City Council of Philadelphia

Finance and Budget Team:

FY18: Mid-Year Financial Update on City of Philadelphia and the School District of Philadelphia

(Based on Release of Second Quarterly Managers Reports)

FY18: Mid-Year Financial Update on City of Philadelphia and the School District of Philadelphia

Executive Summary

Following the close of each quarter of the fiscal year – 9/30 (Q1), 12/31 (Q2), 3/31 (Q3), and 6/30 (Q4) – the City of Philadelphia (City) and the School District of Philadelphia (SDP) separately release a quarterly managers report. The mid-year reports for the period ending 12/31/17 were released to the public on February 15th, 2018. Both the City's report[1] and the School District's report[2] – the sources of this report's data – highlight continuing positive trends as we approach the FY19 Budget Hearing Process.

The General Fund (GF) – Fund Balances for the City and School District have been adjusted positively upwards: **$127.8 million in projected additional funds for the City and $48.9 million in projected additional funds to the School District. The new projected Fund Balances for the City and School District are $203.3 million and $138.7 million, respectively.** For the City, the projected $127.8 million FY18 Fund Balance increase is driven by a $100.7 million increase to FY17's ending balance, a projected $50.8 million increase in FY18 revenues and a projected $27.1 million increase in FY18 expenditures. For the School District, the projected $48.9 million FY18 Fund Balance increase is driven by an upward $16.6 million adjustment in FY17's ending balance, a projected $74.7 million increase in FY18 revenues, and a projected $42.3 million increase in FY18 expenditures.

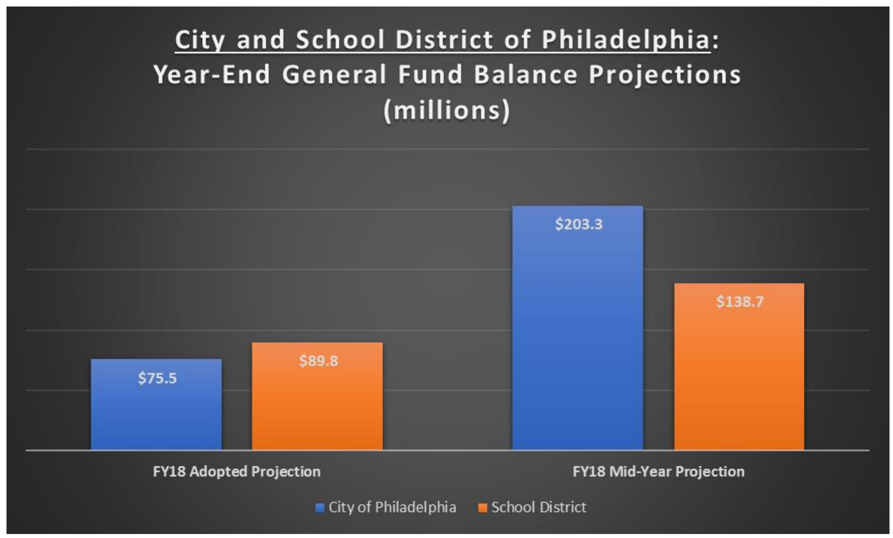

Figure 1

The local economy has continued to follow the larger economic trends of the United States: modest, sustained economic growth since the Great Recession. Philadelphia has experienced consistent declines in the

[1] City of Philadelphia Quarterly City Managers Report – For the Period Ending 12/31/2017

[2] School District of Philadelphia Quarterly Managers Report – For the Period Ending 12/31/2017

unemployment rate as well as growth in business. In FY10 – arguably the low point of the Great Recession, the City collected $364.7 million in Business Income and Receipts Tax (BIRT) and $1.11 billion in Wage Tax receipts. **In FY17, the City collected $417.5 million in BIRT and $1.45 billion in Wage Tax revenue, an increase of $52.8 million and $334 million since FY10, respectively. While revenues were increasing for both taxes, the City continued scheduled business tax rate deductions**.

Given the current environment of rapid growth, as well as the economic sensitivity of our revenues, it is critical that we continue tracking economic indicators in order to be better prepared for the next market downturn. These include unemployment, bond market yields, inflation, savings rates, new home sales, consumer confidence, etc.

