City Council of Philadelphia

Finance and Budget Team:
City and School District of Philadelphia
Fiscal Year 2019 Mid-Year Update

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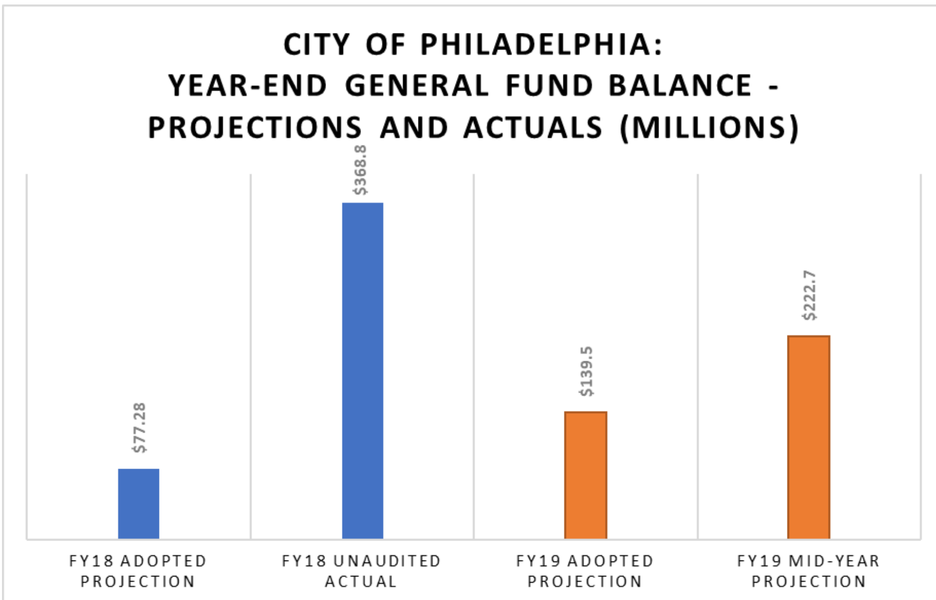
Following the close of each quarter of the fiscal year (FY) – 9/30 (Q1), 12/31 (Q2), 3/31 (Q3), and 6/30 (Q4) – the City of Philadelphia (City) and the School District of Philadelphia (SDP) separately release a quarterly managers report. The mid-year reports for the period ending 12/31/18 were released to the public on February 15th, 2019. Both the City's report[1] and the School District's report[2] – the sources of our data – highlight continuing positive trends as we approach the FY20 Budget Hearing Process.

On February 15th, the Director of Finance released the *Quarterly City Managers Report for the Period Ending December 31st, 2018.* This report is used to inform the FY19 projections included in the Mayor's proposed FY20-24 Five-Year Plan, which was released to the public on March 7th, 2019.

Fund Balances

The most notable sign of the strength of the economy last year was the unanticipated growth in Philadelphia's local taxes. These unanticipated revenues, tied to no expenditure, flowed to the General Fund balance. **At the adoption of the FY18 budget, the year-end fund balance was projected to be $77.3 million. Currently, the actual unaudited year-end fund balance for FY18 is $368.8 million, a $291.5 million increase.** This increase in the General Fund Balance, largely influenced by growth in wage and transfer taxes, would have been even larger had the City not sent an additional $22 million to the pension fund and $30 to current capital expenses. The City also withheld $20 million to deposit into the "Rainy Day" Fund, also known as the Budget Stabilization Reserve.[3]



