City of Lancaster

Baseline projection and deficit closing scenarios

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Introduction

In 2020, the City of Lancaster hired Public Financial Management (PFM) under the Strategic Management Planning Program (STMP) to develop a five-year financial plan for the City. As part of that engagement, PFM developed a baseline projection to show what the City's finances would look like in 2021 through 2025 absent corrective action (tax or fee rate increases, cuts to positions and/or services). The projection at that time showed annual deficits growing from $3.0 million in 2020 to $8.6 million by 2025.

In 2022, we updated the baseline projection through 2028 to include use of APRA funding through. The projection at that time showed a $4.0 million deficit in 2023, growing to $16.1 million by 2028 if the City did not take any corrective action.

Today we are sharing another updated baseline projection, this time using the 2024 adopted budget as a starting point and running through 2029. We will also talk through a couple deficit-closing scenarios to show why using Home Rule to give the City more flexibility with the earned income tax is important and what changes in tax rates practically mean at the household level.

What is a baseline financial 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.

- **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 because it could not sustain the projected deficits in the baseline without exhausting its reserves. However, it is critical to have a baseline projection to understand the magnitude of the City's budget challenges and the value of the flexibility that Home Rule charter can potentially provide.

Baseline projection 2025 – 2029

Revenue – Major Drivers

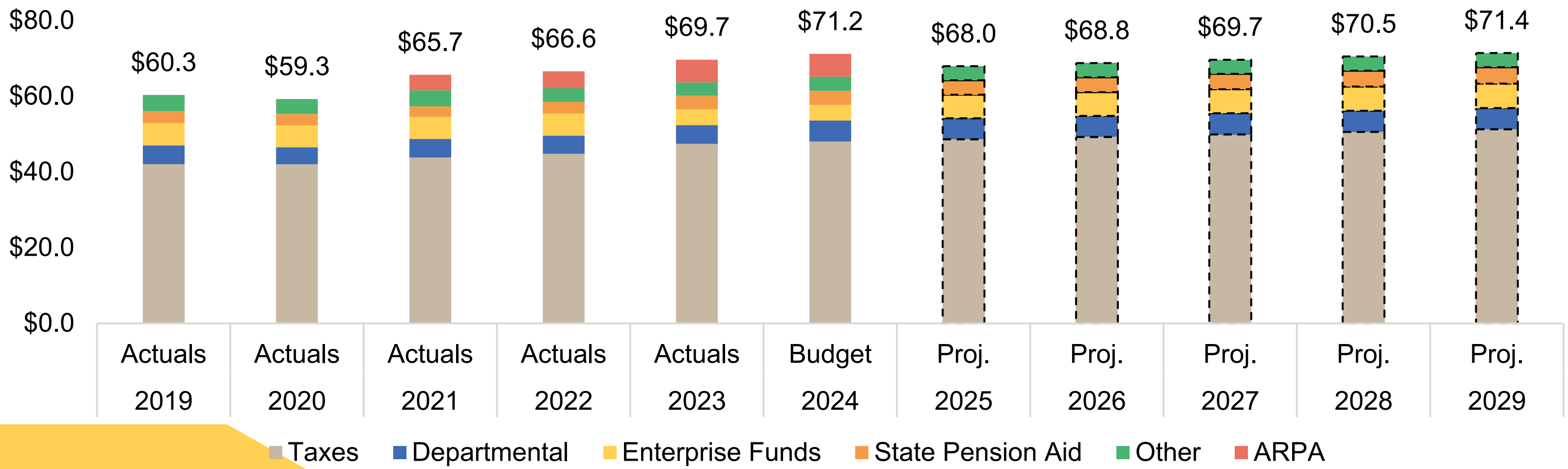
The City's largest revenue is its **real estate tax**, which accounts for $33.5 million or 47.1% of the City's total $71.2 million* budget. When the City increased its millage rate in 2023 from 11.7 to 12.64 (an 8.0% increase), revenue from current year taxes increase by $2.8 million.

