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# Memorandum

**To:** The Honorable Jorge O. Elorza, Mayor, City of Providence
Brett P. Smiley, Chief Operating Officer, City of Providence
Lawrence J. Mancini, Finance Director, City of Providence

**From:** Dean Kaplan, Seth Williams, and Bill Fazioli, Public Financial Management (PFM)

**Re:** Providence Multi-Year Financial Projections –Financial Forecast Model

## Overview

The goal of this project is to quantify any current and future financial shortfalls confronting the City of Providence to help achieve greater consensus as to the City's true baseline fiscal situation. With greater consensus regarding the City's baseline fiscal challenges – now and in the future – City leadership, stakeholders, and the residents of Providence can begin to assess and evaluate how to address its structural deficit. This will create an opportunity to develop and implement solutions that help the City achieve its collective vision for a vibrant future while maintaining balanced, sustainable annual budgets.

Using data provided by the City of Providence, Public Financial Management (PFM) built a multi-year financial projection model of the City's finances. This model uses a baseline version of the City's Fiscal Year 2015 (FY2015) projected results, a baseline version of the City's FY2016 budget, and a series of assumptions to generate a baseline forecast of the City's financial results through FY2021.[1] The model has the capacity to demonstrate the impact of a variety of different assumptions every fiscal year through FY2021, providing the City with a tool to test different financial conditions and strategies – allowing for real-time evaluation – of a wide variety of steps to fill the forecast gap in the baseline.

This memorandum is intended to provide:

1) A brief introduction and overview to the methods and assumptions used to build the baseline forecast;
2) A baseline analysis of the City's projected financial forecasts through FY2021; and
3) An overview of the major revenue and expenditure categories that drive out-year results.

## Methods and Assumptions:

The City provided PFM with several years of detailed budget history, projected results for FY2015, and proposed FY2016 data. PFM used these budget data to create a customized budget forecasting model that projects future results by multiplying the value from the base year by a growth rate for each individual line of the budget. The growth rates reflect a variety of methods used to project City financial results for future years. Among others, these methods include maintaining the same compound annual growth rates from past years; including known specific numbers where PILOTs, debt service, and other projections are available; using inflationary growth rates based on national and other economic data; applying future figures from policy-based estimates from City staff; and including fixed amounts based on recent trends in state grants and subsidies.

[1] It is important to note that the baseline FY2015 projected results discussed in this memorandum may – and likely will – change as a result of various City actions and other occurrences through June 30, 2015. Similarly, the proposed baseline FY2016 budget may potentially vary from the ultimate budget adopted by the City Council and Mayor. Additionally, some figures may vary from City budget data due to rounding and projection methodology.

**The baseline forecast is a projection of what the City's financial results would be if no policy changes are made – it reflects inflation, known or assumed growth in revenues and expenditures, and other known events. The baseline provides an estimate for the City to use in evaluating the need for, and elements of, policy changes that would adjust future financial results.**

In particular, the baseline is not a budget itself, but rather a projection of future financial results based on recent actuals and current-year projected figures. It is assumed that the City will actually prepare and submit budgets which would be quite different from the baseline projection.

The baseline forecast makes a series of key assumptions that have a major impact on the projections. Changing these assumptions will alter – sometimes significantly – the forecast outcome. Key assumptions in the current baseline include:

- Modest revenue growth consistent with expected changes in the tax base over time;
- No wage increases except an already-awarded 3.0% IAFF increase in FY2016;
- No change in the number of employees; and
- Expenditure growth based on the factors described earlier in this memorandum.

## Baseline Projection

Like other local governments, Providence faces a series of challenges that result from both structural and cyclical issues. The combination of growing costs for pension and health care benefits combined with stagnant or slow growth in revenue is not unique to Providence. Moreover, many of these problems have developed over a series of years – in some cases, decades. In the face of these challenges, the traditional approach to budgeting that looks at problems and solutions one year at a time is inadequate to meet the goal of fiscal sustainability.[2]

It is also important to recognize that the development of a multi-year financial projection is not a static process. Projections are not one-time forecasts or calculations. Instead, the intent of a multi-year financial projection process is for the City to regularly update and adjust the forecasts as assumptions, goals, and strategies change. Thus, multi-year financial forecasts require regular review and updates. As a result, this forecast – like all such projections – is a work in progress.

