City Council of Philadelphia

Finance and Budget Team:

Summary and Analysis of Mayor's Proposed FY20-24 Five-Year Plan and Economic Update

(updated as of 3.22.19)

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Introduction

The following report is an internal assessment of the Administration's proposed FY20-24 Five-Year Plan (5YP), including analyses on: proposed changes to expenditures and revenues, budgetary trends for the City of Philadelphia, and an update on the local economy. This report does not offer any recommendations for funding, but instead attempts to inform Council on the latest budgetary trends, budget proposals, and potential impacts to certain constituents based on preliminary information received from the Administration in the City's proposed 5YP, and on the 2017 American Community Survey (ACS).

Five-Year Projections of City Finances

The Five-Year Plan projects the General Fund balance declining from a high of $227.7 million in FY19 to a low of $97.6 million by the end of FY22, and rising to $153.8 million by the end of FY24. On their surface, these projected fund balances are well below the Governmental Finance Officers Association (GFOA) recommendation of 17% (approximately two months of expenditures). **However, due to prudent financial planning, the City's projected financial position is healthier than what is shown in the General Fund balance projections. This improved financial position is reflected in additional reserves for labor costs, potential cuts in federal funding, and budget stabilization, which collectively account for $572.5 million in appropriated expenditures throughout the 5YP (including FY19).**

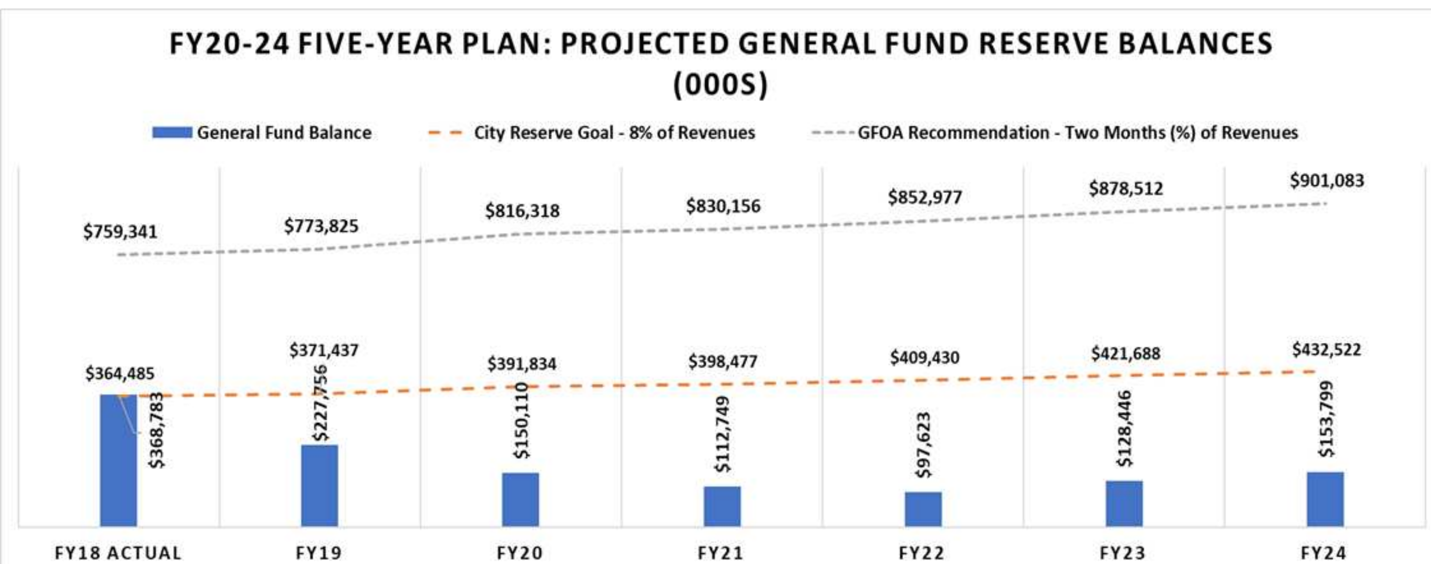


Figure 1

The first reserve not reflected in the General Fund balance is the *Labor Reserve*, which creates a line-item in *anticipation* of increased Class 100 costs due to contract negotiations.[1] The plan has $140 million in the labor reserve – increasing from $20 million in FY20 to $50 million in FY24. **The use of a labor reserve line item is appropriate – past negotiated and awarded increases have been less disruptive to the City's short-term liquidity due to labor reserves. Per the 5YP, 82% of the City's current employees (23,885) are represented by a labor union; accordingly, changes to contracts can have an immediate impact on the City's expenditures. The ability of the City to transfer appropriations from an existing reserve line item can lessen any short-term liquidity problems.**

The second reserve not reflected in the General Fund balance is the *Federal Funding Reserve*, which is an amount held in reserve to mitigate any funding reductions from the Federal or State governments. The amount held in reserve increases annually, from a projected $53.5 million in FY19, up to $58.4 million in FY24. **Over the course of the Plan (not including FY19), the City has proposed to appropriate $286.7 million into this reserve.**

The third reserve not reflected in the General Fund balance is the *Budget Stabilization Reserve,* also known as the "Rainy Day Fund." In FY18, after unprecedented growth of General Fund revenues, the City set aside $20 million to be deposited into the Rainy Day Fund. This $20 million appropriation carried over to FY19. **The reserve, created in 2011 following legislation sponsored by then Councilman Kenney, is budgeted to receive $92 million in deposits through FY24 in the Administration's proposed 5YP.** Further contributions to this reserve would be seen by the credit rating agencies – S&P, Moody's, and Fitch Ratings – as a positive step, as it further improves the probability of meeting debt service payments. Pew Trusts has done extensive research on the benefits and structures of rainy day funds, even hosting a discussion with credit rating agencies, which covered the role of reserves in determining credit rating. Lisa Schroeer, an S&P analyst who works on determining Philadelphia's credit rating, stated, "If you have a [reserve] policy and you're not implementing it, it's not a strengthening factor…" but adding, "You're looking at a city dealing with a lot of competing needs. There are pension costs, there is the school district, there are regular operations, and there is the Rainy Day Fund."[2] During the briefing, it was highlighted that a multitude of factors go into determining credit, and that cities must strike a balance between fiscal responsibility and maintaining levels of service that ensure the economic trajectory of the municipality. So long as those levels of services are maintained, investing in a growing *rainy day fund* is considered a clear plus.