The second largest revenue source is the **earned income tax** (EIT), levied at 1.1% and split with the School District of Lancaster (SDL) – 0.6% is remitted to the City while 0.5% is remitted to the District. Revenue from the EIT grew by 7.0% on an average annual basis from 2019 to 2023, and the baseline projection assumes growth will continue at 5.0% through 2029.

The General Fund receives transfers from the City's **enterprise funds**, most from the water fund. That transfer dropped from $4 million to $2 million in 2023 and is projected to return to $4 million in 2025. In 2021, 2022, and 2023, the City used the revenue replacement provision under the **American Rescue Plan Act (ARPA)** to help close operating deficits in the General Fund. This revenue is no longer available in 2025.

Revenues are projected shrink from $71.2 million in the 2024 budget to $68.0 million in 2025 with the loss of ARPA funding. Thereafter, revenues grow at an average annual rate of 1.3%.

General Fund Revenue, 2019 – 2029 ($ millions)



** Excludes use of prior year fund balance in total revenue.*

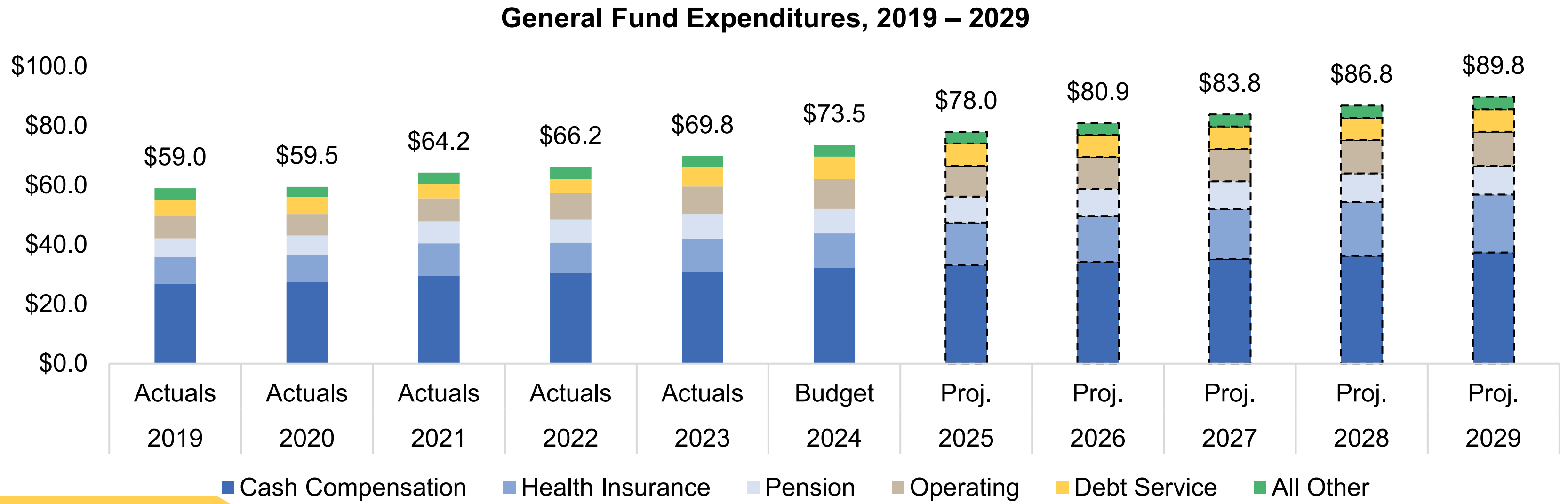
Expenditures – Major Drivers

The City's largest expenditure category is personnel, and the largest personnel cost is **cash compensation** (e.g.. salaries, overtime, premium pay). Many City employees are covered under collective bargaining agreements that set base wage increases and other provisions that drive cash compensation growth, which is projected to grow by 3% annually from 2025 to 2029.

