

FY08-FY12 Five-Year Plan: PICA Staff Report

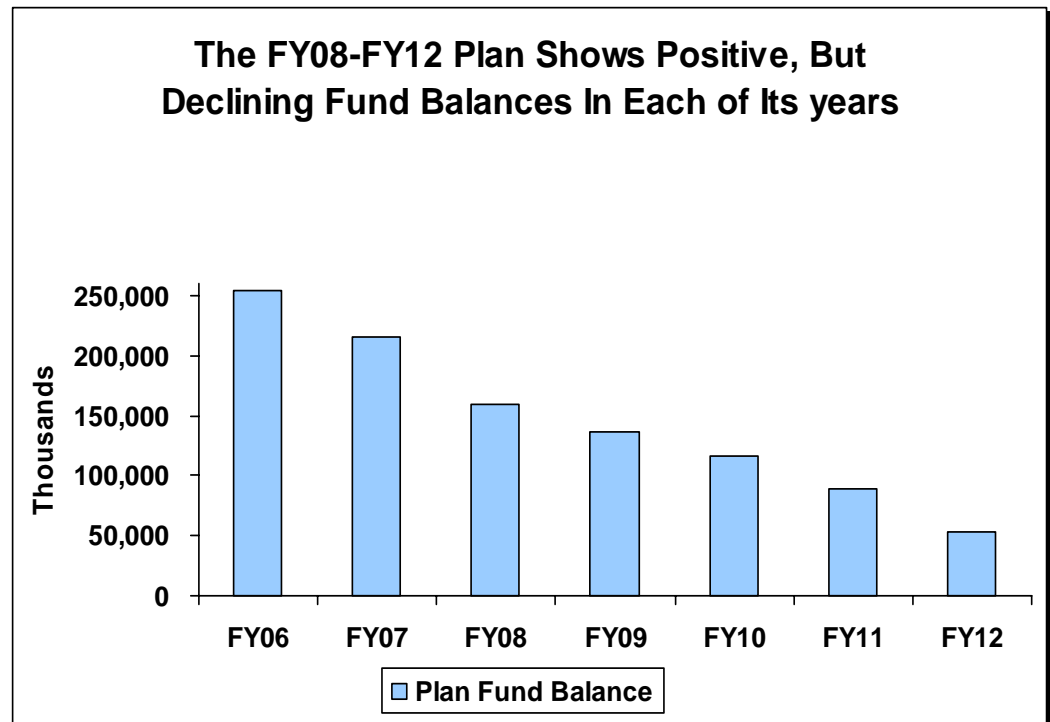
July 26, 2007

FY08-FY12 Five-Year Plan: PICA Staff Report

Is The Plan Balanced?

The Plan is narrowly balanced, but fails to address the structural financial issues facing the City. While leaving the City with an FY12 fund balance that equals less than 1.5% of revenues, the Plan also leaves the City with:

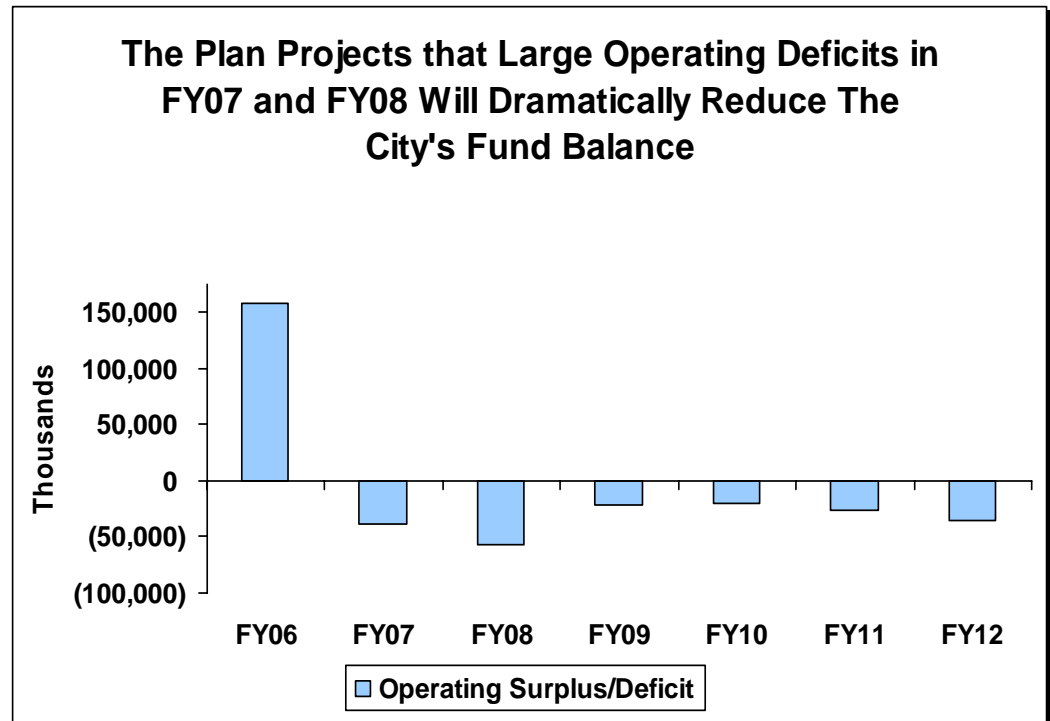
1. A crumbling core infrastructure;
2. An enormous unfunded pension liability;
3. An uncompetitive tax structure;
4. Skyrocketing health benefits and pensions costs;
5. A rapidly increasing prisons census;
6. A School District that faces its own financial challenges; and,
7. Collective bargaining agreements that expire at the end of the Plan's first fiscal year.



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What Are the Plan's Overall Trends?

- The Plan projects that the City will spend more than it will take in each year.
- Because of the imbalance between revenues and expenditures, the Plan is projected to have operating deficits each year from FY07 through FY12.



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How Did the City Bring the Plan into Balance?

The Plan as submitted to City Council in February contained so many speculative items that it was clearly not balanced using reasonable assumptions. The City, however, took a number of steps to bring the Plan into narrow balance, including the following:

1. **Removing DHS appropriations from the General Fund.** The appropriations were based on the assumption that the City would receive far more money from the state and federal governments than had been included in the State budget;
2. **Reducing the projected growth rate for the wage tax.** The initial Plan had more aggressive wage tax projections than any previous Plan.
3. **Including additional funding for Prisons costs.** The initial Plan had assumed that the growth rate for prisons costs would drop 75%.

Actions Taken That Lessened PICA's Concerns	
	\$ Thousands
Move DHS Funding to Grants Fund	350,000
Capping Projected Wage Tax Growth at 4%	47,875
Increasing Projected Growth for Prisons Contracts	24,655
Reducing Projected Property Tax Collections	33,732
Eliminating Projected Health Benefits Savings	10,140
Adding School District Funding	105,000
Total	571,402

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How Did the City Bring the Plan into Balance?

After eliminating speculative items, the City needed to take a number of steps to either add revenues or reduce costs. Those steps included:

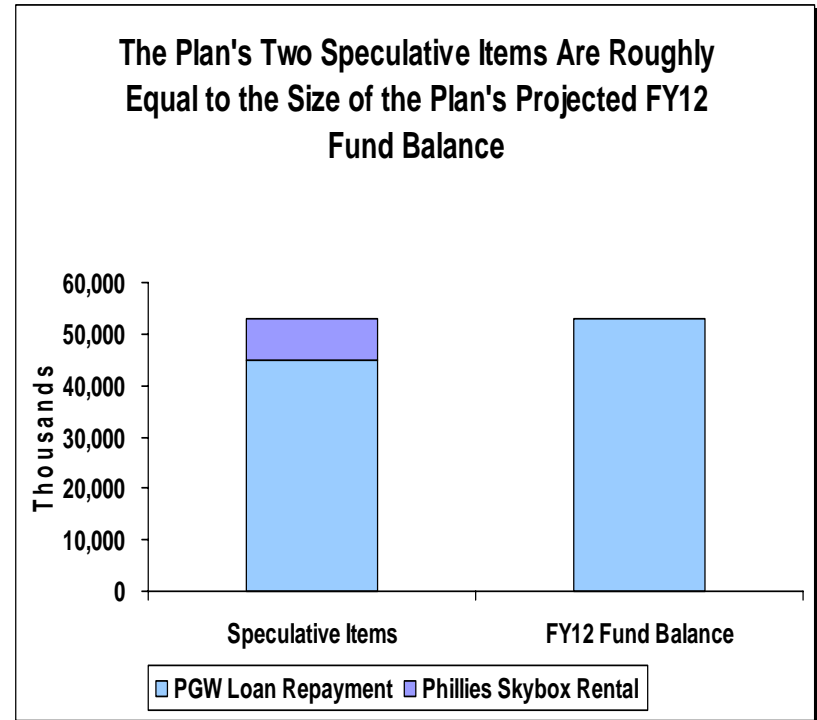
1. Making FY09 the last year of the business privilege tax reductions. This step added \$12 million to the Plan, but would send a damaging message to businesses;
2. Dissolving the productivity bank. This proposal would add over \$30 million to the Plan, but would eliminate one of the only sources the city has for making investments in projects that would improve government efficiency and effectiveness;
3. Recognizing better than budgeted business privilege and wage tax projections;
4. Eliminating funding that City Council had provided to a number of departments.

City's Proposed Gap Closing Measures:		
	\$ Thousands	\$ Thousands
<u>Changes to Tax Policy</u>		
Freeze Bpt Reductions After FY09	12,350	
Total Tax Policy Shifts		12,350
<u>Increased Projected Tax Revenues</u>		
Wage Tax	63,070	
Business Privilege Tax	96,295	
Total Increased Projected Tax Revenues		159,365
<u>Increased Local Non-Tax Revenues</u>		
Casino PILOTS	12,320	
Phillies/Eagles PILOTS	7,560	
Total Increased Local Non-Tax Revenues		19,880
<u>Expenditure Reductions</u>		
Elimination of FY08 Council Additions to Budget	6,125	
Eliminate Productivity Bank	33,018	
Cut Fleet Spending	2,100	
Reduction in Projected Debt Service Payments	13,690	
Shift DHS Appropriations to the Grants Fund	350,000	
Eliminate Council FY08 Additions in FY09 Through FY12	57,409	
Total Expenditure Reductions		462,342
Total Plan Balancing Proposals		653,937

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Despite Being Narrowly Balanced, the Plan Still Contains Some Speculative Items

- The Plan still assumes that the Philadelphia Gas Works will repay the \$45 million loan that it received from the City. Whether PGW will be able to repay that loan and avoid requiring additional assistance from the City will rely, in large part, on the results of a PGW rate increase request that is now being considered by the Pennsylvania Utility Commission.
- For the fourth consecutive year, the City is assuming that the Eagles will pay \$8 million that the City asserts the Eagles have owed since they played at Veterans Stadium. The Eagles are contesting the amount of the payment and say that they have an offsetting claim.
- The Plan's two speculative items are roughly equal to the Plan's projected FY12 fund balance, which means that if the City does not receive either the PGW loan repayment or the Eagles payment, its fund balance will be all but gone at the end of FY12.