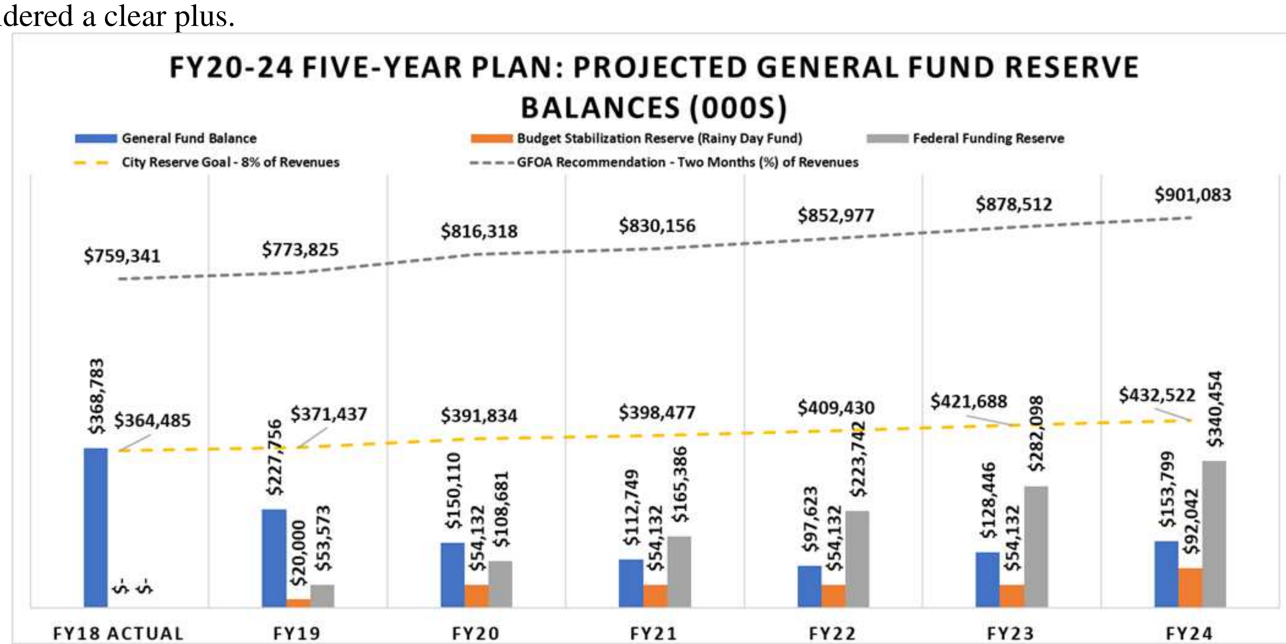


Figure 2

[1] The labor reserve is not included in the charts because it is a reserve for an expected and likely expenditure, while the rest of the reserves are for unanticipated expenditures. Page 40 of the Plan shows that all of the cities' labor contracts end on 6/30/2020 and are likely to exceed the anticipated labor reserves.
[2] PEW Trusts- How Rainy-Day Funds Help Cities Prepare for Revenue Volatility: Officials from Los Angeles, Baltimore, Philadelphia, and S&P discuss how the reserves work and the impact on credit ratings.

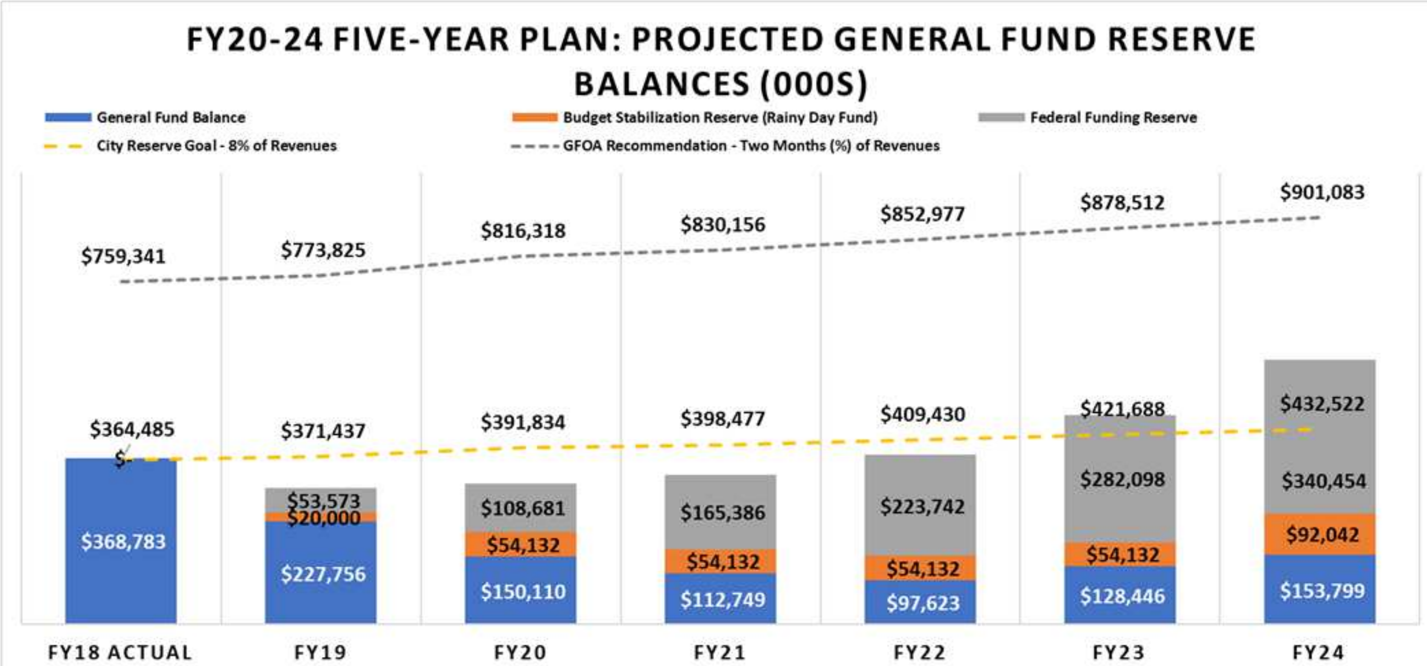


Figure 3

The figure above highlights the projected reserve balances over the course of the 5YP, assuming the reserves are not utilized. In FY22, when the General Fund balance hits its lowest point, the City is projected to have deposited $54.1 million into the "Rainy Day Fund", while a cumulative $223.7 million will have been appropriated in the Federal Funding reserve, which equates to $277.8 million in reserve funding (in addition to the $97.6 million General Fund balance).

If the City does not need to draw from these reserves, there will be ample liquidity. If there is an unforeseen downturn or cut to funding, the City will be in a better position to meet obligations without a tax increase.[3] Although the funding threats from Washington have not yet had a material negative impact on the City's budget during this presidency, the continued threats to affordable housing and public safety funding – which the City relies on for operations – cannot be ignored.

Proposed Changes to Expenditures and Revenues

Although the Mayor's proposed budget includes expanded investments in programs and infrastructure, **this plan, while continuing the Wage and BIRT Tax cuts contained in last year's 5YP, does not include a tax increase in FY20.** Most notably, the 5YP includes the following investments over the course of the Plan:

- $800 million increase over the course of the 5YP in the City's contribution to the School District. This is a continuation of the plan enacted by Council during the last budget process.
- Contributing $80 million to the Housing Trust Fund, paid for through dedicating revenue attributable to expiring Real Estate Tax abatements.
- $12.5 million to the Free Library of Philadelphia in order to expand library service to six days a week during the school year.
- $1.9 million annually to the Office of Property Assessment to improve data collection and system modelling.

[3] The labor reserve is not included in the chart because it is a reserve for an expected and likely expenditure. Page 40 of the Plan shows that all of the cities' labor contracts end on 6/30/2020 and is likely to exceed the anticipated labor reserves. The rest of the reserves are for unanticipated expenditures.

- Additional investments in the Streets Department: $2.3 million annual investment for street cleaning, and a $200 million capital program meant to increase the rate of repaving to 131 miles annually from the current rate of 95 miles annually.
- $746.5 million to the Pension Fund in FY20, $51.4 million above the Minimum Municipal Obligation (MMO).

The proposal does not include significant budgeted increases for Class 100 (excluding pension or health costs), averaging year-over-year increases of 0.9% between FY19 and FY24. As shown below, the largest year-over-year increases are in Class 500 (Contributions, Indemnities, and Taxes), which are anticipated to increase 11% in FY20 and 9% in FY21. **However, increases in Class 500 reflect the discretionary decision to increase funding to the School District through the grant line-item.** This School District grant line-item, as well as the Class 700 line-item for debt service, should not increase unexpectedly. At the same time, the 5YP projects modest revenue growth over the course of the Plan. The City's largest revenue streams – Wage and Net Profits and Real Property taxes – are projected to grow between 2.4% and 4.0%[4] annually through 2024. Overall, the fastest growing tax is the Sales Tax, which is projected to grow an average of 4.7% over the Plan.