Highlights – City of Philadelphia Q2 Report

The City of Philadelphia released its mid-year financial update on February 15th, 2018. This report, which provides updates to Adopted Budget projections for FY18, is the most accurate financial information during the start of City Council's Budget Hearing Process.

The Q2 report for FY18 shows variations in both revenues and expenditures in the General Fund: **a projected $50.8 million increase in revenues coinciding with a projected $27.1 million increase in expenditures above adopted figures.** This $23.7 million net increase should reduce the City's projected GF operating deficit by said amount. Coupled with prior year adjustments, this **brings the projected FY18 Fund Balance to $203.3 million –** $127.8 million above the FY18 Adopted Fund Balance of $75.5 million.

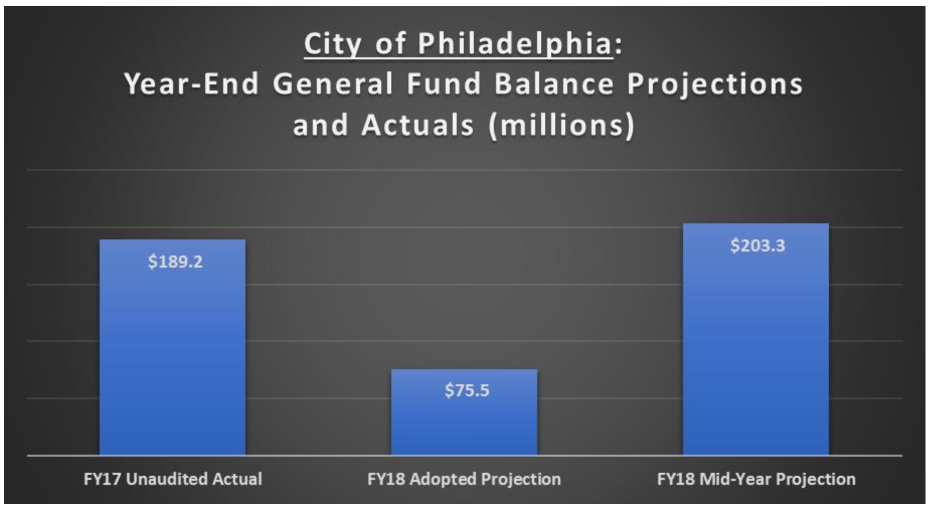

Figure 2

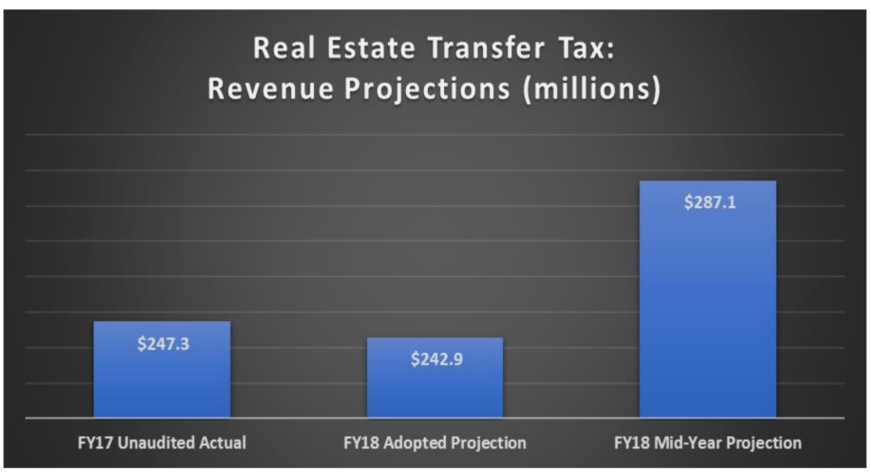

Figure 3

The Real Estate Transfer tax, which is an indicator of Philadelphia's local real estate market, has continued to grow alongside **increasing home values and high sales volume.[3]** Although the original budget anticipated $242.9 million in revenue, **the Q2 report increased the FY18 projection by $44.2 million, shifting year-end total projections upward to $287.1 million.**

[3] Philadelphia Inquirer: "Philadelphia Housing Marker Still Growing", December 2017

Highlights – School District of Philadelphia Q2 Report

The School District of Philadelphia released its Q2 Manager Report on February 15th, 2018. This report, which provides a mid-year financial update, highlights the differences between the June 2017 projections – when the budget was adopted – compared to the current outlook.

