Pennsylvania Intergovernmental Cooperation Authority

Philadelphia Must Reduce Its Need for Tax Revenues

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PENNSYLVANIA INTERGOVERNMENTAL COOPERATION AUTHORITY

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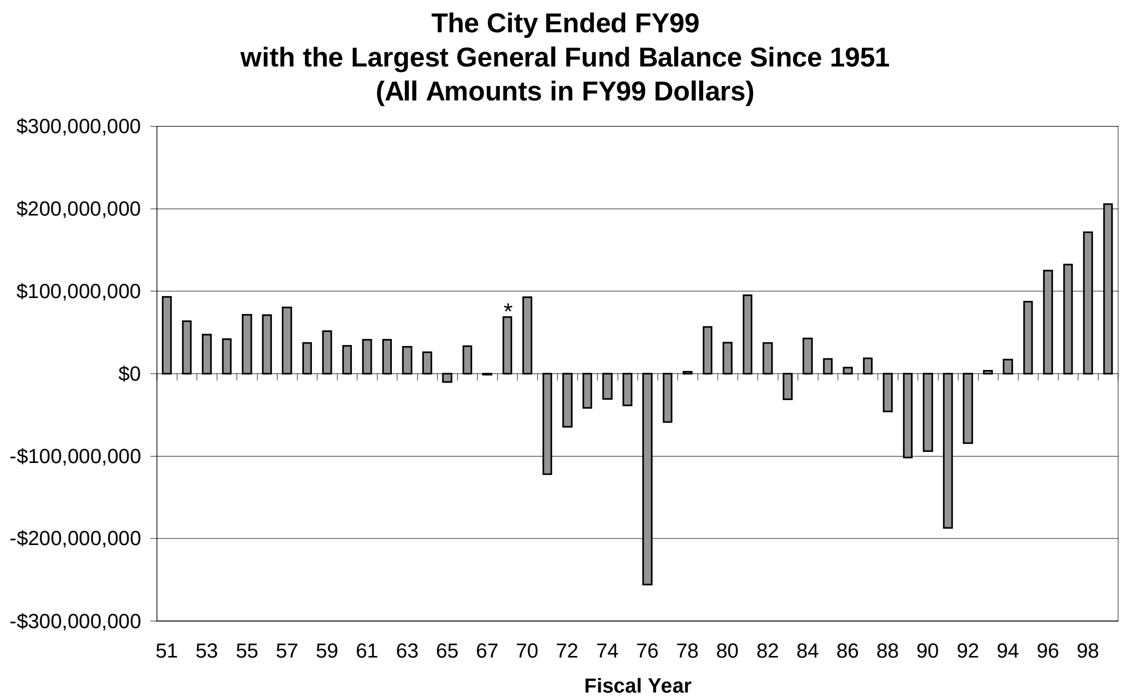
Philadelphia Must Reduce Its Need for Tax Revenues

The City of Philadelphia ended Fiscal Year 1999 (FY99) with its seventh consecutive positive General Fund balance. That balance, having grown each year, now stands at $205.7 million, the largest since the current City Charter was adopted in 1951. This accomplishment occurred even as the City reduced Wage and Earnings, Net Profits and Business Privilege Tax rates, eliminated its Personal Property Tax and improved service levels.



Note: The City's fiscal year went from a calendar year basis to a July 1 to June 30 basis in 1968-1969, resulting in no FY68 and an eighteen month fiscal year in FY69.

The Rendell Administration, having controlled costs and expanded the City's revenue base, received and deserved substantial credit for the City's fiscal achievements. Additionally, in many areas, service levels and quality of City services have improved. Yet, it must be noted that the City spent more than ever in FY99, the last full fiscal year of the Rendell Administration, even after adjusting for inflation. This increased level of spending was made possible primarily through increased state and federal funding for health and human services.

A number of factors, some outside of the City' control, afforded the City the ability to produce tax cuts and positive fund balances simultaneously. The major ones include the prolonged national economic expansion, state enactment of suburban withholding and state authorization and City implementation of the City Sales Tax.