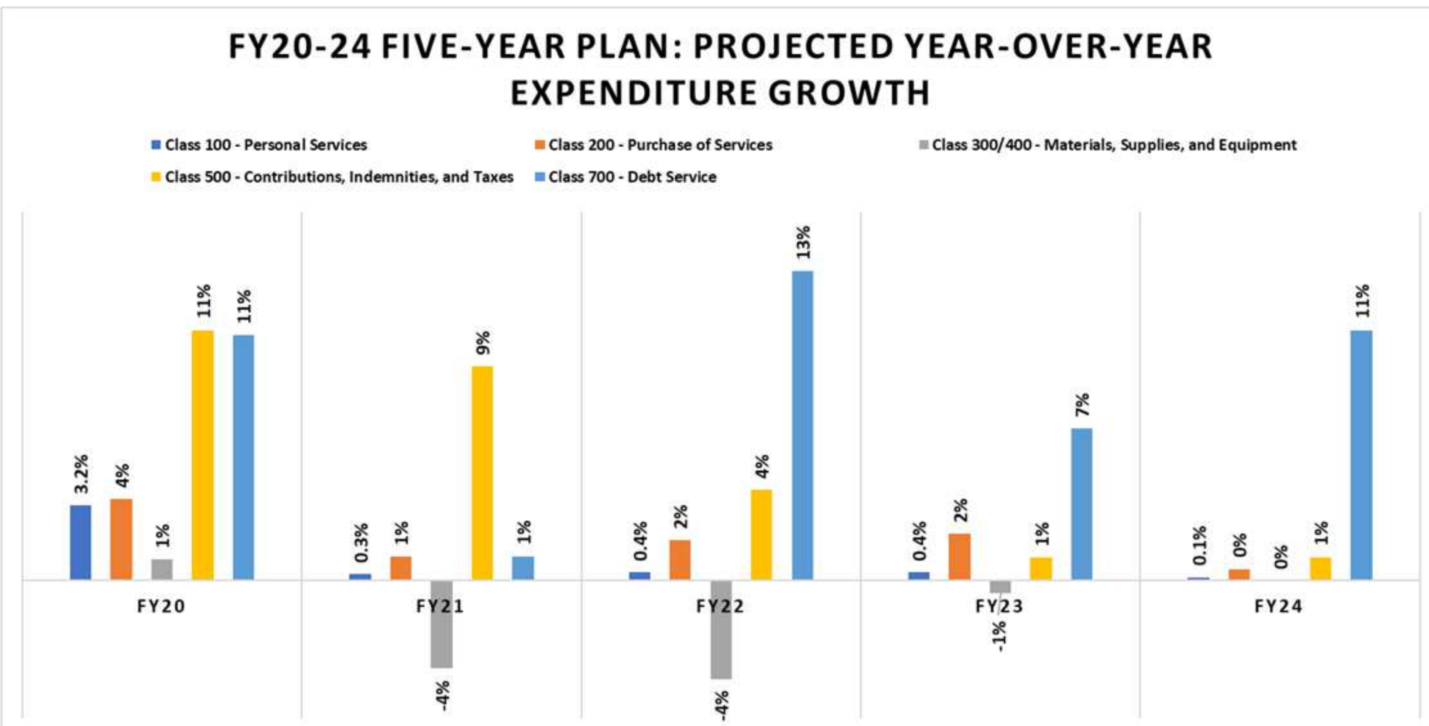


Figure 4

[4] The Real Estate tax is projected to grow 8.0% in FY20. However, this is artificially inflated due to the high number of Real Estate appeals that are ongoing. Once the appeals are settled ─ due to City Council's "tolling" bill ─the difference between FY18 and FY19 will be satisfied.

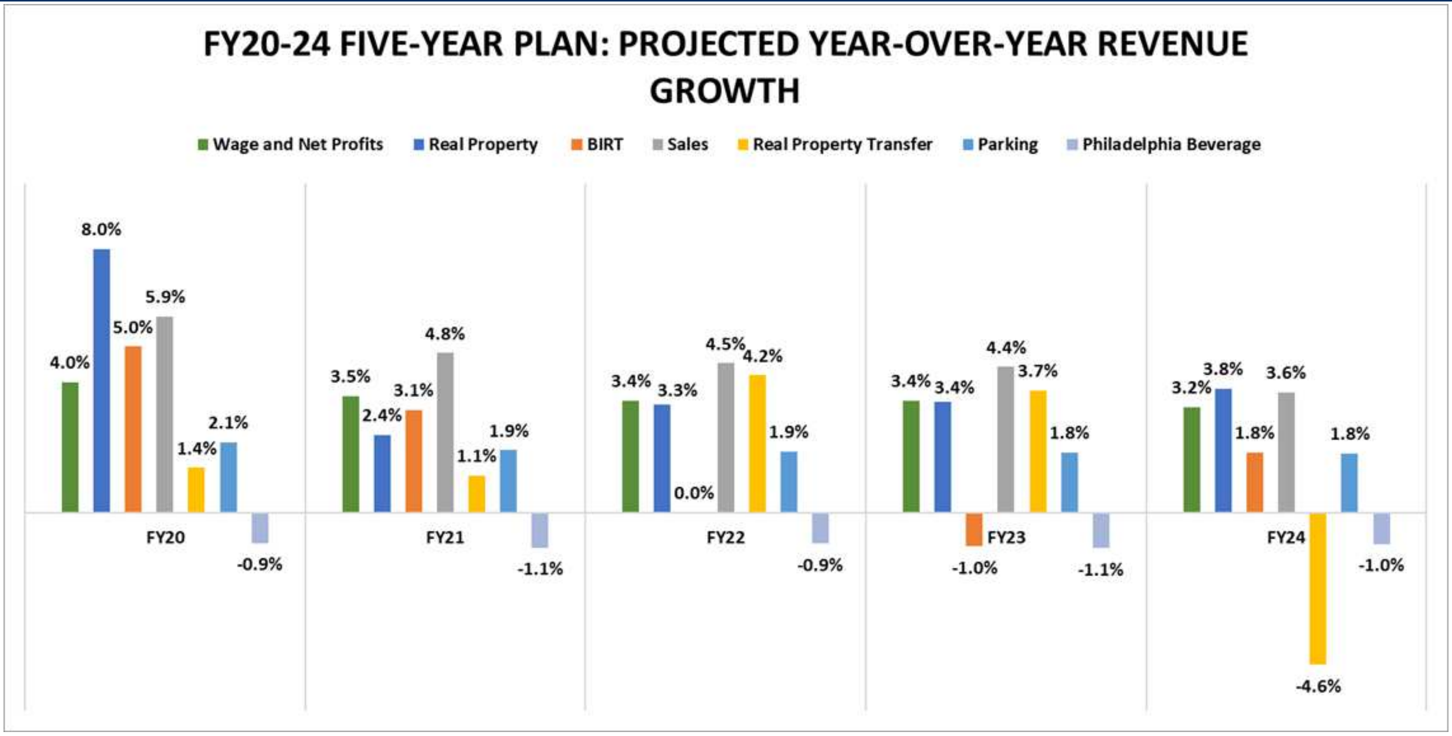


Figure 5

As highlighted earlier, the City is budgeted to send $746.5 million to the Pension Fund, a projected 14.9% of the City's General Fund budget. Last March, prior to the start of the City's budget hearings, the City's credit was downgraded from A+ to A by S&P.[5] One of the main points of concern for S&P was the City's persistent *net pension* liability – the difference between the present value of future benefits and the assets held by the Fund. However, the current costs in the short-term can be explained alongside the large strides the City has taken in stabilizing the Fund over the long term.

Examples of positive steps taken to address the pension challenge are:

1. The increase in City employee contributions from current and new employees;
2. The establishment of stacked-hybrid plans for new employees (capping defined benefit at $65k)
3. The implementation of a Revenue Recognition Policy (RRP), which ensures that all additional distributions to the Fund above the Minimum Municipal Obligation (MMO) are not calculated in the MMO – allowing for said additional revenues to more directly attack the unfunded liability; and
4. The improvement of the "support ratio" (inactive-to-active employee ratio).

