City of Pittsburgh
Allegheny County

Municipalities Financial Recovery Program – Act 47

Rescission Report

November 16, 2017

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Introduction

Since entering Act 47 oversight in 2005, the City of Pittsburgh (City) has structurally balanced its budget with recurring revenues consistently outpacing recurring expenditures. Over time, the City has adopted a series of financial management tools that will guide the decision-making of future leaders on fiscal issues to ensure budgetary stability. The City has strategies in place to address its primary legacy costs -- employee pensions, retired employee health care and workers' compensation – while maintaining its workforce and increasing the necessary investment in Pittsburgh's infrastructure. We recommend that the Commonwealth of Pennsylvania rescind its declaration of financial distress for the City.

This Report reviews the City's financial and operational achievements since 2005 and finds that it has met the requirements for exiting Act 47 oversight. In addition, this Report articulates ongoing challenges that the City must continue to tackle after leaving Act 47, and recommends ways that the City can continue to meet its future obligations while maintaining a sufficient fund balance and positive annual operating results. We are hopeful that the City will continue to adopt best practices for municipal governance, and encourage future leaders of the City to do the same.

Financial Crisis and Recovery

After nearly a decade of papering over underlying structural deficits through a series of asset sales, debt extensions, and accounting maneuvers, the severity of the City's financial condition became clear in the summer of 2003. The City laid off 446 full and part-time employees, including nearly 100 police officers and 24 EMS personnel. City recreation centers were closed, public swimming pools closed, and services from police mounted patrols to salt boxes were eliminated. In October and November 2003, the City's credit rating was downgraded, leaving Pittsburgh as the nation's only major city to hold below-investment-grade "junk bond" ratings. Absent corrective action, Pittsburgh would have strained to pay its bills through the end of 2004 as it exhausted its remaining cash reserves. Mounting annual deficits would have grown from approximately $72 million in FY2005 to nearly $115 million in FY2009.

After a petition from then Mayor Thomas Murphy and a hearing by the Commonwealth of Pennsylvania, in late December of 2003, the City entered the state's Municipalities Financial Recovery Program, known as Act 47. The depth of the City's financial problems were described in the independent auditor's report: "The City's general fund has suffered recurring losses from operations and has negative net assets that raise substantial doubt about its ability to continue as a going concern." With flat revenues and recurring growth in payroll and benefit costs, combined with a significant debt burden, the City's finances were structurally unbalanced.

After consultation with hundreds of stakeholders, we as the state-appointed Act 47 Coordinator drafted a broad-based, multi-year financial recovery plan (Recovery Plan) that was adopted by City Council and signed by the Mayor in June 2004. Prior to the Plan's adoption by City Council, the Pennsylvania General Assembly adopted Act 11 of 2004, which created the Intergovernmental Cooperation Authority for Cities of the Second Class (ICA). The Legislature declared that the ICA and the Act 47 Coordinator were to "operate concurrently and equally".[1] The ICA was charged with fostering the fiscal integrity of the City by ensuring that the City pays the principal and interest owed on its debts, meets financial obligations to its employees, and executes proper financial planning procedures and budgeting practices. Later that year, the ICA spearheaded state legislative approval of a suite of tax revisions based in part on options from the Recovery Plan. The combination of expenditure control and tax reform provided a strong platform for the City to reverse years of financial decline.

Since adoption of the Recovery Plan, the City has recorded recurring positive annual operating results in place of the large deficits originally projected. The City successfully balanced its annual budgets and

[1] *See*, Act 11 of 2004, § 102 (b) (3).

achieved a near-term financial recovery with revenues consistently outpacing expenditures. The City's success in stabilizing its finances was due in part to the successful execution of the following Plan initiatives:

- Improving financial management to make the City's budget decisions more transparent and monitoring the City's progress relative to its budget throughout the year.
- Right-sizing City services like public safety and parks and recreation, taking into account the City's resources and lower population in recent decades.
- Reaching new collective bargaining agreements with all City unions that incorporated major Plan initiatives on staffing and pay.
- Restructuring benefits to establish or increase employee contributions to health, vision and dental insurance coverage.
- Giving management greater flexibility to direct its workforce more efficiently by changing work rules and collective bargaining agreements.
- Encouraging intergovernmental cooperation between the City and Allegheny County and the City and its neighboring municipalities. These initiatives ranged from shared services to the transfer of select duties to County government, to the provision of services to Wilkinsburg.
- Using technology and private sector resources to gain efficiency in emergency medical transport billing, fleet maintenance, and other areas, while challenging in-house services to operate more cost-effectively.
- Controlling expenditure growth across multiple departments.
- Improving the presentation and quality of financial reporting.

The combination of external restrictions reversing poor financial practices and strong fiscal stewardship from the City's Administration, Council, and Controller made Pittsburgh one of the few large American cities to make it through the recent recession with its finances largely intact, generating positive net annual operating balances in all but three years since 2005.[2]

In late 2007, before these changes fully took root, Mayor Luke Ravenstahl and City Council petitioned Pennsylvania's Secretary of the Department of Community and Economic Development (DCED) to review whether the City's Act 47 distressed status could be rescinded and, if not, asked for a "blueprint" to complete its financial recovery. In 2008, then Secretary of DCED Dennis Yablonsky acknowledged Pittsburgh's considerable progress in turning projected multi-million dollar deficits into positive annual operating balances, but also acknowledged the City's need to address the legacy costs that threaten its future financial stability.

Those legacy costs – retiree health care, pensions, workers' compensation and debt – represent hundreds of millions of dollars in liabilities that the City shoulders for services rendered in the past, but which consume a large portion of the City's current annual budgets. To be financially healthy, Pittsburgh needed to address the financial threat to the current employees and retirees who depend on these benefits and to the residents, businesses, and others who must pay for them in lieu of receiving current services.

Therefore, in response to the City's 2007 request for rescission the Secretary determined that:

[2] As described elsewhere in this Report, the three years when expenditures exceeded revenues were characterized by large transfer payments to cover City legacy costs, a strategy approved by the two oversight bodies.

> Pittsburgh needs an amended recovery plan that would provide a blueprint for it to exit Act 47 and address pending legacy costs of debt, pensions, post-retirement benefits, workers compensation along with a long-term capital plan, while maintaining positive operating budgets well into the future.[3]

The Secretary directed us to develop a new Recovery Plan in consultation with all stakeholders; that new Plan was approved by City Council and Mayor Ravenstahl on June 30, 2009. The 2009 Amended Recovery Plan provided a strategy to meet the objectives identified by the Secretary so that the City could complete its financial recovery, fund its legacy costs, and exit Act 47 oversight. In order to meet the Secretary's challenge to address the City's $1.2 billion in unfunded legacy costs while providing a roadmap out of oversight, the Amended Recovery Plan initiatives focused on funding pensions and other post-retirement benefits (OPEB), reducing and reorganizing debt service while drafting a sufficient long-term capital improvement plan, and strengthening management of workers' compensation claims.

Other events also moved the City to address its legacy costs. In September 2009, the Pennsylvania General Assembly passed Act 44 to provide municipalities with near-term pension liability relief. If the relief options failed to mitigate a local government's pension distress, Act 44 moved municipal pension plans that are less than 50 percent funded under the administration of the Pennsylvania Municipal Retirement System (PMRS). Act 44 of 2009 required Pittsburgh to increase its pension funding level to more than 50 percent by January 1, 2011 to avoid PMRS takeover. A takeover would have increased the City's annual pension contributions by a significant amount and ceded local control of pension investments.

In late 2010, the City set a course to contribute at least $13.4 million above its minimum municipal obligation (MMO) to the pension each year. This met the 2009 Amended Recovery Plan's requirement that the City contribute $12.0 million to $14.0 million a year above the MMO. The City committed future parking tax revenues to the pension fund and those revenues were treated as a pension asset, so the City's pension funding level reached 62 percent. The Pennsylvania Public Employee Retirement Commission (PERC) certified the Pittsburgh's employee pension trust fund as "moderately distressed," meaning it was sufficiently funded to avoid the PMRS administrative takeover provided under Act 44. The higher funding level lowered the City's annual MMO, allowing it to make the additional pension contributions while still maintaining annual budget balance and meeting its other obligations. The ICA also reached agreement with the City to dedicate an additional $5.0 million per year from gaming funds to the pensions from 2013 through 2017.

In 2011, partly as a result of the original Recovery Plan initiatives, Pittsburgh generated nearly $2.0 million in workers' compensation savings, and then used the savings to settle existing claims. Pittsburgh's embrace of these initiatives, its success at implementing them and reducing the liability, and its overall financial condition led to the elimination of the annual prefunding requirement for workers' compensation originally imposed by the Pennsylvania Department of Labor and Industry when the City entered Commonwealth oversight.

The 2004 Recovery Plan eliminated retiree health care for new employees, capping the major source of OPEB costs for the City. However, with thousands of current and former employees still eligible for the benefits, retiree health care costs are projected to continue increasing for years. Therefore, in 2012, the City started to address these long-term liabilities by establishing an OPEB trust fund, becoming the first major Pennsylvania city to do so.[4] The OPEB Trust holds the assets aside to fund the long-term liability as opposed to the year-to-year costs of retired employee health insurance that are currently covered by the City's operating budget. The City's 2012 budget included a $2.2 million allocation to the OPEB Trust as required by the Amended Recovery Plan. That annual contribution increased to $2.5 million beginning in 2013, and the 2018 proposed budget increases that contribution to $3.0 million.

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[3] Departmental Order from DCED Secretary Dennis Yablonsky, July 16, 2008

[4] OPEB Trust – Resolution 2012-17 of January 31

In 2011, the City also approved a debt policy that laid out principles to guide the Administration's capital borrowing and debt management decisions.[5] The policy capped tax-supported debt at 17 percent of General Fund expenditures, and set a future goal of reducing the figure to a more manageable 12 percent as debt from the pre-recovery era is paid off in the next several years. The 2012 general obligation bond issue and subsequent bond issuances for capital projects complied with the policy.

The City also enacted a formal collaborative process for developing a multi-year capital improvement program.[6] The process requires the Mayor to declare capital improvement priorities at the beginning of the year and for an interdepartmental committee to select and prioritize projects that will be funded over the next six years. Transparency is dramatically increased with Council participation in capital plan development and public hearings before the final plan is proposed. The ordinance also creates the position of a full time coordinator of capital improvement projects who will monitor the capital budget, ensure timely project execution and handle financial reporting.

The City's progress under the 2009 Amended Recovery Plan led us to recommend that the City exit Act 47 oversight in November 2012. In response DCED Secretary C. Alan Walker issued a decision in March 2014 that the City would remain in Act 47 oversight. The Secretary directed us to work with the newly elected mayor and his administration, City Council, and the ICA on another Amended Recovery Plan. In the Secretary's statement, he cited a continued focus on legacy costs:

> While Pittsburgh has experienced considerable progress in stabilizing the City's financial position and has achieved surpluses in the last several years, legacy costs remain a serious concern and jeopardize the City's ability to maintain a sustainable operating budget without further action.

The second Amended Recovery Plan was approved and adopted in June 2014 after wide consultation with interested parties, including the Administration, City Council, the City Controller, and City labor unions. Although not required for a Recovery Plan amendment, as during the drafting of the first two Plans, a public meeting was also held to gain input on content of the amendment, along with separate City Council hearings. The 2014 Amended Recovery Plan had five basic objectives:

- **Eliminate the operating deficits** in the baseline multi-year financial projection while preserving basic services;
- **Keep the City's fund balance at an appropriate level** to avoid the need for cash flow borrowings and provide an adequate buffer against unanticipated revenue shortfalls or expenditure increases;
- **Gradually reduce the City's debt burden** to provide more resources to support daily operations;
- **Direct more funding to the City's capital budget**, with the priority to invest more in the City's roads, bridges, police and fire stations and other core infrastructure; and
- **Gradually increase the City's pension fund contributions** to the levels recommended by its actuary to better ensure sustainability.

Since the adoption of the 2014 Amended Recovery Plan, the City has continued its trend of recurring positive balances. As of the end of 2016, the City's unassigned fund balance was 17.7 percent of its operating expenditures, higher than the 16.7 percent level recommended by the Government Finance Officers Association of the United States and Canada (GFOA). Pursuant to the Amended Recovery Plan requirements, the City incrementally increased its pension contribution and will reach the actuarially recommended level starting in 2018. The City has directed additional funding to its capital budget through grants, pay-as-you-go, and debt-financed funding. As old bond issues are paid off, the City's debt service

[5] *See*, Debt Policy – Ordinance 2011-29 of December 12.

[6] *See*, Ordinance 2012-2 of January 31.

as a percentage of operating expenditures will drop below the 12 percent target in the City's debt policy, even after the new borrowings projected in the 2018 multi-year plan.

Finally, in 2016, the City refined its revenue forecasting methodology and began subscribing to an external data analytics firm, through which the City receives city- and county-level economic indicators including non-farm wages, gross county product, retail sales, and city employment throughout the year. The City reviews these external economic indicators and uses them to refine its revenue projections.

