City of Lancaster
Strategic Management Planning Program

Financial Condition Assessment and Trend Analysis

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Multi-year planning process

Public Financial Management (PFM) is developing a five-year financial plan for the City of Lancaster with financial support from the Pennsylvania Department of Community and Economic Development and its Strategic Management Planning (STAMP) Program. There are three steps to develop the multi-year plan.

Financial condition assessment

- We first need to understand City government's financial position and the critical underlying factors driving its performance. Then we project the City's financial performance under a baseline *status quo* scenario to identify and quantify specific financial challenges. **This is what we are presenting today.**

Management review

- City government does not exist for purely financial purposes. It exists to deliver critical services to the people who live, work, and visit the City. Similarly, numbers alone won't tell the complete story. So we'll meet with department managers and other staff to discuss what their departments do, how they do it, and why they do it.

Initiative development and plan delivery

- Guided by the quantitative analysis in the financial condition assessment and the qualitative analysis in the management review, we will develop a series of recommendations (or initiatives) that connect back to a mission statement. Those initiatives will be organized into one coherent plan document that we'll deliver at the end of this process.

Financial condition assessment

What is a baseline projection?

"For this engagement, we will develop an Excel-based multi-year financial projection model that covers the City's revenues and expenditures through the next five years as requested in the RFP."

– Scope of Services for Five-Year Financial Management Plan, p. 6

There are two very important contextual points to understand the baseline projection:

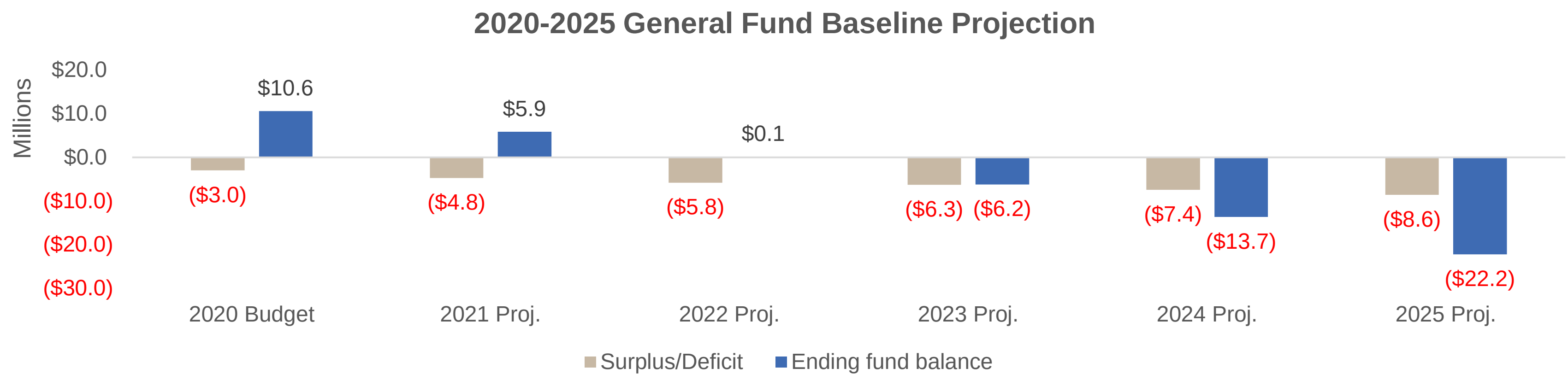
- **The baseline projection presents a status quo scenario.**

  Conceptually, the baseline projection represents a "carry forward" or "current services" set of projections – such that no reduction or enhancement in services, headcount or tax rates are generally assumed, except in cases where already adopted into current law or consistent with existing policy.

- **The baseline projection is not a prescription for City's financial policies, nor is it a prediction of future annual results.**

  The baseline projection shows Lancaster's finances absent corrective action. Practically speaking, the City will have to take corrective action. The City is statutorily required to pass a balanced budget each year and it could not sustain the projected deficits in the baseline without exhausting its reserves. However, it is critical to have a baseline projection in order to understand the magnitude and nature of budget challenges before developing appropriate corrective action.

Baseline projection (as of January 2020)



The baseline projection shows annual deficits growing from $3.0 million in 2020 to $8.6 million by 2025. The projection starts with the $13.6 million in unrestricted fund balance at the end of 2018. The City anticipates using $3.0 million in reserves to balance the 2020 budget, leaving $10.6 million in fund balance at the end of 2020. According to the baseline projection, the City would exhaust its fund balance by 2023 absent corrective action. Practically speaking, however, the City would likely run out of cash before the fund balance is exhausted due to the weak year-end cash flow situation, which we will address later.

On the revenue side, the baseline projection assumes no increase to the real estate tax rate or fees. On the expenditure side, the baseline assumes wage increases according to the provisions in the existing labor agreements. After the expiration of the contracts, the baseline assumes annual wage increases to continue at recent levels (3.0% for Police, 3.0% for Fire, 2.75% for AFSCME and department directors, and 2.0% for other non-represented staff). These wage increase patterns are not a recommendation, but rather reflective of the City's historical trends absent corrective action.

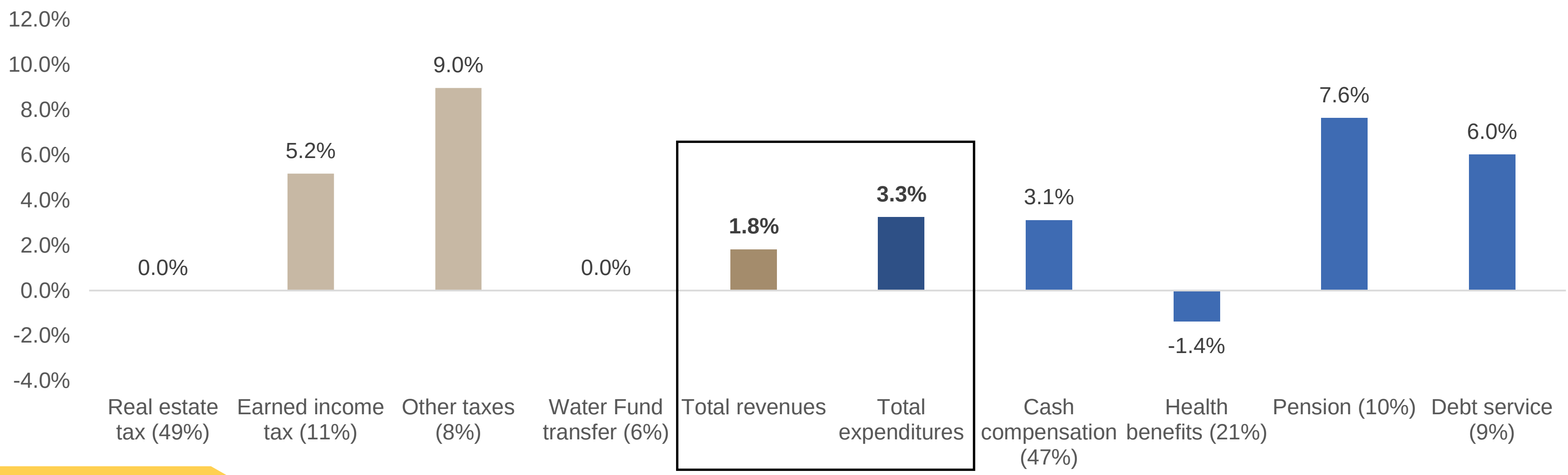
The baseline also assumes no additional debt issuance and very modest pay-as-you-go funding for capital projects ($143,500), consistent with the assumption in the 2020 budget.

Key finding #1: The City has a structural deficit

There are three high-level findings from our financial condition assessment. **The first is that most of the City's major expenditure categories grew more quickly than most of the City's major revenue categories, absent tax increases. The City has a structural deficit.**

Half of the City's General Fund revenues come from the real estate tax and the City's taxable assessed value has been growing at less than one percent absent reassessment. From 2014 to 2018, the City's earned income tax grew at 5.2 percent annually while other taxes, driven mostly by the transfer tax, grew at 9.0 percent annually. Even with the robust growth in these tax revenues, the City's total revenues would have grown by only 1.8 percent absent increases to the real estate tax and water rates, which support the Water Fund transfer. Total expenditures grew by 3.3 percent, driven primarily by growth in personnel costs and debt service.