One of the main points of interest during last year's Council Budget Hearing Process was **the School District's projected negative $701.6 million Fund Balance ending in FY22**. Given the updated projections to SDP's operating surplus and FY17 ending Fund Balance, **the FY22 projected Fund Balance can be conservatively adjusted to negative $648.8 million**, assuming revenues and expenditures for the outer years remain unchanged. If the assumption is that each year in the Five-Year Plan has a $32.3 million decrease to its deficit (as seen in FY18), **the FY22 negative Fund Balance could improve by an additional $182 million above original projections. However, please bear in mind that the projected operating deficit steadily escalates from negative $132 million annually in FY19 to negative $235 million annually in FY22, meaning that the structural deficit continually increases and compounds for every year that it is not initially addressed.**

School District of Philadelphia - FY18 - FY22 Five Year Plan (in thousands)	FY18 Projected (Q2 Adjusted)	FY19 Projected	FY20 Projected	FY21 Projected	FY22 Projected
Total Revenues and Sources	$ 3,024,215	$ 2,975,999	$ 3,037,334	$ 3,114,108	$ 3,181,056
Total Expenditures and Uses	$ 2,995,486	$ 3,112,378	$ 3,225,012	$ 3,320,464	$ 3,402,867
Adjusted Operating Surplus (Deficit)	$ 14,027	$ (131,747)	$ (200,999)	$ (219,677)	$ (235,132)
Beginning Fund Balance	$ 124,697	$ 138,724	$ 6,977	$ (194,022)	$ (413,699)
Ending Fund Balance	**$ 138,724**	**$ 6,977**	**$ (194,022)**	**$ (413,699)**	**$ (648,831)**
Fund Balance as a % of Expenditures	**5%**	**0%**	**-6%**	**-12%**	**-19%**

Figure 4

The Q2 report also illustrates a shift in the assumptions of Local Tax revenues, indicating an increase in Local Tax projections **from an Adopted $1.23 billion to $1.26 billion**. This 2.26% upward increase in the projection amounts to $27.9 million in increased revenues from Local Taxes.

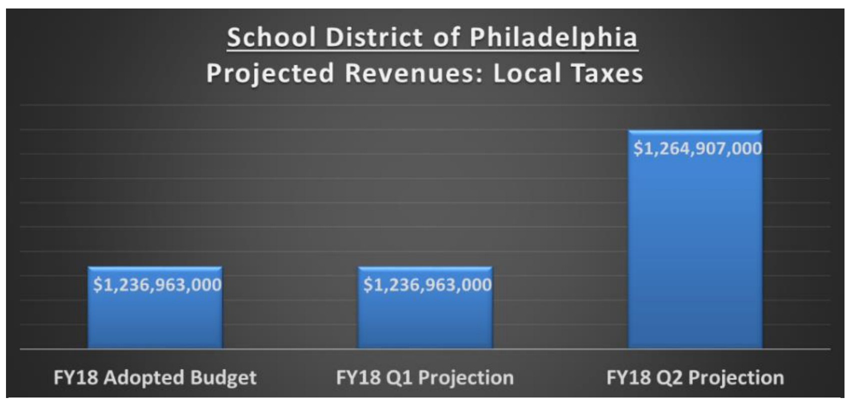

Figure 5

As mentioned above, Local Tax revenue is expected to end FY18 $**27.9 million above Adopted projections.** Projections for Local Non-Tax revenues have **increased $10.2 million above Adopted projections**, driven by a projected increase in the Parking Authority's Contribution. The largest projected increase is seen in State revenues, which are projected to end the year **$35.8 million above Adopted projections.** The increase in revenues from the State stems from a

