

# Municipalities Financial Recovery Act

## Financial Condition Report

City of Reading  
Berks County, Pennsylvania



Prepared on behalf of the

Commonwealth of Pennsylvania  
Department of Community and Economic Development  
Governor's Center for Local Government Services

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# Executive Summary

On October 31, 2014, Governor Tom Corbett signed Act 199 into law, which limits the amount of time that a Pennsylvania municipality can remain in financial oversight according to the Municipalities Financial Recovery Act (Act 47 of 1987). For communities like the City of Reading (the City) that were already in Act 47 oversight, the relevant provision is the following:

*“Municipalities operating pursuant to a recovery plan on the effective date of this section shall be subject to a termination date five years from the effective date of the most recent recovery plan or amendment enacted in accordance with this act...”*

Reading City Council adopted an Amended Recovery Plan on November 24, 2014; Mayor Vaughn Spencer approved the associated ordinance the same day; and the Plan took effect on December 5, 2014. Reading's Act 47 status is subject to termination on December 5, 2019 pursuant to the review process described in Act 199.

That process requires that the financial advisory firm Public Financial Management (PFM) acting as Recovery Coordinator to “complete a report stating the financial condition of the municipality” that is submitted to the Secretary of the Department of Community and Economic Development (the Secretary) and includes one of the following findings:

- Conditions within Reading warrant a termination of the City's distressed status and the City successfully should exit Act 47 oversight;
- Conditions are such that the Secretary should request a determination of a fiscal emergency in Reading; or
- A three-year exit plan is warranted.

**Based on our review of the information presented in this Report, PFM as Recovery Coordinator recommends that the City of Reading adopt a three-year Exit Plan.**

Act 47 sets four criteria that the Secretary shall consider in evaluating a municipality's readiness to exit oversight. The first criterion requires “reasonable probability of future balanced budgets absent participation in this act” and the fourth criterion requires that “reasonably projected revenues of the municipality are sufficient to fund ongoing necessary expenditures.” To evaluate Reading's position relative to these forward-looking criteria, we have updated the baseline analysis presented in the original and Amended Recovery Plans that has been discussed periodically and publicly since 2009.

That analysis shows deficits growing from \$2.3 million in the adopted 2019 budget to \$4.2 million projected in 2022. We believe that the City can perform better than the baseline projection, even without the commuter taxing power provided by Act 47, because the Amended Recovery Plan has gradually reduced the City's reliance on this tax to fund operations. However, City's government's ability to manage away from the projected deficits while delivering critical municipal services is contingent on the City having strong financial management in place. The City struggled to fill four key positions focused on financial management<sup>1</sup> and, in the months leading up to this report's release, the number of vacancies among those four positions regressed back to the level that existed when the City first entered oversight.

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<sup>1</sup> Managing Director, Director of Administrative Services, Controller (i.e. Deputy Finance Director) and Accounting and Treasury Manager

The Administration has taken steps to rebuild this capacity, filling the Director of Administrative Services position and moving an employee from another part of City government into the Accounting and Treasury Manager position. Now that the four positions are filled, the new employees will need time to get acclimated to their new roles; demonstrate that they can produce a balanced budget without intervention from us as Act 47 Coordinator; and show progress in overcoming the long-term problems that will make financial management challenging in Reading for the foreseeable future.

Adopting a three-year exit plan means that the City will have to leave oversight no later than the end of 2022. The three-year exit plan that will be released within 90 days of this Report will provide more specific direction on the steps Reading should take to ensure a successful exit from oversight.

# Background

In September 2009, Mayor Thomas McMahon formally requested that the Pennsylvania Department of Community and Economic Development (DCED, or the Department) review whether the City of Reading qualified as financially distressed according to the criteria listed in Act 47 of 1987. The Department reviewed the City's financial performance and concluded that the City met three criteria in the Act:

- The City had maintained a deficit over a three-year period, with a deficit of 1 percent or more in each of the previous fiscal years;
- The City's expenditures had exceeded revenues for a period of three years or more; and
- The City had accumulated and operated for each of two successive years a deficit equal to five percent or more of its revenues.

The Department designated Reading as financially distressed and selected PFM to serve as the City's Recovery Coordinator beginning in December 2009. PFM and its team members met with City elected and appointed officials; representatives from the employee collective bargaining units; personnel from the associated water, parking, and redevelopment authorities; and other community members to discuss City government's financial challenges. PFM submitted a draft Recovery Plan for public comment in early May 2010 and then submitted a final version of that Plan at the end of the month.

Reading City Council reviewed the Plan and approved it by ordinance on June 11, 2010. Mayor McMahon signed the ordinance into law and the City began implementing the original Recovery Plan with the support of PFM and DCED.

From 2010 through 2014, City government made real progress in improving its fiscal condition by implementing difficult measures that wrenched its finances back into balance – increases in the real estate tax and resident earned income taxes; implementation of a commuter earned income tax; wage freezes and new health insurance cost sharing arrangements for active employees; new wage scales and more affordable pension plans for new hires; staffing reductions in the Departments of Administration, Police and Fire; and shifting collection duties for most major tax revenues to other entities.

Over the course of the original Recovery Plan, the City caught up on its delinquent contributions to its employee pension plans; retired debt owed to the Sewer Fund; and eventually broke the cycle of annual operating deficits. The City's cash balance in its General Fund swung from a \$2.3 million deficit in 2009 to a \$14.9 million positive balance in 2013.

In addition to these improvements in financial performance, the City also improved its financial management by adding a Deputy Finance Director position (called "Controller") supported on a declining basis by DCED grant funding; establishing summary-level monthly and detailed quarterly financial reports; and setting policies that govern interfund transfers.

## **2014 Amended Recovery Plan**

In the summer of 2014, we as Recovery Coordinator began work on an Amended Recovery Plan to cover the period 2015 through 2019. The Plan acknowledged City government's progress while also highlighting the major obstacles to achieving full financial recovery:

*True, full financial recovery for City government means more than reversing the previous trend of operating deficits and building a cash reserve, though those are requisite parts of financial recovery. True, full financial recovery involves bringing the growth in all expenditures, including the City's obligations for*

*employee pensions and retiree health insurance, into balance with recurring revenues. It involves stabilizing, or even lowering, the tax rates so the City is more competitive in its efforts to attract and retain residents and businesses. It involves having a stable source of funding for resurfacing streets, remediating bridges, repairing dams and renovating municipal government buildings.*

The Amended Recovery Plan is a lengthy document with initiatives to address the City's immediate financial challenges and drive progress on the longer term objectives noted above – balancing recurring revenues against recurring expenditures; curtailing the growth in the City's spending on employee pensions and retired employee health insurance; stabilizing tax rates; facilitating economic development and funding improvements to City government owned infrastructure, like roads, parks and fire stations.

In November 2014, Reading City Council approved the Amended Recovery Plan by ordinance and Mayor Vaughn Spencer signed the ordinance into law. The Amended Recovery Plan was adopted shortly after Act 47 itself was amended to limit the amount of time that municipalities could remain in this form of oversight. The Act now states:

*Municipalities operating pursuant to a recovery plan on the effective date of this section shall be subject to a termination date five years from the effective date of the most recent recovery plan or amendment enacted in accordance with this act..”*

Reading will reach the five-year time limit described above in December 2019. Since the City is in its final year of oversight, Act 47 requires us as Recovery Coordinator to “complete a report stating the financial condition of the municipality” that is submitted to the Secretary of DCED with one of the following findings<sup>2</sup>:

- Conditions within Reading warrant a termination of the City's distressed status and the City successfully should exit Act 47 oversight;
- Conditions are such that the Secretary should request a determination of a fiscal emergency in Reading; or
- A three-year exit plan is warranted.

We have met regularly with the City and DCED throughout the oversight process and had multiple public discussions about Reading's progress toward the objectives set in the Amended Recovery Plan and against the timeline set by Act 47. We provided City Council with a public update on the City's progress and the critical remaining steps to exit oversight in April 2018, roughly one year ahead of the release of this report. In that update we stated, “we are focused on the **financial performance** of the City (avoiding deficits, funding capital projects, eliminating the Act 47 tax) and the **financial management** of the City (filling key vacancies, complying with State deadlines, resolving audit findings).”

That continues to be our lens for reviewing the City's readiness to exit financial oversight.

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<sup>2</sup> The Coordinator may also recommend disincorporation if the municipality does not have its own paid police or fire department. This option is not applicable for Reading.

# Financial Condition Review

Act 47 requires that the Secretary of the Department of Community and Economic Development consider four factors in reviewing a municipality's ability to have its distressed status rescinded:

- Operational deficits of the municipality have been eliminated and the financial condition of the municipality, as evidenced by audited financial statements prepared in accordance with generally accepted accounting principles and projections of future revenues and expenditures, demonstrates a reasonable probability of future balanced budgets absent participation in this act.
- Obligations issued to finance the municipality's debt have been retired, reduced or reissued in a manner that has adequately refinanced outstanding principal and interest and has permitted timely debt service and reasonable probability of continued timely debt service absent participation in this act.
- The municipality has negotiated and resolved all claims or judgments that would have placed the municipality in imminent jeopardy of financial default.
- The reasonably projected revenues of the municipality are sufficient to fund ongoing necessary expenditures, including pension and debt obligations and the continuation or negotiation of collective bargaining agreements and the provision of municipal services. Projections of revenues shall include any anticipated tax or fee increases to fund ongoing expenditures for the first five years after a termination of distressed status.