The City's progress in executing Amended Recovery Plan initiatives has been noted in the City's quarterly financial reports produced as a result of the original Plan and the requirements in Act 11. External observers have also pointed out the City's improvement. In March 2017, Moody's Investors Service commented in its credit rating report that the City is "poised to exit Act 47":

> The city's financial position will remain stable given the conservative budgeting practices and new fiscal policies planned with the Act 47 program exit. The latest 5-year budget plan, assumes that revenue trends will continue to improve over time and as expenditures, notably debt service, decline beginning in 2018 as capacity to increase funding for pension and other post-employment benefits (OPEB) liabilities, as well as invest in the city's aging infrastructure.[7]

After more than a decade of Act 47 oversight, the City of Pittsburgh has established strategies to meet its long-term fiscal obligations and demonstrated a commitment to implementing those strategies, while also maintaining structurally-balanced budgets. By incrementally increasing its pension contributions to the actuarially recommended level, formally setting aside annual funding for OPEB, reducing its workers' compensation liability, maintaining its fund balance reserves, and directing additional funding toward its existing infrastructure, Pittsburgh has executed the blueprint for exiting Act 47 set out in the 2014 Amended Recovery Plan. As a result, we recommend that the City of Pittsburgh's Act 47 status be rescinded.

Termination of Distress Status

Act 199 of 2014 made several changes to Act 47 and provided four factors that the Secretary of DCED shall consider in determining whether the conditions that led to a determination of municipal financial distress are no longer present. The factors are:

1) Operational deficits have been eliminated and the financial condition of the City demonstrates a reasonable probability of future balanced budgets;
2) Obligations issued to finance the municipality's deficit have been retired, reduced or reissued;
3) All claims or judgments that would have placed the City in imminent jeopardy of financial default have been negotiated and resolved; and
4) The City is projected to have positive operating balances for the first five years after the termination of distressed status.

Below is a discussion of the City's compliance with each factor for the Secretary's consideration.

Elimination of Operational Deficits

The City has achieved operating surpluses in nine of the last 12 years. The years when this was not the case were characterized by large strategic transfers to address legacy costs or timing quirks in revenue transfers.[8] In contrast, when the Act 47 Recovery Plan was adopted by the City in June 2004, the City's

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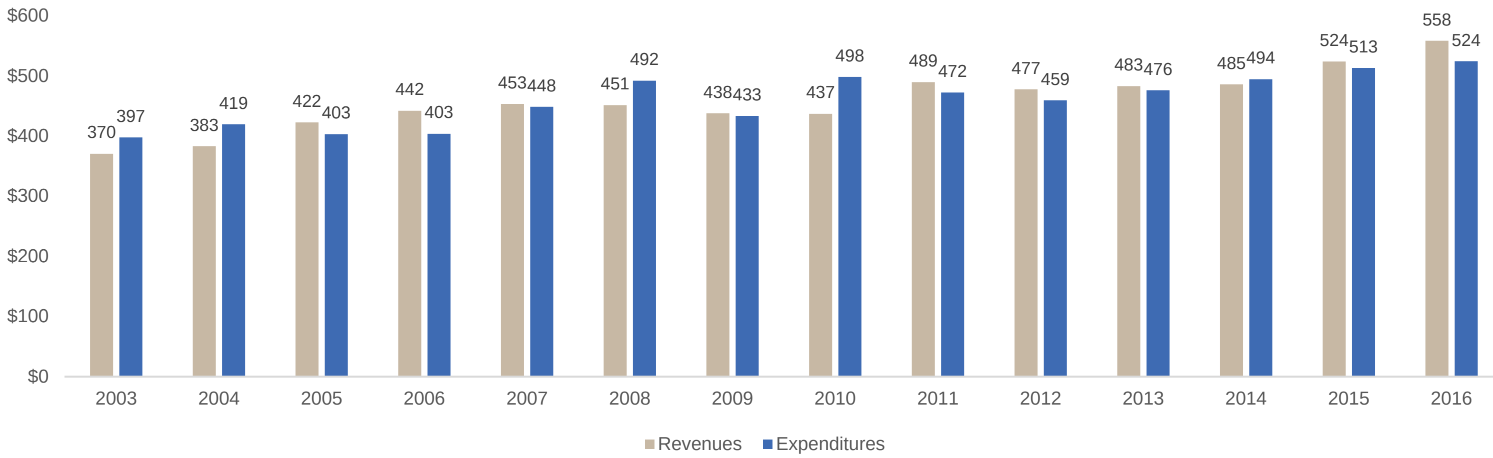
[7] Moody's Investors Service, Credit Opinion, March 17, 2017.

[8] The 2008 deficit was due to an unbudgeted $72.4 million transfer to the capital and debt service funds. The 2010 deficit was largely the result of a $44.1 million transfer to the pension fund and the ICA withholding the local share of gaming revenue until early 2011.

budget shortfall was estimated to be over $34.0 million in 2004, over $70.0 million in 2005 and nearly $80.0 million in 2006 without corrective action. With the approval of new revenues by the General Assembly, expenditure reductions, including the conclusion of new labor agreements with the majority of the City's bargaining units, and the implementation of many of the initiatives identified in the Act 47 Plan, the City eliminated its deficits and achieved positive operating balances.

General Fund Revenues to Expenses Comparison, 2003 – 2016 ($ Millions)



Source: City of Pittsburgh, Comprehensive Annual Financial Reports

According to the City's 2005 comprehensive annual financial report, at year-end 2005 revenues to the General Fund increased by $39.7 million or 10.4 percent, while expenditures decreased by $16.4 million or 3.9 percent compared to 2004. The increase in tax revenue was mostly due to the new payroll preparation tax and increases in other taxes. By the end of fiscal 2005, the City turned a projected $70.0 million deficit into an operating surplus of more than $19 million.

More than a decade later, the City's adherence to the Amended Recovery Plan and control of its expenditures continued to keep operating deficits at bay and, by 2016, the City finished the year with a $33.9 million positive operating result, or 6.1 percent of City's total revenues. According to the audited annual financial statement, revenues increased by 6.5 percent compared to 2015 due primarily to higher real estate and deed transfer taxes, whereas expenditures increased by 2.9 percent as a result of wage increases and increased pension contributions. As of the end of 2016, the City's financial statement shows $98.8 million in unassigned fund balance, or 17.7 percent of operating revenues.

Obligations to Finance Deficits Retired

In December of 2003, as it entered Act 47 oversight, the City secured a $40 million line of credit from a consortium of local banks. The credit was secured as a precautionary measure against a liquidity crunch in the first quarter of 2004 since year-end obligations came due before property tax revenues arrived in March. Moreover, the state's Department of Labor & Industry had asked for a multi-million dollar upfront payment to ensure that workers' compensation payments would be made on time. Though the City secured the line of credit, because the borrowing would occur so late in the year it could not be done as a tax and revenue anticipation note (TRAN) since a TRAN is required to mature and be repaid from taxes and other revenues

The 2014 deficit was due to a shortfall in the local share of gaming revenue and a timing quirk related to the $5.1 million in economic development slots revenue that was counted toward 2015 instead.

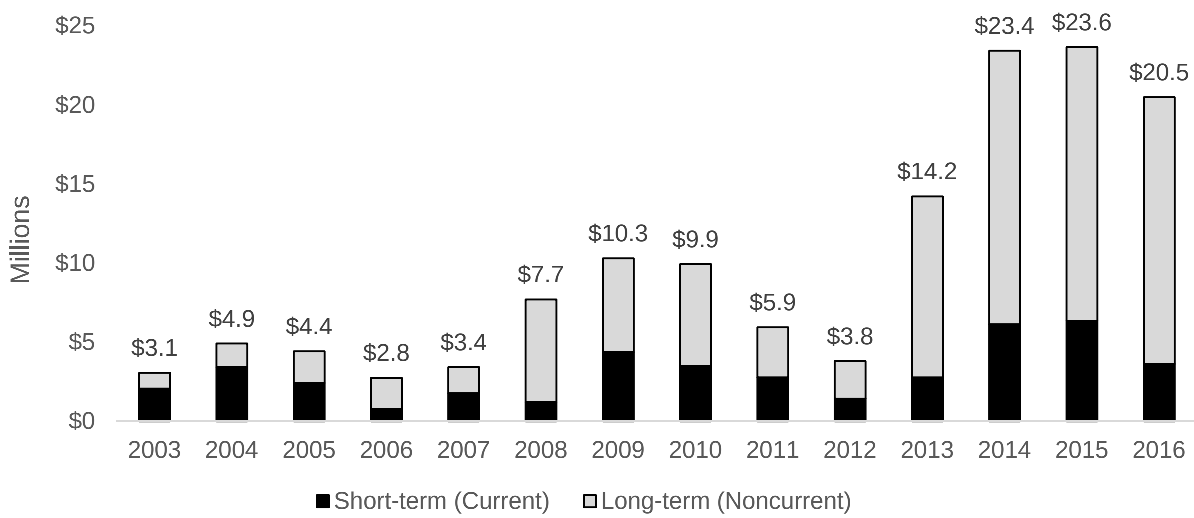
received prior to the end of the fiscal year in which it is issued. However, the City was able to accelerate some tax payments, defer some expenditures, and as a result did not use the line of credit.

The City has no other cash borrowings or loans which are required to be repaid in order to exit Act 47 oversight.

Significant Claims and Judgments Resolved

From 2005 to 2016, the City's claim settlement expenses ranged from $0.7 million to over $5.0 million, but never exceeded two percent of the City's total operating spending. As of December 31, 2016, the City has an outstanding claims and judgment balance of $20.5 million (or 3.9 percent of General Fund expenditures), primarily due to a lawsuit filed in 2013 that has a potential large judgment. Looking forward, the City anticipates that it will continuously resolve these outstanding judgments on a rolling basis without burdening the operating budget. Some amount of liabilities is not uncommon among local governments, especially when the majority of the accrued claims and judgments are long-term liabilities that are not due within the year. Based on the City's current and anticipated estimates, we do not believe that the amounts of those claims and judgments will place the City in any imminent jeopardy of financial default.

Year-End Accrued Claims and Judgments, 2003 - 2016



Source: City of Pittsburgh, Comprehensive Annual Financial Reports

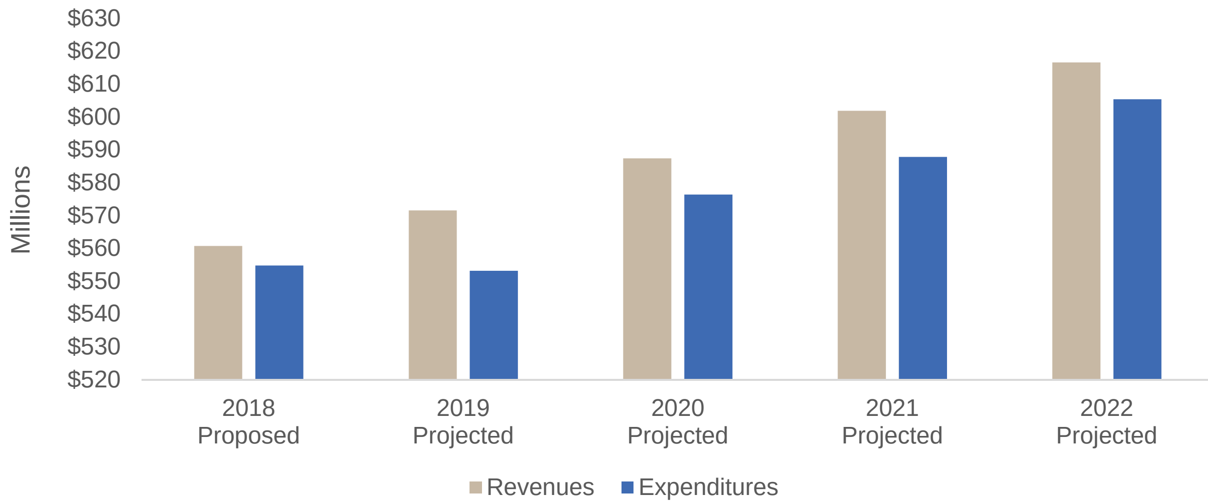
Five Years of Projected Positive Operating Results

Act 199 of 2014 requires that in order to exit Act 47 oversight, the City's projected revenues are sufficient to fund ongoing expenditures for the first five years after a termination of distress status. To determine whether the City satisfies this requirement, the Coordinator started the projection process with the City's proposed 2018 budget, submitted to the ICA and the Act 47 Coordinator on September 22, 2017.

Under the requirements of Act 11 of 2004, the City must include a five-year projection with its budget submission to the ICA. As Coordinator we met with City Finance to discuss a five year projection in early 2017, participated in the revenue estimating process that sets the projections for large sources of revenue and reviewed the projection when it was submitted to us in September. Since the rescission process will occur concurrently with City Council's own process for reviewing the annual budget and five-year projection, we are using City finance's projection as the basis for our analysis.

The five-year projection indicates a positive balance each year from 2018 to 2022. Instead of building up a larger unreserved fund balance, the City plans to make annual transfers to the capital budget to fund "pay-as-you-go" (pay-go) projects.[9] The combination of the positive annual results and the transfers to the capital budget result in an unassigned fund balance that ranges from $63.9 million $72.7 million per year.

Five-Year General Fund Projection, 2017 - 2022



	2018 Proposed	2019 Projected	2020 Projected	2021 Projected	2022 Projected
Revenues	$560,676,492	$571,497,380	$587,345,011	$601,859,324	$616,545,380
Expenditures	$554,765,921	$553,154,563	$576,366,931	$587,799,455	$605,348,218
Surplus/Deficit	$5,910,571	$18,342,816	$10,978,080	$14,059,870	$11,197,162
Unassigned Fund Balance	$69,320,726	$72,663,542	$68,641,622	$67,701,492	$63,898,654

The next section of this report details the operating revenue and expenditure assumptions underlying this projection as well as the major budget drivers.