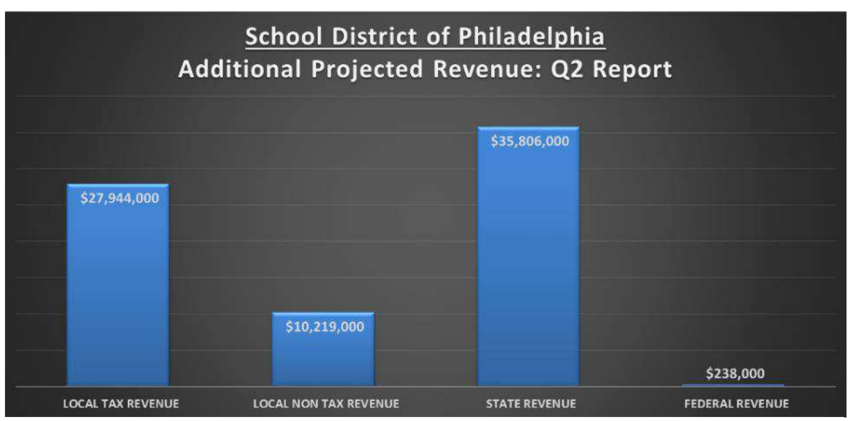

Figure 6

projected $19.3 million increase in "Basic Education" funding, combined with an increase of $9.2 million for "Retirement" and "Social Security".

The increase to Local Tax projections is driven by strong upward adjustments to Business Use and Occupancy ($30.3 million), and modest upward adjustments to current Real Estate ($7.1 million) and the Parking Authority Contribution ($6.9 million).

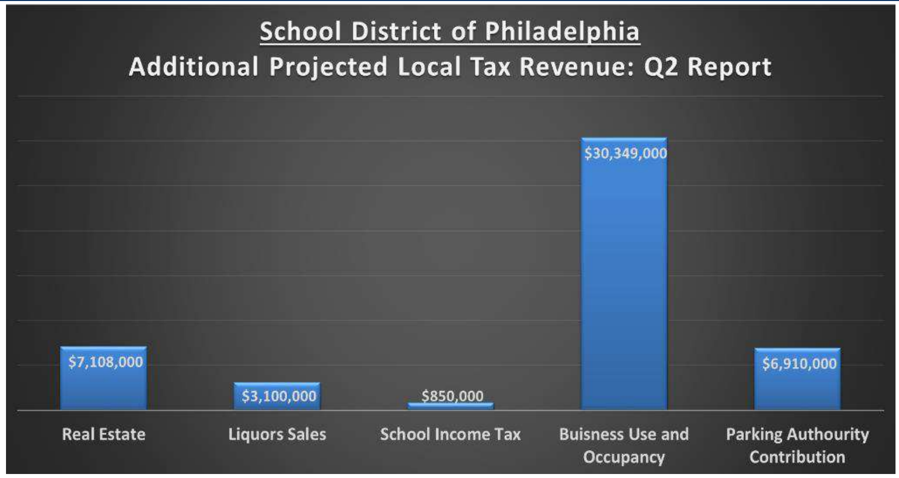

Figure 7

Local Economic Indicators and Market Analysis

As discussed in our pre-budget presentation, the Finance and Budget Team has actively begun tracking leading economic indicators in order to maintain a realistic assessment of where our economy is, and where it may be headed. **Despite the recent market volatility stemming from the recent market correction experienced on Wall Street a few weeks ago, the local economy has continued to follow the larger economic trends of the United States: modest, sustained economic growth since the Great Recession.**