### *Baseline Fiscal Challenges Facing Providence*

In developing a five year projection that looks honestly at the challenges and opportunities before it, Providence takes an important step toward creating solutions needed to address the larger issues that affect quality of life in the City.

We expect that from now until the adoption of the FY2016 budget there will be substantial debate and discussion as to the choices that will be made this year and into the future. While the baseline is the starting point for discussion, the City's budget that is ultimately adopted may – and likely will – differ from this document.

[2] The Government Finance Officers Association (GFOA) has recognized that multi-year financial plans are a best practice. A multi-year plan provides "a comprehensive and systematic management tool designed to help organizations assess the current environment, anticipate and respond appropriately to changes in the environment, envision the future, increase effectiveness, develop commitment to the organization's mission and achieve consensus on strategies and objectives for achieving that mission." The GFOA also suggests that "all governmental entities use some form of strategic planning to provide a long-term perspective for service delivery and budgeting, thus establishing logical links between authorized spending and broad organizational goals." *Recommended Budget Practice on the Establishment of Strategic Plans (2005). Government Finance Officers Association*.

No local government can consistently provide quality public service and maintain balanced budgets in the face of economic stagnation or decline. While local government has an obligation to act as an effective steward of taxpayer dollars, it is usually not possible to rely solely upon efficiency, increased revenue rates, or enhanced collection as a means of balancing budgets for long periods of time. Eventually, the combination of declining service and increasing tax rates will drive businesses and residents to leave.

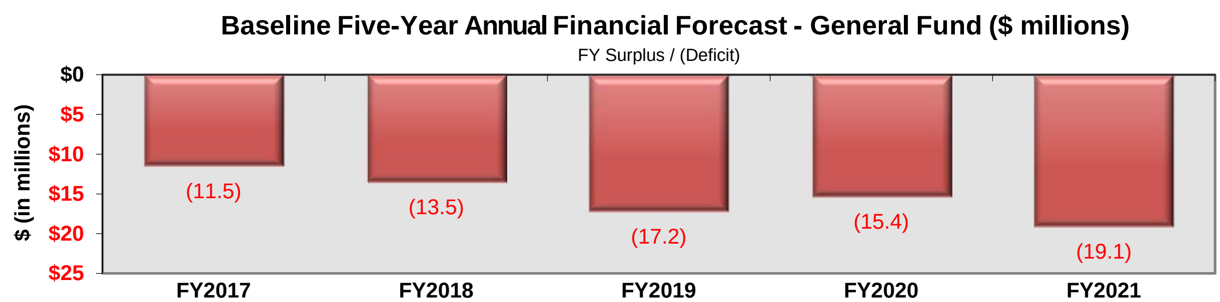
Thus, local governments cannot choose efficiency over revenue collection or revenue collection over growth – they must simultaneously maximize the efficient operation of government, collect enough revenue to maintain quality of life, and make strategic investments to grow the tax base.

Today's fiscal challenge to the City of Providence primarily result from modest revenue growth from taxes and the rising momentum of fixed expenditures related to employee health care, and significant escalating costs related to retiree pension and medical expenses. Together, these factors drive projected deficits during the coming five years.

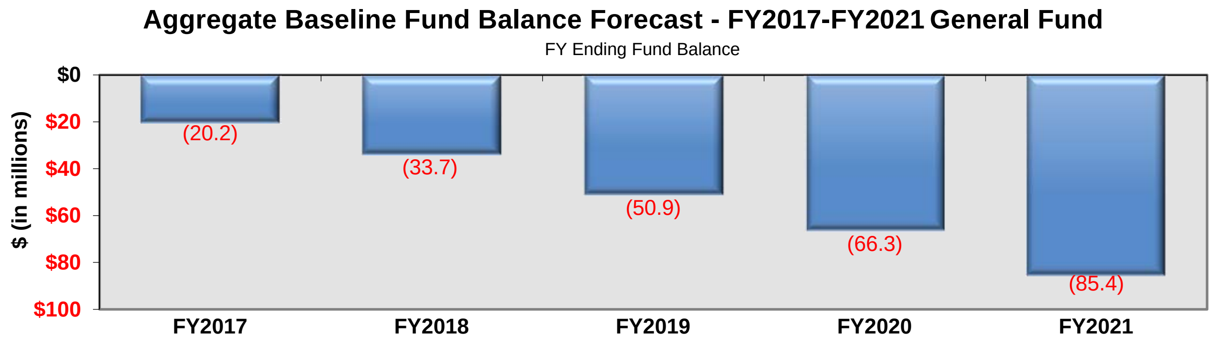
During the next five years, Providence must take action in order to achieve short-term fiscal balance and sustainable long-term growth. Often, local governments seek to avoid difficult choices by deferring costs or relying on non-recurring revenues. This "kick the can down the road" approach defines an unsustainable approach to local government finance and heightens the risk of losing ground. In fact, the longer it takes for the City to acknowledge and confront its fiscal challenges, the harder and more painful it will become to implement viable solutions.