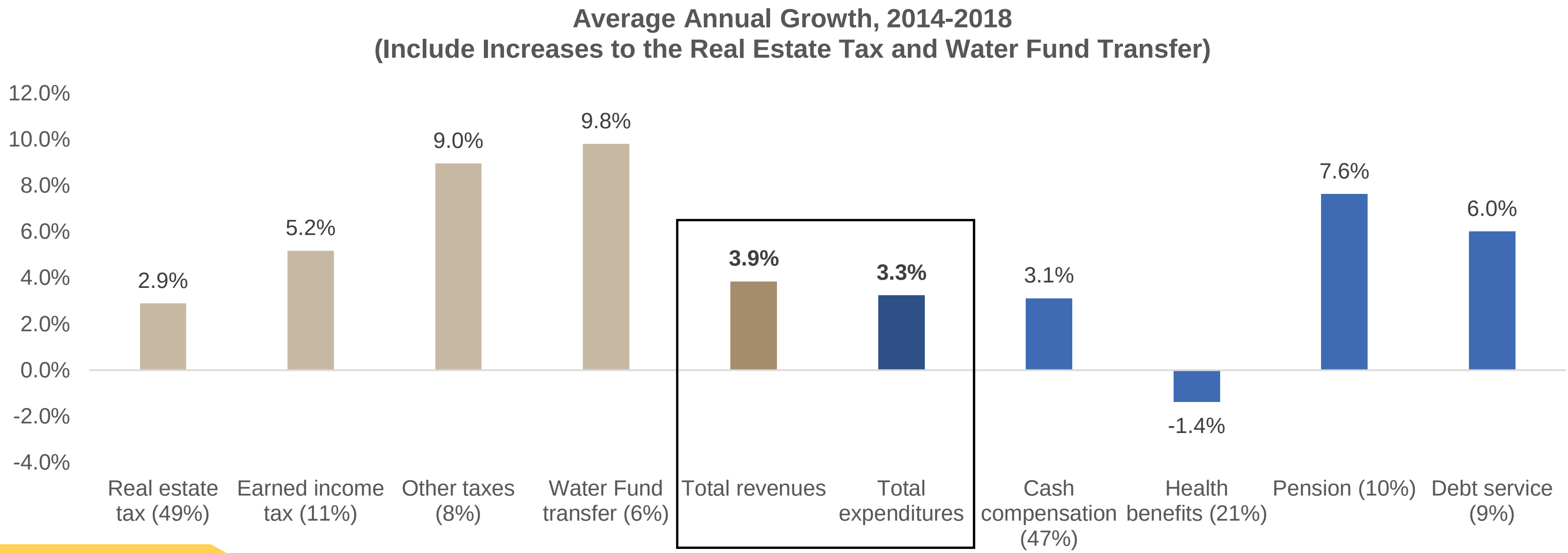
Average Annual Growth, 2014-2018
(Absent Increases to the Real Estate Tax and Water Fund Transfer)



“Why do we always have a balanced budget now and a deficit later?”

Despite the structural imbalance shown on the previous page, the City has always adopted a balanced budget. The primary reason the City has been able to do that is because Lancaster has increased its real estate tax to cover the deficit. The City increased the tax rate by 7.5 percent in 2015 and by 3.0 percent in 2017. Those tax increases helped the City cover the deficit as a result of the structural challenge.

The City also increased its Water Fund transfer over the last five years, which helped eliminate a portion of the deficits. The Water Fund transfer grew from $2.75 million in 2014 to $3.5 million in 2015 and then $4.0 million in 2018. Those increases were possible only because the City increased its water rates in 2015 and 2017 for customers in the City.

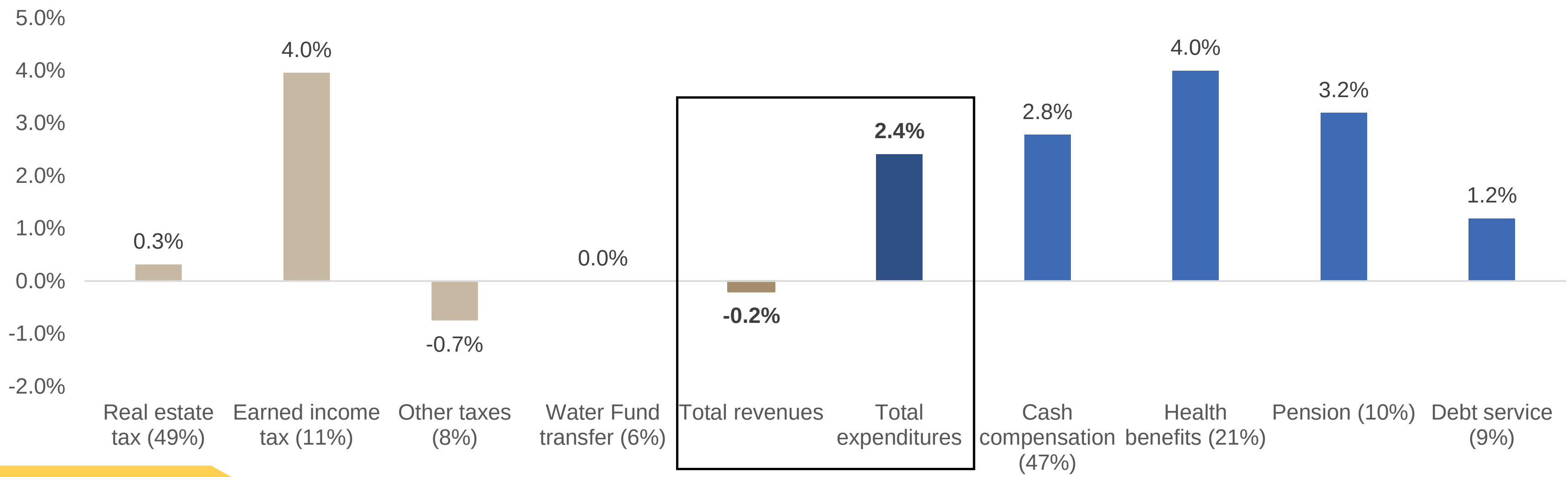


The structural challenge continues in the out-years

The projected deficits in the baseline indicate that the City's structural challenge will continue. Absent future increases to the real estate tax and Water Fund transfer, more than half of the City's revenues would be flat. The 2020 budget counts the use of $3 million in fund balance as revenue, which is a common budgetary practice for Pennsylvania governments but not actually revenue. Other tax revenues have a slight drop assuming the transfer tax revenues return to the 2015 – 2017 average of $1 million per year, instead of the $1.2 million budgeted for 2020.

Meanwhile, expenditures are projected to grow by 2.4 percent annually as cash compensation, health benefits, and pension contributions continue to grow. As a result of that structural imbalance, the baseline projects the City's deficit growing from $3.0 million in 2020 to $8.6 million by 2025 on a carry-forward basis and absent corrective actions.

Baseline Projection Growth Assumptions, 2020 – 2025



Why are the projected and historical growth rates different?

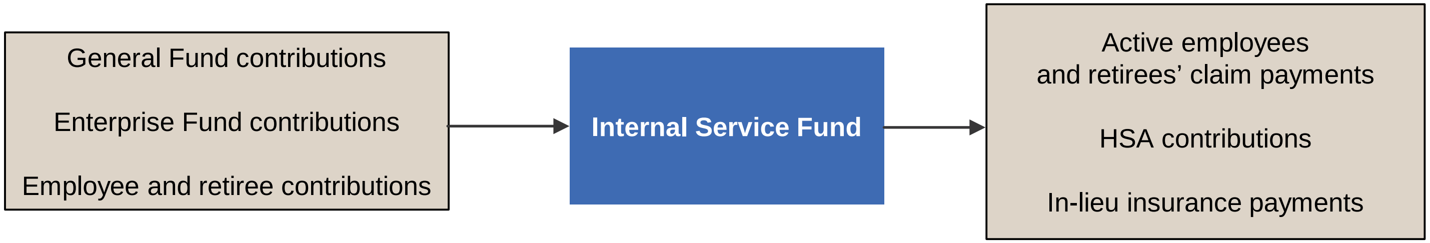
The baseline projection represents a “carry-forward” set of projections, but that does not mean that all historical growth rates are carried forward in the projection. The following table identifies the major revenues and expenditures where the projected growth vary from the historical growth.