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In Addition to Containing Speculative Items, the Plan Includes A Number of Other Risks

- **Like every one of the City's five-year plans, the FY08-FY12 Plan includes no money for salary increases for years not covered by collective bargaining agreements. The risk presented by that approach is particularly large for this Plan because four of its five years are not covered by collective bargaining agreements. A 1% annual increase in wages would add \$140 million costs to the Plan.**
- **The City also assumes that it will be successful in its appeal of healthcare benefits awards to police and firefighters.**
- **The Plan projects that real estate tax assessments will grow by at least 5% in 4 of its 5 years and by 6% in FY09 and FY10. Given the weakening in the real estate market, those projections appear to be aggressive.**
- **The Plan includes two actions that are inconsistent with promises made by both of the major party candidates: it ends the business privilege tax reduction program in FY10 and reduces the number of police officers by 63 in FY09 (when State Police assume full responsibility for patrolling state highways in Philadelphia).**

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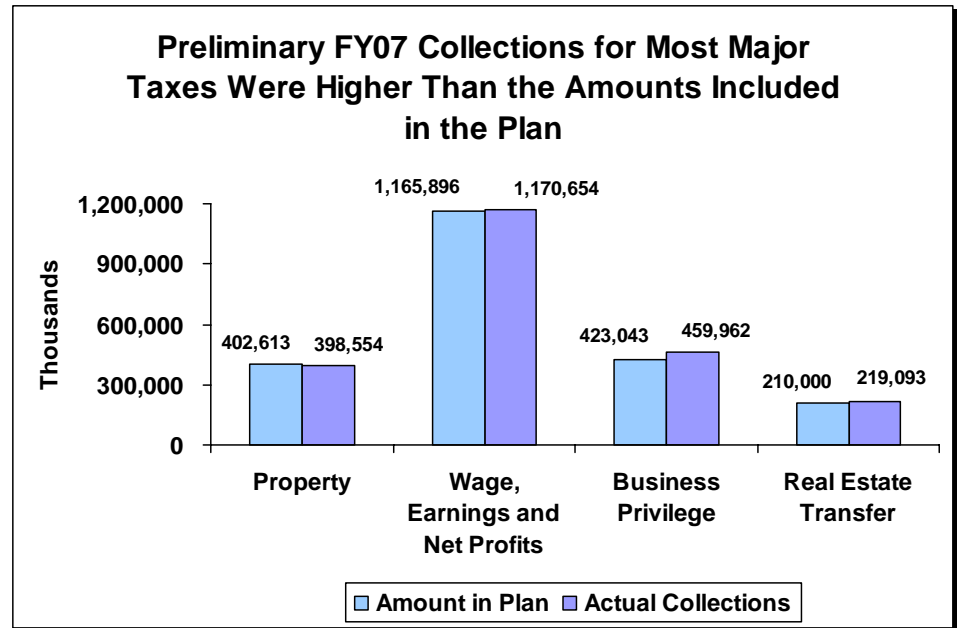
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- **The Plan assumes that the City will begin receiving casino revenues in FY09, but shows not City costs associated with those casinos. In addition to facing a risk that the opening of the casinos may be delayed, the Plan faces the real risk that, when they do open, the casinos will create enormous costs for the City.**
- **The School District is all but certain to continue to have financial challenges. The District has said that \$60 million of the cuts included in its deficit elimination plan are at risk of not being eliminated, the state budget had about \$25 million less in new funding than the deficit elimination plan assumed and the City may also provide less new funding than the School District anticipated.**

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The Plan's Tax Revenue Projections Are Appropriately Conservative