<u>Major Revenue Assumptions</u>

Pittsburgh's General Fund revenue budget is characterized by substantial income from the real estate, earned income, payroll preparation, and parking taxes. Two-thirds of City General Fund revenue come from those four sources.

In aggregate, the City's General Fund revenues grew at an annual compound rate of 3.6 percent from 2012 to 2016. Much of this growth was driven by those four major taxes, which increased by $41.5 million over the five-year period, an annual average rate of 3.3 percent. Higher revenue from the deed transfer tax, commercial and residential permits, and daily parking meters also contributed to the overall growth.

The following table shows the City's General Fund revenues from 2012 to 2016[10].

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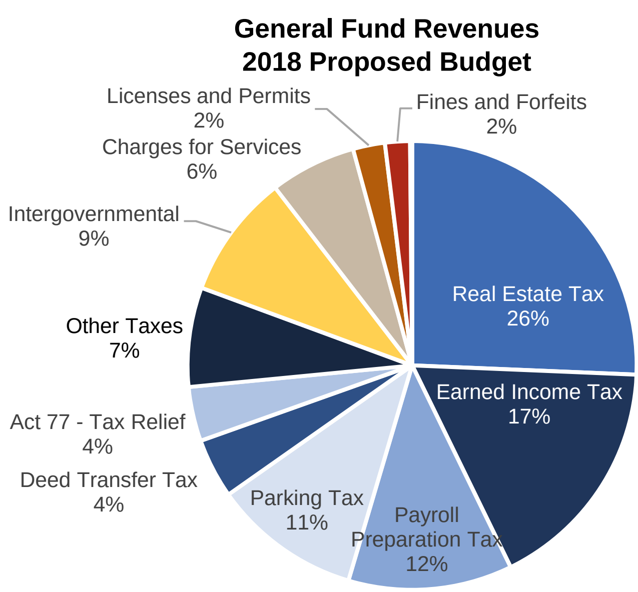
[9] The five-year projection assumes a transfer of $26.0 million to the capital fund in 2018, and an additional $15.0 million each year from 2019 to 2022, totaling $86.0 million in transfers.

[10] The figures presented here are audited results and will differ from the unaudited results presented on a quarterly basis throughout the year. These figures are also different from the chart shown on page 7 because transfers and financing sources are categorized differently in this table than in the Comprehensive Annual Financial Report.

City of Pittsburgh General Fund Revenues, 2012 - 2016

	2012 Actuals	2013 Actuals	2014 Actuals	2015 Actuals	2016 Actuals	CAGR[11]
Real Estate Tax	132,370,831	123,767,812	122,683,320	133,629,943	138,957,331	1.2%
Earned Income Tax	70,753,709	82,122,206	85,929,906	87,803,608	90,395,273	6.3%
Payroll Preparation Tax	52,269,982	54,539,775	56,431,215	59,217,092	60,416,473	3.7%
Parking Tax	47,843,681	49,165,517	50,450,730	52,688,986	55,000,783	3.5%
Act 77 - Tax Relief	12,663,312	12,560,819	12,898,093	19,980,983	20,375,845	12.6%
Deed Transfer Tax	14,767,101	21,328,770	20,059,261	22,722,660	27,732,867	17.1%
Amusement Tax	11,897,850	13,018,901	14,382,766	16,246,209	16,357,780	8.3%
Local Service Tax	13,683,258	13,817,287	14,051,156	14,035,734	14,144,782	0.8%
Facility Usage Fee	3,764,617	3,904,395	4,750,440	5,565,631	5,395,592	9.4%
Public Service Privilege	884,003	787,947	818,291	1,110,828	1,699,917	17.8%
Institution Service Privilege Tax	740,337	695,869	478,787	593,290	559,244	-6.8%
Non-Profit Payment for Services	4,999,609	1,948,577	2,288,392	419,895	433,714	-45.7%
Licenses and Permits	9,384,345	9,795,578	10,378,100	10,618,294	13,484,320	9.5%
Charges for Services	26,563,551	24,999,797	29,322,739	27,225,191	31,361,704	4.2%
Fines and Forfeits	9,313,345	8,850,130	8,565,657	9,285,195	8,988,710	-0.9%
Intergovernmental	50,458,584	51,130,253	39,461,295	40,926,143	47,922,629	-1.3%
Other	205,400	360,824	14,604	475,049	510,127	25.5%
Total Revenues	**$462,563,515**	**$472,794,456**	**$472,964,753**	**$502,544,730**	**533,737,091**	**3.6%**

The pie chart below shows the major categories of City General Fund revenues in the proposed 2018 budget.



[11] CAGR stands for compound annual growth rate

The City's single largest revenue source is the **real estate tax**. For 2018 the City projects $143.8 million, or more than a quarter of total General Fund revenue, will come from this source, including delinquent payments. The five-year projection assumes current year revenues will grow by 1.6 percent on average after 2018 accounting for the anticipated expiration of tax-increment financing agreements. The taxable assessed value grew by an annual average rate of 1.1 percent from 2014 ($18.5 billion) to 2016 ($19.2 billion).

The **earned income tax (EIT)** is the City's second largest revenue, representing 17.0 percent of the total General Fund budget. The City levies a 1.0 percent EIT rate on its residents and 1.0 percent on its non-residents who work within the City, though most of the non-resident revenue is remitted to the commuter's home municipality.[12] EIT revenue grew by 1.5 percent on a compound annual basis from 2009 to 2012 and then jumped by 16.5 percent in 2013 because of changes in the Pennsylvania law governing how the tax is collected (i.e. Act 32 of 2008). Since then, earned income tax growth has slowed down, growing by 2.2 percent in 2015 and 3.0 percent in 2016. The projection assumes a constant municipal EIT tax rate and three percent annual growth after 2018.

The other wage-related revenue is the **payroll preparation tax** first enacted in 2005 after deliberations related to the original Recovery Plan. It is currently levied at the rate of 0.55 percent of the gross payroll of each for-profit employer and the distribution of net income from self-employed individuals, members of partnerships, joint ventures or other for-profit entities who perform work or provide services within the City.

The payroll preparation tax has historically grown at a higher rate than the earned income tax, aside from the one-time jump in 2013. The payroll preparation tax revenue has been growing steadily at an average annual rate of 3.7 percent from 2012 to 2016. The five-year projection assumes a 4.4 percent average annual growth from 2018 to 2022 based in part on projected non-farm wages for Allegheny County.[13]

Earned Income and Payroll Preparation Tax, 2012 - 2016

	2012	2013	2014	2015	2016	2012-16	2013-16
Earned Income Tax	70,753,709	82,122,206	85,929,906	87,803,608	90,395,273	6.3%	3.3%
Payroll Preparation Tax	52,269,982	54,539,775	56,431,215	59,217,092	60,416,563	3.7%	3.5%

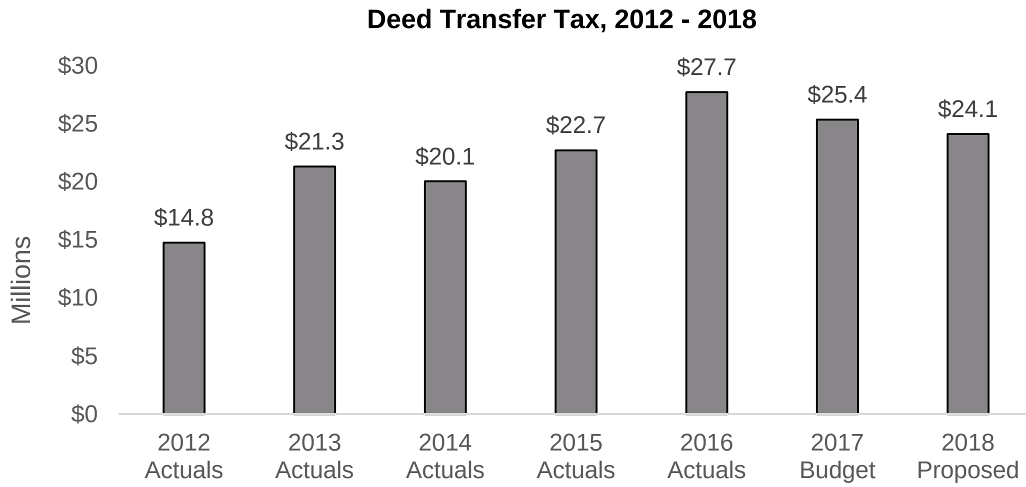
The **parking tax**, the City's fourth largest revenue, is levied at a rate of 37.5 percent on fees charged for parking or storing cars in Pittsburgh. From 2012 to 2016, it grew at an annual average rate of 3.5 percent. The City forecasts this revenue using a regression analysis based in part on Allegheny County's gross county product, given that it serves as a broad economic indicator of activities in and around the City. The parking tax revenue assumes 4.0 percent annual growth in parking tax revenue after 2018.

The **deed transfer tax** is a 2.0 percent tax on real property transfers within the City. This revenue fluctuates from year to year since the presence of a small number of large transactions can skew the results. As shown in the chart below, there were large increases in 2013 ($6.6 million or 44.4 percent) and 2016 ($5.0 million or 22.0 percent). The 2018 budget was set at $24.1 million, an 8.5 percent reduction compared to 2016 and a 4.9 percent reduction compared to the 2017 budget, assuming that some of the recent large transfers of commercial property will not continue.

[12] For example, the municipal statistic database maintained by DCED lists the tax rates for 134 municipalities in Allegheny County besides Pittsburgh. All 134 have a resident EIT rate of at least 1.0 percent so any non-resident EIT revenue collected in Pittsburgh would be remitted back to the home municipality.

[13] Non-farm wages for Allegheny County forecast is provided by IHS Global Inc.

Looking forward, the projection assumes an annual growth of 3.2 percent from 2018 to 2022. The forecast is based on the City's multivariate regression that is based on the projected annual growth in single-family home sales and average price growth.[14]



Act 77 tax relief provides the City with sales tax revenue. Under Pennsylvania Act 77 of 1993, Allegheny County and its municipalities receive one-half of a 1.0 percent County sales tax to support general municipal services. The revenue distributed to the City is based on a weighted formula related to total tax revenue and per capita market value of real property in each County jurisdiction. From 2005 to 2015, the City's share of the sales tax dropped from 53.4 percent to 42.9 percent,[15] but revenues essentially remained flat since the drop in the City's share was mostly offset by growth in sales tax revenues.

In 2016 and 2017, the City saw a reversal in that trend, with the City's share of total revenues starting to rise. The five-year projection assumes the City's share will continue to increase by 0.6 percent annually. Total sales tax revenues are also projected to grow at 1.9 percent annually, the same growth as in 2016. Taken together the City's share of sales tax revenues is projected to increase 2.5 percent per year on average.

	2018 Proposed	2019 Projected	2020 Projected	2021 Projected	2022 Projected	Average Growth
Total Sales Tax	49,355,539	50,205,805	51,223,477	52,284,068	53,149,168	1.9%
Pittsburgh's Share	44.5%	44.8%	45.1%	45.3%	45.6%	0.6%
Pittsburgh's Revenue	**$21,963,215**	**$22,492,201**	**$23,101,788**	**$23,684,683**	**$24,236,021**	**2.5%**

The City has other smaller taxes or tax-like revenues: the amusement tax, local service tax, facility usage fee, public service privilege tax, institution service privilege tax, and non-profit payment for services. These taxes in aggregate grew by 1.8 percent annually from 2012 to 2016, driven primarily by the amusement tax and facility usage fee due to an increase in the number of events held in the City. These two revenues alone grew by 8.6 percent annually from 2012 to 2016 while non-profit payments for service decreased from $5.0 million in 2012 to $0.4 million in 2016. The following details the underlying assumptions of the five-year projection.

[14] Data on home sales is from a forecast by the City of Pittsburgh (RealSTATs) and projections on average price growth is provided by an external data analytics firm.

[15] Data is from the Pennsylvania Treasury Department and is calculated on a fiscal year basis from July 1 to June 30 each year.

- The **amusement tax**, which is a 5.0 percent tax levied on the gross admissions to events,[16] is projected to grow at an annual average rate of 4.1 percent from 2018 to 2022. The growth assumption is based on a multivariate regression that uses revenue forecast for sports teams and clubs (9.5 percent) and inflationary growth (2.0 percent) as variable inputs.

- The **local service tax** is a $1 weekly tax levied on employees working within the City with annual earned income of at least $12,000. Employment within the City is forecast to grow very modestly at 0.3 percent annually in 2018 and 2019, very close to the five-year historical growth in the City's employment from 2010 to 2015 (0.4 percent).

City of Pittsburgh Employment, 5-Year American Community Survey Estimates

	2010	2011	2012	2013	2014	2015	CAGR
Population employed	146,129	145,325	146,133	146,705	147,038	148,758	0.4%

- While the **facility usage fee** is a function of the athletic and performance events held in the City, this fee is levied on non-residents only. The projection uses a 2.0 percent annual growth assumption, assuming that the growth would be indexed to inflation.