The Pension Fund cannot be fixed overnight, but there are strong signs that important structural changes implemented by the City have put the Fund on the path to long-term solvency. In plan year FY18, an extraordinarily significant threshold appears to have been achieved: **The Pension Fund's Actuarial Valuation Report preliminarily shows that net cash flows will be positive -- preliminarily at +27M – and projected to remain flat moving forward.** To be clear, more cash was contributed to the Fund than was paid out to beneficiaries with respect to FY18. When net cash flows are positive it means that **the Fund has significantly decreased its investment risk – and is not relying on current investment returns to pay current obligations, allowing the Fund's investments to grow, and to attack the unfunded liability more directly.**

[5] S&P Credit Rating: City of Philadelphia, 3/26/18

Philadelphia's Persistent Poverty

Data provided by the Census Bureau's American Community Survey underscore the importance of the priorities taken up by City Council and the Mayor. As highlighted by the Mayor in his address, Philadelphia has maintained a persistent level of poverty over time. **Although the rate of poverty has inched down since 2013, it remains at 25.8%, the highest of any large municipality.** Additionally, the rate of *deep poverty* ─$12,129 for two adults with two children ─ is currently 12.5% and has remained flat.

Although the number of Philadelphians in poverty has increased since 2010, the poverty rate has not increased, as the population has seen a similar increase in citizens above the poverty line. Most notably, a large group of the population in *deep poverty* were part-time workers, the number of which has remained constant over the decade. **In 2017, there were approximately 31,520 Philadelphians who were employed part time and 50% below the poverty threshold, compared to 31,923 in 2010**. For the population of those in deep poverty: 2,259 were employed full time, 31,520 were employed part time, and 93,538 were not employed.

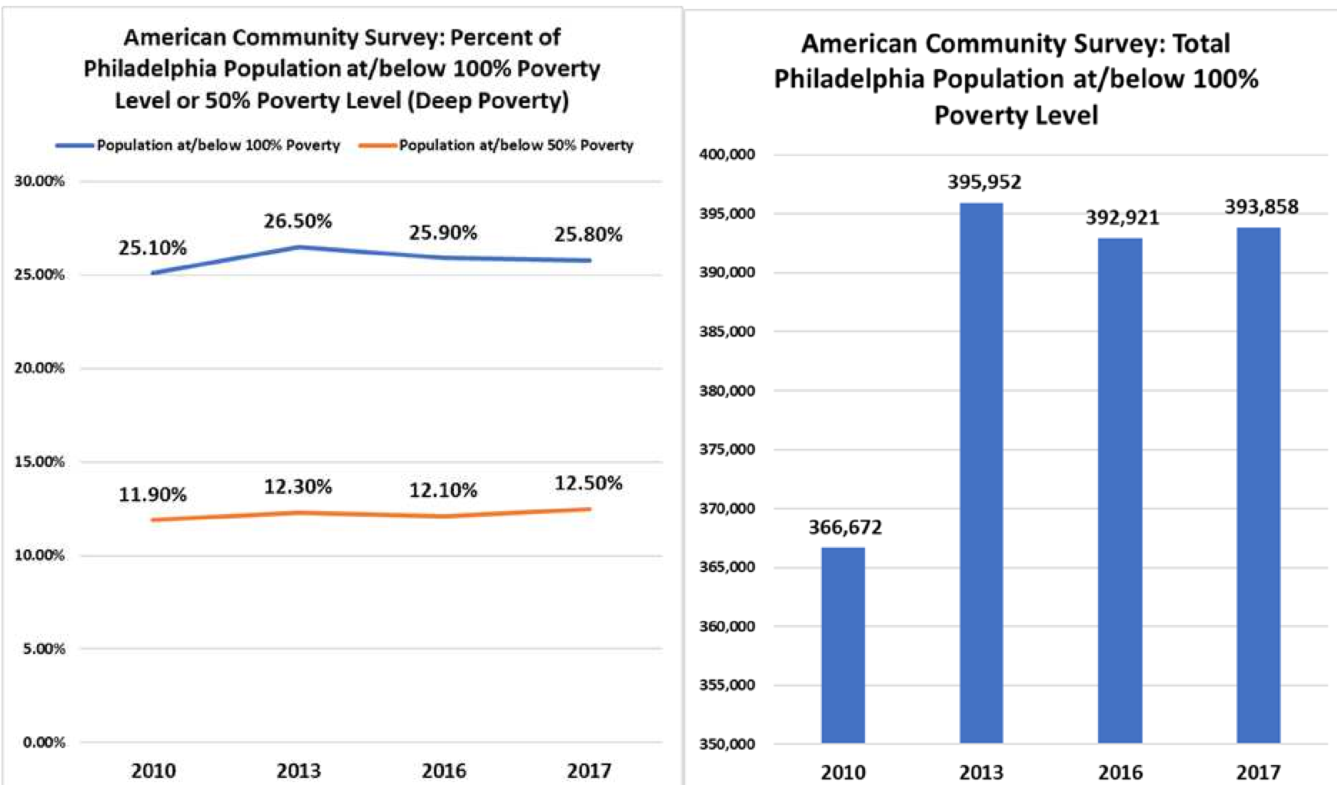


Figure 2 & 7

The data show a connection between full-time employment and poverty status. **Although the number is still discouragingly high, only 3.6% of full-time workers fell below the poverty line – 16,270 workers in 2017 ─ compared to 27.6% of part-time workers.** Part-time workers, who receive limited benefits (i.e., healthcare, paid sick leave, etc.), can be a hidden piece of a seemingly healthy economy. These "involuntary part-time" or "underemployed" workers bring down the unemployment rate, but desire (and need) additional work and benefits.