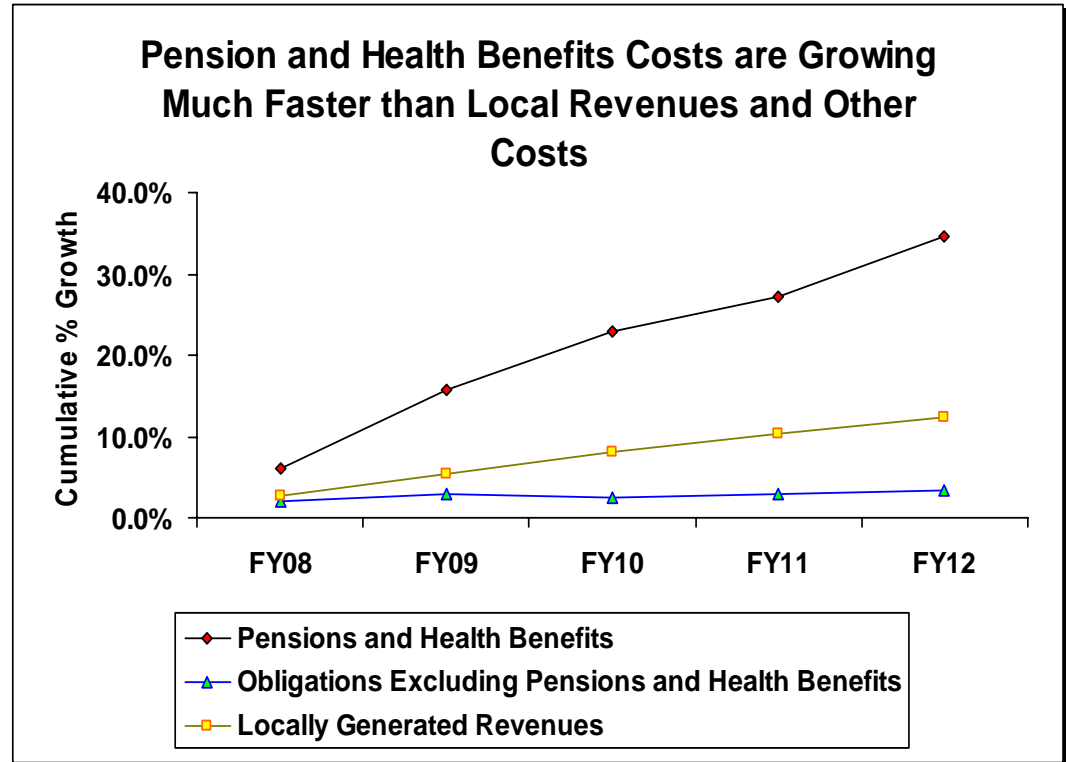
- With the exception of projected property tax collections, the City's tax projections appear to be appropriately conservative.
- While preliminary FY07 property tax collections were slightly lower than the amounts included in the Plan, business privilege, wage and real estate transfer tax collections were all higher than the amounts included in the Plan.



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Why Is It So Hard to Balance the Plan?

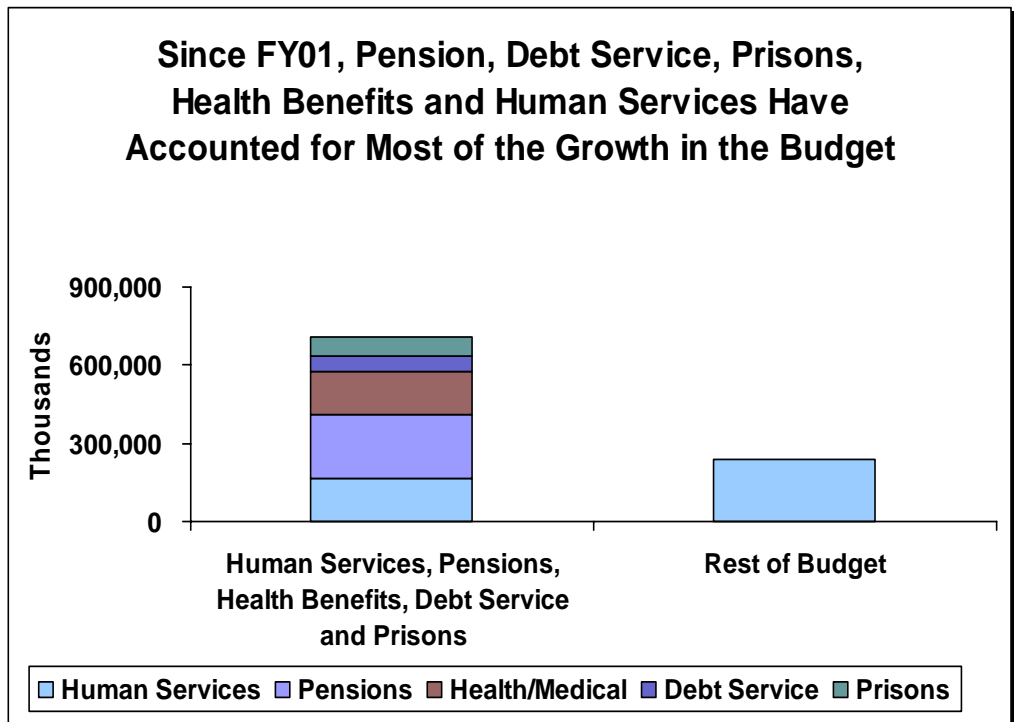
- Pensions and health benefits are projected to grow almost three times as fast as locally generated revenues and more than 10 times faster than other obligations.
- Pensions and health benefits costs are projected to reach \$1 billion in FY12.
- By the end of the Plan, pensions and health benefits will account for about \$1 out of every \$4 the City spends up from \$1 out of every \$8 in FY01.