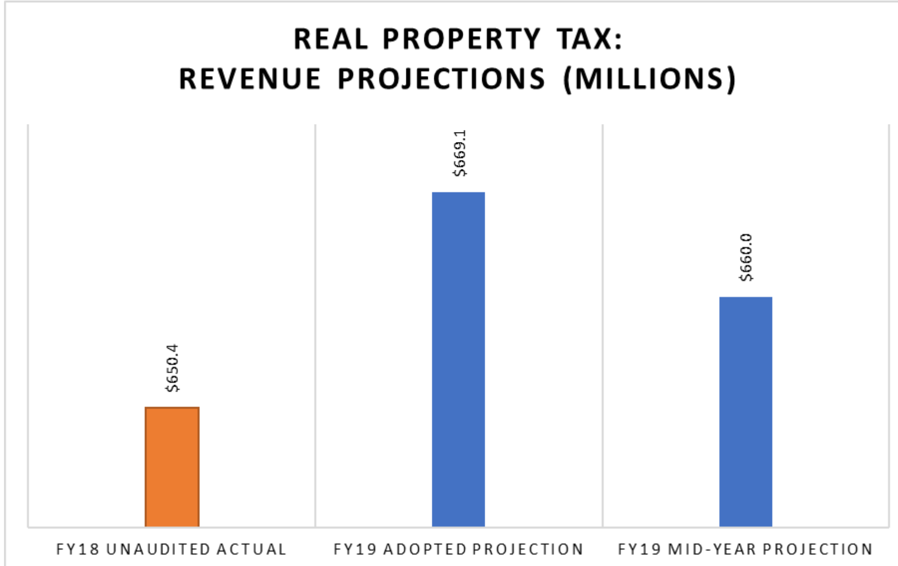
[1] City of Philadelphia Quarterly City Managers Report – For the Period Ending 12/31/2018

[2] School District of Philadelphia Quarterly Managers Report – For the Period Ending 12/31/2018

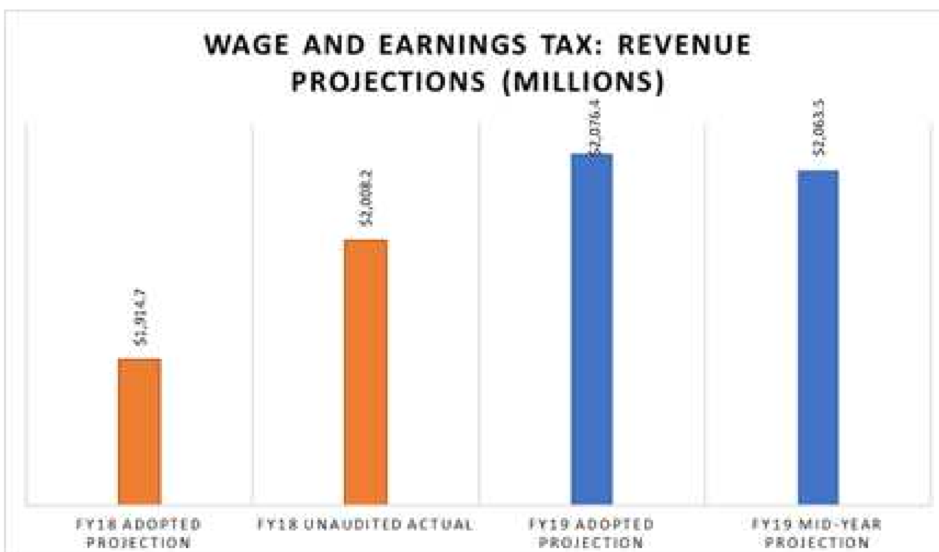
[3] The proposed FY20-24 Five-Year Plan increases the projected year-end fund balance by approximately $5 million. This is due to a projected increase in non-tax revenues for FY19.

City Taxes

As highlighted in PICA's FY19 monthly revenue updates, revenue outlooks have fluctuated on a month-to-month basis, influenced by government instability, trade talks, and fear of a recession. The Q2 report highlights this revenue instability: **The Wage Tax, Real Property Tax, Sales Tax, Parking Tax, and Beverage Tax have all been adjusted downward from the FY19 adopted budget.** The Real Property Tax has been negatively adjusted by $9.1 million compared to the FY19 adopted budget. However, this adjustment is not due to the overall health of the economy, but rather reflects the impact of **Bill No. 171009** which delays the payment of disputed property taxes. This bill triggered a downward adjustment of the City's revenues by $9 million, and the District's revenues by $15 million. **However, if the City is in fact owed these revenues after appeals are exhausted, they will be received in the following fiscal year.**



