Pennsylvania Intergovernmental Cooperation Authority

Staff Report
on the
City of Philadelphia's
Five-Year Financial Plan
for
Fiscal Year 2010 - Fiscal Year 2014

July 21, 2009

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Introduction

"*When written in Chinese, the word "crisis" is composed of two characters – one represents danger and the other represents opportunity*." - John F. Kennedy

The idea that "crisis presents opportunity" was prevalent among state and local governments as they faced fiscal challenges over the past year. Economic realities made it easier to take on "protected" parts of budgets which had long avoided serious scrutiny or oversight. Prospects for increasing efficiency or reducing waste were no longer simply thwarted with the flawed logic of "that is the way it has always been done." That is not to say that all sacred cows were rendered obsolete, but progress was made in areas long thought untouchable.

While some have raised the specter of change being non-existent, it is valuable to consider the response to the fiscal crisis the City faced in 1991 when PICA was first created. That crisis resulted in reforms and changes in expectations which continue to benefit the City today. Many of those changes laid the groundwork for the optimism and new approaches introduced by the current administration. While some reforms were delayed by this fiscal crisis, it is just as accurate to say that new opportunities were identified which would otherwise have been considered "untouchable." The public debate on spending priorities for the City was a tremendous lesson in both how difficult these issues are to tackle, and that change can happen when individuals at every level are willing to work and sacrifice, to make small short-term sacrifices for the sake of the long-term benefit of the entire city.

At the same time there is the recognition that much more could have been accomplished if the reform ethos of crisis had prevailed during the boom years of the last decade. How much more could have been accomplished with the same dedication by citizens and elected officials toward continuing to improve Philadelphia's government?

One of the fundamental principles of Japanese management philosophy is the concept of continuous improvement – the idea that employees and supervisors persistently look for even small modifications and improvements which can add up to major change over time. Regardless of deficit or surplus, the City and all Philadelphia's citizens should demand no less than a commitment to continuous improvement; to building up new institutions to meet the needs of tomorrow, and to get rid of underperforming ones; to creating new processes that will improve the public discourse, and help people inside and outside of government learn and progress.

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Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT ON FY2010-FY2014 FIVE-YEAR FINANCIAL PLAN

SECTION I:

EXECUTIVE SUMMARY AND STAFF RECOMMENDATION

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EXECUTIVE SUMMARY AND STAFF RECOMMENDATION

The FY10-14 Five-Year Financial Plan (Plan) represents a significant response to the economic challenges of the past year, but remains challenged by anticipated new powers yet to be granted by the Commonwealth, an unstable national economy, and assumed changes in labor contracts currently under negotiation. Should all of these Plan assumptions pan out, the City will have stabilized its finances, reduced spending by over 6.5 percent[1], have reasonable expectations of balanced budgets for five years, and begun to address some of its most pressing long-term fiscal challenges. However, these outstanding risks are of such a magnitude as to raise questions about the reasonableness of the Plan.

During the course of the past year, as the City made several revisions to its previous Five-Year Plan, and PICA ultimately declared a variance, the public discussions on the details of the City budget and the public involvement in reshaping the budget priorities of the City were extraordinary. The choices facing the City were a matter of public record and the citizenry played a significant role in the City's response to the world economic crisis. While the Plan contains several risks which will be discussed in detail below, the unprecedented public formation of the Plan is to be commended and should serve as a blueprint for the ongoing involvement of the citizenry with the fiscal health of the City.

As recommended in several previous PICA reports and Issue Papers, the Administration has proposed several first steps in addressing the long-term fiscal challenges faced by the City, though the success of key initiatives will not be known until the conclusion of the labor contract negotiation and arbitration process. The halting of the incremental tax reduction program, though necessitated by the economic collapse, was a step back in addressing the non-competitiveness of the City's tax structure.

Under the PICA Act, the Board is charged with determining whether: "the financial plan projects balanced budgets, based upon reasonable assumptions…for each year of the Plan." The Plan the Board is now considering meets that test, with certain caveats.

Report Summary

The report focuses primarily on six areas:

1. **Substantial risks included in the Plan:** These are items for which a strong possibility exists that the City will not meet its projections, or the potential impacts are unquantifiable, but the risk of the City's missing those projections is not so large that it is unreasonable for the City to include them in the Plan.

2. **Additional risks included in the Plan:** These are qualitatively less substantial risks contained in the Plan where the City may not meet its projections, or the potential negative impact is small enough so as not to upset the Plan's positive Fund Balances.

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[1] The 6.5 percent reduction includes the assumed deferment of $150 million in Pension Fund Payments. Exclusive of the deferment, the reduction would be 2.8 percent.

3. **Tax revenue and expenditure projections included in the Plan:** The tax collection projections are a key determinant of the level of expenditures that can be included in the Plan and an analysis of expenditure trends demonstrates how the City has responded to the fiscal challenge.

4. **The long-term financial risks that face the City:** The City faces an array of issues that must be addressed to secure the City's long-term fiscal health; some issues could impact the City's ability to achieve balanced budgets over the next five years.

5. **Administrative reforms and productivity initiatives of the City**: The Plan includes a series of reforms and initiatives aimed at improving overall administration and efficiency throughout the City. This section reviews some of these initiatives.

Substantial Risks Included in the Plan

State approvals for new taxing authority and pension payment restructuring: The Plan assumes that the State will grant the City the ability to raise the City Sales Tax an additional 1 percent, generating over $580 million of additional revenues over the Plan period. The Plan assumes that the State will grant the City the ability to change its pension fund amortization assumption saving $120 million over the Plan period, and the ability to defer $230 of pension payments in the first two years of the Plan. Although legislation for all of these changes has been introduced, the likelihood of passage, or even passage in a timely fashion, is tied up in the State budget stalemate.

Labor Contracts: All four of the municipal employee contracts with the City expired on June 30, and are currently in the negotiation/arbitration process. The Plan assumes that new contracts will include no raises for the life of the Plan, and will result in annual savings of $25 million a year from benefit and work rule changes. Additionally, these changes would positively impact some of the City's long-term fiscal challenges on pensions and health benefits. **Any contracts which increase General Fund costs beyond the City's ability to pay, or fail to realize the savings assumed in the Plan, will require a revision to the Plan. This revision must demonstrate that there are sufficient funds to cover these costs or unrealized savings.**

Property Tax collection shortfalls due to higher delinquencies and uncertainty surrounding the assessment process in Philadelphia: The Plan's projection of Real Estate Tax revenue is at risk due to higher than anticipated delinquencies and uncertainties surrounding reforms in tax administration and policy that are likely to occur during the FY10-FY14 period. The short-term risk can be seen in FY09 Real Estate Tax collections which were less than projected due to higher than anticipated delinquency rates, likely due in part to the national economy. The more serious long-term risk arises from the Board of Revision of Taxes (BRT), the agency responsible for the assessment of real estate, which has announced its intention to replace its current policy of fractional assessment with an actual value model. Additionally, revelations about questionable management practices at the BRT have raised the possibility that the assessment model for the City may be reformed. All of these challenges put the collection levels anticipated in the Plan at risk.

<u>Additional risks in the Plan</u>

Uncertain national economy: When the FY09-FY13 Plan was approved in June 2008, it was known the economy was weakening, but like most economists, City policy-makers and PICA did not anticipate the extent of the collapse in the global economy that occurred beginning in late summer of 2008. Since then, the city's economy has proved fairly resilient as compared to other U. S. municipalities, owing in part to the high concentration of the city's economy in sectors that have seen relatively less severe impacts from the recession: Health care, education, and government. Nonetheless, economic indicators for Philadelphia have slowly but steadily declined since the third quarter of calendar 2008, and this trend has been reflected in tax revenues as well.

Financial stress at the Commonwealth: The economic collapse has severely impacted the State budget. While it is unclear at this writing where budget cuts may lie, there has been significant discussion regarding reductions in the social service and education programs which strongly impact the City. Should funding be cut in those areas, a greater burden would fall on the City to meet the needs of its most vulnerable citizens. Additionally, as long as no appropriation power exists at the State, normal payments to the City will not happen; the longer it takes to complete the budget, the more likely that the City's short-term cash crisis will worsen.

Philadelphia Gas Works (PGW): PGW continues to present an enormous risk for the City and the entire region. While PGW continues to look at creative ways to ease its fiscal challenges, the difficulties faced by the utility resulting during the bond market volatility of the past year underscored the precarious nature of its situation. Though the leadership of PGW continues to make strides in improving management and operations, structural challenges and an over-sized workforce continue to challenge the utility while the outstanding $1.2 billion in debt dominates the balance sheet. There remains a real possibility that future fiscal crises at PGW will require additional City subsidies and could even damage the entire region's economy.

Casino-Related Revenues and Costs: The Plan assumes that the City will begin receiving fees from casinos in FY12, but the longer that the start of construction is delayed, the less likely it is that those revenues will be received in accordance with Plan estimates. One of the planned casinos has yet to obtain approval from the Commonwealth to move its building site. Further, the Plan does not assume that the opening of those casinos will result in any social, police or infrastructure costs to the City's general fund, beyond the payment amounts pledged by the casino operators, though indirect benefits are also not accounted for in the Plan.

Tax Revenue and Expenditure Projections

As mentioned above, most City revenues have seen slow but steady decline over the past year. Although the Plan assumes that revenues will remain fairly flat for another 12-18 months, continued deterioration could cause shortfalls in the Plan. Each of the key taxes is reviewed in this section. City tax revenues will continue to be monitored closely to determine if any additional weakness emerges.

An analysis of expenditure trends by Department demonstrates where the City has made changes to respond to the fiscal crisis, as well as where it is realigning spending priorities.

Long Term Financial Risks

Among the long-term financial risks facing the City, this Plan does strive to make progress in some areas. The City has taken an aggressive stance in its need to rebalance the contribution and benefit levels in the Pension Fund, and has received declaration by the State as a "Distressed Fund." The City suspended the incremental tax reduction program, but is undertaking a new review of the City's tax structure with recommendations anticipated in the fall. Capital investment remains low relative to the City's needs, though the City continues to find ways to provide "pay-as-you-go" capital funds so as not to exacerbate the high levels of long-term debt. There are no plans to establish a Rainy Day Fund, though it is challenging to establish such a fund when it is already "raining".

Administrative Reforms and Productivity Initiatives of the City

The Administration has instituted numerous reforms and initiatives in its first eighteen months, including PhillyStat and the 311 call center. New approaches to comprehensive information technology strategies for the entire government as well as strategic plans in many key areas hold out opportunities for continued improvements in service delivery and efficiencies.

City Controller's Opinion

As in past years, and per the PICA enabling legislation, PICA Staff requested of the City Controller an opinion or certification prepared in accordance with generally accepted auditing standards, with respect to the reasonableness of the assumptions and estimates in the City's proposed FY10-FY14 Five-Year Plan. The City Controller's opinion did find that the assumptions used in the Plan were reasonable; however, the report also noted key sensitive assumptions, notably that the Plan assumes certain legislative changes regarding the sales tax and pensions payments, and a certain level of State funding which is currently at risk. In the cover letter to the report, the City Controller urged PICA to request a revised Five-Year forecast. A complete copy of the City Controller's transmittal letter and report can be found in Appendix A of this Staff Report.

STAFF RECOMMENDATION

This Plan contains one of the largest quantifiable risks ever evaluated by the PICA Staff. The new authorities to be granted by the State have an impact of over $700 million over the life of the Plan, and a more than $450 million risk in just the first two years of the Plan. While certain other risks are significant, especially those related to the labor contracts, none carry as much challenge for the City. As discussed later in this report, PICA Staff does not question the quantitative impact of these initiatives, but is concerned as to both the likelihood of passage and passage in a timely fashion especially as these issues have been rolled into the ongoing debate over the State budget.

The possibility that the State could delay a decision on granting these new powers exacerbates the risk. While the Pension payment is not scheduled to be made until the spring, the Sales Tax increase cannot be retroactive. Every month delay in implementation costs the Plan nearly $9 million. Even if the State were to give the authority to increase the Sales Tax today, it will take 4-6 weeks for the revenue department to be ready to start collections.

While the City has been drafting a contingency plan should these new authorities not be granted, it will take time to implement the plan, especially the likely significant layoffs that would be required. Additionally, the later in the year the plan is implemented, the deeper the cuts that must be made to make up for the lost revenue and the current year expenditures that have already been incurred. The City cannot afford to wait indefinitely for the State; without action by August 15^{th}, the City will effectively have lost any additional Sales Tax revenues for the first quarter of the fiscal year and have lost the opportunity to realize three months' worth of savings.

PICA Staff recommends that the Board of the Pennsylvania Intergovernmental Cooperation Authority approve the revised Five-Year Financial Plan for FY10-FY14 as submitted to the Authority on June 22, 2009 with the following caveats:

1. The City should be required to continue to provide monthly reporting.

2. Should the General Assembly adjourn its session without taking action on the new authorities requested by the City, a Plan revision must be submitted within 15 days to the Authority for consideration and review;

3. Should the General Assembly fail to enact the new authorities requested by the City by August 15, 2009, a Plan revision must be submitted within 15 days to the Authority for consideration and review;

4. Should any labor contracts be finalized which increase General Fund costs beyond the City's ability to pay, or fail to realize the savings assumed in the Plan, a Plan revision must be submitted within 15 days to the Authority for consideration and review.

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Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT ON FY2010-FY2014 FIVE-YEAR FINANCIAL PLAN

SECTION II:

SUBSTANTIAL RISKS

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SUBSTANTIAL RISKS INCLUDED IN THE PLAN

STATE APPROVALS FOR NEW TAXING AUTHORITY AND PENSION PAYMENT RESTRUCTURING

The Plan assumes that the State will grant the City the ability to raise the City Sales Tax an additional 1 percent, generating over $581 million of additional revenues over the Plan period. The Plan assumes that the State will grant the City the ability to change its pension fund amortization assumption saving $120 million over the Plan period, and the ability to defer $230 of pension payments in the first two years of the Plan. Although legislation for all of these changes has been introduced, the likelihood of passage, or even passage in a timely fashion, is tied up in the State budget stalemate.

Sales Tax

The final budget agreement between the Administration and City Council included a five-year increase in the City Sales Tax of 1 percent. After accounting for an elasticity impact on buyer behavior and a delay in implementation, the additional sales tax is projected to generate $106.4 million in the first year of the Plan, and over $581 million over the life of the Plan. In order to increase the Sales Tax rate, the City requires State approval (authority to institute the original 1 percent City sales tax was granted as part of the original PICA Act). House Bill 1824 was introduced on July 2, 2009 and would grant the City the authority to raise the City Sales Tax rate by an additional 1 percent.

As of this writing, it appears unlikely that this bill will be considered on its own, but rather will be considered as part of the omnibus State budget currently being negotiated. No timetable for completion of the State budget has been established and it remains possible that the General Assembly could choose to complete its budget or go out of session without acting on the City's request for additional taxing authority.

According to the City Revenue Department, it will likely take four-to-six weeks from the time authority is granted until the new tax rate could begin being implemented. The Sales Tax cannot be collected retroactively. Every month that passes without the authority to collect the additional tax costs the Five-Year Plan nearly $9 million. Ultimately the City cannot wait indefinitely for the General Assembly to act; within a few months, the City will have to begin making expenditure cuts in order to make up for the lost Sales Tax revenues assumed in the Plan.

Pension Changes

In order to balance the Plan, the City has requested certain additional authorities from the State relative to the calculation of its Pension Fund payment, and the ability to defer a portion of its required Pension Fund payment. First, the City currently uses a twenty-year average amortization schedule for its actuarial calculations, and is requesting approval to utilize a thirty-year average amortization schedule. The net impact of the change would be to lower the amount the City is required to pay into the fund on an annual basis. The

City has also stated that if this approval is granted, it will lower the fund's assumed earnings rate which would lessen the positive cash-flow impact of the reamortization, but would improve the long-term assumptions of the Pension Fund overall.

The City has also requested approval to defer a portion of the required Pension payments during the first two years of the Plan - $150 million in FY10, and $80 million in FY11. All of the deferred monies would be repaid to the Pension Fund in FY13 and FY14, and interest on the deferred monies (at the Fund's assumed earnings rate) would be paid annually. The reamortization proposal is estimated to save the City $120 million over the life of the Plan while the interest costs associated with the payment deferment total approximately $56.8 million.

Similarly to the Sales Tax legislation, as of this writing, it appears unlikely that this bill will be considered on its own, but rather will be considered at the same time as the omnibus State budget currently being negotiated. No timetable for completion of the State budget has been established and it remains possible that the General Assembly could choose to complete its budget or go out of session without acting on the City's request for changes in its Pension Fund contributions.

This approach to dealing with the increasing liabilities of the Pension Fund is effectively a short-term approach which only serves to construct a temporary dam while long-term structural reforms are implemented. While structural changes in the pension system are the key to solving the most serious long-term fiscal challenge facing the City, these changes will not generate significant savings in the short-term. The City is attempting to simultaneously implement structural changes to rebalance the Pension Plan benefit and contribution levels over the long-term through the labor negotiation process, an effort which is discussed below in greater detail. Failure to achieve the structural changes would ultimately render these short-term efforts meaningless.

LABOR CONTRACTS AND THE MUNICIPAL WORK FORCE

All four of the municipal employee contracts with the City expired on June 30, and are currently in the negotiation/arbitration process. The Plan assumes that new contracts will include no raises for the life of the Plan, and will result in annual savings of $25 million from benefit and work rule changes. Additionally, these changes would positively impact some of the City's long-term fiscal challenges on pensions and health benefits. **Any contracts which increase General Fund costs beyond the City's ability to pay, or fail to realize the savings assumed in the Plan, will require a revision to the Plan. This revision must demonstrate that there are sufficient funds to cover these costs or unrealized savings.**

LABOR COSTS

By far, the City's largest General Fund cost is for personnel. For FY09, projections show that of every dollar City government spends, more than 60 cents goes to labor costs. Changes in labor costs can, as a result, have a major impact on the City's finances. During the public budget forums this past spring, the focus was on the "choice" between increasing revenues or reducing services. In truth there is another answer – reducing the cost of delivering the service.

All four labor contracts expired on June 30, 2009. While the City has already entered negotiations with the unions representing non-uniformed employees, and begun the arbitration process with the unions representing the unformed employees, it is unlikely that any of them will be settled soon, and as such pose a significant risk to the Plan. The Plan has significant assumptions about the end result of this process, including no raises over the life of the Plan; and work rule changes and structural changes in benefits which will save the City $25 million per year of the Plan for a total Plan savings of $125 million. Work rule changes alone could lead to significant savings, particularly in the City's overtime costs. Benefit changes would have the most significant positive impact on the City's short-term costs while also ameliorating two of the City's most pressing long-term fiscal challenges.

Pension Benefits

PICA has long cited the growing unfunded liability of the Pension Fund as the greatest long-term fiscal challenge facing the City.[2] The fundamental flaw in the current pension system is that contribution levels do not equal benefit levels. City contribution levels have been low ever since FY2003 when the decision was made to reduce the contribution level from a City determined actuarially derived funding formula to the State's mandated actuarially derived Minimum Municipal Obligation (MMO) payment. At the same time, despite a generous benefit level, non-uniformed City employees contribute less than 2 percent of salary to the Pension Fund, as compared to national average of over 5 percent, and State employees who contribute 6.5 percent.

This structural imbalance has left the Pension Fund overly reliant on strong investment returns and their inherent risks. Due in large part to last year's market performance, the funding level dropped from 55 percent funded at the end of FY08, to an estimated 43 percent funded.[3] It is unrealistic to believe that outside earnings can make up that unfunded portion while the structural imbalance remains.

