Pennsylvania Intergovernmental Cooperation Authority

Caution:
Severe Threats to Philadelphia's Fund Balance Ahead

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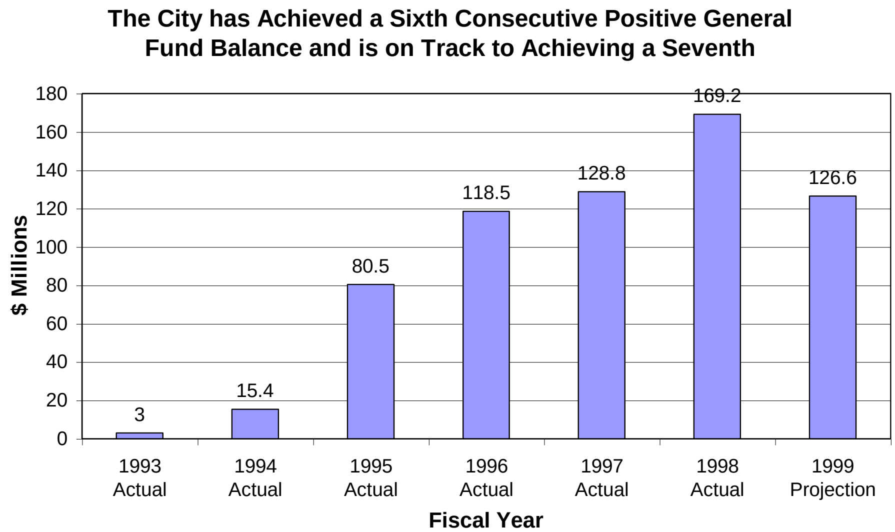
Caution: Severe Threats to Philadelphia's Fund Balance Ahead

The City of Philadelphia recently announced its achievement of a sixth consecutive positive year-end General Fund balance. Each of the past five years has seen an increase in that positive balance. This financial success is largely the result of the City's ongoing efforts to limit expenditure growth and enhance revenues. This decade's extended national expansion has also played a major part in that ongoing success.

There is every reason to believe that Philadelphia will successfully maintain a positive General Fund balance in Fiscal Year 1999. As of the latest Quarterly City Managers Report, the City is projecting a positive year-end balance in excess of $126.6 million.



The current Five-Year Plan anticipated a $99.5 million positive General Fund balance at the close of Fiscal Year 1999 and that it would be applied toward the succeeding two budgets. Currently it is anticipated that any balance above $99.5 million will be needed to help fund the recent FOP arbitration award, which the City has estimated will cost $102.8 million over the life of the current Five-Year Plan.

Additionally, there are four major risks/uncertainties that the City will confront over the next two fiscal years. Welfare reform and international economic upheaval have the potential to severely undermine the City's ongoing budgetary success. Also, in little more than one year, the City will begin negotiations with its four major unions for new labor contracts. The City will need to demonstrate the ability to fund those contracts over the following five-year planning period, at a time when continuing structural changes to Philadelphia's economy threaten to erode the City's tax base further.

The City Confronts Significant Demands on the General Fund Balance

Projected FY99 Fund Balance	Existing Funding Demands	Risks/ Uncertainties
$126.6 million	$ 99.5 million (Funding for Contingencies) 102.8 million (FOP Arbitration Award)	Welfare Reform International Economy Labor Contracts Economic Restructuring

Philadelphia is currently reaping the rewards of prudent fiscal management. It is also enjoying the benefits of sustained national economic growth. However, the City must exercise caution in its contemplated use of the current positive General Fund balance. In addition to the two known existing demands which are anticipated to adversely affect the current positive fund balance, Philadelphia confronts a growing number of risks/uncertainties that pose a strong possibility that the City could soon confront a substantially increased demand for services concurrent with a shrinking tax base.

The City needs to plan now, while it has time, to take appropriate actions that ensure its future financial health.

