QUIET NO MORE

Philadelphia Confronts the Cost of Employee Benefits

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OVERVIEW

When Mayor Michael Nutter took office in January 2008, everything seemed to be going Philadelphia's way. The regional economy was growing. City coffers were filled. Nutter pledged financial prudence and more tax cuts. And he vowed to start fixing, once and for all, the city's biggest and oldest fiscal albatross—its unfunded pension obligation to city government workers, which then amounted to nearly $3.8 billion.

A year-and-a-half later, those heady days have given way to a new bleak reality.

The worst recession since the Great Depression has enveloped the nation and city. Financial and housing markets have slowed to a crawl, and the stock market has plummeted. In Philadelphia, thousands of jobs have evaporated, pushing unemployment beyond 9 percent this spring. The city's tax revenues have dwindled. Instead of a surplus, the city has projected a cumulative $2.4 billion shortfall from 2010 to 2014.

Against this backdrop, one of Philadelphia's biggest expense items—its employee benefits—has emerged front and center. The amount Philadelphia spent on health care benefits and pension costs alone stood at $830 million, or 21 percent of its general fund budget in fiscal 2009. This is up from $590 million, or 17 percent in 2005 and $403 million, or 16 percent, in 1998. Under a city plan that needs approval from the state legislature, pension costs are projected to decline over the next two years—before rising dramatically. By 2013, the bill for pensions and health care combined is projected to approach $1.1 billion, or 26 percent of general fund spending. And that estimate is based on the assumption that the city's total health care expenses will stay about where they are now.

These rising costs, and concerns about them, are not new or unique to Philadelphia; cities across the nation are worried that the costs, as they grow, will limit the ability of local governments to perform core functions. But this long-simmering problem is the focus of public attention now in a way that it has not been before.

In Philadelphia, the average city retiree's pension check is roughly in line with that in other major cities. But the city's pension fund itself is deeper in the hole than many public pension funds—due largely to past underpayments by the city—and may be beyond the city's ability to fix without dramatic changes. The stocks, bonds and other investments held by the city Board of Pensions and Retirement, which have generated about half of each retiree's pension check, nose-dived last year on Wall Street like the investments of many other funds. As of March 31, the market value of the fund's holdings had shrunk by 30 percent—from $4.66 billion to $3.26 billion—over 12 months.[1] In early June, city officials estimated that the pension fund had less than 50 percent of the assets it needed to pay retirees over the long run, its lowest level since 1996.

In Harrisburg, legislators are considering two pension restructuring proposals, one from the city and the other from state pension regulators that would cover Philadelphia and Pittsburgh, which is in worse shape, and other plans across the state. City officials are seeking permission to withhold part of their annual required payment into the already-depleted fund and use the money to bridge what officials hope will be short-term, recession-driven budget deficits. This, in turn, will result in total pension-related payments by the general fund ballooning past $700 million a year in fiscal 2013 and 2014.

The little-noticed state proposal would take a different tack and is more radical: It would impose a partial but permanent takeover of distressed systems across the state and freeze all benefits at whatever levels exist at the time of the takeover.

On employee health care, city costs have been a sizeable part of total employee compensation—a projected 12.8 percent of total compensation this year. Philadelphia is different from other cities in that it does not administer health care benefits for most of its unionized employees. Rather, the city hands over a negotiated, per-employee amount of money to the unions' four legally-independent health and welfare trusts funds, in which it has a minority voice in management. Unlike their counterparts in many cities, most of Philadelphia's unionized workers are not required to contribute directly to the payment of their health care premiums. There is an area in which Philadelphia's city workers get less than their peers elsewhere: They get only five years of retiree health care coverage, instead of the lifetime retiree benefits in many other cities.

Both health care and retirement compensation should be seen in the context of total compensation—wages and overtime, plus health care, pension and other benefits. On that score, Philadelphia appears roughly in line with other local and state governments nationwide, although the slice of total compensation it devotes to health care is bigger than average. This picture, drawn from a comparison of city figures with national survey data from the Bureau of Labor Statistics and the U.S. Census Bureau, should be taken with caution due to differences in living costs and salary scales, among other factors, from place to place.