- The **Public Service Privilege Tax** is a telecom licensing fee levied on telecommunications companies for running lines under public streets, bridges, and sidewalks. This tax revenue is projected to grow by 2.0 percent annually.

- The **Institution Service Privilege Tax** is a six-mill tax levied on the gross income of foundations, partnerships, and non-profit organizations that provide a public service, and is projected to grow at an average annual growth of 2.2 percent.

- **Non-Profit Payments** come from tax-exempt entities that rely on the City's services and infrastructure to maintain their day-to-day operations and carry out their organizational mission. In the beginning of the recovery period, local non-profits made substantial contributions to bolster the City's finances. Most of the agreements underpinning those contributions have lapsed, and discussions for new agreements have been held sporadically for years with no progress. Because discussions with the City's non-profits are still ongoing, the projection assumes a modest 2.0 percent growth based on the 2018 budget, absent any new agreements and assuming that current payments will track inflationary growth.

The City budgeted $50.0 million in **Intergovernmental revenues** in 2018, which consist primarily of the state pension aid ($23.6 million)[17], the City's share of slots revenues ($10.0 million), and a Gaming Economic Development and Tourism Fund grant ($4.5 million). The City also receives annual payments from the Pittsburgh Water and Sewer Authority and the Pittsburgh Parking Authority, and transfers $3.5 million annually from the Liquid Fuels Fund to the General Fund for street-related expenditures.

[16] Only applies to events within the City and excludes non-profit performing arts organizations.

[17] State pension aid is funded by a two-percent tax on out-of-state casualty insurance premiums, a portion of the out-of-state fire insurance tax designated for paid firefighters, and any investment income earned on the collection of these taxes. The unit value is calculated and adjusted annually by dividing the available insurance tax proceeds by the statewide total of municipalities' worker units, of which non-uniformed employees are counted as a single unit and uniformed employees are counted as two units.

The projection assumes the state pension aid to grow at an annual average rate of 2.2 percent and eliminates the $4.5 million gaming grant beginning in 2019, in accordance with the provisions governed by Act 53 of 2007.[18] Other intergovernmental revenues are generally projected to remain flat.

Charges for Services account for $34.7 million of the 2018 proposed budget. The largest revenue within this category is emergency medical service (EMS) revenues generated by reimbursements for the City's paramedic services. EMS revenues have fluctuated in recent years due to collection challenges. In 2016, EMS revenues dropped to an all-time low of $8.2 million, so the City changed its payment contractor in 2017 and projects to collect $10.8 million in 2018. Moving forward, EMS revenues are projected to grow at an annual average rate 0.5 percent. Charges for Services also include $9.0 million in daily parking meter revenues that are projected to grow by 1.3 percent beginning in 2019.

Almost half of the City's **licenses and permits** revenues are commercial permits ($6.4 million) related to construction. The City also generates $1.6 million from zoning fees and another $1.2 million from excavation permit fees. Total licenses and permits revenues grew by 9.5 percent annually from 2012 to 2016, mostly because of commercial permits that almost doubled from $3.5 million in 2012 to $6.7 million in 2016. Looking forward in five-year projection, the City projects licenses and permit revenues to grow at 2.8 percent annually, driven by the continuous growth in commercial permit revenues.

The majority of the City's **fines and forfeits** revenues come from parking authority tickets ($8.5 million) and traffic court fines ($1.3 million). From 2012 to 2016, this revenue category dropped by an average rate of 0.9 percent from $9.3 million to $9.0 million due to lower traffic court fines and minimal growth in parking authority tickets. The City projects fines and forfeits to grow at 2.2 percent annually, driven primarily by parking authority ticket revenues governed by an agreement with the Pittsburgh Parking Authority.

Over the five-year projection period from 2018 to 2022, aggregate General Fund revenues are projected to increase at an annual average rate of 2.4 percent. The following table summarizes the projection.

Projection of General Fund Revenues, 2018 - 2022

	2018 Proposed	2019 Projected	2020 Projected	2021 Projected	2022 Projected	CAGR
Real Estate Tax	143,844,950	146,969,418	149,795,881	151,679,509	153,507,286	1.6%
Earned Income Tax	95,991,119	98,860,013	101,820,488	104,872,481	108,017,363	3.0%
Payroll Preparation Tax	66,172,921	69,167,989	72,127,289	75,316,331	78,594,311	4.4%
Parking Tax	59,803,431	62,192,728	65,064,179	67,589,630	70,091,309	4.0%
Act 77 - Tax Relief	21,963,215	22,492,201	23,101,788	23,684,683	24,236,021	2.5%
Deed Transfer Tax	24,125,278	24,899,266	25,698,085	26,522,531	27,373,427	3.2%
Amusement Tax	17,907,333	18,757,329	19,659,895	20,290,898	21,000,653	4.1%
Local Service Tax	14,461,179	14,519,023	14,577,099	14,591,677	14,620,860	0.3%
Facility Usage Fee	5,610,300	5,722,506	5,836,956	5,953,695	6,072,769	2.0%
Public Service Privilege	1,091,007	1,111,736	1,138,418	1,165,740	1,192,552	2.2%
Institution Service Privilege Tax	593,199	604,412	618,846	633,627	648,131	2.2%
Non-Profit Payment for Services	484,275	493,476	505,319	517,447	529,348	2.2%
Licenses and Permits	12,888,730	13,225,391	13,620,292	14,022,860	14,419,411	2.8%

[18] Act 53 of 2007 provides funds through the Gaming Economic Development and Tourism Fund appropriations to offset debt service payments for the 1995 Urban Redevelopment Authority bonds. Even though the City refunded the 1995 Urban Redevelopment Authority bonds in 2005 and those bonds have already been paid off in 2014, Act 53 of 2007 allows the City to continue receiving gaming funds through 2018.

	2018 Proposed	2019 Projected	2020 Projected	2021 Projected	2022 Projected	CAGR
Charges for Services	34,749,192	35,334,633	35,792,380	36,145,535	36,492,759	1.2%
Fines and Forfeits	10,068,006	10,237,960	10,462,034	10,713,122	10,964,040	2.2%
Intergovernmental	50,077,053	46,036,023	46,622,950	47,225,533	47,818,957	-1.1%
Other	845,306	873,275	903,112	934,026	966,183	3.4%
Total Revenues	**$560,676,492**	**$571,497,380**	**$587,345,011**	**$601,859,324**	**$616,545,380**	**2.4%**

Major Expenditure Assumptions

The City's General Fund expenditure budget, like that of most municipal governments, is primarily comprised of employee wages and benefits. Local governments are labor-intensive, requiring workers to police the streets, fight fires, maintain thoroughfares, and provide services ranging from recreation programming to building permit inspections. As a result, the projection is heavily impacted by the forecasted growth rates for wages and health benefits costs and the planned growth in contributions to the employee pension plans. In 2018 employee wages and benefits will account for almost 75 percent of all City General Fund expenditures.

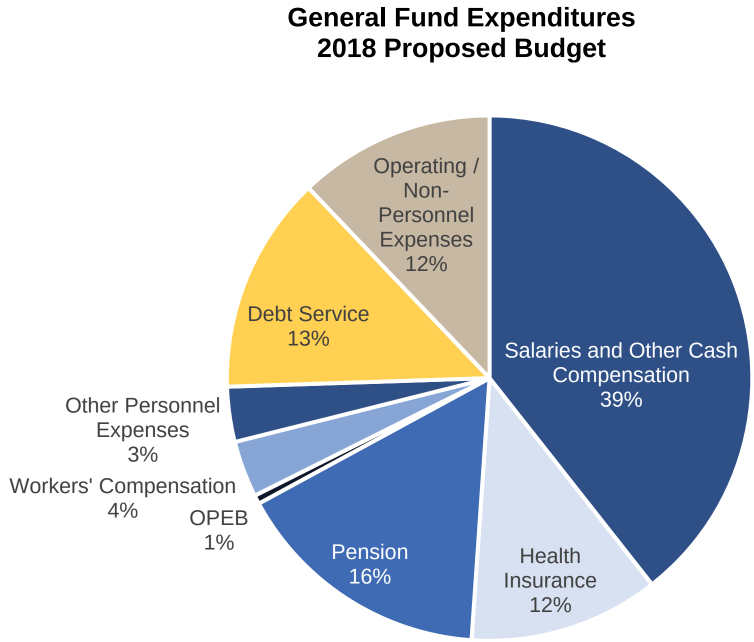
In aggregate, the City's General Fund expenditures increased by an annual compounded average of 2.9 percent from 2012 to 2016, driven primarily by personnel expenses.

General Fund Expenditures, 2012 - 2016

	2012 Actual	2013 Actual	2014 Actual	2015 Actual	2016 Actual	CAGR
Salaries and Other Cash Compensation	179,415,376	187,957,120	189,782,986	193,809,214	197,792,687	2.5%
Health Insurance	47,931,303	49,701,320	55,104,158	59,869,661	57,720,393	4.8%
Pension[19]	58,414,358	52,463,189	54,727,930	63,567,022	67,177,355	3.6%
OPEB[20]	2,200,000	2,500,000	2,500,000	2,500,000	2,500,000	3.2%
Workers' Compensation	18,834,501	22,744,177	20,174,224	20,194,203	19,213,693	0.5%
Other Personnel Expenses	13,191,955	13,532,166	15,985,453	16,401,747	16,275,596	5.4%
Debt Service	82,528,663	87,135,416	87,269,068	89,251,129	88,560,030	1.8%
Operating / Non-Personnel Expenses	43,942,561	46,324,639	46,101,785	49,428,755	51,781,815	4.2%
Total General Fund Expenditures	**$446,458,716**	**$462,358,026**	**$471,645,604**	**$495,021,730**	**$501,021,570**	**2.9%**

[19] This is primarily the City government's contribution to the employee pension plans, a portion of which is offset by the state pension aid revenue. The employees' contribution is collected separately, outside the General Fund.
[20] This is the City's contribution to the Other Post Employment Benefit (OPEB) trust fund. The City's annual expenditures on health insurance claims for retired employees are included in the health insurance category.

The chart below shows the major categories of City General Fund expenditures in the 2018 proposed budget/



Almost 40 percent of the City's spending is on employee **salaries and other cash compensation**, which includes longevity and overtime payments. The City has nine collective bargaining units and more than 3,000 employees. The bargaining units with the largest numbers of employees are the Fraternal Order of Police (FOP) and International Association of Firefighters (IAFF).

Collective Bargaining Units	2018 Budgeted Headcount
FOP (Police)	873
IAFF (Fire)	653
PJCBC (Public Works)	302
AFSCME 2719 (Clerks)	258
FAPP (Paramedics)	181
Teamsters (Environmental Services & Animal Control)	182
AFSCME 2037 (Blue Collar)	44
SEIU 192-B (Crossing Guards)	102
SEIU 668 (Recreation staff)	38
Non-Union	514
Total	**3,147**

The projection assumes headcount stays at the 2018 budgeted level over the five-year period. Employees who retire or separate from City employment would be replaced. All base salaries grow by a blended salary growth rate that assumes:

- Three-percent annual across-the-board wage increases after the expiration of the current collective bargaining agreement, as outlined in the table below

Assumed Across-the-Board Salary Increases

	2018	2019	2020	2021	2022
FOP (Police)	2.0%	3.0%	3.0%	3.0%	3.0%
IAFF (Fire)	2.0%	3.0%	3.0%	3.0%	3.0%
PJCBC (Public Works)[21]	1.0%	3.0%	3.0%	3.0%	3.0%
AFSCME 2719 (Clerks)	2.0%	2.0%	3.0%	3.0%	3.0%
FAPP (Paramedics)	2.0%	3.0%	3.0%	3.0%	3.0%
Teamsters (Environmental Services & Animal Control)	2.0%	2.0%	2.0%	3.0%	3.0%
AFSCME 2037 (Blue Collar)	2.0%	2.0%	3.0%	3.0%	3.0%
SEIU 192-B (Crossing Guards)	2.0%	2.0%	3.0%	3.0%	3.0%
SEIU 668 (Recreation staff)	2.0%	2.0%	3.0%	3.0%	3.0%
Non-Union	2.0%	3.0%	3.0%	3.0%	3.0%

Shaded areas are years with no contract or arbitration award currently in place

- Step increases for police, fire, paramedics, and truck drivers according to the most recent contracts
- Longevity payments for employees based on employees' hire dates and years of service assumed in the 2018 proposed budget
- An extra payroll in 2020, which will have 27 payroll periods instead of 26

The City spends $65.0 million (or 11.7 percent) of its total General Fund budget on **health benefits** for active and retired employees. From 2012 to 2016, active employees' health insurance spending grew by an annual average of 5.9 percent while retirees' health insurance grew at a lower rate at 3.0 percent. The City also became self-insured beginning in 2016 and spending on health insurance dropped for the first time since 2011. The projection assumes health benefits grow at an annual average rate of 6.3 percent based on forecasts provided by the City's healthcare benefits consultant.

The City's **pension contribution** represents one of its largest spending categories, third only to salaries and debt. The City has three pension plans: the Policemen's Relief and Pension Fund, the Firemen's Relief and Pension Fund, and the Municipal Pension Fund. Combined the City's pension systems were funded at 57.0 percent as of January 1, 2015.

Across the three pension plans, the City will contribute $86.4 million in 2018 with $49.7 for the minimum municipal obligation (MMO), $26.8 million from committed parking tax revenue and an additional $10 million required under the Amended Recovery Plan to bring the City's contribution to the level recommended by its actuary. City employees will contribute another $10.9 million to bring the total contribution to $97.3 million next year.