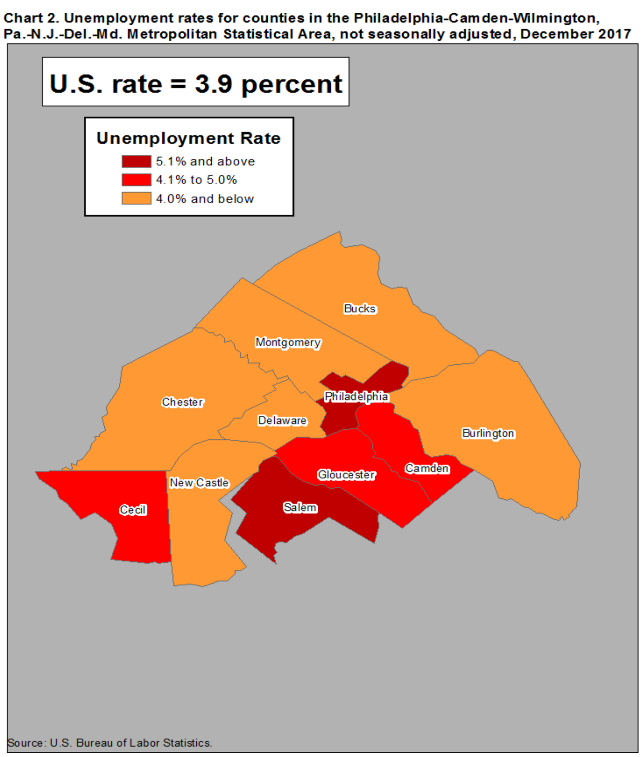

Figure 8

The *Unemployment Rate* is viewed as a straightforward indicator of economic health. Although Philadelphia's unemployment rate has lagged behind the national and regional economy's rate, it has continued to improve since the depths of the Great Recession: **Philadelphia County's unemployment rate is currently 5.6% (as of December 2017), falling steadily from a high of 12.0% in July of 2012.** Although the current rate of 5.6% is 1.7% higher than the national rate, the City has reaped the rewards of expanded employment through robust growth in our Wage and Sales taxes.[4]

[4] U.S Bureau of Labor Statistics, Unemployment in the Philadelphia Area by County – December 2017 (See: Map – Figure 8)

Consumer Price Index for All Urban Consumers (CPI-U) measures the average change in prices of a fixed "market basket" of goods over a set period of time. This indicator can help track the economic value of the wages received by Philadelphians. The rate of inflation has been a persistent topic of discussion over the last month: fear of *future* inflation has driven dramatic market fluctuations, including the **largest single day drop, in number, ever**[5] in the DOW Jones Industrial Average on February 5th. This drop also coincided with the appointment of a new Federal Reserve (Fed) Chair – Jerome Powell – in late January, and the release of the Federal Reserve Board and the Federal Open Market Committee's January session meeting minutes, which reinforced the Fed's plans to continue to raise short-term interest rates a few more times this year.[6] Additionally, the Bureau of Labor Statistics revealed on February 2nd that wages are currently growing at their fastest rate since before the Great Recession.[7] Wages, as shown in *Figure 10*, have historically risen alongside CPI[8], and their current rise may force action by the new Federal Reserve Chair (in theory, increases in lending rates cause consumers to reduce consumer spending and increase savings – which should slow inflation, with the goal of strategically regulating growth).