The baseline financial forecast for the City of Providence indicates that without any corrective action, the City will face important financial challenges. These challenges are exacerbated in future years by the impact of market forces and long-term liabilities. As illustrated in the chart below, based on PFM's forecast, the City can expect to see a baseline budget gap of **$11.5 million** in FY2017, which will grow to a baseline deficit of **$19.1 million** by the last year of the five-year forecast (FY2021). The forecasted FY2017 operating deficit would continue to grow the City's inherited fund balance deficit.

Fundamentally, Providence has a structural deficit in the range of $14-19 million. This is the recurring shortfall that the City would see in its annual finances each year without corrective action. The baseline financial forecast shows an annual shortfall of $13.5 million in FY2018 that increases in FY2019, when it reaches $17.2 million, before slightly declining to $15.4 million in FY2020, and ultimately reaching $19.1 million in FY2021. While the City's revenue receipts grow somewhat as revaluations increase revenue in FY2017 and FY2020, the City's expenditures (again, absent any wage increases or the hiring of additional staff) continue to outpace its revenues and result in the annual deficits displayed below.



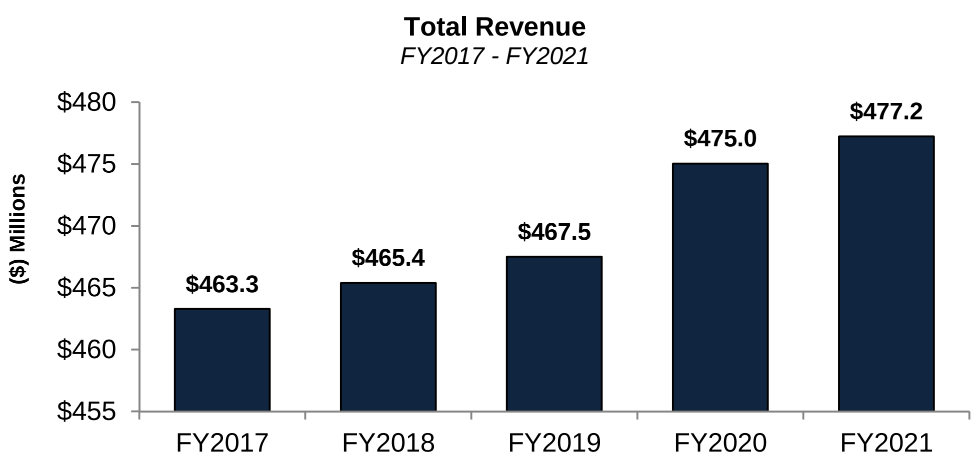

The City also has an existing shortfall from prior years. As of June 30, 2014, the City's negative General Fund balance was $8.7 million. This negative balance is carried forward and added to the annual budget deficits, creating significant growth in the City's projected General Fund deficit through FY2021, when it reaches, in aggregate, $85.4 million.




## Key Revenue and Expenditure Items

*Key Revenues*

The foundation for PFM's multiyear baseline forecast are the projected FY2015 results and baseline proposed budget data for FY2016. Assumptions on revenue growth or decline are applied to each revenue category in the baseline proposed FY2016 budget to generate the multiyear revenue forecast. As illustrated in the chart below, total General Fund revenues are projected to increase through FY2021.[3] The specific assumptions driving this forecast are outlined below:




Combined, the following five revenue streams detailed below represent 82.9 percent of the City's total projected revenue in FY2017 – and 83.2 percent of projected FY2021 revenue.