The five-year forecast maintains pension contributions at the actuarially recommended level plus the $26.8 million parking tax commitment. It also includes a $3.5 million annual contribution to cover the projected cost of reducing the assumed investment rate of return from 7.5 percent to 7.25 percent,[22] and an additional contribution of between $4.7 million and $8.5 million to improve the pension funds' funding status beginning in 2019.

[21] The City and PJCBC are currently negotiating a successor agreement to the one that expired at the end of 2016. According to the proposals shared with us to review Amended Recovery Plan compliance, the assumed term of that new agreement would run through 2021.

[22] On February 2, 2017, the City's Comprehensive Municipal Trust Fund board voted to reduce the pension funds' assumed investment rate of return from 7.5 percent 7.25 percent, effective January 1, 2019.

That final "additional contribution" can be viewed as a contingency in case the City's MMOs rise by more than the modest amount shown in the five-year projection. The five-year projection assumes the MMOs will increase by 1.0 percent (or $0.5 million) starting in 2019. The last time the City went through the usual two-year cycle of pension valuation updates the MMO rose by 14.2 percent (or $6.1 million). The City should receive an updated pension valuation report in 2019 that sets the underlying calculations for the MMO in 2019 and 2020.

Pension Contribution Projection, 2018 - 2022

	2018 Proposed	2019 Projected	2020 Projected	2021 Projected	2022 Projected
Municipal Minimum Obligation (MMO)	49,662,394	50,192,000	50,717,000	51,262,000	51,830,000
Parking Tax Commitment	26,752,000	26,752,000	26,752,000	26,752,000	26,752,000
Assuming a 7.25% Investment Return	0	3,500,000	3,500,000	3,500,000	3,500,000
Supplemental Amount to reach the Actuarially Recommended Contribution	9,886,000	13,886,000	13,886,000	13,886,000	13,886,000
Additional contribution	114,000	4,717,483	5,999,912	7,999,912	8,547,060
City pension contribution	**$86,414,394**	**$99,047,483**	**$100,854,912**	**$103,399,912**	**$104,515,060**

Pursuant to the recommendation in the 2009 Amended Recovery Plan, the City set up an **other post-employment benefits (OPEB)** trust fund in 2012 and currently contributes an annual amount of $2.5 million to the trust fund. The City will increase the annual contribution to $3.0 million beginning in 2018 to comply with the terms of its recent FOP arbitration award[23]. As of January 1, 2014, the City's unfunded OPEB liability was $564.1 million.

Representing 3.4 percent of the City's total General Fund budget, the City's **workers' compensation** spending has been dropping since reaching an all-time high of $22.7 million in 2013. This expenditure category had been an area of concern due to the escalating costs prior to 2013. Since then, the City has made continuous efforts in controlling workers' compensation cost growth and now projects this spending to remain flat throughout the projection period.

The City budgeted another $18.8 million for **other personnel expenses** in the 2018 budget. This category includes uniform allowances, leave buyback, the employer's share of federal payroll taxes, unemployment compensation, retirement severance, and other benefits. The projections assumes 2.7 percent growth in 2018, the same rate as the blended salary growth rate. From 2019 to 2022, the five-year projection includes $5.0 million to implement recommendations from a Classification and Compensation Study that will be released in 2018. Including the $5.0 million allowance, the other personnel costs category is projected to grow at an annual average of 6.1 percent from 2018 to 2022.

Debt service spending represents 13.4 percent of the City's budget in 2018, but that will drop over this projection period. Based on the City's existing debt schedule, there will be a debt cliff that results in debt service dropping by more than 30 percent in 2019. Because of the projected drop in debt service and the ongoing needs to fund capital investments, the 2018 proposed budget currently assumes annual new debt issuances of $60 million beginning in 2019.

[23] The July 2016 arbitration award requires the City to set up a trust fund for retiree health insurance for police officers hired from 2004 through 2015. Under the terms of the original Recovery Plan, those employees are not eligible for the retiree health insurance benefit provided to officers hired before 2004. The benefit provided by this arbitration award provision will be a "defined contribution" level of coverage that limits the City's liability and does not guarantee a level of benefits. The City's annual contribution is equal to 2 percent of the annual base salary for a Master Police Officer, multiplied by the number of officers eligible hired from 2004 through 2015.

Projected Debt Issuances and Debt Service Spending

	2018 Proposed	2019 Projected	2020 Projected	2021 Projected	2022 Projected
Debt Issuances	$0	$60,000,000	$60,000,000	$60,000,000	$60,000,000
Debt Service Expenditures	$74,439,434	$48,875,475	$53,519,735	$58,358,805	$63,179,270

The City allocates 12.1 percent of its 2018 proposed budget to **non-personnel operating expenses**, a category that includes contracted services, material and supplies, maintenance and repair, utilities, and vehicles. This category also includes some grant- and claim-related expenditures. From 2012 to 2016, this category grew by an annual average of 4.2 percent. The reason historical growth exceeded inflationary growth was due in part to the transfer of over $5 million in ineligible capital expenditures from the capital budget to the operating budget, in accordance with the 2014 Amended Recovery Plan requirement.[24]

In the 2018 budget, the City included some short-term expenditures to implement new software, which would be eliminated by 2020. So the five-year projection estimates the City's total operating expenditures to drop by 5.7 percent in 2019 and by another 1.2 percent in 2020, after which they are projected to grow by 1.0 percent on an average annual basis.

Looking forward over the five-year projection period, personnel expenditures are projected to grow by 3.7 percent per year while spending on debt and other operating expenditures drop by 4.0 and 1.3 percent respectively.

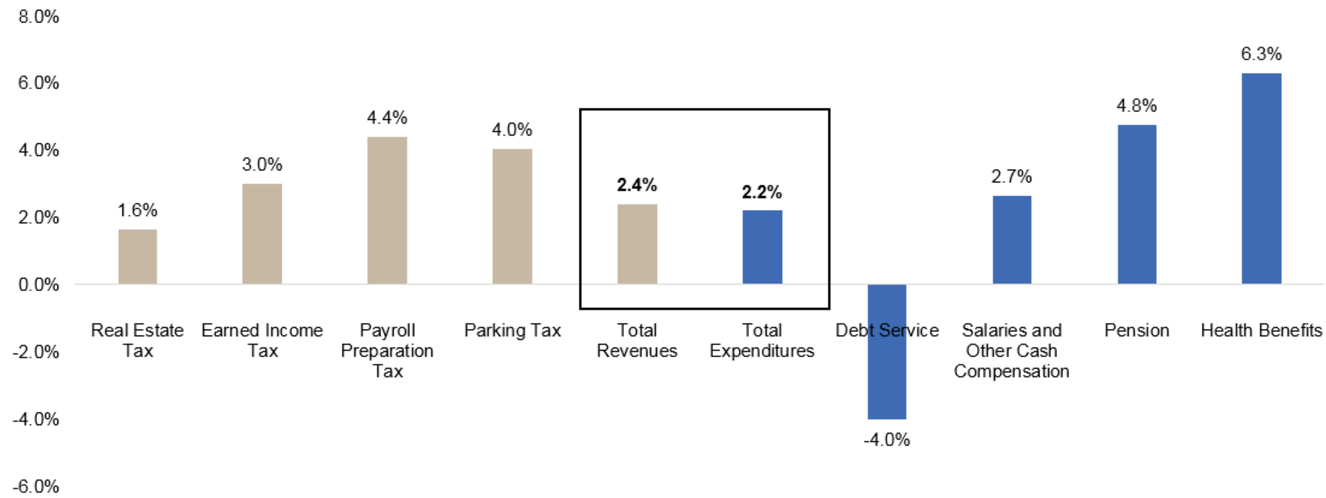
Projection of General Fund Expenditures, 2018 – 2022

	2018 Proposed	2019 Projected	2020 Projected	2021 Projected	2022 Projected	CAGR
Salaries and Other Cash Compensation	218,495,850	223,978,582	237,396,449	235,704,612	242,605,773	2.7%
Health Insurance	64,988,166	69,429,492	74,427,121	79,372,133	82,971,251	6.3%
Pension	88,632,894	101,265,983	103,073,412	105,618,412	106,733,560	4.8%
OPEB	3,000,000	3,000,000	3,000,000	3,000,000	3,000,000	0.0%
Workers' Compensation	19,278,285	19,209,171	19,209,171	19,209,171	19,209,171	-0.1%
Other Personnel Expenses	18,774,795	24,039,047	23,138,657	23,473,087	23,789,846	6.1%
Debt Service	74,439,434	48,875,475	53,519,735	58,358,805	63,179,270	-4.0%
Operating / Non-Personnel Expenses	67,156,497	63,356,813	62,602,386	63,063,234	63,859,347	-1.3%
Total General Fund Expenditures	**$554,765,921**	**$553,154,563**	**$576,366,931**	**$587,799,455**	**$605,348,218**	**2.2%**

Overall General Fund revenues are projected to grow at an annual average rate of 2.4 percent driven largely by the major taxes, while total General Fund expenditures are projected to grow by 2.2 percent. Personnel costs would grow by 3.7 percent with the anticipated growth in health insurance costs (6.3 percent) and pension contributions (4.8 percent). The following graph highlights key revenue and expenditure budget drivers in the forecast period.

[24] The City transferred $2.2 million in ineligible capital spending from the capital budget to the operating budget in 2015, and another $0.4 million in 2016 and $3.0 million in 2017.

Average Projected Growth of Major Budget Drivers, 2018 – 2022



Key Accomplishments and Challenges

As noted earlier, the City has made significant progress since entering financial oversight in late 2003. The City has achieved financial stability as evidenced by its positive annual financial results while managing and increasingly funding its legacy costs, and directing additional investments toward its backlog of capital needs. At the same time, some challenges require vigilance to build on recent progress or avoid backsliding to poor practices. While these challenges are often not unique to Pittsburgh, the City must continuously address these issues to sustain the achievements made since entering oversight and pave a path toward long-term fiscal sustainability.

Increased Pension Contributions

At the time the City entered Act 47 oversight in 2004, the aggregate funded ratio for its three pension plans was just 44.3 percent (2005 valuation), and this fell further to 34.3 percent as of January 1, 2009. Because of this extremely low funding level, the City undertook a series of significant steps to address its unfunded liability and improve plan funding from 2010 to 2014, including:

- Placing a moratorium on further benefit improvements;
- Transferring $45 million from the debt service fund into pension system in 2010 to improve short-term funding status;
- Making additional contributions above the legally required Minimum Municipal Obligation;
- Pledging future parking tax revenues to the pension fund -- $13.3 million from 2011 to 2017, rising to $26.8 million from 2018 through 2041; [25]
- Adopting more prudent actuarial assumptions, including reducing the investment return rate and updating mortality assumptions; and,
- Scheduling quarterly payments to the fund.

Even with those improvements, however, the City had not adequately funded the plan at the levels recommended by its actuaries. In the valuation reports produced in March 2014, the plan actuary raised

[25] Ordinance 42-2010, of December 30.

serious concerns about the soundness of the actuarial methodology permitted by a Pennsylvania law specific to Pittsburgh, Act 82 of 1998:

> *"Act 82 of 1998 has a significant impact on the minimum funding requirements.* ***We believe that the procedure for determining amortization amounts in accordance with Act 82 no longer produces an actuarially appropriate funding level****." [emphasis added]*

Under Act 82, the City was authorized to change the amortization schedule and calculate the minimum amortization payment for the 1998 Unfunded Actuarial Accrued Liability amount using a special procedure that effectively lowered the payment the City would have otherwise had to make under the general requirements of Act 205. With the special provisions of Act 82, the City was permitted to amortize the 1998 Unfunded Actuarial Accrued Liability over a 40-year period as opposed to a 30-year period.