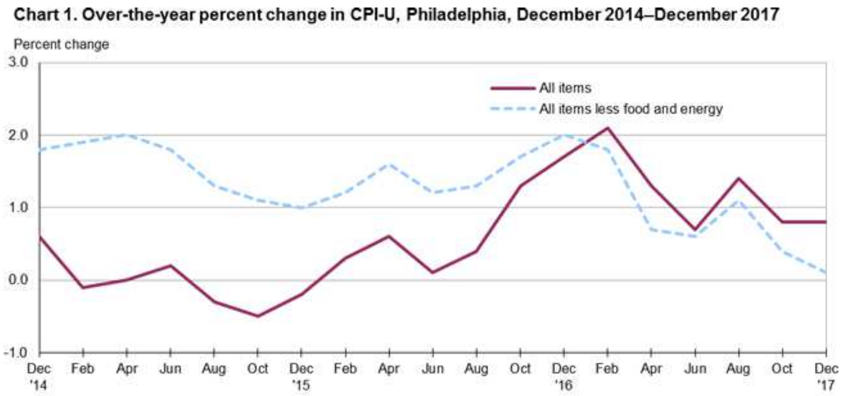

Figure 9

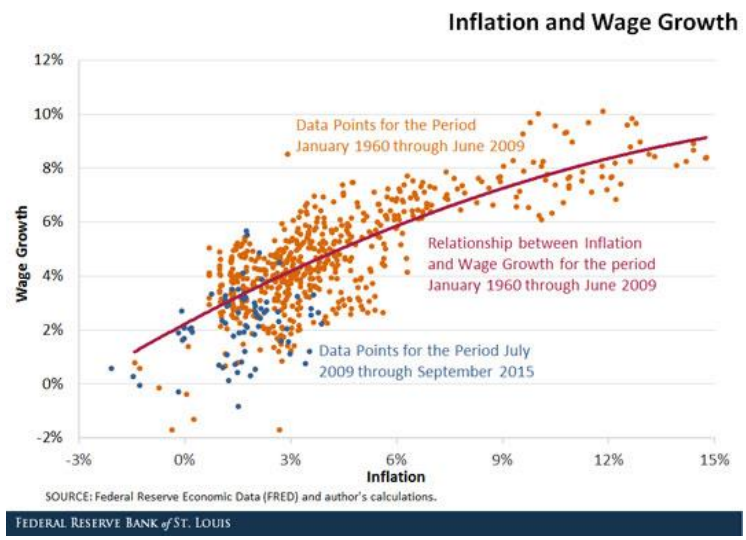

Figure 10

Figure 11

Another indicator that we have closely monitored is the *Personal Savings Rate* (see *Figure 11* to the left) – the percentage that a consumer saves compared to their disposable income. Historically, consumers save less of their income when they are confident in the direction of the economy – when wages rise, when interest rates are low, etc.[9]

---

[5] CNBC: DOWS Nearly 1600 Plunge Marks its Biggest One Day Point Drop Ever – February 5th, 2018
[6] Wall Street Journal: Fed Gives Bullish Signals on Economy
[7] Reuters: U.S hiring accelerates; annual wage growth strongest since 2009 – February 2nd, 2018
[8] Federal Reserve Bank of St. Louis: The Relationship between Wage Growth and Inflation – November, 2015 (See: Chart – Figure 10)
[9] The Long-Run Relation Between the Personal Savings Rate and Consumer Sentiment – Ewing, Payne, 1997

Although a lower Personal Savings Rate indicates high consumer confidence and a perception of rising wages (partially supported by the wage growth numbers released in early February), low rates of savings can leave consumers vulnerable, with little security in the event of an economic downturn. **In July 2016, US consumers saved an average of 5.1% of their disposable income. That number has since dropped to 2.4% in December 2017.**[10] With consumer spending accounting for 70% of our economy[11], personal savings are critical in maintaining consumer spending during economic downturns: if the personal savings rate is low at the start of an economic downturn, consumer spending could be further constrained, thereby exacerbating the downturn.

Also, while inflation has remained consistent over the preceding years (currently at a 12-month average of 0.8%)[12], the recent market reaction elevates the CPI (a leading indicator that measures inflation) to one of the top indicators on our watch list. However, the S&P 500, Treasury Yield Curve, and Unemployment indicators are comparatively important indicators that must be continually tracked - in terms of important indicators for economic trajectory as we move towards the consideration of the FY19 budgets for the City and School District of Philadelphia. Attention should also be directed towards the Fed's future actions, as they relate to planned interest rate hikes. Many economists are still skittish concerning the projected long-term economic growth rate purportedly stemming from the recently enacted tax cuts or the President's proposed increase in federal funding, both of which may put more pressure on the Fed's future actions to raise rates.[13]

In conclusion, the local economy has continued to experience modest, sustained economic growth since the Great Recession. Unemployment continues to remain low, corporate earnings continue to remain strong, and consumer confidence continues to remain high. However, given the recent market volatility stemming from rising-future inflation concerns and the recent drop in the Personal Savings Rate, there are a few local indicators that should be watched moving forward, including but not limited to CPI, the S&P 500, the Treasury Yield Curve, Unemployment, and the Personal Savings Rate. The Fed's future actions should also be carefully watched, as they relate to their planned interest rate hikes and the potential that such hikes could catalyze market retraction, a slow-down in economic growth (below targeted growth), and a resulting reduction in Local Tax revenues.

---

[10] Federal Reserve Bank of St. Louis Economic Research: Personal Saving Rate – December 2017 (See: Chart – Figure 11)

[11] Federal Reserve Bank of St. Louis Economic Research: Personal Consumption Expenditures / GSP – December 2017

[12] U.S Bureau of Labor Statistics, Consumer Price Index, Philadelphia-Wilmington-Atlantic City -- December 2017 (See: Chart – Figure 9)

[13]***See:*** https://www.wsj.com/articles/fed-officials-marked-up-growth-inflation-outlook-in-january-1519239983