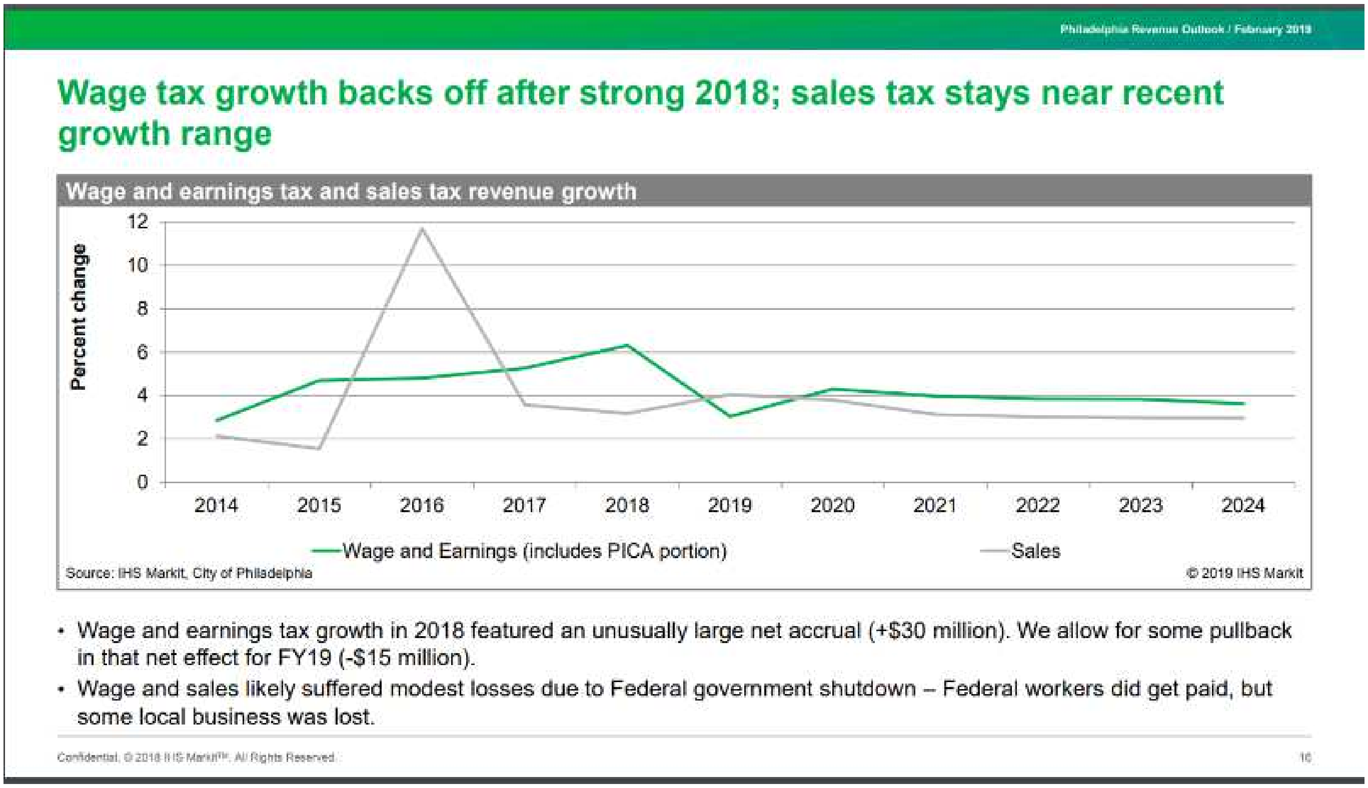
The Realty Transfer Tax has seen significant growth over the past decade and is a strong indicator of Philadelphia's strong real estate market. The tax, which is split between the buyer and seller, is 4.278% of the final sale value. **In FY18, the Realty Transfer Tax raised $331.5 million**, **$88.6 million higher than projected in the adopted Five-Year plan.** For FY19, this tax is projected to raise $323 million ─ slightly less than FY18's total ─ but significantly higher than previous projections. According to *IHS Markit*, the firm that advises the Finance Department on revenue projections, FY18 was an abnormally productive year for Real Estate sales. During a recent presentation at the *Federal Reserve Bank of Philadelphia*, IHS Markit stated, "Realty Transfer Tax receipts were driven up by commercial real estate transactions in FY18. Big deals (sic) are still being done, but the pace of activity is not expected to maintain that pace".[4] The downward movement of receipts is not indicative of Philadelphia's housing market as a whole ─ receipts are based on the *value* of sales as opposed to the *volume*. Currently, Philadelphia has a housing inventory of 3.4 months ─ meaning if no new properties entered the market, all homes would be sold within 3.4 months ─ compared to 6 months for the U.S. as a whole.[5] This low inventory is indicative of a strong real estate market, but one in which sellers have an advantage over buyers, pushing up prices and lengthening sales.