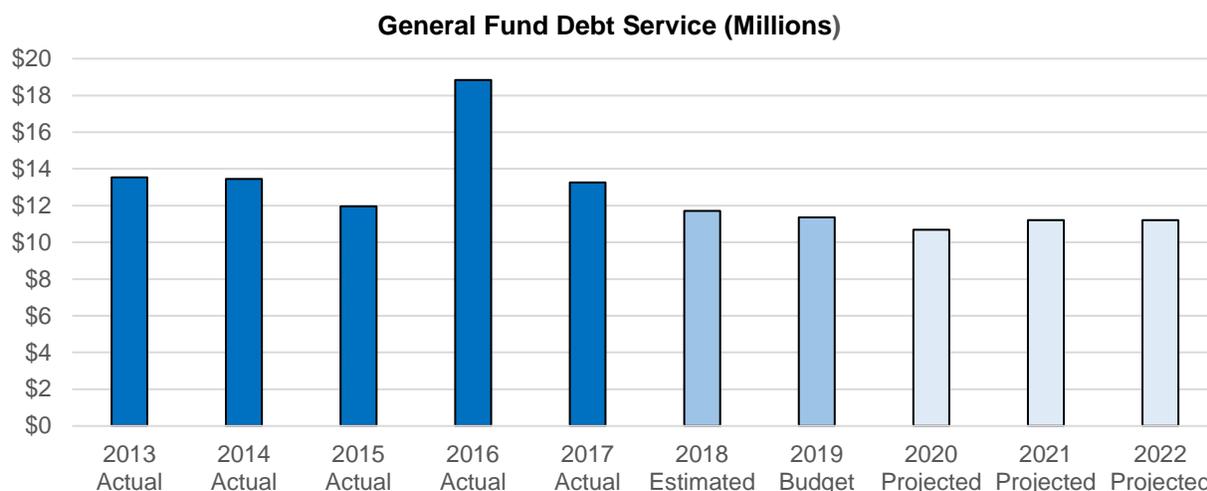
On the second criterion, the City has generally limited its debt-related activity within the General Fund<sup>3</sup> to refunding loans and bank notes that were issued before the City entered financial oversight. The City received a new bank loan in 2014 to replace some of its information technology equipment and repaid the loan ahead of schedule in 2017. Otherwise the City refunded debt in 2011, 2012, 2014, 2015 and 2017.

After needing an unfunded debt loan to sustain operations in 2010, the City has not needed additional borrowing to fund basic operations. The City retired the 2010 unfunded debt loan ahead of schedule, making a \$6.6 million early repayment in 2016. With the exception of 2016, debt service as a share of total General Fund expenditures dropped from 17.4 percent in 2013 to 15.3 percent in 2017. The \$11.4 million budgeted for debt service in 2019 is 12.1 percent of the General Fund total.

The City's scheduled debt service will drop from \$11.4 million in 2019 to \$10.7 million in 2020; return to \$11.2 million in 2021; and stay at that level until 2029. The City has made its full debt service payments when due throughout the financial oversight period and should be able to do so going forward.

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<sup>3</sup> This analysis does not include debt activity in the City's enterprise funds for water and sewer utilizes. That debt is repaid using service charge revenues collected in those separate funds.



For the third rescission criterion, there are no unresolved claims or judgments that place the City in imminent jeopardy of financial default to our knowledge. That leaves the first and fourth criteria as the most critical to evaluate Reading’s readiness to exit Act 47 oversight.

### Historical financial review

Reading qualified for financial distress status in late 2009 because annual expenditures exceeded annual revenues in the City’s governmental funds, especially the General Fund that the City uses to pay for many core municipal services (i.e. police patrol, fire protection, code enforcement). The City has since implemented initiatives in the original and Amended Recovery Plans and undertaken its own budget-balancing efforts. Those efforts contributed to the City registering positive operating results in all but one year since 2013.

### Audited General Fund Results, 2013 - 2017<sup>4</sup>

	2013 Actual	2014 Actual	2015 Actual	2016 Actual	2017 Actual
GF revenues	\$73,369,647	\$75,542,238	\$78,138,297	\$77,853,337	\$76,488,141
Transfers in	\$7,970,000	\$8,170,000	\$12,275,000	\$12,275,000	\$12,275,000
<b>GF revenues with transfers</b>	<b>\$81,339,647</b>	<b>\$83,712,238</b>	<b>\$90,413,297</b>	<b>\$90,128,337</b>	<b>\$88,763,141</b>
GF expenditures	\$76,110,237	\$81,278,441	\$84,810,853	\$89,916,761	\$85,306,430
Transfers out	\$0	\$0	\$0	\$774,127	\$0
<b>GF expenditures w/ transfers</b>	<b>\$76,110,237</b>	<b>\$81,278,441</b>	<b>\$84,810,853</b>	<b>\$90,690,888</b>	<b>\$85,306,430</b>
<b>Surplus / (Deficit)</b>	<b>\$5,229,410</b>	<b>\$2,433,797</b>	<b>\$5,602,444</b>	<b>(\$562,551)</b>	<b>\$3,456,711</b>

<sup>4</sup> These results exclude debt related items recorded in the audit as “other fund sources” (e.g. the City receiving bond proceeds) and “other fund uses” (e.g. the City making payments to an escrow agent) so the reader can more clearly see the City’s performance without the skewing effect of individual debt transactions.

The 2016 financial results were more positive than the table above suggests. The \$89.9 million in expenditures includes \$6.6 million to repay debt ahead of schedule. With that removed, the City would have had an operating surplus that year, too.

The City will not have preliminary 2018 year-end figures available until after this report is released and the audited results will follow in early fall 2019. The 2019 budget suggests revenues again exceeded expenditures last year since it includes \$2.3 million in unspent money carried forward from 2018 into 2019.

As positive as these “bottom line” results are – especially in light of the deficits that the City ran before it entered financial oversight -- they only tell part of the story.

It is important to understand how the City is generating these results because not all surpluses are created equal. If the City is making reasonable revenue estimates and then economic growth drives revenues higher than expected, that is a positive contributor to a surplus. It is also positive if the City identifies efficiencies where it can deliver the same quality of service at a lower cost during the year and reduces its expenditures below budgeted levels.

But negative factors can also contribute to a financial surplus. If the City incorporates expenditures in its budget for an important project and then fails to execute it – because of lack of capacity, inefficient work processes or disagreement on how to proceed -- that can produce savings relative to the budget at the cost of effective government.

There is evidence that has started to occur.

The 2017 audit shows a \$3.5 million surplus at the end of that year. Total General Fund revenues finished almost exactly at the level budgeted with a variance of only \$24,000 (or 0.03 percent)<sup>5</sup>. So the surplus was generated by spending less than budgeted.

The City spent \$860,000 (or 3.0 percent) less than budgeted on salaries, temporary wages and premium pay across all employees in the General Fund, partly because of vacancies in key positions like the Director of Administrative Services<sup>6</sup>. Some of those savings were offset by the City spending \$674,000 more than budgeted on overtime, primarily in police and fire. The City spent \$1.7 million less than budgeted on employee health insurance where we expect some volatility relative to budget because the City is self-insured.

The other areas with substantial savings relative to budget were not related to personnel.

- The City budgeted \$1.0 million for a demolition and roof replacement program that it did not execute.
- The City budgeted \$11.3 million for operating costs, which are mostly the materials, supplies and contracted services that City government uses in its regular operations. The City spent \$2.8 million less than budgeted with large variances in Public Works’ budget for traffic engineering and public property maintenance. Subsequent discussions with management indicated that the City had difficulty executing some projects incorporated in the 2017 budget.

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<sup>5</sup> 2017 comprehensive annual financial report. Page 108

<sup>6</sup> We are using the preliminary unaudited results for some of this analysis because it has a higher level of detail than the summary figures presented in the annual financial reports.

We have not seen the 2018 year-end results yet, but we anticipate that lack of execution will again account for some of the surplus. The City budgeted \$400,000 for sidewalk repair during 2018 and was still discussing the parameters of the program in early 2019.

Lack of execution is not the only reason for the City's surpluses. Earned income tax revenue growth has been strong and real estate transfer tax revenues have exceeded the budget targets in recent years. The City has taken steps to try to improve the collection rate on other taxes and Reading's elected and appointed officials have been mindful of the need to control expenditures and live within the level of revenues available. Those are all real and positive factors in the City's financial success. But some of the surplus has been created by not executing the plans incorporated in the annual budgets, which raises concern about management capacity.

The rescission criteria also require the City to have positive financial results projected in the future. The first criterion requires "reasonable probability of future balanced budgets absent participation in this act" and the fourth criterion requires that "reasonably projected revenues of the municipality are sufficient to fund ongoing necessary expenditures."

The next section evaluates Reading's readiness to exit oversight according to that forward-looking perspective.

# Baseline Projection

The original and Amended Recovery Plans each begin with a baseline projection of the City’s General Fund revenues and expenditures in a *status quo* scenario. The baseline projection is a diagnostic exercise to identify the critical factors that drive financial performance; determine whether there is a structural deficit; and quantify any deficit and demonstrate how it will change over time. We have updated this analysis and presented it to the Administration, City Council and the public periodically throughout Reading’s time in oversight.

The rescission criteria require us to use this analysis to demonstrate that the City’s revenues will be “sufficient to fund ongoing necessary expenditures,” particularly the City’s mandatory contributions to the employee pension plans, debt repayment and personnel costs. The law requires that the projection cover “the first five years after a termination of distressed status,” which in Reading’s case would run through 2024.

At the time of our analysis, the City did not have a contract with an actuarial firm to estimate its future minimum municipal obligations (MMOs) to the employee pension plans. In early 2018, the prior actuary provided an estimate of the MMO payments through 2022, which we have used in this report. The MMO is a large and potentially volatile number as described below, so we will not present projections for 2023 or 2024 until the actuary is under contract and can participate in the process.

The baseline projection takes the most recent adopted budget as the starting point; accounts for known future changes (such as wage increases in existing collective bargaining agreements and scheduled debt payments); and then applies growth rates calculated based on a combination of historical performance, socioeconomic trends, and other factors.

