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CENTER CITY REPORTS

Center City's Office Sector: Restarting the Engine for Growth

Philadelphia's civic and political leaders have been trapped in a policy conundrum that pits **economic competitiveness** against **neighborhood vitality**, forcing a false choice between cutting business taxes and funding municipal services. As a city that has been losing jobs and residents for more than 50 years, Philadelphia needs to put aside divisive debates and develop a consensus strategy to expand both private-sector jobs and municipal services. This report, based on original research by CPDC on where employees work and live, offers new information essential to such a strategy.[1]

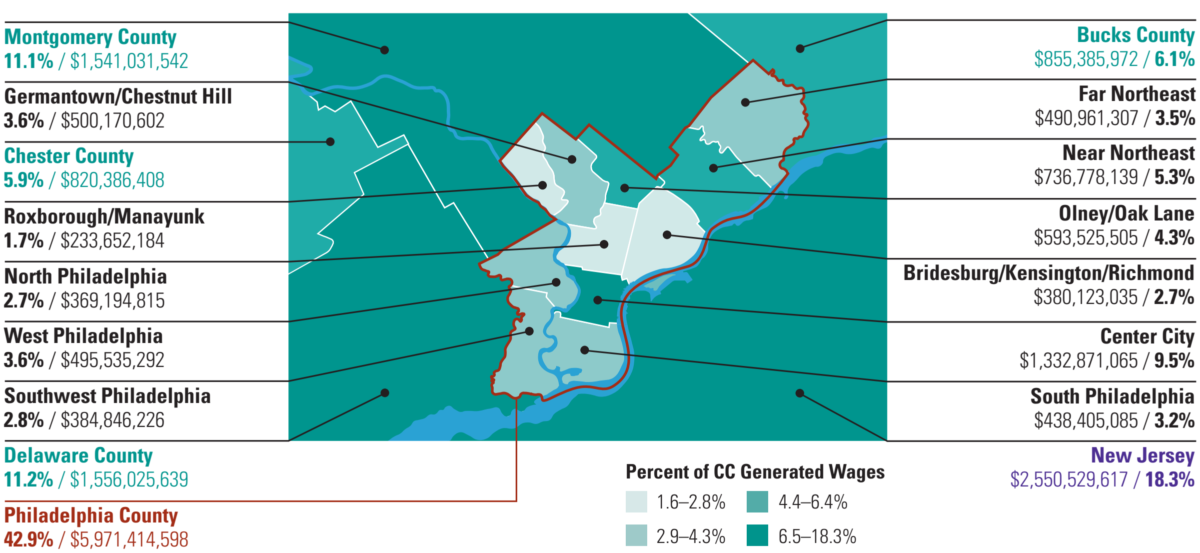
Looking Back

A century ago, Philadelphia was the largest, most diversified industrial city in North America. More than 16,000 factories in Fishtown, Kensington, Nicetown, Germantown, North, South and West Philadelphia generated a quarter-million jobs for rowhouse residents. But in the last 50 years, these jobs have almost entirely vanished from Northeastern cities and from North America. Once 52% of the city's workforce was engaged in manufacturing; today, it's only 6%.

Major public investments, begun in the 1950s, enabled Philadelphia to reposition itself as the national economy shifted to service-sector employment. Today, 70% of Philadelphia's private-sector jobs are in office buildings, in education and health care, or in leisure and hospitality. While downtown comprises just 3% of the city's land area, its jobs account for 47% of all private-sector wages paid citywide. They generate $6 billion in annual salaries to Philadelphia residents and another $7.9 billion in salaries to households in surrounding counties. The institutions of University City account for an additional 10% of all private-sector wages paid citywide and generate $774 million in annual salaries to Philadelphia residents and another $1.1 billion in salaries to those in surrounding counties. In sum, **57% of the city's economy can be found between Front and 40th Streets, Spring Garden to South Street.**[2]

Just as Stetson Hats, Midvale-Heppenstall Steel and Cramp Shipyards were the economic backbone of our neighborhoods at the start of the 20th century, post-industrial jobs in offices, hospitals, hotels and educational institutions are the economic lifeblood of the 21st century. They offer a broad range of opportunities from entry-level, to technical, to high-skill, high-wage jobs. As a result, CPDC's research shows that downtown employers pay $500 million in annual salaries to households of Philadelphia's Northwest, $495 million to West Philadelphia residents, $491 million to households in the Far Northeast, $438 million to South Philadelphia residents and $369 million to households in North Philadelphia.

SALARIES PAID BY CENTER CITY EMPLOYERS: $13,921,942,974 TOTAL



Residents of Philadelphia earn 42.9% of downtown income. The residents of the Pennsylvania suburbs in Bucks, Chester, Delaware and Montgomery counties together earn 32.2% of Center City income; residents of New Jersey suburbs earn 18.3%.

Given their importance to the prosperity of all city residents, downtown jobs should be treated as a strategic asset like the international airport, or research and educational institutions, or cultural and historic attractions and sports teams. This dense cluster of business enables Philadelphia to compete with other cities and regions, export services, import income and talent and provide quality opportunities to residents. Instead of acting like adversaries, elected officials and business leaders are better served by partnering in a strategy to grow the post-industrial economy.