The City is self-insured for **health insurance**, making contributions into a separate fund from which claims are paid. For several years, the General Fund's contributions have fallen short of claims spending – the baseline projection brings the contribution amount up to the level of claims spending and assumes 8.2% annual growth.

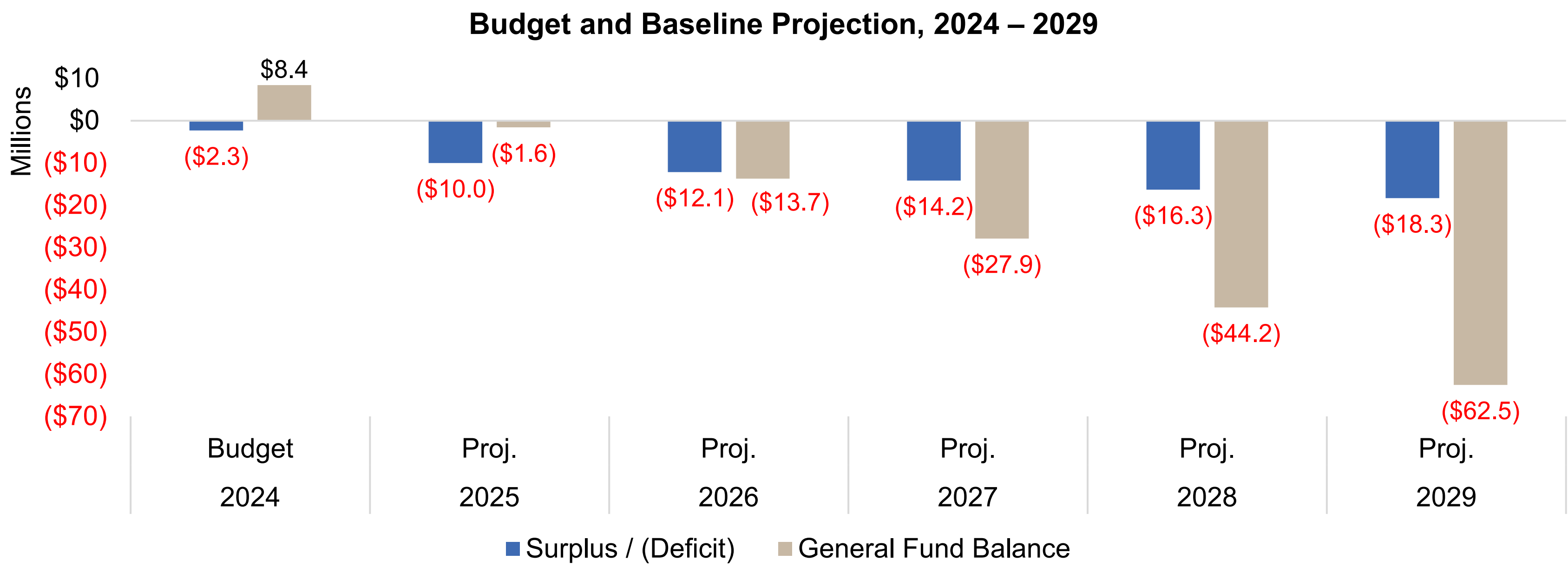
Required annual contributions into the City's three **pension** plans are called the minimum municipal obligation (MMO). The baseline includes an actuarial projection for these expected contributions. The 2024 budget includes $7.5 million for **debt service**, or 10.2% of the General Fund budget. The baseline projection includes the current debt schedule without any future borrowings or refundings.

Projected expenditures grow from $73.5 million in the 2024 budget to $78.0 million in 2025, and then by 4.1% annually thereafter.



Baseline projection 2025 – 2029

The 2024 budget relies on using $2.3 million in prior year fund balance and $6 million in ARPA support to fund government services. Unless Lancaster City government takes corrective action, it faces a $10.0 million deficit in 2025. This would exhaust the City's general fund balance (a measure of reserves) within a couple years.