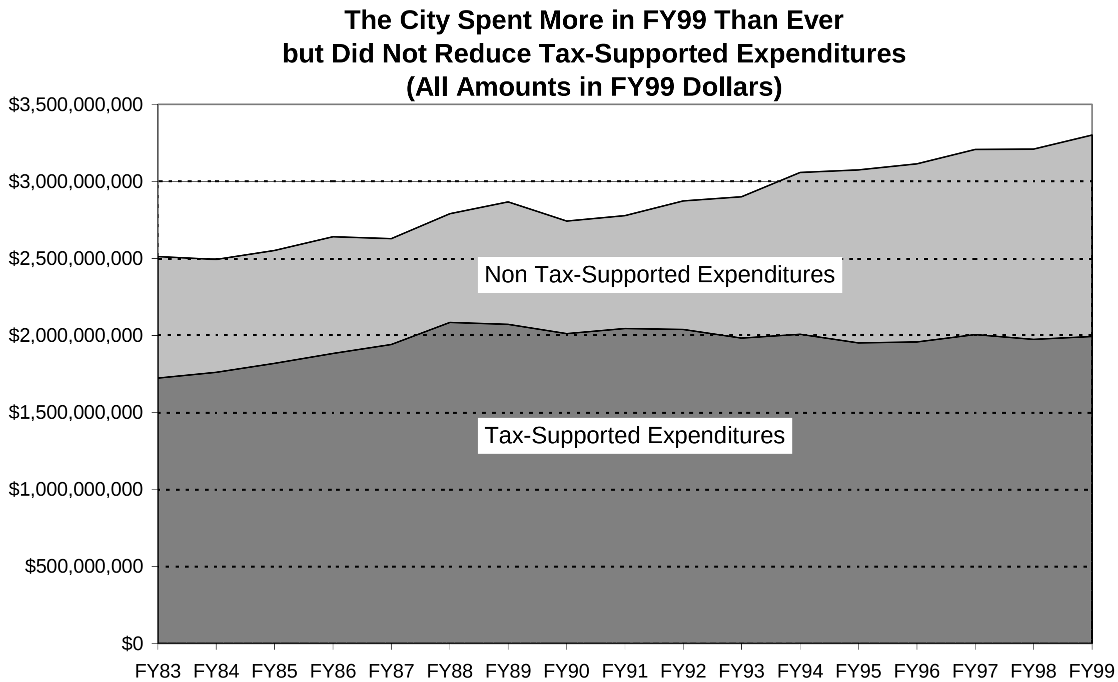
Significantly, the City has not adequately addressed one of its major underlying challenges – reducing the amount of tax revenues it spends. In FY99, the City spent slightly more tax dollars than it did in FY93, the first full fiscal year of the Rendell

Administration. Only by reducing tax-supported expenditures can the City significantly reduce tax rates or even simply accommodate the funding capacity of what in the future will likely be a shrinking tax base.

Total Spending Continues to Rise; Tax-Supported Spending has not Declined

Despite its $205.7 million General Fund balance, the City spent more in FY99 than ever before. This increase in total City spending since FY90 has been funded primarily with greater state and federal funding for health and human services,[1] but also with increases in non-tax revenue, such as fees, fines and interest earnings.

Tax-supported expenditures have remained relatively flat during this period. This demonstrates that while the City has been able to increase spending without relying on increased tax revenues, it has also not managed to reduce the amount of tax revenues it spends.



Note: Tax-Supported Expenditures + Non Tax-Supported Expenditures = General Fund Expenditures + Grants Fund Expenditures + PICA Debt Service. Non Tax-Supported Expenditures = Revenue from Other Governments except PICA + Local Non-Tax Revenue + Revenue from Other Funds.

Given that tax-supported expenditures have remained flat and overall expenditures have grown, it is clear that the recent tax rate reductions and current positive General Fund balance were not made possible by reduced City spending. Rather, rate reductions have been paid for with improved enforcement and collection efforts, particularly suburban

[1] See *PICA Staff Report on the City of Philadelphia's Five-Year Financial Plan for Fiscal Year 2000 - Fiscal Year 2004*, pp. 39-40 for a brief discussion regarding increased state and federal funding for human services.

withholding, and the City Sales Tax, while the General Fund balance has been generated as a result of an improved City economy.