Comparison between Historical and Projected Growth Rates

	2014-2018 average growth	Baseline assumption	Rationale
Earned income tax	5.2%	4.0%	EIT grew at an annual average rate of 5.2 percent over the last five years, but the growth has been gradually declining from 6.4 percent in 2015 to 4.5 percent in 2018. So we project EIT to grow at 4.0 percent annually moving forward as a result of this trend.
Other taxes	9.0%	-0.7%	The 9.0 percent historical growth in other taxes was largely driven by a 38.6 percent annual average growth in the transfer tax as a result of large transactions (e.g. Park City Center sale) in the last few years. The baseline assumes that the transfer tax revenue would drop from $1.2 million in 2020 to $1.0 million in 2021 (equivalent to 2015 to 2017 average) and remain flat at that level absent one-time, large transactions. The $1.0 million flat amount is almost twice as much as the $0.5 million collected in 2014.
Pension	7.6%	3.2%	The City’s total pension contributions across all funds increased from $4.8 million in 2014 to $6.5 million in 2018. Moving forward, the City’s actuary projects pension contributions to stabilize absent any changes to the mortality or investment assumptions or any actuarial gains and losses.
Debt	6.0%	1.2%	General Fund debt service increased from $4.3 million in 2014 to $5.4 million in 2018 because the City issued GO debt in 2014, 2016 and 2018. The baseline assumes no additional debt issuances and is based on the existing debt schedule.
Health benefits	-1.4%	4.0%	See next slide.

Why was the healthcare growth negative?

The City is self-insured and uses a separate Internal Service Fund to pay its insurance claims with money flowing in and out of the fund as shown below. The General Fund's contribution into the Internal Service Fund should be tied to the spending out of it, with some reserves as a buffer for a year when claims increase.



Internal Service Fund, Revenues and Expenditures

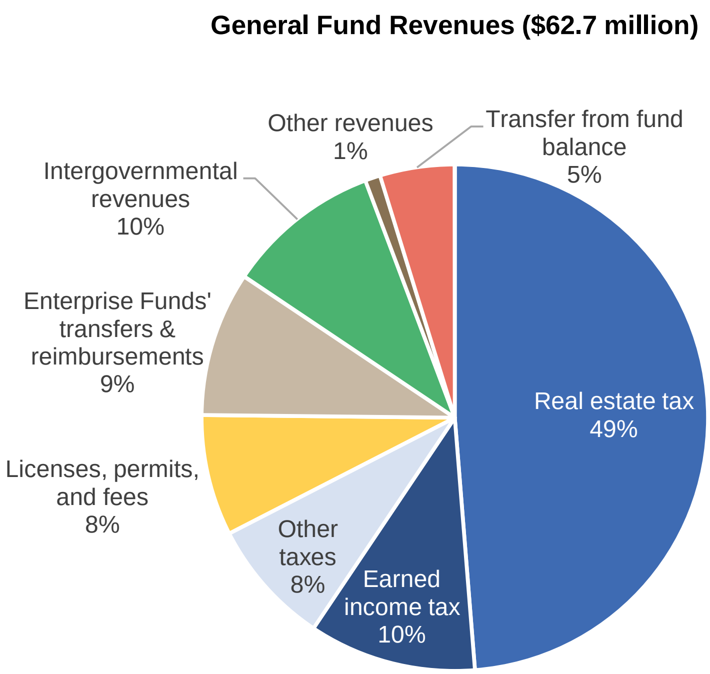
	2013	2014	2015	2016	2017	2018	2013-18 CAGR
Revenues	$12,525,068	$11,651,801	$11,397,829	$11,218,444	$12,134,477	$12,081,082	0.9%
Expenditures	$10,959,745	$11,072,147	$11,754,727	$11,521,447	$12,329,699	$12,893,355	3.9%
Surplus/Deficit	**$1,565,323**	**$579,654**	**($356,898)**	**($303,003)**	**($195,222)**	**($812,273)**	N/A
Unrestricted fund balance	**$1,513,907**	**$2,144,977**	**$1,788,079**	**$1,485,076**	**$1,289,854**	**$490,515**	N/A

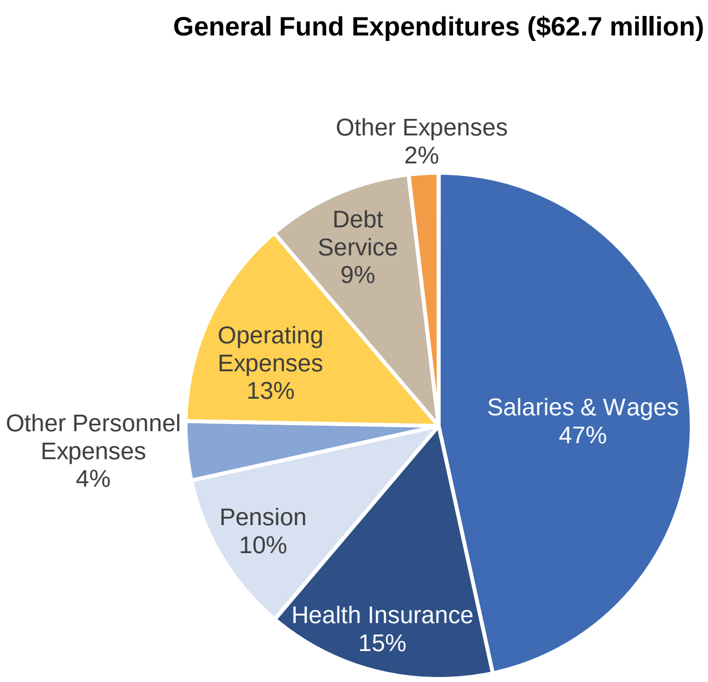
It appears that the City has been using the reserves in the Internal Service Fund to cover the cost of claims. In 2018, the General Fund contributed $7.8 million, the Enterprise Funds contributed $3.6 million, and employees and retirees contributed another $0.7 million. In aggregate, the Internal Service Fund received $12.1 million in revenues but spent $12.9 million in health benefits spending. So the Internal Service Fund absorbed the loss, and the fund balance dropped from $1.3 million to $0.5 million that year.

Because the City has been using the reserves in the Internal Service Fund, the 2019 budget had to increase its health insurance spending by 9.7 percent to catch up. If we account for the actual spending growth in health insurance, the structural imbalance as shown on the previous page would be even bigger.

Key finding #2: The City uses the fund balance to balance the budget

The 2020 budget anticipates the City will use $3.0 million from its fund balance (i.e. reserves) to cover operating expenditures. That is equivalent to 5.0 percent of the total General Fund budget or about half of what the City will spend on employee pensions. Use of fund balance is not a recurring revenue, so the baseline removes it from the projection, which creates a $3.0 million deficit in 2021. The City's fund balance grew from $9.9 million in 2014 to $13.6 million in 2018. Please note that the fund balance at the end of the year is much higher than the cash balance at the end of the year, as we describe later.





Why economic development alone isn't the answer

"During the eight-year period from 2007 through 2014, the City saw $1.5 billion in economic investment, a net increase of 100 new businesses and expansion of an additional 60 businesses. Since June 2015, there has been another $392 million in privately led investment with over 150,000 square feet of new retail and restaurant space developed, 200 new hotel rooms built, and 175 new residential units developed. The City continued to experience high levels of construction and renovation activity in 2018 with 2,643 building permits issued for projects worth a total of $230 million."

– Excerpt from the City's economic condition and outlook, 2018 Annual Financial Statements

The economic development described above should boost the City's revenues, both on a short term basis (permits for construction projects, possible transfer tax revenue) and a recurring basis (higher assessed value for real estate tax, more residents for EIT). As noted earlier, the City's transfer tax revenues grew, but that revenue growth is difficult to predict since it can be driven by large individual sales (like Park City Center in 2018). The City's EIT revenues grew by 6.4 percent in 2015, 5.0 percent in 2016, 4.8 percent in 2017 and 4.5 percent in 2018, indicating that the growth is leveling off on a larger tax base.

However, the degree to which economic development impacts tax revenue growth is also impacted by the tax incentives in effect such as:

Local Economic Revitalization Tax Assistance (LERTA)

- Improvements to deteriorated properties receive exemptions ranging from 7 to10 years depending on the type of property.
- Exemptions are provided on a sliding scale, with exemption dropping from 100% in year 1 to 10% in year 10 for residential properties and to 15% in year 7 for commercial properties.
- New constructions receive 100 percent exemptions for 3 to 5 years depending on the National Green Building Standard certification (Bronze, Silver, or Gold).

Tax Incentive Financing (TIF) and City Revitalization and Improvement Zone (CRIZ)

- The basic concept of both TIF and CRIZ is that the City designates an area as a TIF or CRIZ district, issues debt to pay for projects within that district, then uses the resultant increase in tax revenue to repay the debt.
- For example, the additional real estate tax revenue from the TIF district is used to pay for the North Queen Street garage construction and the additional EIT and LST revenues from the CRIZ are used to pay for projects such as those at the Convention Center and Lancaster Square.[1]

[1] The majority of the funding for capital projects in the CRIZ are funded by state tax revenues.

