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Intergovernmental Cooperation Authority
For
Cities of the Second Class



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PRELIMINARY REPORT

INTERGOVERNMENTAL COOPERATION AUTHORITY

CITIES OF THE SECOND CLASS
PITTSBURGH, PENNSYLVANIA

APRIL 12, 2004

I. Introduction

Pursuant to Section 203(c)(5) of the Intergovernmental Cooperation Authority Act for Cities of the Second Class, the Authority submits this Preliminary Report to the Honorable Edward G. Rendell, Governor of Pennsylvania, and the General Assembly of the Commonwealth of Pennsylvania in pursuit of our charge to make recommendations to the Governor and the General Assembly regarding legislation or resolutions which relate to an assisted city's fiscal stability. The Intergovernmental Cooperation Authority (ICA) presents these preliminary recommendations concerning the fiscal stability of the City of Pittsburgh.

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While the preliminary nature of this Report must be emphasized in light of the fact that the ICA has been operational for only forty days, it is clear that the City is in major financial distress requiring immediate supervised action by the ICA to address its short-term challenges. The long-term financial plight of the City is even more important. It will require continuous long-term supervision by the ICA to assure the development and implementation of a sound and fair financial plan that will not only avoid any replication of the current crisis but will provide the City with a plan to foster major economic growth and the highest quality of life.

II. ICA and Act 47 Coordination

Prior to the appointment of ICA members, studies of the distressed financial condition of the City of Pittsburgh under the Municipalities Financial Recovery Act (Act 47) were in progress. The ICA recognizes the differences in the statutory responsibilities of the two entities, particularly the ICA's responsibility to assure the long-term fiscal integrity of the

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City. The ICA recognizes its fiduciary responsibility to make independent judgments that require independent investigations and studies of all dimensions of the City's current financial plight. Beyond the individual and team efforts of its members, the ICA has, in accordance with the Act, appointed an executive director with extensive background in the analysis of distressed cities in Pennsylvania. It also has contracted with independent experts in areas such as pensions, health benefits, and worker's compensation, and it is currently interviewing experts in other areas such as public safety to insure the most comprehensive analysis of the issues and the creation of sound recommendations.

III. Basic Challenges to the Creation of a Sound Financial Plan

A. Pittsburgh Past and Present

It is well known that the loss of manufacturing has had a devastating effect on the City of Pittsburgh. Notwithstanding its development as one of the leading education and health care centers in the country, the City has steadily declined in population. Once the 8th largest

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city in the United States, it is currently ranked 54th among cities with populations of 100,000 or more. From a population of 604,332 in 1960, Pittsburgh's population had declined to 423,938 in 1980. Ten years later, the number had dropped to 369,879. The 2000 census showed a huge decline of 9.5 percent to 334,563. As of 2002, the City of Pittsburgh recorded a population of 327,898, little more than half of what it was in 1960.

B. Pittsburgh Worker Population

Of the 324,986 people who work in the City, 203,427 of these workers live in adjacent municipalities, counties, or states. Like City residents, they require the services of the City. They share the tax burdens of a diminishing resident population by paying the RAD tax, parking and amusement taxes, and contribute to the economics of the City by virtue of their presence.

C. Immediate Deficit

The major declines in the tax base have not been offset by corresponding reductions

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in City expenditures. Instead of long-range strategic planning and realistic decisions, the City has pursued stopgap measures that have resulted in major fiscal distress. The immediate ICA challenge was to determine the truth concerning the current City deficit. The Mayor had been quoted as stating that the City had a \$40 million deficit and would run out of money in 2003. The ICA called upon other City officials and examined the relevant materials. Unlike the Mayor's prediction, the Director of Finance for the City, the City Controller and the Director of Finance for City Council state that the City is likely to confront a four to six million dollar cash flow deficit by December 2004, or early January 2005. While the estimates from these critical sources differ slightly, there is unanimous agreement among these officials that the City will not be able to pay its employees or bills in January of 2005 if no action is taken.