As this structural problem has been allowed to fester, the impact on the short-term finances of the City has increased dramatically. In 1981, when the liability was first identified, the initial cost to the General Fund was $64 million; by 2001 the cost was $194 million, and in 2009 was $461 million. The size of the problem has been increasing as a series of short-term fixes were implemented (Pension Obligation Bonds in FY99; reducing the annual payment to the MMO in 2003) but no fixes were ever made to the long-term structural problems of the pension system.

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[2] A more comprehensive discussion on the problems facing the Pension Fund and recommendations for changes can be found in the PICA Issues Paper: "An Ounce of Prevention: Managing the Ballooning Liability of Philadelphia's Pension Fund" available on the PICA website at www.picapa.org.

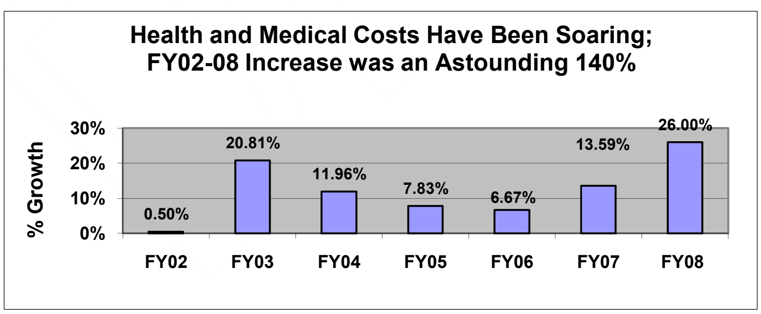
[3] This estimate was provided by the City's actuary in early June and assumed that the Pension Fund had sustained losses of 20% for FY2009. Actual losses were closer to 17.3% so the actual final numbers should be higher, but still less than 50%.

The current Administration has taken several steps to try to address the long-term structural problems with the Pension Fund. In its opening proposals of labor negotiations, and in public comments, it has called for realigning contributions and benefit levels, and consideration of a "hybrid pension plan" which would include a defined benefits option with lower benefit levels then the current plan, and a defined contribution option, with a partial City match. Additionally, the City has sought and received classification as a "Distressed Fund" from the State Public Employee Retirement Commission (PERC) to gain wider latitude in imposing these changes. There is also discussion at the State to give PERC additional oversight powers including the ability to assume responsibility and management for any distressed fund.

While these proposed changes to the system are crucial for the City's long-term fiscal health, they would not result in dramatic short-term savings. The City's proposals to lengthen the pension amortization period of the Pension Fund and defer a portion of the required payments only make sense as part of a comprehensive strategy to fix this problem. The short-term fixes provide short-term relief to the General Fund while the long-term structural changes can take effect. However, it should be noted that failure to make changes in the existing Pension Fund benefits, or employee contribution rates, or expected rate of return is tantamount to half of a solution. If changes are not made during the current employee contract negotiations, then the City has failed to properly mitigate the risks in the Pension Plan.

Health Benefits

Over the past several years, health benefit costs have risen dramatically. The labor contracts agreed to last year were the first in a decade to lower the health care costs for the City. In FY02, City health care costs totaled $187.5 million; by FY08, they were $421 million, or more than 11 percent of the total City budget.



* The FY08 Health Care increase was impacted somewhat by onetime payments associated with renegotiated labor contracts, however the increase from FY02-FY07 alone was over 70 percent.

The last contracts reduced health costs by 11 percent and recognized that more could and should be done to control health costs. A Joint Labor-Management Healthcare Evaluation Committee was formed with representatives for all employees to explore various opportunities for efficiencies and savings while preserving a competitive level of benefits. Unfortunately, none of the recommendations of the Committee have been made public, and it is unclear what if any changes will be implemented in the contracts currently being negotiated. The Plan assumes no increase in health care costs over the five years, and it is unclear how those levels will be achieved.

Work Rule Changes

For many years, City managers have highlighted the need for increased management flexibility in administering their workforce of over 28,000. The current labor contracts include many examples of inflexible requirements, which prevent City operations from functioning at its most cost effective. Many of the rules surrounding overtime usage, including the ability to earn overtime when not working a full week, and the ability to make use of flexible schedules, lead to significant costs for the City. The ability for Police Officers to take earned vacation for most of the year without management input as to timing, prevents the Police Department from properly managing personnel and leads to sharp increases in overtime costs during the summer months.

Many of the desired changes in work rules have been proposed by the City in labor negotiations and if implemented could result in better management of City resources and significant savings for the City.

Any contracts that increase General Fund costs above the amounts included in the Plan, will require a revision to the Plan that demonstrates sufficient revenues to cover the increased costs.

IMPACT OF REFORMS IN REAL PROPERTY ASSESSMENT PROCESS AND GOVERNANCE

In the short-term, property tax revenue assumptions are at risk due to increased delinquencies most likely resulting from the economic downturn. Actual revenues were $8 million below projections in FY09, despite assessment figures consistent with the City's projections. Eventual economic recovery and improved delinquency collection efforts should ultimately resolve that issue. In the long-term, the Plan's projection of Real Estate Tax revenue is at risk due to uncertainties surrounding reforms in tax administration and policy that are likely to occur during the FY10-FY14 period.

The Board of Revision of Taxes (BRT), a quasi-independent agency responsible for the assessment of real estate for purposes of the City and School District Real Estate Tax, has been engaged since 2004 in a process of upgrading its system of assessing real property in Philadelphia. Partly in response to recommendations made by the City's Tax Reform Commission in 2003, and utilizing funding from the City's Productivity Bank, BRT has developed a computerized system to appraise the over 500,000 residential and commercial properties subject to the Real Estate Tax. This Computer-Assisted Mass Appraisal (CAMA) system produces estimated market values for individual properties based on statistical modeling of the relationship between observable property characteristics and actual sale prices. CAMA is a standard approach to the mass appraisal of property for purposes of real estate taxation.[4]

Along with the new CAMA system, the BRT has announced its intention to eliminate its current policy of fractional assessment, under which the Board calculates the "assessed value" of an individual property as a fraction (32 percent) of its officially-determined "market value." The elimination of the fractional assessment policy and the automation of the assessment process through CAMA are collectively referred to by BRT as the Actual Value Initiative (AVI). This initiative is expected to result in several effects. First, the aggregate assessed value of city property should increase and the BRT-estimated market value of individual properties should generally more closely approximate actual market value as determined by sale prices. Second, the extent to which deviations in the assessment ratio (the ratio between assessed value and actual market value for individual properties) are systematic across neighborhoods or types of property should also be reduced. Third, the regressivity of the current property tax system is likely to decrease. Evidence suggests that, under the current assessment system, the assessment ratio of higher-value properties is generally lower than the ratio of lower-value properties. This systematic inequity should be reduced by the move to AVI.

AVI clearly represents an improvement from the unsystematic approach BRT has used to determine assessments in the past. A recent series of *Philadelphia Inquirer* articles detailed serious shortcomings in BRT operations and assessment processes, including the lack of systematic and publically transparent assessment procedures, patronage employees, and political influence on the assessment process.[5] AVI should improve the transparency of the assessment process, and the accuracy of assessments, and reduce the potential for political influence on assessed values.

However, significant challenges remain. One such challenge is ensuring the quality of data on property characteristics. The accuracy of the CAMA assessments depends critically on the quality of this data. A recent *Inquirer* article called the accuracy of BRT's property characteristics data into question.[6] The ongoing process of maintaining an accurate database of property characteristics is essential if the CAMA system is to produce reliable estimates of market value for all properties.

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[4] See *Standard on Automated Valuation Models* (Chicago: International Association of Assessing Officers, 2003), and Standard 6 of the 2008-2009 Uniform Standards of Professional Appraisal Practice (Washington, D.C.: Appraisal Foundation), available at www.appraisalfoundation.org.
[5] Mark Fazlollah and Joseph Tanfani, "Assessment: Broken," "BRT serves as political jobs bank," "BRT thrives at expense of schools," and "Crossing Fumo," *Philadelphia Inquirer*, May 2-5, 2009.
[6] Mark Fazlollah, Joseph Tanfani, and Dylan Purcell, "New BRT Data May Be Flawed from the Start," *Philadelphia Inquirer*, May 24, 2009.

The increase in the equity and credibility of the assessment process expected to result from AVI will be a major benefit to the City and School District. These improvements should increase public confidence in the property tax system, which is essential if the property tax is to continue to play a role as a major source of revenue for the City and School District. However, the process of conversion to the new AVI system does present some financial risk to the City.

Because of the significant increase in the aggregate assessed value of city property expected to result from AVI, once the new AVI values are adopted, City policy-makers will need to determine new Real Estate Tax rates for the City and School District in order to prevent major increases in the overall tax burden on city taxpayers. City officials have indicated that they expect the conversion to AVI will be revenue neutral to the City and School District. While maintaining revenue neutrality is certainly achievable, there is some risk that this may be difficult to achieve in practice, for several reasons. First, the significant changes in property assessments under AVI could result in a large increase in taxpayer appeals. City officials need to ensure that the new AVI values are legally defensible before implementation to avoid the potential for significant revenue losses due to appeals from taxpayers who are negatively affected by the change.

Another concern is the impact of the redistribution of the tax burden resulting from AVI on collection rates. Because of the considerable disparities in the assessment ratio across properties under the current system, AVI is expected to result in a significant reallocation of the tax burden across properties. Taxpayers whose properties were under-assessed relative to the citywide average assessment ratio in the past will generally face higher tax burdens under AVI, just as taxpayers whose properties were over-assessed relative to the average will pay less. City officials will need to consider the ability of taxpayers whose tax burdens increase under AVI to pay their higher tax liabilities under the new system, and the likely effect of AVI on overall collection rates.

In addition, the revenue impact of continued declines in real estate values on assessments and tax revenues under the new assessment system is unclear. Even in jurisdictions that are not making major changes to assessment practices, declining property value in recent years has resulted in major reductions in assessments and property tax revenue.[7] Accurate property valuation requires continual updating of property characteristics information and recalibration of statistical valuation models. This requires professional expertise and there are serious questions about whether this level of expertise currently exists at BRT.

Aside from issues of administrative capacity, the *Inquirer* articles have raised questions about the integrity of the assessment process. As a result, there have been calls from the Mayor and members of City Council to reform the property assessment and appeals process, including proposals to change the composition of the BRT board, to shift

[7] Jack Healy, “Tax Bill Appeals Take Rising Toll on Governments,” *New York Times*, July 5, 2009.

responsibility for property assessment to an agency under the control of the Mayor, and to separate the assessment function from the function of adjudicating assessment appeals. The potential for significant changes in administration and governance of the property tax assessment system is yet another uncertainty that may affect Real Estate Tax collections over the FY10-FY14 period. As a result of all these concerns, the Real Estate Tax projection in the Plan represents a major financial risk.

Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT ON FY2010-FY2014 FIVE-YEAR FINANCIAL PLAN

SECTION III:

ADDITIONAL RISKS TO THE PLAN

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OVERVIEW

In addition to the items listed above, there are a number of additional areas of risk for the Plan.

- Uncertain National Economy
- Financial Stress at the Commonwealth
- Philadelphia Gas Works (PGW)
- Casino-Related Revenues and Costs

UNCERTAIN NATIONAL ECONOMY: MACROECONOMIC TRENDS

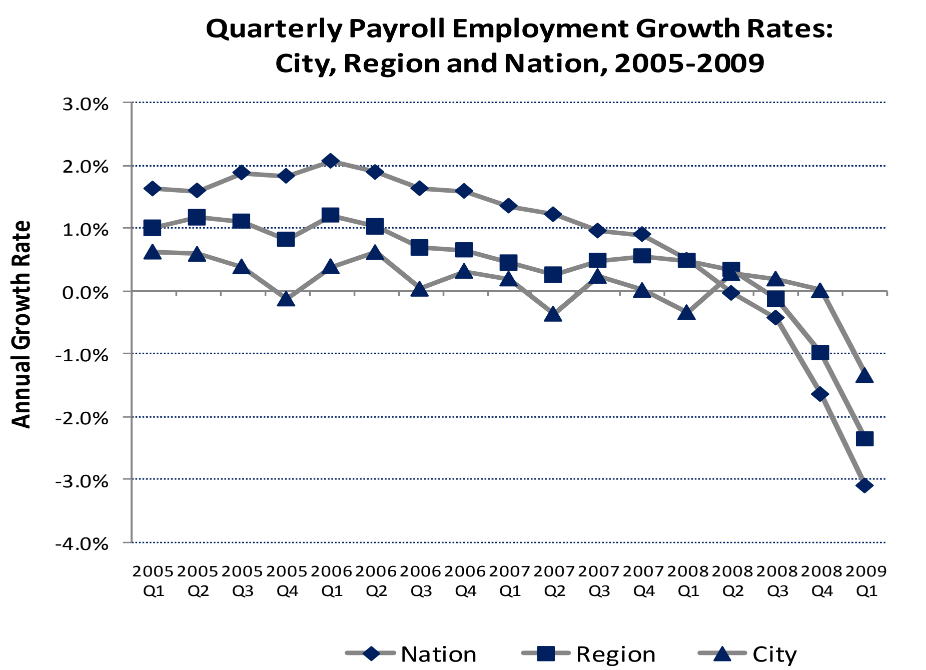
The impact of the global recession on the city's economy over the FY10-FY14 period, and the associated impact on City General Fund revenues, is uncertain and a risk to the Plan. When the FY09-FY13 Plan was approved in June 2008, it was known that the economy was weakening, but City policy-makers and PICA did not anticipate the collapse in the global and national economies that occurred beginning in late summer of 2008. Since then, the city's economy has proved fairly resilient as compared to other municipalities, owing in part to the high concentration of the city's economy in sectors that have seen relatively less severe impacts from the recession: health care, education, and government. Nonetheless, economic indicators for Philadelphia have slowly but steadily declined since the third quarter of calendar 2008, and this trend has been reflected in tax revenues as well. Throughout FY09, quarterly collections of the four major City taxes that are collected on a continuous monthly basis – the Wage, Realty Transfer, Sales, and Parking taxes – have indicated a deteriorating tax base as the fiscal year progressed.

Although federal intervention in the financial and housing sectors, the American Recovery and Reinvestment Act of 2009 (ARRA), and other federal initiatives are designed to bolster the flagging economy, and certain indicators indicate that the pace of economic decline is slowing, nonetheless the duration of the current period of economic contraction, and the pace of eventual recovery, remain uncertain.

With the assumption of positive growth in Wage Tax revenues beginning in FY10, the Plan is implicitly assuming that earnings trends will level off fairly quickly and return to positive growth in calendar 2010. The Business Privilege Tax is projected to reach a low point in FY10 and return to positive growth in FY11, again reflecting the City's assumption that economic growth will return slowly beginning in calendar 2010. If earnings and business activity in Philadelphia continue to decline in 2010, these projections will be at risk. The Plan also assumes that the Realty Transfer Tax will return to positive growth in FY11, which suggests the assumption that property values will stabilize within the calendar year 2010 or early 2011. While these assumptions are consistent with some economic projections, whether the recovery will occur this rapidly is uncertain.

The pace of economic recovery will also affect the status of the City's Pension Fund. The degree to which the stock market recovers will influence the health of the fund and the City's obligations to contribute under the current funding system. Even if a major restructuring in the City's pension program and funding obligations occurs during the FY10-FY14 period (discussed elsewhere in this report), the investment performance of the Pension Fund will remain an important determinant of the City's financial obligations to the Fund and the City's overall financial balance.

Trends in city-based payroll employment have been progressively weaker since the second quarter of 2008. But as shown in the figure below, the decline in employment in Philadelphia has been less drastic than in the nation as a whole. This is apparently due in part to the composition of the city's economy, which is more highly concentrated in health services and education than the nation. These sectors have declined less rapidly than others in the current recession. Although Philadelphia's employment trends have been less weak than national trends through recent months, this relationship may not continue. Some of the city's strongest sectors have shown signs of weakening in recent months.[8] While there has been some sign of moderation in the rate of employment loss nationally, it is still not clear at what point stabilization and growth may be achieved. How Philadelphia's employment and earnings base will perform relative to the nation during the remainder of the recession and the ensuing recovery is also unknown.



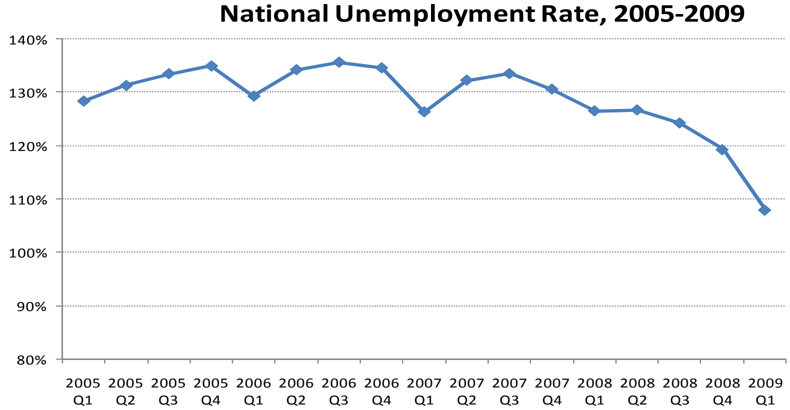
Source: U. S. Department of Labor, Bureau of Labor Statistics, Current Employment Statistics, Seasonally Adjusted Non-Farm Payroll Employment

8 *City of Philadelphia Monthly Economic and Quarterly Revenue Review*, Department of Finance, Office of Budget and Program Evaluation, City of Philadelphia, June 2009.

Underscoring concerns about the labor market in the city is the continuing increase in the unemployment rate, which reached 9.9 percent in May, the highest level since July 1993, according to the U. S. Bureau of Labor Statistics. Philadelphia's unemployment rate has historically exceeded that of the nation. The chart below indicates that the gap between the city and national unemployment rate has narrowed somewhat in recent months, which is consistent with the payroll employment trends that show the city's labor market to date as less negatively impacted by the recession than the nation as a whole. Nonetheless, unemployment in Philadelphia has increased from an annual average of 6.0 percent in 2007 to an average of 7.2 percent in 2008, and an average of 9.5 percent through the first five months of 2009.

Most economic projections suggest that the labor market will continue to deteriorate through 2010, which places the City's projection of Wage Tax revenues at some risk. The Federal Reserve Bank of Philadelphia's Survey of Professional Forecasters indicates that the national unemployment rate will average 9.1 percent in 2009 and 9.6 percent in 2010, before falling to 8.7 percent in 2011 and 7.7 percent in 2012. The number of jobs is expected to fall an average of 422,600 per month in 2009 and 13,900 in 2010.[9] The Congressional Budget Office's most recent economic projection, published in March 2009, projects the national unemployment rate increasing from an average of 8.8 percent in 2009 to 9.0 percent in 2010, before declining to 7.7 percent in 2011.[10] Given economists' expectation that the calendar year average unemployment rate will increase in 2010, the assumption of nominal Wage Tax growth of 1.7 percent in FY10 may be somewhat optimistic.

Philadelphia Unemployment Rate as a Percentage of National Unemployment Rate, 2005-2009



Source: U. S. Department of Labor, Bureau of Labor Statistics, National Unemployment Rate from Current Population Survey, City unemployment rate from Local Area Unemployment Statistics. Data are not seasonally adjusted.

[9] *Survey of Professional Forecasters*, Second Quarter 2009 (Philadelphia: Federal Reserve Bank of Philadelphia, Research Department, May 15, 2009).