[4] http://www.picapa.org/2019/02/pica-hosts-2-regional-economists-meeting/

[5] https://www.philly.com/real-estate/housing/philadelphia-suburbs-housing-market-still-hot-inventory-sellers-market-bidding-wars-20190222.html

Overall, the best indicator of Philadelphia's economy is the Wage and Earnings Tax ("Wage Tax"), which taxes 3.8809% of income earned by residents and 3.4567% of income for non-residents. The Wage Tax is the largest source revenue for the General Fund, raising $2.01 billion in FY18 and projected to raise $2.06 billion in FY19. This tax, which is dependent on local wages, is a very "economically sensitive revenue," meaning revenues grow in periods of economic expansion and retract during recession. As a comparison, in FY14, this tax raised $1.63 billion, a $430 million improvement over just five fiscal years, when compared to FY19. IHS Markit projects that the Wage and Earnings Tax, which grew more than 6% in FY18, will continue to grow at around 4% through 2024.[6]



Overall, IHS Markit's report**, which helps the Finance Department craft revenue projections,** has a positive outlook for the City of Philadelphia. IHS projects a 25% chance of a recession, describing the scenario as a "Loss of confidence and risk aversion resulting in a 3-quarter recession." **Outside of that projection, IHS states that there is a 60% chance of continued, albeit moderate, growth, and a 15% chance of accelerated productivity and low inflation.**[7]

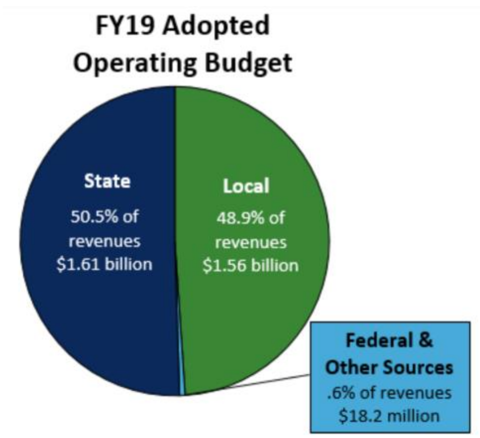
[6] IHS Market Presentation: Regional Economist Meeting, page 16 (see footnote 4)

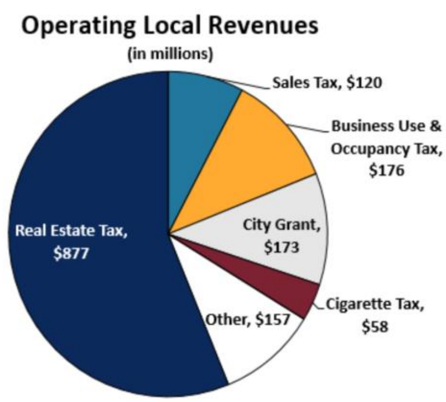
[7] IHS Market Presentation: Regional Economist Meeting, page 7 (see footnote 4)

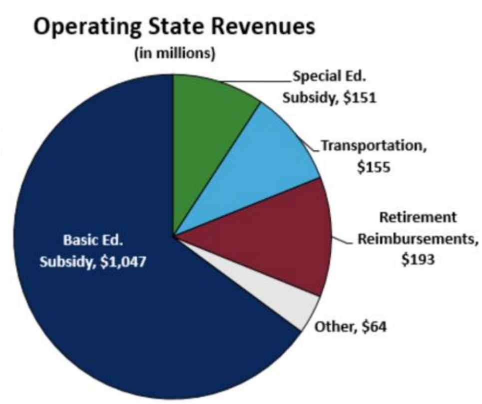
School District

The School District released its own mid-year quarterly report, detailing the District's updated projections of revenues and expenditures. Revenues are updated in two significant ways: Real Estate revenues, both for Real Estate and Use and Occupancy, have been adjusted downwards collectively by $15 million. As with the City's revenue, this is due to the "tolling bill", and only affects revenues in the short term. **This decrease in Real Estate receipts is partially offset by a $6.3 million increase in revenues from the Philadelphia Parking Authority and the State.**

According to the Q2 revenue projections, the City is projected to cover approximately 48% of the School District's revenues, while the State and Federal government cover the remaining 52%. This near 50/50 split, which has increased slightly since the adoption of this year's budget, is unprecedented, and began during Governor Corbett's budget cuts in FY11, when State and Federal Governments covered approximately 2/3 of the School District's operating budget. Since then, the City has dramatically increased revenues in the following ways: increases to the Real Estate Tax, the implementation of the Sales Tax, the creation of the Cigarette Tax, increases to the grant line-item, and agreements with the PPA.