Baseline projection summary

What's changed from what we've seen before?

The City's 2023 results were better than projected in 2022, largely because the City increased its real estate tax rate and had stronger EIT revenue growth than projected (7% versus 4%). The impact of higher real estate taxes and stronger EIT growth carries through subsequent years.

Operating result in baseline projections (2022, 2024)

	2021	2022	2023	2024	2025	2026	2027	2028
2022 Projection Operating Result	$1.4	$0.0	($6.2)	($8.6)	($14.3)	($15.7)	($17.6)	($19.2)
2024 Projection Operating Result	$1.4	$0.5	($0.1)	($2.3)	($10.0)	($12.1)	($14.2)	($16.3)

Actual Budget Projected

Why does the deficit increase from $2.3 million in 2024 to $10.0 million in 2025?

The largest reason is the expiration of ARPA. The City will not be able to use $6 million in ARPA funding to balance the 2025 budget, as it did this year. We remove that $6 million subsidy and return the water fund transfer to $4 million.

On the expenditures side, each year the City estimates potential medical claims for the upcoming year and makes a contribution to the health insurance fund in that amount. In recent years, actual claims have exceeded estimates so we have, for the baseline calculations, applied an adjustment of $2.7 million starting in 2025 to account for any potential fund shortfalls.

Deficit closing scenarios

Scenario analysis

The following slides present scenario analysis to demonstrate why giving the City more control over the resident EIT rate is important. None of the scenarios presented here are intended to predict what will happen or what the City should do. They show what would happen in a specific set of assumptions so you can weigh the value of options before the Commission.

We have simplified the options for closing the deficit down to the three that would help the City close the deficit quickly and on a recurring basis:

- Increase the real estate tax
- Reduce services and cut positions via attrition, layoffs or both
- Increase the resident EIT rate (only possible with Home rule charter)

While each scenario shows the City relying exclusively on one of these options, that is not our recommendation. Even if the City adopts a Home Rule charter that gives the City control over the resident EIT rate, the City should not try to close the deficit solely by increasing the EIT rate every year.

Also, while there are other deficit-closing initiatives not included in these scenarios, these are the three primary moves that would help close the deficit **fast enough** and on **a recurring basis**. Speed and recuring benefit are critical. The City has a large projected deficit in the fiscal year that starts less than seven months from now, and it gets larger over time.

Scenario 1: Rely only on real estate tax increase

The City has the statutory authority to increase the real estate tax rate up to 30.0 mills, even without Home Rule.

If the City relied **solely on the real estate tax** to close projected deficits in the baseline projection, it would need a 31% tax increase in 2025 and then additional increases of 4-5% annually to close the deficit.

For homeowners whose properties are assessed at $179,500 (the median value in the most recent census data), their tax bill would increase by $692 in 2025 and then by $125 - $140 annually thereafter. Commercial property owners would also pay the higher real estate tax. Renters also pay the real estate tax increase if the property owner passes it along through higher monthly rent.

	2024 Budget	2025 Proj.	2026 Proj.	2027 Proj.	2028 Proj.	2029 Proj.
Current Level (mills)	12.64	12.64	12.64	12.64	12.64	12.64
Deficit Closing Level (mills)	N/A	16.50	17.27	17.99	18.73	19.46
Increase relative to 2024 (mills)	0.00	3.86	4.63	5.35	6.09	6.82
Increase relative to 2024 (%)	0.0%	30.5%	36.6%	42.3%	48.2%	53.9%
Year over year increase (mills)	0.00	3.86	0.78	0.72	0.74	0.73
Year over year (%)	0.0%	30.5%	4.7%	4.1%	4.1%	3.9%
Estimated total City tax bill by assessed taxable value						
Median Home Value ($179,500)	$2,269	$2,961	$3,100	$3,229	$3,362	$3,493
Increase over 2024 tax bill	$0	$692	$831	$960	$1,093	$1,224

Scenario 2: Rely only on cuts in full-time personnel

The City has the statutory authority to cut spending, even without Home Rule, but there are restrictions on what spending it can cut. For example, the City cannot choose to not pay its debt without triggering potential entry into Act 47 oversight.