[10] Congressional Budget Office, *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook* (March 2009).

Philadelphia's housing market has also shown weakness in recent years. According to the S&P/Case-Shiller Home Price Index, housing prices in 20 metropolitan areas nationally declined 32.6 percent from their peak in the second quarter of 2006 to April 2009.[11] Philadelphia's decline in recent years has been smaller than in these areas, with a decline of approximately 18 percent from the peak level as of April.[12] Nonetheless, whether prices will continue to fall substantially is a major concern for the FY10-FY14 Plan. The Plan projects that Realty Transfer Tax revenue will decline 23.4 percent in FY10, and increase each year beginning in FY11. The implicit assumption is that prices and transaction levels will begin to stabilize before the end of calendar 2010. This represents a risk to the Plan, given the dramatic declines in the housing sector since 2006, and weakness in the labor market and other economic trends which could continue to affect the housing market for some time to come.

FINANCIAL STRESS AT THE COMMONWEALTH

The economic collapse has severely impacted the State budget. While it is unclear at this writing where budget cuts may lie, there has been significant discussion regarding reductions in the social service and education programs which strongly impact the City. Should funding be cut in those areas, a greater burden would fall on the City to meet the needs of its most vulnerable citizens. The Plan anticipates receiving over $595 million from the State in FY10 through various programs.

In the absence of a final State budget it is difficult to quantify the specific impacts of any State cuts. The State is facing a budget gap estimated at anywhere from $1 to 3 billion; scenarios for closing the gap have run the gamut from primarily spending cuts to primarily revenue enhancements. Potential areas facing cuts include social service program and mental health service programs which are City activities primarily funded by the State. The first impacts would likely be felt by prevention programs, leading to increased levels of individuals with emergent and more costly needs.

Such a scenario would not only put additional pressure on the City budget to make up for the loss in State funding, but would likely result in additional burdens on local hospitals and emergency responders. Potential changes in State funding levels are an as yet unquantifiable but certainly possible risk to the City's fiscal health, and the health and welfare of its citizenry.

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[11] 20-City Composite Index as reported in "The Pace of Home Price Declines Moderate in April According to the S&P/Case-Shiller Home Price Indices," press release dated June 30, 2009, available at www2.standardandpoors.com.
[12] "Philadelphia's Housing Market Deteriorates Sharply in Q1," (Philadelphia: Econsult Corporation, April 23, 2009), available at www.econsult.com.

PHILADELPHIA GAS WORKS (PGW)

PGW continues to present an enormous risk for the City and the entire region. While PGW continues to look at creative ways to ease its fiscal challenges, the difficulties faced by the utility resulting during the bond market volatility of the past year underscored the precarious nature of its situation. Though the leadership of PGW continues to make strides in improving management and operations, structural challenges and an over-sized workforce continue to challenge the utility while the outstanding $1.2 billion in debt dominates the balance sheet. There remains a real possibility that future fiscal crises at PGW will require additional City subsidies and could even damage the entire region's economy.

PGW's Fiscal Condition
PGW continued to maintain a status quo in its operational finances, with a relatively small negative cash flow. Collection rates continued to maintain to a level consistent with those of other public and private utilities despite the economic downturn. While the utility now has a narrow positive annual operating balance, the nearly $1.2 billion debt load and other fiscal constraints make it unlikely it will be able to gain true fiscal stability during the Plan period. PGW's high exposure to the variable rate market necessitated an expected $56 million fixed rate bond issue to reduce its variable rate exposure. Effectively, PGW is treading water financially until serious plans for its future can be determined.

PGW's Plan for Recovery
As in the last several years, PGW has established a series of initiatives aimed at gaining fiscal security. However, as in the past, many of these initiatives remain questionable. The utility is likely to recognize some savings from restructuring and has cut its capital budget providing short-term relief, though raising the possibility of higher cost capital needs in the future. Unfortunately, the key to PGW's Improvement Plan relies on additional rate relief from the Public Utility Commission (PUC) and the implementation of a new Distribution Services Infrastructure Charge (DSIC) mechanism.

Last year, the PUC granted PGW $60 million in rate relief on a temporary basis. Part of PGW's financial plan assumes that rate relief will be made permanent. PICA Staff continues to believe that PGW has a compelling case to make in making that increase permanent. Over the last several years cost increases and the loss of its customer base have diminished its operating margins. The utility also continually operates with dangerously low cash balances necessitating extensive use of short-term borrowings.

The DSIC mechanism would allow PGW to use a third party with a higher credit rating to sell bonds to finance PGW improvements. The PUC would allow PGW to put a surcharge on bills to make principal and interest payments, serving as a surety for the bond issuance. Ultimately, the arrangement would allow PGW to lower its borrowing costs and restructure its outstanding debt. However, it remains unclear if the savings are as great as highlighted by PGW, and the proposal has yet to garner the support of the Philadelphia Gas Commission or City Council. It is unclear how long it would be until the DSIC mechanism is available to PGW, if ever.

Structural Changes Needed at PGW
A 2008 analysis by the Economy League of Greater Philadelphia highlighted how many of the previously identified structural issues at the utility remain despite the progress made by the current management team in recent years. PGW remains hampered by an expensive and oversized workforce relative to other utilities. The utility is beholden to too many officials making it difficult to set coherent policies for change. PGW is treated by too many as a social service agency, with discounts for low-income and senior clients which shift the burden to the remaining customers, leading to rates that are among the highest in the nation. While opportunities exist for dramatic change in these areas, including the expected 40 percent of PGW's labor force reaching retirement age in the next two years, it is unclear what PGW's plans are to make progress in these key areas.

Long-term Risk: The City's Exposure to PGW's Debt
PGW has restructured its capital program to meet pressing needs despite having over $900 million in outstanding debt. The combination of increasing capital demands and a loss in revenue could render PGW unable to meet its debt obligations, forcing the City to either further subsidize the utility or allow it to default on its obligations. Either scenario would have dramatic implications for the fiscal stability of the City.

According to the City, there has been no official legal opinion on whether the City is contractually liable to repay PGW's debt should PGW be unable to meet those obligations. However, considering that PGW serves nearly all of Philadelphia's commercial and residential gas users, the City would be forced to deal with the aftermath of a PGW default.

Long-term Risk: Potential for Regional Impact
Unlike many of the risks highlighted in this Staff Report, the impact of a PGW collapse could be both sudden and dramatic. An abrupt failure would be beyond the City's fiscal capability, and would require help from other governments, putting additional strain on surrounding state and local authorities. Regional businesses and employees who are dependent on the City's economy would be vulnerable, as the main economic driver for the Commonwealth was disrupted. In short, a PGW failure would have consequences far beyond the City's fiscal stability.

GAMING REVENUES AND COSTS

The Plan assumes that the City will begin receiving fees from casinos in FY12, with a total of $70.8 million assumed over the life of the Plan, but the longer that the start of construction is delayed, the less likely it is that those revenues will be received in accordance with Plan estimates. At least one of the planned casinos has yet to obtain approval from the Commonwealth to move its building site. Further, the Plan does not assume that the opening of those casinos will result in any social, police or infrastructure costs to the City's General Fund, beyond the payment amounts pledged by the casino operators, though indirect benefits are also not accounted for in the Plan.

Gross slots revenues made available for tax reductions across Pennsylvania last year totaled $774 million, a small increase over the previous year. State gaming funds to be remitted to the City will total $86.6 million in FY10 which will result in a very slight reduction in the City's wage tax rate.

Host Fees

The ongoing battles over construction of the two casinos in Philadelphia have forced the City to once again push back its expected receipt of hosting fees. The estimate of $23.6 million annually in hosting fees is reasonable based on the success of the casinos already functioning throughout the Commonwealth. However, these estimates assume that both facilities will be up and running by the start of FY12. Given the current schedule for the Sugarhouse casino, it seems likely that the receipt of half of the host fees is reasonable. At this time, questions remain about the final site and financing issues for the Foxwoods casino, now presumed to be located in Center City. Should initial construction be further delayed, the City will have to further delay the expected revenues, or remove them from the Plan altogether.

Costs of Additional Law Enforcement

Police Department officials estimate it would cost nearly $18 million in start-up costs for a new officer unit to patrol around the casinos. After the first year officials estimate that the annual cost to run the unit would be $12.8 million. The City had reached tentative agreements with the casino operators regarding payments to offset these costs; however, the details of these commitments have not been made available. It is unknown if they will be sufficient to offset the Police costs, or other direct costs the City will incur.

PICA Staff noted last year that the Plan does not isolate secondary costs associated with the opening of casinos in Philadelphia. Experts say the costs are real, but the range of estimated costs is so great, that it is effectively unquantifiable. At the same time, the City does not isolate secondary revenues from job creation and additional business activity resulting from the casinos, figures which are also difficult to quantify. If and when the casinos are in fact operational in Philadelphia, it will be incumbent on the City to try and quantify any resulting secondary revenues and costs.

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Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT ON FY2010-FY2014 FIVE-YEAR FINANCIAL PLAN

SECTION IV:

REVENUE AND EXPENDITURE PROJECTIONS IN THE PLAN

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REVENUE AND EXPENDITURE ANALYSIS

Overview

This section analyzes the Plan's major assumptions with respect to General Fund revenues and expenditures over the FY10-FY14 period. Each of the four major categories of General Fund revenues – taxes, locally-generated non-tax revenues, revenue from other governments, and revenue from other funds – are discussed in the first two sections. Two aspects of the expenditure projections in the Plan are then discussed: the FY10 obligation projection, which reflects the City Council-approved operating budget, and the assumptions about spending growth over the FY11-FY14 period.

Tax Collections

Preliminary data on FY09 tax collections suggest that the Real Estate Tax, Business Privilege Tax, and Parking Tax revenues were below the FY10-FY14 Plan estimates, but these negative variances were offset by Wage, Sales, Realty Transfer, and Amusement tax collections that exceeded Plan projections. As a result, the City is expected to meet its overall projection for FY09 General Fund tax revenue. However, quarterly collection patterns in FY09 indicated a continuing slowdown in economic activity in the city as the fiscal year progressed. Collections for the four major taxes that are collected continuously throughout the year – the Wage, Realty Transfer, Sales, and Parking taxes – suggested continued weakening of the tax base throughout FY09. This apparently reflects the continuing slowdown in economic activity in the city as a result of the recession, and poses a concern for the achievability of the Plan's tax revenue projections. Uncertainty surrounding national macroeconomic trends, and how they will impact the city's economic and tax revenue growth over the FY10-FY14 period, is a risk to the Plan, as discussed in Section III.

Total General Fund tax revenue is projected to grow at an average annual rate of 3.0 percent from FY10 to FY14. The highest growth rate is projected for FY10 (4.1 percent). After FY10, tax revenue growth is projected to decline to 2.3 percent in FY12, and then increase to 3.3 percent in FY13 and 3.0 percent in FY14. The high growth rate in FY10 is largely the result of the assumed increase in the City Sales Tax rate from 1 to 2 percent. Table IV.1 presents the Plan's assumed growth rates for major General Fund taxes.

Table IV.1: General Fund Tax Revenue Annual Growth Assumptions, FY10-FY14

Tax	FY10	FY11	FY12	FY13	FY14	FY10-FY14 Average Annual Growth
Real Estate						
Current	2.0%	2.1%	3.2%	3.3%	3.3%	2.8%
Prior	0.0%	2.4%	2.3%	-3.4%	-3.5%	-0.5%
Wage and Earnings						
Current	1.7%	1.7%	1.9%	3.9%	3.2%	2.5%
Prior	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Business Privilege						
Current	-5.0%	2.0%	2.0%	2.0%	2.0%	0.6%
Prior	0.0%	4.0%	0.0%	0.0%	0.0%	0.8%
Net Profits						
Current	1.3%	3.4%	0.2%	2.0%	2.2%	1.8%
Prior	14.3%	0.0%	0.0%	0.0%	0.0%	2.7%
Sales	83.3%	4.3%	1.0%	1.5%	1.8%	14.8%
Amusement	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%
Realty Transfer	-23.4%	10.0%	10.0%	10.0%	10.0%	2.3%
Parking	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%
Other	4.8%	2.5%	2.5%	2.5%	2.5%	3.0%
Total *	4.1%	2.5%	2.3%	3.3%	3.0%	3.0%

* It is important to note that the 4.1 percent growth in revenues in FY10 is largely driven by the increase in the Sales Tax rate. Exclusive of the Sales Tax, FY10 revenue growth is negative 0.7 percent, and the five year average is 2.1 percent.

The most significant source of General Fund tax revenue is the Wage and Earnings Tax (collectively referred to as the "Wage Tax"). Current Wage Tax revenue is projected to grow 1.7 percent in FY10 and FY11, 1.9 percent in FY12, 3.9 percent in FY13, and 3.2 percent in FY14. These projections incorporate the assumption that the tax rate will decline over the Plan period due to an annual increase in State gaming revenue. By implication, the tax base (total revenue divided by the projected tax rate) is projected to grow by 2.5 percent in FY10, 1.8 percent in FY11, 4.0 percent in FY12, 4.75 percent in FY13, and 4.15 percent in FY14. The City is basing these projections on its own econometric modeling as well as economic forecasts published by the Congressional Budget Office, Office of Management and Budget, and other sources.

The greatest concern associated with the Wage Tax projection, and the projections of other General Fund tax revenues, is that the economic recovery may occur at a slower pace than is suggested by the current forecasts. The Wage Tax base, measured on a quarterly basis, showed continuing deterioration throughout FY09. In comparison with the previous fiscal year, the tax base increased 5.5 percent and 2.5 percent in the first and second quarters of FY09, respectively, and declined 0.8 percent and 2.3 percent, respectively, in the third and fourth quarters. If this downward trend continues for a significant length of time in FY10, the Plan's Wage Tax projection will be at risk.

The Plan's projected Real Estate Tax (RET) revenue assumes assessment growth of 3 percent in FY10 and FY11 and 4 percent in FY12-FY14. The projection also takes into account the impact of currently abated properties returning to the tax rolls. The projection makes no assumption as to the timing of implementation of the Actual Value Initiative (AVI) by the Board of Revision of Taxes (BRT). As discussed in Section II of this report, this initiative poses a major risk to the Plan because of the uncertainty associated with the transition to the new system of valuation and the impact that will have on revenues. The Plan projects annual growth rates for the current portion of the RET ranging from 2.0 to 3.3 percent. This projection would be reasonable in light of past trends, but because of the recent decline in collection rates for this tax, as well as uncertainty about the impact of AVI, there is risk associated with this projection.

Historically, the Business Privilege Tax (BPT) has been most sensitive to the business cycle. As a result of recent rate reductions in the gross receipts portion of the tax, approximately 80 percent of BPT revenues now derive from the net income portion of the BPT, and only 20 percent from the gross receipts portion. Accordingly, the BPT is particularly susceptible to cyclical economic trends, insofar as these influence business profits. The Plan assumes no changes in either the gross receipts or net income portion tax rate through FY14. Revenues are projected to decline by 5 percent in FY10, and increase 2 percent annually from FY11 through FY14. Historically, it has been particularly difficult to forecast revenues from this tax, in part due to the volatility of the tax base. While the FY10 projection is based on econometric modeling and credible forecasts of business activity at the national and regional level, the inherent uncertainty associated with this tax is a concern.

The increase in the Sales Tax rate from 1 to 2 percent in FY10 is projected to result in an 83.3 percent increase in revenue in FY10. This projection implicitly assumes some reduction in the tax base resulting from reduced retail activity associated with the tax increase, as well as a two-month lag between the legal imposition of the higher rate and the realization of revenue by the City. The Plan assumes that the higher rate will become effective August 1, 2009, an assumption that clearly will not be met. Further delays in the authorization of the increased Sales Tax rate by the State will further reduce the City's realization of revenue from this source in FY10.

Another factor affecting Sales Tax revenues over the FY10-FY14 period will be the economy, as Sales Tax revenues reflect consumer spending in the city. The revenue performance of the Sales Tax gradually deteriorated as FY09 progressed, reflecting the weakening economy. Revenues increased 2.8 percent from the FY08 level in the first quarter of FY09, but declined 5.8 percent, 5.3 percent, and 7.1 percent, respectively, in the second, third, and fourth quarters. The achievability of the Plan Sales Tax projection will also depend on macroeconomic trends in the FY10-FY14 period.

The continuing weakness in the national and regional real estate market means a particular concern is associated with projections of Realty Transfer Tax (RTT) revenue. The Plan assumes a decline of 23.4 percent in RTT revenue in FY10, followed by annual increases of 10 percent in the period from FY11 through FY14. As a result of deteriorating market conditions, RTT revenue declined 53 percent from a peak of $236.4 million in FY06 to a projected $110.6 million in FY09. The amount by which the tax can be expected to decline further will depend on trends in market values and transaction levels. It is reasonable to expect further declines in FY10 in light of national forecasts, but the actual magnitude of decline is subject to considerable uncertainty.

The Amusement Tax, Parking Tax, and other miscellaneous taxes are generally projected to increase 2.5 percent annually throughout the term of the Plan.

Other Revenue Categories

Aside from taxes, the City's General Fund revenues are classified into one of three major categories: locally-generated non-tax revenue, revenue from other governments, and revenue from other funds. This section reviews the Plan projections for these revenue types.

Total locally-generated non-tax revenues are projected to grow from $243.4 million in FY08 to $317.4 million in FY14, for an average annual growth rate of 4.5 percent.[13] This level of growth is achieved as a result of initiatives to impose new fees, increase existing fees, sell City assets, and implement a strategic marketing initiative. Locally-generated non-tax revenues are projected to increase from 7.1 percent of total General Fund revenues in FY08 to 7.6 percent in FY14.

Compared to the FY08 actual revenue, the Plan projects the following annual revenue increases due to fee increases: $9.3 million from Emergency Medical Services (EMS) fees, $4.5 million from health and sanitation license fees, $1.2 million from street use permits, $1 million from business license fees, $2.9 million in document recording fees (by FY12), $1.2 million in false alarm fees, and $4.9 million in court fees. Payments in lieu of taxes are projected to increase by $2 million annually beginning in FY12. The Plan projects gaming fees revenue of $23.6 million beginning in FY12. (The risk associated with this projection is discussed in Section III.) Interest earnings are projected to increase from $11 million in FY09 and FY10 to $20 million by FY13, which reflects the assumption of a substantial increase in the City's cash balances. A new trash collection fee to be levied on commercial property owners is projected to result in $7 million in new annual revenue beginning in FY10.

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[13] This calculation excludes $22.5 million in FY08 revenue received from the Philadelphia Gas Works to repay a City loan. Because of the unusual nature of this revenue, the exclusion is necessary to allow a meaningful comparison of revenue over time.

Two elements within the locally-generated non-tax revenue category represent risks to the Plan: A projected $3 million in annual revenue from strategic marketing and a projected $7.5 million in annual asset sale proceeds. The strategic marketing initiative is still in the early phases of implementation, and its exact elements are undetermined at this time. The projection of $3 million in annual revenue from this initiative is somewhat speculative. The projection of $7.5 million in asset sales revenue appears overly optimistic, in light of the fact that revenues from this source have ranged from $0.6 million to $4.1 million annually since FY05. The City's ability to increase asset sale revenue to the level projected in the Plan is uncertain.

Total revenues from other governments are projected to grow from $1,033.4 million in FY08 to $1,240.5 million in FY14, for an average annual growth rate of 1.5 percent.[14] Revenues from other governments, excluding State funding for Wage Tax reduction, are projected to decline from 27.8 percent of total General Fund revenue in FY08 to 26.3 percent in FY14.