Suburban Withholding and the City Sales Tax Paid for Tax Rate Reductions

Over the last eight years, the City has enhanced its tax collection efforts. By improving enforcement, the tax burden has been spread over a larger tax base, thereby allowing the City to reduce tax rates without suffering a loss in tax revenue. The tax enforcement initiative with the greatest financial impact has been suburban withholding, a state legislative mandate which requires suburban employers in Pennsylvania to withhold Wage Taxes from those employees who live in the City. This new mechanism generated enough revenue on an ongoing basis (approximately $20 million per year) to offset the cost of the Rendell Administration's first reduction of the Wage Tax rate in FY96.

The City Sales Tax has enabled the City to reduce tax rates even more. The Sales Tax was enacted prior to the tenure of the Rendell Administration, with the intention of using it to offset the costs of PICA debt service. For this analysis, PICA debt service is considered a tax-supported expenditure, as it is paid for with Wage, Earnings and Net Profits Taxes that previously went directly into the General Fund.[2]

The City's ability to afford PICA debt service was not solely dependent on Sales Tax revenues. As illustrated by the above chart, the City reduced costs elsewhere and absorbed PICA debt service without increasing total tax-supported expenditures. To a certain degree, Sales Tax revenues helped the City maintain its recent level of tax-supported expenditures as, absent the Sales Tax, tax collections remained below their FY91 level until FY97 (see chart on next page). Yet, Sales Tax collections were not needed in full to cover the costs associated with PICA debt service.

The City began recognizing Sales Tax revenues in October 1991, three months prior to the Rendell Administration's inauguration. This new revenue source has generated $666 million over the last eight fiscal years. As mentioned in the above paragraph, some of these revenues have helped the City maintain a relatively constant level of tax-supported expenditures. Yet, the excess revenues generated by this new tax, combined with the revenues generated from suburban withholding, have afforded the City the ability to reduce certain taxes by over $250 million since FY96.[3]

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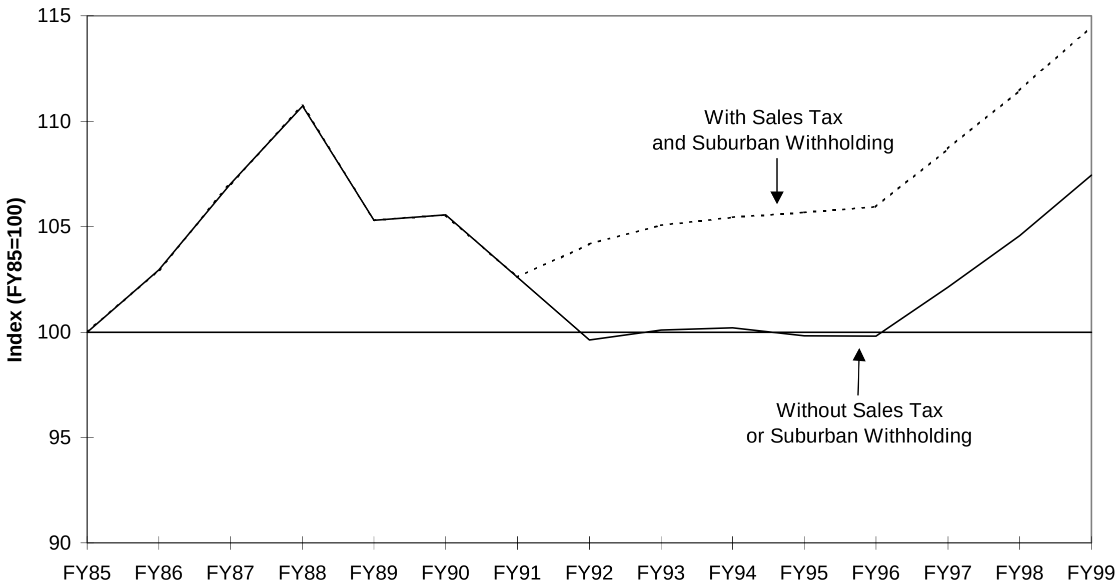
[2] PICA has provided in excess of $1.1 billion to the City to help it eliminate its accumulated deficit, fund its capital budgets, retire certain high interest debt, pay for certain indemnity costs and create the Productivity Bank.