Sensitivity analysis: What if the existing revenue sources grew more?

Using our financial projection model, we created a scenario in which the City's revenues grew more robustly than they do in our baseline projection. This "what if" analysis helps demonstrate the extent to which certain changes in policy or circumstance can help close the projected deficit. In our higher growth scenario we assume:

Major revenues	Growth Scenario	Baseline Assumption
Real estate tax	0.3% growth assuming the historical growth in assessment, absent reassessments[1]	0.3% growth assuming the historical growth in assessment, absent reassessments
Earned income tax	6% annual growth	4% annual growth based on the historical trend in the last five years
Transfer tax	Remain flat at $1.2 million (same as projected in the 2020 budget)	Remain flat at $1.0 million (equivalent to 2015 to 2017 average revenues)
Local services tax	2% annual growth	0.2% annual growth based on the historical population growth
Building permits	10% annual growth (equivalent to the growth from 2017 to 2018)	Flat assuming the same amount of construction and renovation activity
Water Fund transfer	Flat given the projected deficit in the Water Fund in 2020	Flat given the projected deficit in the Water Fund in 2020

[1] Because of the tax incentives (LERTA and TIFs) and the City's lack of control over the assessment cycle, the growth rate would remain the same in a robust growth scenario.

Key finding #3: The City cannot “grow its way” to stability

In this growth scenario, the City would still have projected deficits. The results shown below apply the higher growth rates to the 2020 budget, which is our starting point. The deficits are smaller than in the baseline but still exist.

Growth Scenario Projections

	2020 Budget	2021 Proj.	2022 Proj.	2023 Proj.	2024 Proj.	2025 Proj.
Revenues	$59.7	$60.2	$61.0	$61.8	$62.7	$63.6
Expenditures	$62.7	$64.6	$66.2	$67.2	$68.9	$70.6
Surplus/Deficit	($3.0)	($4.3)	($5.1)	($5.4)	($6.2)	($7.0)

Even in this scenario at least half of the City’s revenue would remain flat for reasons explained on the prior page. Increased economic development would not change the frequency with which reassessment occurs or the tax incentives referenced on the prior slide. Real estate tax revenues would remain flat absent tax increases, just as they were during the increased economic development activity in recent years. An increase in the rate paying base would help the Water Fund but that fund already has a deficit that needs to be addressed before the fund can contribute more to the General Fund

The revenue growth does reduce the 2021 deficit from $4.8 million in the baseline to $4.3 million and reduces the 2025 deficit from $8.6 in the baseline to $7.0 million. But there are still deficits because the revenue growth in this scenario is still not enough to catch up with expenditure growth. Personnel costs are projected to grow by at least three percent as a result of wage increases, healthcare inflation, and growing pension contributions absent corrective actions. Debt service will also continue to grow based on the existing debt schedule, even before any additional debt issuances.

Even in this scenario, the City does not grow its way out of a deficit and into financial stability.

Recession readiness

Recession readiness analysis

The baseline projects the City's General Fund deficits growing from $3.0 million in 2020 to $8.6 million in 2025 on a carry-forward basis and absent corrective actions. This does not account for the possibility there could be a recession during the five-year projection period.

The Great Recession officially reached its trough nationally in June 2009.[1] On the tenth anniversary of that milestone (June 2019), the U.S. economy tied its record for the longest expansion phase since business cycles began to be tracked in the 1850s. Since the end of World War II, the average length of the prior 11 economic expansions was 58.4 months.

Although periods of economic expansion do not die of old age alone, history strongly suggests that it is now critical for state and local governments to actively prepare for the next downward turn.

The following pages evaluate the City's readiness for an upcoming recession using the following criteria:

1. **Revenue volatility** – how economically sensitive are the City's General Fund revenues?
2. **Flexibility to cut spending** – based on the amount of fixed costs and the service demands Lancaster has, how much spending could City government realistically cut in light of the budgetary pressures?
3. **Amount of Reserves** – how much reserves and cash balance does the City have as financial buffer in the event City government needs to use reserves to balance the budget?

[1] *National Bureau of Economic Research, Business Cycle Dating Committee.*

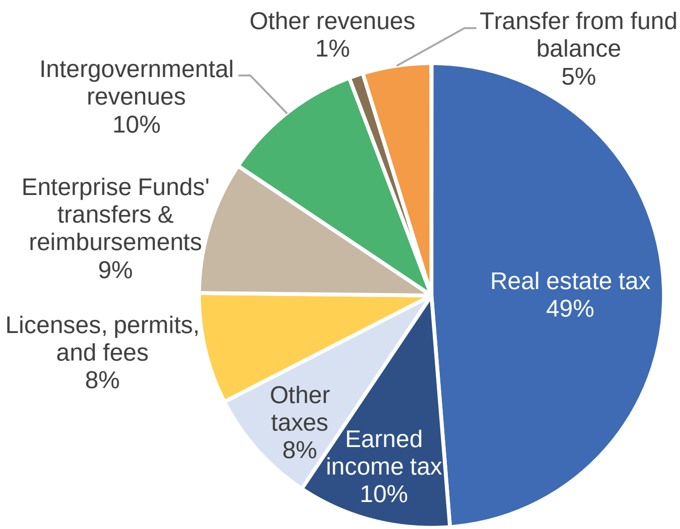
Revenues at a glance

According to the 2020 adopted budget, half of the City's General Fund revenues comes from the real estate tax. The City generates about 20 percent of its revenues from other taxes (mostly EIT). The City does not levy a business gross receipts tax (also known as the business privilege and mercantile taxes). Most of the Intergovernmental revenues is State pension aid.

For the next largest category, the General Fund receives an annual payment from the Water Fund that totaled $4.0 million in 2020. The General Fund receives another $1.8 million in reimbursements from the Enterprise Funds (Water, Sewer, and Trash and Recycling Funds) for work performed by the General Fund, such as vehicle maintenance and payroll processing. In aggregate, this category totaled $5.8 million, or 9.2 percent of total General Fund revenues.

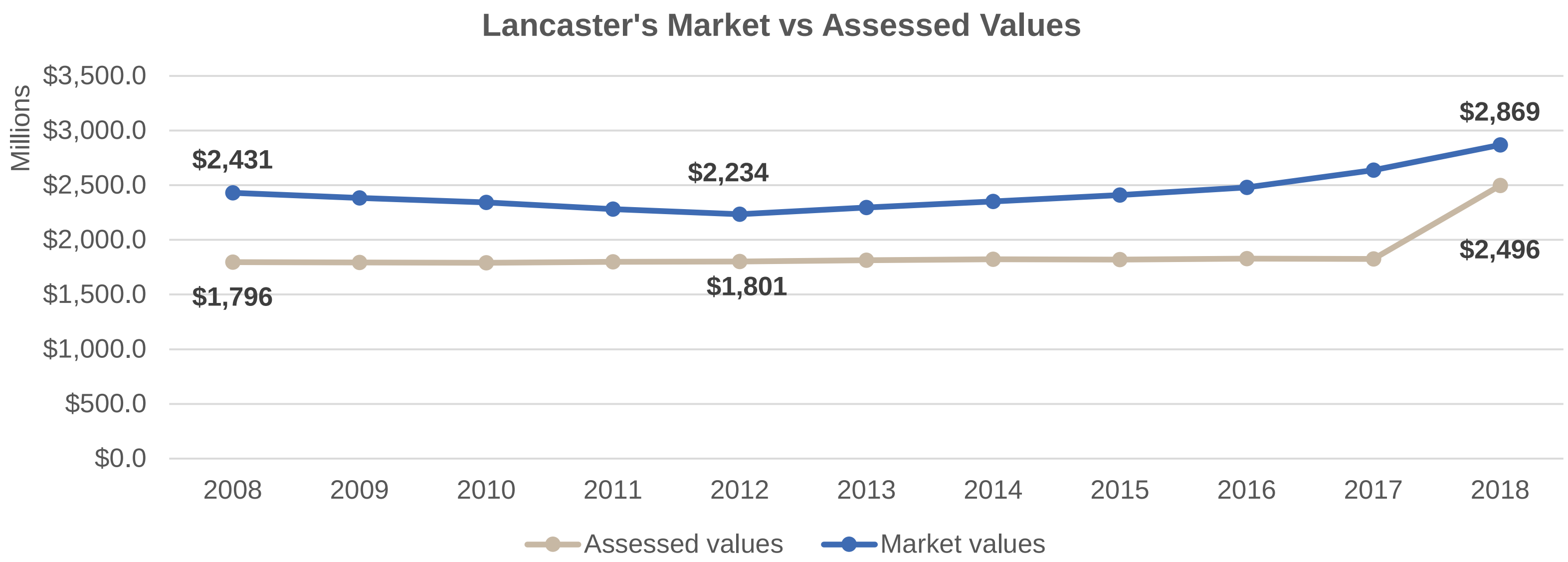
2020 Budget (Revenues)	
Real estate tax	30,553,500
Earned income tax	6,700,000
Other taxes	5,045,000
Licenses, permits, and fees	4,835,000
Enterprise Funds' transfers	5,790,451
Intergovernmental revenues	6,180,783
Other revenues	609,792
Transfer from fund balance	2,991,221
Total General Fund Revenues	**$62,705,747**

