Analysis of the City of Philadelphia Five-Year Plan

FY2019 – 2023

Photo by C. Smyth for Visit Philadelphia

March 2018
INTRODUCTION

To aid in deliberation around the City of Philadelphia FY2019 budget and FY2019-2023 Five-Year Plan, the Economy League has compiled analysis to situate budget discussions within the broader context of the Philadelphia economy in 2018 and examine key linkages between the Five-Year Plan and what we see as the primary drivers of growth and prosperity—education and jobs. In addition to presenting a summary of relevant economic and employment trends and potential risk factors at the federal and state levels, we discuss the context behind and potential implications of Mayor Kenney’s proposals to slow planned reductions to the wage tax, increase the property tax rate, and raise the real estate transfer tax rate in the City.

Additional funding for the School District of Philadelphia represents the most significant expenditure increase in Mayor Kenney’s proposed Five-Year Plan. The forthcoming return of School District governance to local control will bring considerable challenges to City government, which will assume more responsibility for School District finances. At the same time, local control of the District presents a unique opportunity for the City to enhance educational outcomes, connect more of our young people to economic opportunity, and make Philadelphia a more desirable and attractive place for residents and businesses.

Improving District performance and addressing projected deficits will require parallel efforts to enhance resources and gain administrative efficiencies. As Council engages in difficult discussions around how to balance District needs with sound and reasonable tax policy, we encourage members not to view District spending in a vacuum. Research has demonstrated a clear connection between high-performing schools and higher tax revenues.¹ It is no secret that challenges at the District have a direct impact on the ability of many Philadelphia students to enter and remain in the workforce, and also serve as a deterrent for many families and businesses that have a choice in where to live or do business. In short, improving District performance is likely to result in revenue growth for the City. This is neither a short-term proposition nor an easy feat, but is an important consideration as Council discusses options for supporting the District at this turning point in its history.

EXECUTIVE SUMMARY

ECONOMIC & DEMOGRAPHIC TRENDS

- Job growth in Philadelphia accelerated rapidly in recent years, but the pace of job creation began to slow in 2017.
- The unemployment rate in Philadelphia has declined steadily since 2013, but remains significantly higher than the national rate.
- Nationally, wage growth has been modest in recent years, but wage growth in Philadelphia has been more volatile.
- After years of decline, Philadelphia’s population has grown each year during the past decade.

EXISTING & POTENTIAL RISK FACTORS

- Recent policy actions and looming decision points at the federal level present tangible risks during the next five years.
- Similarly, policy in Harrisburg could negatively impact local economic growth and revenue projections.

EXECUTIVE SUMMARY, CONTINUED

THE WAGE TAX

• The wage tax accounts for a smaller share of City revenues than in years past, yet remains the single largest source of revenue for the City.

• During the past four years, wage tax revenue grew at the fastest pace in nearly 30 years.

• Philadelphia’s large and dynamic educational and health services base provides stability for wage tax revenues throughout the business cycle.

• Recent economic and demographic trends in Philadelphia create a much different context today for the wage tax conversation.

• The proposed slowdown in the wage tax rate reduction could generate significant revenue for the City—and by design, the School District.

• Still, the wage tax presents challenges—most notably, that the overall City and State income tax burden is among the most regressive nationally.

• Furthermore, wage tax revenue projections rely on an anticipated uptick in wage growth, which is far from certain in the current environment.

REAL ESTATE TAXES

• Revenues from the real property tax and realty transfer tax account for more than \( \frac{3}{4} \) of FY18 total tax revenues.

• Real property tax revenues remained flat during the recession, while the realty transfer tax closely tracked the market.

• Housing values have surpassed pre-recession levels and are projected to continue growing.

• Rising market values are partially driven by low inventory, which is stifling the market for starter and trade-up homes.

• Philadelphia’s homeownership rate is falling and rental activity is growing, driven by wealthier millennials and baby boomers.

• Philadelphia’s overall effective property tax rate is average compared to other US cities, but places a higher burden on lower income households.

• The Office of Property Assessment has taken steps to modernize tax assessments and collections, and there is further opportunity to improve the assessment and appeals process.

• Increasing real property and real estate transfer tax rates is likely to exert slight downward pressure on housing values in the short term, but losses could be recaptured by long-term gains in value associated with improved school quality.

• Other tools exist for generating additional real estate tax revenues, but each has its challenges and caveats.
**ECONOMIC & DEMOGRAPHIC TRENDS**

In recent years, Philadelphia’s economy has improved significantly. Job creation surged in 2015 and 2016, the unemployment rate continues to decline, wage growth is up, and the city’s population continues to grow. Still, there are challenges on each of these fronts going forward. The pace of job creation began to slow in 2017; the unemployment rate is nearly two percentage points higher than the national average and above the local pre-recession level; continued wage growth remains uncertain; and population growth has decelerated during each of the past ten years.