[3] According to the *Five-Year Financial Plan, FY2000 - FY 2004*, p. xiii, the first four rounds of tax rate reductions accounted for $206.9 million in lost revenue, and the FY98 elimination of the Personal Property Tax has accounted for an additional $17 million per year.

The Improved Economy Created the Positive General Fund Balance

Over the past three years, the City's economic base, as measured by City tax collections, has been growing much faster than inflation. Over the short-term, increased tax revenues resulting from an improved economy enable the City to accrue a General Fund balance. Over the long-term, however, the City must remain cautious about whether tax revenues will continue to grow at recent rates, as it is likely that they will eventually contract.

Philadelphia's Tax Base has Grown Significantly the Past Three Years and, Along with Suburban Withholding and the City Sales Tax, has Enabled the City to Provide both Tax Rate Reductions and Positive General Fund Balances



Note: Chart is based on tax collections and is adjusted for rate changes and inflation. The Personal Property Tax is excluded.

Economic growth over the past three fiscal years, as illustrated in the above chart, has increased City tax collections by an estimated $172 million since FY96. This amount accounts for 84% of the City's FY99 $205.7 million General Fund balance. The rest of the General Fund balance can be attributed to the one-time revenues realized as a result of the tax lien securitization in FY97.

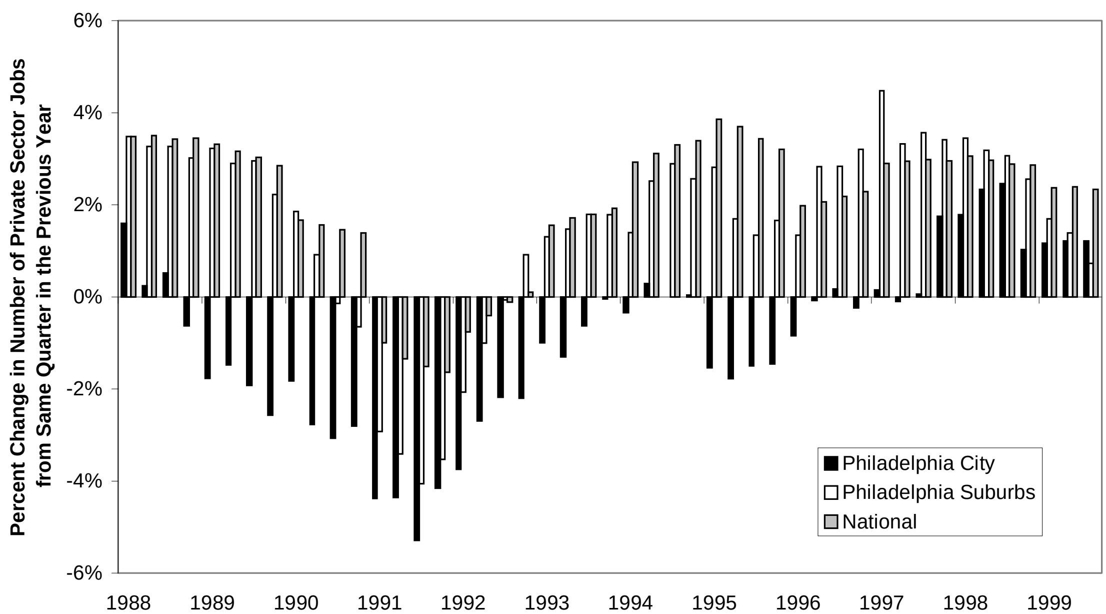
This analysis does not dismiss the significant work done by the Rendell Administration to keep total tax-supported expenditures under control while enhancing City services. Even as total tax-supported expenditures remained flat, existing tax revenues were stretched to pay for new costs, such as PICA debt service, new labor contracts and the local costs of the 753 Crime Bill police officers. If not for the City's successful efforts to generate savings elsewhere in the budget, these new costs would have consumed all of the FY99 accumulated fund balance and jeopardized the City's tax rate reduction plan.

<u>The City must Reduce Tax-Supported Expenditures</u>

The national economy has been rebounding from the 1990-1991 national recession for almost nine years.[4] As of February, this will have been the longest period of national economic expansion on record. Yet, as the City Controller has pointed out, the City's economy emerged from its recession-like state only in 1996, five years after the national recession ended.[5]

As was discussed in PICA *White Paper #6: The Adverse Consequences of Philadelphia's Continuing Population Loss*, demographic trends indicate that the City's underlying economic base continues to erode. Although the City's economy has done well over the past three years, this is mostly due to the prolonged national economic expansion. As measured by private sector job growth, the City's economy continues to lag national growth.