The three-year projection starts with the City’s 2019 budget that shows a \$2.3 million deficit between revenues and expenditures. The City anticipates that it will have a year-end surplus of at least \$2.3 million in 2018 and carries that surplus forward to fill the deficit in 2019. The baseline projection shows the deficit growing to \$4.2 million, or 4.1 percent of total expenditures, at the end of the projection period.

## General Fund Baseline Projection

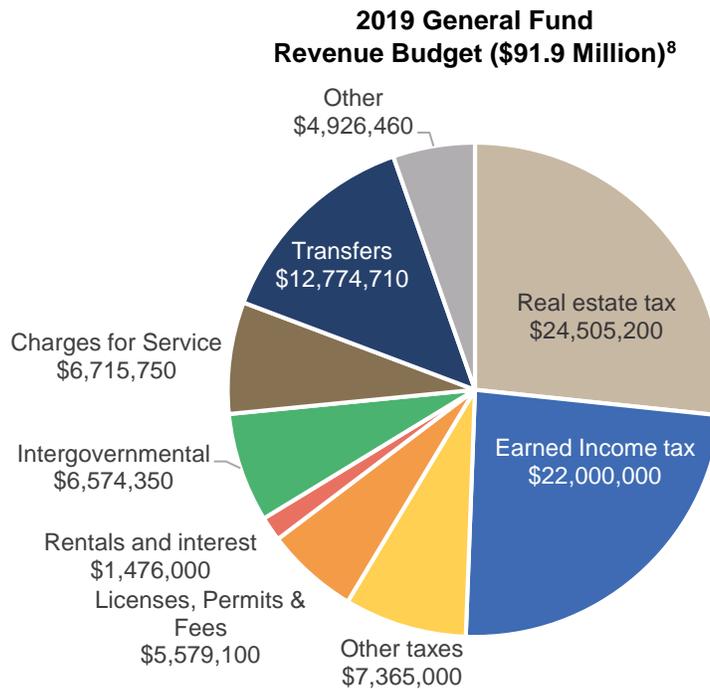
	Budget 2019	Projected 2020	Projected 2021	Projected 2022	CAGR <sup>7</sup>
Total revenues	\$91,917,000	\$93,934,000	\$96,334,000	\$98,664,000	2.4%
Total expenditures	\$94,217,000	\$97,223,000	\$99,832,000	\$102,902,000	3.0%
Surplus / (Deficit)	<b>(\$2,300,000)</b>	<b>(\$3,289,000)</b>	<b>(\$3,498,000)</b>	<b>(\$4,238,000)</b>	<b>N/A</b>
% of Expenditures	<b>-2.4%</b>	<b>-3.4%</b>	<b>-3.5%</b>	<b>-4.1%</b>	<b>N/A</b>

The remainder of this section summarizes the baseline assumptions underlying this projection and the major budget drivers.

<sup>7</sup> Compound annual growth rate (CAGR)

## Major Revenue Assumptions

About half of the City's General Fund revenue comes from the real estate tax and the earned income tax (EIT). Those two items combined with the revenue from other taxes and interfund transfers account for close to three quarters of the 2019 General Fund revenue budget.



	<b>2019</b>	<b>2020</b>	<b>2021</b>	<b>2022</b>	<b>CAGR</b>
	<i>Budgeted</i>	<i>Projected</i>	<i>Projected</i>	<i>Projected</i>	
Real estate tax	24,505,200	24,689,654	24,790,809	24,802,315	0.4%
Earned Income tax	22,000,000	22,361,000	23,104,000	23,719,000	2.5%
Other taxes	7,365,000	7,585,900	7,816,764	8,058,072	3.0%
Charges for Service	6,715,750	6,731,250	6,747,231	6,763,706	0.2%
Licenses, Permits & Fees	5,579,100	5,657,951	5,739,762	5,824,659	1.4%
Intergovernmental	6,574,350	6,730,951	6,892,087	7,057,892	2.4%
Rentals and interest	1,476,000	1,476,000	1,476,000	1,476,000	0.0%
Other	4,926,460	5,779,872	6,697,529	7,740,730	16.3%
Transfers	12,774,710	12,921,331	13,070,151	13,221,203	1.2%
<b>Total Revenues</b>	<b>91,916,570</b>	<b>93,933,908</b>	<b>96,334,332</b>	<b>98,663,578</b>	<b>2.4%</b>

<sup>8</sup> This excludes the \$2.3 million carryforward that the City uses to close the budget deficit.

### Real estate tax

The City's real estate tax generates a little more than a quarter of the City's General Fund revenues. The City projects approximately \$24.5 million will come from this source, including delinquent payments, in 2019. The 2019 tax rate is 17.489 mills with an additional 0.20 mills levied to support the City's separate Shade Tree Fund.

The total assessed value for taxable property in Reading has been flat since 2013, growing by just 0.2 percent from \$1.430 billion that year to \$1.433 billion in 2019. The real estate tax base for 2019 was a little larger than the City assumed in its 2018 budget<sup>9</sup>, so if we apply the historical collection rate for current year real estate taxes, the City can expect to receive \$170,000 more than budgeted in its General Fund this year.

We also adjusted the real estate tax revenue projection to account for the expiration of tax abatements that properties currently receive under the Keystone Opportunity Zone (KOZ) program and the Local Economic Revitalization Tax Assistance (LERTA) program. Expiring LERTA benefits will generate minimal additional tax revenue during the projection period, but expiring KOZ benefits will add \$5.7 million to the City's real estate tax base in 2021. That translates to about \$90,000 in additional tax revenue that year. Another set of properties that includes the Doubletree Hotel will have its KOZ abatements expire in 2024, which is outside our projection period.

The baseline projection assumes that the other major variables for projecting real estate tax revenues remain constant. The current year collection rate is assumed to be 89.2 percent, which was the five-year average of collection performance for 2013 – 2017. The tax rate is held constant in the baseline scenario. Delinquent collections are held constant at the \$2.3 million level budgeted for 2019 and the tax base is held constant, following the aforementioned historical trend.

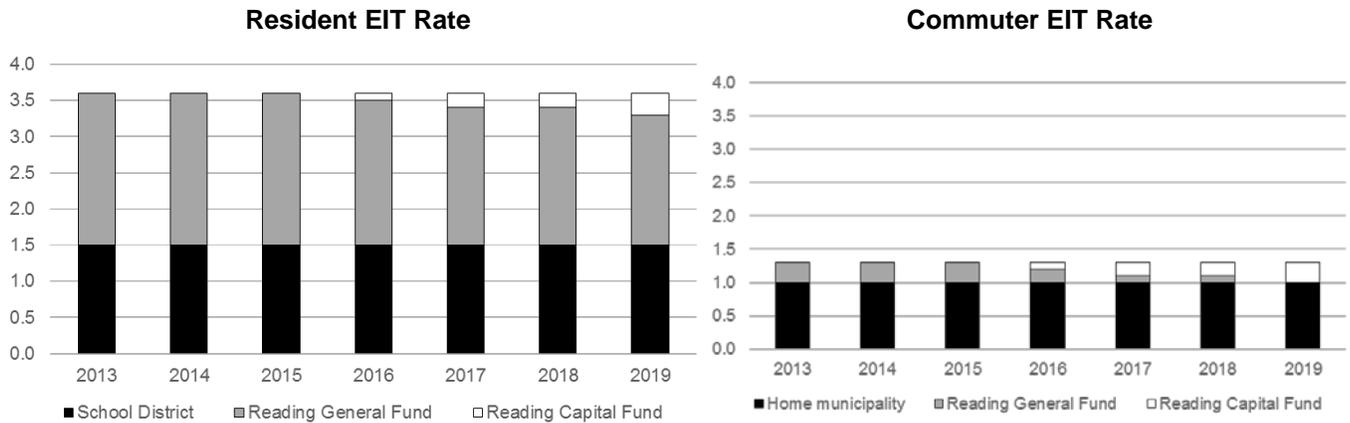
This translates to minimal growth in total real estate tax revenues -- they increase from \$24.5 million budgeted in 2019 to \$24.8 million in 2022.

### Earned income tax

The earned income tax (EIT) is the second largest source of General Fund revenue and the largest source of tax revenue overall, once EIT revenue dedicated to the separate Capital Project fund is included. The City has been shifting a growing portion of the resident and commuter earned income tax rate to the Capital Project fund as shown in the graphs below.

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<sup>9</sup> The City assembled the 2019 budget in September 2018, at which point the most recent set of property valuation figures were from 2018. The County provided an updated property valuation in early 2019, which is the actual basis for the City's real estate taxes.



The Amended Recovery Plan required this shift, partly to help the City make progress against the backlog of critical capital projects and partly to reduce the City's dependence on the additional taxing power tied to its Act 47 status. The City cannot levy the commuter tax once it exits Act 47 oversight.

Starting January 1, 2019, the City no longer uses any current year commuter EIT to fund daily operations. Commuters will generally pay 1.0 percent to their home municipality<sup>10</sup> and 0.3 percent to Reading to fund Capital Projects. Because of the time lag between when the EIT is levied and when the revenue is remitted to the City, Reading will receive some commuter EIT associated with late 2018 in its General Fund in early 2019 and then minimal commuter EIT revenues in that Fund after 2019.

We have monitored the trends in Reading's EIT receipts closely throughout the oversight process because of their size relative to most other revenues and their growth relative to the flat real estate tax base. To isolate the effects of rate changes, the aforementioned time lag, and changes in delinquent collections, we have calculated the amount of revenue that each 0.1 percent levied generates per quarter in current year revenues. We have then compared that to external data that provides insight on how the tax base itself is growing in terms of the number of employed residents and the median household income.