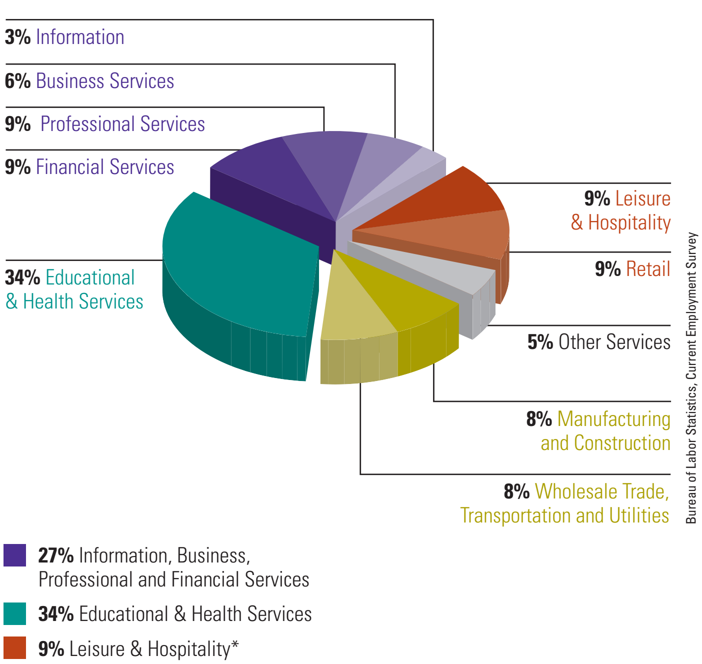
Understanding the Downtown Economy

The starting point for dialogue is an understanding of where jobs really are. Construction jobs, for example, loom large in any public policy debate about economic development. Though they are a highly visible sign of development, they constitute only 2% of the city's jobs. By contrast, education and health care provide 34% of Philadelphia's jobs and the commercial office sector accounts for another 27%.

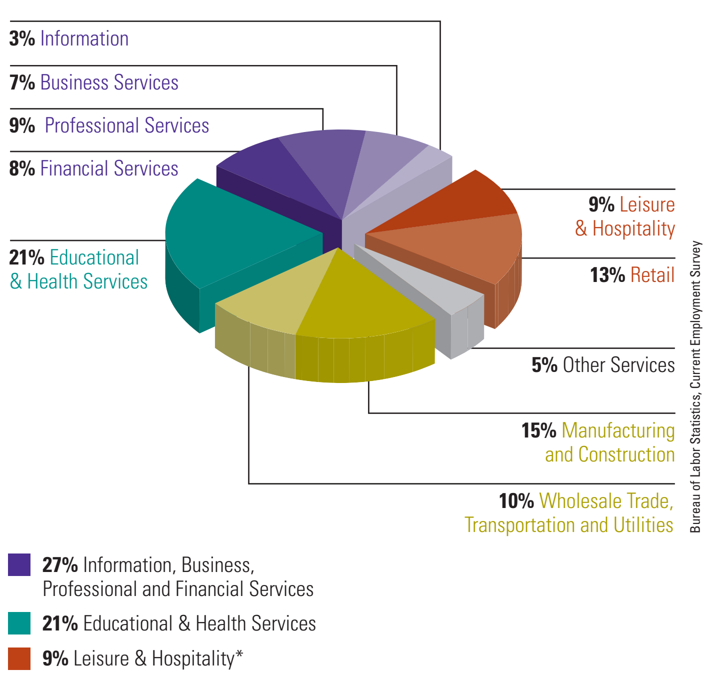
Downtown, 41% of all private-sector jobs are in office buildings filled with professional, business and information services, as well as finance, insurance and real estate firms. This is a significantly higher concentration than the city and the region as a whole, where this sector accounts for only 27% of total employment. Even in the age of cell phones and hand-held computers, there is a distinct advantage in being at the center of the regional labor market, well served by highways and transit, and in a dense environment that enables frequent face-to-face interaction.

If one counts the Center City headquarters of chemical and pharmaceutical firms, which are classified as manufacturing, downtown's office buildings are the locale for 44% of Center City jobs. Twenty-one percent of downtown jobs are in health care and education, compared to 34% citywide. Leisure and hospitality, which make up 9% of city and regional employment, constitute 12% of Center City's jobs. Construction jobs account for 4.1% of Center City employment. So any strategy for economic development should focus first on the basics and ask: "How do we enhance our strongest sectors and remove barriers to their growth?"

