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PHILADELPHIA'S FISCAL FUTURE

How Future Employment Patterns Could Put Philadelphia's Operating Budget at Risk

Four scenarios that will affect tax revenues—and who pays for them

Overview

In the first of a series of briefs examining Philadelphia's fiscal future, The Pew Charitable Trusts looked at how the COVID-19 pandemic has affected the city's economy. The second brief presented four potential scenarios for Philadelphia's economic performance over the next several years.

This third brief focuses on the impact that each of the four scenarios would have on the city's operating budget. In the rosiest scenario, Philadelphia's economy would generate 70,000 more jobs than in the grimmest. The presence or absence of these jobs—and the associated economic activity—translates into a cumulative difference of nearly $1.6 billion in local tax revenues through fiscal year 2026, a difference that means total revenues over that period would be either slightly higher than the city has projected in its 2022-26 five-year plan or significantly lower. (Dollar figures throughout this brief, including the tables, are rounded to the nearest million; percentage change calculations are based on the actual figures.)

The goal of this work, being done by Pew in partnership with the William Penn Foundation, is to inform the choices that await local policymakers as they consider what to do to help enhance equitable growth in Philadelphia and ensure the fiscal stability of city government.

With Mayor Jim Kenney's administration planning to devote its $1.4 billion allocation under the American Rescue Plan Act (ARPA) to replacing lost revenues, Philadelphia is unlikely to face major fiscal distress in the next few years. But the picture could be quite different when that money runs out—spending decisions must be made by 2024 and the dollars spent by 2026—potentially leaving the next mayor in a challenging fiscal position.

All the scenarios show a larger share of the local tax burden falling on city residents than in the pre-pandemic period, primarily because of the projected decline in the wage tax paid by nonresidents. Econsult Solutions Inc., which created the four scenarios, estimates that the city will lose $572 million in nonresident wage tax revenues over the course of 2022 through 2026 compared with what might have been expected had there been no pandemic.

And it's possible that all these estimates of city revenues may err on the high side because of two major risks to city revenues that can't be realistically assessed at this point. Both center on where workers, particularly nonresidents attached to workplaces located in the city, end up doing their jobs.

The first risk is that employers will make the changes necessary to exempt from the wage tax some city-based jobs held by nonresidents. The other is that property taxes paid by owners of office buildings will decline if the demand for workspace softens and the spaces can't be put to other uses.

To a large degree, the city's fiscal future depends on the number and type of jobs that Philadelphia's economy generates and where the actual work is done. These factors, along with population growth, will determine how much revenue city government can raise—and the degree to which the burden of funding essential services falls more heavily on residents than in years past.

Revenues

In a previous report, Pew laid out the four Econsult scenarios for the city's future economic performance, measured in terms of jobs. The baseline was the city's official five-year plan for fiscal years 2022-26, the projections of which are embodied in a scenario called Uneven Gains; this scenario would achieve 754,500 jobs by mid-2025.[1] Another scenario, Overall Growth, would be stronger, with 774,900 jobs. The remaining two, Competitive Loss and Stunted Recovery, would be weaker, with 727,700 and 704,800 jobs, respectively.

In addition to being a critical measurement of the health of the city's economy, the number of jobs is essential to the ability of city government to fund its operations—through the wage tax revenues the jobs generate; the property taxes paid by the owners of the buildings where the jobs are located; and the sales, parking, and other consumption taxes paid by jobholders. The job count also is a key indicator of the health and vitality of local businesses.

Philadelphia's general fund spending for fiscal 2021—which began on July 1, 2020, and was the first full budget year to reflect the effects of the pandemic—was $4.7 billion. Of the revenue to support that spending, $3.933 billion came from local taxes on wages (51%), real estate (26%), business (14%), and consumption (9%). In these categories, taxes on wages include the levy on net profits and wages, which applies to sole proprietors, partnerships, and limited liability companies; real estate taxes include the real estate transfer tax as well as the property tax; business taxes include both the net income and gross receipts portions of the business income and receipts tax; and consumption taxes include those on sales, beverages, parking, and amusements.