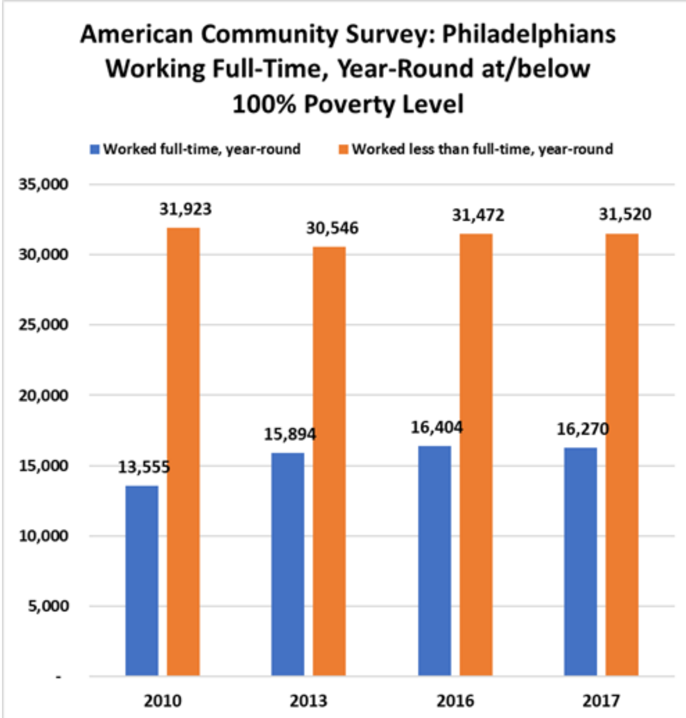


Figure 8

Philadelphia's High-Income Growth

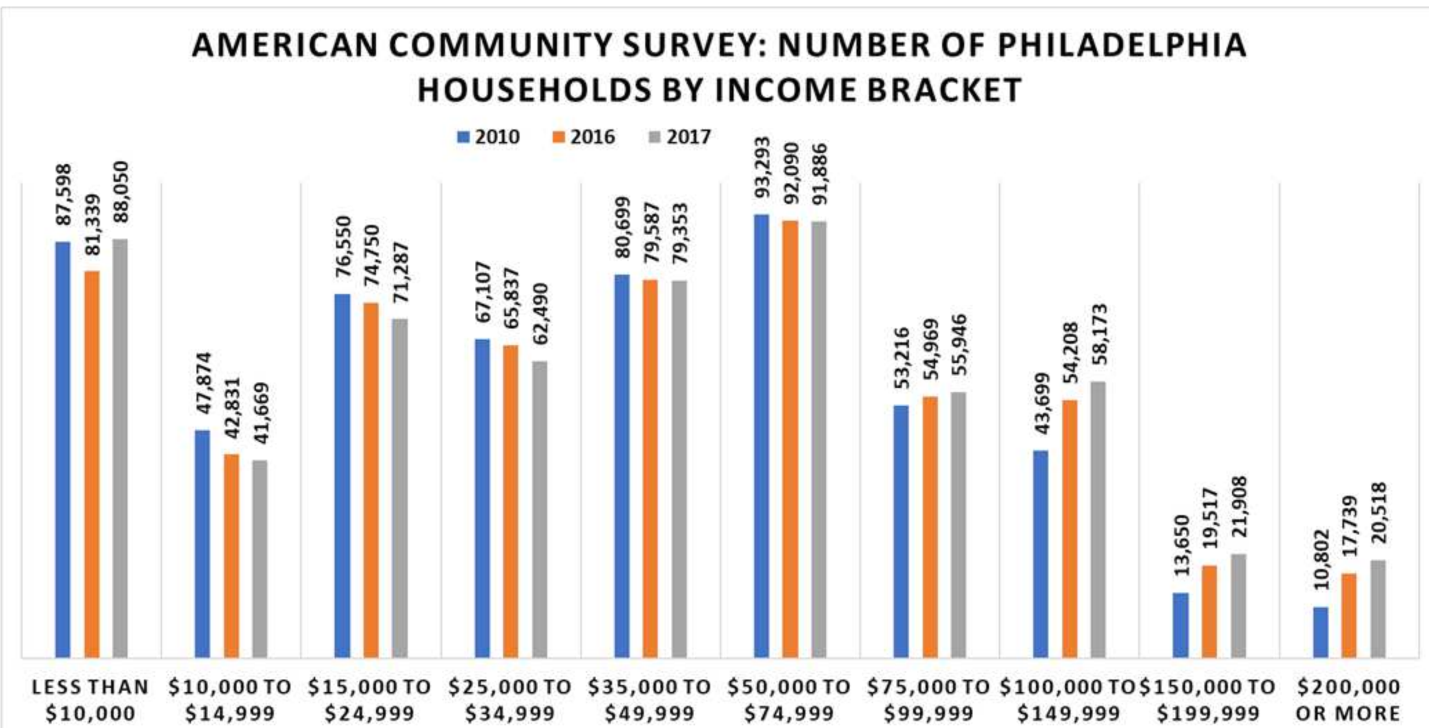


Figure 9

As highlighted in *Figure 9*, Philadelphia has experienced significant growth in "high-income" households. From 2010 to 2017, the City of Philadelphia experienced across-the-board growth in all households with incomes higher than $75,000: **The City has gained approximately 8,258 households with incomes between $150,000 and $199,999 and 9,716 households above $200,000 in income.** While this is certainly a positive trend as it concerns Philadelphia's economy and its citizens' overall quality of life, it is also perhaps an indicator of the City's "gentrification," and growth in high-value neighborhoods, where new residents with higher wages – as opposed to existing residents enjoying income increases – push property values up.

As this report will highlight further, Philadelphia has seen a steady increase in the cost of housing. **According to the Federal Reserve Bank of Philadelphia, "Gentrifying neighborhoods lost low-cost units at nearly five times the rate of non-gentrifying neighborhoods."[6]**

On a positive note, the growth in higher-income residents may explain the City's robust growth in Wage and Earnings Tax revenues. **At our current resident tax rate of 3.8809%, an additional 9,716 households earning $200,000 annually would pay $75.4 million annually in wage taxes. In FY12, the City collected $1.2 billion in wage taxes, rising to $1.54 billion in FY18 while the tax rate incrementally decreased.** The 5YP projects that by FY24, Wage and Net Profits receipts will be $300 million higher than FY19 collections, even as tax rates slowly decline:

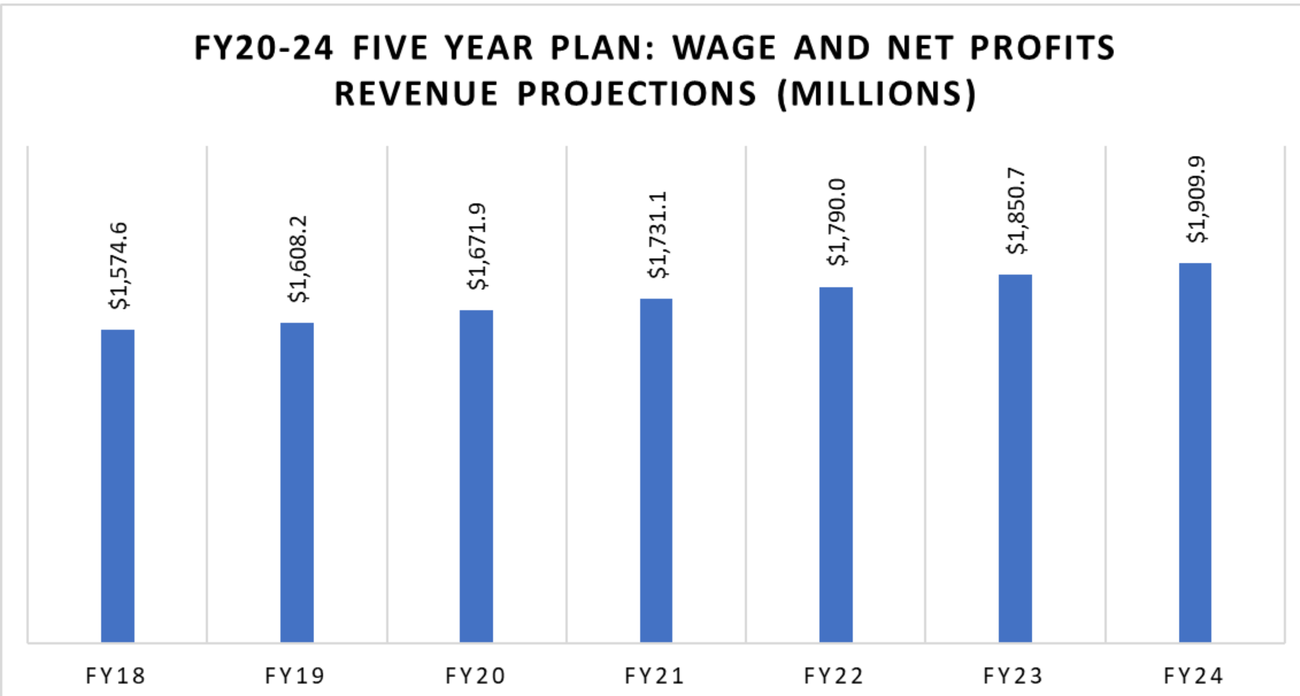


Figure 10

Eds, Meds, and Retail

The changing landscape of Philadelphia's careers helps to provide insight as to why incomes are rising. As shown in the figures that follow, more Philadelphians are entering the "Eds and Meds" sector. Between 2010 and 2017, an estimated 24,194 Philadelphians entered the field of *Educational Services, Health Care, and Social Assistance.* An increase in the availability of these jobs is an overall positive for Philadelphia, as these jobs tend to provide higher wages and are much more resistant to shifts in the business cycle – sometimes being referred to as "recession-proof" jobs. Currently, the three largest non-government employers in Philadelphia are the University of Pennsylvania, Temple University, and the Children's Hospital of Philadelphia.[7]

[6] Gentrification and Changes in the Stock of Low-Cost Rental Housing in Philadelphia, 2000 to 2014.