D. Long-Range Deficit Challenge

Beyond the immediate challenge, the more serious challenge is the long-term City debt of more than \$935 million of bonded indebtedness. The Pittsburgh debt per capita of

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\$2,800 is the highest for cities of comparable size. The debt service alone requires an expenditure of \$90 million annually, placing an average obligation on every man, woman, and child in Pittsburgh of \$274 per year, the highest per capita debt of any comparable city in the United States. The overall tax burden to City residents averages \$850 per year compared to \$500 or less in comparable cities. The challenge of reducing the City's annual debt payment of \$90 million has been made prohibitively difficult because the City, in stopgap efforts, refinanced the debt a number of times with non-callable bonds at a rate of interest at or above 6.5 percent. Even under the dubious assumption that the debt represented by non-callable bonds could be refinanced, the City's continuous refinancing of the debt over the last ten years would make still another refinancing more than doubtful under Internal Revenue Service rules. As a direct result of these financing tactics almost 25 percent of the City's revenues must be committed for debt service. A further consequence is that the outstanding debt is currently rated as non-investment grade. It also must be stated that by comparison, as the City was entering into these transactions with no call features, various

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Authorities within the City were issuing debt but instead used call features that have allowed them to refinance and achieve real savings. The consequence to the taxpayers of the city for the use of non call features is conservatively estimated to be millions of dollars per year in unnecessary added costs paid from the city budget.

With a growing unfunded pension liability, the City incurred some \$280 million in non-callable Pension Obligation Bonds (POB's). By comparison, other governments have issued POB's, but as callable bonds, i.e., when interest rates go down, the outstanding bonds may be recalled and paid by the government which then issues new bonds at the lower interest rate saving millions of dollars. Since Pittsburgh gambled by issuing non-callable bonds, it cannot recall these bonds and take advantage of the very low interest rates that have been experienced in recent years. It is our opinion that the financing structure of these bonds was ill advised and a tragic error that disadvantages the citizens of the City of Pittsburgh and this entire region. Further, the City pledged \$7.5 million of the Regional Asset District (RAD) revenues annually until the year 2015 as repayment for a \$60 million URA venture.

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Differing opinions aside, the fact remains that over the next decade an additional \$75 million will be spent for debt service on projects that now appear to be worth \$30 million.

E. The Counterproductive Tax Structure

The existing tax structure of the City is a curious assortment of levies that have a negative effect on locating a business in the City. In order to overcome the negative tax policy and structure, that policy must be reinvented. The ICA will aggressively study and compile testimony and input to that end.

F. Public Safety

Pittsburgh's per capita spending on public safety in 2002 was \$541 compared to \$349 for comparable cities. Public safety now absorbs more than 50 percent of the annual City budget in salaries, pensions, health care and workers compensation. As a percentage of the overall tax burden to City residents the percentage is closer to 60% of taxes paid. Pittsburgh is spending \$60 million more per year in public safety than similar cities. It must be noted

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that under Act 111, all police and firefighter contracts are subject to arbitration to insure uninterrupted public safety. However, since the public safety budget consumes such a large part of the current budget resources, a major review of all contracts, practices, and spending patterns including such provisions as no cut or minimum staffing clauses must be conducted.

G. Pensions, Workers Compensation and Health Care

The City pension plan recorded an unfunded pension liability of \$375 million as of December 2003. After preliminary review of the actuarial assumptions used by the City to support those numbers, the ICA believes the amount to be significantly higher. After preliminary assessment, the ICA believes the yearly pension cost will actually increase in order to chip away at the unfunded liability, but rather than speculate, the ICA will produce an independent set of facts using more realistic assumptions. The City's workers compensation payments exceed those of comparable cities. Two major factors contributing to this situation are the large proportion of public safety employees in the City and State law requiring 100 percent compensation for injuries incurred in the line of duty. There is a

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financial incentive for the injured party to remain at home to earn more. Based on testimony of current City officials, health care and medical insurance costs are currently at \$30 million annually. City officials projected a growth rate of 8 percent annually in these costs. Preliminary indications are that this projection is significantly understated. The ICA intends to fully examine this issue and expects that substantial changes will be necessary.

H. Duplication of Services-City and County

Notwithstanding extensive studies, meetings and discussions concerning the unnecessary and costly duplication of services between the City and Allegheny County over many years, the coordination of duplicative services has produced only limited cost reductions. Excessive duplication continues. Currently, the City and County officials are, again, pursuing discussions aimed at improving service and reducing costs.