Pension and health benefits are central to the contract renewal talks between the city and its four municipal unions, which represent 89 percent of city workers. City officials have said they are seeking $25 million a year in savings through reduced benefits and higher contributions, among other things, and they have indicated that service cuts and layoffs may be necessary absent those savings.[2]

Philadelphia's benefits system, particularly its pension fund, appears to be at a crossroads. One thing is certain: the city's employee benefits crisis is not quiet anymore. In a report called *Philadelphia's Quiet Crisis: The Rising Cost of Employee Benefits*, released in January 2008, The Pew Charitable Trusts and the Economy League of Greater Philadelphia set out to shine a light on the problem.[3] The report documented some of the main challenges confronting Philadelphia's benefits system in relation to nine other cities—Atlanta, Baltimore, Boston, Chicago, Denver, Detroit, Phoenix, Pittsburgh and San Francisco—and gathered more than a dozen expert recommendations. Today, city, union and state officials are giving the situation all the attention it deserves, and then some.

To help inform the public discussion, the Philadelphia Research Initiative, with assistance from the Pew Center on the States, sought to update the situation regarding pension and health-care conditions in Philadelphia and the comparison cities, based on interviews with officials as well as the latest available documents. We reviewed policy changes and proposals that have arisen regarding Philadelphia over the past year and a half. We interviewed two dozen experts on employee benefits from across the spectrum. Three of the four major unions that represent Philadelphia city workers provided varying amounts of information. They are the Fraternal Order of Police, Lodge 5; the International Association of Fire Fighters, Local 22; and District Council 47 of the American Federation of State County and Municipal Employees, which represents white-collar workers. District Council 33, which represents blue-collar workers, did not respond to repeated requests for information.

KEY FINDINGS

Pension Benefits

- On the fundamental indicator of the pension fund's condition—the level of assets it needs to pay retirees—Philadelphia's main municipal pension fund sank from 55 percent in July 2008 to below 50 percent this June.[4] Blame the bear market on Wall Street, which pushed the severely-depleted fund further into the red. But even before the plunge, Philadelphia's fund was in worse shape than those of most state and local governments and all of the nine comparison cities except Atlanta and Pittsburgh, thanks largely to the failure of city officials in past decades to make the necessary contributions. In 2006, Philadelphia was ranked the fifth-worst funded local plan among 84 systems studied by pension experts at Boston College.[5]

- The contributions by Philadelphia's workers, which are set by contract, were lower in percentage terms than those of their peers in most but not all of the comparison cities. The majority of Philadelphia's police and firefighters put 5 percent of their pay into the pension fund. The bulk of non-uniformed municipal employees last year paid 1.85 percent. At the same time, the average size of Philadelphia's pension checks appeared to be roughly in line with those of other major cities in the comparison group. Average pensions in 2007 ranged from $18,784 for most retired non-uniformed workers to $27,632 for most retired firefighters, far below Chicago's range of $27,960 to $52,446 but slightly above Detroit's range of $17,231 to $27,218.[6] Bigger retirement checks in some cities are sometimes the result of higher employee contributions and the desire to compensate for the fact that many municipal employees are not covered by Social Security.

- To cope with a current budget shortfall, City Council has voted for a new schedule of payments (which also require Harrisburg's approval) that pushes much of the city's annual pension liabilities three years down the road. So instead of paying $479 million in total pension costs in fiscal 2010, which begins July 1, the city general fund would pay $332 million. The relief would turn to extra pain in 2013, when what would have been a $644 million total pension cost instead would become nearly $709 million.[7] A sustained rally on the stock market would reduce taxpayers' share of this obligation.

- As part of the same restructuring plan, the city, if it gets approval from Harrisburg, would make actuarial changes to improve its pension projections and planning. One change would lower the assumed rate of return on investments—including dividends, interest and change in market value—from the current 8.75 percent, which many experts consider too high, to 8.25 percent. A higher target eases city budget planning by presuming higher revenues down the road, but it also causes pension boards to underestimate eventual liabilities and set aside smaller contributions to cover them. The city also would stretch out payments aimed at eliminating its unfunded liability over 30 years; its current liabilities have an average of 20 years left to run.