Revenues from wage and consumption taxes, which are the taxes most directly linked to the job numbers, were substantially lower in fiscal 2021 than they had been in fiscal 2019, the last fully pre-pandemic year. Real estate and business taxes were essentially unchanged from fiscal 2019 to fiscal 2021; over a normal two-year span, they would have been expected to grow. (See Table 1.)

Table 1

Revenues by Tax Type, Fiscal 2019 and 2021

In millions of dollars

Tax type	Fiscal 2019	Fiscal 2021	Net change	Percentage change
Wage	$2,111	$2,004	($107)	-5.1%
Real estate	$1,025	$1,027	$2	0.2%
Business	$541	$542	$1	0.1%
Consumption	$431	$360	($71)	-16.6%

Note: Dollar figures are rounded to the nearest million; percentage change calculations are based on the actual figures.

Sources: Quarterly City Managers Reports for the periods ending June 30, 2020, and June 30, 2021

A closer look at the consumption tax numbers for fiscal 2019 (the last full year before the COVID-19 shutdown), 2020 (about 70% of which came before the shutdown), and 2021 (the first budget year that took place entirely during the pandemic) shows how changes in people's behavior affected city revenues during that period.

Table 2 indicates that sales tax revenues fell in fiscal 2020 as a result of the shutdown, then rose in the following year as residents spent more on consumer durable goods and major personal items—such as televisions, major kitchen appliances, and phones—while spending less on travel, dining, and entertainment. With out-of-the-house entertainment options at a minimum, amusement tax revenues plummeted in fiscal 2021; the parking tax, paid largely by people driving to work or to events, also dropped dramatically.

Table 2

General Fund Consumption Tax Revenue

Fiscal years 2019-21, in millions of dollars

	Fiscal 2019	Fiscal 2020	Fiscal 2021	Change 2019-21	Percentage change 2019-21
Sales tax	$224	$205	$230	$6	2.7%
Beverage tax	$77	$70	$70	($7)	-9.1%
Parking tax	$99	$77	$53	($46)	-46.5%
Amusement tax	$26	$18	$3	($23)	-88.5%
Other consumption taxes	$4	$4	$3	($1)	-25%
Total	**$431**	**$374**	**$360**	**($71)**	**-16.6%**

Note: Dollar figures are rounded to the nearest million; percentage change calculations are based on the actual figures.

Sources: Quarterly City Managers Reports for the periods ending June 30, 2020, and June 30, 2021, and Five-Year Financial Plan, 2022-26

The amount of future revenue raised by all city taxes varies substantially, depending on which of the four scenarios turns out to be closest to how the local economy actually performs—and also on actions that city leaders take in response to that performance.

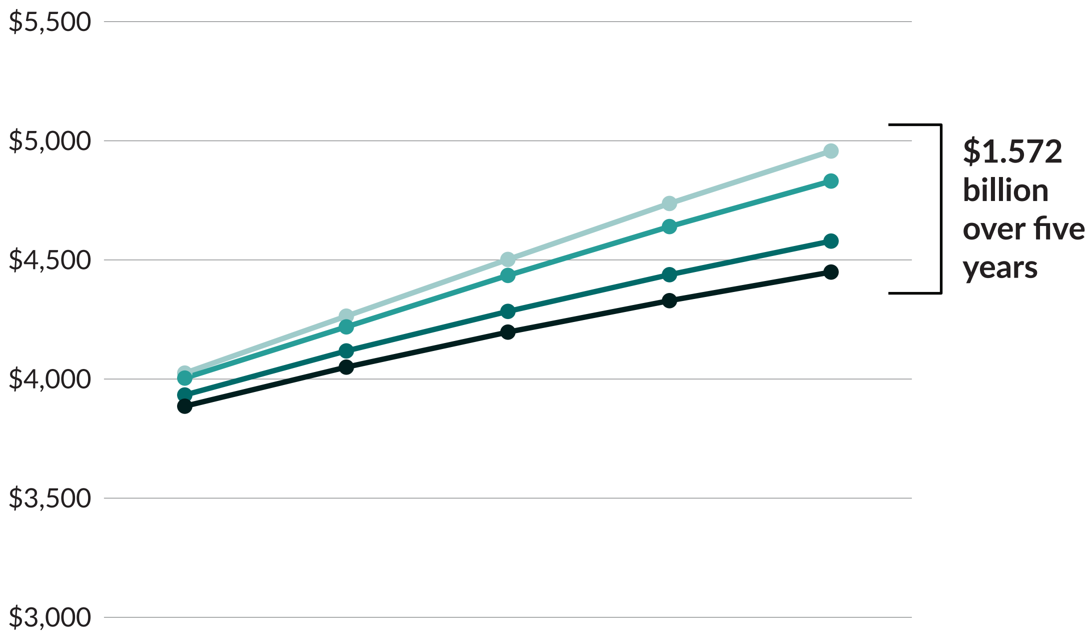
Figure 1 shows projections for locally generated tax revenue through fiscal 2026 under each scenario, assuming no changes in current tax policy. The amounts range from a low of $20.911 billion over the five-year period in the Stunted Recovery scenario to a high of $22.484 billion in the Overall Growth scenario. The difference of $1.572 billion represents a substantial amount in terms of city government's ability to maintain its operations.