I. Authorities and School District

The participation of the Authorities such as the Urban Redevelopment Authority and

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the Parking Authority as well as the Pittsburgh School District in comprehensive financial planning for the City is critically important. The ICA is currently studying the potential contributions by other City Authorities and discussions have begun with the School District to determine its potential contribution to a sound and fair strategic plan. The initial scope of the ICA review will be limited to those municipal authorities that receive financial assistance from the City and those municipal authorities whose debt obligations are paid or guaranteed by the City. Since it currently enjoys a \$90 million dollar budget surplus, the ICA also calls on the Pittsburgh School Board to immediately redirect the expected \$4 million RAD payment from the city to be used to open the swimming pools and recreation centers. The ICA is prepared to work with the School District and City to intercept those funds and insure that the money is used for the purposes of providing necessary relief to the current freeze imposed by the City Administration.

J. Non-Profits

The Constitution of the Commonwealth prohibits the direct taxing of not-for profits,

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broadly defined for the purposes of this report. However, the ICA intends to reach out in a cooperative manner and ask the non-profit community to participate in the recovery of the City. While it is essential for the non-profit community to continue to pursue their various missions, it is essential they participate in a meaningful way to the overall recovery of the City.

IV. Meeting the Challenges

A. Long-Term Challenges and Goals

The long-term challenges of the City, particularly its unfunded debt, require extensive investigation to determine what remedies can be applied. The City's repeated refinancing and issuance of non-callable bonds suggests that the City, alone, may find it prohibitively difficult to meet this challenge. While the ICA will continue to pursue this challenge, a remedy for this significant dimension of the City's plight may require Commonwealth assistance in the long term.

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The current major expenditures in pensions, workers compensation and health care raise other major challenges. While the ICA is pursuing studies of these dimensions with the assistance of experts, preliminary studies suggest the necessity of major increases in both pension and health care costs while workers compensation expenditures may be reduced.

Substantial reductions in expenditures for public safety must occur while insuring optimum public safety for the residents, workers and visitors in the City. While some limited reductions in these expenditures have begun, substantial reductions must begin to occur in 2005 and continue thereafter to insure the ability of the City to defray these expenditures in perpetuity. Beyond the fire and police departments, a comprehensive plan must be created for 2005 to react effectively to the cost of Emergency Medical Services.

The goal should not be merely to reduce costs to a tolerable level that will allow the City to stumble along without major financial crises. The goal must be to convert the City to a vibrant center of economic development with an enhanced quality of life. This goal

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cannot be achieved unless costs of doing business and living and working in the City compare favorably to other places where so many former Pittsburghers now live and work. The long-range focus should not be on how tax revenues should be increased to allow the City to survive, but how they may be decreased to make the City and the County more attractive to future growth possibilities.

The ICA is convinced that, with proper planning and a culture change in the management of the City, these long-range goals can be achieved. The ICA will continue its exploration of these goals and present specific recommendations in a subsequent report to the Governor and General Assembly.

B. Immediate Challenges and Recommendations

The immediate impact of the financial distress of the City is that it will not be able to meet basic obligations sometime in January of 2005 and requires immediate redress. The current City administration believes that it deserves new revenue streams from sources

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outside the City to meet its obligations while it insists that it cannot reduce expenditures further. Critics insist that the City can assure solvency exclusively through steep reductions in City expenditures. The ICA finds neither view to be supportable.

(1) Reductions in Expenditures-Structural Changes

While the City cannot meet its immediate and long-range fiscal challenges by reductions alone, it is clear that the City can and must make substantial reductions in its budget. For the year 2005 alone, the City administration must pursue substantial reductions in expenditures to begin the process of achieving long-range financial stability.¹ Significant reductions in 2006 and subsequent budgets must also occur. It is imperative that these reductions emanate not only from reductions in public safety but that they also include substantial reductions in other departments. Privatization and outsourcing, competitive bidding and best practice efforts put forth by the work force must be carefully considered as

¹ The members of the ICA received a letter dated April 5, 2004, from Council member Alan Hertzberg, the Chair of City Council Budget and Finance, recommending a 10% decrease in certain

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part of the overall effort to assure substantial cost reductions. These reductions are essential not only to reduce operating costs but are critically important to reduce the record-level debts the City has amassed over the last decade and more. Within 60 days from the date of this report, the ICA will file a detailed report on realistic reductions in specific areas including, without limitation, areas of consolidation of services with Allegheny County. Among other options, the ICA will study and make recommendations on a restructuring of City government and the possibility of disincorporation. Members of the ICA believe that leaving the present operating structure in place will cause the same problems to resurface and that the ICA must look around the country for best practices to permanently solve the problems plaguing the City.