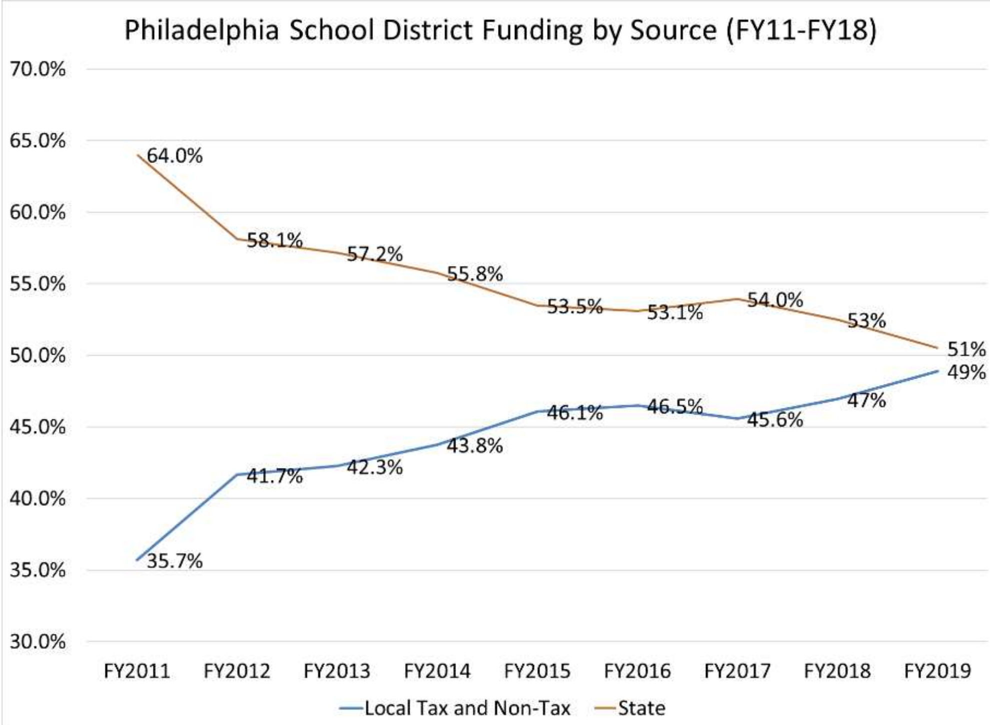




[8]

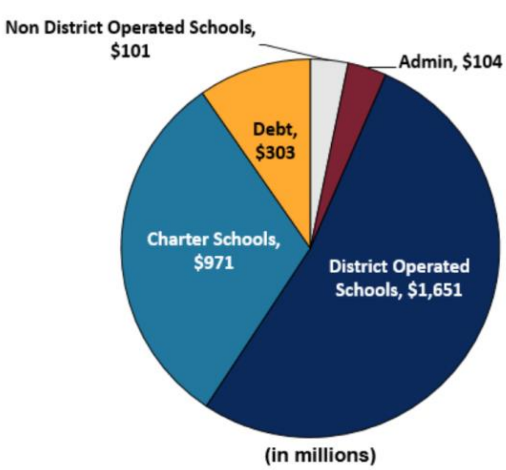
In terms of spending, the Q2 report does indicate a structural increase in the District's overall expenditures. The following increases are likely to continue in future fiscal years: **a $19 million increase in payments to charter schools, $8.3 million increase in facilities expenditures, $5.8 million increase in professional development costs, and a $4.7 million increase in compensatory education payments**. The increase in professional development costs are due to a reduction in Title II grants from the Federal Government and have triggered a utilization of the "Reserve for Federal Cuts" line-item in the budget. **Over the previous two fiscal years, the "Reserve for Federal Cuts" is shown as an expenditure, meaning when the reserve is redirected, it does not increase the overall level of spending and does not impact the fund balance.**