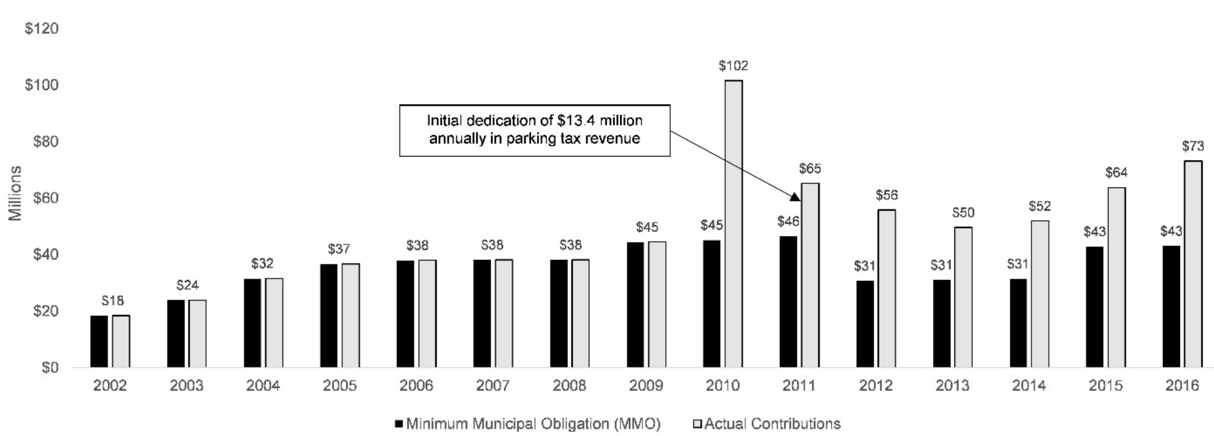
Act 82 also permits the amortization payment to be calculated using a 10 percent investment rate of return assumption as opposed to the plans' then-current 8.75 percent return assumptions as of 1998. The actuary noted that this "special procedure" of calculating the minimum payment on the amortization amount actually resulted in that portion of the unfunded liability growing for many years instead of being paid off as one would expect. As the actuary's valuation noted, *"When this legislation [Act 82] was enacted in 1998, investment conditions were different. An average 10 percent rate of return on a significant block of assets no longer seems reasonable."*

As a result of this outdated and unusual actuarial methodology, the actuary found a heightened risk that the unfunded liability would not be paid off at the end of the amortization period but instead:

> *"[w]ill likely lead to significant experience losses, an increasing pattern of amortization payments and a funded ratio which will still be well below 100% at the end of the 40-year period due to remaining balances on these losses."*

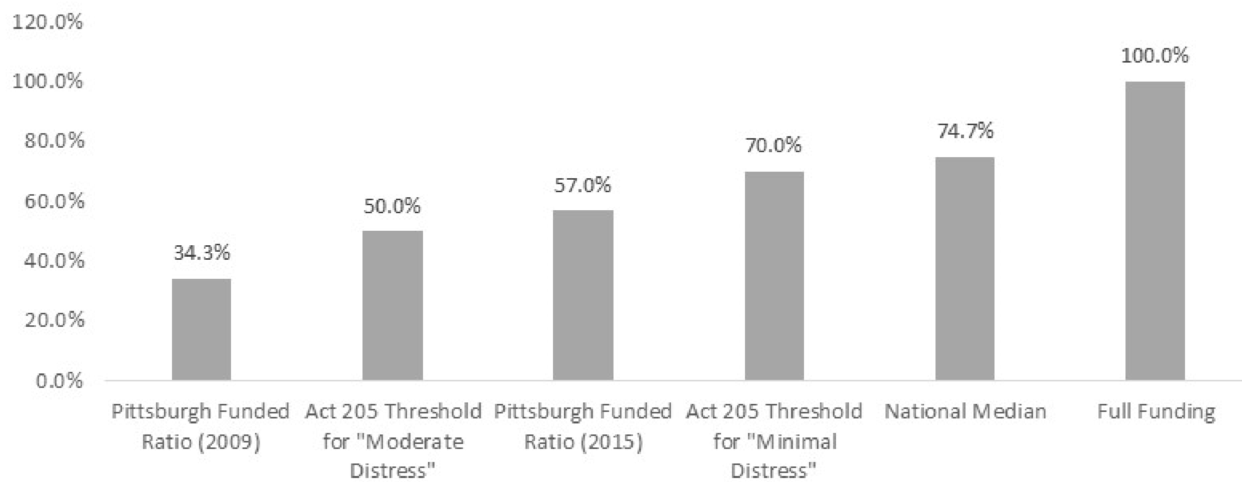
To increase the pension funding level, the 2014 Amended Recovery Plan required the City to incrementally make additional contributions above the legally required Minimum Municipal Obligation and achieve the actuarially recommended contribution by 2018.

Employer Pension Contributions, 2002 - 2016



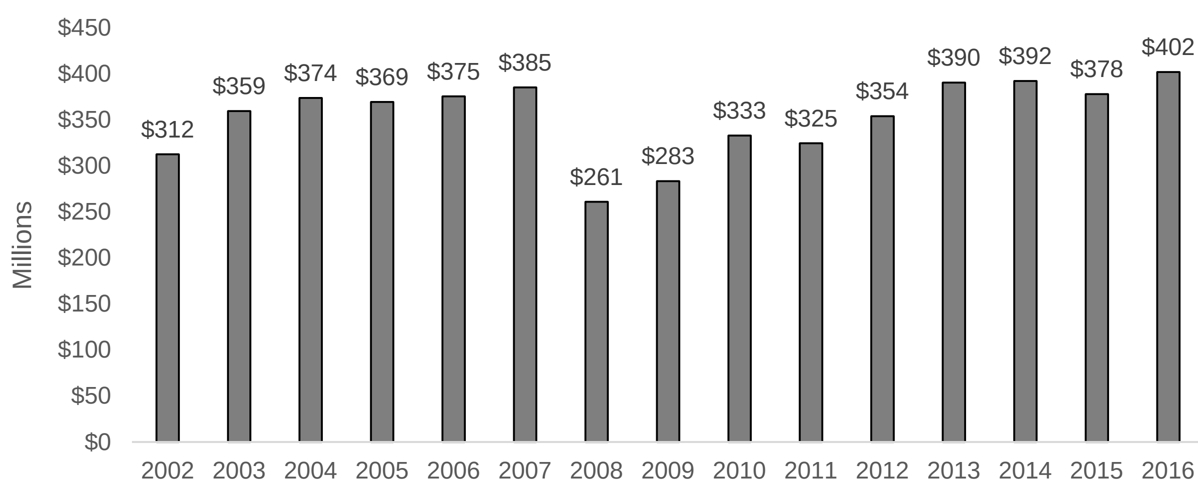
While these actions set a foundation for addressing this underfunded liability, there is more work to do. According to the most recent actuarial valuation, unfunded pension liability across the three pension funds (police, fire, and municipal) totaled $518.0 million and the funded ratio was still just 57.0 percent. The 57-percent ratio funded ratio as of January 1, 2015 is better than the extremely low level in 2009, but it remains well below the national median of 74.7 percent[26] and the level needed to shed the pension's distressed status according to the Commonwealth's standards. This is true even with the full actuarial recognition of the pledged parking tax revenue.

Pittsburgh Pension Fund Funded Ratio



Moving forward, the City must continue to increase its contributions, limit further growth in its liabilities and improve the funding level. At the minimum, the City must contribute at the actuarially recommended level in order to maintain funding levels and buffer against investment losses as seen in 2008 when the pension fund balance dropped from $385.2 to $260.9 million due to a $106.6 million in investment loss. The following chart shows the pension funds' ending fund balance from 2002 to 2016. The significant drop in 2008 was a result of the investment loss, and the slight decrease in 2015 was due to increased benefit payments with more employees retiring through the Severance Incentive Program.

Pension Fund Ending Fund Balance, 2002 - 2016



[26] Public Fund Survey, Summary of Findings for FY2015 (December 2016)

By the end of next year, the City's contribution will match the actuarially recommended levels for what is necessary to fund the pensions, and not just meet the minimum allowed under Pennsylvania law which is less than actuarially recommended level. The parking tax revenue commitment also rises from $13.3 million to $26.8 million next year and the scheduled drops in debt service will provide more flexibility to put more into the pension plan. Beginning in 2019, the City is also dedicating another $3.5 million in pension contribution as a result of the reduction of the assumed investment rate of return from 7.5 percent to 7.25 percent.[27]

The City is taking steps in the right direction to address this liability. Much of the progress cited earlier, like contributing more than the MMO and avoiding pension enhancements, came at the initiative of the Act 47 Recovery Plans and the enforcement by the ICA in the annual budget process. The large contribution in 2010 and commitment of future parking tax revenues were driven entirely by a deadline set by the Pennsylvania General Assembly. To build on this progress, boost the funding levels, and eventually bring down the annual required contributions, the City needs to stay on this path of increased contributions after Commonwealth oversight ends.

Addressing OPEB

Along with pensions, the City also provides retiree medical and life insurance benefits to police and firefighters[28] hired before the City entered Act 47 oversight (generally before January 1, 2005). According to the OPEB valuation as of January 1, 2016, the liability for these benefits was $506.9 million.

Prior to entering Act 47 oversight, the City did not have reserves set aside for these liabilities. It only covered the cost of retiree health benefits on a "pay-as-you-go" basis, covering the cost of health insurance premiums or medical claims as they came due each month. The annual cost of these benefits has increased from $18.7 million in 2009 to $22.1 million in 2016.

The 2009 Amended Recovery Plan required the creation of an OPEB Trust Fund to start to prefund these liabilities with minimum annual contributions of $2.5 million starting in 2012. The trust fund balance, which totaled $14.7 million as of the end of 2016,[29] has not been used to pay any retiree benefits and should not be tapped for that purpose until the trust fund reaches a level that can support the City's annual retiree benefits cost.

In addition to initiating an OPEB Trust, past Recovery Plans implemented benefit reforms to address the City's significant OPEB liability in the long-term, including:

- Eliminating the "defined benefit" level of retiree health coverage for employees hired in the Act 47 period (generally after December 31, 2004); and,
- Extending police cost-sharing requirements for retiree medical premium increases to fire retirees. Eligible retirees are charged for premium increases occurring after their retirement.

The most recent FOP arbitration award provided a mechanism to give more recently hired police officers access to medical coverage at a more affordable cost to City government and its taxpayers. Under that arrangement, the City will make monthly contributions into the OPEB trust fund in an amount equal to 2.0 percent of a Master Police officer's base salary, with the intention that the fund assets will eventually be distributed to retired police officers hired between 2005 and 2015 for the purchase of healthcare coverage. There is an important distinction between the "defined contribution" coverage in this arrangement and the "defined benefit" coverage that employees hired before 2005 receive after retirement, where the City guarantees a level of health benefits, without proper regard for the cost of those benefits or the City's ability to pay them. We encourage the City and its labor unions to discuss similar "defined contribution" types of

[27] On February 2, 2017, the City's Comprehensive Municipal Trust Fund board voted to reduce the pension funds' assumed investment rate of return from 7.5 percent 7.25 percent, effective January 1, 2019.

[28] Other employees are also eligible for retiree life insurance.

[29] According to the 2016 Comprehensive Annual Financial Report

OPEB arrangements when the issue of retired employee health insurance is raised during subsequent negotiations.

Enhanced Revenue Projection Methodology

Under the requirements of Act 11 of 2004, the City must include a five-year financial projection with its budget submission to the ICA. Prior to 2016, those projections were primarily based on historical trends and broader economic indicators, and then adjusted to provide a more conservative forecast to prevent budgeting more spending than actual revenues could support.

Beginning in 2016, the City enhanced its revenue projection process. The City now subscribes to an external data analytics firm that provides city-level and county-level economic indicators such as non-farm wages, gross county product, retail sales and city employment throughout the year. The City uses these external economic indicators as a reference point and input for projecting related revenues.

For example, the City uses growth in Allegheny County's non-farm wages to inform projections for the earned income and payroll preparation taxes. The City also uses the County's retail sales forecast to inform its Act 77 tax relief revenue projections. These are not the only data points considered in the revenue projection process, but they are useful additions.

This change builds on the improvements made under Commonwealth oversight, such as the implementation of an informal multiparty (Administration, Council, Controller and oversight bodies) revenue estimating committee that reviews and agrees on the revenue forecasts early in the budget process. The City should continue to use these tools and processes and adopt changes to its own statutes to formalize the revenue estimating committee.

Collective Bargaining

Employee wages and benefits are City government's single largest expense. In 2018, employee wages and benefits, including all forms of cash compensation, health benefits, pension, and other post-employment benefits, represent almost three-quarters of the City's total General Fund budget.

Since employee compensation accounts for the majority of the City's operating budget and most City employees are members of one of the nine employee unions, the City's ability to keep its finances balanced on an ongoing basis depends on its ability to successfully negotiate affordable collective bargaining agreements that also attract and support a capable workforce.

The original 2004 Recovery Plan provided a specific wage and benefits structure that was applied to City employees as their collective bargaining agreements expired. The 2009 and 2014 Amended Recovery Plan used a different approach and provided maximum allocations for compensation and benefits to be paid to all members in each bargaining unit. The approach used in the Amended Recovery Plans allowed each bargaining unit and the Administration the flexibility to negotiate a different base wage pattern or changes to other elements of compensation so long as the total compensation costs did not exceed the Amended Recovery Plan's allocations.

The City and all of its unions reached agreements in compliance with the 2009 Amended Recovery Plan. Subsequently, the City and seven of its nine employee unions successfully negotiated new collective bargaining agreements that comply with the cash compensation provisions in the 2014 Amended Recovery Plan. The City and Fraternal Order of Police did not negotiate a new contract, but the parties received an interest arbitration award in 2016 that complies with the Amended Recovery Plan. At the time of publication, the City was in negotiations with the Pittsburgh Joint Collective Bargaining Council (PJCBC).[30]

[30] The City and International Association of Firefighters, Local No. 1 negotiated a collective bargaining agreement that complies with the Amended Recovery Plan in terms of cash compensation. Firefighter's health insurance is governed by a separate arbitration award that expires on December 31, 2018.

In most cases, the City and its unions demonstrated the ability to negotiate changes to employee compensation after calculating the cost of wage and benefit proposals and while considering total compensation costs within the context of the City's broader financial picture, including the cost of retiree pension and health insurance benefits and the need to invest in the City's infrastructure.

The City and the unions should continue to follow that process in subsequent negotiations.

Reduced Debt Burden and Adoption of a Debt Policy

When the original Recovery Plan was proposed in 2004, the City had outstanding $845.7 million of principal amount in General Obligation and Pension Obligation bonds. The 2004 debt service obligation of $86.2 million represented almost 23 percent of the City's budgeted expenditures for that year[31].