1) Real Estate Taxes – Current: Using information from the City Assessor, the baseline forecast projects that real estate tax revenues will increase by approximately 2.3 percent in FY2017 (largely due to revaluation) before realizing a 0.3 percent increase in FY2018 and FY2019, respectively. In FY2020 growth will be approximately 2.3 percent (again, due to effects of revaluation), before increasing by approximately 0.3 percent in FY2021. This revenue stream alone represents 54.2 percent of the City's total General Fund revenue in FY2015 – and, at baseline, comprises 54.9 percent of total projected revenue in FY2021.

[3] Projections are based upon information received from the City Assessor, City Finance Department, growth rate projections based upon historical trends, national and economic data, and policy-based information from the City.

The property tax rates (residential–owner occupied, residential-non-owner occupied, and commercial) are assumed to remain static for the purposes of assessing the City's baseline budget projection. The forecast also includes projections for exemptions, final year abatements, and new development growth that are based on the most recent available information and estimates from the City. When property values increase, a flat tax rate would mean that the City is collecting more taxes than it did in the prior year. Additionally, the projections utilize the City's presumed 93.0 percent current year collection rate for property taxes.

**Forecasted Real Estate Tax Collections**

| FY2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 |
|---|---|---|---|---|---|---|
| $243.8M | $248.7M | $254.3M | $254.9M | $255.46M | $261.3M | $262.0M |

2) Tangible Taxes – Current: The baseline projection uses projections from the City Assessor and forecasts annual growth of 1.75 percent in FY2016 and 1.0 percent from FY2017 through FY2021. Tangible Tax revenue represents approximately 10.1 to 10.2 percent of the City's total General Fund revenue in each year from FY2017-FY2021.

   As with real estate taxes, the tangible tax rate is assumed to remain flat in future years to provide a true baseline projection. Similarly, the City's 93.0 percent collection rate is again applied to this revenue stream.

**Forecasted Tangible Tax Collections**

| FY2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 |
|---|---|---|---|---|---|---|
| $45.3M | $46.1M | $46.6M | $47.0M | $47.5M | $48.0M | $48.4M |

3) Excise Taxes – Current: The baseline projection uses projections from the City's Assessor and forecasts annual excise tax revenue growth of approximately 2.9 percent in FY2016. In FY2017, revenue growth is assumed to be nearly 3.0 percent before growing annually at approximately 2.4 percent from FY2018 to FY2021. Excise tax revenue represents 7.0 percent of the City's total General Fund revenue in FY2015, 7.1 percent in FY2016, and modestly increases to reach a proportional share of 7.7 percent in FY2021.

   As with the other property tax rates, the excise tax rate is assumed to be static so as to provide a baseline forecast. The forecast includes projections for exemptions and again utilizes the City's presumed collection percentage (93.0 percent).

**Forecasted Excise Tax Collections**

| FY2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 |
|---|---|---|---|---|---|---|
| $31.6M | $32.5M | $33.5M | $34.3M | $35.1M | $36.0M | $36.9M |

4) State PILOTS. State PILOT revenue is assumed to return to the FY2014 level of $27.1 million in FY2016 before receding to $24.6 million through FY2021.[4] As a result of projecting flat State PILOT revenue in FY2017 through FY2021, its proportional share of total General Fund revenue declines slightly from FY2016 (5.7 percent) to FY2021 (5.2 percent).

**Forecasted State PILOT Revenues**

| FY2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 |
|---|---|---|---|---|---|---|
| $26.2M | $27.1M | $24.6M | $24.6M | $24.6M | $24.6M | $24.6M |

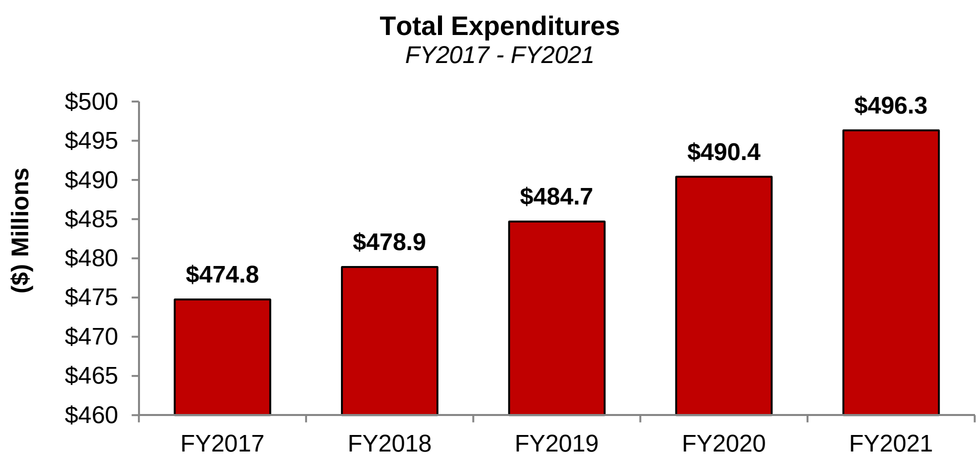
5) School Debt Construction. Based upon information from the City, projections for School Debt Construction revenue are flat for the FY2016-FY2021 period – slightly decreasing in proportional share of total General Fund revenue from 5.4 percent in FY2016 to 5.3 percent in FY2021.