These four indicators—job growth, the unemployment rate, wage growth, and population growth—do not tell the whole economic and demographic story of Philadelphia in recent years. Still, these key indicators shed considerable light on the fiscal health of the city and are critical in assessing the trajectory of the economy and city tax revenues for the next five years.

**Job growth in Philadelphia accelerated rapidly in recent years, but the pace of job creation began to slow in 2017.**

- Employment growth in Greater Philadelphia outpaced growth at the national and state levels during the past two years, and the city of Philadelphia has been the primary driver of growth within the region.
- Between 2015 and 2017, the city saw average annual employment growth of 1.9% (12,300 jobs per year), compared with 1.6% (40,100 jobs per year) at the metro level, 1.3% (67,500 jobs per year) in Pennsylvania, and 1.6% nationally.

![Annual Employment Growth, 2004-2017](image)

- The city, home to approximately 25% of all jobs in the metro area, accounted for nearly 31% of area job growth between 2015-2017.

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2 The employment and unemployment figures cited in this analysis are seasonally-adjusted figures from the U.S. Bureau of Labor Statistics. Per the BLS, “Seasonal adjustment is a statistical technique that attempts to measure and remove the influences of predictable seasonal patterns to reveal how employment and unemployment change from month to month. As a general rule, the monthly employment and unemployment numbers reported in the news are seasonally adjusted data.”
• However, the pace of job creation in Philadelphia has been slowing since reaching a peak in late 2016, returning by December 2017 to a level comparable with growth rates at the metro, state, and national levels.

• According to the Federal Reserve Survey of Professional Forecasters, national employment is projected to grow by 1.4% in 2018 and to 1.2% in 2019.

• In Philadelphia, IHS projects City employment to grow by 1.3% in 2018 and 1.0% in 2019, but then projects negligible growth through 2023, in line with its projection of slow national employment growth as the stimulus effects of tax reform fade.

The unemployment rate in Philadelphia has declined steadily since 2013, but remains significantly higher than the national rate.

• At 6.4%, the unemployment rate in Philadelphia at year-end 2017 was significantly higher than the nation (4.1%), Pennsylvania (4.8%), and the Philadelphia MSA (4.7%).

• The current unemployment rate in Philadelphia is only now approaching recent lows from the mid-2000s, even with the markedly faster employment growth during the past few years as compared with the mid-2000s.

• A key reason for the current high unemployment rate is that Philadelphia’s recovery from the recession took hold much later than most of the nation. The unemployment rate in Philadelphia peaked at 11.5% in January 2013, more than three years after the national peak of 10% in November 2009.

• As a result, it is unrealistic to expect the Philadelphia unemployment rate to be in line with the national average.

• However, given the employment gains in Philadelphia during the past two years, one might expect the difference between the Philadelphia unemployment rate and the national rate to be smaller than it is. The 2.3 percentage-point spread between the Philadelphia rate and the national rate in December 2017 is notably higher than the 1.7 percentage-point average spread since 2004.

• According to the Federal Reserve Survey of Professional Forecasters, the national unemployment rate is expected to remain near 4% through 2021.
Nationally, wage growth has been modest in recent years, but wage growth in Philadelphia has been more volatile.

- Following the recession, wage growth was sluggish at the national level, but began to accelerate during the past few years as annual wage growth averaged 2.3% in 2015, 2.5% in 2016, and 2.7% in 2017.
- This nominal wage growth does not account for inflation. In real terms, workers’ wages have essentially been flat in recent years.
- Annual wage growth in Philadelphia averaged 2.1% between 2008 and 2017, but wages were much more volatile than at the national or state levels.
- IHS forecasts wage growth near 4% throughout forecast period in Philadelphia, which would be in line with annual growth rates during the second half of 2017, but would represent a marked acceleration from the 2.1% annual average since 2008. Furthermore, the volatility in wage growth during the past decade presents risk to city revenues for any given year during the next five years.

![Annual Nominal Wage Growth, 2008-2017](chart)

**After years of decline, Philadelphia’s population has grown each year during the past decade.**

- Between 2006 and 2016, Philadelphia’s population increased by 5.3% cumulatively (or an annual average of 0.5.) The cumulative growth between 2006 and 2016 is equivalent to nearly 30% of the net population growth in the Commonwealth during this period, despite the fact that Philadelphia only accounts for 12% of the Commonwealth’s population.