General Fund Revenues – 2020 Adopted Budget ($62.7 Million)



Real estate taxes remained stable in the last recession…

The total amount that the City bills for its real estate tax (gross levy) is the product of the ***assessed*** value of taxable property and the tax millage rate. The total assessed value of taxable property has been essentially flat for the last decade, growing very slightly from $1.80 billion in 2008 to $1.82 billion in 2017. The Countywide reassessment in 2018 increased the tax base by 36 percent and the City reduced its tax rate by 26 percent. The last reassessment before 2018 was in 1997.



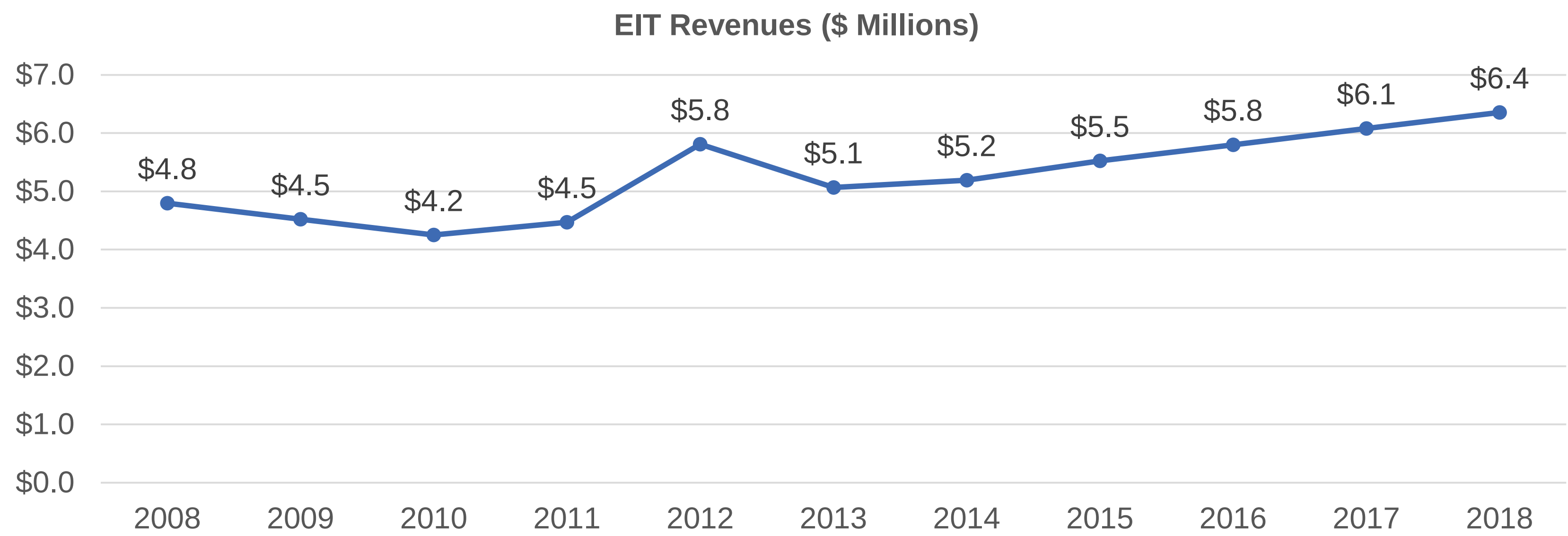
Infrequent reassessments mean that **growth in market values generally does not translate to higher tax revenues**, which are based on assessed values. The same is true when market values drop. Throughout and following the 2008 Recession, the City's assessed value remained flat when market values dropped by an annual average rate of 2.1 percent from 2008 to 2012.

Source: Market Values are presented as a function of the Common Level Ratio to Assessed Value based on information from the State Tax Equalization Board (STEB)

…but EIT revenues dropped

Revenues from the **earned income tax**, however, are likely to be affected in an economic downturn. Lancaster levies a 1.1 percent earned income tax (EIT) on its residents, of which 0.6 percent goes to the City and the remaining 0.5 percent goes to the School District of Lancaster. Because the earned income tax is based on residency, not the place of employment, most commuters who work in Lancaster and live elsewhere do not pay EIT to the City.

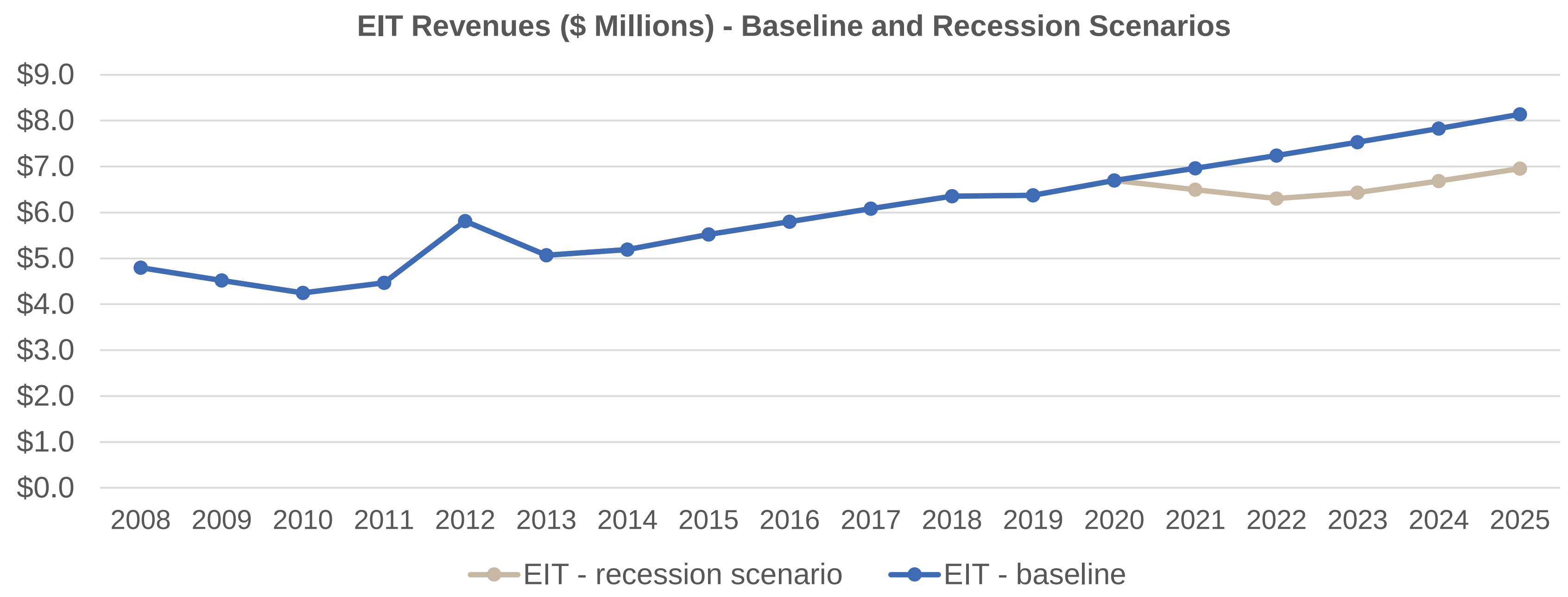
During and immediately following the last recession, the City's earned income tax revenues dropped from $4.8 million in 2008 to $4.5 million in 2009, and then to $4.2 million in 2010. EIT revenue grew again in 2011 and spiked in 2012 when the Commonwealth changed the law governing how the EIT is collected and remitted (i.e. Act 32). As noted earlier, growth continued at a slowing rate from 2014 to 2018.



