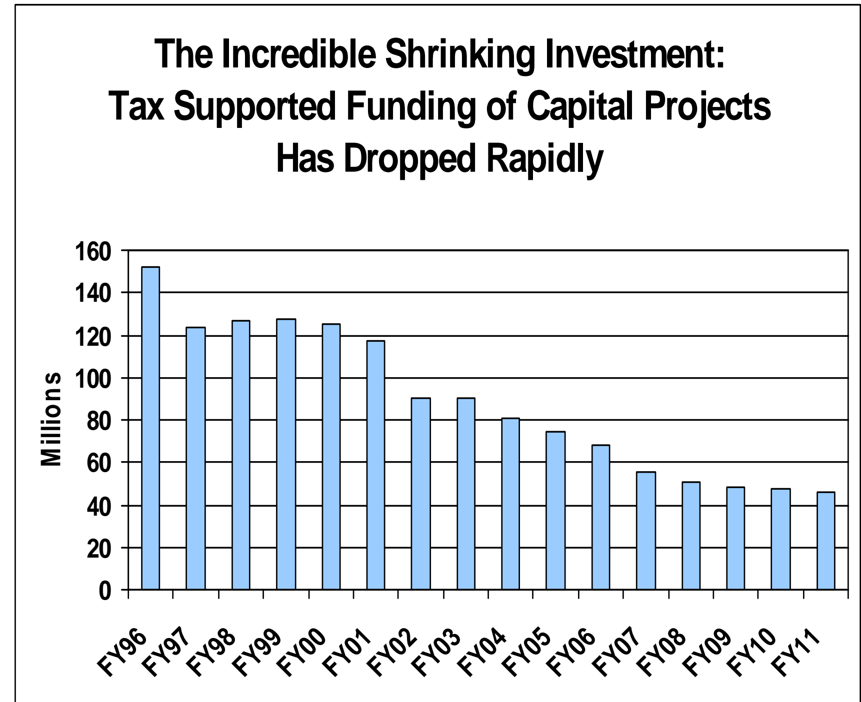
Extent of the Investment Problem

- From FY2001 to the FY2006 capital budget, the City's tax supported investment in its infrastructure declined 42% from $117.4 million to $68 million.
- The rapid reduction over the last five years is part of a long term trend as tax supported capital investments, which were $152 million as recently as FY1996 are projected to be only $45.8 million in FY2011.



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How Does the City's Infrastructure Investment Compare to Levels the City Planning Commission Says are Necessary to Keep That Infrastructure in Good Condition - Baseline

The Planning Commission did an analysis in FY2000 that detailed the impact on the City's infrastructure of various levels of capital investment. The Commission found the following impacts:

- **$185 million.** At $185 million, which the Commission called Level A, the City would be able to keep all of its infrastructure resources in good condition, which should be the City's goal.
- **$153 million.** At $153 million, which the Commission called Level B, the City would be able to renovate facilities; invest in major economic development initiatives such as the Avenue of the Arts and Naval Base conversion; meet regulatory requirements for the environment; and invest in projects to improve technology and energy conservation.
- **$83 million**. At $83 million, which is Level C, funding would be sufficient only to maintain basic infrastructure; provide some funding for economic development initiatives and fund the basic support for transit systems and general efficiency initiatives.
- **$35 million.** At $35 million, which is level D, the City Planning Commission says there would be "widespread and highly visible deterioration of Philadelphia's Public Infrastructure." The City must find ways to avoid the inevitable negative consequences of the projected lowering of capital investment to only $45.8 million in FY2011.