CITYWIDE PRIVATE-SECTOR EMPLOYMENT, 2004

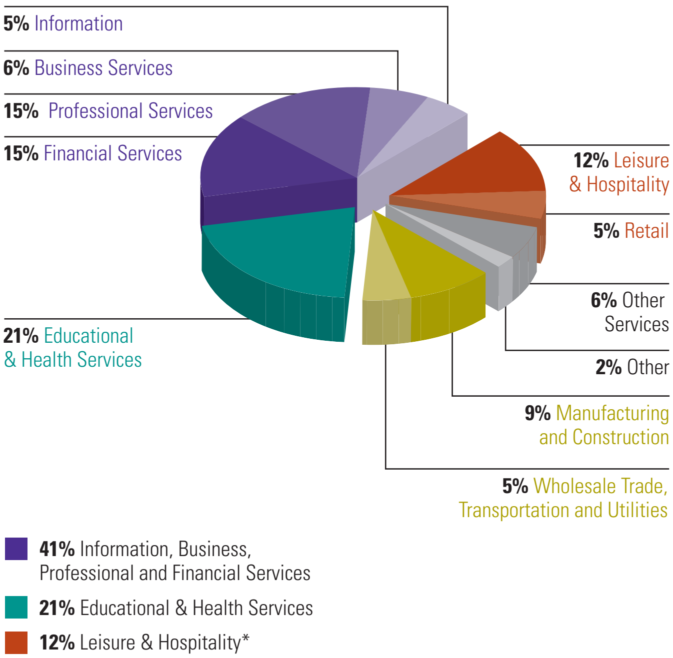


REGIONAL PRIVATE-SECTOR EMPLOYMENT, 2004



** Includes restaurants and food services.*

CENTER CITY EMPLOYMENT ESTIMATES BASED ON WAGE TAX RETURNS, 2003



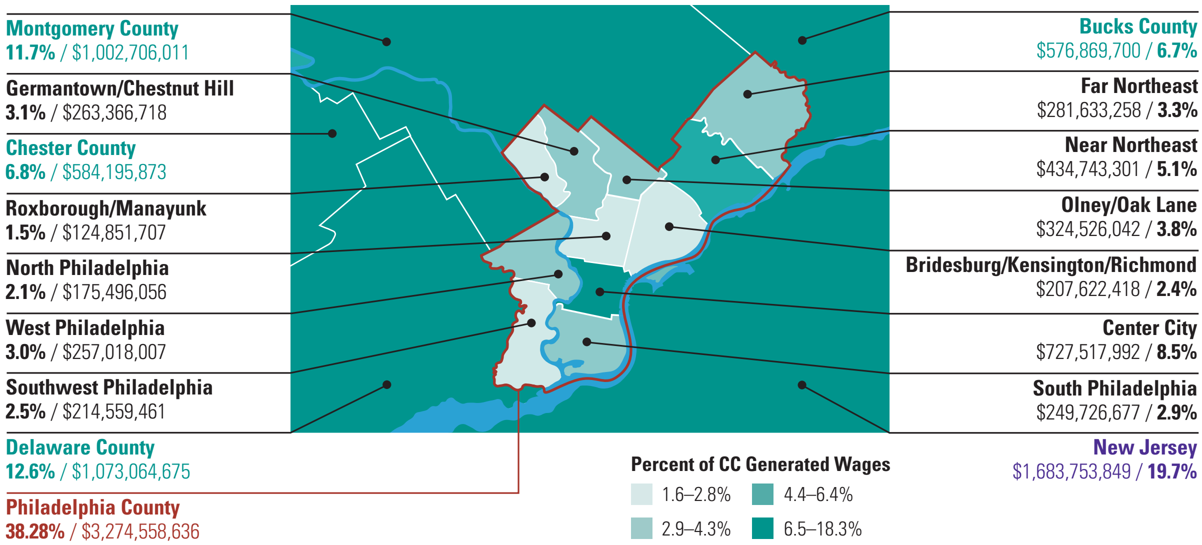
** Includes restaurants and food services.*

Who Benefits from Jobs?

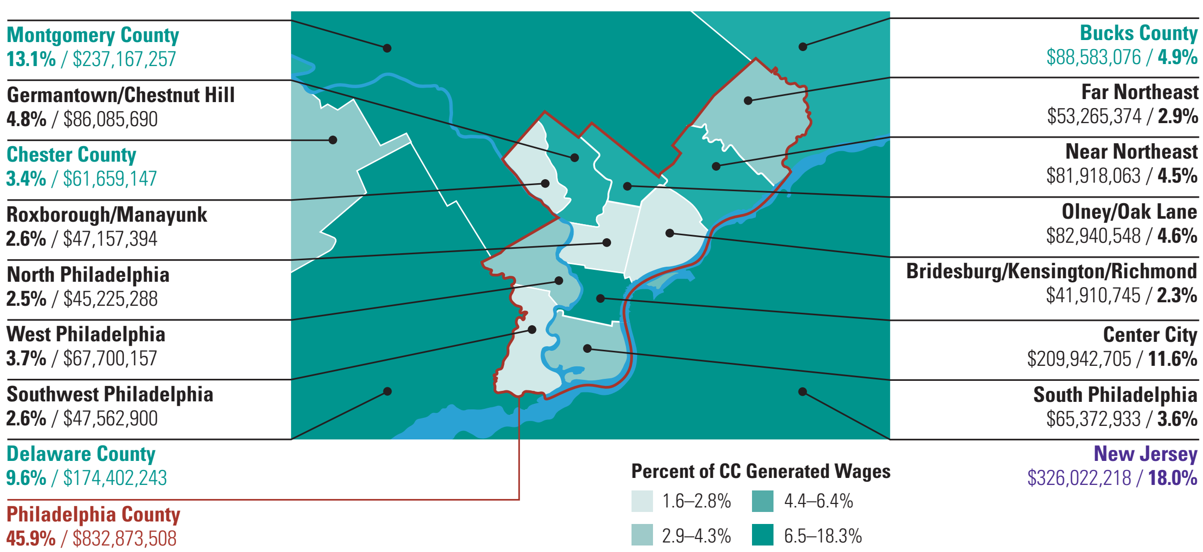
A second question is of paramount importance to elected officials: Which sectors create the greatest opportunities for constituents? Buses, trolleys, subways and the regional rail make downtown jobs highly accessible to residents of Philadelphia neighborhoods, especially those without cars.[3] In return, the downtown economy enables city residents to pay mortgages or rent, purchase food and clothing, shop and dine, and send their children to college: 65.3% of salaries paid by Center City hospitality employers go to Philadelphia residents;[4] 57.3% of salaries paid by educational institutions go to city residents; for health services, 44.9%;[5] and for the office sector 38.3% is paid to city residents.[6]