**Forecasted School Debt Construction Revenues**

| FY2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 |
|---|---|---|---|---|---|---|
| $23.4M | $25.1M | $25.1M | $25.1M | $25.1M | $25.1M | $25.1M |

*Expenditures*

Like the baseline revenue forecast, the foundation for the baseline expenditure forecast are the projected FY2015 results and proposed budget data for FY2016. Assumptions on expenditure growth or decline are applied to each expenditure category in the FY2016 baseline budget to generate the multi-year forecast. As illustrated in the following graph, total General Fund expenditures are projected to increase by nearly $6.1 million in FY2017 and increase between $4.1 million and $5.9 million in each year thereafter. Future growth is, in large part, the result of projected growth in active and retired employee benefit costs. At baseline, by FY2021, City expenditures are projected to reach $496.3 million in ($368.3 million when excluding the school transfer, which includes growth for the recent teacher wage increases during the projected five-year period).




[4] The Governor of Rhode Island's proposed FY2016 budget projects Providence to receive $24.6 million in State PILOT revenue. However, based upon the most recent information available to the City, that sum is likely to return to the FY2014 level in FY2016. As such, if the adopted State budget contains PILOT revenue to Providence that differs from the City's projection, the FY2016 impact to the City's budget will vary from the assumption contained herein.

The specific assumptions driving this forecast are outlined below.

Combined, the following four expenditure areas detailed below represent 66.5 percent of the City's total projected General Fund expenditures in FY2017 (less transfer to schools) and grows in each subsequent year through FY2021 when the four expenditure areas comprise 68.0 percent of the City's total projected General Fund expenditures.

1) Salaries. Salaries comprise the largest expenditure category in the City's General Fund budget (not including transfer to schools) in FY2015 – at $116.4 million – representing 35.3 percent of total General Fund expenditures (less transfer to schools). By FY2021 – again, with salaries held flat – salaries are projected to comprise 32.6 percent of total General Fund expenditures (less transfer to schools).

   Underlying all personnel cost forecasts is the assumption that the size of the City's workforce will remain the same over the five-year period. Most of the City's collective bargaining agreements with its employees expire at the end of FY2015 (June 30, 2015). As a result, the forecast baseline assumes no wage increases for City employees other than one known contractual increases in compensation for certain Fire Department employees in FY2016.

   The salaries category includes all full-time salaries, part-time salaries and other elements of paid compensation, such as overtime, shift differential, holiday pay, and uniform pay. All of these elements of paid compensation are assumed to remain flat over the five-year baseline period; however the figure grows slightly due to increased compensation triggered by other non-salary compensation (e.g. longevity, uniform pay, etc.)

**Forecasted Salary Expenditures**

| FY2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 |
|---|---|---|---|---|---|---|
| $116.4M | $119.9M | $120.0M | $120.0M | $120.1M | $120.1M | $120.2M |

2) Health Benefits (Active and Retired).[5] Health benefits costs are among the largest growth factors for the City during the forecasted period. In FY2016, active and retiree health benefits are projected to be $47.1 million before reaching $58.9 million in FY2021 – an $11.8 million, or 25.1 percent, increase.

   The health benefits projection assumes that no changes in the plan design offered to City employees and retirees during the forecasted period.

   Based on historical trends in health care cost growth nationally, national projection data, information from the City's health care consultant, and policy information from the City's Finance Department, the baseline forecast assumes that the FY2016 cost of active health benefits ($23.2 million) will grow by 4.7 percent in FY2017, 5.1 percent in FY2018, 5.5 percent in FY2019, and 5.6 percent in FY2020 and FY2021 (29.5 percent growth from FY2016 to FY2021).