Putting the Positive Fund Balance in Perspective

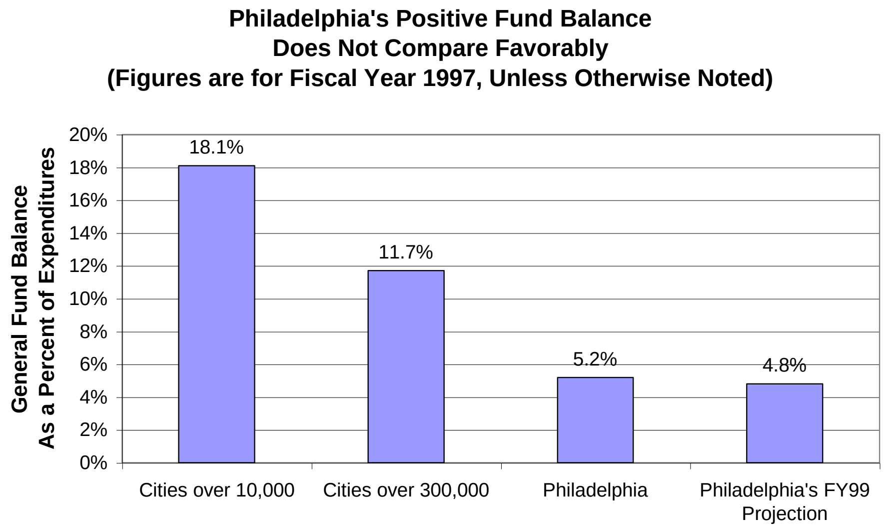
In a time of national economic expansion, municipal positive General Fund balances are expected. Indeed, according to a recent National League of Cities' survey,

> [t]he municipal sector's General Fund ending balances as a percentage of expenditures increased in 1997, to 18.1 percent, marking the sixth year in a row that ending balances have increased. Projections for 1998 indicate an improvement to approximately 21.5 percent.[1]

State governments are also currently running positive fund balances of, on average, 8% in Fiscal Year 1997 and a budgeted 6% in Fiscal Year 1998.[2] Even the Federal government has run a year-end surplus for the first time in three decades.

[1] *City Fiscal Conditions in 1998*, National League of Cities, June 1998, p. 2.
[2] *The Fiscal Survey of States*, National Governors' Association and the National Association of State Budget Officers, May 1998.

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.[3] Philadelphia's currently projected General Fund balance for FY99 is less than 5% of expenditures.



Philadelphia's current positive fund balance results in part from PICA's having provided deficit elimination/indemnities funding totaling $256.2 million. Even the City's accumulated balance of $169.2 million at the end of Fiscal Year 1998 could not have covered that funding shortfall.[4]

Major Risks/Uncertainties

Welfare Reform

The City estimates that 26,000 Philadelphians are threatened with the loss of cash assistance on March 3, 1999, with thousands more threatened with such a loss prior to the close of the fiscal year. As a result of welfare reform, thousands more poor residents than would otherwise be expected will likely turn to the City for emergency housing, health care and social services. In addition, the termination of cash assistance on such a large scale will result in the removal of millions of dollars from the City's economy, impinging on the City's ability to fund services and to place welfare recipients into jobs that will allow them to meet mandated work requirements.

There are significant efforts underway to move welfare recipients into work and to ensure that the most vulnerable do not lose the benefits for which they remain eligible. Even so,

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[3] *City Fiscal Conditions*. This figure is based on a survey response of 53% (27 of 51 cities).
[4] Adjusted for inflation, PICA's deficit elimination/indemnities funding was over $290 million.

the City already has seen an increase in uninsured visits to its health centers as a result of previously implemented changes to certain State welfare programs. It remains unknown how large of an impact the upcoming changes will have. However, the City estimates that the total loss of benefits to City residents will be more than $3 billion over the next five years.[5]

International Economic Upheaval

The world economy is reeling as a result of the financial crises in Asia, Russia and Latin America. Recently, there have been indications that U.S. economic growth has begun to slow as well.[6] Given the direction of the world and national economies, Philadelphia needs to prepare itself for a probable cooling, and potential contraction, of its economy.

Labor Negotiations

The City's current labor contracts with its four major unions expire on June 30, 2000. One of the first major activities of the next administration will be to negotiate new contracts covering over 24,000 employees for up to a four year period.[7] Tens of millions of dollars will likely be required to fund any new labor contracts over the five-year planning process, barring any severe reduction in the size of the municipal labor force or major savings resulting from negotiated improvements to productivity.

The PICA legislation and cooperation agreement require that the City demonstrate an ability to pay the costs of any new contract. Given the continuing fragility of the City's fiscal situation, the City must exercise extreme caution in planning for the upcoming contract negotiations.

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[5] *Five-Year Financial Plan Fiscal Year 1999 - Fiscal Year 2003,* City of Philadelphia, January 1998, p. 147.