The Plan generally does not assume significant changes in revenues from other governments from the FY09 projected level. The Plan does project a $4.9 million increase, beginning in FY09, in Medical Assistance (MA) Outpatient funding in the Department of Public Health (DPH). Revenues received from the Pennsylvania Convention Center Authority (PCCA) are projected to end in FY10 due to the assumption that with the completion of the Convention Center expansion, the new financing arrangement will be implemented which includes the assumption of PCCA-related revenues and expenditures by the State.

State funding for Wage Tax relief is projected to increase modestly during the initial years of the Plan, from $86.6 million in FY09 to $87.3 million in FY11, and then increase significantly beginning in FY12, reflecting the assumption that both Philadelphia-based casinos will begin operations by FY12. Total Wage Tax relief revenue is projected at $112.3 million in FY12, $123.4 million in FY13, and $135.6 million in FY14. Risks associated with these projections are discussed in Section III of this report. However, any reductions in the revenues received from the State for Wage Tax reduction will have no net impact on the Plan, since the Plan assumes that any reductions in the rate of the Wage, Earnings, and Net Profits taxes will be determined based on the actual level of Wage Tax relief funding received in the prior fiscal year.

The Plan generally does not project significant changes in revenues received by the General Fund from other funds of the City. Total revenues from other funds is projected to increase slightly, from $27.5 million in FY09 to $31.3 million in FY14.[15]

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[14] This calculation excludes $20.6 million in FY08 revenue from the Pennsylvania Convention Center Authority and $135.6 million in State Wage Tax Relief funding in FY14, to promote comparability over time.

[15] For the sake of comparability over time, this calculation excludes from the FY09 revenue $11.8 million in revenue received from the Grants Revenue Fund representing a

Expenditures: The FY10 Base
The Plan's obligations projections are based on the FY10 budgeted appropriation levels, and a series of assumptions about the rate of obligation growth over the FY11-FY14 period. This section reviews the FY10 base obligations, and the next section reviews the FY11-FY14 growth assumptions.

The FY10 base reflects savings from various management initiatives, some implemented after the November 2008 rebalancing plan and others described in the Plan in Appendix II. The level of savings from these initiatives is illustrated by comparing actual General Fund obligations in FY08 with the FY10 obligations projected in the Plan. This comparison, shown in the figure below, indicates that significant cost reductions are projected to occur over the FY08-FY10 period for most City agencies. The cost reductions that are factored into the FY10 budget are crucial for the overall balance of the Plan through FY14.

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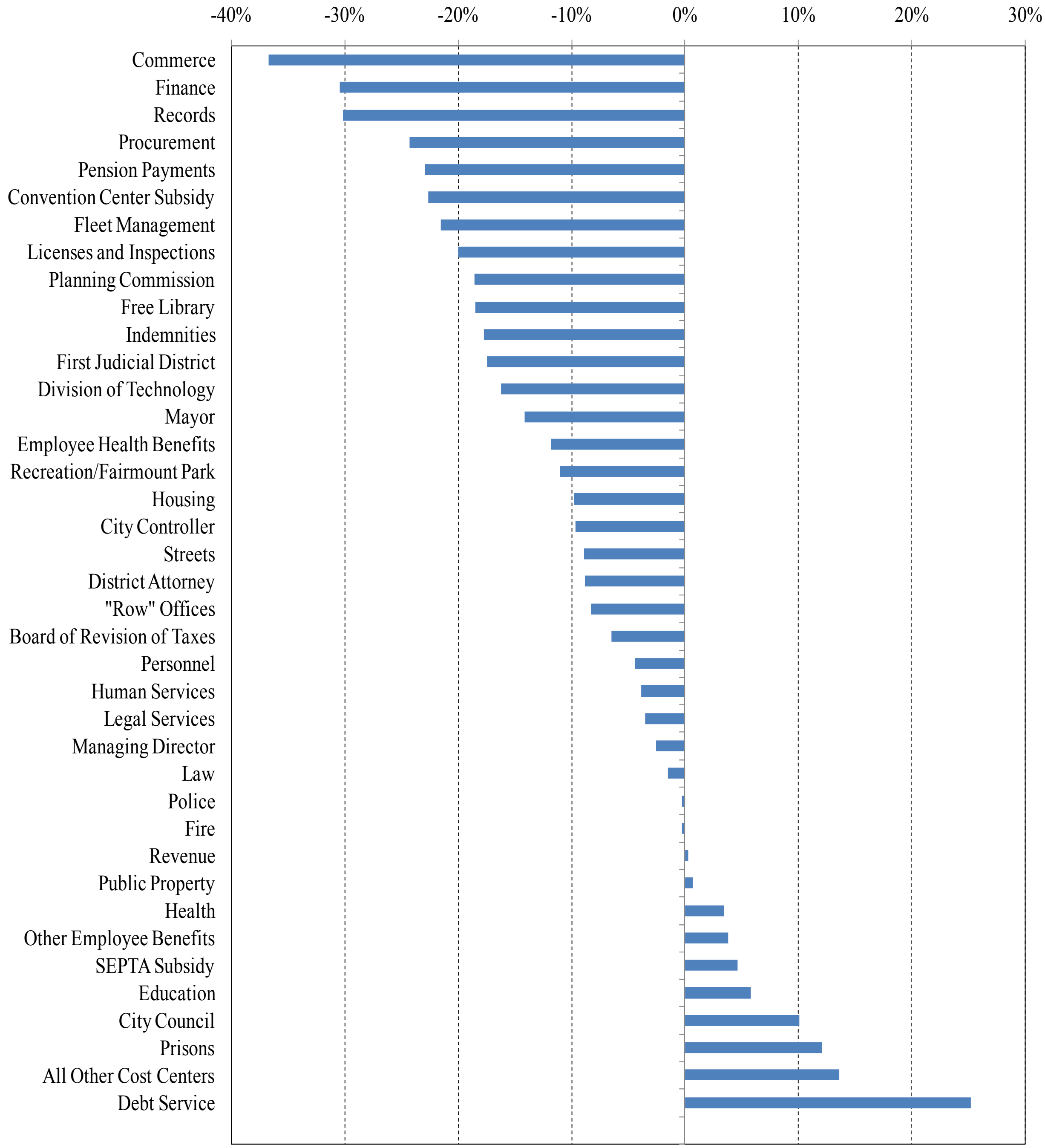
distribution from the Productivity Bank, $10.1 million in funding from the Grants Revenue Fund for HAVA grant reimbursement, and $86.6 million in revenue from the Wage Tax Reduction Fund representing funds received from the State for Wage Tax relief.

Percentage Change in General Fund Obligations by Agency and Cost Center, FY08 - FY10 (Projected)



Notes to Figure:

1. Pension payments assumes State approval of $150m deferment in FY10, and reamortization over 30 years.
2. Figures are adjusted for the transfer of the Capital Program Office to Public Property, Finance, Personnel, and DoT, and transfer of some telecommunications costs from DoT to Public Property.
3. Mayor includes Mayor's Office of Transportation.
4. Commerce includes City Rep, Office of Arts, Culture, and the Creative Economy, and Economic Stimulus.
5. Managing Director includes Mayor's Office of Community Services.
6. "Row" offices include Clerk of Quarter Sessions, Register of Wills, Sheriff, and City Commissioners.
7. Fleet Management includes vehicle purchases.
8. Housing includes Office of Supportive Housing and Office of Housing and Community Development.
9. Health includes Dep. of Public Health and Dep. of Behavioral Health and Mental Retardation Services.
10. Education includes contributions to the School District of Philadelphia and CCP.
11. "All other cost centers" includes Hero Awards, Scholarships, Refunds, Witness Fees, Camp William Penn, Atwater Kent, Mural Arts, Art Museum, Labor Relations, Com on Human Relations, Historical Com, Treasurer, Civil Service Commission, Board of Ethics, Zoning Code Commission, Youth Com, and OIG.

Among the key initiatives that occurred as a result of the rebalancing plan were: reduced personnel costs through eliminating vacant positions, layoffs, reduction of salaries, reduction of overtime, and furloughs; reduced funding to outside agencies; consolidation of information technology functions; reduction of the existing fleet and reduced purchasing of new vehicles; new departmental efficiencies and reorganizations; elimination of 5 engines and 2 ladder companies in the Fire Department; reduction in hours of operation of libraries; reduced prevention programs in the Department of Human Services; closure of one emergency housing site and reduced case management services in the Office of Supportive Housing; elimination of bulk and tire collections and special collections for leaf/yard waste.

Among the initiatives that have been proposed under the Plan include: additional reductions in personnel costs through elimination of vacant positions, layoffs, furloughs, and salary and overtime reductions; elimination or reduction of contracted services; additional fleet reduction; additional reductions in supplies and equipment costs; shifting funding for some functions to external grants; and additional reductions in the cost of facilities maintenance.

The impact of these initiatives is an overall decline in obligations from FY08 to FY10 of $226.0 million, or 5.8 percent. A substantial portion of the decline is due to the deferral of $150 million in pension contributions in FY10. Even without this deferral, however, overall obligations would still decline by $76.0 million or 1.9 percent from FY08 to FY10.

The cost reductions are significant for most City departments. The only City agencies or cost centers that have increased spending over the FY08-FY10 period are: Revenue (0.3 percent), Public Property (0.7 percent), Public Health and Behavioral Health (3.5 percent), City Council (10.1 percent), Prisons (12.1 percent), and the group of agencies included in "all other cost centers" (13.6 percent). Positive growth has also occurred in employee benefits other than pensions and health care (3.8 percent), the SEPTA subsidy (4.6 percent), subsidies to the School District of Philadelphia and Community College of Philadelphia (5.8 percent), and debt service (25.1 percent). It is important to note that spending for debt service and Prisons is largely outside the control of the Administration. Prisons spending is largely reflective of the population in City correctional institutions, which reflects crime trends and criminal justice system policies that are to a significant degree outside of the Administration's control.

Expenditures: FY10-FY14 Growth Assumptions

As in past years, the obligation projections for the final four years of the Plan (FY11-FY14) are generally consistent with a set of baseline growth assumptions. These assumptions are presented in Appendix VIII of the Plan. They call for zero growth in each year for all major categories of expenditures. This section describes the areas where expenditure projections deviate from the baseline assumption of no growth, and the basis for the deviation.

The Plan projects that health insurance costs will increase minimally (from an estimated $368.8 million in FY09 to $370.5 million in FY14), which assumes that the Administration will be successful in holding the line on increases in the cost of health benefits as a result of new efficiencies in the administration of these programs or other policy changes. Costs for other categories of employee benefits are projected to increase modestly over the FY10-FY14 period.[16] The Plan also projects an additional $25 million in annual savings beginning in FY10 as a result of other changes in employee benefits or labor contracts to increase workforce productivity. These changes will have to result from the negotiation and arbitration processes for the City's four major unions.

As detailed in Appendix VII of the Plan, projected debt service is based on specific assumptions about interest and principal on outstanding short- and long-term debt, planned new debt issuances, sinking fund reserve payments, commitment fees, and arbitrage. Projected expenditures for payments to other funds are based on specific assumptions about the growth rates in each of the departments that are required to make such payments.

Other cases in which obligation projections deviate significantly from the zero growth assumption are as follows. Streets Department contractual spending declines significantly in FY10, based on projected reductions in trash disposal costs due to increased recycling and waste minimization initiatives. The City's subsidy to the Southeastern Pennsylvania Transportation Authority (SEPTA) is projected to grow at 2.5 percent annually in the final four years of the Plan, which reflects the obligation of the City and other counties in the region to match State contributions to the transit agency. Prisons contractual obligations are projected to grow at 5.0 percent annually after FY10, a reflection of

[16]These programs include disability programs, unemployment compensation, FICA taxes, group life insurance, legal insurance, tool allowances, and flex cash payments.

anticipated increases in the cost of prisoner health care, food services, maintenance, and other contracted services.

The cost of vehicle purchases by the Office of Fleet Management is projected at $6.3 million in FY09 and $4.6 million in FY10, well below the necessary level of investment to maintain the City's fleet, even considering the substantial reduction in the size of the fleet that has occurred recently. Vehicle purchase costs are projected to increase to $11.6 million in FY11 and beyond, in anticipation of an improved financial condition in these years. Annual increases of 0.2 percent are projected in FY11, FY12, and FY13 for the City's contribution to support the School District of Philadelphia (SDP). These projections are consistent with the City's financial obligations to support SDP under state law.

The City's subsidy to the Pennsylvania Convention Center Authority (PCCA) is projected to decline from $25 million in FY10 to $15 million beginning in FY11, a reflection of the City's reduced financial obligation to support PCCA operating costs following completion of the Convention Center expansion.

Utilities costs are projected to increase by over 20 percent from the FY09 estimate through FY14. Although the City's goal, as articulated in *Greenworks Philadelphia,* is to reduce energy consumption 30 percent by 2015, it is reasonable to expect an increase in the cost per unit of energy consumed in light of past volatility of energy prices and the expiration of the PECO rate cap beginning in 2011.

Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT ON FY2010-FY2014 FIVE-YEAR FINANCIAL PLAN

SECTION V:

THE LONG-TERM FINANCIAL ISSUES FACING THE CITY

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OVERVIEW
Over the past several years, PICA has identified the key long-term financial issues which could have the greatest impact on the fiscal health of the City. In large measure, the goal was to make sure that current City leaders were fully aware of these issues looming on the horizon – the earlier these problems were addressed, the lighter the impact on current government. Unfortunately, most of these issues were not addressed in any form, and some were made worse over the past several years. Some, like the unfunded Pension Fund liability have already begun to impact current budgets; other issues remain in the not too distant horizon. Below we update the status of each of these issues, and the proposals, if any, to address them.

UNFUNDED PENSION LIABILITY
The problems in the Pension Fund are discussed in detail in Section II of this report. At the beginning of FY2009, the Pension Fund was only 55 percent funded; the losses in the market will result in a figure at year's end of less than 50 percent. The City has proposed a two-pronged approach to dealing with the pension problems – one short-term, one long-term. While the short-term fixes (reamortization and payment deferrals) will ease pressure on the General Fund, they will ultimately be meaningless without implementation of the long-term fixes proposed by the City.

The City's long-term proposals include increasing the level of employee contributions and implementing a new Pension Plan. The new Plan would be a hybrid with a defined benefit option with a lower level of benefits than the current plan, and an optional defined contribution plan which will function like a 401(k) including a City match of a portion of each employee's contributions. The City has also received designation as a "Distressed Fund" by the State Public Employee Retirement Commission (PERC). Failure to achieve changes which realign contribution levels with benefit levels will leave the Pension Fund in worse condition than before, as the liability will have been exacerbated by the short-term fixes.

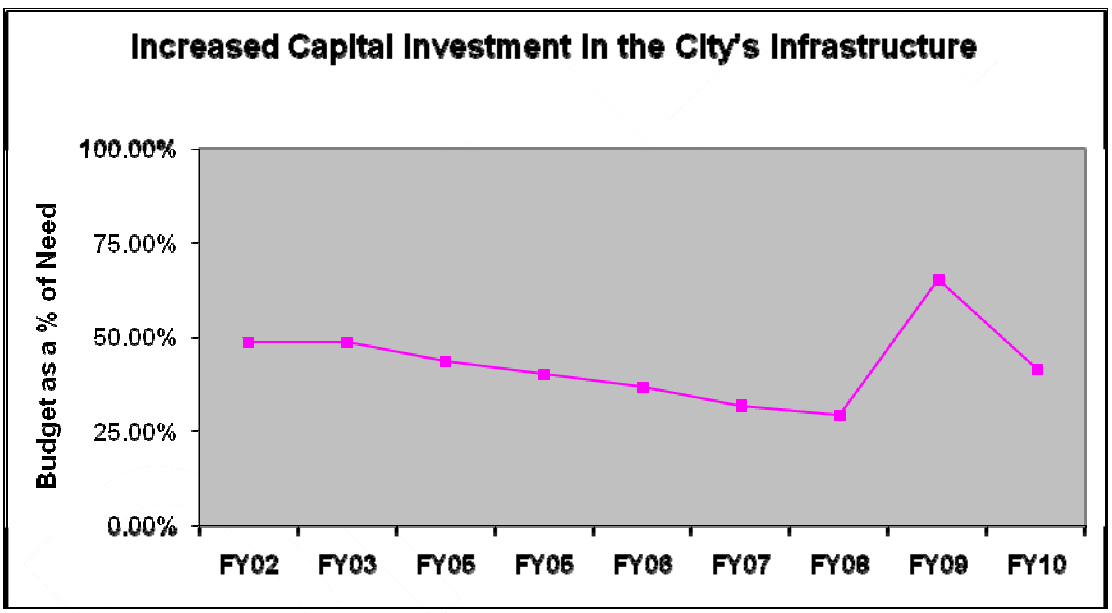
THE CITY'S TAX STRUCTURE
Philadelphia's burdensome tax structure has been the topic of numerous reports. Historically, the high levels of the Wage Tax and the BPT, especially the gross receipts portion, have discouraged businesses from entering the Philadelphia market, or driven away existing businesses. In order to address this competitive disadvantage relative to other major cities and to boost economic growth, the City has been reducing its Wage and BOT gross receipts tax rates since FY95. The economic downturn and resulting fiscal crisis led the City to suspend its incremental tax reduction program for the life of the Plan. However, gaming revenue from the State should continue to decrease the Wage Tax rate over the life of the Plan.

The Plan also calls for a temporary, five-year increase in the Sales Tax by 1 percent, assuming authority to raise the tax is granted by the State. Of all of the major taxes, this increase should have the least long-term impact on the local economy, but the City will be closely watched to see if it eliminates the 1 percent increase after FY2014.

The Mayor has also commissioned a Task Force on Tax Policy and Economic Competitiveness which is expected to make a series of recommendation in the fall about how to further reform the City's tax structure.

LACK OF INVESTMENT IN THE CITY'S INFRASTRUCTURE

After years of under-investing in the City's infrastructure, the Nutter Administration has pledged to invest $76.7 million in FY10. In 2001 the City Planning Commission found that the City needed to invest $185 million annually to keep its infrastructure in good condition. From FY02 to FY08 the City invested less than half of that amount each year; an average of $53 million per year of new loans was invested in the city's infrastructure. The FY10-FY14 Plan increases the level of investment slightly.



Because of the historical lack of investment, in early 2007, PICA funded a Facility Assessment Project. This project assessed the physical condition of each of the facilities in the Prisons System, City Hall and the Police, Fire and Health Departments. The project was completed in October of 2007 and it provided the City with a working tool to prioritize and allocate adequate capital funding. The City also received an ongoing maintenance schedule for the facilities covered by the project as well as an IT system to track the condition of its infrastructure.

Over the past few years, PICA has recommended that the City institute pay-as-you go funding for certain capital projects. Starting in FY09 the city attempted to tackle the ever-growing backlog of streets resurfacing by utilizing $10 million per year of this type of funding. The funds were generated by a twenty percent increase in the Parking Tax.

Request for PICA Funds

In July 2008, PICA approved the City's request to utilize $27.5 million in existing PICA capital funds for improvements to Police and Fire facilities and projects at the Free Library. The City has begun to utilize those funds. Much of the requested funding for departmental facilities is as a result of the PICA Assessment Project that was completed in the fall of 2007.

RAINY DAY FUND

The establishment of a budget stabilization fund, also known as a rainy day fund, remains an important goal for the City. A rainy day fund would have enabled the City to cover budget shortfalls which resulted from the dramatic economic downturn. Also important, rating agencies use the existence and structure of a rainy day fund in deciding cities' bond ratings. By establishing a fund, the City would be able to reduce its borrowing costs, creating cost savings in the long run. According to a paper published in 2004 in the *National Tax Journal,* government entities can expect a ten basis point reduction in bond yields after the creation of a reserve fund.