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3 The population data cited in this analysis is from the Census Population Estimates Program, which provides comprehensive annual population estimates at the national, state, and county levels. This program utilizes a wide range of data sources to estimate population, including federal tax returns, immigration data, and Medicare enrollment. As a result, estimates in this program will not match any single estimate from one of the component sources. Population estimates are as of July 1 of the given year.
• Philadelphia’s population growth was slower than national population growth during the same period, in which the U.S. population increased by 8.2% cumulatively, or an annual average of 0.8%.

• Still, considering significant population gains across southern and western states, Philadelphia’s population has expanded at a healthy pace given the national context.

• And in real terms, in Philadelphia there were nearly 80,000 more residents in 2016 than in 2006.

• The pace of population growth in Philadelphia, though, has steadily decelerated each year over the past decade.

![Annual Population Growth, 2004-2017](chart)

Source: Bureau of Labor Statistics, FRED (seasonally-adjusted)

• Between 2016 and 2026, the Census Bureau projects that the U.S. population will grow by 7.2% cumulatively, a slightly slower pace than during the prior decade.⁴

• The Delaware Valley Regional Planning Commission projected cumulative population growth of 3.1% in Philadelphia during the decade spanning 2015-2025, similarly slower than in the recent past. Still, this would represent more than 49,000 new Philadelphia residents.⁵

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⁵ Delaware Valley Regional Planning Commission, [https://www.dvrc.org/Reports/ADR22.pdf](https://www.dvrc.org/Reports/ADR22.pdf)
EXISTING & POTENTIAL RISK FACTORS

Several key risks at the federal and state levels could impact economic growth—and therefore tax revenues—in the coming years. Broader forces such as automation will certainly have impacts in future, but the following analysis focuses on risks that have a higher likelihood of notable impact on the Philadelphia economy during the five-year horizon of the plan.

Recent policy actions and looming decision points at the federal level present tangible risks during the next five years.

TARIFFS

• The recent tariffs enacted on foreign steel and aluminum are likely to have targeted direct impacts in Philadelphia.

• Steel and aluminum imports to Pennsylvania in 2017 totaled $2.6 billion, the sixth-highest figure nationally.6

• In the Philadelphia metro area, there are 19,000 jobs in fabricated metal product manufacturing, an industry that faces particularly direct risk from higher materials costs. This local industry is likely to face negative effects on employment and revenues because of higher costs, presenting downside risk for city revenues.7

• Before Canada and Mexico were exempted from the tariffs, the Trade Partnership projected the loss of 145,000 jobs nationwide, with significant losses in industries where Philadelphia has a higher-than-average concentration of jobs, such as professional services and financial services, as well as other major industries like construction.8

• The exemption of Canada and Mexico—the primary steel and aluminum exporters to the U.S.—will soften the direct impacts of the tariffs, but nearly all industries outside of steel and aluminum manufacturing are likely to face negative employment effects from the tariffs.

• The broader threat to Philadelphia is an escalating application of other tariffs and restrictions, particularly targeted at China. Recently floated restrictions on Chinese student visas and science & technology imports from China would likely have a more direct effect in Philadelphia than the aluminum and steel tariffs. The city’s large education and healthcare base—and, in turn, city wage tax revenues, which rely significantly on these institutions—would likely face particular risk.

• The timing of the impact from these tariffs is difficult to predict, as the full extent of the tariffs and the potential retaliatory measure by foreign governments is not yet known.

TAX REFORM

• The Tax Cuts and Jobs Act included broad tax cuts that will likely serve as an economic stimulus in the short term.

• However, those tax reductions are funded in part by caps on certain deductions. Specifically, state, local property, income, sales tax (SALT) deductions are capped at $10,000, and the mortgage interest tax deduction capped at $750,000. Moody’s estimates a 4% nationwide drop in home prices as a result of the act.

• As noted earlier, IHS projects that employment growth is expected to slow considerably starting in 2020 once the immediate effects of the tax cuts pass.

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7 Governing database
• And over the medium to long term, the foregone revenues from the tax cuts are likely to put added pressure on Congress to enact cuts to social services, which would have a detrimental effect on city revenues.

WHITE HOUSE BUDGET PRIORITIES

• The first two budgets presented by the current administration highlight some potentially significant cuts that could impact city revenues and directly impact city residents, including the proposed elimination in the 2018 budget of the Community Development Block Grant, to major proposed cuts to HUD and the Small Business Administration in the 2019 budget.

• The administration’s position portends a broad devolution of the federal role for investment not only for social services, but also with respect to transportation and infrastructure. The administration’s infrastructure plan would require local government to raise 80% of a project’s costs, a reversal from the 20% currently required.