EIT revenues under a recession scenario

To provide a sense of potential lost EIT revenue during a recession, the projection below assumes EIT revenue declines by 3.0 percent in 2021 and 2022, which would be half of the decline experienced during the Great Recession. After two years of revenue decline, EIT revenues grow by 2.0 percent in 2023 and 4.0 percent in 2024 and 2025.

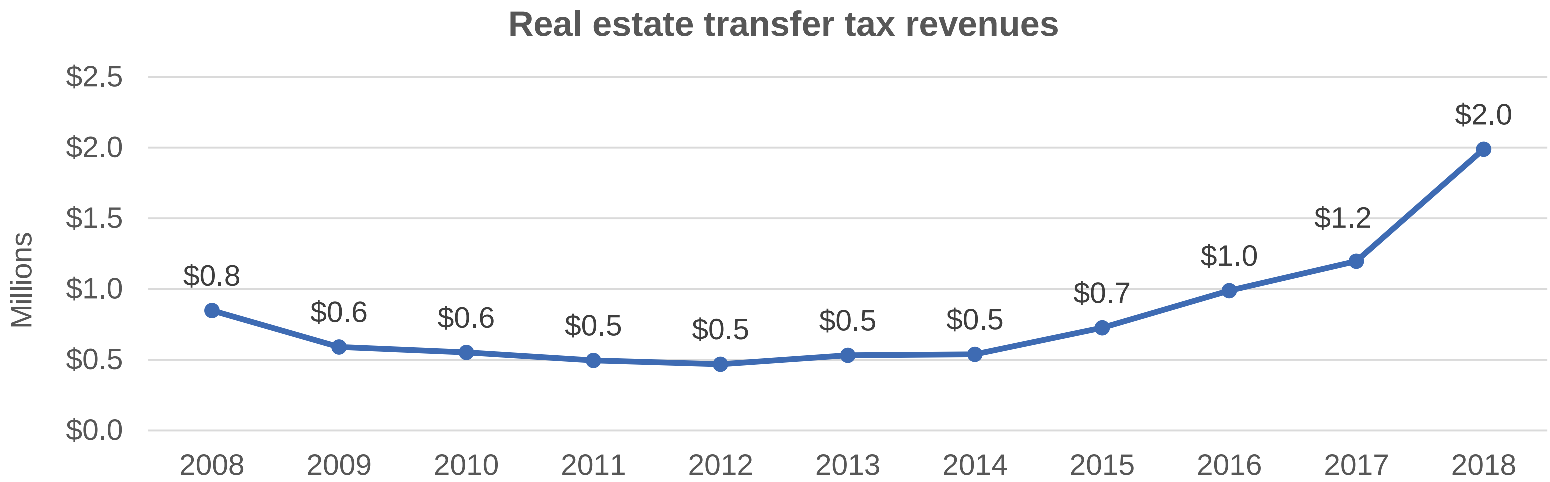
Note that, in this scenario, the City has less revenue during the recession and in subsequent years because the 4.0 percent growth is applied to a smaller tax base. In aggregate, the City would collect almost $5.0 million less in EIT revenues over the five-year period from 2021 to 2025.



Real estate transfer tax in the last recession

The other revenue with a significant decline during the last recession was the real estate transfer tax. This is a 1.0 percent tax on all real estate transactions, of which 0.5 percent goes to the City and the remaining 0.5 percent to the School District. From 2008 to 2010, transfer tax revenues dropped by 35 percent from $848,000 in 2008 to $552,000 in 2010. The revenue remained flat until 2015 when it jumped by 36 percent. Individual large transactions such as the sale of the RR Donnelley properties in 2016, the sale of the Rose City HMA property in 2017, and the sale of Park City Center in 2018 boosted revenues in those years, but there has also been some growth in the revenue absent these individual transactions.

There is a large difference between the revenue trend in recent years (38.6 percent annual *growth* from 2014 through 2018) and the trend during the last recession (30.3 percent annual *decrease* from 2008 through 2009) or even the trend after it (1.8 percent annual decrease from 2009 through 2014). If the recession dampens real estate transaction activity back to 2015 levels, that would cost the City $0.3 million a year relative to the baseline projection.



Finding #1: The City relies on growth in economically sensitive taxes

Key revenues	% of revenues	Economic sensitivity
Real estate tax	49%	Because the real estate tax is based on assessed values, it would likely remain relatively stable in a recession, absent changes in the level of appeals activity
Earned income tax	**11%**	**In the last recession, EIT dropped by 5.8 percent in 2009 and 6.0 percent in 2010**
Real estate transfer tax	**2%**	**In the last recession, real estate transfer tax dropped by 35 percent from 2008 to 2010**
Local services tax	**3%**	**In the last recession, local services tax dropped by 3.1 percent in 2009 but growth returned in 2010**
Licenses, permits, fines, and fees	**8%**	**In a recessionary environment, building and construction activity may decline, reducing the permit fees associated with it. In the last recession, this category dropped by 10 percent in 2010**
Water Fund transfer	6%	There is potential risk in this area if the number of customers decrease (i.e. business closures) or if delinquent accounts increase during the recession (economic hardship). The amount available to the General Fund depends on whether the utilities can afford those transfers

Finding #2: About 20 percent of the General Fund spending are fixed costs

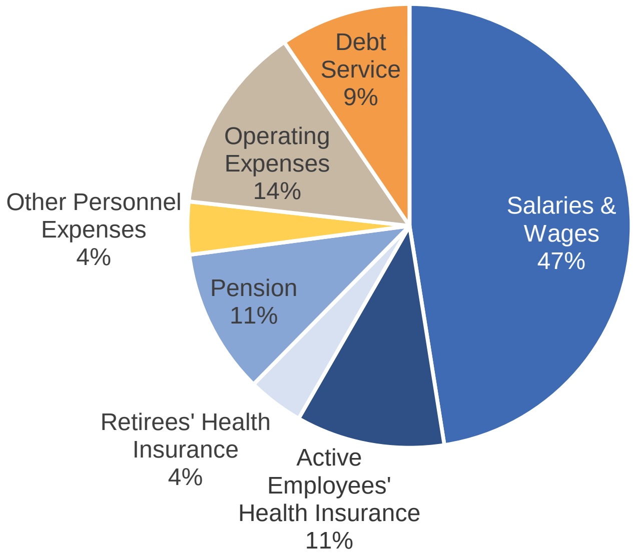
Almost 20 percent of the City's General Fund expenditures are debt service and pension contributions, which are largely fixed costs. The City is legally required to make a minimum contribution to its employee pension plans each year as calculated by its actuary. The City budgeted $6.5 million for its pension contribution in 2020, most of which ($4.0 million) is the amortization cost to pay off the pension plans' unfunded liability and not easily affected by headcount reductions. In addition, the City budgeted $2.5 million for retiree health benefits, which are obligations to former employees.

Another 9.3 percent (or $5.9 million) of the 2020 budget is spent on debt service, which are the principal and interest payments related to the City's debt borrowing, including the 2006 pension obligation bonds. There are opportunities to refund debt in 2021, 2024, and 2026. Debt service accounts for 9 percent of the 2020 budget and an even higher percentage of total expenditures for the utilities. According to the 2020 budget, debt service represents at least a quarter of total spending in the Water, Sewer, and Stormwater Funds.