**Resident EIT Revenue and Tax Base Growth, 2013 – 2017<sup>11</sup>**

	2013	2014	2015	2016	2017	CAGR
Resident revenue per tenth percent per quarter	\$180,222	\$191,334	\$203,251	\$217,944	\$235,515	6.9%
Annual growth	N/A	6.2%	6.2%	7.2%	8.1%	
Employed residents	34,486	34,153	34,076	34,032	33,925	-0.4%
Annual growth	N/A	-1.0%	-0.2%	-0.1%	-0.3%	
Median Household Income	\$26,777	\$26,867	\$26,784	\$27,247	\$28,755	1.8%
Annual growth	N/A	0.3%	-0.3%	1.7%	5.5%	

Source: EIT receipt data from Berks EIT, Incorporated; number of employed residents from the US Bureau of Labor Statistics, Local Area Unemployment Statistics; median household income from the US Census Bureau's American Community Survey, 5-year estimates.

<sup>10</sup> This depends on the earned income tax rates in the commuters' home municipality. Commuters living in municipalities where the resident EIT rate is less than 1.0 percent will pay more to Reading and commuters living in municipalities where the resident EIT is more than 1.0 percent will pay less to Reading.

<sup>11</sup> The 2018 ACS data on median household income is not yet available for comparison.

EIT receipts consistently grew more than the two variables that should drive growth in the tax base. The number of employed residents in the City did not grow by this measure and the median household income had very modest growth until 2017. Meanwhile current-year revenue collected from residents per 0.1 percent per quarter grew by 6.9 percent. One explanation for the divergent trends is that the current year collection performance has been improving as the collector improves its processes and software and identifies more of the existing tax payers.

The good news is that Reading's EIT receipts have grown consistently and often more than expected. Even in years where the City expected General Fund EIT revenues to drop because part of the tax rate was shifted to the Capital Fund, they either did not drop (3.0 percent growth in 2016) or dropped less than expected. Strong EIT performance has compensated for minimal or sporadic growth in other revenues absent tax increases.

The bad news is that, if this growth is primarily because of improving collection performance, eventually that growth will slow once the collector reaches the point where it is collecting everything it can from the existing tax payers. The number of resident tax payers is not growing and the income for each tax payer has grown by a much slower rate. Eventually we expect the EIT growth rate to drop closer to what the tax base is doing, though we cannot predict when that will happen. The amount of resident revenue per tenth percent per quarter grew by 6.3 percent in 2018 versus 8.1 percent in 2017, so perhaps that is already happening. The 2019 budget anticipates 5.0 percent growth in the resident EIT revenue generated per 0.1 percent per quarter and the baseline continues that downward trend, lowering it to 4.0 percent in 2020, 3.0 percent in 2021 and 2.5 percent in 2022. Even that level would be a little higher than the compound annual growth in median household income in recent years.

Once the impact of the tax rate shift and the time lag between tax levy and revenue collection are taken into account, the City's annual General Fund EIT revenues are projected to grow on average by 2.5 percent during the projection period. We will continue to monitor this trend closely because it is critical to the City's financial stability.

#### Other tax revenues<sup>12</sup>

The City uses Act 511 to levy other taxes which are grouped together in this category.

- The City levies a 3.5 percent **real estate (or deed) transfer tax** on the value of real estate transferred by deed, instrument, long-term lease or other writing. Transfer tax revenue rose from \$2.8 million in 2013 to \$4.0 million in 2017, which translates to an average annual increase of 9.2 percent, but with a lot of volatility between those two end points. Transfer tax revenues fell by 11.2 percent in 2014, shot up 27.7 percent in 2015 and then grew at declining (but still large) rates in 2016 (14.6 percent) and 2017 (9.5 percent).

The presence or absence of a few transactions involving large commercial properties can skew the growth rates, making it hard project a reasonable growth rate. In 2017, we analyzed the data on taxable transactions provided by Berks County and found that the number of transactions was also increasing at that time.

The City budgeted \$3.8 million for 2019 which is 13.4 percent higher than the 2018 budget target, but less than the \$4.0 million collected in 2017. For now we are projecting five percent annual growth in this tax revenue and will revisit that projection once the 2018 year-end numbers are finalized.

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<sup>12</sup> The City's admissions tax is grouped under service charges and discussed there.

- The **business privilege tax (BPT)** is levied on the gross receipts of all entities engaged in commercial activities for gain or profit within Reading's borders. The tax is 0.5 mils on whole sale businesses, 0.75 mils on retail businesses and 1.5 mils on other businesses. Current year BPT revenues have alternated a year of growth with a year of decline since 2013 with the compound annual growth rate over that period at 1.4 percent. The baseline projection assumes 1.5 percent growth in line with that historical average.
- The **local services tax (LST)** is a weekly tax of \$1 per employee working in Reading for anyone who earns more than \$12,000 a year. The tax is levied based on where a person works, so it includes commuters working in the City. Similar to the BPT, total LST revenues have alternated a year of growth with a year of decline since 2013 and have hovered around \$1.2 million. The City budgets that amount for 2019 and we carry it forward.
- The City levies a \$20 tax on each City resident who is at least 18 years old and the Reading School District adds another \$10 for a total annual **per capita tax** of \$30. As discussed frequently, the collection rate for the per capita tax rate has been very poor. The City collected \$263,000 in current year PCT revenue in 2017, which translates to 22.2 percent of the City population over age 17 paying the tax. Collection performance did improve over 2016 levels (14.3 percent), and the City has changed external collectors in the hope of further improvements. Population growth slowed to effectively zero from 2013 to 2017 (0.1 percent per year) so we do not anticipate much natural growth in the tax base. The baseline carries the City's \$275,000 budget target forward.

Taking all of these taxes together, the baseline projects 3.0 percent annual growth, mostly due to the deed transfer tax.

The City's non-tax revenues fall into the following categories.

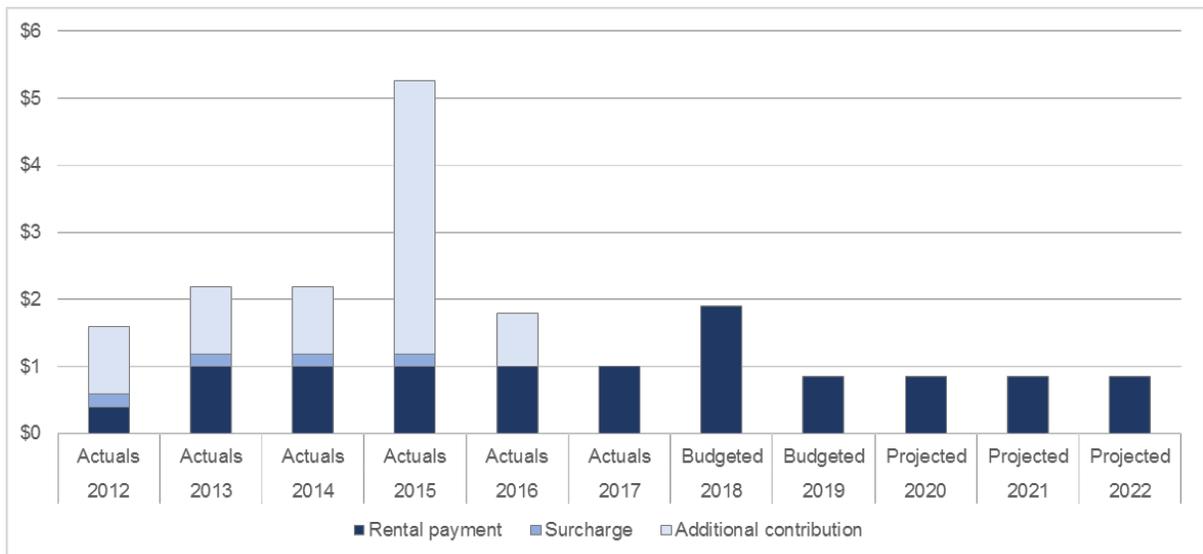
- **Charges for service:** The City has several fees and service charges that are intended to cover most, if not all, of the cost associated with providing services to specific individuals or organizations. The largest item in this category are the **emergency medical service (EMS) user fees** that the Reading Fire Department receives. User fee revenues have been flat at \$2.9 million since 2013 so the baseline does not project any growth. The second largest item is \$1.7 million from a **water meter surcharge**, which is a flat transfer amount from the Reading Area Water Authority. The only significant item in this category that grew from 2013 to 2017 is the 5.0 percent **admissions tax** on events at the Santander Arena, Santander Performing Arts Center and FirstEnergy Stadium. Admission tax revenue jumped from \$419,000 in 2015 to \$542,000 in 2016 (29.3 percent) and then settled into a more moderate 2.3 percent growth rate in 2017. The baseline projection applies the historic growth in the County gross domestic product (3.1 percent from 2013 – 2017) as a reflection that these venues draw from the regional economy. Other items in this category are generally held flat since that is the trend across items except for the admissions tax.
- **License, permits and fees:** The largest item in this category is **rental housing permits**, the revenue from which grew each year from 2013 through 2017. But revenue from **rental housing inspections** dropped over that same period so that the trend across the category was negative for 2013 through 2017 (-1.6 percent per year). The 2019 budget anticipated a slight improvement in this area and the 2018 year-end numbers are not available yet, so we carry the City's 2019 budget targets forward through 2022. Revenues from **cable franchise fees** grew by 5.2 percent per year over this period so the baseline assumes 5.0 percent annual growth going forward. Fine revenues related to District Court Summary Offenses dropped from \$1.0 million in 2014 to \$368,000 in 2017 because the City decriminalized parking-related offenses and the revenue now flows to the Reading Parking Authority. For other items the baseline projects flat or inflationary growth off the 2019 budgeted amounts assuming the City does not make significant changes in enforcement or fee levels.
- **Intergovernmental:** The largest item in this category is the **Commonwealth pension aid**, which is based on the City's employee headcount and the amount of revenue that the Commonwealth

collects from taxes on out-of-state insurance policies. Assuming that the City’s headcount remains constant, the baseline applies the 3.0 percent historical growth rate in the State Aid unit value<sup>13</sup> to the \$3.7 million budgeted for 2019. The second largest item is the **Reading Public Library** contribution from Berks County that helps offset the salary costs of the Library employees who work for the City. The amount recorded in the City’s financial records fluctuates year to year, partly depending on when the City receives it. The compound annual growth rate from 2014 through 2017<sup>14</sup> was 3.0 percent so the baseline applies that going forward. Other items in this category grow by inflation or are held flat depending on their funding source and historical trend.