• Although the specific levels of cuts proposed by the White House are not likely to fully be implemented by Congress, the signaling of priorities is nonetheless important. More modest cuts enacted by Congress in any of these areas will still present significant downside risk for Philadelphia.

Similarly, policy in Harrisburg could negatively impact local economic growth and revenue projections.

• State legislators in Pennsylvania are repeating a pattern that has become common in the last three years; there is an impasse over the means to close a $2 billion spending deficit in the budget. The impasse has already negatively impacted the finances of the Commonwealth as Standard & Poor’s downgraded Pennsylvania’s credit rating over the inability to pass a balanced budget.

• Equally troubling are the potential cuts that may have to be made to the budget. Governor Wolf’s proposed budget is 10% below budgets passed between 1997 and 2011, as a share of the gross state product, indicating continued austerity measures.

• Although Pennsylvania leans Democrat during the upcoming gubernatorial race, there is a reasonable chance of a Republican victory. Scott Wagner, the Republican nominee, has expressed, for example, that aggressive spending cuts are the way to close the state budget. A Republican victory would likely imply cuts for Philadelphia as well.

• The forthcoming court decision on the high-profile school funding lawsuit filed in Pennsylvania will have lasting implications on the School District of Philadelphia. The suit, brought by various school districts and parents, claims that the state fails to live up to its constitutional mandate of a “fair and efficient” education. The lawsuit was initially dismissed by the Commonwealth Court, but that decision was overturned by the Supreme Court last fall and the suit is once again being considered by the Commonwealth Court. While the outcome remains uncertain, a favorable ruling could result in additional funding for the School District of Philadelphia.
THE WAGE TAX

Wage tax revenues are driven by three main determinants: the number of jobs, wage levels, and the tax rate. As highlighted earlier, employment growth in Philadelphia has been relatively strong in recent years, but the pace of job growth began to slow during the past year and a further slowdown is expected in the latter part of the Five-Year Plan as the short-term impacts from tax reform wear off. National wage growth began to pick up during the past year, but wage growth in Philadelphia has been volatile.

The proposed slowdown in the wage tax reduction is one of the major changes proposed in Mayor Kenney’s 2019-2023 Five-Year Plan, and would have a significant impact on city revenues.

The wage tax accounts for a smaller share of City revenues than in years past, yet remains the single largest source of revenue for the City.⁹

- The wage tax has long been the dominant revenue source for the City, and accounted for 47% ($1.45B) of city tax revenues in 2017.
- Wage tax revenues as a share of city tax revenues reached a peak of 64% in the mid-1970s, and the share was as high as 60% as recently as 1990. With the creation of PICA in 1992 and subsequent accounting for PICA revenues separately, wage tax revenues as a share of city tax revenues fell from 59.8% in 1991 to 53.9% in 1992.
- Wage tax reductions started in 1996, with the resident rate cut from 4.95% to 4.85% and the non-resident rate cut from 4.31% to 4.21%. Reductions in both resident and non-resident rates continued steadily until 2009, when reductions were halted due of the effects of the Great Recession. Reductions resumed in 2013.
- Historically, wage tax revenues from residents have accounted for approximately 60% of total wage tax revenues, compared with 40% from non-residents, according to analysis from the City Controller’s office.

⁹ Wage tax revenue figures cited in this analysis exclude PICA collections unless otherwise noted.
During the past four years, wage tax revenue grew at the fastest pace in nearly 30 years.

- With sustained annual employment growth near 2% in recent years—significantly faster than historical job growth in Philadelphia—the surge in new jobs drove substantial gains in wage tax revenues.
- Between 2015 and 2018, wage tax revenues grew by an annual average of 5.0%, easily the fastest pace since the late 1980s, when wage tax revenue growth averaged 5.3% annual from 1987 through 1990.
- And wage tax revenue grew significantly faster during the current economic expansion than during the mid-2000s national economic expansion, when wage tax revenues grew by an annual average of 2.5% between 2004 and 2007. Of course, Philadelphia job growth significantly lagged the nation during the mid-2000s expansion, contributing to weaker wage tax revenues than during the current expansion when Philadelphia job growth has matched or exceeded national job growth.
- During the recession, wage tax revenues declined by an annual average of 1.5% between 2008 and 2010. As the local economy began to recover between 2011 and 2014, wage tax revenue growth averaged 3.2% annually.
- Going forward, wage tax revenues are projected to expand by an annual average of 3.4% between 2018 and 2023, accounting for the projected slowdown in job growth.

Philadelphia’s large and dynamic educational and health services base provides stability for wage tax revenues throughout the business cycle.

