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Philadelphia Schools Seek to Tax Smokers for Funds: Muni Credit.

Philadelphia's schools are counting on smokers to fill a budget gap that threatens to extend the summer vacations of the city's children. Any fiscal gains may be as ephemeral as a puff of smoke.

The district, the nation's eighth-largest, needs state lawmakers to allow the city to levy a new tax of \$2 per pack of cigarettes. A delay may lead to firings or push out the first day of school, said Superintendent William Hite Jr. He said he will decide by Aug. 15. The deadline underscores the precarious condition of the district, which educates about 200,000 students and owes \$3.3 billion of municipal debt.

Even if legislators approve the tax, proceeds won't cover the shortfall for the year that began in July, said Matthew Stanski, the district's chief financial officer. What's more, revenue relying on cigarettes may decline along with smoking, said John Donaldson, who helps manage \$750 million of munis at Haverford Trust Co. in Radnor, Pennsylvania.

"It's not a sustainable, long-term foundation for funding," said Donaldson, Haverford's director of fixed income, who let his last district holdings mature last week.

Confronting Costs

Even as a nationwide economic recovery has buoyed cities and states, urban school districts such as Philadelphia and Chicago are struggling to cope with rising costs for areas such as pensions and health care. Philadelphia, the nation's fifth-most-populous city, in December won its highest Standard and Poor's rating, A+, four below the top. Yet Moody's Investors Service in May called the school system "a deterrent to economic growth."

"Longer-term, it could impede the city's progress and the city's strong comeback," said Alan Schankel, managing director at financial-services firm Janney Montgomery Scott LLC in Philadelphia. The city, whose population started to rebound in 2006, needs to attract employers and people who would want to raise children there, he said.

Mayor Michael Nutter, a Democrat, said during a state senate committee hearing in Philadelphia Aug. 6 that when he meets business executives, "increasingly, people are asking me, what's going on with schools? How am I going to have the necessary workforce to expand and grow my business?"

Investor Assurance

While children in the city of 1.5 million may not be confident of returning to school as scheduled on Sept. 8, bondholders have more assurance in getting repaid.

The district's debt is issued under a system in which aid can be diverted to bond trustees before the obligations are due, said Tom Lemmon, a Moody's spokesman.

The program “provides good security for bondholders,” said Kathleen Evers, managing director of municipal credit analytics at BMO Capital Markets in New York.

Moody’s may cut the district’s credit mark of Ba2, two steps below investment grade. Yet it’s not doing the same for the bonds, ranked A1, fifth-highest, because of the state program.

Philadelphia district securities maturing in September 2020 traded Aug. 7 with an average yield of about 2.2 percent, or 0.69 percentage point above benchmark munis, lower than the average gap of about 0.80 percentage point for the past five months, data compiled by Bloomberg show.

The district’s woes stem from climbing mandatory expenses as Pennsylvania cut aid from 2010 through 2012, Moody’s said.

Charter Expense

The system, which doesn’t have authority to raise its own revenue, must cover the cost of charter-school students. In this year’s \$2.55 billion spending plan, charters take up 31 percent, compared with 18 percent in fiscal 2011, according to a district presentation. Pension and health-care outlays account for 11 percent, compared with 7.5 percent in 2011.

In response to the financial strains, the district, which faces an \$81 million budget gap for the fiscal year that began in July, has closed 31 schools and last year fired 3,790 workers. It employs about 17,000 as of December. State and city lawmakers extended a 1 percent city sales tax that was set to expire in June, bringing the district an estimated \$120 million this fiscal year.

Canceled Vote

The proposed new cigarette tax, which city council passed last year, would provide about \$7 million a month, Stanski said. Although the Pennsylvania House was scheduled to vote Aug. 4 on a bill enabling the move, it canceled its session. Some representatives concluded that the bill, passed by the senate with provisions that weren’t applicable to Philadelphia education, needed vetting because of the additional items, said Stephen Miskin, a spokesman for House Republican Majority Leader Mike Turzai.

The state assembly is scheduled to return Sept. 15. Republican Governor Tom Corbett on Aug. 6 said he’s advancing \$265 million in already budgeted state aid for the district. The disbursement doesn’t assure a timely school opening, Hite said alongside the governor at a news conference in Philadelphia.

The delay in authorizing the cigarette tax “is eroding public confidence in public education and hindering the city’s economic prospects,” Hite said later at the state senate committee hearing.

School officials had estimated that if the tax were in place by September, proceeds would generate at least \$65 million for the fiscal year, Stanski said. Even that wouldn’t fill the budget gap.

Asked if there were other revenue options, Stanski said, “not at this time.”

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