- **Rentals and interest:** The 2019 budget has \$1.5 million in revenue associated with this category, most of which comes from the **Reading Parking Authority (RPA)**. The RPA has historically paid the City an amount associated with the parking meters and then made a supplemental payment to support City government’s General Fund operations<sup>15</sup>. The RPA also previously transmitted \$190,000 to the City for a parking-related surcharge. The total RPA contribution across these three items jumped from \$2.2 million in 2014 to \$5.3 million on a one-time basis in 2015 and then dropped back to \$1.8 million in 2016.

The City budgeted \$1.3 million for 2017 and the RPA paid \$1.0 million. The City consolidated the three items into one line budgeted at \$1.8 million in 2018. Midway through last year the RPA explained that it could not afford to make this level of contribution because of its own financial challenges. The RPA eventually agreed to make an \$850,000 payment, which is incorporated in the City’s 2019 budget. The RPA has not agreed to make a contribution beyond 2019 but for now we are carrying the \$850,000 contribution forward through 2022. We have encouraged the City and RPA to reach an agreement that sets the RPA contribution for multiple years so both parties have that stability and predictability for their own budgeting and financial planning purposes. The City’s lease agreement with the Reading Area Water Authority provides a good model for this type of arrangement.

**RPA Related Revenues (\$ Millions)**



- **Other revenues:** This catch-all category includes all other items not counted in the previous categories. The largest item are the **employees’ contributions to the premium costs of their**

<sup>13</sup> This is the amount of State pension aid provided for each City employee with two units provided for each police officer or firefighter.

<sup>14</sup> The 2013 contribution was unusually low so we use 2014 as a more standard starting point for the growth rate calculation.

<sup>15</sup> The RPA has also collected some revenue, such as traffic fines, and remitted it to the City. In those cases the RPA is not contributing money to the City but rather acting as a pass through.

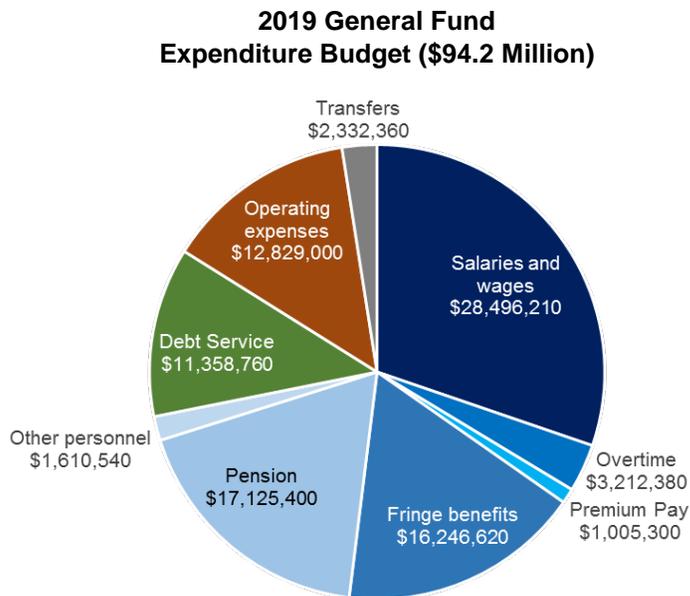
**health insurance.** The City budgets the full premium costs of employee health insurance on the expenditure side, and then records the employees' share as revenues. For reasons that we explain in the expenditure section, the baseline projection currently shows employee contributions increasing from the \$2.1 million in the 2019 budget to \$4.7 million in 2022. The reader should treat these figures as place holder until we can work with the City to resolve an issue related to its employee health insurance expenditures which we explain below.

This category also includes the **indirect cost reimbursements** that the General Fund receives from other funds, primarily the sewer funds. This is a common mechanism that governments use to recover the cost of services provided to the City's separate enterprise operations (e.g. sewer, recycling). The baseline projects these indirect cost reimbursements to grow at inflation as a proxy for the cost recovery calculations that should be updated periodically through a cost recovery study.

The City receives two large interfund transfers into the General Fund, which appear as revenues in the budget<sup>16</sup>. The **Reading Area Water Authority (RAWA)** leases and operates the water filtration and distribution system from City government, and pays the City an agreed-upon amount under the terms of its lease arrangement. The City then transfers a portion of the lease payment into the General Fund. That transfer amount is \$9.8 million in 2019 and grows by 1.5 percent per year under the lease terms. Under the terms of a federal consent decree, the City also transfers \$3.0 million a year into its General Fund from its Sewer Fund. The baseline holds that transfer payment flat through 2022.

### Major Expenditure Assumptions

Like other Pennsylvania cities, Reading spends the majority of its General Fund budget on its employees. Personnel expenditures – including employee salaries, overtime, other forms of cash compensation, health insurance and the City's pension plan contribution – account for more than 70 percent of the 2019 budget. Debt accounts for another 12.1 percent, which leaves less than 17 percent to cover everything else.



<sup>16</sup> Interfund transfers are not revenues from a traditional accounting perspective, but Pennsylvania local governments often record them as such in their budget and related documents.

	2019 <i>Budgeted</i>	2020 <i>Projected</i>	2021 <i>Projected</i>	2022 <i>Projected</i>	CAGR
Salaries and wages	28,496,210	29,806,955	30,705,524	31,466,735	3.4%
Overtime	3,212,380	3,310,778	3,419,116	3,507,614	3.0%
Premium Pay	1,005,300	1,020,177	1,048,666	1,069,630	2.1%
Fringe benefits	16,246,620	18,033,748	20,017,461	22,219,381	11.0%
Pension	17,125,400	17,401,800	16,150,800	15,812,600	-2.6%
Other personnel	1,610,540	1,575,285	1,604,720	1,631,635	0.4%
Debt Service	11,358,760	10,686,313	11,209,922	11,209,157	-0.4%
Operating expenses	12,829,000	13,055,160	13,343,770	13,653,312	2.1%
Transfers	2,332,360	2,332,360	2,332,360	2,332,360	0.0
<b>Total Expenditures</b>	<b>94,216,570</b>	<b>97,222,576</b>	<b>99,832,339</b>	<b>102,902,424</b>	<b>3.0%</b>

Cash compensation

The City allocates 30.2 percent of its 2019 General Fund budget for employee salaries and wages, including those paid to temporary, part-time or seasonal workers. Total spending on employee salaries within the General Fund was flat from 2013 through 2017, rising by just \$0.7 million (or 0.7 percent per year) across all employees. Employees received base wage increases over that period, though they were limited by the terms of the Recovery Plans. Employees who were eligible for tenure-based step increases<sup>17</sup> received them and individual employees received promotion-based raises, so wages for individual employees were not as flat as the overall trend. But turnover-related savings and vacancies kept the City's total spending on employee salaries and wages below the budgeted level in recent years.

**Salaries and Wages in the General Fund (All Departments, All Employees)**

	2015			2016			2017		
	Actual	Budget	%	Actual	Budget	%	Actual	Budget	%
Salaries and Wages	\$27,164,187	\$28,680,444	94.7%	\$27,086,151	\$28,473,699	95.1%	\$27,256,695	\$28,118,837	96.9%

While salary spending has been flat, the City increased its spending on **overtime** in the General Fund from \$3.0 million in 2013 to \$3.6 million in 2017, or 4.8 percent per year. Most overtime spending occurs in the Police Department (\$1.9 million budgeted in 2019) and Fire Department (\$1.2 million budgeted in 2019) because of the around-the-clock nature of those operations.

The City allocates \$1.0 million for additional cash compensation related to employees working on holidays (holiday pay) or tenure-based longevity payments. Spending on holiday pay, which is indexed to base salaries, was flat from 2013 through 2017. Spending on longevity dropped because the Recovery Plans' cost control provisions freeze the payment amounts and eligibility for those payments, so turnover gradually reduces total expenditures.

We monitor the City's total spending on salaries, wages, holiday pay and overtime in the Police and Fire Departments on a quarterly basis since they have the largest allocations in the General Fund. Total spending on these items increased by 2.2 percent for the Fire Department and 1.2 percent in the Police

<sup>17</sup> This is primarily police officers and firefighters in the early part of the career.

Department in 2017 and similar percentages in 2016. Through the first three quarters of 2018, spending on these items increased by 3.4 percent in Fire and 3.6 percent in Police.

The baseline projection assumes 2.0 percent wage increases for all employees in all years and assumes any employee eligible for a step increase receives it. Expenditures indexed to salaries, such as overtime and the City's share of payroll taxes<sup>18</sup>, also increase by 2.0 percent. Items that are a flat dollar amount under the terms of the current collective bargaining agreements are projected to remain flat.

### Fringe Benefits

This category is primarily the City's expenditures on employee medical and prescription drug insurance coverage, with smaller amounts recorded for employee dental, vision and life insurance coverage. As noted earlier, the City budgets the full premium costs of employee health insurance on the expenditure side, and then records the employees' premium contributions as revenues. The City is also self-insured, so it pays the cost of claims as employees receive medical care with some time lag associated with the medical billing and payment posting process. The City has a stop-loss insurance policy that covers an employee's medical treatment after the total costs for an injury or illness reach \$225,000.