- The educational and health services sector—anchored by the city’s universities and hospitals—accounted for approximately 30% of wage tax revenues in 2017. The next three largest sectors—government; professional and business services; and trade, transportation, and utilities—each accounted for just 11% of wage tax revenues.

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10 2018e data refers to 2018 estimates cited in the Mayor’s Five-Year Plan based on collections to-date in FY18.
• The educational and health services sector has accounted for 29-30% of wage tax revenues each year since 2011, all while annual wage tax revenues from this sector grew by an annual average of 4.3% during that span.

• Educational and health services, as a sector that pays above average wages and as a sector in which job growth is largely driven by demographic dynamics, provides some resiliency for overall wage tax revenues in the event of an economic slowdown or downturn.

• However, the sector has its share of risks that could negatively impact wage tax revenues going forward.

• In the policy sphere, the elimination of the individual mandate of the Affordable Care Act could drive up costs for local healthcare providers. Furthermore, as highlighted in a recent Economy League analysis for the City, the changing nature of healthcare employment—in which lower-wage home healthcare employment is surging compared with more modest job growth at local hospitals, where average pay is higher—presents downside risk for tax revenues.

Recent economic and demographic trends in Philadelphia create a much different context today for the wage tax conversation.

• With sustained growth in both employment and population, the city's vitals are much stronger today than at the start of the century.

• As worker preferences shift toward amenity-rich, easily accessible workplaces, Philadelphia has a compelling value proposition that at least partially offsets its higher tax burden compared to suburban locations. Knowledge-economy firms want access to talent, and talent wants to be in places like Center City and University City.

• Financial services and tech firms like Vanguard and Bentley have recently opened gateway offices in the city to make themselves more attractive to talented individuals who want to live and work in the city. And in the media industry, Entercom recently announced it would move its headquarters from Bala Cynwyd to Philadelphia, while NBC10 will similarly relocate as it moves into the new space of parent company Comcast.
• Of course, many firms are not moving into the city, and those firms opening gateway offices in the city are not by any means abandoning their suburban headquarters. Despite shifting preferences among many workers for amenity-rich, easily accessible locations, in the full competition for talent—not just young, childless workers, but also mid-career professionals and senior executives—a high-quality school district is a paramount amenity, and Economy League believes this is a more important consideration for many firms than the wage tax.

The proposed slowdown in the wage tax rate reduction could generate significant revenue for the City—and by design, the School District.

• The Five-Year Plan projects wage tax revenues of $1.60B in 2019, steadily rising to $1.82B in 2023, for a total of $8.56B in cumulative revenues during the five-year horizon. These projected revenues are bolstered by the proposed slowdown in the wage tax rate reduction, compared with the rates in last year’s Five-Year Plan.

• Assuming the same tax base and underlying economic assumptions included in those projections, the proposed rate change would result in estimated additional revenue of $362M, cumulatively, between 2019 and 2023 under the proposed rate structure, compared with revenue that would have been generated under the rate structure in last year’s Five-Year Plan.

• Of course, the proposed slowdown in the wage tax rate could have an impact on the overall tax base, by encouraging individuals to choose to work outside the city, or for employers to relocate outside the city. However, for such a small marginal change in rates over a relatively small time horizon, the Economy League does not expect that such a change will materially alter location decisions for individuals and firms.
Still, the wage tax presents challenges—most notably, that the overall City and State income tax burden is among the most regressive nationally.

- For high-income households ($150,000), the combined city wage tax and state income tax burden in Philadelphia (6.96%) is comparable to several large peer cities.¹¹
- Cities like New York and Los Angeles have slightly higher combined rates, and combined rates even in cities like Louisville, Kentucky and Portland, Oregon are on par with those in Philadelphia. Many other cities are in the 5-7% range.
- But because our taxes at the local and state levels are flat taxes, they are inherently regressive.
- In some states, like Massachusetts, where state income taxes are also flat, low-income families are eligible for generous refundable earned income tax credits. Pennsylvania does not have a similar system, meaning that all families pay the same share of income in state taxes.
- Workers in Philadelphia are able to submit an income-based wage tax refund petition, which can reduce their wage tax rate by 0.5% and is received as part of any state tax refund. For tax filers who are married with two children, the upper income limit is $34,250; with four children, the limit is $53,250.¹²
- However, this is relatively cumbersome process and it is unclear how many workers take advantage of this credit.
- In contrast, cities such as New York with progressive state and local taxes, a family making $25,000 would receive a refundable credit of approximately $1,000.

Furthermore, wage tax revenue projections rely on an anticipated uptick in wage growth, which is far from certain in the current environment.