City expenditures. The ICA welcomes such initiatives and looks forward to further creative efforts by Council, the Mayor, the Controller and all City officials and workers to pursue further reductions.

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(2) *City Taxes / Structural Changes*

As suggested earlier, the current tax structure is antiquated and counter productive. It requires serious structural change. The ICA is studying existing and new tax and revenue sources in pursuing a new tax structure that is revenue neutral if at all possible.

The City imposes five taxes that affect business location in Pittsburgh. Those taxes are the Business Privilege Tax (BPT), the Mercantile Tax (MT), Parking Tax (PT), Occupational Privilege Tax (OPT), and Real Estate Property Taxes (REPT) Mayors Caliguiri, Masloff, and Murphy have stated the need to eliminate the BPT and MT because they are levied on gross revenues and are assessed primarily on startups, small and medium size businesses. Those taxes exempt many large banks and corporations creating further imbalances. The Parking Tax increase from 31% to 50% is the highest rate of tax in the nation and is another example of serious tax imbalance.

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The ICA is studying the effect of eliminating, in whole or in part, the BPT and MT, and substituting a Payroll Employment Tax (PET), to generate revenue in a more equitable manner.

The ICA is studying the effect of increasing the Occupational Privilege Tax which has the advantage to the City of assessing employees of non-profits estimated to be 100,000 people. We acknowledge the statewide nature of such a tax and recognize the many positive benefits of the purchasing power brought by residents and non-residents alike to this City.

The ICA is also studying the effect of rolling the Parking Tax back to 31% since it appears the increase has been a detriment to business location and to shoppers in Downtown Pittsburgh.

Further, the ICA will examine all sources of revenue, including but not limited to, the redirection of that portion of the RAD Tax not currently used for essential and fundamental

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direct city operating costs. We will examine user and permit fees and other sources of revenue the City has the power to implement under its existing legislative powers.

It is critically important to emphasize that absent the substantial reductions in the City budget, approved and monitored by the ICA, the City will receive no additional tax revenue. The new tax revenue will be paid into trust accounts to be released only with the approval, and under the supervision of the ICA.

(3) Intergovernmental Cooperation Agreement

By the end of this week, Friday, April 16, pursuant to its statutory mandate, the ICA will present to the City an agreement between the City and the ICA that will contain provisions to effectuate the foregoing understanding. An agreement is necessary to insure fiscal prudence and help restore confidence. The public is acutely aware that the RAD tax, a tax no other City in the Commonwealth has as a benefit, was designed to solve some of the City fiscal woes. We urge City officials to review this document and to execute it at the

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earliest possible time to insure the health, safety and economic opportunity of the Citizens of Pittsburgh and all of the citizens of the region.

V. Conclusion

The ICA seeks the total commitment of all citizens and entities within the City and the region in this critical effort not only to restore the City to financial stability, but also to reverse the decline of population as a necessary prerequisite to the creation of an economically vibrant City and region with the highest quality of life. The School District, tax-exempt non-profit institutions and all who live and work in the City as well as the thousands of others who are otherwise served by the City must join this effort. We seek the total and unified support and cooperation of the Governor and General Assembly to whom this Report is addressed. Absent such a unified effort by all, bankruptcy of the City of Pittsburgh is more than a theoretical possibility. From the perspective of the members of the ICA, the notion that the second largest City of this Commonwealth would record the

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unprecedented status of bankruptcy is simply an unacceptable alternative. It is our hope and expectation that all of our fellow citizens as well as our leaders in Harrisburg find that possibility equally unacceptable. It is our privilege to serve you in meeting this challenge. Thank you for your concern and cooperation.