The city's five-year plan is reflected in the Uneven Gains scenario. In the Overall Growth scenario, revenues would exceed the five-year plan by $355 million; in the Competitive Loss and Stunted Recovery scenarios, they would fall short of the five-year plan by $777 million and $1.218 billion, respectively. These numbers do not take into account any potential drop in commercial property taxes due to businesses needing less space—nor any moves on businesses' part to exempt nonresident workers from the wage tax.

Figure 1

Fiscal Outcomes of Alternate Scenarios

Projected general fund revenues, fiscal years 2022-26 in millions of dollars



	2022	2023	2024	2025	2026
Stunted recovery	$3,886	$4,050	$4,197	$4,438	$4,449
Competitive loss	$3,933	$4,118	$4,284	$4,438	$4,579
Uneven gains	$4,004	$4,219	$4,435	$4,640	$4,831
Overall growth	$4,025	$4,264	$4,502	$4,737	$4,957

Source: Calculations by Econsult Solutions Inc.

The details of those projections are shown in Table 3.

Table 3

Projected Revenues by Tax Type and Scenario, Fiscal Years 2022-26

In millions of dollars

Scenario	Fiscal 2022	Fiscal 2023	Fiscal 2024	Fiscal 2025	Fiscal 2026	Total
Overall Growth - Total	**$4,025**	**$4,264**	**$4,502**	**$4,737**	**$4,957**	**$22,484**
Wage taxes	$2,043	$2,170	$2,297	$2,417	$2,537	$11,464
Real estate taxes	$1,029	$1,071	$1,123	$1,180	$1,227	$5,631
BIRT tax	$545	$571	$609	$645	$676	$3,046
Consumption taxes	$407	$452	$472	$494	$517	$2,343
Uneven Gains (Five-year plan) – Total	**$4,004**	**$4,219**	**$4,435**	**$4,640**	**$4,831**	**$22,129**
Wage taxes	$2,036	$2,152	$2,270	$2,377	$2,484	$11,319
Real estate taxes	$1,025	$1,059	$1,106	$1,155	$1,194	$5,540
BIRT tax	$545	$566	$600	$631	$657	$3,000
Consumption taxes	$398	$442	$459	$477	$495	$2,270
Competitive Loss - Total	**$3,933**	**$4,118**	**$4,284**	**$4,438**	**$4,579**	**$21,352**
Wage taxes	$2,000	$2,099	$2,191	$2,269	$2,347	$10,907
Real estate taxes	$1,008	$1,037	$1,073	$1,112	$1,140	$5,371
BIRT tax	$528	$542	$566	$587	$604	$2,828
Consumption taxes	$396	$439	$454	$470	$487	$2,247
Stunted Recovery – Total	**$3,886**	**$4,050**	**$4,197**	**$4,329**	**$4,449**	**$20,911**
Wage taxes	$1,984	$2,072	$2,155	$2,224	$2,293	$10,727
Real estate taxes	$997	$1,019	$1,051	$1,083	$1,107	$5,256
BIRT tax	$524	$535	$555	$571	$585	$2,769
Consumption taxes	$381	$424	$437	$451	$465	$2,159
Gap between Overall Growth						
and Stunted Recovery	**$139**	**$214**	**$304**	**$407**	**$508**	**$1,572**

Note: Because of rounding, in some cases numbers do not add up.