- As previously discussed, the Five-Year Plan projects wage growth near 4% during the next five years in Philadelphia, which would be in line with annual growth rates from the past few quarters but much faster than the annual average since the recession.
- With employment growth projected to slow considerably during the latter part of the forecast period, wage tax revenue projections are heavily reliant on sustained wage growth. Such wage growth is certainly possible as the local labor market gets closer to full employment, but represents a risk going forward.
- Furthermore, the volatility in wage growth during the past decade presents risk to city revenues for any given year during the next five years.

REAL ESTATE TAXES

Real estate tax revenues depend on four key drivers real estate inventory, market prices, millage rates and the systems in place for property assessment and tax collection. In the short term, housing prices in the city are projected to rise, though that growth will likely be hampered by slower growth in inventory. While high-value, high-end homes are expected to continue seeing rapid growth, first-time home buyers, trade-up home buyers, and buyers in lower-income neighborhoods may struggle to find for-sale housing at attainable price points. If inventory does not catch up with demand, Philadelphia could experience a downward readjustment of the market.

¹¹ Unless otherwise note, data regarding tax burdens by income level are from the District of Columbia report, “Tax Rates and Tax Burdens In the District of Columbia - A Nationwide Comparison, 2016”
Real property tax differs from most taxes in that the assessment process provides a buffer between tax revenues and the market. Realty transfer tax yields, on the other hand, move with the market. For this reason, changes to the real property tax rate will not affect market value as directly as changes to the realty transfer tax. In either case, however, downward pressure on market values associated with a rate increase could be offset by the positive impact of long-term improvement in school performance and outcomes.

Revenues from the real property tax and realty transfer tax account for more than \( \frac{3}{4} \) of FY18 total tax revenues.

- Real Property Tax general fund revenues were $587.1M in 2017 and are projected to reach $646.3M in 2018, a 10.1\% y-o-y increase. This increase is driven by a major commercial property reassessment performed by the Office of Property Assessment in 2017.
- Realty Transfer Tax general fund revenues were $247M in 2017 and are projected to reach $287 in 2018, a 16.2\% y-o-y increase.

Real property tax revenues remained flat during the recession, while the realty transfer tax closely tracked the market.

- During the recession, the transfer tax proved to be significantly more volatile than the property tax. During the recession, property tax revenues remained flat, while realty transfer tax revenues fell by 35\%.
- Real Property Tax is insulated from the volatility of the market by the property assessment system. This buffer can provide stability during economic downturns, but can also prove to be a liability when assessments do not accurately capture property value growth, as demonstrated by the decline between 2004–2007.
- Because of the realty transfer tax’s inherent volatility, for budgeting purposes it is important to treat the realty transfer tax revenues as a high-risk funding pool and use other funding sources to supplement the revenue shortfall during market downturns.

<table>
<thead>
<tr>
<th>Period</th>
<th>Real Property Tax revenue growth rates</th>
<th>Realty Transfer Tax revenue growth rates</th>
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<td>FY04–07 (growth)</td>
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<td>40%</td>
</tr>
<tr>
<td>FY08–10 (recession):</td>
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<td>-35%</td>
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<td>FY11–14 (recovery):</td>
<td>3%</td>
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<td>FY15–18e (growth):</td>
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<tr>
<td>FY19–23 (projection):</td>
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Housing values have surpassed pre-recession levels and are projected to continue growing.

- Home values have surpassed pre-recession levels and seem poised to continue growing. In 2018, Zillow’s median home value estimate for Philadelphia was $146,000, the highest value since 2007. Looking ahead, Zillow projects median home values to grow by just 3.46\% in the next year.
- As expected, there is great variability in market value trends by neighborhood. Over the last 10 years, Center City housing prices grew by 17.9\%, while various neighborhoods in North Philadelphia grew slowly or declined.
- Continued market growth will contribute to transfer tax revenues. Growth in property taxes, on the other hand, is contingent on how market trends are incorporated into the assessment model.
Rising market values are partially driven by low inventory, which is stifling the market for starter and trade-up homes.

- While rising values may be driving record levels of high-end sales (2017 saw the 3rd highest sales of million-dollar homes in city history), higher housing prices are beginning to crowd out starter and trade-up home buyers. First-time home buyers are having an increasingly difficult time finding affordable homes, and trade-up buyers sit on their properties as they face a similar problem. Without growth in all segments of the market, housing sales and prices may hit their peak and begin to decline.

- Part of the reason for this dynamic is the fact that housing starts are still below pre-recession levels. This contributes to a historically low housing inventory in Philadelphia (4.7 months in February compared to 5-7 months required for a healthy market).

- Without an influx of new construction, potential first-time home buyers will continue to rent and families willing to trade up will choose not to sell as affordable options dry up.