The City Lags the Nation in Private Sector Job Growth
but in the Most Recent Quarter Surpassed the Suburbs



Source: U.S. Bureau of Labor Statistics

Interestingly, the Bureau of Labor Statistics estimates that, for the first time in at least three decades, the City experienced stronger private sector job growth over the last year than its surrounding suburbs. This reversal in fortune is less an indication of an improving underlying economic trend in the City than a result of stagnated suburban job growth in the health services sector. If the health services sector is excluded, the number of private sector jobs grew by 1.0% in the suburbs and 0.5% in the City over the last year.

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[4] According to the National Bureau of Economic Research, the last national recession began in July 1990 and ended in March 1991.

[5] *1997 Mid-Year Economic and Financial Report*, Office of the City Controller, March 1997, pp 4-5.

A downward population trend combined with weak private sector job growth indicates that although the City's economy is currently on an upswing, its underlying base continues to erode. Indeed, a new economic forecasting model for Philadelphia recently projected that, by the end of the City's FY2000, "job losses will resume, and the city will give up most of the jobs it has gained since the end of 1997."[6] While the City's economy has performed better than expected over the last six months of 1999, the model's forecast indicates the persistent weakness of Philadelphia's economy. When the national economy next begins to slow, the City will be among the first to experience it and, as with the last three national recessions, its experience with it will likely be deeper and longer than average.

Given this outlook, the City needs to reduce its tax-supported expenditures now. The City's future economy is not likely to generate the same level of tax revenues as it has the past eight years, diminishing the City's ability to maintain its current level of tax-supported expenditures. Unless the City reduces its dependence on tax revenues, it will likely need to raise tax rates in the future just to maintain its current level of tax-supported expenditures.

Furthermore, to improve its long-term economic outlook, the City needs to continue its efforts to reduce the costs of living and doing business in the City. Reducing tax rates is the most immediate and direct way the City can do so. Reducing tax-supported expenditures, and thereby its need for tax revenues, would make it much easier for the City to reduce tax rates.

How the City can Reduce Tax-Supported Expenditures

The most frequently mentioned approach to cutting tax-supported expenditures is by instituting more efficient systems. Many of the managerial and systemic improvements made by the City over the last eight years have resulted in enhanced service levels. Yet, at the same time, many more efficiencies can be made. Technological advancements, reengineering operations, better coordination of services, adapting "best practices" from other local governments and reducing the number of patronage employees could all contribute to reduced costs while maintaining or improving service levels.[7]

In addition to the City becoming a more efficient service provider, the state could also play a role in reducing the City's reliance on tax revenues. For example, if the state were to meet its court-ordered mandate to assume the costs of the unified court system, the City estimates that it could reduce its tax-supported expenditures by over $160 million.[8]

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[6] Theodore M. Crone and Michael P. McLaughlin, "The Philadelphia Story: A New Forecasting Model for the Region", Federal Reserve Bank of Philadelphia *Business Review*, September/October 1999, p.22.

[7] The City Controller's recent book, *Philadelphia: A New Urban Direction*, offers numerous recommendations in this regard.

[8] In FY97, the City budgeted $163,799,258 of its own revenue to pay for court costs (see *Five-Year Financial Plan FY2000 - FY2004*, p. 195).

Conclusion

Tax-supported expenditures have been reduced by only 2.5% since FY91, the last full fiscal year of the Goode Administration, and 4.4% since FY88, when tax-supported expenditures reached their peak. Each 1% reduction in tax-supported expenditures would allow the City to add $20 million to its General Fund balance, reduce the Wage Tax rate by 1.7% or reduce the BPT Gross Receipts Tax rate by 20%.

Improved enforcement and collection of taxes and continued economic growth will never afford the City more than an incremental ability to reduce tax rates. If it is to further reduce tax rates, thereby enhancing its economic outlook, or even simply accommodate the funding capacity of what in the future will likely be a shrinking tax base, the City must reduce tax-supported expenditures.