Despite the smaller percent of office wages that stay in the city, the sheer number of downtown office jobs, between 150,000 and 170,000, means this sector has the largest impact, **generating $3.27 billion in annual salaries to city residents,** as compared to $833 million from education and health-care institutions, and $259 million from hospitality employers. For residents of North Philadelphia alone, the annual salary statistics are of almost the same magnitude. The office sector generates **2.5 times the combined total** of salaries paid in health care, education and hospitality: $175 million from the office sector, $45 million from education and health-care employers, $24 million from the hospitality industry. For Bridesburg/Kensington/Port Richmond, the office numbers are **3.5 times the combined total** of salaries paid in health care, education and hospitality: $207.6 million from the office sector, $41.9 million from education and health-care employers, $17 million from the hospitality industry.

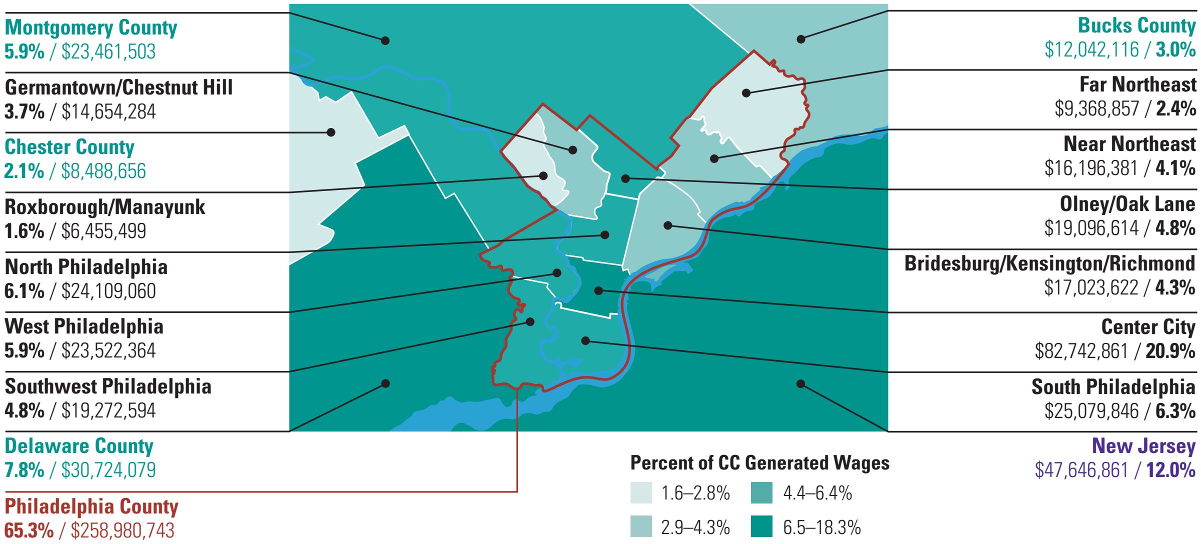
SALARIES PAID BY CENTER CITY OFFICE EMPLOYERS: $8,553,579,010 TOTAL



SALARIES PAID BY CENTER CITY HEALTH & EDUCATION EMPLOYERS: $1,813,935,726 TOTAL

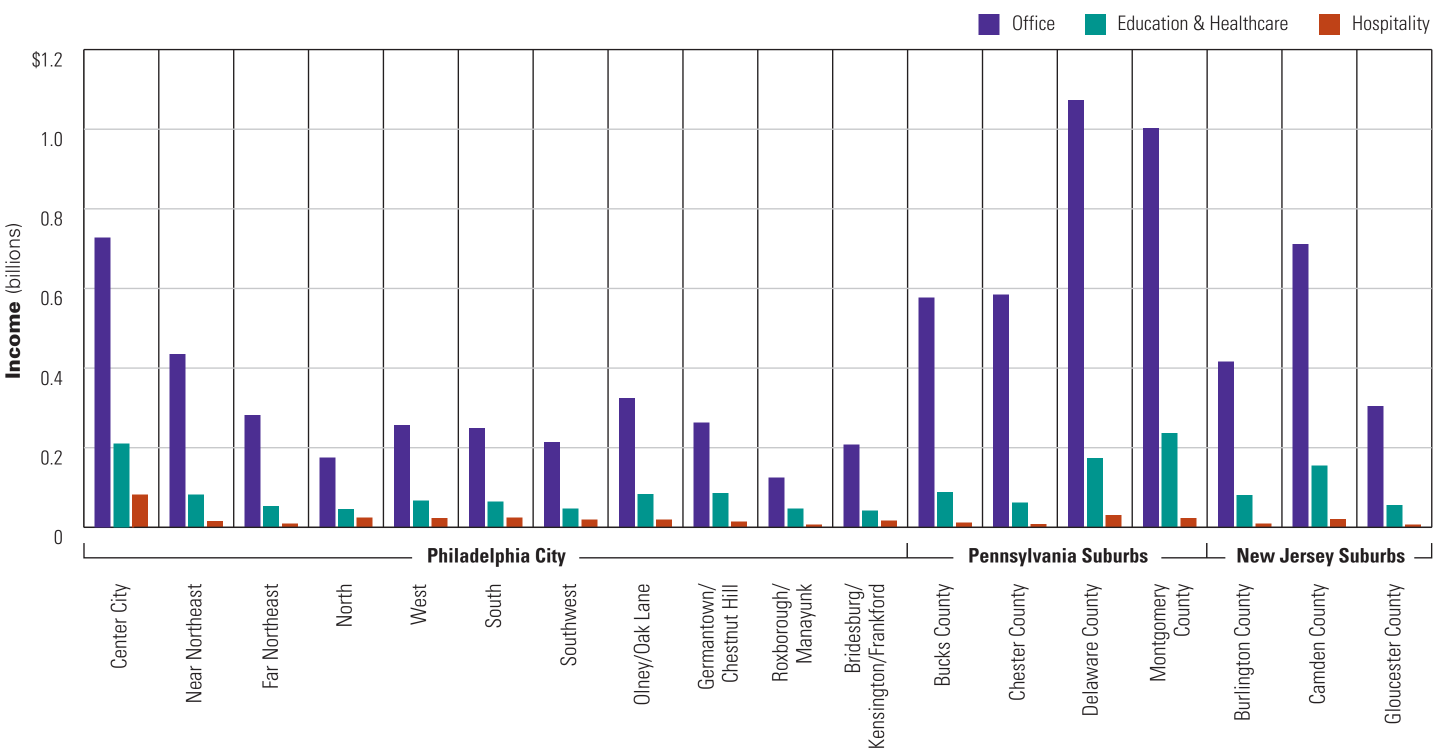


SALARIES PAID BY CENTER CITY HOSPITALITY EMPLOYERS: $396,415,143 TOTAL



The graph below displays in a comparative manner the same information that is contained in the maps.

SECTOR COMPARISON OF CENTER CITY WAGES BY NEIGHBORHOOD



Partnerships for Success

Elected officials have long understood that the growth of education and health-care institutions is tied to their ability to have land available for expansion. With strong city, state and federal support, this sector's employment grew in Philadelphia between 2000 and 2004 by 11%, outperforming the surrounding suburbs.

• When labor-management problems drove major conventions and trade shows from the Pennsylvania Convention Center and hospitality jobs declined by 7% between 2000 and 2004, city and state officials, regional business and labor leaders all came together to rectify the situation. The Convention Center is again on track, rebooking major conventions and trade shows. Expansion is getting underway.

• As insufficient runways at the Philadelphia International Airport cause a spiraling cycle of delays, Philadelphia has been spurred to work at the state and federal level to expedite approvals and financing for new and expanded runways.

• In 2000, as a wave of 15-year commercial leases executed at the end of the 1980s started to come due, a public-private outreach to major downtown businesses helped secure the renewal of 82 out of 83 of these leases. But downsizing and the continuing movement of some operations to the suburbs meant that Philadelphia still lost 5% of its office jobs in the last four years. In fact, the appearance of two new office buildings on the skyline actually masks a much more profound challenge: Center City has been quietly losing jobs from its largest employment sector for over 15 years and did so even in the boom years of the 1990s.[7]