[7] Pennsylvania Department of Labor and Industry – Center for Workforce Information and Analysis – 1st Quarter 2018

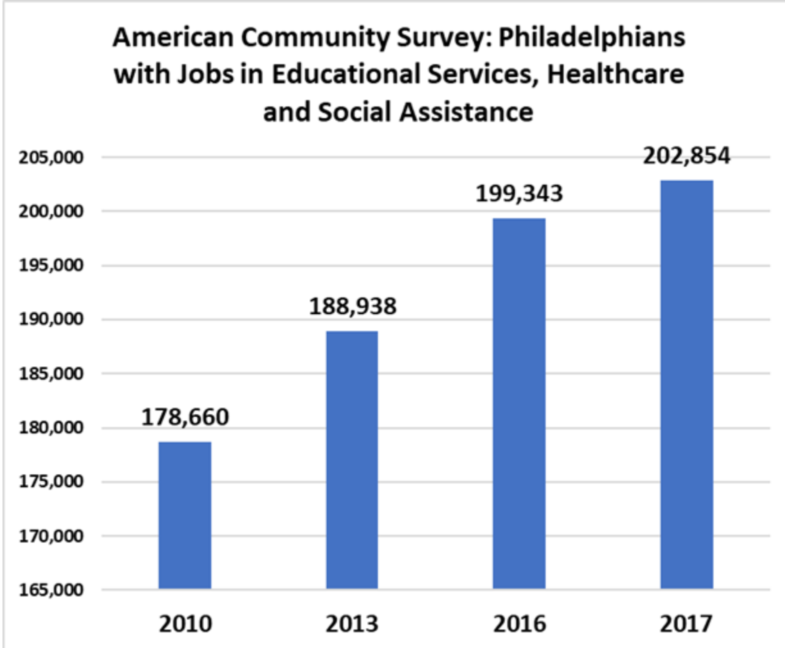
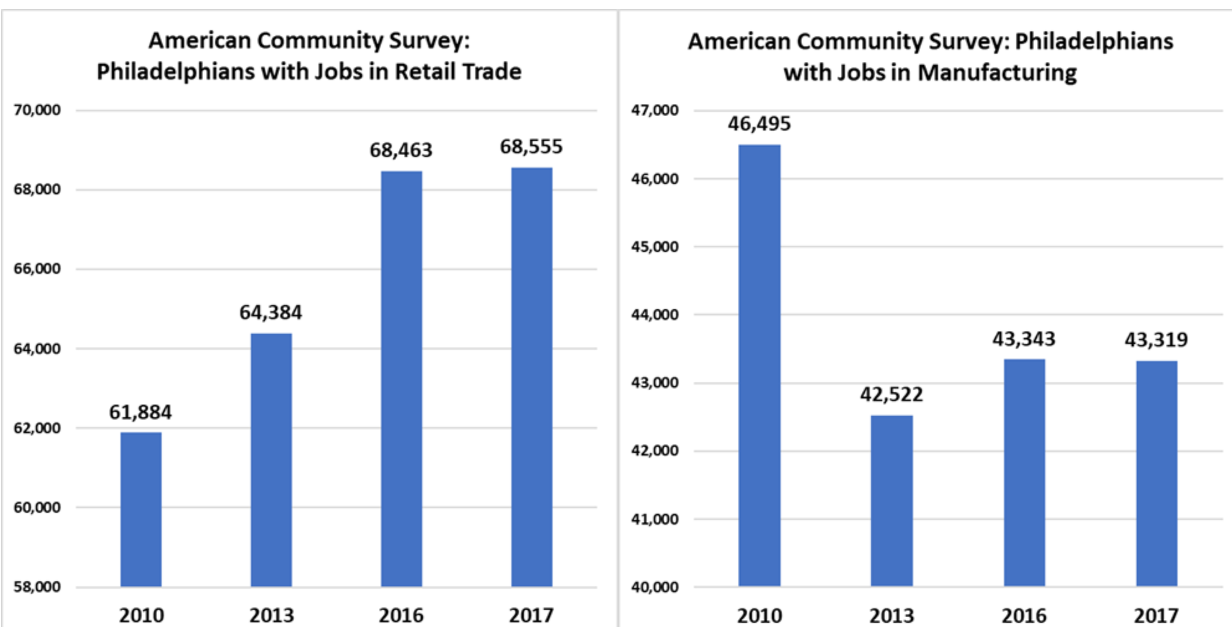


Figure 11

At the same time, the trends of blue-collar employment are concerning. As shown below, the number of Philadelphians in manufacturing decreased dramatically from 2010 to 2013. While that decline reversed slightly through 2017, the total number of jobs remains substantially below 2010 levels. These jobs, which provide an estimated median wage of $18.30/hr., have historically been the backbone of Philadelphia's economy.[8] While the decrease in manufacturing has a multitude of explanations, including the offshoring of jobs to nations paying lower wages, it is also important to note the significant increase in the productivity of workers and increases in technological automation: Since 1987, the U.S. has lost 29% of its manufacturing jobs, while increasing overall output by 85%.[9]

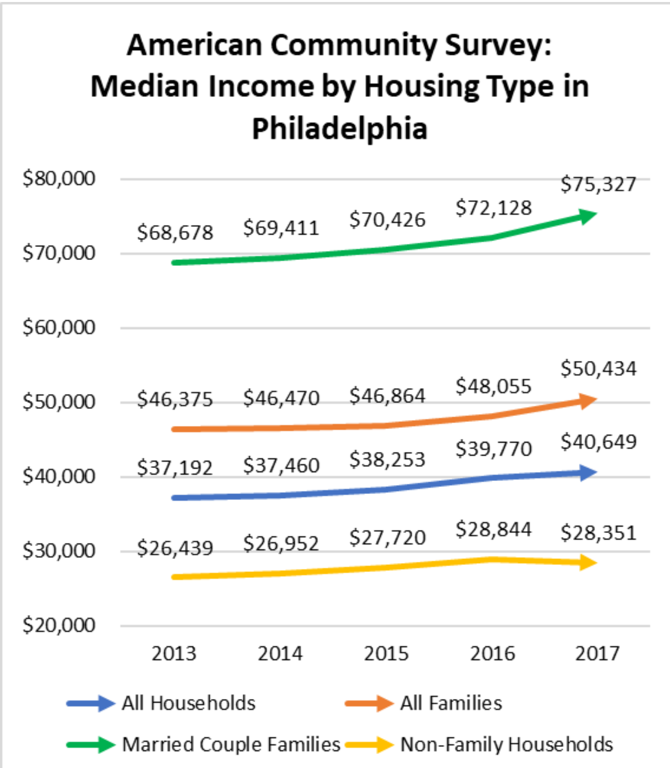


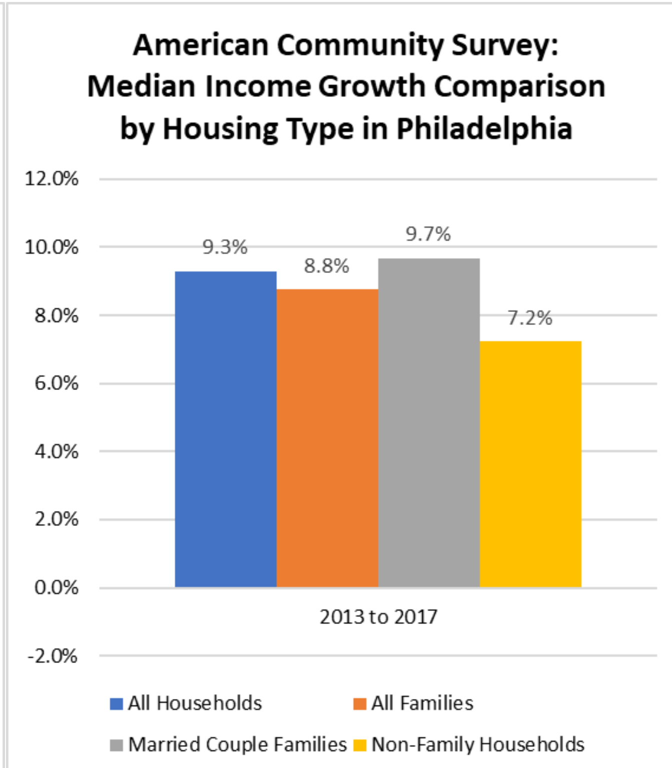
Figures 12 & 13

[8] Bureau of Labor Statistics: National Occupational Employment and Wage Estimates United States- Production Occupations, as of 12/13/18