The severe economic distress has made establishing a fund nearly impossible – it is already "raining." Once Philadelphia emerges from fiscal crisis, PICA Staff will continue to press the City to establish a Rainy Day Fund.

LONG-TERM OBLIGATIONS

Keeping track of the City's long-term obligations is crucial; as these increase, the City's financial flexibility decreases and its credit strength weakens. The need for monitoring has become particularly urgent in recent years, as the City has seen its fixed costs rise dramatically; in FY09 the City is projected to spend about $287 million *more* on fixed costs than it did in FY01. That represents a 72 percent increase, while General Fund obligations for the same period increased by only 37 percent. In other words, fixed-cost increases far outpaced total cost increases, which translate into fewer dollars available to fund citizen services.

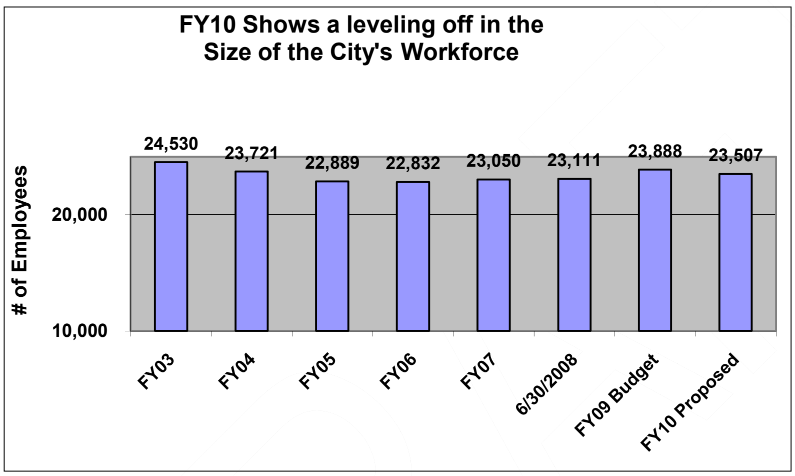
The City has taken steps in the right direction to address and monitor its ballooning long-term liabilities, including:

- Formulating a comprehensive debt management policy: the policy issued in August 2008 represents the first time since 1997 that the City has updated its debt management policy and has set forth fiscally prudent guidelines.
- Using more pay-as-you-go capital spending: the City has included funds in the Streets Department budget from pay-as-you-go financing.
- Reducing the number of facilities it maintains: the City has indicated that the Department of Public Property has launched a more aggressive evaluation and feasibility study of the cost-effectiveness of each of the City's facilities in order to identify the ones that the City can close, sell or outsource.

- Making changes to the Pension System in order to reduce its unfunded pension liability over time (discussed elsewhere in this report).

REDUCING THE SIZE OF THE WORKFORCE

Finding a viable solution for the issue of balancing the increasing demand for services while healthcare, pension and wage costs are also increasing has been a significant challenge for the current Administration. In prior years, while prisons, health, pension, and debt service costs grew faster than City's revenues, the City tried to cut costs by shrinking its workforce. While that trend has ended, the fiscal crisis has helped halt the growth in the size of the City's workforce.



Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT ON FY2010-FY2014 FIVE-YEAR FINANCIAL PLAN

SECTION VI:

ADMINISTRATIVE REFORMS AND PRODUCTIVITY INITIATIVES OF THE CITY

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PERFORMANCE MANAGEMENT

Performance management is a concept that has been widely adopted by state and local governments throughout the country in recent years. It has succeeded in transforming the culture of many government agencies toward a greater orientation toward customer service and results.[17] The Nutter Administration has made a significant commitment to the adoption of performance management. This commitment is a very promising development for Philadelphia.

Since the creation of PICA in 1991, government reform efforts in Philadelphia have generally focused on improved financial management and operational efficiency. This focus was an appropriate response to the City's severe financial problems of the early 1990s. But the current financial crisis notwithstanding, the ultimate challenge for the City is not simply to deliver services efficiently. The City, together with the State and Federal government and the private sector, must also focus on developing policies and programs that will solve Philadelphia's most fundamental social problems: Crime, poverty, and the lack of economic opportunity for the most disadvantaged city residents. These problems are at the root of the City's long-term economic and fiscal challenges. To shift the focus of City government toward solving these fundamental policy problems requires increasing emphasis on strategic planning, performance measurement, and performance management.

Partly in response to encouragement from the PICA Board, the City instituted departmental strategic planning and performance measurement under the Rendell Administration. Measures of departmental activities, outputs, and outcomes have been regularly reported in the Quarterly City Managers Report since that time. The Nutter Administration, led by the Managing Director's Office (MDO), has taken a crucial next step, moving beyond measuring performance to using performance measures as part of the ongoing policy-making and management process.[18]

In this regard, a key institutional change has been the establishment of the PhillyStat process. Under PhillyStat, MDO regularly convenes meetings with City officials to discuss agency performance. At these meetings, officials review the status of performance measures, assess progress in defining and refining measures, report on progress in implementing initiatives, and seek to understand and resolve problems in implementation that have occurred. The meetings are open to the public, and presentation

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[17] See, for example, the case studies of performance management in *Quicker, Better, Cheaper: Managing Performance in American Government*, edited by Dall W. Forsythe (Albany, NY: The Rockefeller Institute Press, 2001).

[18] Based on the experience in New York City, the importance of actually using performance information to manage toward better outcomes, as opposed to simply generating quantitative performance information, is described in Dennis C. Smith, "Making Management Count: A Case for Theory- and Evidence-Based Public Management," *Journal of Policy Analysis and Management*, Vol. 28, No. 3 (Summer 2009), pp. 497-505.

materials from the sessions and video records of the proceedings, are available over the Internet. Because the process is public, it facilitates the exchange of information not only within government, but between government and external stakeholders and the public at large.

As it has continued to develop and refine performance measures for City agencies, MDO has sought to instill a greater customer service orientation within government. Departments have developed customer service standards that focus on those aspects of department operations that directly impact citizens. The extent to which departments are meeting those standards is tracked and reported. Uniform policies for redress in cases where service standards are not met are being developed.

Another major performance management initiative instituted by MDO is the 3-1-1 call center. This call center allows citizens, by dialing 3-1-1, to access City representatives who can answer questions, direct callers to appropriate agencies, and help solve problems. The goal is to make City government more accessible to citizen-customers and help residents find answers to their questions and meet their needs expeditiously. Through PhillyStat meetings, MDO officials have been monitoring the type and number calls received at 3-1-1. The data received through this monitoring should improve officials' understanding of citizen needs, allowing greater responsiveness in allocating funding and designing programs.

The Administration's performance management initiatives are a major step forward toward reforming government and improving the quality of life for citizens. Still, the City faces challenges related to performance management, related to institutionalization, flexibility, and links between performance management, the budget process, and departmental strategic planning.

Like the financial and budget process reforms that occurred in the 1990s, the performance management processes instituted in 2008 must outlive the Administration that created them. This will require administrative capacity and commitment to performance management within operating departments and MDO so that the next Administration, whatever its policy agenda, will have the ability and the desire to continue performance management as a way to increase the ability of the City to execute on its priorities. While the exact means of performance management will likely evolve over time, the capacity to manage for results will remain essential.

PhillyStat is a powerful innovation in part because it is being applied to all city agencies. But its comprehensiveness should not prevent a flexible approach tailored to the type of policy challenge faced by each City agency. Agencies vary in terms of the availability of quantitative indicators of the social outcomes they seek to influence, the number of these outcomes and the extent to which they conflict, and the level of agreement among citizens and stakeholders about an agency's goals and means for achieving them. Performance management processes, ideally, are flexible across agencies, to account for these differences. For some agencies, performance management should focus on developing consensus about goals or appropriate trade-offs among them, and developing information about the efficiency of various means for achieving desired outcomes. For agencies whose goals are easily measurable, less controversial, and less contradictory, performance management should focus on improving program efficiency.

PhillyStat and other performance management processes should be designed with the needs of various constituencies in mind. Reporting to the public is important, but this will likely take a different form than reporting designed to meet the needs of City officials and program managers. The City's performance management system should not only be about public accountability, but also about helping managers and City officials do a better job of defining goals and managing.

A key goal is to link performance management to the budget process. PhillyStat is generating much information about agency operations, reform goals, and performance. This information should be utilized in decision-making about financial allocations across and within departments. These allocations should be consistent with citywide strategic goals, and the extent to which departmental and programmatic performance is advancing those goals efficiently. The Office of Budget and Program Evaluation is in the process of developing a program budget for the City, with financial allocations organized in terms of programmatic objectives rather than by organization. This new approach to budgeting should facilitate the integration of performance management with the budget process.

The Administration has also made significant progress toward articulating strategic goals, both for the City as a whole, and for particular agencies, through strategic plans. These plans are described in more detail below. The plans bear an important relationship to performance management since they provide a policy context for the development of relevant performance measures. At the same time, the PhillyStat process provides an excellent mechanism to oversee implementation of these plans. Departmental strategic planning, therefore, should be fully integrated with the performance management process.

INFORMATION TECHNOLOGY

Under the leadership of the Division of Technology (DoT) within the Managing Director's Office, the City is in the process of redesigning and centralizing its information technology (IT) infrastructure and updating applications. These initiatives have the potential to significantly increase the productivity of City employees and reduce the costs of service delivery.

DoT is developing a multi-year information technology strategy that seeks to reduce technology spending while creating a better IT platform that will enable process improvements across City government. DoT's goal is to reduce the annual IT operating costs by 15 percent over five years. Direct cost savings are expected to result from increased use of in-house personnel and reductions in professional services contracts. Centralization of technology operations under DoT is also expected to reduce spending by eliminating the duplication of personnel and hardware across departments.

Even more significant than the direct cost savings associated with DoT's initiatives is their potential to enable process and productivity improvement throughout City government. Improvements in technology resources should increase the capacity of internal service departments to function more efficiently. Greater coordination among criminal justice agencies or human service agencies should also be facilitated by the adoption of compatible systems. Increased utilization of electronic documents should increase the transparency of government by making more information available to the public over the Internet.

STRATEGIC PLANNING

The City, in recent years, has devoted an increasing level of effort to strategic planning. Since the beginning of the current Administration, strategic plans have been produced for several agencies of City government including the Prisons System and the Police Department among others. The Department of Human Services has an effective reform plan contained in a report by the Philadelphia Child Welfare Review Panel in 2007, the implementation of which is overseen by a Community Oversight Board.[19] The City's strategic initatives related to homelessness are also the subject of a multi-year strategic plan. *Greenworks Philadelphia*, issued this spring, is a City-wide plan for environmental policy that will affect all City agencies. The Office of Arts, Culture, and the Creative Economy has expressed its intention to develop a city cultural plan.[20] The Managing Director's Office (MDO) has organized various "reform teams" which have been charged to address specific programmatic and managerial issues, and it is anticipated that these teams will issue public reports in the fall containing various strategic objectives for addressing specific issues. Other plans, such as that of the Zoning Code Commission, are also expected in the coming years.

These various planning efforts have resulted in a high degree of transparency and publicity surrounding policy goals for City agencies. Collectively, they represent a policy framework to guide the operations of agencies, and a way to assess progress of City government toward meeting fundamental goals.

One additional development that should occur is formalization of the strategic planning process and integration with the annual budget and Five-Year Financial Plan. Integration with the annual budget and financial planning process is important for several reasons. First, it will enhance the realism of the city's budget and financial plan through direct incorporation of the financial implications of program and policy initiatives contained in strategic plans. Second, it will help rationalize resource allocation by promoting consistency between the city's strategic objectives and the way money is raised and

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[19] The Panel's report, issued May 31, 2007, was entitled *Protecting Philadelphia's Children: The Call to Action.* The Community Oversight Board released a detailed progress report on DHS's reform efforts in January 2009; the next progress report is slated for release in July.

[20] Presentation to PhillyStat, June 10, 2009.

spent. Finally, it can improve the strategic planning process by emphasizing the financial costs and benefits of strategic objectives.

PICA Staff believes that future financial plans should make a greater emphasis on directly incorporating the initiatives of the City's strategic plans into the annual budget and Five-Year Financial Plan. A model can be found in the earliest Five-Year Plans submitted to PICA in 1992 and 1993. The FY92-96 Plan and FY94-98 Plan, the first two submitted to PICA, directly incorporated the financial impact of management and productivity initiatives into revenue and obligation projections.

1. Public Safety

After devising a new crime fighting strategic plan for the Philadelphia Police Department (PPD), the City's anti-crime efforts over the past year have been comprehensive and focused primarily on intelligent policing, collaboration, prevention, and improvements to operations and overall administration. It appears that the Administration's strategy has proven effective since Mayor Nutter issued an Executive Order declaring a crime emergency in January of 2008. As of July 19th, 2009, there was a calendar year-to-date decline of 11.8 percent in the number of homicides.

Consistent with its overall efforts toward intelligent policing, PPD's Compstat system has been integrated with PhillyStat. Consequently, crime briefings now occur every day whereas under the old system they occurred every 28 days. PPD officials also note that arrests are down and the numbers of people entering the prisons system are down as well.

PPD's strategic plan identified the need to work with civilian experts, and the PPD has forged institutional working relationships with leading criminologists, sociologists and other academic experts to identify the most prevalent crime zones. Accordingly new recruits have been deployed to areas of the City where violent crime is highest and resources most needed. The PPD has also engaged in cooperative initiatives with federal agencies to provide additional resources on Fridays and Saturdays (when crime activity is heightened).

In line with their strategic plan, the PPD is working on several efficiency measures related to the deployment and usage of their officers in order to address crime patterns more efficiently. To that end, the PPD will work together with its officers to attain greater flexibility with regard to its personnel decisions, including the authority to transfer officers, change schedules and vacation hours. Additionally, in order to ensure that it maximizes efficiency and reduces overtime costs, the PPD is also working with the Common Pleas and Municipal Court to limit the number of officers needed to be physically present at Court during cases.

During the planning process, the PPD identified a series of information technology upgrades needed to support the critical functions of the department. PPD technology needs span from basic improvements to their technology systems and infrastructure to updated software applications and reductions to the need for redundant data entry.

Moreover, the PPD would also like to have the capacity to do more data entry in the field. The PPD is working with DoT on these identified needs.

Finally PPD's strategic plan emphasized a need to seek out opportunities for grants or non-City resources to support its efforts. PICA Staff encourages the PPD to work with the State and/or Federal government to seek out additional resources, such as those that may be available under the American Recovery and Reinvestment Act of 2009.

2. Planning and Economic Development

As a result of the global recession, the City's economic development efforts over the past year have focused primarily on reorganizing and rationalizing economic development programs and policies. While fewer private development projects are moving forward as a result of the economic downturn, the Administration has taken steps to improve the public policy context within which economic development takes place. This has been facilitated by the consolidation of oversight for various agencies that influence economic development – Commerce, Licenses and Inspections, the Office of Housing and Community Development, the Historical Commission, and the City Planning Commission – under a Deputy Mayor.

The Administration has also focused on a variety of economic development goals, including: redevelopment at the Navy Yard, expansion of port capacity, supporting growth in the education and health sectors, improvements along the Delaware River waterfront, the expansion of the Pennsylvania Convention Center and the relocation of the Barnes Museum to the city, preparing for the development of Philadelphia's two casinos, and improvements to commercial corridors and cultural facilities. The Administration has emphasized planning and zoning and their relationship to development. This new emphasis should improve the city's amenities and attractiveness as a place to live and work, promoting growth over the long term.[21]

The Commerce Department is in the process of developing a strategic plan that includes policy priorities and specific goals and objectives. This plan should help the City continue to improve its overall approach to economic development during the Plan period and is scheduled for publication in the fall.

Commerce and the Department of Licenses and Inspections have been working toward updating and simplifying City business codes related to licenses and permits, so that these regulatory policies do not impose an undue burden. A Managing Director's Office Reform Team is examining city policies relating to development approval processes to increase the efficiency and predictability of the process. Efforts have also been focused on reforming the zoning variance process.

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[21] The importance of public amenities for the economic growth of older American cities is discussed in Edward L. Glaeser, "Growth: The Death and Life of Cities," in *Making Cities Work: Prospects and Policies for Urban America,* edited by Robert P. Inman (Princeton, NJ: Princeton University Press, 2009).

Commerce is also working to streamline service delivery and better allocate and coordinate functions across the various public and private entities that are involved in economic development. As one example, the functions of the Philadelphia Commercial Development Corporation have been absorbed into the Commerce Department and the Philadelphia Industrial Development Corporation.

In May 2007, City voters approved a referendum to amend the City Charter and create a Zoning Code Commission that would review the existing code and recommend reforms designed to modernize the code. The Commission seeks to develop a code that is simple, updated, and consistent with modern design and planning principles and environmental sustainability. The Commission is expected to release recommendations in September 2009. The work of the Zoning Code Commission should complement ongoing efforts by the City Planning Commission to update the City's Comprehensive Plan.

Since the 2007 publication of the *Action Plan for the Central Delaware: 2008-2018*, the City has had a detailed blueprint for development along the Delaware River. This plan, developed by PennPraxis in collaboration with various community organizations, is guiding policy-makers as they seek to create new amenities along the river and realize the potential to make the city's historic waterfront a major economic asset once again. In January 2009, the City created the Delaware River Waterfront Corporation, which has a broad mandate to promote development along the river from Oregon Avenue to Allegheny Avenue.

The federal American Recovery and Reinvestment Act (ARRA) of 2009 created new funding opportunities for the State and City that should result in a significant number of new jobs in Philadelphia. The City is seeking to capitalize on available ARRA funding streams, which should pay off in increased funding for housing, public safety, the environment, workforce development, infrastructure, and transit-oriented development. These new funding streams should help the City maintain progress in areas that would otherwise be at risk due to the severity of the current fiscal situation.

3. Health and Opportunity

The City is engaged in a number of strategic reform processes in its four major social service agencies: the Department of Human Services, the Department of Public Health, the Department of Behavioral Health and Mental Retardation Services, and the Office of Supportive Housing. In addition to the initiatives that are occurring within each of these agencies, there is considerable effort taking place to better coordinate the efforts of these agencies. Under the leadership of the Deputy Mayor for Health and Opportunity, the City is seeking to more effectively address the needs of the low-income population, with increasing emphasis on evidence-based programs and preventive services. This section briefly describes some of the initiatives underway in each of the four major social service agencies.

Department of Human Services. The Department of Human Services (DHS) is engaged in a major reform process, guided by a series of recommendations contained in *Protecting*

Philadelphia's Children: The Call To Action, a report issued in May 2007 by the Philadelphia Child Welfare Review Panel. The Panel was organized in response to a series of *Philadelphia Inquirer* investigative reports that revealed significant problems at DHS. In January 2008, the Mayor established a Community Oversight Board (COB) composed of external experts to oversee implementation of the recommendations of the Review Panel. The COB issued a detailed progress report in January 2009.

According to the report, DHS has made substantial progress in several areas. These include: implementing a decision-making process designed to reduce the acceptance of cases that do not involve serious threats to safety; expedited visitation; instilling a greater sense of accountability within the culture of the agency; moving toward a more community-focused system; and engaging families in problem solving through group conferences. The report also detailed areas where further progress is needed: restructuring prevention programs; meeting the goal of monthly visitation by a DHS caseworker for all active cases; clarifying and refining the new "hotline guided decision making" process for intake; improved documentation of "expedited response" cases; better use of information gained from child fatality reviews; implementing policies for criminal background checks; creating annual report cards with key indicators of performance; and integrating information systems and streamlining paperwork requirements.