- According to Trulia, the top two causes of low inventory are low homebuilding and investor ownership. For every 1 percentage point increase in homebuilding, there is a +13.3% change in inventory. For every 1 percentage point increase in investor ownership, there is a -2.5% change in inventory.

- If supply continues to fall behind demand, the market could experience a painful readjustment. Once again, this may not directly impact the bulk of real estate tax revenues immediately, but it will drive down revenues over the long term.

Philadelphia’s homeownership rate is falling and rental activity is growing, driven by wealthier millennials and baby boomers.

- Philadelphia’s home ownership rate fell from 58.2% in 2006 to 52.1% in 2016. This shift is driven by a significant increase in renter-occupied units. The total number of owner-occupied units in the city fell slightly (6%) during this period while renter occupied units grew 20%.
• As Philadelphia residents age, they hold on to their homes. However, younger cohorts are waiting longer to purchase starter homes. The number of homeowners younger than 45 fell by 17%, while the number of homeowners between the ages of 55 and 74 grew by a corresponding 16%.

• The racial composition of Philadelphia homeowners did not change markedly over the past decade. In 2006, 51% of homeowners were white and 39% were black or African American. In 2016, 49% of homeowners were white, 39% black or African American. The difference can be accounted for by the growth in homeownership among Asian households.

• Home ownership has been falling across all income brackets lower than $100,000 between 2006 and 2016. For the $100K-$150K bracket home ownership grew by 32%, while ownership by individuals making over $150,000 increased 116%.

• The number of renters has been increasing for all income brackets, except for individuals making between $5,000 and $15,000. Particularly noteworthy is the fact that the number of renters making over $150,000 grew 326% since 2006.

• Overall the data indicate that wealthier individuals are occupying a variety of housing units, with rentals growing in popularity among most income segments.

• As property values rise and homeownership rates for low-income individuals and families drop, measures to protect affordable housing, especially for long-term homeowners, will be critical to inclusive growth in Philadelphia.

![Owner-Occupied Units by Household Income Brackets, Philadelphia County](image_url)

Source: Census Bureau, American Community Survey
Philadelphia’s overall effective property tax rate is average compared to other US cities, but places a higher burden on lower income households.

- Property tax is traditionally a regressive tax, because of the flat nature of the tax. This is exacerbated in Philadelphia by the Commonwealth’s Uniformity Clause, which requires a flat tax between all categories of real estate.

- Philadelphia’s effective property tax rate of 1.4% falls in the middle of the pack among peer cities (27th of 51). However, Philadelphia’s rate surpasses those of New York (1.2% effective rate), DC (0.85%) and Boston (1.1%).

- Additionally, Philadelphia places the 13th highest property tax burden on individuals in the lowest tax bracket. The estimated property tax burden by income bracket is as follows:
  - $25,000 - $1,494 (13th highest)
  - $50,000 - $1,371
  - $75,000 - $2,266
  - $100,000 - $3,161
  - $150,000 - $4,952

- To offset property tax’s regressive nature, municipalities typically provide various exemptions to protect lower-income households. The Longtime Owner Occupants Program and the Homestead Exemption are two Philadelphia examples of policies that help tilt the tax towards a more progressive distribution.

- However, Philadelphia’s primary property tax exemption program, the property tax abatement, accrues most value to owners of high-value properties. While over 60% of abatements are granted to homes with an assessed value of less than $400,000, nearly half of abated dollars are granted to homes valued at over $750,000.

• It is important to note that renters are not shielded from property tax increases, as the full amount of the property tax is typically passed through via rent increases. Some states offer ‘circuit breaker’ programs – an income tax deduction to offset the property tax equivalent of rent.

The Office of Property Assessment has taken steps to modernize tax assessments and collections, and there is further opportunity to improve the assessment and appeals process.

• In 2013, the Office of Property Assessment completed a reassessment of residential real estate followed by a reassessment of commercial real estate in 2017. The goal of both reassessments was to align assessed values with market values.

• Instituting a Computer Assisted Mass Appraisal (CAMA) would help insure assessment consistency and may assist with translating market movements into property values more effectively.

• In addition, there is opportunity to gain efficiency in the assessment appeals process. In 2017, Philadelphia lost 12% of assessed Residential and Other value on appeal, and 15% on Commercial and Industrial. This far lags peer cities, which average 5–7% appeal losses. Historically, one of the reasons for the high number of appeal losses was the ad-hoc nature of reassessments. With the residential and commercial reassessment process greatly improved in recent years, it is worth tracking any remaining appeal losses closely to identify and address outstanding issues.