The City allocates \$11.0 million for active employee fringe benefits in its General Fund and another \$5.2 million for retired employees in 2019. From 2013 to 2017, spending on retiree health insurance grew faster than spending on active employee insurance (10.9 percent per year for retirees versus 4.9 percent for active employees). Across all employees the City's total spending grew by 7.1 percent per year net of employee contributions.

#### **General Fund Fringe Benefit Expenditures**

	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>CAGR</b>
	<b>Actuals</b>	<b>Actuals</b>	<b>Actuals</b>	<b>Actuals</b>	<b>Actuals</b>	
Active employees	\$6,584,351	N/A	\$7,757,503	\$8,038,466	\$7,966,000	4.9%
Retired employees	\$3,437,477	N/A	\$4,588,965	\$5,537,924	\$5,192,328	10.9%
Gross expenditures	\$10,021,828	\$11,630,373	\$12,346,468	\$13,576,390	\$13,158,328	7.0%
Employee contributions	(\$1,451,416)	(\$1,362,744)	(\$1,289,566)	(\$1,875,949)	(\$1,874,349)	6.6%
Net expenditures	\$8,570,412	\$10,267,630	\$11,056,902	\$11,700,441	\$11,283,979	7.1%
Annual % change	N/A	19.8%	7.7%	5.8%	-3.6%	N/A

We consulted with the City's third-party health insurance administrator to get their insight on how the City's health insurance expenditures may grow over the projection period. Based on national trends, the TPA suggested an 11 percent growth rate for future health insurance costs was reasonable, for both active and retired employees. The Amended Recovery Plan caps the growth in the City's share of total premiums (or premium equivalents since Reading is self-insured) for active employees at 5 percent per year. That means any cost growth over the 5 percent would shift to the employees and get recorded as additional employee contributions on the revenue side. Employees could also switch to lower cost health plans that are already available or agree to plan design changes that lower the costs. The impact of the premium increases on retirees would vary according to their date of retirement, the plan they use and their cost sharing agreement.

The baseline projection shows the City's net share of expenditures growing by 7.3 percent – more than the five percent cap because many retirees are not subject to the same cost sharing provisions as active employees.

<sup>18</sup> The City's share of payroll taxes and uniform allowance account for the majority of the expenditures grouped in Other Personnel in the table at the top of page 18.

### General Fund Baseline Projection – Fringe Benefits

	2019 Budget	2020 Projected	2021 Projected	2022 Projected	CAGR
Active employees	\$11,026,500	\$12,239,415	\$13,585,751	\$15,080,183	11.0%
Retired employees	\$5,220,120	\$5,794,333	\$6,431,710	\$7,139,198	11.0%
Gross expenditures	\$16,246,620	\$18,033,748	\$20,017,461	\$22,219,381	11.0%
Employee contributions	(\$2,100,000)	(\$2,866,590)	(\$3,744,284)	(\$4,746,644)	31.2%
Net expenditures	\$14,146,620	\$15,167,158	\$16,273,176	\$17,472,737	7.3%
Annual % change	N/A	7.2%	7.3%	7.4%	

There are some important contextual notes for this part of the projection:

- The City is self-insured so its actual expenditures could vary significantly from the projections, depending on the volume and cost of medical care that employees actually receive. As shown above, the City's expenditures on active employee health insurance grew by 4.9 percent from 2013 to 2017, which was less than half of the 11 percent projected. From 2015 to 2017, expenditures on active employees grew by only 1.3 percent per year. So, while the 11 percent projection is based on the best information available at this time – and it is close to the recent expenditure growth for retirees -- actual expenditure growth could be lower.
- In recent years the City spent less than budgeted on health insurance for active employees and the gap between actual and budgeted expenditures grew. The City spent \$1.5 million less than budgeted on active employee health insurance in 2016 and \$2.1 million less in 2017. We do not have the 2018 results yet, but we calculated the cost of active employee health insurance for each position in the 2019 budget across all funds, based on the employee's level and type of coverage at the time and the TPA's premium equivalency rates. The aggregate cost in that analysis was \$10.9 million, including dental and vision coverage, versus the \$13.0 million in the budget. While it is reasonable for the City to budget conservatively for health insurance given its self-insured status, and position vacancies can reduce spending below budgeted levels, the City may be budgeting more than it needs for active employee health insurance.
- For retiree health insurance, the City may be doing the opposite. The City spent \$1.0 million (or 21.4 percent) more than budgeted for retiree health insurance in 2016 and \$0.4 million more than budgeted in 2017. Estimating retiree health insurance costs is even more difficult than active employees because of the large variety of cost sharing arrangements depending on the employees' retirement date, plan selected and other factors.

### General Fund Fringe Benefits Expenditures, Actual to Budget

	2016			2017		
	Actual	Budget	%	Actual	Budget	%
Active employee fringe benefits	\$8,038,466	\$9,520,713	84.4%	\$7,966,000	\$10,061,640	79.2%
Retired employee fringe benefits	\$5,537,924	\$4,561,498	121.4%	\$5,192,328	\$4,772,829	108.8%
Total employee fringe benefits	\$13,576,390	\$14,082,211	96.4%	\$13,158,328	\$14,834,469	88.7%

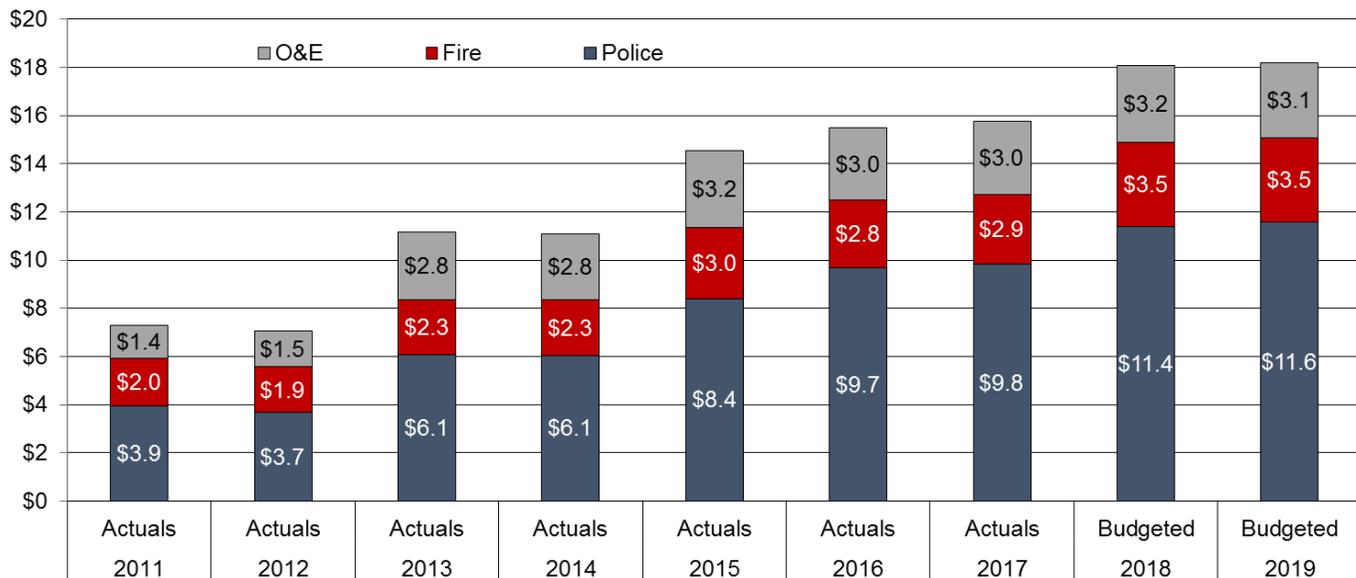
We will review this issue with the City and discuss alternatives for improving the accuracy of the budgeting process. We will also review the cost sharing arrangements to determine whether they need to be adjusted

so that the City continues to receive the stability in year-to-year cost growth that it needs without employee contributions more than doubling over a four-year period as currently projected.

### Pension

As noted earlier, we rely on the City’s actuary to project the City’s minimum municipal obligation (MMO) to the employee pension plans. The City makes annual contributions to the plans for firefighters, police officers and non-uniformed employees. As has been described many times throughout the oversight process, these contributions have increased at a faster rate than the other major forms of active employee compensation, especially for the police pension fund. The General Fund covers the entire contribution to the police and fire plans and historically has covered about 60 percent of the non-uniformed contribution, with the rest covered by other funds (e.g. Sewer, Solid Waste, Shade Tree).

**City Pension Contributions (All Funds)<sup>19</sup>**



Several factors drive the City’s pension contributions including investment performance; how the actual investment performance compares to the plans’ earnings assumptions; how the pension plan assets are valued; and actuarial assumptions regarding mortality, inflation, etc. These assumptions are generally reviewed every other year by the pension boards and then the actuary uses the boards’ approved assumptions to produce Actuarial Valuation Reports (AVRs) that in turn are used to set the City’s MMOs.

The most recent set of AVRs was released in March 2018 and covered the pension plans’ position through January 1, 2017. The City has since created an aggregated pension board that will work with the actuary on AVRs to cover the period through January 1, 2019. Until those reports are ready, we are using the MMO projections provided by the previous actuary using the assumptions in the 2017 AVRs. Those MMO projections show the City’s contributions across all funds rising to \$18.8 million in 2020 and then dropping to \$17.6 million in 2021 and \$17.3 million in 2022. The prior actuary explained that the anticipated drop was due to amortization bases expiring in the police and fire plans. The baseline projection incorporates these figures and assumes the General Fund will continue to cover 60 percent of the non-uniformed employee plan contribution.

<sup>19</sup> The contribution amounts for 2011 through 2017 cover all funds. The budgeted amounts for 2018 and 2019 exclude small contributions that the City made from its Self-Insurance, Shade Tree and Community Development funds.