Health Care Benefits

- Philadelphia's spending on health care benefits in fiscal 2009 (which ends this June) declined 12.4 percent from an abnormally costly 2008. Health care expenditures were 11 percent higher than two years ago and 45 percent higher than five years ago—a rise faster than city spending as a whole but comparable to long-term national trends.[8] Per-employee costs stayed constant last year for members of the two non-uniformed unions. Costs came down for police officers and firefighters; those costs had been abnormally high during the previous year as the result of one-time payments to settle arbitration disputes. The health plans run directly by the city were costlier this year than two of the union-affiliated plans.

- Health care benefits remain one of the city's single biggest expenditures. Health care accounted for 12.8 percent of total compensation for active employees in fiscal 2009.[9] By comparison, state and local governments across the country spent an average of 10.8 percent of total com–pensation on health care last year. Last year, Philadelphia devoted 7.5 percent of its general fund expenditures to health care for active employees and 1.9 percent for retiree health care benefits.[10]

- Members of three of the four city unions have no payroll deductions for health care and pay modest co-pays when they seek medical services. The fourth, AFSCME District Council 47, through its Health and Welfare Fund, requires employees to contribute to the cost of coverage on an as-needed basis. Enrollees in the city-administered health plans pay between 3.5 percent and 15 percent of the cost of health care premiums, which is close to the percentages typical for city employees elsewhere.
- A distinguishing characteristic of Philadelphia's health-care benefit system is that labor unions' health and welfare trust funds—legally-independent entities run by union and city trustees—administer the coverage with city-provided funds. In the past, city officials have suggested that consolidation in some form could reduce administrative costs and health-care coverage rates. But the city had not proposed such a move in contract talks as of mid-June.[11]
- In 2008, as part of contract talks, the city and its four unions agreed to create a joint labor-management committee to study, discuss and release recommendations on best practices to contain costs. The committee has not released any findings.

PENSION BENEFITS

An old problem gets worse

Why, at a time when millions of Americans feel their retirements are less secure, is the dismal condition of the pension fund for 65,883 current and retired Philadelphia city government employees and their beneficiaries particularly important?

On one hand, the huge cost of city pensions seems likely to either gobble up resources needed for vital city services or drive up city taxes and fees for everybody—or do both—for decades to come.[12] On the other hand, the existence of a secure pension system helps the city hire qualified people and ultimately enables retired city workers to keep corner stores busy, neighborhoods alive and property values stable.[13] And thousands of city employees, both active and retired, are counting on the system to make good on its commitments.

To be clear, Philadelphia's pension problem centers on too little money being paid into the system to cover promised benefits, which are mostly in line with other cities. In fiscal 2007, the average annual pension benefit for the majority of retired Philadelphia workers (those hired before 1987) ranged from $18,784 for municipal workers to $27,632 for firefighters, with former elected officials receiving the highest average of $42,948.[14] (Average pension checks are lower for retirees who were hired after 1987 under a less generous plan; these individuals made up about 4 percent of total retirees last year.[15,16]) The 2007 range was higher in Chicago, Phoenix and San Francisco, and slightly lower in Detroit and Pittsburgh.[17] Comparison figures for elected officials in other cities were spotty.

The under-funding of the pension system has its roots in the 1970s and 1980s, when city officials fell short of paying the city's full annual required contributions. In the late 1980s, to help many Pennsylvania cities reduce pension liabilities, the state allowed Philadelphia to create a new pension plan for new employees that had lower benefits and lower contributions by employees themselves.[18] By 1998, however, the pension system was still severely underfunded, holding just 52 percent of the assets it needed to meet liabilities—far below the 80 percent level considered healthy.[19] In response in 1999, the city sold a $1.29-billion pension obligation bond designed to replenish the fund in one fell swoop, gambling that the city could make enough in the markets to pay back bond holders and then some. It has not worked so far. Market declines in 2000-2001 reduced the city's returns. The bond repayment is slated to cost the city $94 million in the coming year.[20] A bull market on Wall Street later helped improve the fund's asset-to-liability ratio slightly to 55 percent by mid-2008, still worse than all but Pittsburgh in the comparison group. But the stock market collapse in the second half of 2008 drove the ratio back down, a blow that will fall on the city's general fund.[21]