Increasing real property and real estate transfer tax rates is likely to exert slight downward pressure on housing values in the short term, but losses could be recaptured by long-term gains in value associated with improved school quality.

• Increases in real estate transfer taxes are typically fully capitalized in home prices; in other words, prices decrease by the full amount of the tax. In some cases the announcement of a tax increase is in itself sufficient to drive down values.
That said, the impact on home values of increased property taxes is likely to be a relatively small in the context of the rising trajectory of the real estate market in Philadelphia.

- On the other hand, school quality in Philadelphia has driven down prices and encouraged a migration to the suburbs for decades. Philadelphia attracts young, wealthy millennials, who tend to return to the suburbs once they start families and their kids reach age 5. For every 100 families with kids that move in, 270 families move out. If an increase in funding to the District effectively addresses school quality, the corresponding gains in housing values in the city could more than recapture losses associated with a tax increase. A study commissioned by The Reinvestment Fund in 2007 found that for each percentage point increase in school district PSSA score of students who scored proficient or above, the prices of housing in that area increase by $0.52 per square foot.

- School performance is, in turn, connected to funding. According an NBER paper, “Event-study and instrumental variable models reveal that a 10 percent increase in per-pupil spending each year for all twelve years of public school leads to 0.27 more completed years of education, 7.25 percent higher wages, and a 3.67 percentage-point reduction in the annual incidence of adult poverty; effects are much more pronounced for children from low-income families.”

- The catchment area around the Penn Alexander school provides a case study of the relationship between school quality and real estate prices. After the University of Pennsylvania created the school, housing prices grew significantly in the catchment area, even though not all eligible students attended the schools.

- In the long run, it can be safely assumed that if the added funding from property tax increases effectively improves the quality of public schools, the net effect on the real estate market will be positive. However, as the case of Penn Alexander demonstrates, affordability of housing will continue to be a challenge for inclusive growth in the city.

Other tools exist for generating additional real estate tax revenues, but each has its challenges and caveats.

Besides raising taxes, Philadelphia has limited options for enhancing revenues. The City is particularly hamstrung by the Uniformity Clause in the state constitution, which requires that a flat tax be applied, limiting the ability to implement variable tax rates to different types of real estate properties or different income levels. Changes to the tax abatement program and the implementation of payments in lieu of taxes (PILOTS) have both been commonly proposed as options. While both have the potential to bring in revenue, amending the abatement program is the more promising route.

ABATEMENT REFORM

- Reforming the tax abatement program could yield significant revenue; any changes, however, should take affordable housing and variability by neighborhood into account.

- The City forgoes a considerable amount of real property revenue via the tax abatement incentive. Currently, approximately $8B in taxable building value or nearly 15,000 properties are abated. This represents 11% of the city’s total assessed value and 2.7% of real estate stock. Additionally, the program is growing. In dollar terms, the amount of abatements granted increased 393% from 2014.

- The abatements program was initially started to reverse the depopulation and declining housing stock of Philadelphia. However, as has been mentioned previously, most abatement dollars are granted to those who seem to need them the least - high-value properties concentrated in Center City, and other high-growth real estate markets. It is worth evaluating limiting the abatement program to neighborhoods that are experiencing the conditions that made abatements necessary to begin with – depopulation, crime, low-quality housing stock.

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14 This number varies slightly depending on which exemption and usage code is considered in the analysis.
• The maximum value the City could extract from ending the abatements program immediately is approximately $800-$900 million. This is based solely on new abatements, as existing abatements will be grandfathered in. In the last five years, the average new abatements totaled $837 million ($1.2B in 2018).

• Given the decrease of affordable housing, any reductions to the abatements program should be targeted towards high-value, high growth property types and areas.

**PAYMENTS IN LIEU OF TAXES (PILOTS)**

• Reinstating a Payments In Lieu of Taxes program is another popular suggestion for attracting more revenue to the city. Philadelphia first implemented a PILOTs program from 1995-2000 and brought in $9,000,000 from 46 nonprofits ($13.6M if adjusted for inflation). The payments were based on 33% of the nonprofits’ assessed real estate value.

• An ambiguity in state law provided the City with the ability to revoke an organization’s nonprofit status via a lawsuit; in 1997, the law was amended at the state level, reducing the leverage of cities.

• Because PILOTs have always been based on extra-legal agreements, this mechanism may work as a stop-gap, but not a stable contribution to the school district or general fund.

• The majority of the participating institutions was represented by Philadelphia’s universities and hospitals, which contribute a considerable amount to city coffers via the wage tax.

• Overall, because of implementation difficulties and low potential revenues, the PILOTs approach is the least attractive instrument for raising revenue.