Source: Calculations by Econsult Solutions Inc.

Of that $1.572 billion revenue difference between the most and least optimistic scenarios, $737 million (47%) is the result of variation in wage taxes, with variations of $375 million (24%) in real estate taxes, $277 million (18%) in business taxes, and $184 million (12%) in consumption taxes.

Although the ARPA funds will help the city balance its budget, at least in the short run, the annual gap between the top and bottom scenarios grows as time goes on—reaching $407 million in fiscal 2025 and $508 million in fiscal 2026—which highlights the potential impact of any fiscal decisions that might be made in the earlier years of the period.

The impact on the tax mix

Across the four scenarios, there are only minor variations in the share of revenue raised in each of the four main tax categories—wages, real estate, business, and consumption. What changes more is the share paid by residents as opposed to nonresidents, particularly when it comes to the wage tax. The Philadelphia wage tax has two elements: One applies to residents, who pay a current rate of 3.8398% regardless of where they work. The other is the 3.4481% imposed on nonresidents who work in the city.

In 2019, nonresidents paid an estimated $793 million in wage tax, 37.6% of the total raised by the tax; residents paid the other 62.4%. In 2021, the first full pandemic year, the residential share rose to 68.5%, as many workplaces in the city had to temporarily close their doors, forcing employees who had commuted from the suburbs to work from home—making them exempt from the wage tax. The residential share is projected to wind up at roughly 66% in 2026 under all scenarios, significantly higher than before the pandemic.

Econsult's analysis of the five-year plan indicates that the city will lose an estimated $572 million in nonresidential wage taxes over the course of five years compared with what might have been expected had there been no pandemic.

This has significant equity implications in terms of taxation. That's because the Philadelphia-based jobs held by nonresidents, some of whom won't be paying the wage tax anymore, tend to be higher-paying than those held by residents[2]—so the wage tax burden will shift generally to city residents with lower incomes. According to an annual report put out by the District of Columbia comparing state and local taxes around the country, Philadelphians with annual household incomes of $25,000 already pay more in such taxes than their counterparts in the largest cities in each state.[3]

A similar but smaller change, with the same type of equity implications, is projected with consumption taxes.

Prior to the pandemic, consumption taxes paid primarily by residents (mainly taxes on sales and beverages) accounted for about 71% of such revenue. In fiscal 2021, that figure rose to more than 84% because of a drop in the parking and amusement taxes; suburban commuters and tourists pay a major portion of those. In 2025 and 2026, the share of consumption taxes paid by residents is projected to settle in the 75% to 77% range, lower than in 2021 but higher than before the pandemic.

Risk factors

To be sure, much of what happens to city revenues over the next several years will hinge on broad national and social factors, including the performance of the U.S. economy and the perceived desirability of living in densely populated cities in a country emerging from a pandemic. And two local factors, related to one another, could drive the city's actual revenue figures lower across the board than projected in this brief.

One has to do with nonresident remote workers and how the Philadelphia wage tax applies to them. Under city rules, work from home done by a nonresident employed in a city-based job is exempt from the tax only if the employer requires that it be done remotely—as was the case when workplaces were closed in 2020 and 2021, during the pandemic's height. When work is done from home at the employee's choice, on the other hand, the tax applies.

If the desire for remote work remains strong, some businesses may decide to operate remotely on a long-term basis, perhaps creating new legal locations outside the city. Or they could develop secondary suburban sites, where remote nonresident employees could be deemed to be based. Or they could simply require employees to work from home all or part of the time. Businesses have an economic incentive to reduce the wage tax liability of nonresident employees, effectively giving them a pay increase.

The nature and extent of these potential changes—and their impact on the city's bottom line—cannot be reliably estimated; a variety of considerations will influence what happens. Some businesses will likely move to operate as they did pre-pandemic, and some may feel an obligation to keep supporting the city with wage tax revenues. Whatever happens, there are likely to be legal challenges about the rules and how they apply. The stakes are high; in the 2022-26 five-year plan, the city has projected nonresident wage tax revenues of $849 million, a number that could turn out to be overly optimistic if numerous jobs held by nonresidents become no longer taxable.