### Non-personnel expenditures

As noted earlier, the City's payments for principal and interest on existing **debt** is scheduled to drop from \$11.4 million in 2019 to \$10.7 million in 2020, return to \$11.2 million in 2021 and then stay at that level until 2029. The baseline projection incorporates that debt schedule and does not account for any new debt, though the City has discussed potentially issuing debt to help fund the fire station construction projects.

The 2019 budget includes a \$2.3 million **transfer to the Self-Insurance Fund** to cover the cost of general liability claims. The baseline holds the transfer amount flat. The rest of the General Fund budget is allocated to non-personnel operating expenditures including the following:

- The City allocates \$4.2 million for **contracts and consulting services** across all General Fund departments. The largest allocations are in the Public Property section of Public Works (\$600,000); the contribution to the Reading Recreation Commission (\$500,000); and the Building/Trades section of Community Development (\$400,000). While spending within individual lines fluctuates, the City's total spending on contracts and consulting services within the General Fund grew by 1.7 percent per year from 2013 to 2017. The baseline grows these lines at an inflationary rate of 2.2 percent to account for gradual price growth, assuming the City continues the same level of activity through 2022.
- The City allocates \$2.4 million for **utility costs** paid from the General Fund with the largest amounts directed to street lighting (\$900,000); light and power (\$463,000) and telephones (\$371,000). The City held spending across these lines flat from 2013 through 2017. The baseline applies growth rates ranging from 2.5 percent to 3.6 percent, depending on the utility, based on average price projections from the U.S. Energy Information Administration's 2018 Annual Energy Outlook report.
- The City allocates \$1.1 million for **maintenance and repairs to buildings, roads, vehicles and other equipment**. The largest allocations are in Public Works' divisions for Traffic Engineering (\$276,000), the Vehicle Maintenance Garage (\$260,000) and Highways (\$175,000). The City also allocates \$205,000 for building and equipment maintenance in the Fire Department. The City's expenditures grew by 1.0 percent from 2013 to 2017 across all lines in this category. The baseline uses a 2.2 percent inflationary growth rate.
- The City allocates \$0.9 million apiece for **supplies** and **maintenance agreements**. Supply expenditures are scattered across the General Fund departments while the maintenance agreement costs are primarily related to information technology.

The City allocates \$486,000 for **equipment** in 2019, including a grant-funded purchase in Fire that we remove from the baseline. We have adjusted the **collection costs** that the City pays to its third party tax collectors to match the projected growth in the associated tax revenues since the collection cost is often tied to the amount collected.

### High fixed costs

The City allocates \$11.4 million to debt service in its 2019 budget, and debt payments will remain around that level for the next decade absent any future refunding moves or new debt issuance. The City allocates \$17.1 million for its contribution to the employee pension plans. The City also allocates \$5.2 million for retired employee health insurance. These three long-term liabilities account for 35.8 percent of the 2019 budget and consumed closer to 40 percent of actual expenditures in 2016 and 2017.

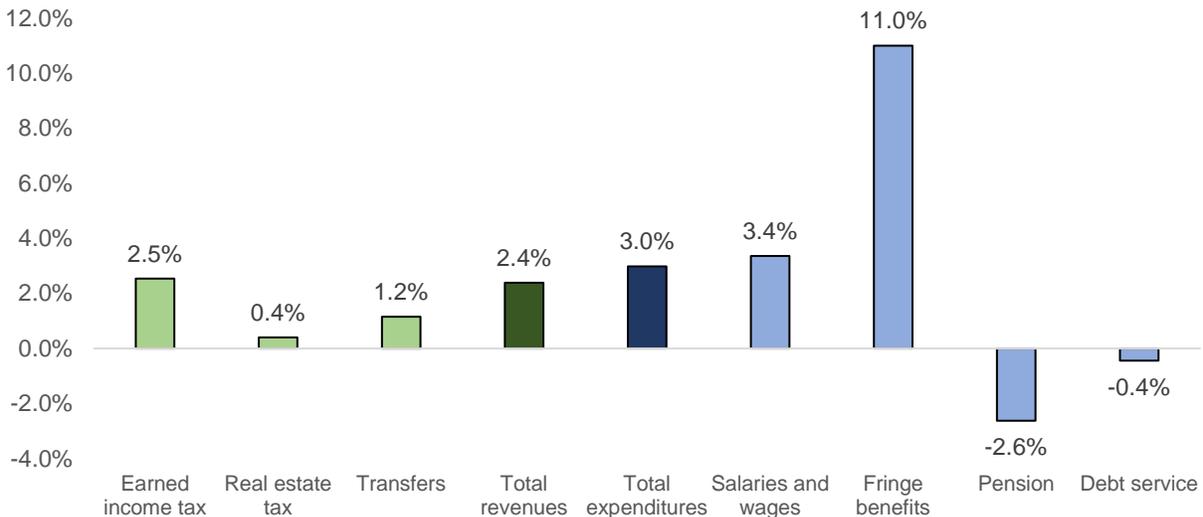
### Long-Term Liabilities (\$ Millions)

	2013	2014	2015	2016	2017	2018	2019
	Actuals	Actuals	Actuals	Actuals	Actuals	Budgeted	Budgeted
Debt service	\$13.5	\$13.4	\$12.0	\$18.8	\$13.3	\$11.7	\$11.4
Retiree health insurance	\$3.4	N/A	\$4.6	\$5.5	\$5.2	\$5.0	\$5.2
City pension contributions	\$9.9	\$10.0	\$13.2	\$14.3	\$14.9	\$17.1	\$17.1
<b>Long-term liability subtotal</b>	<b>\$26.9</b>	<b>N/A</b>	<b>\$29.7</b>	<b>\$38.7</b>	<b>\$33.3</b>	<b>\$33.7</b>	<b>\$33.7</b>
<b>% of Total</b>	<b>34.6%</b>	<b>N/A</b>	<b>34.9%</b>	<b>41.8%</b>	<b>38.4%</b>	<b>36.4%</b>	<b>35.8%</b>

There is potential for some relief in each of these areas. As described above, the prior actuary projected the City's pension contributions could start to drop in 2021. The City has stopped providing health insurance to retired police officers with access to similar health insurance coverage through their employment in Berks County government. The City may have opportunities to refund its existing debt over the next 10 years, though it may also need new debt for capital projects, like fire station construction.

Overall, though, the City will continue to have limited means to increase its spending on current or new services so long as it has to commit such a large percentage of its budget to these long-term liabilities. In the near term we project the City's revenues to grow by 2.4 percent and the expenditures by 3.0 percent in the baseline scenario. The graph compares the growth rates for some of the categories that have driven the City's financial performance in the past.

### Growth Rate Projection Comparison



### Financial Management

We are focused on the *financial performance* of the City (e.g. avoiding deficits, funding capital projects, maintaining an adequate reserve) and the *financial management* of the City (filling key vacancies, complying with State deadlines, resolving audit findings).

Inadequate financial management was one of the primary contributors to Reading falling into Act 47 oversight in late 2009. In the original Recovery Plan we wrote, “The Finance Department has been at the center of the financial storm that has precipitated the City’s entry into distressed status. It has had some of the same challenges as other departments related to changes in leadership, structure and technology and limited flexibility to add staff even where sorely needed, given the financial condition<sup>20</sup>”. The original Plan highlighted the City’s shortcomings in financial reporting, tax collection<sup>21</sup> and purchasing controls and, in recognition of this critical need, DCED provided a grant to fund the Controller position over three years.

That Controller position is one of four within City government that are critical to financial management:

- The **Managing Director** is the “chief administrative officer of the City” according to the Home Rule Charter and has primary responsibility for preparing and submitting an annual budget and five-year financial plan to the Mayor for eventual introduction in City Council.
- The **Director of Administrative Services** reports to the Managing Director and, according to the Charter, is responsible for the “administration of the City of Reading personnel and finance departments and their functions as set forth in the Administrative Code.” The Director oversees the units responsible for accounting, purchasing, human resources, information technology and the Citizens Service Center.
- The **Controller**<sup>22</sup> position was created under the original Recovery Plan to “install professional accounting support” for the Director of Administrative Services. This position has evolved into a Deputy Finance Director position.
- The **Accounting and Treasury Manager** oversees the 6-person unit that handles those functions on a daily basis.

When the City adopted the original Recovery Plan in June 2010, it had only two of the four positions filled. The same person held the Managing Director and Director of Administrative Services positions after the prior Managing Director resigned. The Accounting and Treasury Manager position was filled, though that person left City government soon after the original Recovery Plan was adopted. The Controller position was new and not yet filled.

During the term of the original Recovery Plan (2010 – 2014), the City hired its first Controller and filled the other vacancies. The City had an interim Director of Administrative Services at one point but, unlike recent situations, the interim Director was someone separate from the Managing Director and Controller. The City had four people to do four jobs.

After the Director of Administrative Services resigned in 2015, that position had only been filled on an interim or acting basis until the recently appointed Director started work on March 18, 2019. Aside from a short stint, the acting or interim Director was someone who already held one of the other three critical positions. Essentially the City had been using three or fewer people to do four jobs for years.

During 2018 we publicly and privately communicated the importance of filling the Director position on a permanent basis. We highlighted this as a necessary step to exit Act 47 oversight in public City Council meetings and in regular private meetings with the Administration where we first discussed a target date of April 2018 to fill the vacancy, with the understanding that the new Director would need time to settle into

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<sup>20</sup> 2010 Recovery Plan, page 96

<sup>21</sup> Most tax collection functions have since been moved to entities outside City government.

<sup>22</sup> This is separate from the elected City Auditor position. In early 2019 that position was also vacated and is now held on a temporary basis by the Accounting Coordinator.

the position and work with the other team members before the City could exit financial oversight. In December 2018 the Director position remained vacant and the Accounting and Treasury Manager resigned. In the months leading up to this report’s release the City had the same number of vacancies in these four key positions as it did when the City adopted the original Recovery Plan in 2010.