DHS has an ambitious reform agenda, and its progress in implementing the Panel's recommendations is being closely monitored. The agency is clearly making progress, with the ultimate goal of reducing the incidence of child maltreatment in the city, and responding in the most appropriate manner to occurrences of abuse and neglect that are not prevented. However, the Department is concerned about recent changes in State funding policies that could jeopardize its programmatic reform process.

State funding for DHS was a considerable fiscal problem for the City in the 1980s and early 1990s, and played a role in precipitating the City's 1991 fiscal crisis. The State established a new funding process under Act 30 of 1991 in response to the fiscal problems experienced by Philadelphia and other counties responsible for delivering child welfare services. This process, known as the "needs-based budget," has generally worked well. PICA will monitor changes to this process for their effects on the level and predictability of State funding for DHS programs.

Office of Supportive Housing. Philadelphia has emerged as a national leader in homeless policy in recent years. The result of cooperation between public and private sector leadership, and growing levels of financial assistance from the State and federal government, the City has made progress toward building a system that more adequately addresses the needs of the homeless and seeks to prevent homelessness from occurring. In 2005, the City published *Philadelphia's Ten-Year Plan to End Homelessness: Creating Homes, Strengthening Communities, and Improving Systems.* This document included eight strategic goals and various specific objectives.

In 2008, the City began implementing several new initiatives as part of its "recalibration" of the Ten-Year Plan. These initiatives were supported by the agreement of the

Philadelphia Housing Authority (PHA) to provide 500 new units to support homeless families and 200 units for chronically homeless individuals. In addition, the City established overnight "cafes" as an alternative to treatment or shelter, created a new housing retention program, implemented new models for shelter services and emergency housing and case management standards, increased the level of behavioral health services available to the chronically homeless, and increased access to education and job readiness and training services. The City will also receive $21.5 million over the next three years in new federal Recovery Act funding for homelessness prevention. These funds will be used to provide mortgage foreclosure counseling, emergency relocation, and rapid re-housing programs.

Department of Behavioral Health and Mental Retardation Services. The City, through the Department of Behavioral Health and Mental Retardation Services (DBHMRS), provides services to the low-income population with behavioral health and mental retardation needs. DBHMRS is in the process of refocusing its programs to emphasize a new model of recovery-oriented services.

DBHMRS faces some financial challenges relating to State funding received under the Medical Assistance (MA) HealthChoices program. Under HealthChoices, the City administers behavioral health services funded through MA. Funding is provided to the City from the State on a capitated basis, reflecting MA enrollment in Philadelphia. This program has allowed the City to coordinate the array of behavioral health services provided to both MA-eligible and non-MA-eligible residents. To the extent program revenues exceed costs, the surplus can be reinvested in other social programs, subject to approval by the State Department of Public Welfare (DPW). Since 1997, $201.7 million has been reinvested in drug and alcohol programs, services targeted at the homeless, child advocacy, DHS programs, and school-based programs.

The HealthChoices reinvestment program, however, does face some financial challenges. These include a projected deficit for calendar 2009, possible return of HealthChoices surplus funds to DPW, and a possible cap on reinvestment dollars of 2 percent of annual revenues. These financial and policy challenges could result in the City's inability to maintain current programs funded through reinvestment dollars. In particular, programs for the uninsured and homeless, and funding for the Forensic Intensive Recovery (FIR) program could be at-risk. The funding challenges faced by HealthChoices do not represent a financial risk to the Plan, but they do present a challenge to DBHMRS as it seeks to continue to improve the effectiveness and adequacy of its services to city residents with behavioral health or developmental needs.

4. Sustainability

In spring 2009, the City issued *Greenworks Philadelphia,* a detailed strategic plan for environmental sustainability. This plan, developed by the Mayor's Office of Sustainability (MOS), contains over 130 initiatives designed to improve the city's environmental quality. The plan focuses on efforts to increase the energy efficiency of City facilities and vehicles, promote more energy efficiency in the private sector, create of new financing mechanisms to fund investments in energy efficiency, promote use of alternative energy, increase recycling and minimize waste, increase the accessibility of park and recreation facilities, increase access to locally-produced food, increase tree coverage, encourage use of public transportation and other environmentally-friendly forms of transportation, and create "green" jobs. All of these initiatives are likely to benefit the city's economy by improving environmental quality and therefore the attractiveness of the city as a place to live and work. But three initiatives in particular are important from the standpoint of City finance: reducing energy use at City facilities, increasing the fuel efficiency of City vehicles, and minimizing waste and increasing recycling.

Greenworks sets a target of increasing recycling rates to 25 percent by 2015. In part as a result of the implementation of single-stream recycling in January 2009, Philadelphia's recycling rate has already increased from 7.1 percent in FY07 to 12.4 percent in FY09.[22] The potential for savings from further increases in recycling is significant. In 2005, the City Controller estimated that the City could potentially increase its recycling diversion rate to 40 percent, resulting in annual savings of $17 million.[23] Clearly, the recent increases in recycling, and future increases likely to result from the *Greenworks* initiatives, will provide significant financial benefits to the City's General Fund. But a more ambitious goal is possible. San Francisco currently diverts 72 percent of its waste stream into recycling and composting.[24] PICA Staff encourages the City to consider adopting even more ambitious goals for recycling, in the interest of the environment and City finances.

Savings can also be achieved by reducing vehicle fuel costs. *Greenworks* anticipates that this will be achieved by reducing the number of City vehicles, increasing fuel efficiency, and by creating fuel budgets for each department that incorporate a goal of 10 percent reduction in fuel use per year. The City has already achieved significant fleet reduction of 429 vehicles between FY08 and FY09.[25] Currently, the City has nearly 20 percent of the fleet using some type of alternative fuel.[26] Further progress in the area of reducing the cost of fuel will have an important financial benefit to the General Fund.

Another important environmental goal with financial benefits is reducing energy use at city buildings. *Greenworks* anticipates that this can occur through a combination of behavioral change, investments in energy efficiency, and efforts to minimize the City's exposure to energy rate increases that may occur as a result of the expiration of the PECO rate cap in 2011.

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[22] Mayor's Office Press Release, July 15, 2009.
[23] Office of the Controller, City of Philadelphia, *Streets Department Review of Recycling Program*, May 2005.
[24] Malia Wollan, "San Francisco to Toughen a Strict Recycling Law," *New York Times*, June 11, 2009.
[25] Philly Stat presentation, Office of Fleet Management, June 3, 2009.
[26] FY10 Operating Budget Testimony to City Council by James Muller, Fleet Manager, April 27, 2009.

The City is using its authority under State Act 77, the Guaranteed Energy Savings Act, to utilize a special financing mechanism to increase the energy efficiency of major facilities at the Airport, Prisons, and the four major downtown City buildings. Under this approach, Energy Service Companies (ESCOs) will propose specific projects to reduce energy use at the facilities, and guarantee specific reductions. The cost savings achieved over a 15-year period will be used to repay the cost of the projects. The City is currently in the process of selecting an ESCO for the downtown office buildings, and plans to engage ESCOs to make energy efficiency investments in another 50 City buildings over the next 7 years.

Another *Greenworks* initiative is to create target energy budgets for City departments. Departments are expected to reduce energy use by 10 percent in FY10. Any savings that result from reductions beyond this target will be returned to the departments. This effort should increase the incentives for departments to save energy and increase accountability of departments and their employees for achieving City-wide energy cost reduction goals. The Plan assumes savings of $7 million due to reduced energy usage.

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Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT ON FY2010-FY2014 FIVE-YEAR FINANCIAL PLAN

SECTION VII:

APPENDICES

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APPENDIX A

Statutory Background, Plan Review Methodology and Summary of Events

Overview

The General Assembly created PICA in June of 1991 by its approval of The Pennsylvania Intergovernmental Cooperation Authority Act for Cities of the First Class (Act of June 5, 1991, P.L. 9, No. 6). As in previous PICA Staff reports concerning the City's prior five-year financial plans, rather than re-state in the body of this Staff Report the principal provisions of the PICA Act and the Intergovernmental Cooperation Agreement, PICA Staff has included such information in this Appendix.

A brief summary of events to date including comments as to PICA's future focus, a summary of PICA Staff's Plan review methodology and a compilation of required future City reporting to PICA is also included herein.

Statutory Basis -- The PICA Act

The mission of the Authority, as stated in the PICA Act (Section 102), is as follows:

> Policy.--It is hereby declared to be a public policy of the Commonwealth to exercise its retained sovereign powers with regard to taxation, debt issuance and matters of Statewide concern in a manner calculated to foster the fiscal integrity of cities of the first class to assure that these cities provide for the health, safety and welfare of their citizens; pay principal and interest owed on their debt obligations when due; meet financial obligations to their employees, vendors and suppliers; and provide for proper financial planning procedures and budgeting practices. The inability of a city of the first class to provide essential services to its citizens as a result of a fiscal emergency is hereby determined to affect adversely the health, safety and welfare not only of the citizens of that municipality but also of other citizens in this Commonwealth.
>
> Legislative Intent
>
> (1) It is the intent of the General Assembly to:
>
> (i) provide cities of the first class with the legal tools with which such cities can eliminate budget deficits that render them unable to perform essential municipal services;
>
> (ii) create an authority that will enable cities of the first class to access capital markets for deficit elimination and seasonal borrowings to avoid default on existing obligations and chronic cash shortages that will disrupt the delivery of municipal services;
>
> (iii) foster sound financial planning and budgetary practices that will address the underlying problems which result in such deficits for cities of the first class, which city shall be charged with the responsibility to exercise efficient and accountable fiscal practices, such as:

(A) increased managerial accountability;
(B) consolidation or elimination of inefficient city programs;
(C) recertification of tax-exempt properties;
(D) increased collection of existing tax revenues;
(E) privatization of appropriate city services;
(F) sale of city assets as appropriate;
(G) improvement of procurement practices including competitive bidding procedures;
(H) review of compensation and benefits of city employees; and

(iv) exercise its powers consistent with the rights of citizens to home rule and self government.

(2) The General Assembly further declares that this legislation is intended to remedy the fiscal emergency confronting cities of the first class through the implementation of sovereign powers of the Commonwealth with respect to taxation, indebtedness and matters of Statewide concern. To safeguard the rights of the citizens to the electoral process and home rule, the General Assembly intends to exercise its power in an appropriate manner with the elected officers of cities of the first class.

(3) The General Assembly further declares that this legislation is intended to authorize the imposition of a tax or taxes to provide a source of funding for an intergovernmental cooperation authority to enable it to assist cities of the first class and to incur debt of such authority for such purposes; however, the General Assembly intends that such debt shall not be a debt or liability of the Commonwealth or a city of the first class nor shall debt of the authority payable from and secured by such source of funding create a charge directly or indirectly against revenues of the Commonwealth or city of the first class.

The PICA Act establishes requirements for the content of a five year financial plan, and Sections 209 (b)-(d) of the statute and the Cooperation Agreement provide:

(b) Elements of plan. -- The financial plan shall include:

(1) Projected revenues and expenditures of the principal operating fund or funds of the city for five fiscal years consisting of the current fiscal year and the next four fiscal years.

(2) Plan components that will:
(i) eliminate any projected deficit for the current fiscal year and for subsequent years;
(ii) restore to special fund accounts money from those accounts used for purposes other than those specifically authorized;
(iii) balance the current fiscal year budget and subsequent budgets in the financial plan through sound budgetary practices, including, but not limited to, reductions in expenditures, improvements in productivity, increases in revenues, or a combination of these steps;

(iv) provide procedures to avoid a fiscal emergency condition in the future; and

(v) enhance the ability of the city to regain access to the short-term and long-term credit markets.

(c) Standards for formulation of plan:

(1) All projections of revenues and expenditures in a financial plan shall be based on reasonable and appropriate assumptions and methods of estimation, all such assumptions and methods to be consistently applied.

(2) All revenue and appropriation estimates shall be on a modified accrual basis in accordance with generally accepted standards. Revenue estimates shall recognize revenues in the accounting period in which they become both measurable and available. Estimates of city-generated revenues shall be based on current or proposed tax rates, historical collection patterns, and generally recognized econometric models. Estimates of revenues to be received from the state government shall be based on historical patterns, currently available levels, or on levels proposed in a budget by the governor. Estimates of revenues to be received from the federal government shall be based on historical patterns, currently available levels, or on levels proposed in a budget by the president or in a congressional budget resolution. Non-tax revenues shall be based on current or proposed rates, charges or fees, historical patterns and generally recognized econometric models. Appropriation estimates shall include, at a minimum, all obligations incurred during the fiscal years and estimated to be payable during the fiscal year or in the 24-month period following the close of the current fiscal year, and all obligations of prior fiscal years not covered by encumbered funds from prior fiscal years. Any deviations from these standards of estimating revenues and appropriations proposed to be used by a city shall be specifically disclosed and shall be approved by a qualified majority of the board.

(3) All cash flow projections shall be based upon reasonable and appropriate assumptions as to sources and uses of cash, including, but not limited to, reasonable and appropriate assumptions as to the timing of receipt and expenditure thereof and shall provide for operations of the assisted city to be conducted within the resources so projected. All estimates shall take due account of the past and anticipated collection, expenditure and service demand experience of the assisted city and of current and projected economic conditions.

(d) Form of plan. -- Each financial plan shall, consistent with the requirements of an assisted city's home rule charter or optional plan of government:

(1) be in such form and shall contain:

(i) for each of the first two fiscal years covered by the financial plan such information as shall reflect an assisted city's total expenditures by fund and by lump sum amount for each board, commission, department or office of an assisted city; and

(ii) for the remaining three fiscal years of the financial plan such information as shall reflect an assisted city's total expenditures by fund and by lump sum amount for major object classification;

(2) include projections of all revenues and expenditures for five fiscal years, including, but not limited to, projected capital expenditures and short-term and long-term debt incurrence and cash flow forecasts by fund for the first year of the financial plan;

(3) include a schedule of projected capital commitments of the assisted city and proposed sources of funding for such commitments; and

(4) be accompanied by a statement describing, in reasonable detail, the significant assumptions and methods of estimation used in arriving at the projections contained in such plan.

The Cooperation Agreement (at Section 4.04(a)-(h)), and similar provisions of the PICA Act also require the following as supporting data for the Plan:

(a) a schedule of debt service payments due or projected to become due in respect of all indebtedness of the City and all indebtedness of others supported in any manner by the City (by guaranty, lease, service agreement, or otherwise) during each fiscal year of the City until the final scheduled maturity of such indebtedness, such schedule to set forth such debt service payments separately according to the general categories of direct general obligation debt, direct revenue debt, lease obligations, service agreement obligations and guaranty obligations.

(b) a schedule of payments for legally mandated services included in the Financial Plan and due or projected to be due during the fiscal years of the City covered by the Financial Plan;

(c) a statement describing, in reasonable detail, the significant assumptions and methods of estimation used in arriving at the projections contained in the Financial Plan;

(d) the Mayor's proposed operating budget and capital budget for each of the Covered Funds for the next (or in the case of the initial Financial Plan, the current) fiscal year of the City, which budgets shall be consistent with the first year of the Financial Plan and which budgets shall be prepared in accordance with the Home Rule Charter;

(e) a statement by the Mayor that the budgets described in section 4.04(d) hereof:

(i) are consistent with the Financial Plan;

(ii) contain funding adequate for debt service payments, legally mandated services and lease payments securing bonds of other government agencies or of any other entities; and

(iii) are based on reasonable and appropriate assumptions and methods of estimation.

(f) a cash flow forecast for the City's consolidated cash account for the first fiscal year of the City covered by the Financial Plan;

(g) an opinion or certification of the City Controller, prepared in accordance with generally accepted auditing standards, with respect to the reasonableness of the assumptions and estimates in the Financial Plan; and

(h) a schedule setting forth the number of authorized employee positions (filled and unfilled) for the first year covered by such Financial Plan for each board, commission, department or office of the City, and an estimate of this information for the later years covered by the Financial Plan. The schedule required under this paragraph (h) shall be accompanied by a report setting forth the City's estimates of wage and benefit levels for various groups of employees, such information to be presented in a manner which will allow the Authority to understand and effectively review the portions of the Financial Plan which reflect the results of the City's labor agreements with its employees, and an analysis of the financial effect on the City and its employees of changes in compensation and benefits, in collective bargaining agreements, and in other terms and conditions of employment, which changes may be appropriate in light of the City's current and forecast financial condition. The parties agree to cooperate such that the form of the report required under this paragraph (h), and the subjects covered, are reasonably satisfactory to the Authority.

City Reporting and Variances

The PICA Act (Section 209) and the Cooperation Agreement (Section 409(b)) require submission of quarterly reports by the City on its compliance with the Plan within 45 days of the end of a fiscal quarter. If a quarterly report indicates that the City is unable to project a balanced Plan and budget for its current fiscal year, the Authority may by the vote of four of its five appointed members declare the occurrence of a "variance", which is defined in Section 4.10 of the Cooperation Agreement as follows:

> (i) a net adverse change in the fund balance of a Covered Fund of more than one percent of the revenues budgeted for such Covered Fund for that fiscal year is reasonably projected to occur, such projection to be calculated from the beginning of the fiscal year for the entire fiscal year, or (ii) the actual net cash flows of the City for a Covered Fund are reasonably projected to be less than ninety-five percent (95 percent) of the net cash flows of the City for such Covered Fund for that fiscal year originally forecast at the time of adoption of the budget, such projection to be calculated from the beginning of the fiscal year for the entire fiscal year.

As defined in Section 1.01 of the Cooperation Agreement, the City's "Covered Funds" are the General Fund, General Capital Fund, Grants Revenue Fund and any other principal operating funds of the City which become part of the City's Consolidated Cash Account.

The statute mandates the submission of monthly reports to PICA by the City after determination by the Authority of the occurrence of a variance.

As provided in Section 210(e) of the PICA Act, there are legal consequences flowing from a determination by the Authority that a variance exists, and in addition to the City's additional reporting responsibilities, it also is required to develop revisions to the Plan necessary to cure the variance. The remedies which PICA has available to it to deal with a continuing uncorrected variance are to direct the withholding of both specific Commonwealth funds due the City, and that portion of the 1.5 percent tax levied on the wages and income of residents of the City in excess of the amounts necessary to pay debt correction of the variance.

Plan Review Methodology

Staff Report - The Plan was submitted to PICA by the Mayor on June 22, 2009 and the PICA Act provides a 30 day period for review. Authority Staff has consulted with the City, both on the departmental level and otherwise, since the Plan was initially submitted to City Council by the Mayor on March 19, 2009 and has referred to material presented to City Council and the Controller's Office, as well as information included in reports submitted by the City to PICA and other data developed by PICA Staff. This report includes reference to materials received by the Authority through July 17, 2009.

Under Section 5.07 of the Cooperation Agreement, PICA agreed not to disclose information provided to it in confidence by the City with respect to negotiation of collective bargaining agreements and ongoing arbitration proceedings, and the Authority has consistently followed that requirement.

Relationship to Future Plan Revisions - The City is obligated under the both the Cooperation Agreement and the PICA Act to submit a revised Plan in the event it enters into a collective bargaining agreement, or receives a labor arbitration award, at variance with that which was assumed in the Plan. The Cooperation Agreement anticipates that the Plan must be revised to deal with such matters within 45 days after declaration of a "variance" by PICA.