By 2009, the City had reduced its outstanding principal due to $723.1 million and the annual payments from the General Fund remained over $80 million. So the City continued to primarily use "pay-as-you-go" sources of funding for capital projects and focused on retiring existing debt.

In 2012 the City restructured its debt and supplemented its pay-as-you-go funding by issuing $80.0 million in new debt and another $50.0 million in 2014. As of 2017, the City had $526.6 million in General Obligation and Pension Obligation debt outstanding, and debt service spending as a percentage of operating expenditures dropped to 16.2 percent. In 2019, debt service as a percentage of total expenditures is scheduled to drop to 8.8 percent, even with $60.0 million in proposed new borrowing for capital projects.

In addition to reducing its debt burden, the City also adopted a debt policy by ordinance[32] that sets clear standards to guide debt issuance and refinancing decisions. As the ordinance states, the foundation of a well-managed debt program is a "comprehensive debt management policy that exists to establish parameters and provide guidance governing the issuance, management and evaluation of debt obligations."[33]

Pittsburgh's debt policy requires that the City contract with an independent financial advisor when issuing debt; issue debt only for capital projects that are included in the capital program; limit the use of Tax Revenue Anticipation Notes (TRANs); limit its tax supported debt service to 17 percent of General Fund revenues; and establish a 10-year goal of reducing this ratio to 12 percent. The ordinance prohibits the City from issuing debt with derivative products. Overall the debt policy is another tool for ensuring long-term financial stability, if it is followed.

As noted earlier, the Mayor's FY2018 budget and five-year plan assumes the City would issue $60 million a year in new debt beginning in 2019 to fund capital projects. If the City follows that proposal through 2022, its debt service that year would fall below the 12 percent target in the debt policy and be about $24 million less than the City budgeted this year[34]. There would be another debt cliff in 2027 when debt payments drop below $30 million, but presumably there would also be additional debt associated with issuing bonds after 2022 (see graph below)

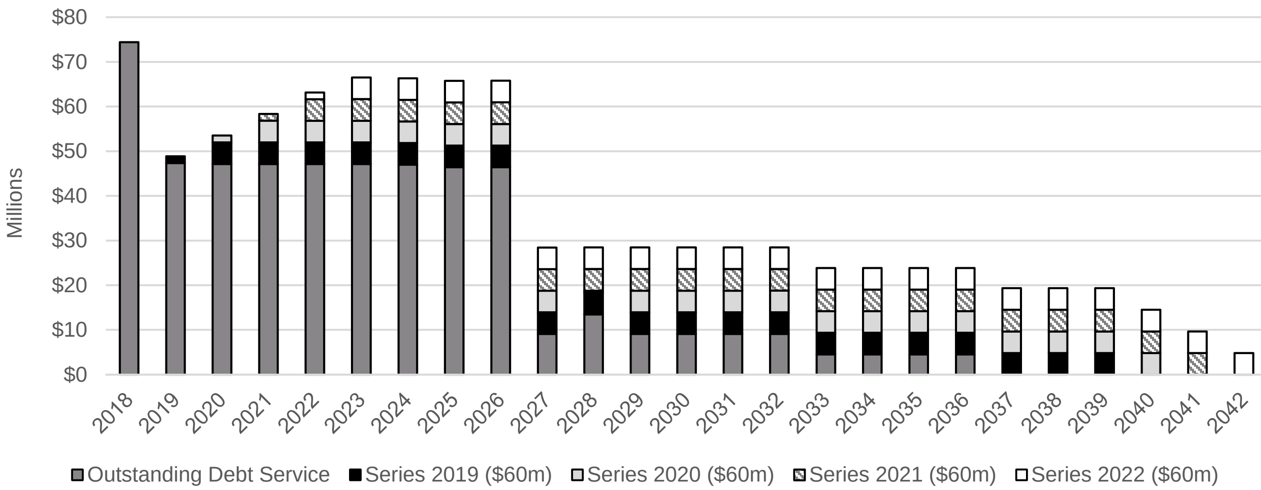
[31] The total debt burden, including General Obligation Bonds, Pension Obligation Bonds, and related payments to authorities was $86.2 million or approximately 24.6 percent of budgeted expenditures.

[32] Ordinance 29-2011 of December 12.

[33] *Id*.

[34] Using the assumptions in the City's projection, debt service spending in 2022 would be $63.2 million or 10.4 percent of projected total expenditures.

Projected Debt Service 2018 – 2042



Source: 2018 Budget, Department of Finance, City of Pittsburgh

While issuing $60 million in new debt each year starting in 2019 will not increase total debt service beyond the 12 percent target in the debt policy, we recommend the City revisit this assumption as it gets closer to 2019. It is positive that the City finally has more capacity to issue debt to fund the capital projects identified through its capital improvement plan process and urgent needs will emerge outside of that process over time (see next session). But the City has waited a long time to reduce its debt to a more manageable level and should schedule debt issuances as needed to fund its CIP. There are also practical questions whether the City has the capacity to execute $60 million a year in new capital projects or whether it is cost effective to go through the debt issuance process every year.

<u>Continuous Capital Improvements</u>

The City's Capital Improvement Program has come a long way since entering oversight. Prior to 2012, the City Code lacked a definition for "capital projects", there were no objective criteria for identifying, prioritizing and funding projects, and many expenditures in the annual capital budget were actually operating programs and social welfare initiatives. The City Charter laid out a general process that required the administration to develop a multi-year capital plan and budget for Council to review and adopt, but neither the Charter nor City Code specified the mechanics for creating the plan or budget.

In 2012, City Council enacted and Mayor Ravenstahl signed an ordinance to establish a formal process for developing a capital improvement plan and budget.[35] The ordinance defined "capital projects", established an interdepartmental committee to select and prioritize project funding, and provided Council and City residents an expanded opportunity to participate in the process. Under the new ordinance, the Mayor must declare the capital priorities by May, each department must submit its proposed projects to the Office of Management and Budget by June, the interdepartmental committee submits a report to the Mayor by the end of August, and two public meetings are held to allow residents to comment on the multiyear plan. In addition, the City appointed a Capital Improvement Manager, and capital project accounting was established in the ERP system.

As described above, the City also expanded its capital program by issuing new debt and continuing annual pay-as-you-go contributions. The positive results in the operating budget also allowed the City to maintain its pay-as-you-go funding toward its capital assets, as demonstrated in the chart below.

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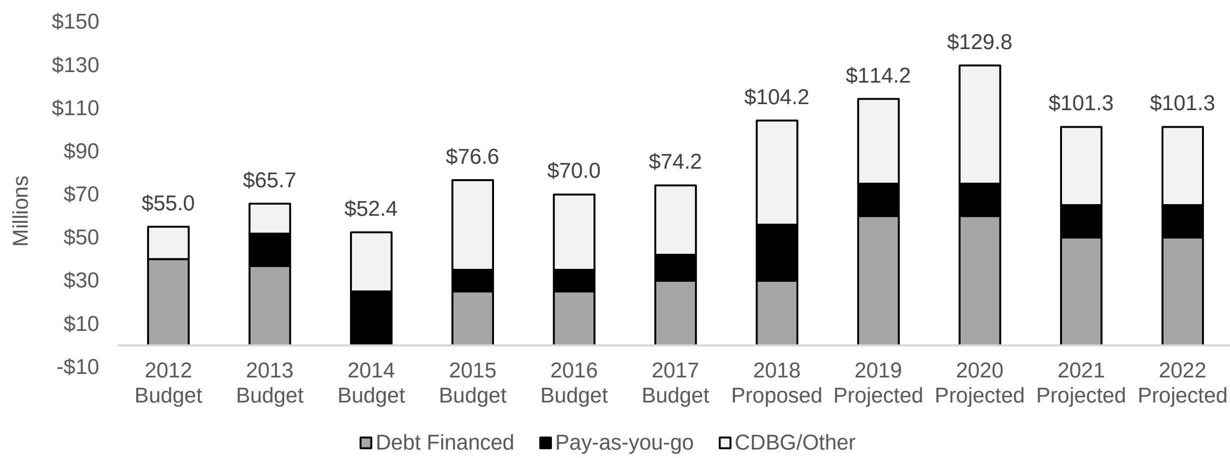
[35] *See*, Ordinance 2-2012 of February 7.

Budgeted and Projected Capital Spending, 2012 - 2022



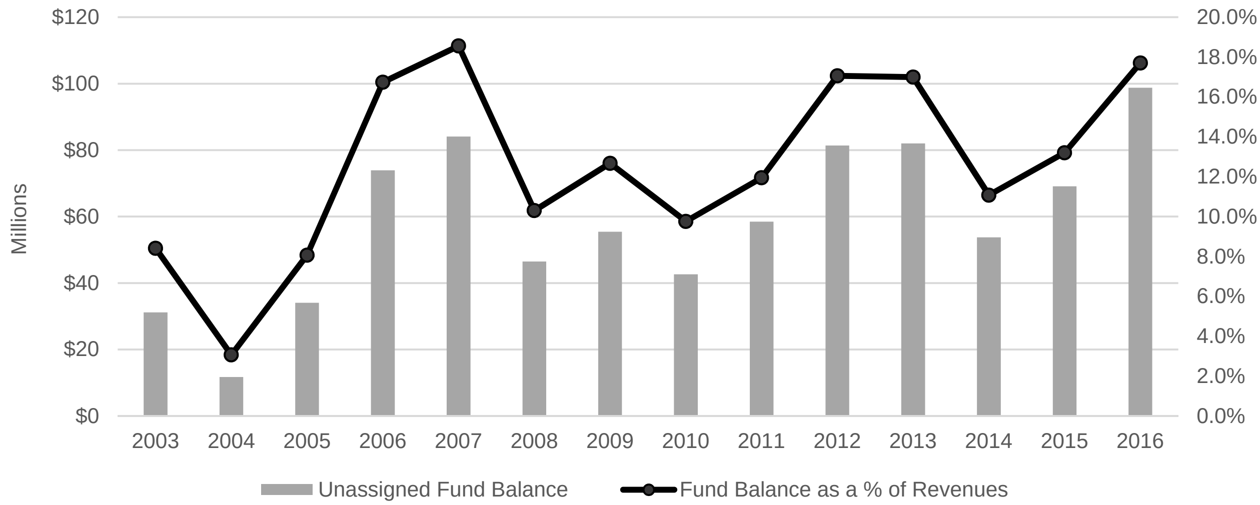
In addition to increasing its capital investments, the City also advanced its capital improvement program by transferring ineligible projects from its capital budget to the operating budget as recommended in the 2014 Amended Recovery Plan. Moving forward, the City should focus on funding existing infrastructure, including its roads, sidewalks, and bridges. In addition, the City must ensure that it has the capacity – whether through internal (completing projects in-house) or external (completing projects through contracted services) means -- to complete those capital projects planned for each year on time and under budget

Sufficient Reserves

Throughout the Recovery Plan period, we have required the City to maintain an unassigned General Fund balance as a buffer against unexpected revenue shortfalls or unbudgeted expenditures. The City's unassigned balance increased from 3.1 percent of General Fund revenues when it first entered oversight to 18.6 percent in 2007. Because of the pension plans' needs and the economic downturn during the next few years, unassigned fund balance slipped to 9.8 percent in 2010. The 2014 Amended Recovery Plan required the City to maintain a minimum 10 percent unassigned fund balance and, by the end of 2016, the City's fund balance was at 17.7 percent, above the 16.7 percent recommended by the Government Finance Officers' Association[36].

[36] The GFOA recommends "no less than two months of regular general fund operating revenues or regular general fund operating expenditures," or 16.7 percent.

Unassigned Fund balance, 2003 - 2016



Moving forward, the City plans to using some of its reserves for capital investments on a pay-as-you-go basis between 2018 and 2022, reducing its unassigned fund balance from $98.8 million at the end of 2016 to $67.5 million by the end of 2022. The projected $67.5 million is equivalent to 11.0 percent of General Fund revenue.

Unassigned Fund Balance, 2017 - 2022[37]

	2017 Budget	2018 Proposed	2019 Projected	2020 Projected	2021 Projected	2022 Projected
Net Operating Result	6,234,668	5,910,571	18,342,816	10,978,080	14,059,870	11,197,162
Capital Paygo	12,000,000	26,000,000	15,000,000	15,000,000	15,000,000	15,000,000
Unassigned Fund Balance (incl. transfer to Paygo)	93,028,303	72,938,874	76,281,690	72,259,771	71,319,640	67,516,802
Fund Balance as a % of Revenues	17.1%	13.0%	13.3%	12.3%	11.8%	11.0%

It will be difficult for the City to maintain fund balance at the GFOA recommended level of 16.7 percent while increasing its contribution to the employee pension fund and making additional investments in its infrastructure. But the City should establish a formal fund balance policy that requires unassigned fund balance be maintained above a specific threshold with the long-term goal of eventually raising that threshold to the recommended 16.7 percent**.** [38]

<u>Improved Credit Rating</u>

In October and November 2003, each of the three major national credit rating agencies downgraded the rating of Pittsburgh's general obligation debt to speculative or "junk bond" status. The original Recovery Plan noted that the return of the City's bond ratings to investment grade status would not occur until the Recovery Plan was implemented and the City had sufficiently demonstrated both that it had balanced revenues and expenditures and would continue to do so in the future.