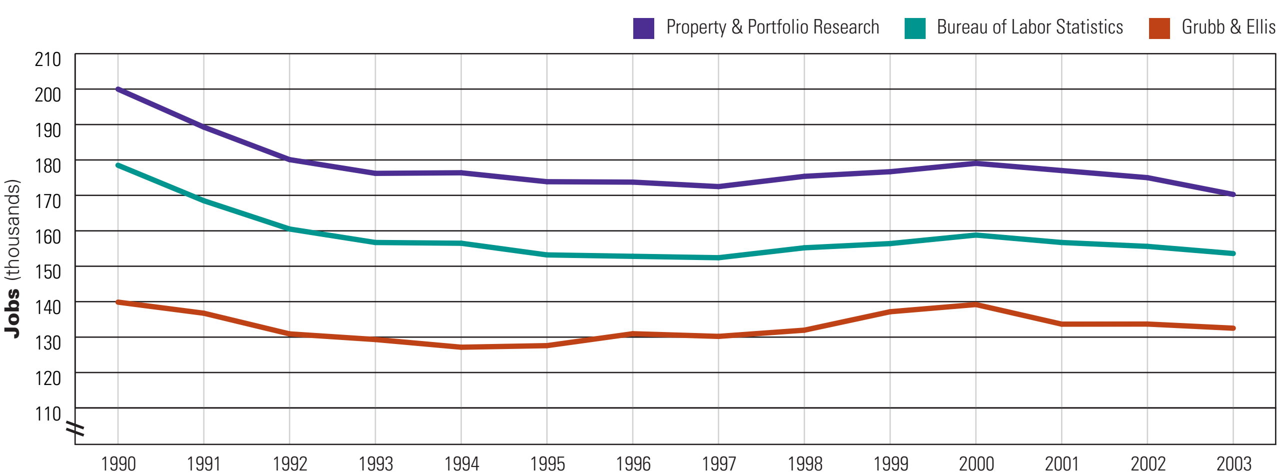
At the same time, from 1990 to 2005, the total number of regional office jobs increased by 10%. But because Center City failed to keep pace, its share of regional office jobs plummeted from 47% to 32%, as growth occurred beyond the reach of the regional rails.

The same trend is apparent when looking at commercial office space. Between 1986 and 2005, the region's office inventory expanded from 58.9 million to 122 million square feet, an average of 3.3 million square feet added per year.[8] But since no new downtown commercial office buildings were added in the nineties, Center City dropped from a 41% share of the region's office space in 1993 to only 28% in 2004, six points below the national average for CBDs.[9]

In the last five years, the vacancy rate in downtown office buildings has climbed from 7% to 16%.[10] Based on CPDC's analysis of the residence of Center City workers, the loss of office jobs directly results in a reduction in disposable income in all of Philadelphia's neighborhoods. It is a contributing cause as well to the city's population decline, as those who can, follow their firms to the suburbs.

But this is not an inevitable or irreversible trend. Other East Coast cities added significantly more office jobs than Philadelphia in the last 15 years. The Select Greater Philadelphia business marketing initiative now creates an opportunity to attract new firms to the region. Based on the experiences of Greater Philadelphia Tourism Marketing Corporation and the Philadelphia Convention & Visitors Bureau, it's clear that when we advertise our assets and improve our product, we grow market share. If Philadelphia

CENTER CITY OFFICE JOBS BY METHODOLOGY



Source: See footnote 7 for explanations of each methodology is to capture its proportionate share of new regional business growth and enhance the prosperity of neighborhood residents, it has to address its competitiveness within the region.

The Opportunity to Attract Regional Firms

There are clearly macro-economic and demographic trends beyond the city's control that are driving the decentralization of firms. But any number of studies has also documented that the city's wage and business privilege taxes are substantial contributing factors. As gaming revenues achieve expected levels, the wage tax will be significantly reduced to 3.8% for residents in 2007 and will steadily drop to 2.8% by **2015 when the rate for residents will be below the rate for non-resident workers.** This creates a major opportunity for Philadelphia to focus on regional firms, who have no presence in the city, but who employ a significant number of city residents who already pay the wage tax. *A Comparison of Office Occupancy Costs: Center City and Pennsylvania Suburbs* demonstrates how the falling wage tax, when combined with the advantages of commuting by transit, will make Center City a very cost-effective location for many regional firms by 2007.[11]

Currently, six million of downtown's 38 million square feet of office space is vacant. Next year, an additional 1.8 million square feet will become vacant in the Bell Atlantic Tower Building and in Liberty Place 1 and 2. Because commercial real estate taxes are calculated on an income approach to value, vacant space and falling rents will cause all three owners to appeal their assessments to the city's Board of Revision of Taxes. The reduced assessments that will be granted will result in significantly lower payments to the City of Philadelphia and the School District of Philadelphia.

On the other hand, every 500,000 square feet of vacant office space that is reoccupied by firms moving in from outside the city, or by the growth of existing firms, results in approximately 2,000 more office jobs. Based on current patterns, this translates into $11.4 million in new salaries to Center City residents, $39.7 million in new salaries to residents of other city neighborhoods, including $7.8 million in salaries to all of North Philadelphia and $7.37 million in new salaries to residents of West and Southwest Philadelphia.

From a municipal tax perspective, every 500,000 square feet of reoccupied office space in existing Center City buildings generates $11.1 million in total city wage, real estate, business, and use and occupancy taxes. Roughly the same calculus holds true for new buildings constructed downtown to the extent they are filled by firms from outside the city and region.[12]

Based on the *Mayor's Report of City Services, FY 2003*, $11.1 million annually would fully support 257 new caseworkers in the Department of Human Services, 228 additional employees for the Department of Public Health, 198 new firefighters or 186 more police officers.[13] If Philadelphia could return to 2000 occupancy levels, there would be **$76 million** more in total city wage, real estate, business, and use and occupancy taxes from just the commercial office sector to fund schools and municipal services.