Apart from labor-related revisions, revisions mandated by conditions of Plan approval, or those required by declaration by PICA of a variance in the Plan in the future, the Plan is subject to mandatory revision on March 22, 2010 (100 days prior to the end of FY2010). At that time, the City is required to add its Fiscal Year 2015 to the Plan and make any other alterations necessary to reflect changed circumstances. Under the PICA Act, the City may determine to revise the Plan at any time and submit the revision to the Authority for its review.

Accounting Concerns

The PICA Act requires that a modified accrual accounting system be used in preparation and administration of the Plan, in accordance with generally accepted accounting standards. Specifically, the Cooperation Agreement (at Sections 4.02(a) and (b)) provides:

> Estimates of revenues shall recognize revenues in the accounting period in which they become both measurable and available….

Appropriation estimates shall include, at a minimum, all obligations incurred during the fiscal year and estimated to be payable during the fiscal year or in the twenty-four (24) month period following the close of the current fiscal year….

The Plan as submitted meets the requirements of the PICA Act and Cooperation Agreement.

Summary of Events to Date/Future Focus

PICA's creation was an action taken by the Commonwealth of Pennsylvania in direct reaction to Philadelphia's financial crisis. Accordingly, PICA's primary focus during its initial years of existence has been to assist the City to avoid insolvency; to provide the funds directly required for that purpose and for essential capital programs; and to oversee the City's efforts to lay a sound foundation for its return to fiscal stability. The negotiation of the Cooperation Agreement to set out the basic terms of the City-PICA relationship, the PICA sponsored effort resulting in the establishing of the format and content of the Five-Year Financial Plan process, and the issuance of bonds to provide funds to assist the City to stabilize its finances were all major accomplishments. Successful defense against challenges to the constitutionality of the PICA Act was another vital PICA process component. PICA's annual assessment of Plan progress, successful challenges to overgenerous prior Plan revenue estimates and suspect methodologies, evaluations of City reporting, and analysis of City practices and programs have assisted in the ongoing City improvement as envisioned by the PICA Act.

PICA also provides continuing oversight as to the encumbrance by the City of PICA provided capital funds for capital projects deemed required to rectify emergency conditions or necessary for Plan operational success.

PICA has provided in excess of $1,191 million in funding to assist the City, allocated to the following purposes:

Purpose	Amount (thousands)
Deficit Elimination/Indemnities Funding	$ 269,000
Productivity Bank	20,000
Capital Projects	518,003
Retirement of Certain High Interest City Debt	384,300
TOTAL	**$1,191,303**

PICA's authority to issue new money debt has expired. PICA anticipates that its future activities with respect to the City will focus more closely on oversight on the City's efforts to maintain financial balance, further institutionalize management reforms (both those initiated to date and those still to be made) and to implement ongoing operations changes in accordance with the City Strategic Plan.

The City had taken full advantage of the tools PICA made available to it. It is anticipated that the PICA/City relationship will continue to be a catalyst for further City operational improvements.

Future City Reporting to PICA

Absent the occurrence of a variance, receipt of an arbitration award which is at variance with the Plan or a determination by the City that further revisions to the Plan are necessary, the City will not submit a revised Plan to the Authority until March 2010. During future months, the Authority will receive quarterly reports on the City's performance under the Plan, together with other data.

The reporting system established in the Cooperation Agreement and the PICA Act anticipates a regular flow of data to PICA, and the reporting system which has been established by agreement between the City and PICA under the provisions of the PICA Act is divided into several groups, which are described below:

> Quarterly Plan Reports The Authority receives reports from the City on a quarterly basis (45 days after the end of each fiscal quarter) concerning the status of compliance with the Plan and associated achievement of initiatives. The remaining quarterly reporting deadline for FY2009 is August 17, 2009. Quarterly reporting deadlines for FY2010 are November 16, 2009, February 15, 2010, May 17, 2010 and August 16, 2010. The Cooperation Agreement also requires that the City provide reports to PICA concerning Supplemental Funds (*i.e.*, the Water and Aviation Funds) on a quarterly basis.
>
> Grants Revenue Fund Contingency Account Report. The Cooperation Agreement provides that a report on the Grants Revenue Fund Contingency Account be prepared and submitted, by department, not later than 20 days after the close of each fiscal quarter. For FY2010, the reporting dates are October 20, 2009, January 20, 2010, April 20, 2010 and July 20, 2010. The report details the receipt of Federal and Commonwealth funds by the City, as well as the eligibility for fund withholding by the Commonwealth at PICA's direction in the event the City cannot balance the Plan after an extended period of intensive reporting and PICA review of proposed corrective efforts.
>
> Prospective Debt Service Requirements Reports The Cooperation Agreement requires submission of a report detailing prospective debt service payments by the City, as well as lease payments, 60 days prior to the beginning of a fiscal quarter. The dates for submission of such reports for FY2010 are August 1, 2009, October 31, 2009, January 30, 2010 and May 1, 2010.

APPENDIX B

Schedule of Findings, Office of the City Controller

In accordance with Section 4.04(g) of the Intergovernmental Cooperation Agreement between PICA and the City, the City Controller's Office submitted to PICA its report upon the Forecasted Statements of General Fund Revenues, Obligations and Changes in Fund Balance for the Fiscal Years Ending June 30, 2010 through June 30, 2014, included in the Plan. That report included the Controller's Office opinion that the underlying assumptions provide a reasonable basis for City management's forecast. PICA Staff is grateful for the assistance provided by the Controller's Staff in evaluating this Plan.

The Independent Auditor's Report of the Controller's Office resulting from its work with respect to the Plan, formally reported to PICA on July 14, 2009, is reproduced in this Appendix as well as the transmittal letter from the City Controller highlighting concerns and risks. Certain findings have been previously discussed in this report from a PICA Staff perspective. PICA Staff believes the reader will gain added value from a review of the Office of the Controller's perspective on such matters.

FORECASTED GENERAL FUND STATEMENT OF OPERATIONS

CITY OF PHILADELPHIA

AUDITOR'S REPORT

FISCAL YEARS 2010 – 2014

CITY OF PHILADELPHIA

OFFICE OF THE CONTROLLER
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ALAN BUTKOVITZ
City Controller

ALBERT F. SCAPEROTTO
Deputy City Controller

July 14, 2009

Mr. Uri Z. Monson
Executive Director
Pennsylvania Intergovernmental Cooperation Authority
1500 Walnut Street, Suite 1600
Philadelphia, PA 19102

Dear Mr. Monson:

In accordance with Section 12720.209(f)(1) of the Pennsylvania Intergovernmental Cooperation Authority Act, my office conducted an examination of the Forecasted General Fund Statement of Operations for the fiscal years ending June 30, 2010 to 2014 (the forecasted statement). The forecasted statement was prepared by the Office of the Director of Finance and submitted to Pennsylvania Intergovernmental Cooperation Authority (PICA) on June 22, 2009.

Although the narrow rules of American Institute of Certified Public Accountants (AICPA) mandate that we give an opinion on the reasonableness of the forecasted statement assumptions as of its completion date of June 22, 2009, as City Controller, I believe I have a broader responsibility to PICA and the general public to bring attention to recent developments. While the city's assumptions used in the forecasted statements were reasonable as of June 22, 2009, recent developments regarding the state budget, render these assumptions useless as of today.

My staff conducted its examination of the forecasted statement in accordance with attestation standards established by the AICPA. Those standards require that we evaluate whether the assumptions used by city management at the time the plan was submitted provide a reasonable basis for management's forecasted statement. Attached is an opinion signed by my deputy who is a Certified Public Accountant. Although the report indicates the assumptions used in the plan were reasonable, it identifies the following particularly sensitive assumptions and subsequent events that PICA should consider in assessing the forecasted information.

- The forecasted statement is balanced on assumptions that the Commonwealth of Pennsylvania will enact legislation to enable the city to receive an additional one percent sales tax increase, defer pension payments, and make actuarial changes to its pension plan. These provisions represent additional revenues and cost savings totaling $252 million for fiscal 2010 and $604 million over the remaining years of the forecast. However, we have no way to determine if and when such legislation will be enacted.

CITY OF PHILADELPHIA
OFFICE OF THE CONTROLLER

- The forecasted statement is balanced on assumptions that revenues will be received from the Commonwealth of Pennsylvania based on the budget submitted by the governor to the state legislature. However, subsequent to June 22, 2009, Senate Bill 850, which would significantly reduce state expenditures including funding to the city, is under consideration by the General Assembly. The effect on the city's budget of that bill, if enacted in its present form, has been characterized by the Mayor of Philadelphia as having "dire consequences".

  Furthermore, in the Management Representation Letter signed by the Mayor and the Finance Director, they state the following: "Subsequent to June 22, 2009, it came to my attention that senate Bill 850 could move through the legislature. The Bill has major reductions in state expenditures including funding to Philadelphia, relative to the budget submitted by the state governor upon which our General Fund state revenue forecast amounts were based. In addition, if the state legislature fails to timely enact a budget, the state will lack appropriation power and will therefore be unable to make any expenditures. These conditions could have a significant adverse effect on the City's cash flow."

The situation in Harrisburg appears to be quickly moving, highly volatile, and unpredictable. Therefore, I urge caution on PICA, and I urge PICA to immediately request that the city submit a revised five year forecasted statement.

I would like to express our thanks to the management and staff of the city's Office of Budget and Performance Evaluation for their courtesy and cooperation in the conduct of our examination.

Respectfully submitted,

ALAN BUTKOVITZ
City Controller

cc: Chair and Board Members of the
Pennsylvania Intergovernmental Cooperation Authority
Michael A. Nutter, Mayor
Rob Dubow, Director of Finance
Steven Agostini, Deputy Director of Finance

CONTENTS

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ALAN BUTKOVITZ
City Controller

ALBERT F. SCAPEROTTO
Deputy City Controller

INDEPENDENT AUDITOR'S REPORT

To the Chair and Board Members of the
Pennsylvania Intergovermental Cooperation Authority

We have examined the accompanying Forecasted General Fund Statement of Operations for the fiscal years ending June 30, 2010 through June 30, 2014 (the forecasted statement). The City of Philadelphia's management is responsible for the forecasted statement, which was prepared for the purpose of complying with the provisions of the Pennsylvania Intergovermental Cooperation Authority (PICA) Act. Our responsibility is to express an opinion on the forecasted statement based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by the city's management and the preparation and presentation of the forecasted statement. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, the accompanying forecasted statement is presented in conformity with guidelines for presentation of forecasted information established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's forecasted statement. However, there will usually be differences between the forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

The forecasted statement referred to in the preceding paragraph includes assumptions that are particularly sensitive because they require state legislative approval and successful labor negotiations. The sensitive assumptions that require state legislative approval are described in notes B.4 (d) and B.7 (c). These assumptions would provide $581.5 million in revenues from a temporary one percent sales tax increase and $275.3 million in pension cost savings resulting from payment deferrals and actuarial changes to the pension plan. The sensitive assumptions that are dependent on successful labor negotiations relating to wage and benefit savings totaling $125 million are described in Note B.7 (a).

As discussed in Note C.1 the city based its assumptions of revenues received from the Commonwealth of Pennsylvania on a budget submitted by the governor to the state legislature. Subsequent to June 22, 2009, the completion date of the forecasted statement, an alternative Senate Bill 850, which would significantly reduce state expenditures including funding to the city, is under consideration by the General Assembly.

The accompanying forecasted statement and our report are intended solely for the information and use of the management of the City of Philadelphia and PICA and are not intended to be used and should not be used by anyone other than these specified parties.

July 9, 2009

ALBERT F. SCAPEROTTO, CPA
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CITY OF PHILADELPHIA – OFFICE OF THE DIRECTOR OF FINANCE
Forecasted General Fund Statement of Operations
Fiscal Years Ending June 30, 2010 to 2014

(Amounts in Thousands)

NO.	ITEM	F.Y. 2010 Estimate	F.Y. 2011 Estimate	F.Y. 2012 Estimate	F.Y. 2013 Estimate	F.Y. 2014 Estimate
(1)	(2)	(3)	(4)	(5)	(6)	(7)
	REVENUES					
1	Taxes	2,339,328	2,396,753	2,452,687	2,533,259	2,610,502
2	Locally Generated Non-Tax Revenues	275,972	282,849	313,144	316,613	317,357
3	Revenue from Other Governments	1,171,136	1,153,774	1,182,410	1,211,690	1,240,458
4	Sub-Total (1) +(2)+ (3)	**3,786,436**	**3,833,376**	**3,948,241**	**4,061,561**	**4,168,317**
5	Revenue from Other Funds of City	28,134	28,777	29,788	30,698	31,268
6	Total - Revenue (4) + (5)	3,814,570	3,862,153	3,978,028	4,092,259	4,199,584
7	Revenues Forgone	0	0	0	0	0
8	**Total Revenue and Other Sources (6)+(7)**	**3,814,570**	**3,862,153**	**3,978,028**	**4,092,259**	**4,199,584**
	OBLIGATIONS/APPROPRIATIONS					
9	Personal Services	1,358,423	1,358,423	1,358,423	1,358,923	1,358,923
10	Personal Services-Pensions	332,175	494,030	586,809	708,816	724,183
11	Personal Services-Other Employee Benefits	480,600	485,409	493,602	501,879	506,118
12	**Sub-Total Employee Compensation**	**2,171,198**	**2,337,862**	**2,438,834**	**2,569,618**	**2,589,224**
13	Purchase of Services	1,149,555	1,168,896	1,179,928	1,198,594	1,209,709
14	Materials, Supplies and Equipment	78,322	84,338	84,678	85,178	85,178
15	Contributions, Indemnities, and Taxes	117,875	117,934	117,999	118,067	118,066
16	Debt Service	121,867	125,913	131,952	142,019	148,635
17	Capital Budget Financing	0	0	0	0	0
18	Advances and Miscellaneous Payments	25,000	15,000	15,000	15,000	15,000
19	Sub-Total (12 thru 18)	3,663,817	3,849,943	3,968,391	4,128,476	4,165,812
20	Payments to Other Funds	30,012	35,458	35,914	36,424	36,972
21	**Total- Obligations (19+20)**	**3,693,829**	**3,885,401**	**4,004,305**	**4,164,900**	**4,202,784**
22	Operating Surplus (Deficit) for Fiscal Year (8-21)	120,741	(23,248)	(26,277)	(72,641)	(3,200)
23	Prior Year Adjustments:					
24	Revenue Adjustments	0	0	0	0	0
25	Other Adjustments	24,500	24,500	24,500	24,500	24,500
26	Obligation Spending Reserve	0	0	0	0	0
27	Total Prior Year Adjustments	24,500	24,500	24,500	24,500	24,500
28	**Adjusted Operating Surplus/(Deficit) (22+27)**	**145,241**	**1,252**	**(1,777)**	**(48,141)**	**21,300**
	OBLIGATIONS IN RESPECT TO PRIOR FISCAL YEARS					
	Fund Balance Available for Appropriations					
29	June 30 of Prior Fiscal Year	(59,979)	85,262	86,514	84,737	36,596
30	Residual Equity Transfer	0	0	0	0	0
31	Fund Balance Available for Appropriation June 30 (28)+(29) + (30)	**85,262**	**86,514**	**84,737**	**36,596**	**57,897**

See accompanying summaries of significant accounting policies and assumptions and auditor's report.

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City of Philadelphia – Office of The Director of Finance
Notes to Forecasted General Fund Statement of Operations
Fiscal Years Ending June 30, 2010 – 2014

A. Summary of Significant Accounting Policies

The Forecasted General Fund Statement of Operations is presented on the budgetary basis of accounting. The budgetary basis of accounting differs from the modified accrual (GAAP) basis in that both expenditures and encumbrances are applied against the current budget, adjustments affecting activity budgeted in prior years are accounted for through fund balance or as reduction of expenditures and certain interfund transfers and reimbursements are budgeted as revenues and expenditures.

B. Summary of Significant Forecast Assumptions

The City of Philadelphia Office of Budget and Performance Evaluation (OBPE) is responsible for providing revenue and obligation forecasts to the Director of Finance for discussion and inclusion in the proposed annual budget and FY2010-2014 five-year financial plan (FYP) submitted by the Mayor and adopted by the City Council. OBPE provides forecasts of 6 major taxes, totaling over $2.3 billion dollars in the adopted FY10 budget, as well as $275.9 million locally generated non-tax revenues, including departmental fees, and $1.1 billion in revenues from other governments. These three sources comprise 99 percent of the revenues anticipated for the FY10 budget. The assumptions disclosed are those we believe are most significant and are based on our best judgment on June 22, 2009, the time of preparation.

There may be differences between the forecasted and actual results because events and circumstances frequently do not occur as expected.

1. Approach to Revenue Forecasting

The OBPE employs a number of approaches to developing its forecasts of local revenues:

a. National and local forecasts of economic activity provided by the Federal Reserve Federal Open Market, the Congressional Budget Office, and Blue Chip Economic Indicators and Moody's Economy.com;
b. Continuous evaluation of current national and local economic data on employment, inflation, interest rates, and economic growth;
c. Ongoing examination of current tax receipts for the six largest tax sources;
d. An economic model of the local economy;
e. Econometric forecasts of wage taxes, real estate transfer taxes, sales taxes, and parking taxes; and
f. The extensive experience of its staff.

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City of Philadelphia – Office of the Director of Finance
Notes to Forecasted General Fund Statement of Operations
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OBPE has developed an econometric model which uses The Bureau of Economic Analysis (BEA) national and regional data to create a U.S. Real Gross Domestic Product (GDP) equivalent, "gross county product" (GCP), as a major indicator of economic activity in the City and as a primary input for forecasting certain taxes. The model uses a framework described by Matthew Drennan in ***Modeling Metropolitan Economies for Forecasting and Policy Analysis***, which Drennan used to provide analysis on the New York City economy as part of the Setting Municipal Priorities series in the 1980's and 1990's, and adapted by Stephen Agostini in *"Searching for a Better Forecast: San Francisco's Revenue Forecasting Model,"* published in Government Finance Review in 1991. Mr. Agostini, the current Budget Director, has created similar models for forecasting revenues for the State of Wisconsin, the City of Milwaukee, and the City of Seattle.

The model uses a calculation of economic output for seven consolidated industry groupings (Construction, Manufacturing, Transportation, Communications and Utilities, Trade, Finance, Insurance and Real Estate, Services, and Government) for Philadelphia in a series that dates back to 1969. Econometric estimates for each industry are used to calculate future economic activity in each industry based on national forecasts of demand, prices, the cost of capital and production. The sum of these individual industry estimates provides a dollar value for total economic activity for Philadelphia, or GCP. Philadelphia GCP is used to estimate and forecast two local tax base variables – total Philadelphia personal income and total Philadelphia wages – which are then used, along with tax rates, to forecast future receipts for wage and earnings, realty transfer, sales and parking taxes. These 4 taxes in recent years have generated almost 50% of the city's total revenues.

2 The Economic Context

The Philadelphia economy, and the revenues collected by Philadelphia City government, is directly impacted by the performance of the US economy. Consequently, understanding the current economic context becomes critically important for the purpose of developing revenue estimates for the City's Five Year Plan and annual operating budget.

The world economy remains in the grips of a severe economic contraction. According to the International Monetary Fund "world growth is projected to fall to ½ percent in 2009, its lowest rate since World War II."[1] This deep downturn in global economic activity is the result of severe dislocations in global credit markets, the collapse of critical banking firms, the bursting of housing bubbles in the United States and much of Western Europe, a seeming halt in consumer and corporate spending, and losses in equity markets that as of March 2009 approach 35%.