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What Does The Increase in The Four Areas of the Budget Mean for the Rest of the Budget?

- Since FY01, Pensions, health benefits, prisons and debt service have grown from under a quarter of the budget to almost a third of the budget.
- If the four areas were not consuming a larger percentage of the budget than they did in FY01, there would be an additional \$330 million to either spend on other areas of the budget like police or streets or to use for tax reduction.



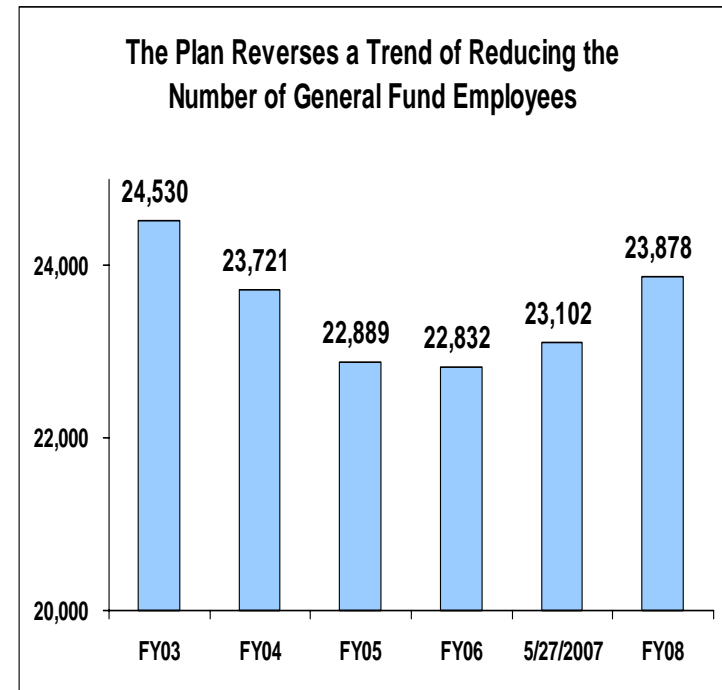
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What Changes in Staffing Does the Plan Propose? :

The plan proposes to reverse a recent trend of reducing staffing.

In total, the FY08 budget includes 776 positions more than were filled at the end of May 2007. The largest components of that increase are:

- 203 in Prisons to handle a projected continued increase in the census;
- 139 in the Streets Department;
- 104 in the Department of Human Services;
- 55 in the Police Department;
- 53 in the Recreation Department ; and
- 41 in the Mayor's Office of Information Services to improve project management and to move 26 employees in Public Property's telecommunication division to MOIS as part of a shift of the function.