   Based on information from the City's actuary, the FY2016 retiree medical costs ($22.2 million) are projected to grow by 4.1 percent in FY2017, and 4.0 percent in each of FY2018, FY2019, FY2020, and FY2021 (21.7 percent growth from FY2016 to FY2021).

**Forecasted Health Benefits Expenditures**

| FY2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 |
|---|---|---|---|---|---|---|
| $47.4M | $47.1M | $49.1M | $51.3M | $53.7M | $56.3M | $58.9M |

[5] Includes Local 1033 benefits expenses and dental expenses.

3) Pension.[6] One of the main drivers of the sizeable increase in personnel spending – again, absent any wage increase – is the cost of the City's retirement benefits. The FY2016 pension expenditure is estimated to be $59.4 million, 17.3 percent of the City's General Fund budget when the schools transfer is excluded. Based on the most recent actuarial valuation report prepared by the City's external actuaries, the annual required contribution (ARC) is forecasted to continue to grow in each year of the forecast period – and combined with Local 1033 pension costs – total pension spending will reach $71.1 million in FY2021 – a $10.7 million increase, or 17.6 percent growth.

   PFM's baseline forecast assumes that the pension expenditure in FY2017 and each year thereafter will be equal to the actuarially determined ARC.[7] The rationale for this assumption is the understanding that the ARC represents the true cost of the future benefit promised for current service. Assuming no direct action is taken to reduce the total pension liability or to defer costs to the future, the ARC represents the annual baseline cost for this benefit.

**Forecasted Pension Expenditures**

| FY2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 |
|---|---|---|---|---|---|---|
| $56.0M | $59.4M | $62.6M | $64.4M | $66.5M | $68.8M | $71.2M |

4) Debt Service. Based on information from the City's Financial Advisors and City's Finance Department, the City's FY2016 debt service ($63.6 million) will grow marginally to $63.9 million in FY2017 before slightly decreasing in FY2018 ($62.4 million) and ultimately leveling at approximately $63.0 million in FY2019, FY2020, and FY2021, respectively.

**Forecasted Debt Service Expenditures**

| FY2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 |
|---|---|---|---|---|---|---|
| $60.3M | $63.6M | $63.9M | $62.4M | $63.0M | $63.0M | $63.0M |

## Key Baseline Budget Results – FY2016 – FY2021[8]

- **Overall revenue growth** — **2.1% ($9.8M)**
  - *Property Taxes (current)* — *6.1% ($20.0M)*
  - *State Aid* — *-9.4% (-$5.9M)*
  - *Non-State PILOTs* — *-19.7 % (-$2.8M)*
  - *Licenses, Permits, Fines, Forfeits, Fees, and Other Charges* — *-2.5% (-$1.6M)*
- **Overall expenditure growth (less school transfer)** — **7.5% ($25.7M)**[9]
  - *Salaries* — *0.2% ($0.3M)*
  - *Health Benefits* — *25.1% ($11.8M)*
  - *Pension* — *19.9% ($11.8M)*
  - *Debt* — *-1.0% (-$0.6M)*
  - *All Other* — *4.5% ($2.4M)*

**Forecasted Annual Budget Deficit and Cumulative Fund Balance Deficit**

| | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 |
|---|---|---|---|---|---|---|
| Annual Budget Deficit | $0.0[10] | $11.5M | $13.5M | $17.2M | $15.4M | $19.1M |
| Fund Balance Deficit | $8.7M | $20.2M | $33.7M | $50.9M | $66.3M | $85.4M |

[6] Figures represents General Fund-only portion of ARC. Total also includes Local 1033 pension benefits.

[7] The FY2017-FY2021 figures include the projected interest due to the pension fund as a result of the timing of the City's ARC payments.

[8] Totals may not sum due to rounding.

[9] When including transfer to schools, total growth is projected to be 6.2% ($28.8M)

[10] The FY2016 proposed budget does not include interest due to the pension fund related to the timing of the City's ARC payments. The City's actuary estimates the City will be required to pay $1.1M-$1.2M in interest in FY2016. Projected interest costs due to timing of the City's ARC payment are included in out-year projections