[1] International Monetary Fund, January 2009 World Economic Outlook

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According to the National Bureau of Economic Research the U.S. economy is in a recession that began in December 2007. Preliminary estimates from the BEA show that the GDP took a sharp downward turn in the fourth quarter of 2008, contracting at an annual rate of 6.2% compared with a 2.8% increase in the second quarter of 2008. Blue Chip Economic Indicators, the International Monetary Fund (IMF) and the Congressional Budget Office (CBO) all project a continued contraction in GDP for 2009, with annual estimates of -2.6%, -1.6% and -2.2%., respectively. The economic downturn as of May 2009 is in its 18th month. The severity of the current contraction cannot be underestimated. As the Blue Chip editors stated in their March 2009 report

> *"It is looking more and more likely that the current U.S. recession will not only be the longest in post World War II history but also the deepest. In April, the current downturn will have exceeded in length the 16-month recessions of 1974-1975 and 1981-1982. And based on our March 4th-5th survey, the consensus now predicts real GDP will contract by -2.6% on a year-to-year (y/y) basis in 2009, easily surpassing the 1982 decline of -1.9% that until now marked the largest y/y contraction in the post war era."* [2]

Unemployment rates continue to rise across the U.S. as a consequence of the deepening recession. According to the Bureau of Labor Statistics, since the start of the recession in December 2007, 4.4 million jobs have been lost nationwide while the average work week fell to a record low of 33.3 hours. In February 2009, national unemployment reached 8.1%, while Philadelphia reached 8.9% in January 2009 (the most recent available data). Some forecasters anticipate that the national economy will lose an additional 2.5 million jobs this year, with unemployment exceeding 10%. Philadelphia continues to experience higher unemployment rates than the surrounding counties of Bucks, Chester, Delaware and Montgomery, as well as the nation. Most major national industries are experiencing decline, with the largest losses incurred in the manufacturing and construction industries. Locally, Philadelphia's finance, leisure and hospitality industries have performed worse than the nation in FY09. Meanwhile, Philadelphia has maintained positive but slow growth in the education, health, professional, and construction sectors.

3. The City's Economic Forecast

An unsettling aspect of the current economic downturn is the significant uncertainty surrounding any and all forecasts of economic growth and activity. A March 2009 gathering of Philadelphia regional economists hosted by the Federal Reserve Bank of Philadelphia and sponsored by the Pennsylvania Intergovernmental Cooperation Authority (PICA) underscored this point: all of those gathered to review economic forecasts made by the Administration cautioned that there was a great deal of uncertainty regarding the

[2] Blue Chip Economic Indicators Top Analysts' Forecasts of the U.S. Economic Outlook for the Year Ahead Vol. 34, No. 3 March 10, 2009, page 1

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depth and length of the current recession, which will make forecasting very difficult. Uncertainty in economic forecasting was emphasized in the minutes of the January 2009 Federal Open Market Committee meeting released by the US Federal Reserve Board of Governors:

> *"Participants continued to view uncertainty about the outlook for economic activity as higher than normal. The risks to their projections for real GDP growth were judged as being skewed to the downside and the associated risks to their projections for the unemployment rate were tilted to the upside."*[3]

The Administration's economic and revenue forecasts for the FY10-14 Five Year Plan, displayed in the accompanying table, are also subject to the same uncertainty and downside risk surrounding national economic forecasts. The forecasts of economic activity for the City over the next five years, whether measured using total economic output (real gross county product), total personal income, or total wages will be subject to revision, especially if the current economic situation worsens over the coming months. If the US and global economies falter further, the accompanying estimates of economic and revenue growth for the City will have to be adjusted downward.

The Administration is anticipating that the Philadelphia economy will shrink by 2.2% in 2009 and 0.4% in 2010. We expect that Philadelphia will suffer a similar decline in economic activity anticipated for the US in 2009; however, we anticipate that the recession will continue to affect the City's economy in 2010 when most observers anticipate the US will emerge from the current recession with modest growth. These estimates are less pessimistic than similar forecasts graciously provided by Moody's Economy.com, which anticipates a sharper recession for the City in 2009 and 2010. Similarly, the Administration anticipates less severe contractions in personal income than Moody's Economy.com in 2009 and 2010. Moody's Economy.com also anticipates that the City will experience unemployment approaching 12% by 2010, an 18% decline in single-family residential prices from the peak price in 2007, and significant erosion in the city's job base until 2012.

The contraction in Philadelphia's economic activity will have consequences for the City's revenue growth. As the accompanying table shows, growth rates for the City's major forecasting indicators correspond with national and regional projections.

[3] Federal Open Market Committee, Summary of Economic Projections for the Meeting of January 27-28 2009, page 3.

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Selected Economic Growth Assumptions for the U.S. And Philadelphia					
US Real GDP Growth (rate)					
	CY2009	**CY2010**	**CY2011**	**CY2012**	**CY2013**
CBO	-2.2	1.5	4.2	4.4	4.1
Blue Chip Consensus	-2.6	1.9	3.4	3.4	3
Moody's Economy.com	-2.9	1.8	4.6	5.5	3.5
Philadelphia Real Gross County Product					
Moody's Economy.com	-3.2	-0.8	1.8	2.7	1.1
City's Budget Office	-2.2	-0.4	1.2	3.1	3.6
Philadelphia Nominal County Personal Income					
Moody's Economy.com	0.5	1.6	2.2	3.7	4.6
City's Budget Office	-0.4	0.5	1.9	4.2	4.7
Philadelphia Nominal Wages and Salary					
Moody's Economy.com	-0.1	-0.1	1.3	3.7	4.6
City's Budget Office	0.7	1.3	2.3	3.8	4.1

4. The City's Major Taxes

The City receives revenue to fund its services and programs from 6 major taxes (contributing to 63% of the expected General Fund revenue in FY10), as described below:

Change in Major Tax Revenues FY08-FY10 (Amounts in Thousands)					
Major Tax Revenues	**FY08**	**FY09**	**FY10**	**% Change from FY08-10**	**FY10 General Fund %**
Wage, Earnings and Net Profits	1,197,325	1,139,107	1,158,374	-3.3%	30.37%
Property Tax	402,789	412,780	420,242	4.3%	11.02%
Business Privilege Tax	398,828	365,724	348,688	-12.6%	9.14%
Real Estate Transfer Tax	184,048	110,600	84,745	-54.0%	2.22%
Sales Tax	137,275	128,000	234,660	70.9%	6.15%
Parking Tax	55,459	69,000	70,725	27.5%	1.85%

Note: Wage Tax does not include PICA contribution. The decline in the Wage tax between FY08 and FY09 is primarily due to the rate decrease.

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Major Taxes ($ in Millions)										
	History				Forecast					
	FY05	**FY06**	**FY07**	**FY08**	**FY09**	**FY10**	**FY11**	**FY12**	**FY13**	**FY14**
Wage	1,087.30	1,125.80	1,182.70	1,197.30	1,139.10	1,158.40	1,178.40	1,200.20	1,245.90	1,285.80
Property	392.7	395.8	397.5	402.8	412.8	420.2	429.3	442.8	454.5	466.7
BPT	379.5	415.5	436.4	398.8	365.7	348.7	356.2	362.8	369.5	376.4
Sales	119.9	127.8	132.6	137.3	128	234.7	244.7	247.1	250.8	255.3
RTT	192.3	236.4	217.3	184	110.6	84.7	93.2	102.5	112.8	124.1
Parking	45	48.4	50.3	55.5	69	70.7	72.5	74.3	76.2	78.1
Other Taxes	13.6	19.2	19	20.8	21.3	21.9	22.4	23	23.6	24.2
Total Taxes	**2,230.30**	**2,368.90**	**2,435.90**	**2,396.50**	**2,246.50**	**2,493.30**	**2,514.40**	**2,452.70**	**2,414.50**	**2,489.60**

Note: Other Taxes include Amusement and miscellaneous tax revenue. Wage tax revenues do not include PICA tax. Revenue forecasts include temporary sales tax increases.

Smaller taxes, such as the amusement tax, provide less than 1% of General Fund revenue. Philadelphia's reliance on the Wage tax (30% of the General Fund) and the BPT (9%) places the City at risk from economic trends and employment fluctuations of the wider economy. Other cities and states that rely more heavily on property tax revenues are more susceptible to dramatic shifts in the housing market. In FY09, the City was expected to receive $4.03 billion in revenue, mostly through modest growth in these 6 taxes. However, with the economy in decline, tax revenues are estimated to be significantly lower than was originally forecast, and total revenue is now estimated at $3.815 billion for FY10.

a. Wage Tax

The Wage, Earnings and Net Profits (Wage) tax is the largest source of revenue for the City, and its receipts remain at risk as local unemployment rises and wage growth across the local economy stagnates. The wage tax is collected from all employees working within the city's limits, and from all city residents, regardless of their employment location. Currently, the resident wage tax rate is 3.93% and 3.5% for non-residents. The resident wage rate includes 1.5% that is reserved for the Pennsylvania Intergovernmental Cooperation Authority (PICA). PICA has overseen the City's finances since 1992, when the State oversight board was first established. The PICA Statute permits the Authority to a "first dollar" claim on its portion of wage tax proceeds.

Wage tax receipts are expected to reach $1.158 billion (excluding PICA contribution) in FY10, with average annual growth of 2.6% from FY10-14. In FY95, the City established a schedule to gradually reduce the wage tax rate each year. As of July 1, 2008 the rate for residents was lowered below 4% for the first time in over thirty years. The decline in revenues from the Wage Tax between FY08 and FY09 is primarily due to this rate decrease. However, as a result of the recent downturn, the City has established a rate reduction moratorium on further City-financed reductions (the State will continue reductions from Gaming revenue) through 2014 or until economic pressures lift.

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b. Property Tax

Property tax revenues are projected to be the second largest source of tax revenue for the City. This tax is levied on the assessed value of residential and commercial property in the City, and is set at a rate of 82.64 mills. The City receives 40% of property tax revenues, with the other 60% allocated to the School District of Philadelphia. City property tax revenues are projected to reach $420.2 million in FY10, with average annual growth of 2.6% over the course of the FY10-14 Five Year Plan.

c. Business Privilege Tax (BPT)

BPT declined considerably since FY08 and is expected to decline again in each of FY09 and FY10. Even after these sharp declines, BPT receipts are expected to grow by an average of 1.9% annually over the course of the Five Year Plan. Businesses pay a percent of net income and gross receipts toward the BPT. The net income contribution for FY09 is 6.45%, and gross receipt contribution is 0.1415%. There are modified rates for financial institutions, public utilities, some manufacturers, wholesalers and retailers. In response to current economic conditions, the City has kept the BPT rates at the FY08 level until 2014 or when there are indications of recovery.

d. Sales Tax

The sales tax is also significantly affected by the downturn in the economy, particularly as consumer spending weakens. The tax rate is 7% in Philadelphia, of which 1% is levied by the City and the remaining 6% is levied by the Commonwealth of Pennsylvania. As of January 2009, total national retail sales have declined over 9% from the same month in the previous year. As a result, Philadelphia sales tax receipts are estimated to reach $128 million in FY09 (a drop of almost 7% from FY08 receipts) and $234.7 million in FY10 due to additional revenue forecasted from the temporary sales tax increase described below. Revenues are estimated to grow an average of 1.2% from FY10-14 excluding additional revenues projected from the temporary sales tax increase. Revenues are estimated to grow an average of 2.1% including the temporary increase.

Note: The Five Year Plan Sales Tax estimates assume a five year temporary one percent increase in the local rate that requires State authorization. The FY2010 estimate assumes an additional $106.5 million will be generated by the temporary increase. The Five Year Plan assumes the temporary increase yields a total of $581.5 million over the life of the Plan. Since authorization for the temporary tax rate increase is dependent on State action, this is a particularly sensitive assumption. For further information, please see City of Philadelphia Five Year Plan, Addressing the FY10-14 shortfall (page 28).

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e. Real Estate Transfer Tax

The City imposes a 3% tax on real property sales within the city under the Real Estate Transfer tax (RTT). An additional 1% is charged by the Commonwealth of Pennsylvania, for a 4% total tax. In FY06 revenue from RTT peaked at $236.4 million in collections. Since 2007, an unstable housing market coupled by the start of the recession has led to a significant reduction in the amount of revenue generated from the RTT. The current projection for RTT in FY10 totals $84.7 million – a decrease of 64% since the peak in FY06.

The second quarter of FY09 marked the eighth consecutive quarter where RTT revenues came in lower than the prior year, falling short in both receipts and records. By the fourth quarter of FY08, total RTT receipts were down by 21.7% while records fell by 22.7%, compared to the same quarter in the previous year. In keeping with nationwide trends, median home sale prices have begun to decline in Philadelphia, prompting a rising number of homeowners to delay selling. Decreasing sales for residential properties, the largest component of the transfer tax, has largely contributed to the decline in transfer tax revenues. Residential properties (single-family homes, apartment buildings and condominiums) comprised 86.6% of total RTT receipts in FY07, and 73.9% in FY08. In recent years, average home sale prices for condos have shown the greatest potential for growth. However, considerable volatility was seen in the past fiscal year. In the first and second quarters of FY09, average condo sale prices fell by 19.7% and 11%, respectively, as compared with the same quarter in the previous fiscal year. The plan assumes real estate transfer tax receipts will grow an average of 10 percent over the life of the plan, after a severe drop off in receipts for fiscal 2010 and 2011.

f. Parking Tax

The parking tax is levied on the gross receipts from all parking transactions. In 2008, the Administration raised the tax to 20%, which brings expected revenue up to $70.7 million in FY10. Parking tax receipts are expected to grow at the regional inflation rate of 2.5% each year from FY10-14.

5. Locally Generated Non-Tax Revenues

Locally Generated Non-Tax revenues are estimated based on historical trends, rate changes and current collection patterns. Certain revenues such as interest earnings, licenses and permits and recording fees are subject to economic contractions and are estimated accordingly.

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6. Revenues From Other Governments

Revenue from Other Governments is estimated based on historical trends, and state and federal budget information. The PICA city account which represents over 25% of total other governmental revenue is estimated using wage tax variables.

7. Obligation Estimates

The City of Philadelphia Office of Budget and Performance Evaluation (OBPE) is responsible for providing obligation estimates to the Director of Finance for discussion and inclusion in the proposed annual budgets and five-year financial plans (FYP) submitted by the Mayor and adopted by the City Council. OBPE provides forecasts of all major expenditure categories. The Five Year Plan obligation estimates assume significant efficiencies and budget reductions as detailed in the Five Year Plan. See City of Philadelphia Five Year Plan, Addressing the FY10-14 Shortfall (page 28).

a. Labor Agreements

The City's labor agreements with its four major bargaining units expire on June 30, 2009. As part of the overall strategy for addressing the City's $1.4 billion five year plan deficit, the cost of wages and benefits for City employees must decrease by at least $25 million in the first year of the plan, and by at least $125 million over the life of this Five Year Plan. Dividing that $25 million among the four unions (along with exempts and non-represented employees) based on their percentage of the current City payroll, requires annual reductions of Fraternal Order of Police costs by at least $8.7 million, the International Association of Fire Fighters costs by at least $2.7 million, and AFSCME District Councils 33 and 47 costs by a combined total of at least $9.1 million. Exempt employees costs would be reduced by at least $3.3 million and non-represented employees costs would be reduced by at least $1.2 million.

Although wage freezes can slow the growth of payroll overall, such steps will not be enough to achieve the significant savings in the City's employment costs that the City's financial situation requires. Rather, achieving a balance between the employment needs of workers and the City's ability to continue to provide key services to the public requires an actual reduction in the per employee cost of wages and benefits. Toward that end, the City proposes a number of changes that seek to bring the benefits of the City's workers more in line with those of the City's citizens and taxpayers, give the City greater flexibility to be smarter and more efficient in the provision of City services and reduce unnecessary costs, including excess overtime.

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This includes achieving long-term savings through a new pension plan for newly-hired and non-vested employees. As part of the Administration's proposal to generate these savings, the City submitted an application to the Pennsylvania Employee Retirement Commission to have Philadelphia's pension fund declared "severely distressed" – the highest level of distress. Along with that declaration of severe distress comes an obligation to make significant changes to the pension fund to reduce employee costs. This new plan will provide a guaranteed level of benefits - lower than the benefits under the current plan - to employees who work for the City for a number of years and allow those who want higher benefits to contribute more of their own money and have the City match a portion of it. The new plan would also establish a defined contribution plan for new employees.

The City also proposes changes in health benefit plans to reduce costs in both the short and long-terms. In addition, the City is seeking immediate relief from its current pension liability by proposing higher levels of contributions by existing employees towards their future pension benefits.

Other immediate cost savings proposals target elimination of expensive contract provisions including: the requirement that all Police Officers and Fire Fighters be guaranteed vacation during the limited summer months, as opposed to distributing leave time year round, leading to high overtime costs to replace vacationing employees; limitations on the City's ability to change work schedules efficiently; staffing mandates; and guaranteed overtime far above what the law requires. Similarly, the City seeks to reduce the number of paid holidays from an extraordinarily high twelve holidays (including each Police Officer's birthday) for uniform employees and eleven for civilian employees to nine holidays. Because these changes are dependent on the successful completion of civilian negotiations and uniform arbitration, this is a particularly sensitive assumption.

b. Wage Reserve Eliminated

The Five Year Plan for FY09-13 allocated $402.9 million over the five years of the Plan in a separate line for funding wage and/or benefit increases that had not yet been negotiated with the City's employee bargaining units. With the FY10-14 Plan, this reserve has been completely eliminated.

c. Changes in the Pension Fund Assumptions

Another way the City is seeking to generate savings over the FY10-FY14 plan is by making actuarial changes to its pension fund assumptions. The City proposed to lower the assumed return on the pension investments from 8.75% to 8.25% and spread out the fund's earnings and losses from five to 10 years, provided that a 30 year amortization schedule for the payment of Philadelphia's unfunded liability is enacted into Pennsylvania law. In addition, the City is seeking to partially defer pension payments in FY10 ($150 million) and FY11 ($80 million). The deferrals will be repaid in full by FY14.

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The estimated savings of these changes total $275 million to the City's General Fund. The net impact of all three steps of these pension changes will be to lower the amount the City is required to contribute to the pension fund over the next five fiscal years, and increase its ability to fund existing liabilities in the long-term.

The proposed changes to the pension fund assumptions have been tested by the City's actuary and have been determined to be actuarially sound. According to the City's actuary, "each of these changes is individually supportable and in the aggregate provides a system of funding that recognizes the current funded status and implications for the City while providing a long-term approach to meeting the obligations to continue to provide retirement benefits. Because the savings associated with these changes are dependent on State authorization, this is a particularly sensitive assumption.

Projected Savings from Changes in Pension Fund Assumptions

	$
FY10	$146,014,000
FY11	$196,960,000
FY12	$41,278,000
FY13	-$47,789,000
FY14	-$61,183,000
Total	**$275,280,000**

C. Subsequent Events

1. Subsequent to June 22, 2009, the completion date of the forecasted statement, it came to management's attention that Senate Bill 850 could move through the legislature. Senate Bill 850 has major reductions in state expenditures including funding to Philadelphia, relative to the budget submitted by the state governor upon which our General Fund state revenue forecast amounts were based. In addition, if the state legislature fails to timely enact a budget, the state will lack appropriation power and will therefore be unable to make any expenditures. These conditions could have a significant adverse effect on the timing and amount of the City's cash flow. Based on the current information, however, the amount of that effect cannot be estimated.

2. Subsequent to June 22, 2009, the completion date of the forecasted statement, the Pennsylvania Employee Retirement Commission accepted the City's application and declared Philadelphia's pension fund "severely distressed".