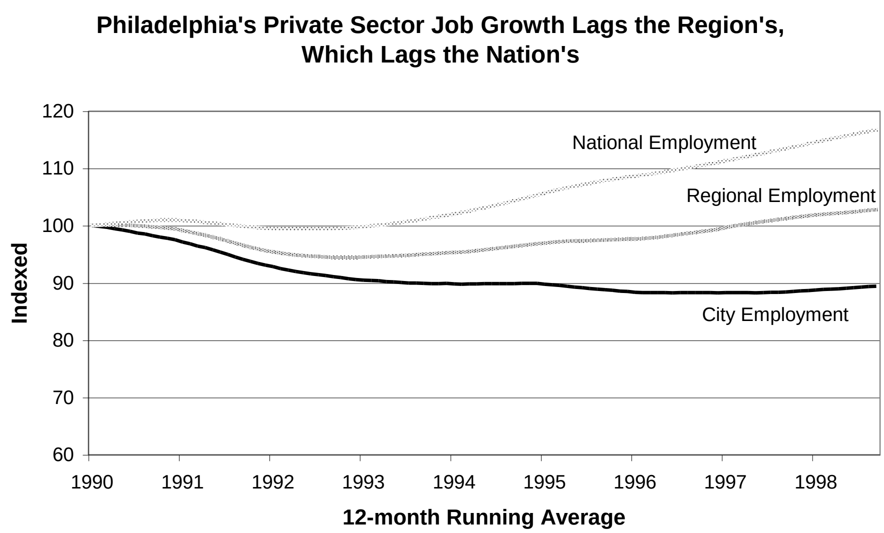
[6] The Conference Board's Index of Leading Economic Indicators remained flat in September, indicating slower national economic growth, although not a recession.

[7] Simultaneously, the School District will be negotiating a new contract with its major union covering approximately 20,000 employees.

Continuing Structural Changes to Philadelphia's Economy

Over the last two years, Philadelphia has lost three Fortune 500 corporate headquarters and witnessed the bankruptcy of a major player in the health care industry. These occurrences are indicative of the City's vulnerability in the face of national and international economic competition.

Preliminary figures from the Bureau of Labor Statistics indicate that the number of City-based private sector jobs have been increasing slightly during the past year.[8] In comparison, the greater eight-county region has been experiencing job growth since 1992. National job growth has been even stronger than in the region.



The Pennsylvania Economy League projected three years ago that the health care industry in this region would likely suffer an average loss of 2,000 jobs annually through the end of the century.[9] Indeed, according to Bureau of Labor Statistics estimates, City employment in the Health Services industry has remained relatively flat since 1994, following many years of tremendous growth. While this industry will remain a vital employment base for the City, significant growth in the total number of jobs will need to come from elsewhere.

The City has been ardently promoting hospitality and tourism as its primary industries with job growth potential, particularly for entry-level positions. Such jobs typically pay less than the manufacturing and other high-value jobs they are replacing.[10] They also tend to have weaker economic multiplier effects.[11] While job numbers are a key

[8] A change in the way the US Department of Defense calculates its employment figures precludes the possibility of comparing total employment figures.
[9] *Greater Philadelphia's Challenge: Capitalizing on Change in the Regional Health Care Economy*, Pennsylvania Economy League, February 1996.
[10] *1996 Mid-Year Economic and Financial Report*, Office of the Controller, January 1996, pp. 7, 12-13.
[11] *1998 City of Philadelphia Economic Update*, Office of the Controller, April 1998, p. 18.

indicator of economic health, the composition of the job base is also significant, and the City's job base appears to be shifting toward lower skilled, lower paying positions.

At the same time, the Census Bureau continues to revise Philadelphia's population estimate downward by nearly 1.5% annually. As PICA has noted previously, this trend is troublesome primarily because the City loses those who have the economic resources to afford to move elsewhere, the very residents the City needs to keep.[12]

Philadelphia's economic base remains weak and vulnerable. At a time when national and regional employment is growing, City job growth is sluggish at best. The composition of the job base appears to be continuing to shift toward service jobs, many of them in the lower paying hospitality and tourism industries. Concurrent with these trends is the City's continuing loss of residents. Most of these negative trends have been masked by the prolonged national economic expansion. In the event of a slowdown in national growth, the City can reasonably expect to feel more significantly the burden these trends place on its ability to generate local revenues.

Conclusion

The City's positive General Fund balance is largely the result of years of disciplined budgeting and significant efforts to generate new revenues. In spite of such success, now is not the time to be complacent. Although Philadelphia has not recently faced projected deficits or the need for emergency deficit closing measures, the City confronts a number of risks and uncertainties over the next two years that threaten its future fiscal health.

The City direly needs to continue making Philadelphia a more competitive place to live, work and visit by further enhancing services, reducing taxes, investing in economic growth and improving the public schools. However, the City should not view the accumulated positive General Fund balance as a funding source for these initiatives. Instead, the City should use any existing balance to maintain a fiscal cushion that will ensure continued budgetary balance.

[12] See *White Paper #1 Continuing Economic Decline: A Foreboding Future for Philadelphia*, PICA, October 15, 1996.