Since the City spends most of its General Fund budget (almost 75%) on personnel, **cutting spending translates to cutting positions.** Again, there are restrictions on which personnel costs the City can cut – it cannot cut its pension contribution in the short term.

For simplicity, this scenario assumes position cuts are applied across City government proportionally. Practically, this would be difficult since position cuts in police and fire translate to higher overtime. So, non-public safety units may absorb more cuts than shown below. The scenario also does not fully account for unemployment costs, which could push these cuts higher. Those costs will depend on how many cuts involve vacant positions versus layoffs.

If the City relied **solely on spending cuts** to close projected deficits in the baseline projection, it would need to cut 23% of all positions relative to the 2024 budget in 2025, and then make 3-5% cuts annual cuts thereafter.

	2024 Budget	2025 Proj.	2026 Proj.	2027 Proj.	2028 Proj.	2029 Proj.
Current Level (174 Police, 77 Fire, 132 Other)	**383**	**383**	**383**	**383**	**383**	**383**
Deficit Closing Level	*N/A*	296	282	271	260	251
Police Reductions	*N/A*	*(39)*	*(46)*	*(51)*	*(56)*	*(60)*
Fire Reductions	*N/A*	*(17)*	*(20)*	*(23)*	*(25)*	*(27)*
Other Reductions	*N/A*	*(30)*	*(35)*	*(39)*	*(42)*	*(46)*
Reduction relative to 2024 (FTE)	0	(87)	(101)	(113)	(124)	(133)
Reduction Relative to 2024 (%)	0%	-23%	-26%	-30%	-32%	-35%
Year over year reduction (FTE)	0	(87)	(14)	(11)	(11)	(9)
Year over year reduction (%)	0%	-23%	-5%	-4%	-4%	-3%

Pennsylvania’s earned income tax

Who and what is taxed?

The City taxes the wages, salaries, commissions, net profits, or other compensation of Lancaster residents at a rate of 0.6% by the City. The School District of Lancaster adds another 0.5% for a total resident EIT rate of 1.1%.

The City also levies a 1.0% EIT on the earned income or net profits derived by non-residents (commuters) while working in Lancaster, but this revenue is almost always remitted back to the commuters’ home municipality. Less than five percent of the City’s EIT revenue comes from non-residents.

Because the resident EIT is applied to a tax base that grows over time, resident EIT revenues also grow “naturally” (i.e. without increasing the tax rate each year). This is a key difference between the resident EIT and the real estate tax (only grows when assessed values rise) or other flat taxes (LST is $52 per year perpetually).

When is the tax paid?

For most employees working in Lancaster, the tax is withheld by their employer from their paycheck and then remitted to the Lancaster County Tax Collection Bureau which then distributes the taxes to the appropriate municipality and school district. Self-employed residents or those with net profits may pay the taxes on a quarterly basis.

EIT collectors remit revenue to municipalities throughout the year, though there is usually four big months (e.g. February, May, August, and November). This again differs from the real estate tax which is remitted to City government in one lump sum during the year. **Since the City has expenditures throughout the year, like employee payroll, it is helpful to have a large revenue that is also distributed throughout the year.**

Scenario 3: Rely only on resident EIT increase

The City does not currently have the statutory authority to increase its resident EIT. It needs a Home Rule charter that grants that power to use that option.

Setting aside the 0.5% EIT paid to the School District, the City receives 0.6% resident EIT. A very small number of non-residents (commuters) pay EIT to the City (less than 5% of total revenue), and they would not be impacted by Home Rule.