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[37] The unassigned fund balance is based on the 2016 comprehensive annual financial report, which is reported on a modified accrual basis and different from the City's operating budget document, which is reported on a cash basis.

[38] See Key Principle 5 in the next chapter.

As a result of entering oversight, implementing the Recovery Plan, and improving financial management, the City returned to investment grade status in 2005, and its credit rating has since been upgraded by all three rating agencies. Holding other factors constant, higher credit ratings lower the City's costs when it issues and repays debt.

Standard and Poor's (S&P) upgraded the City's credit rating by three notches to A in 2013 and assigned an A+ rating to the City's $50 million general obligation bonds in 2014. Both reports noted the City's adequate reserves, structural balances, and strong financial management. The rating upgrade in 2014 also commended the City's progress in funding its pension and OPEB liabilities, but noted the risk of a credit downgrade if long-term liabilities increased without a sustainable solution.

The most recent credit rating upgrade was in 2017 when Fitch raised the rating to AA-. The rating upgrade was a result of Fitch's revised rating criteria that more heavily weights the City's reserve levels and its ability to increase revenues. The report cited the City's stable revenue growth and expenditure controls in recent years, which allowed the City to be resilient throughout economic cycles.

Credit Rating History, 2003 - 2017

Year	Action	Moody's	Fitch	S&P
2003	Credit downgrade to speculative or "junk bond" status	Ba1	BB	BB
2005	Return to investment grade status	Baa3	BBB	BBB-
2009	$725 million in outstanding GO bonds	Baa1	BBB+	BBB
2010	Credit upgrade by Moody's and Fitch	A1	A	BBB
2013	Credit upgrade by S&P	A1	A	A
2014	$50 million in new GO bonds	A1	A	A+
2017	Credit upgrade by Fitch	A1	AA-	A+

Paving the Path to Long-Term Sustainability

As detailed throughout this report, City government has successfully improved its financial management, performance and position since entering Commonwealth oversight. That success is the result of a collective effort, including current and prior elected and appointed officials, department managers, employees, tax payers and the private sector. All contributed to the turnaround.

In preparing this report, we met with City leaders to receive their input. The most frequently expressed sentiment was acknowledgement that the City has made progress tempered by concern that the City could backslide into the poor practices that precipitated the plunge into financial oversight in 2003. Several City officials asked for guidance on ways to "protect us from ourselves" once the parameters, procedures, and prohibitions of financial oversight are lifted.

As mentioned earlier, some guidelines are already in place in the form of the debt policy and capital budget ordinance. The Peduto Administration and Council are discussing ordinances to codify more of the best practices driven by the Recovery Plans and ICA oversight, including adopting a five-year plan with each annual budget and reporting the City's revenues and expenditures on a quarterly basis. This is a good strategy for making the current practices a permanent part of City government, irrespective of oversight status.

Below are five key principles that the City should follow to pave the path to long-term sustainability, even without the guard rails of Commonwealth oversight.

Principle 1: Be vigilant to ensure that recurring revenues cover recurring expenditures

The most important principle is also the most basic one – the City should evaluate every budgetary decision, collective bargaining proposal, new program, hiring initiative and tax question based on how it impacts recurring revenues and recurring expenditures over a multi-year period.

At a high level, the City should regularly evaluate whether growth in recurring expenditures is covered by growth in recurring revenues, separate from any one-time events that skew either side of the financial ledger. Recurring expenditures should include pension contributions that at least match the actuarially recommended levels (see principle 3), regular investments in capital projects (see principle 4) and annual contributions to the OPEB Trust Fund. Those items are not discretionary. They are essential to meaningful, sustainable financial recovery. Recurring revenues should exclude one-time events that boost tax revenues or fee levels, whether those events are driven by City policy or external factors, and should not include use of fund balance (see principle 5).

As an example, before the City proposes wage increases or benefit enhancements during collective bargaining, **City Finance Department should evaluate the financial impact of those proposals over multiple years and determine whether recurring revenues, which are primarily tax revenues, can support the projected spending growth**. Finance should apply the same rigor to evaluating proposals involving increasing the number and compensation for non-represented employees. The City Finance Department has repeatedly demonstrated the analytical capacity to provide thoughtful, fair, useful analysis during the annual budget process and collective bargaining. The City's elected and appointed leaders should continue to rely on that analysis.

If there is an imbalance between recurring revenues and expenditures, this does not necessarily mean the proposal needs to be discarded. In those cases, the **City should identify realistic and practical initiatives to keep recurring revenues and expenditures balanced**, whether that occurs through increasing revenues, reducing other types of expenditures or both. Those initiatives should be actions that the City can take on its own, not more prospective ventures that require action from others or good fortune.

The corollary to this principle is that the **City should use one-time windfalls[39] to fund one-time expenditures**, ideally accelerating the execution of high priority capital projects (see principle 4) or making contributions to the employee pension plan above the actuarially recommended levels (see principle 3). There will be occasions when revenues are higher or expenditures lower than projected because of one-time events, like selling assets or debt refinancing moves. The City should match the benefit of this non-recurring event with a non-recurring cost to avoid falling into the pattern of using one-time proceeds to close a structural gap.

Because of the time and effort that is often required to evaluate policy decisions and their associated fiscal impacts, we recommend that **the City continue to release its proposed budget before November each year** so that the Administration, Controller and Council have sufficient time to evaluate the budget based on this principle as discussed.

[39] The 2014 Amended Recovery Plan defines a windfall as a positive change in an individual budget line of at least $5 million relative to the levels budgeted for the current year with reasonable expectation that the change will not recur in the next five years. Positive change means revenues are at least $5 million higher than budgeted or expenditures are at least $5 million lower than budgeted. At the time the $5 million threshold was equal to roughly 1 percent of the General Fund budget.

Principle 2: Adopt a long-term financial plan in conjunction with the annual budget

The City should continue to adopt a five-year financial plan in conjunction with its annual budget. This is a requirement during ICA oversight and a widely recognized "best practice." Such a multi-year perspective is essential for addressing long-term needs like pension funding or capital improvements. It forces a perspective on financial questions that looks beyond the next election cycle. Having a multi-year financial plan also has the tangible benefit of bolstering the City's credit rating. The improvement in that credit rating, and the resulting lowered cost of borrowing, is one of the most tangible benefits of City government's financial recovery.

Principle 3: Make annual contributions to the employee pension plans at no less than the actuarially recommended levels

As described in the 2014 Amended Recovery Plan, Pennsylvania law allows the City to contribute less money to its employee pension plans than the amount that the actuary recommends is necessary to cover the pension liability[40]. The City's actuary expressed concerns that continuing to rely on this allowance would result in the pension plan failing to approach full funding, even over a longer period of time than Pennsylvania law usually allows for doing so.

Actions taken in response to the 2014 Amended Recovery Plan have gradually brought the City's annual contributions up to the actuarially recommended level by 2018. The 2018 budget and five-year plan shows the City's annual contributions exceeding the actuarially recommended level as currently projected through 2022 and reaching $104.5 million by 2022. This includes the parking tax revenue already committed to the pension fund but not the employees' own contributions. Next year the City's total contributions, not including the employees' contributions, will reach $86.4 million, or one of every six dollars spent out of the General Fund[41].

Looking forward, the City must exercise rigorous fiscal discipline and contribute an amount equal to or higher than the actuarially recommended amounts. Doing so will help increase the pension plan's funded ratio and provide a buffer against the next economic downturn, whenever it occurs, so the funding ratio does not crash back to the levels of a few years ago. While it will take commitment and focus from City officials to do more than the minimum required by Pennsylvania law, addressing the unfunded pension liability will ultimately benefit the employees who draw benefits from the pension plan, City government as their employer and the taxpayers who are ultimately responsible for making the largest part of these annual contributions.

A related principle is that **the City should continue to make annual contributions to the OPEB Trust Fund, over and above the annual "pay-as-you-go" expenditures on retiree health and life insurance**. Credit rating agencies and other financial stakeholders outside City government are increasingly viewing

[40] Act 82 of 1998 allows Pittsburgh to use more favorable actuarial assumptions for a portion of its unfunded pension liability than are otherwise permitted under Commonwealth law. Those assumptions in turn allow the City to contribute less toward the pension fund than is actuarially recommended such that the contribution is likely insufficient to cover the liability. Please see page 65 of the Amended Recovery Plan for more information.

[41] Includes the parking tax revenue commitment.

OPEB liabilities similar to pension liabilities. As of 2016, the City had $14.7 million in the OPEB Trust Fund versus a $506.9 million liability, equivalent to a funding ratio of just 2.9 percent if it were a pension plan. At some point it will be appropriate to use investment earnings from the OPEB Trust Fund assets to help cover a portion of the OPEB liabilities, just as is the case with the employee pension plans, but that is likely still years away.

Principle 4: Continue to make pay-as-you-go contributions to the capital improvement plan

There are two primary mechanisms for municipal governments to fund the necessary improvements to existing infrastructure, like roads, bridges, police and fire stations, recreation facilities, etc. Governments can make annual "pay-as-you-go" contributions or they can borrow money to finance projects using long-term debt[42].

In the early stages of the City's financial recovery, the City could only afford pay-go capital project funding, either by transferring a portion of prior year unassigned fund balance to the capital budget or allocating small portions of current year revenues to the capital budget. The City's low credit rating and high existing debt burden put the City on a "debt diet' where the City did not issue new debt to fund capital projects for nine years[43].

In 2012, the City issued $80 million for new capital projects and it subsequently issued $50 million more in 2014 and another $60 million in 2017. The FY2018 budget and five-year plan assumes the City will issue $60 million in bonds annually beginning in 2019. While the steep decline in existing debt payments starting in 2019 will enable the City to afford this new debt and pursue a more extensive capital improvement plan, the City needs to carefully manage its debt burden going forward so that debt service stays at least below the 12 percent target in its debt policy.

The City should also continue to make annual pay-as-you-go contributions to the capital budget. Using past experience as a guide, the City could transfer portions of the unassigned fund balance above the amount required to maintain a healthy reserve (see principle 5). It could also continue to allocate a portion of its current year revenues to the capital budget.

The City should ideally use pay-as-you-go money for capital projects like road paving and large vehicle purchases where the useful life of that project is not long enough to justify long-term repayment schedules. The City will also need to use pay-go funding and debt financing to fund capital projects since neither alone are sufficient to address the backlog of infrastructure needs.

As described in the Amended Recovery Plan, **one appropriate source for capital project funding is larger contributions from Pittsburgh's tax-exempt institution**. These organizations, particularly the major "eds and meds" institutions, play a critical role in stabilizing the local economy and they provide residents and visitors with world-class education, medical, and cultural offerings. These institutions also heavily rely on City infrastructure, like roads, bridges and fire stations, and should contribute to their repair and replacement.

In the early stages of financial oversight, the City received $14 million in payments-in-lieu-of-taxes (PILOTs) from tax-exempt institutions over three years, mostly through the Pittsburgh Public Service Fund. This was a landmark agreement, the first under the provisions of the state's Act 55 law regarding tax-exempt

[42] Governments also use external sources of funding, like federal or state grants, to pay for capital projects. Grants are often similar to pay-go funding and the money is provided with the condition that it be used for specific types of projects.

[43] The City did not issue any new debt between 2003 (Series A of 2003) and 2012 (Series A and B of 2012).

institutions. However, when the City improved its financial position and the agreement establishing that Fund expired, PILOT revenues also declined.

For years, the City has reported that conversations continue with the tax exempt institutions about their returning to larger contributions, but there has been no tangible progress to date. The FY2018 multi-year plan does not anticipate any non-profit contributions[44].

From our perspective, if non-profit contributions are directed to City capital needs this remains a significant untapped resource for addressing an unquestioned need with broad benefits to everyone, including the tax-exempt institutions' employees, patients, college students, and others. Furthermore, these contributions will help the City diversify its revenue structure and allow the City to continue its success in balancing recurring expenditures against recurring revenues without repeated reliance on tax increases.

Principle 5: Maintain sufficient reserves

Throughout the oversight period, we and the ICA have required the City to maintain an unassigned General Fund balance as a buffer against unexpected revenue shortfalls or unbudgeted expenditures. The GFOA recommends maintaining an unassigned fund balance at a level equivalent to two months (or 16.7 percent) of regular general fund operating revenues or regular general fund operating expenditures. The Recovery Plans had a more incremental approach, starting with a fund balance target of 5 percent in the original Plan adopted in 2004, then increasing to 10 percent in 2014. But the City should establish a formal fund balance policy that requires unassigned fund balance be maintained above a specific threshold with the long-term goal of eventually raising that threshold to the recommended 16.7 percent**.**

The City should also consider establishing a budget stabilization (or rainy day) reserve as part of the assigned fund balance. Moving some of the reserves from the unassigned to the assigned fund balance will provide a more structured purpose to the reserves while still providing the City with the financial flexibility to react to unanticipated economic downturns, budget shortfalls, or other unforeseen circumstances in a timely manner. The creation of a budget stabilization reserve is usually accompanied by an adopted policy that identifies the minimum size of the reserve, the purposes for which the reserve may be used for, and guidelines in ways to replenish that fund. Similar to the debt and capital budget policies that the City adopted in recent years, the fund balance policy will be a guide post and a measuring stick for current and future leaders.

[44] The $484,000 budgeted non-profit payments in 2018 are contractual payments through tax abatement agreements instead of contributions from tax-exempt entities.