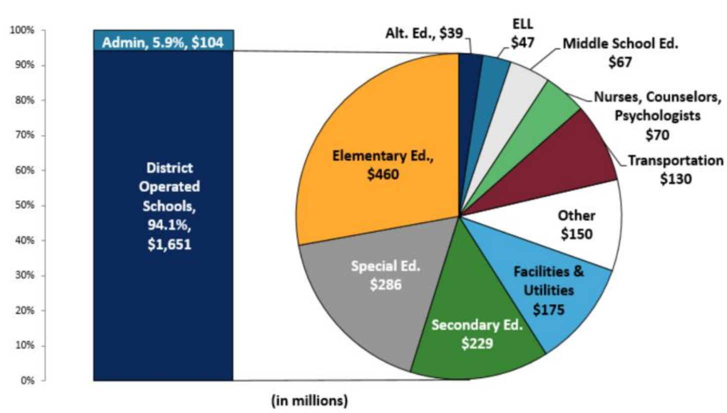
[8] https://cdn.philasd.org/offices/budget/Consolidated%20Book_Final%20Web.pdf



Overall, the changes highlighted do not dramatically alter the budget priorities and structure of the School District's financial outlook. For FY19, $1.65 billion is budgeted for District-Operated Schools, with $971 million going to Charter School tuition. **Charter Schools, which receive a fixed amount of funding per student paid by the District, have leveled off in terms of funding and population in the last two fiscal years and currently account for 31% of all operating expenditures, compared to 52.7% for District-Operated Schools.** For perspective, in FY09, the School District spent $324 million, or 14.7%, on Charter Schools, which represents the biggest structural shift overall in the District's budget.

Below highlights the distribution of expenses for the District's FY19 adopted operating budget. Overall, the $104 million for administration costs is low: Governing Magazine showed, using 2015 data, that the average school district spends 7% of its operating budget on administration, compared to Philadelphia's 5.9%. Additionally, States with "highly fragmented districts" such as Pennsylvania generally have the highest portion of expenses dedicated to administrative expenses.[9]





[9] http://www.governing.com/topics/education/gov-education-funding-states.html

In 2008, just prior to the Great Recession, the School District invested a peak of $374 million in its infrastructure through the Office of Capital Programs. Unfortunately, the current rate of investment is not adequate to keep up with deferred maintenance costs. In the FY19 budget, the School District states: "With an average building age of 67.9 years, the Capital Program Office has estimated the District's optimal annual life-cycle replacement costs to be $320 million. This amount has been determined by counting the District's major building components such as roofs, windows, boilers…evaluating their respective life cycles; estimate their respective current replacement costs; and summing up the costs per year per component."[10] By not meeting the current life-cycle replacement costs, small capital expenses - e.g., patching a roof or replacing a window ─ lead to higher costs overall, such as full roof replacement or higher heating costs. **In the current fiscal year budget, the School District is budgeted to spend $272.9 million on capital expenditures, the majority of which is budgeted for life-cycle replacements (29%) or major renovations (26%). The Q2 report shows that the District is in a position to meet budgeted projects, ending the year with $265.25 million on-hand, with $217.3 million in active projects.**

Over the past two fiscal years, the need for additional investment in the District's infrastructure has become increasingly apparent: from the cancellation of school days due to inadequate cooling systems to the presence of harmful materials, such as lead. The Q2 report revises the amount going to debt service downward $3 million to $300 million, or 9.5% of its budget, annually on debt expenses. The ratio of debt service to total operating expenditures leaves room for further expansion, as the District has indicated. In late 2018, the School District received a credit rating upgrade from Moody's, rising to Baa3, out of "junk status".[11] **This is the first time since 1977 that the School District has been considered "investment grade," meaning that the District can reinvest in its schools and infrastructure at a lower cost than it has in the past. These lower borrowing costs will make any additional bond issuances more impactful, and allow for more City tax dollars to flow directly into classrooms. Moody's states that although the District has narrow reserves and high charter enrollment, "These challenges are currently met by a very strong management team, which has developed a detailed understanding not only of the District's finances but also the ongoing operation of managing a highly dynamic, large, urban school district."[12]**

[10] https://cdn.philasd.org/offices/budget/Consolidated%20Book_Final%20Web.pdf
[11] https://www.philasd.org/blog/2018/12/18/moodys-upgrades-school-districts-bond-rating-to-first-investment-grade-in-decades-baa3/
[12] https://www.philasd.org/finance/wp-content/uploads/sites/789/2018/03/MoodysReportPhlSchoolDistrict2.pdf