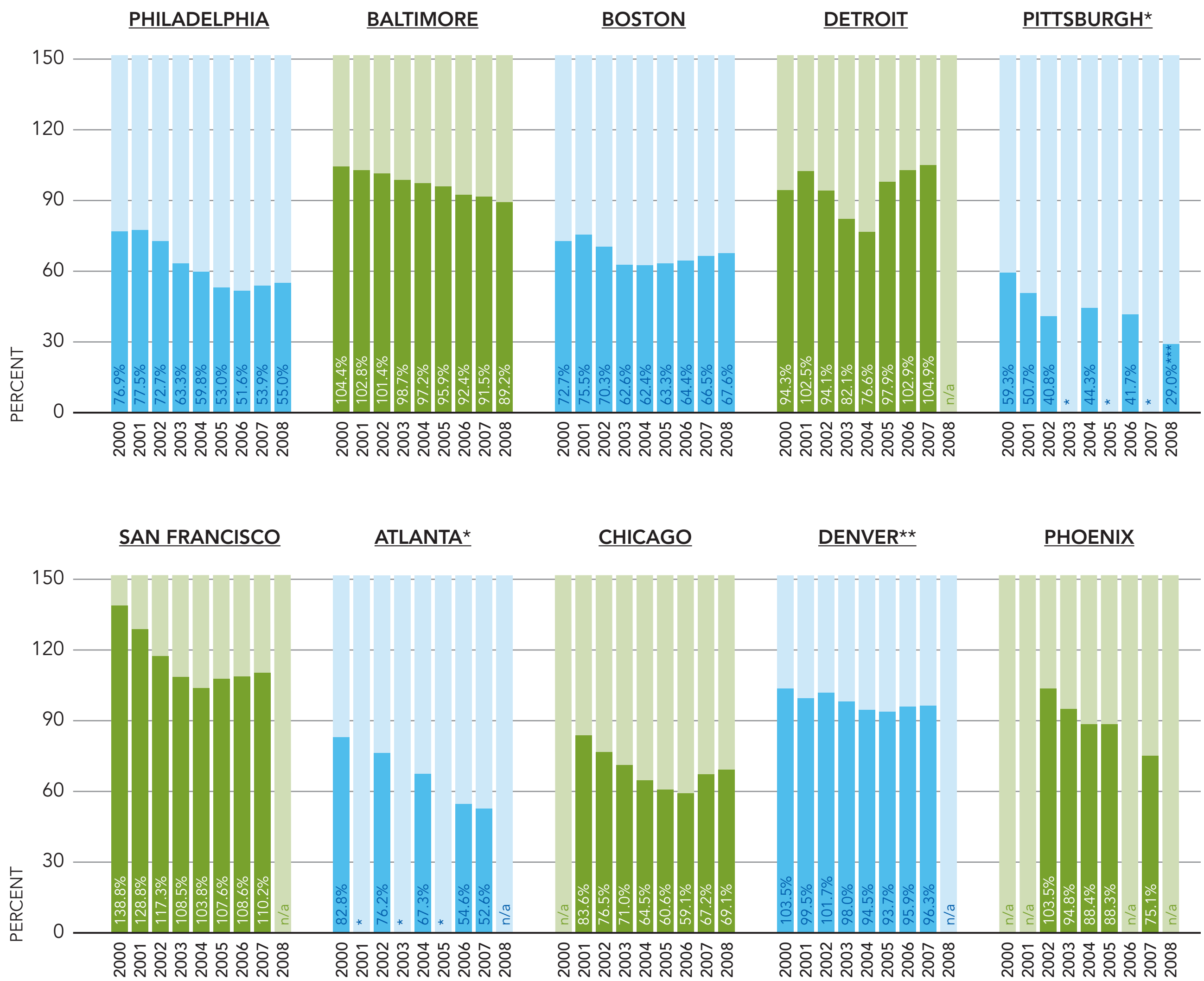
COMPARISON CITIES

At various points in this report, Philadelphia is compared to nine other cities: Atlanta, Baltimore, Boston, Chicago, Denver, Detroit, Phoenix, Pittsburgh and San Francisco.