The Business Privilege Tax

The business privilege tax (BPT) remains a particularly onerous burden, particularly for professional-services firms structured as partnerships. Rather than receive salaries from which the wage tax is withheld, partners are compensated with a share of firm profits, after the deduction of BPT. Serving clients throughout the region and country in a wireless age, these firms have the most flexibility to move some or all of their operations outside the city and avoid the BPT.[14] Virtually all downtown law and accounting firms report the majority of their job growth is in their suburban offices, or their offices in other cities.

Thus, it is not surprising that the anchor tenants in the Keystone Opportunity Improvement Zone (KOIZ) in which the Cira Centre sits are not corporations whose senior executives would continue to pay the wage tax under the rules of a KOIZ, but partnerships that will have their BPT totally abated for 15 years when they relocate into the zone. If the success of the Cira Centre shows anything, it is that professional-services firms — even with senior partners who live in the suburbs — clearly value proximity to the center, near universities, and atop public transit lines, especially if they don't have to pay Philadelphia's BPT.

An economic development strategy that provides to a limited few in a small geographic area a business tax reduction that is not available to other firms outside the zone, is, at a minimum, a strategy fraught with risk. To the extent that a KOIZ attracts new firms from outside the city, there is a demonstrable gain. To the extent that such zones induce new growth that might not have otherwise happened, or retain jobs that might otherwise have left, there may be benefits to the city. But when such zones draw taxable businesses from taxable buildings into a tax-free area, it produces a questionable result. We appear to be giving up 15 years of real estate and BPT taxes from the relocating business in return for 18 months of construction jobs and the retention of wage taxes from lower-level, salaried employees of these firms.

With the help of the Commonwealth, Philadelphia now has a way to make steep, across-the-board reductions in its wage tax. The local economy would benefit enormously from an analogous effort to "buy down" the BPT to competitive levels sufficient to induce the job growth that will quickly offset the revenues initially lost in the cuts.

Conclusion

Sixty-one percent of all private-sector jobs in Philadelphia are in health care, educational services and the office sector. All three require a clean and safe environment and a well-educated workforce. Hospitals and educational institutions, large land owning entities, require assistance from the city for their physical expansion plans. By contrast, the commercial office sector is comprised primarily of tenants who — in the wireless age — are highly mobile employers with highly mobile workers. Amenities matter to this sector. But first and foremost, given their regional and global alternatives, office tenants need a cost-competitive setting. If not, they will continue to leave, just as manufacturing firms did when the numbers no longer made sense.

A strategy for the office sector can be founded on two simple principles: more competitive tax policies and an enhanced, well-funded public transit system. The dividends will be unmistakable: greater prosperity in neighborhoods and more revenues for improved city services.

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1 This report is an update of the July 2003 *Office Sector: A Strategic Approach*. Employment statistics are generally only available at the county level from the Bureau of Labor Statistics. But through work that CPDC has been doing for the last three years in cooperation with the City of Philadelphia Departments of Finance and Revenue, we have been able to link together three categories of data related to the wage tax: 1) employee residence locations from W2 returns submitted to the Philadelphia Department of Revenue, 2) employer business locations from information in the Department of Revenue's taxpayer database, and 3) industry sector coding in the same database. As a result we can now identify the wages and salaries that are paid to wage earners working in Center City (defined as zip codes 19102, 19103, 19106, 19107), categorize and aggregate this income by the industry of the employer, and then map the distribution of this aggregated income by the counties and neighborhoods where the wage earners reside.

The W2 file for 2003 on which this analysis is based accounted for 75% of all wage tax collected by the city, compared to just less than 50% in the earlier report. The wage earnings estimates were calculated by dividing the amount of the collected wage tax by the average 2003 tax rate. The salaries generated from the W2 file are underestimates for two reasons. First, 25% of returns were filed non-electronically, and therefore are not included in the analysis. But both the 2001 and 2003 samples are representative by sector, firm size and geography of all wage tax collected by the city and therefore can serve as the basis for extrapolation for all employee wages. More significantly, the wage tax data does not count a portion of the income earned by partners, primarily in law and accounting firms. So the report underestimates the full economic impact of Center City's office sector. CPDC is working with the Philadelphia Bar Association and the Philadelphia Departments of Finance and Revenue to estimate the total amount of this compensation.

2 Substantial additional work is needed to map the far more decentralized economy of the balance of the rest of the city. But this information should be an essential component of any neighborhood-oriented economic development strategy.

3 From its own 2001 survey of downtown firms, CPDC estimates that 70% of office workers take public transit to work.

4 Restaurants make up a significant portion of hospitality jobs. It is thus not surprising, given the size of wait staffs for whom this is often a transitional career, that the largest share of hospitality salaries, 21.8%, goes to Center City — where young adults, 25-34, constitute 30% of the downtown population.

5 The numbers for University City education and health-care employers are analogous: 41% of their wages go to city residents.