The high amount of fixed costs was highlighted by Moody's Investor Services when it downgraded the City's credit rating by two notches in 2018 from A1 to A3. The rating report noted that the downgrade "*reflects the City's highly leveraged position given this 2018 [debt] issuance.*"

In the 2019 update to credit analysis, Moody's again affirmed its position: "*The City has issued general obligation debt to support its water and sewer enterprises, and while its debt burden has been historically high as a result, the addition of substantial debt in 2018 has resulted in a particularly outsized debt burden.*"

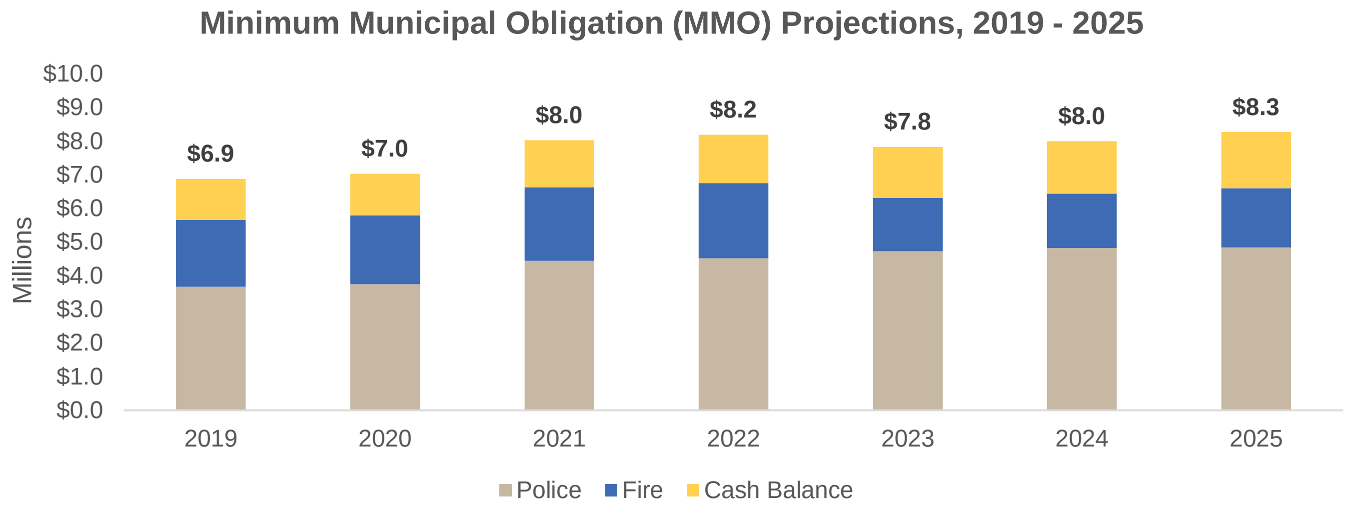
General Fund Expenditures – 2020 Proposed Budget ($60.3 Million)



Pension projections

Moving forward, the City's actuary projects that Lancaster's annual MMO will increase to $8.0 million in 2021 and $8.2 million in 2022. In 2023, pension contributions are projected to drop slightly due to a lower contribution to the Fire pension plan. These projections are based on the updated mortality table that will be incorporated in the January 1, 2019 valuation[1] and assume no additional actuarial gains or losses. The Police and Fire pension plans both use an 8.0 percent investment return assumption and the Cash Balance pension plan uses a 7.5 percent investment return assumption.

The City's pension contributions would increase following an economic downturn, if investment earnings fall short of the 8.0/7.5 percent investment assumptions. The City's pension contribution doubled in the years following the recession[2] and its pension funding level slipped from 91.0 percent in 2007 to 81.8 percent in 2013, although that was in part because of assumption changes including the reduction of investment assumptions for the Police and Fire plans.[3]

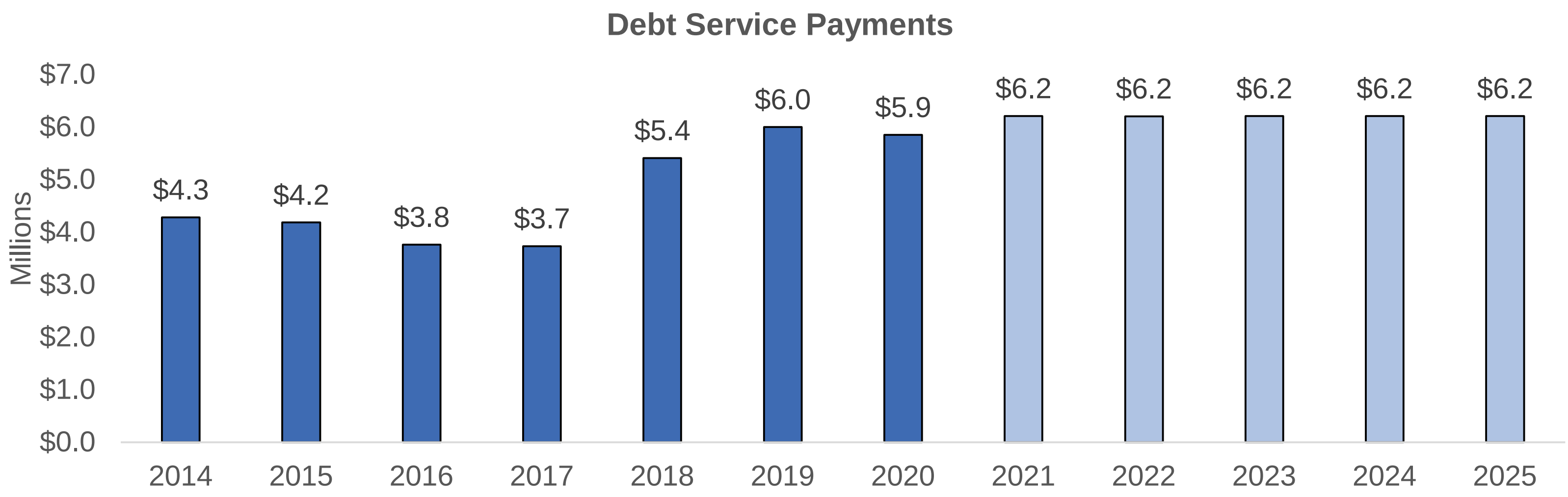


[1] The January 1, 2019 actuarial valuation will be based on the SOA Public Plan Mortality Table instead of the IRS 2017 mortality table.
[2] The City's pension contribution grew from $3.0 million in 2009 to $6.5 million in 2018.
[3] The investment return assumption for the Police and Fire pension plans dropped from 8.5 percent to 8.0 percent as of January 1, 2011.

Debt projections

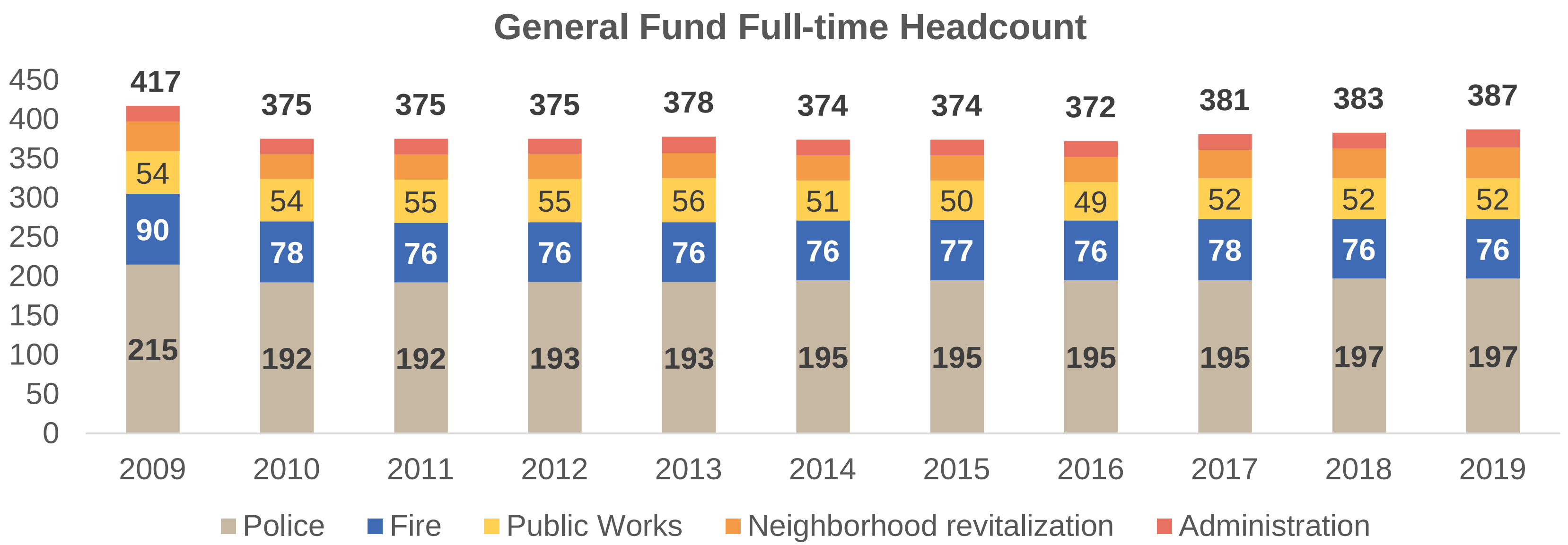
Over the last decade, the City issued over $200 million in bonded debt, of which about $40 million was dedicated for General Fund capital improvement projects. The remaining proceeds were dedicated to the City's sewer, water, and stormwater infrastructure improvements. The City's annual General Fund debt service payments increased from $4.3 million in 2014 to $6.0 million, equivalent to an annual average increase of 7.0 percent. Debt service as a percentage of expenditures also increased from 8.7 percent in 2014 to almost 10 percent in 2019.