**Status of Four Key Financial Management Positions<sup>23</sup>**

	2010	2011	2012-15	2016-18	February 2019	Goal
Managing Director	Yes	Yes	Yes	Yes	Yes	Yes
Director of Admin Services		Acting	Yes		Acting	Yes
Controller (Deputy Finance Director)		Yes	Yes	Yes		Yes
Accounting & Treasury Manager	Yes	Yes	Yes	Yes		Yes

Filling these vacancies is not just a matter of “checking a box” or filling the blanks in an organizational chart. The City needs qualified candidates who can help rebuild the financial management capacity and there are tangible negative consequences for not doing so.

During the 2017 year-end auditing process the external auditor found that the City had to make “material adjustments” in its sewer funds, including \$4 million in construction costs not submitted to the Commonwealth for reimbursement until May 2018. The auditor notes, “This led to the City not being reimbursed timely for construction costs incurred.” The City’s response was, “Due to staffing shortages in the Administrative Services department, the oversight of the project accountant position was not maintained.”

The City acutely felt the absence of the Director of Administrative Services during the 2019 budget process last fall. Because of that vacancy and the September transition in Managing Directors, the City was not able to finalize its revenue projections for the 2019 budget until a few days before the budget was due for public presentation. That did not leave enough time for the newly appointed Acting Managing Director to review the departmental budget requests and make adjustments so that the Mayor could submit a balanced budget to Council. It also resulted in a proposed budget that did not comply with the Amended Recovery Plan as Act 47 requires.

The submitted budget had a \$4.7 million deficit – more than twice the size of the \$1.8 million baseline deficit we projected in April 2018 -- and two of the biggest changes during City Council’s subsequent review process were driven by Council and us as Coordinator. We were able to work with the Administration and Council toward a Plan-compliant budget, but the City needs stability in the four key finance positions during the budget process so it can execute that process without our involvement.

In Mid-March the City filled the Director of Administrative Services position on a permanent basis. Shortly after that the City moved an employee from another part of City government into the Accounting and Treasury Manager position. Now that the four positions are filled, the new employees will need time to get acclimated to their new roles; demonstrate that they can produce a balanced budget without intervention from us as Act 47 Coordinator; and show progress in overcoming the long-term problems that will make financial management challenging in Reading for the foreseeable future. Presenting a balanced budget to Council this fall will be a tangible way to demonstrate the City is rebuilding its financial management capacity.

<sup>23</sup> Except for a short stint in 2016, the City used people already holding one of the other three positions as the Acting Directors of Administrative Services from 2016-18.

## Putting the Baseline Projection in context

In preparation for this Financial Condition Review process, we presented similar analysis to the City in April 2018. The baseline projection at that point showed a \$1.8 million deficit for 2019 that grew to \$3.3 million in 2022. The updated baseline projection presented earlier in this report starts with the larger deficit in the 2019 budget (\$2.3 million versus \$1.8 million) that grows to \$4.2 million in 2022. The updated baseline projection assumes more growth in real estate and deed transfer tax revenues than the 2018 version, but it also assumes more growth in salary and fringe benefit expenditures.

The Recovery Plans provided initiatives to close the structural deficit and the City has taken other measures beyond those initiatives. When done correctly, the City's annual budget provides a kind of Plan implementation scenario that applies the Plan initiatives and other changes to the baseline, resulting in much smaller or no deficits. The City's budgets have had modest deficits since 2015, some of which were because of one-time expenditures. There was a small structural deficit in the 2018 adopted budget (\$0.6 million) that grew to \$2.3 million in the final version of the 2019 budget.

### General Fund Surplus / (Deficit) (\$ Millions)

	2011	2012	2013	2014	2015	2016	2017	2018	2019
	Original Recovery Plan				Amended Recovery Plan				
Baseline projection	(\$14.3)	(\$16.6)	(\$19.0)	(\$21.4)	(\$3.1)	(\$8.8)	(\$11.3)	(\$13.1)	(\$14.8)
Annual budget	\$0.0	\$0.0	\$1.0	\$0.9	(\$0.2)	(\$1.0)	(\$0.9)	(\$1.1)	(\$2.3)

The City enacted real estate tax increases in 2011, 2013 and 2016 and has held the tax rate constant since then. Over the 10-year period of Act 47 oversight this translates to a 4.0 percent annual increase in the real estate tax rate.

The City increased the resident EIT from 1.7 to 2.1 percent under the terms of the original Recovery Plan, temporarily reduced the tax rate to 1.9 percent in 2012, restored the tax rate to 2.1 in 2013 and has held it level since then. Over the 10-year period of Act 47 oversight, this translates to a 2.1 percent annual increase in the EIT rate.

### Real Estate and Resident Earned Income Tax Rates<sup>24</sup>

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Real estate tax (GF + Shade Tree)	11.945	11.945	14.334	14.334	15.689	15.689	15.689	17.689	17.689	17.689	17.689
% change		0.0%	20.3%	0.0%	9.5%	0.0%	0.0%	12.9%	0.0%	0.0%	0.0%
Resident EIT (GF + Capital)	1.7%	2.1%	2.1%	1.9%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%
% change		23.5%	0.0%	-9.5%	10.5%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

<sup>24</sup> The real estate tax rates includes 0.2 mills for the Shade Tree Fund and 0.2 mills for the Library, which is passed through the General Fund. The resident EIT rates include the growing portion shifted to the Capital Project Fund beginning in 2016. It excludes the 1.5 percent that City residents pay to the Reading School District.

The City has adopted budgets without tax increases in five of the last six years. Practically speaking, the City may need to increase real estate tax rates at some point during the next three years to balance its budget. But tax increases are not the only way to generate more revenue to pay for services. If the City's tax base grows, then the City should receive more revenue "naturally" (i.e. without increasing taxes), assuming the associated tax revenue is collected when due.

Tax base growth is important for reasons other than City government's fiscal performance. An increase in the resident earned income tax base translates to more employed Reading residents, residents with higher earnings or both. Reading's struggles with a high poverty rate and low household incomes are well documented and translate to a relatively weak ability to pay for the services that local government is expected to provide. As the table below shows, there is still a large disparity between income and poverty levels in Reading and in Berks County as a whole<sup>25</sup>.

<b>Median Household Income</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>Growth</b>
Reading	\$27,416	\$27,206	\$26,777	\$26,867	\$26,784	\$27,247	\$28,755	4.9%
Berks County	\$54,823	\$55,021	\$55,170	\$55,798	\$55,936	\$57,068	\$59,580	8.7%
<b>Poverty rate (all people)</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>Growth</b>
Reading	37.3%	37.9%	38.7%	40.1%	39.6%	39.3%	36.6%	-1.9%
Berks County	13.1%	13.5%	13.9%	14.3%	14.2%	14.3%	13.6%	3.8%
<b>Per Capita Income</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>Growth</b>
Reading	\$13,350	\$13,355	\$13,306	\$13,339	\$13,217	\$13,282	\$13,912	4.2%
Berks County	\$26,332	\$26,478	\$26,723	\$26,998	\$27,146	\$27,844	\$29,041	10.3%

City government alone will not drive the economic development activity that closes this disparity, but it can be a constructive partner in efforts to make Reading a more attractive place to live and work.

That depends in part on having adequate management capacity in the City's Community Development Department. The City currently has or recently had vacancies or interim appointments for the Department Director, Code Enforcement Manager and Chief Building Code Official positions. We also note the City's difficulty in returning the Fifth and Penn Properties to productive use; tension between City government and related entities that should be partners (Downtown Improvement District, Redevelopment Authority, Reading Parking Authority); and the lack of consensus between the Administration and Council on how to use the money that has been set aside for building demolition or microloan management.

We also note that the City has an opportunity to be more a constructive partner in community and economic development through its capital budget. The City has progressed from not having a meaningful capital budget, either in terms of projects or money to fund them, to having multi-million dollar capital improvement plans adopted in concert with the budget the last couple years. The 2019 capital budget has \$20 million in capital projects, with \$6.9 million funded by the designated portion of the resident and commuter earned income tax. The Administration used the information in the recently completed asset condition evaluation to select the projects in the 2019 capital budget.

The next step in this process is to execute the capital projects in the budget so the City's progress translates into actual improvements in City-owned facilities, roads, bridges, parks and vehicles. Public Works management has raised concerns about its ability to execute this volume of capital projects.

<sup>25</sup> Please note that the Berks County figures include the City of Reading. Removing Reading from the County's figures would widen the gap even farther.

Once the City leaves oversight, it will lose the commuter tax that funds about \$3 million in 2019 projects. We hope the City will continue to designate a portion of the resident earned income tax to capital projects and eventually the City will issue new debt to fund capital projects. So adding capacity to execute capital projects on time and on budget is not just a short-term need.

## **Conclusion**

Based on our review of the City's financial condition and the lack of financial management capacity leading up to the release of this report, we recommend that the City of Reading adopt a three-year Exit Plan. The new employees in the City's four key financial management positions need time to get acclimated to their new roles and demonstrate their ability to keep expenditures balanced against revenues, without the commuter taxing power and despite the familiar trend of revenues naturally growing more slowly than expenditures in the residency-based taxing system that Pennsylvania establishes for its local governments. The next process during which Reading can most convincingly demonstrate its ability in this manner is the 2020 budget process.

Act 47 does not allow the City to stay in this Exit Plan phase of oversight beyond the end of 2022. Because of these time limits we are primarily focused on Reading's readiness to exit Act 47 and its ability to meet the criteria for a successful exit. We also recognize that true, meaningful financial recovery means more than having a balanced budget or avoiding deficits. It means that City government can deliver the types and levels of public services that Reading's residents and businesses need at a price they are willing to pay. To achieve that ultimate objective, City government will need to make progress in addressing the major financial challenges during the term of the Exit Plan and beyond.