[9] Pew research: "Most Americans unaware that as U.S. manufacturing jobs have disappeared, output has grown"- July 2017

Outside of *Eds and Meds*, the fastest growing job sector is *Retail Trade*. While the growth of this sector is welcome in a city with structurally high unemployment, these jobs are often plagued by unpredictable schedules and low pay. According to the Bureau of Labor Statistics, the average wage for a *retail sales worker* is $10.77/hr..[10] Given this fact, an affordable place to live – using the Census' 30% of gross income threshold for determining affordability – would cost $560 per month. **According to the current 5-year estimates, however, the *Median Gross Rent* for a housing unit in Philadelphia is $970 per month, and is therefore considered unaffordable to the average retail trade employee.**





Figures 14 & 15

Although each household type increased similarly on a *percentage basis*, these households did not see similar increases on a *dollar basis.* As shown in Figure 14, since 2013, median income has increased, on a dollar basis, for *married-couple families* by $6,649 (9.7%) compared to a $1,912 increase for *non-family households* (7.2%).[11] This is important, as *marginal propensity to consume (MPC)* is higher as a household's income decreases. The MPC variable is a measurement of the *percentage increase in consumption associated with increases in disposable income*. **More simply, if a family with an income of $20,000 receives an additional $500 in wages, they are much more likely to spend that $500 than a family earning $200,000. Due to this fact, any local tax relief given to low-income households – whether it be LOOP, the Homestead Exemption, or the Tiered Assistance Program – pays significant dividends due to the marginal value of increases in income.**

Homeownership Trends

There are some worrisome trends that we have observed over the decade, most notably regarding Philadelphia's homeowners. As shown in Figure 16, **Philadelphia is likely experiencing a decline in the number of homeowners over the long term.** Although the ACS shows an estimated increase from the 2016 release to the

[10] Bureau of Labor Statistics: "National Occupational Employment and Wage Estimates United States", as of 12/13/18

[11] Note, the Census defines households as "family" or "non-family' households. A family household is a home in which members are related, where non-family households have members who are not related or married to one another. A married-couple family is a subset of family households, where the primary relation is marriage.

2017 release, the decrease from 2010 is notable, as it falls far outside the +/- 3,618 margin of error. Not only is the number of homeowners declining, but the age of homeowners appears to be rising.

As shown in Figure 17, the number of homeowners below the age of 54 decreased from 2010 to 2017, while the number of older Philadelphia homeowners increased. Millennial homeowners have decreased by approximately 5,763 between the 2010 and 2017 estimates, while homeowners aged 35-to-44 and 45-to-54 years old decreased 6,860 and 7,277, respectfully. The combined 19,900 reductions in homeowners under the age of 54 were partially offset by a combined increase of 12,980 homeowners between the ages of 55 and 74.