If the City relied **solely on resident EIT increases** to close projected deficits in the baseline projection, it would need to double the City's share of the resident EIT to 1.22% with smaller annual increases thereafter. This would not change the income tax paid to the School District, Commonwealth, or US government. The table below shows the impact on the tax bill for an average household according to the most recent census data ($381 in 2025, $35 - $60/year thereafter).

	2024 Budget	2025 Proj.	2026 Proj.	2027 Proj.	2028 Proj.	2029 Proj.
Current Level (City only)	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%
Deficit Closing Level (City only)	*N/A*	1.22%	1.32%	1.40%	1.48%	1.54%
Increase relative to 2024 (tax rate %)	0.0%	0.6%	0.7%	0.8%	0.9%	0.9%
Increase relative to 2024 (% change)	0.0%	104.0%	120.4%	133.8%	146.6%	156.9%
Year over year increase (tax rate %)	0.00	0.01	0.00	0.00	0.00	0.00
Year over year increase (% change)	0.0%	104.0%	8.0%	6.1%	5.5%	4.2%
Impact on households (per year) by annual taxable income						
Average Household Income $61,104	$366	$747	$807	$856	$903	$941
Increase over 2024 bill	$0	$381	$441	$490	$537	$575

Scenario comparisons: What's my tax bill?

	2024 Budget	2025 Proj.	2026 Proj.	2027 Proj.	2028 Proj.	2029 Proj.
Scenario 1: Rely only on real estate tax increase						
<$100,000 *14% of owner-occupied units*	Up to $1,264	Up to $1,650	Up to $1,727	Up to $1,799	Up to $1,873	Up to $1,946
$100,000 - $299,999 *73% of owner-occupied units*	$1,264 to $3,792	$1,650 to $4,949	$1,727 to $5,182	$1,799 to $5,396	$1,873 to $5,619	$1,946 to $5,837
>$300,000 *13% of owner-occupied units*	$3,792 and up	$4,949 and up	$5,182 and up	$5,396 and up	$5,619 and up	$5,837 and up
Scenario 3: Rely only on earned income tax increase						
<$25,000 *20% of households*	Up to $150	Up to $306	Up to $331	Up to $351	Up to $370	Up to $385
$25,000 - $99,999 *55% of households*	$150 to $600	$306 to $1,224	$331 to $1,322	$351 to $1,403	$370 to $1,479	$385 to $1,542
>$100,000 *25% of households*	$600 and up	$1,224 and up	$1,322 and up	$1,403 and up	$1,479 and up	$1,542 and up

Bottom line

The City faces deficits starting in 2025 after it is no longer able to use ARPA funding under the revenue replacement provision to balance its budget – the baseline projection currently shows a $10.0 million deficit in 2025 growing to $18.3 million absent corrective actions (cutting positions, raising tax or fee rates).

Realistically, the City will have to take corrective action (as it did in the past by reducing positions and cutting spending, or in 2023 when it increased the real estate tax millage) to avoid deficits, otherwise it would exhaust its reserves.

The levers that City government can currently use to make a meaningful impact on its finances are (1) the real estate tax, and (2) spending/personnel cuts. Adding the EIT flexibility through the Home Rule process would give the City one more lever to balance its budget.

We acknowledge that not all of Lancaster's residents fall in the middle – some are retired homeowners with no taxable earnings, others are renters – but using median household incomes and home values gives some sense for the comparative impact of these tax options. Comparing the two tax increase options (real estate and EIT), **using the EIT alone to close the deficit would have a lower impact on the average resident's annual tax bill than using the real estate tax alone.**

Typical Taxpayer Impact in Deficit-Closing Scenarios

Assuming Median Household Income ($61,014) and Home Value ($179,500)

	2024 Budget	2025 Proj.	2026 Proj.	2027 Proj.	2028 Proj.	2029 Proj.
Scenario 1: Rely on RE Tax	$0	$692	$831	$960	$1,093	$1,224
Scenario 3: Rely on EIT	$0	$381	$441	$490	$537	$575