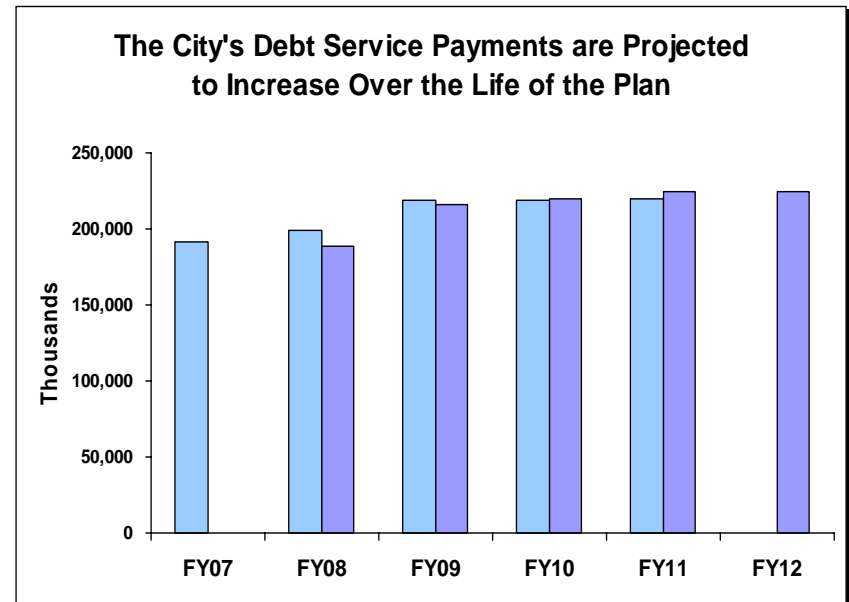


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How Does the Plan Deal With the Major Structural Issues Facing the City's Finances?

Rainy Day Fund: Potential progress. The Plan does not take any steps towards establishing a Rainy Day Fund, but Administration officials have been having productive discussions with Council representatives about establishing a fund.

Reducing the City's Debt Burden: Limited Progress. The Plan takes a very small step towards pay-as-you-go capital funding, which would help reduce the size of future borrowings. In FY08, the salaries of ten full-time and two temporary employees are shifted from the capital budget to the operating budget. Projected debt service payments over the life of the Plan, however, will total about \$25 million more than payments in the FY07-FY11 Plan. In addition, the City missed an opportunity to increase its investment in its infrastructure without adding to its debt burden when it refused to spend money transferred by City Council from the operating budget to the capital budget to spend on police, fire and recreation facilities.

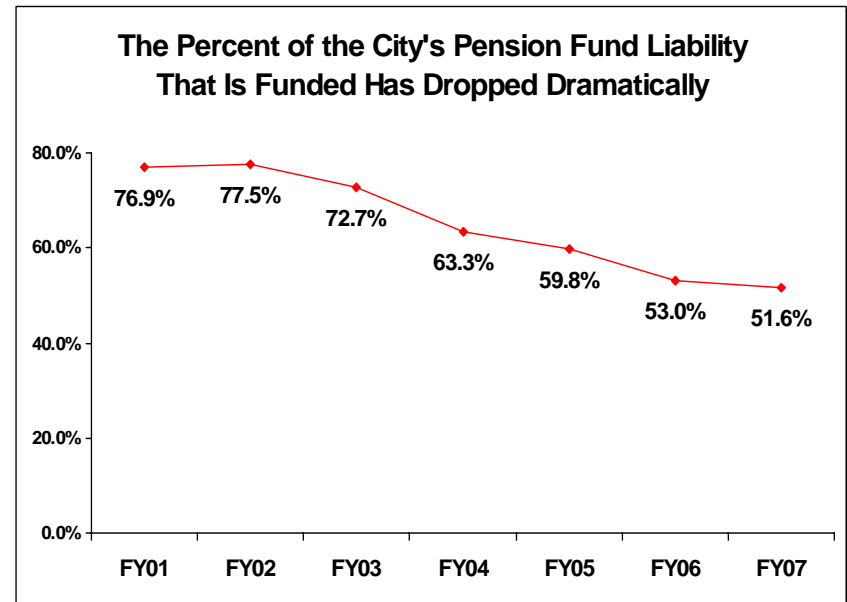


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How Does the Plan Deal With the Major Structural Issues Facing the City's Finances?