The second risk involves the assessments, and thus the property tax liabilities, of office buildings.

In all four scenarios, the amount of money generated by commercial property taxes—which currently is budgeted at roughly $155 million per year in revenue for the city—is projected to grow, very slightly in the worst case and by a healthy margin in the best case. But any growth is far from guaranteed.

If the desire for remote work endures, the demand for office space will decline. One recent study that looked at office space in eight large cities (not including Philadelphia) estimated that to accommodate their number of employees in the years to come, businesses will need 12% to 25% less space than in 2019.[4] Less demand for space means a drop in occupancy levels and/or rents, ultimately resulting in lower assessments of the buildings and/or successful appeals of current assessments; commercial assessments are based on the rents that tenants pay. All those factors mean lower property tax revenues for the city—as well as for the Philadelphia school district, which gets 55% of local property tax revenue and all of the money raised by the use and occupancy tax, a tax on the commercial use of real estate. Based on recent history, city government may feel responsible for making up the school district's losses.

Other factors that could have an impact on revenues include the level and perception of public safety and the quality of city services, both of which could either help retain and attract residents and businesses—or make them want to leave or stay away.

Conclusion

This brief illustrates the degree to which the fiscal future of Philadelphia's city government is tied to the health of the city's economy. And maintaining fiscal well-being will prove challenging in the coming years, particularly once the federal ARPA money is spent.

The possible reduction of local revenues could create difficult decisions for policymakers, all with unpleasant fallout. One path would be to cut expenditures, presumably reducing the quality and quantity of services, which could make it harder for the city to attract and retain residents and jobs. Another would be to raise taxes on residents, who will already be bearing an increased share of the city's overall tax burden. A third would be to raise taxes that disproportionately affect nonresidents, which would further discourage them from coming into the city for work or for pleasure.

For city leaders, the task ahead is to help retain and grow jobs in as inclusive a way as possible—which will generate the needed city revenues—and to review both tax revenues and the tax mix, all with the goal of setting Philadelphia on course for a solid post-pandemic recovery.

About this brief

This brief was written by Larry Eichel, senior adviser to The Pew Charitable Trusts' Philadelphia research and policy initiative, based on research performed for Pew by a team at Econsult Solutions Inc., led by Ethan Conner-Ross. Seth Budick, a senior officer with the initiative, also contributed to the research. Pew senior officer Sandra Shea edited the brief, along with Bernard Ohanian, senior director, editorial. .

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Endnotes

1 On March 31, 2022, as part of the budget process, the city issued a proposed new financial and strategic five-year plan for fiscal 2023 through 2027. The analysis in this brief is based on the five-year plan that is currently in place, the one for fiscal 2022 through 2026. The economic projections underlying the new plan—which come from IHS Markit, an international firm that provides economic research and analysis for business and government—are similar to the ones on which the 2022-26 plan was based. They differ in some ways, influenced by economic trends that have emerged in the past year.

2 L. Eichel and S. Budick, "Philadelphia Job Growth Not Closing Wage Gap Between Residents and Suburban Commuters," The Pew Charitable Trusts, Aug. 13, 2019, https://www.pewtrusts.org/en/research-and-analysis/articles/2019/08/13/philadelphia-job-growth-not-closing-wage-gap-between-residents-and-suburban-commuters.

3 Government of the District of Columbia, Office of the Chief Financial Officer, "Tax Rates and Tax Burdens in the District of Columbia—a Nationwide Comparison" (2021), https://cfo.dc.gov/sites/default/files/dc/sites/ocfo/publication/attachments/2019%2051City%20Study_Final.pdf.

4 H. Chernick, D. Copeland, and D. Merriman, "The Impact of Work From Home on Commercial Property Values and the Property Tax in U.S. Cities" (Institute on Taxation and Economic Policy, 2021), https://itep.org/the-impact-of-work-from-home-on-commercial-property-values-and-the-property-tax-in-u-s-cities/.

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