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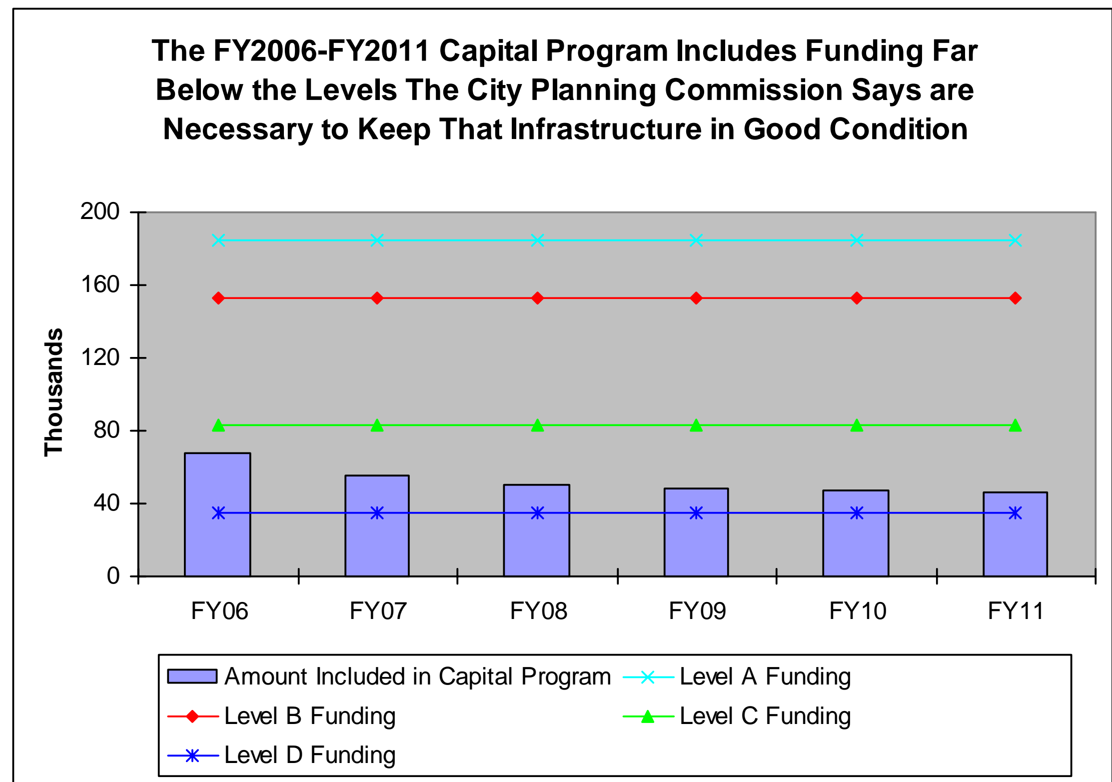
How Does the City's Infrastructure Investment Compare to Levels the City Planning Commission Says are Necessary to Keep That Infrastructure in Good Condition - Performance

The City's investment in its infrastructure is far below the levels the City Planning Commission says are required to keep that infrastructure in good condition.



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Recommendations

FINANCIAL RECOMMENDATIONS

- **The City Should Do More Pay as You Go Capital Spending**

  Almost all City-supported capital spending is funded through bond issues, but the City should pay for more of those costs out of its operating funds. For example, the City could move $37.3 million from new borrowings to the general fund operating budget over the life of the current FY06-FY11 capital program by shifting the Capital Program Office's payroll for administration and architects and engineers to pay as you go funding. Shifting to more pay as you go financing could allow the City to reduce its projected debt service at the same time as it was increasing its investment in its infrastructure.

- **The City Should Consider Retiring Some of Its Outstanding Bonds**

  By purchasing some of its bonds, the City would lower its debt service going forward, even though that payment would increase current year spending.

Recommendations (cont.)

FINANCIAL RECOMMENDATIONS

- **The City Should Consider Reducing the Number of Facilities It Maintains**

  Given its level of existing long-term obligations, the City cannot substantially increase the amount it borrows for infrastructure improvements and given the pressures on its operating budget, it cannot provide enough money to adequately fund infrastructure improvements without threatening its ability to provide essential services while making its tax structure more competitive. The only way the City could provide adequate funding to properly maintain its facilities, is if it had fewer facilities. The City should continue to look for ways to close, outsource or sell facilities. Reducing the number of facilities will allow the City to increase the amount it invests in the facilities it retains, which should improve the condition of those facilities.

Recommendations (cont.)

MONITORING/REPORTING RECOMMENDATIONS

- **The City Should Base Its Debt Incurring Limit On Its Total Revenues**
  The State Constitution's limit is clearly too narrowly based since it only focuses on the City's property tax base. A more meaningful test would look at all of the City's revenues. There are a range of percents that are appropriate, but each City that looked at total expenditures or revenues used a percent from five to fifteen. The City's goal should be to get its long-term obligations as a percent of revenues below 15% in the short term and below 10% in the long term. In FY06, long-term obligations are budgeted to be just over 15% of revenues and they are projected to be close to 16% by FY2010.

- **Each Year's Five-Year Plan Should Include Projections for Long-Term Obligations as a Percent of Revenues**
  The City's five-year plans should show what those obligations would be as a percent of revenues. If the Plan showed that long-term obligations exceeded the City's target, the Five-Year Plan should include a strategy for reducing that percentage to a level below the City's target.

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Recommendations (cont.)

MONITORING/REPORTING RECOMMENDATIONS

- **The City Planning Commission Should Regularly Update Its Needs Assessment and That Document Should Be Discussed in the Capital Program Chapter of the Five-Year Plan**

  The assessment should show the annual investment needed to keep the City's infrastructure in good repair and the effects of various levels of investment. Including this discussion in the plan will allow the Mayor and City Council to understand the implications of the capital budget choices they are making.