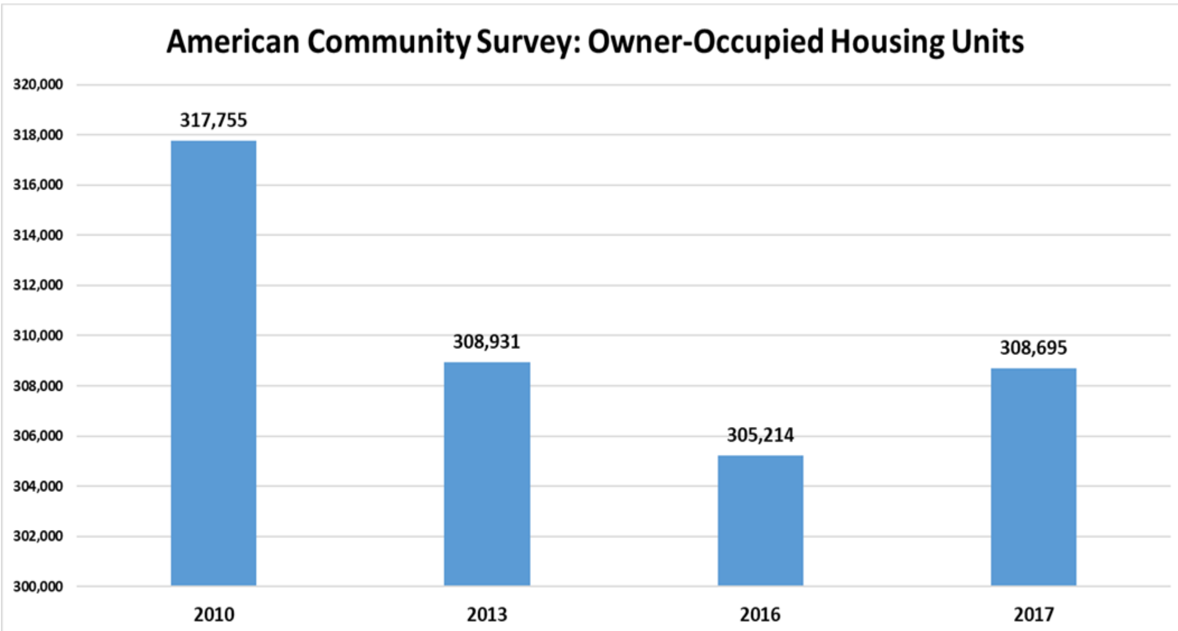


Figure 16

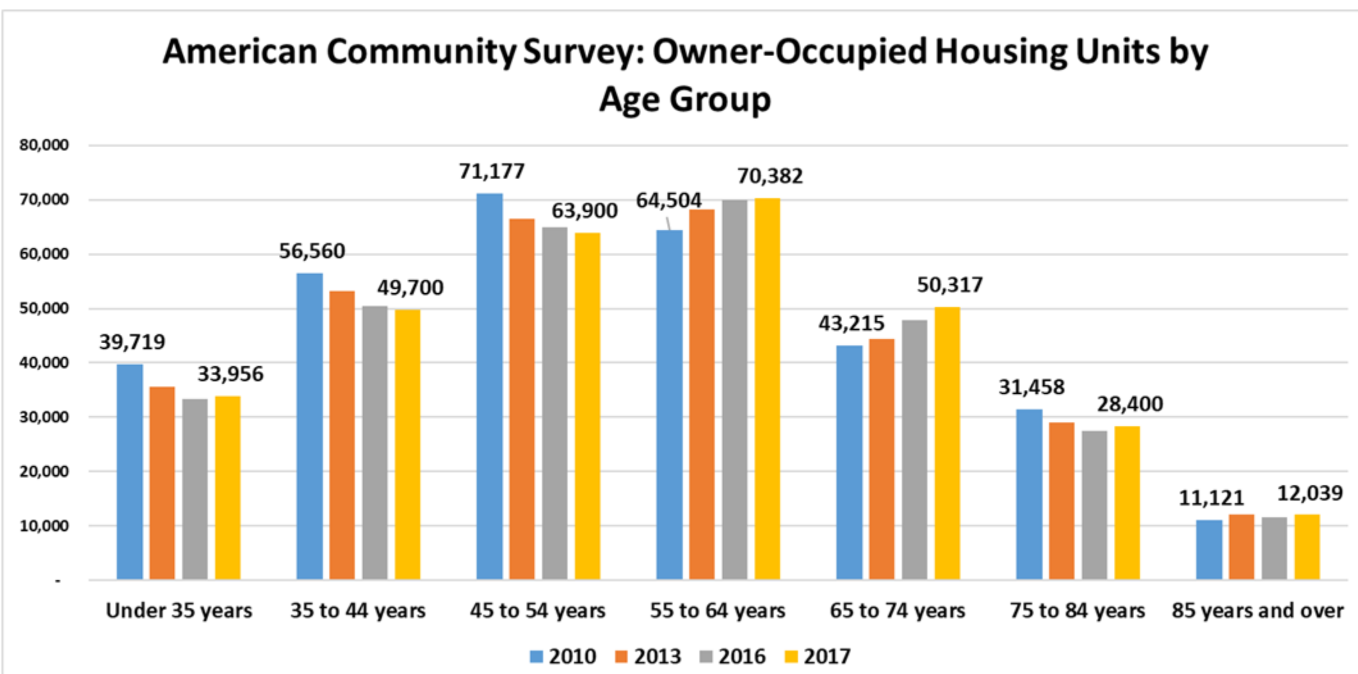


Figure 17

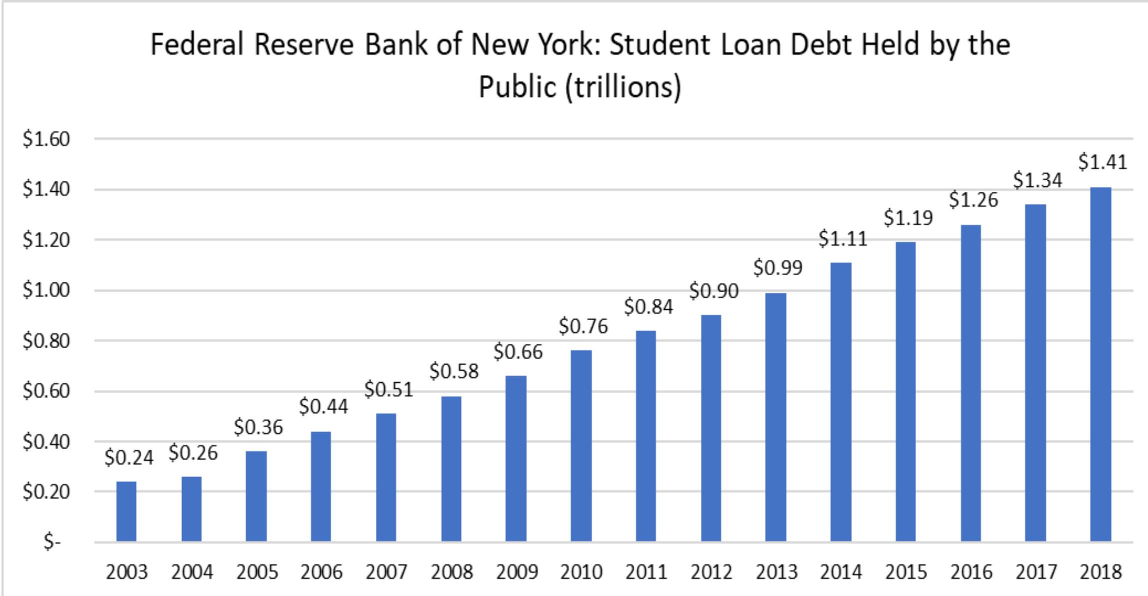
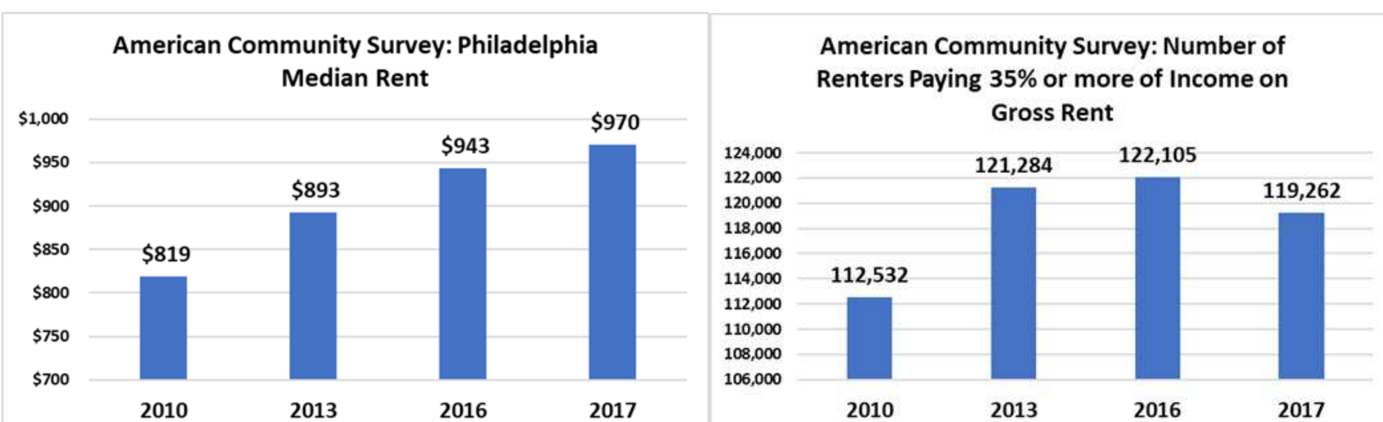


Figure 18

One of the largest impediments to homeownership is student loans, and the resulting difficulty of saving for a down payment. As shown in the Figure above, student loan debt has dramatically increased over time, as the rates of homeownership decrease. **In 2003, the population carried a collective student loan debt of $240 billion, increasing five-fold to $1.41 trillion by 2018.** Since mortgage lenders typically require a debt-to-income ratio of a third of a borrower's income, every additional dollar toward student loan payments decreases the amount one can borrow for a home. Moreover, while Americans were saddled with increasing amounts of student loan debt, the price of housing dramatically increased. Between 2003 and 2018, the median price of homes sold increased 74.7%, from $186,000 to $325,200.[12]

A similar trend has been seen in Philadelphia. From 2003 to 2017, the median value of occupied housing nearly tripled, rising from approximately $50,000 to a current value of $151,200.[13]

According to the FY17 ACS, the median rent for occupied units in Philadelphia is approximately $970 per month. This has steadily increased since 2010, when the median rent was $819 per month. This increase in median rent has likely influenced the increase in the number of "rent-burdened" units – **currently, the occupants of 119,262 units are paying more than 35% of their income on rental costs.**



Figures 19 & 20

[12] St Louis Federal Reserve: Median Sales Price of Houses Sold for the United States

[13] Philadelphia Price Indices: Kevin Gillen, Ph.D.

The 2017 ACS datasets do not show any dramatic year-over-year changes in Philadelphia's income, housing statistics, or job market. Rather, these changes happen gradually over time. This is why it is critical that City Council continue to monitor the trends of declining homeownership, evolving job market, stagnant poverty and growth of high-income households, as highlighted in this report.

Conclusion

City Council's continued focus on housing preservation, housing affordability, and job stability will potentially aid in reversing some of the negative trends the City has experienced since the beginning of the Great Recession. As City Council moves forward toward the FY20 budget process, City Council's Finance and Budget Team and Technical Staff will continue to monitor and provide details on the litany of datasets provided by the Census, in order to enable the City to more strategically distribute its resources.

This proposed Five-Year Plan reflects the City's need to manage growth, reduce poverty, and aid the School District in achieving long-sought fiscal stability. Over the next eight weeks, Council's challenge will be to explore numerous ways to achieve these goals by comparing proposed revenue solutions with possible alternatives.