Even without additional debt issuances, the City's General Fund debt service payment will remain at $6.2 million over the next five years. If the City decides to issue additional debt for capital improvement projects, the debt service payments and debt burden will be even higher.



Could the City cut staff in a recession?

Most of the City's General Fund expenditures are for employee compensation, so headcount reductions would have to be considered during a recession. We have not conducted the management review yet which would determine whether there are opportunities to reduce staffing while maintaining service levels. For now we note that the City cut the number of full-time equivalent positions (FTEs) after the Great Recession from 417 in 2009 to 375 in 2010, with the bulk of reductions occurring in Police (23) and Fire (12). Headcount remained at that level until 2017 – 2019 when the City added positions in the Departments of Public Works and Neighborhood Revitalization. The City has not restored headcount in Police and Fire to the levels in place before the Great Recession.

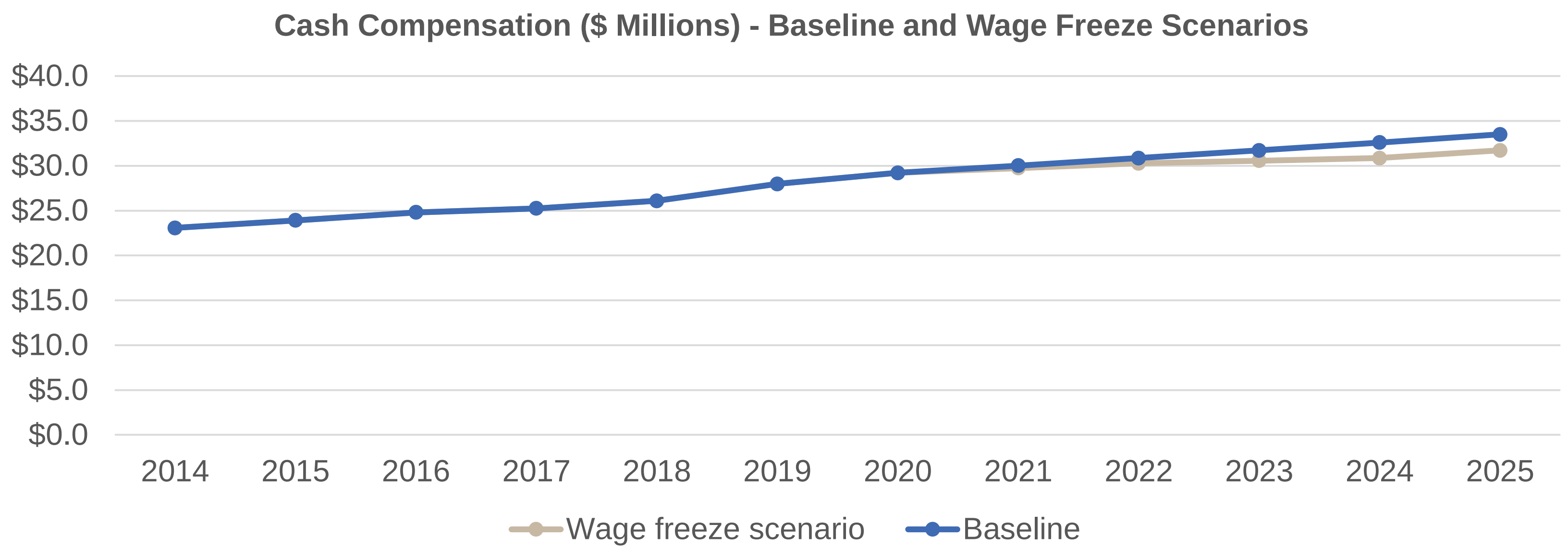


Note: The decrease in Police headcount in 2010 was in part because the City stopped providing coverage to Lancaster Township, reducing 10 FTE as a result.

What about wage freezes?

Another option to reduce spending is lower wage increases. To provide a sense of potential savings from wage freezes, the projection below assumes all bargaining units receive wage freezes for two years before returning to the three-percent baseline increase. Different employee groups have different contract expiration dates (Fire in 2020, Police and AFSCME in 2022), so the wage freezes for Fire would begin in 2021 and the freezes for Police and AFSCME would begin in 2023, after the contracts expire.[1]

Under this scenario, the City would generate annual savings of $0.3 million in 2021 that grows to $0.6 million in 2022, $1.1 million in 2023, and $1.7 million in 2024 and 2025. In aggregate, the City would generate savings of $5.5 million over the five-year period from 2021 to 2025. In other words, two years of wage freezes would close about 15 percent of the deficits projected in the baseline.



[1] *The City is currently finalizing the bargaining agreements with these two employee groups and expect those contracts to be finalized no later than Spring 2020.*

Finding #3: The City has limited cash flow buffer

If governments cannot balance recurring expenditures with recurring revenues during a recession, they may temporarily draw down their reserves to fund operations. So the third criteria evaluates whether the City has sufficient reserves to provide the financial buffer the City may need during a recession.

General Fund

As of the end of 2018, the City's unrestricted fund balance as a percentage of operating revenues was 24.1 percent, higher than the minimum amount recommended by the Government Finance Officers Association (16.7 percent). That said, the amount of cash on hand is very low, as the majority of the reserves is money due from the Water and Sewer Funds. The City's financial statements show the City only having $12,645 in unrestricted cash at the end of 2018. Because of the City's weak cash position, it has been issuing tax anticipation notes (TAN) to ensure that it has sufficient cash on hand.

Enterprise Funds

Even though both the Sewer and Water Funds had positive fund balances, a significant portion of the fund balances were invested in capital assets, which means that there is little liquidity in those reserves. The narrow cash position was cited by Moody's in its 2019 update to credit analysis:

> "*Lancaster has historically experienced a narrow cash position during the end of its fiscal year and has routinely issued TANs to bridge its cash flow until tax revenues are received in the spring. While the city's overall cash position has improved moderately in 2019, it remains markedly narrow when compared to its combined general fund and utility budgets.* ***The city's overall narrow liquidity and reserve position is especially concerning given its exceptionally high debt and rising fixed cost burden" (emphasis added).***

Recession readiness: So what?

- **The City depends on growth in its earned income tax and, to a lesser degree, its real estate transfer tax. History shows those revenues are economically sensitive.** This dependence is especially true since half of General Fund revenues comes from the real estate tax that is likely stable during a downturn but stagnant during expansion, absent tax rate changes. The rest of the revenues have to “pick up the slack” to keep pace with growing expenditures.

  So what: Lancaster, like many of its peers, needs more options to generate revenue that grows naturally without a rate increase, for the sake of revenue diversity and sustainability.

- **The City allocates about 20 percent of its budget allocated to pension contributions and debt, and those costs are not likely to drop in a recession.** Pension contributions would potentially rise during a recession and the City is already “highly leveraged” with respect to debt, even without borrowing money for new capital projects. We have not evaluated the City’s staffing levels yet, but we note that the FTEs reductions in police and fire following the Great Recession were not restored and that a two year wage freeze would close 15 percent of the five-year deficit in the baseline projection and less than that during a recession.

  So what: Lancaster has to be careful with regard to adding new positions, expanding services, or adding new or enhanced forms of compensation. Finances do not give City leaders flexibility to respond to new demands.

- **The City has limited cash flow buffer**. Even though the City has a healthy fund balance according to the 2018 financial statements, most of the General Fund reserves is money due from the Enterprise Funds. The City’s cash flow position continues to be very narrow.

  So what: The City needs to address the deficits in the Water and Sewer Funds before a recession arrives that would put more strain on all funds. The utilities appear to be a drag on the City’s cash position and debt burden, even with the development occurring since 2015. The General Fund’s liquidity is not strong enough to support those utilities in a recession.

Two final thoughts

- From a financial stand point, the goal is not simply to balance to zero. The City needs to have an appropriate level of reserves (cash and fund balance) to provide a contingency against any economic downturn, to maintain its credit rating, and for practical cash flow reasons at the beginning of the year. The City also needs to ensure that it makes the capital investment in the assets that people see, drive on, work in, and play on every day.
- From a strategic stand point, the goal for this engagement is not just financial. City government does not exist for purely financial purposes. It exists to deliver critical services to the people who live in, work in and visit Lancaster. Similarly, numbers alone won't tell the complete story. So our next step is to meet with department managers and other staff to discuss what their departments do, how they do it and why they do it, in relation to the City government's mission.