Making the City's Tax Structure More Competitive: A Major Step Backwards. While the Plan maintains and extends by one year the wage tax reductions that were included in last year's plan, it proposes to end, after 14 years, the business privilege tax reduction program after FY09.

Reducing the City's Unfunded Pension Liability: No Progress. The Plan eliminates language included in the approved FY07-FY11 Plan that said the City would 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.

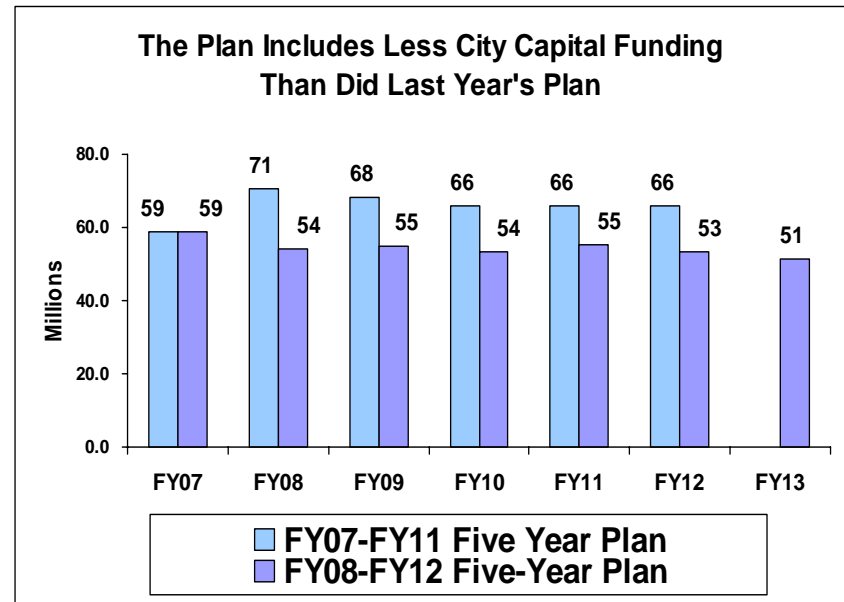


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Investing in Infrastructure: No Progress.

The Plan includes lower levels of funding for City infrastructure spending than did last year's approved Plan. The funding levels included in the Plan are less than a third of the amount that the City Planning Commission says is necessary to keep City facilities in good condition.



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PICA STAFF RECOMMENDATION

The PICA Board Should Approve the FY08-FY12 Five-Year Financial Plan.

PICA Staff finds itself facing a situation very similar to the one it faced a year ago. Like last year, based on the PICA statute, which requires that at a minimum the Plan demonstrate balanced budgets for the life of the Plan, the strength of the City's revenues leaves PICA Staff little choice but to recommend that the Board approve the Plan. In last year's report, PICA Staff said its recommendation should in no way be viewed as an endorsement of the Plan or its approach to fiscal management. That is still true, but with more urgency since a year has passed and the City has still shown very little progress in addressing the long-term issues it faces.

Time is not on the City's side in dealing with these issues. The longer the City waits to deal with these problems, the more challenging they will become. Philadelphians cannot afford for the next mayor to propose a five-year plan that does as little as the FY08-FY12 Plan does to address the City's long-term financial issues.

With all of the caveats discussed above, PICA Staff recommends that the Board of the Pennsylvania Intergovernmental Cooperation Authority approve the revised Plan as submitted to the Authority on June 27, 2007.