6 While salaries paid to suburban office workers who live in the suburbs are not directly recycled in the city's neighborhoods, their expenditures in downtown shops and restaurants were estimated at $4,000 per employee, per year in a 1999 CPDC survey. Non-residents also account for 37.4% of all wage taxes paid to the city. Suburban residents may not be the constituents of Philadelphia's elected officials, but they certainly account for a substantial portion of the revenues that fund municipal services. It should be clear from these statistics, too, how vital SEPTA and PATCO are to the economy of the city and how important it is to secure a long-term, dedicated funding base for SEPTA and increase the frequency and quality of service on both the city transit division and on the regional rail lines.

7 CPDC has used three different methodologies for historical estimates of the number of Center City private-sector office jobs:

- Occupied commercial office inventory for the CBD from Grubb & Ellis (1985-2005), divided by an estimated 250 square feet per employee.
- Employees in traditional office sectors from the Bureau of Labor Statistics (BLS) (1990-2005). These include financial services, insurance and real estate; professional and business services such as advertising, legal, public relations, engineering and architecture, and computer science and data management, as well as administrative and support services; and information services such as publishing and printing, media and Internet. But these estimates are citywide and only count salaried employees eligible for unemployment compensation, not partners who are compensated with a share of profits.
- A detailed analysis of Center City office trends (1990-2003) conducted by Wharton real estate researcher Kevin C. Gillen. Ph.D., based on data from Property & Portfolio Research (PPR).

8 Based on data provided by Cushman and Wakefield of Pennsylvania, Inc.

9 Colliers International, 3rdQ 2004.

10 Grubb & Ellis, 1stQ 2005.

11 Available online at www.centercityphila.org. Click on "Recent Publications."

12 The difference is that any new commercial office building will enjoy the city's ten-year tax abatement. They will also have a lower economic impact to the extent to which they are filled by relocating firms.

13 City of Philadelphia: *Mayor's Report on City Services, July 1, 2002 – June 30, 2003.*

14 Legal-services firms, for example, account for 20% of all the city's business privilege tax accounts and these firms have been following corporate clients to the suburbs and shifting business activities outside the city.

Summary

• While downtown comprises just 3% of the city's land area, its jobs account for 47% of all private-sector wages paid citywide. They generate $6 billion in annual salaries to Philadelphia residents and another $7.9 billion in salaries to households in surrounding counties. The institutions of University City account for an additional 10% of all private-sector wages paid citywide and generate $774 million in annual salaries to Philadelphia residents and another $1.1 billion in salaries to suburban residents. In sum, **57% of the city's economy can be found between Front and 40th Streets, Spring Garden to South Street.**

• In Center City, 41% of all private-sector jobs are in office buildings containing professional and information services, as well as finance, insurance and real estate firms.

• Approximately 150,000 to 170,000 private-sector office jobs pay $3.27 billion in annual salaries to city residents, as compared to $833 million from education and health-care institutions, and $259 million from hospitality employers. For residents of North Philadelphia, the office sector is equally significant, generating **2.5 times the combined total** of salaries paid in health care, education and hospitality: $175 million from the office sector, $45 million from education and health-care employers and $24 million from the hospitality industry.

• From 1990 to 2005, as the total number of regional office jobs increased by 10%, Philadelphia steadily lost office jobs. As a consequence, the share of regional office jobs that is downtown and easily accessible to city residents by public transit dropped from 47% to 32%.

• The vacancy rate in Center City office buildings is now 16%. Next year, three first-class office buildings, Bell Atlantic Tower, Liberty Place 1 and Liberty Place 2, are expected to contain 1.8 million square feet of space that is vacant and off the tax roles.

• As gaming revenues achieve expected levels in 2007 and 2008, the wage tax will be significantly reduced to 3.8% for residents in 2007 and will steadily drop to 2.8% by 2015 when the rate for residents will be below the rate for non-resident workers. This creates a significant opportunity for Center City to attract firms from the region to open branch offices downtown and for the downtown to capture a significant percent of new businesses attracted to the region by Select Greater Philadelphia.

• Philadelphia would benefit enormously from an analogous effort to "buy down" the business privilege tax (BPT), which imposes a burden on professional services firms, such as law and accounting, which are structured as partnerships. In a wireless age, these firms simple move some or all of their operations outside the city, avoid the BPT, taking with them a broad range of jobs.

• Every 500,000 square feet of vacant office space reoccupied by firms moving in from outside the city, or by the growth of existing firms that stay in the city, results in approximately 2,000 more office jobs. This translates into $11.4 million in new salaries to Center City residents and $39.7 million in new salaries to residents of other city neighborhoods, including $7.8 million in salaries to all of North Philadelphia and $7.37 million in new salaries to residents of West and Southwest Philadelphia.

• From a municipal tax perspective, every 500,000 square feet of reoccupied office space in existing Center City buildings generates $11.1 million in total city wage, real estate, business, and use and occupancy taxes — enough to pay for 257 new case workers in the Department of Human Services, 228 additional employees for the Department of Public Health, 198 new firefighters or 186 more police officers.

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