FIGURE 1

PENSION FUNDING LEVELS

A key indicator of a pension fund's condition is how much in assets it has to cover its longterm liabilities to retirees. In other words, a fund that is 50 percent funded has half the assets it needs. A safe level is considered to be 80 percent. All figures represent locally-run pension systems for general fund employees only.



* Certain cities calculate the funding ratio every two years.
** Ratio for 2003 and earlier do not include state-run police and fire pension plans.
*** Latest estimate for Pittsburgh as of December 21, 2008, provided by the Pennsylvania Department of Community and Economic Development.

SOURCE: Cities' pension and budget reports, various years.

How the pension fund is filled

Each year, money is added into the pension fund equal to the cost of benefits earned in that year by employees, plus an amount for amortized payments on investment losses, past missed payments and other operating liabilities. This money comes from three sources: contributions by employees, payments from the city's general fund, and earnings on investments held by the pension fund.

The employee share, based on a rate set by union contracts or city benefits policies, amounted to between 4 percent and 7 percent of overall additions to the fund from fiscal 2005 to fiscal 2007, the last years for which such information is available.[22]

The city's share comes in two parts. One is the "normal cost" to cover its share of employee yearly-accrued benefits, which amounted to between 5 percent and 6 percent of total additions. The other is money to cover investment losses or previous payments that the city failed to make in years past. Combined, those payments from 2005 to 2007 amounted to 34 percent to 39 percent of total additions. (The city's payments to bond-holders for its 1999 pension obligation bond are paid and accounted for separately.)

The share from investment earnings traditionally is the biggest. From 2005 to 2007, it ranged between roughly 55 percent and 64 percent of total additions. But in the year ending on June 30, 2008, the investments lost money and made the fund smaller instead of bigger.[23] When that happens, the added burden falls on the city, which can pay the shortfall or push it off to subsequent years, causing the bill and the total unfunded liability to grow ever larger.

Under widely accepted standards set by the independent Governmental Accounting Standards Board (GAB), which establishes accounting practices for local governments, pension systems are supposed to pay all current obligations each year plus make payments to cover past shortfalls and interest spread out over 30 years.[24] Philadelphia used a similar formula until 2003. But in the years since, the city has used a Pennsylvania formula that allows for lower payments to be made each year—in part by letting some makeup payments be spread out over 40 years.[25] Last year, measured by the city's previous GASB-type formula, the city paid 79.5 percent of its obligations, its lowest since 2003.[26] That was a greater shortfall than any comparison city except Chicago.[27] Under Pennsylvania's formula last year, the city paid 103 percent of its obligations. While the city is legally allowed to use the lower formula, the payments have not been enough to keep the fund from falling farther behind.

Apart from the city's long-term record of underfunding, the question of whether employees themselves are contributing enough is part of the negotiations between the city and its unions. Philadelphia employees last year ranked below their peers in most comparison cities in terms of the share of their own paychecks that they contribute to their pensions. The numbers were 5 percent or 6 percent for firefighters and police, and 1.85 percent or 3.75 percent for municipal employees—unionized or not. The lower contributions are paid by individuals hired after 1987 under the new pension plan. Workers in most comparison cities paid more out of their own paychecks, notably in San Francisco (7 percent to 8 percent) and Chicago (8.5 percent to 9.1 percent), though less in Denver (2.5 percent by municipal employees). Philadelphia residents appear amenable to making city workers pay more: an April 2009 poll by the Philadelphia Research Initiative found 53 percent of residents in favor of increased employee contributions and 36 percent opposed.

Many factors go into determining how much workers pay in to pension funds and how much they get out after retirement, including their wages, years of service, retirement age and benefit formulas set by contract negotiations, arbitration or law. In general, higher contribution rates tend to accompany more generous payouts for defined-benefit plans. Another factor is Social Security, in which some cities do not participate at all (Atlanta and Chicago) while others participate just partially (firefighters and police officers are exempt in Philadelphia, Baltimore, Detroit and San Francisco, for instance). In such cases, both employees and cities enjoy some savings by being exempt from federal withholding requirements. In those cities, pension contributions—by both employees and government—may be higher, along with benefits.

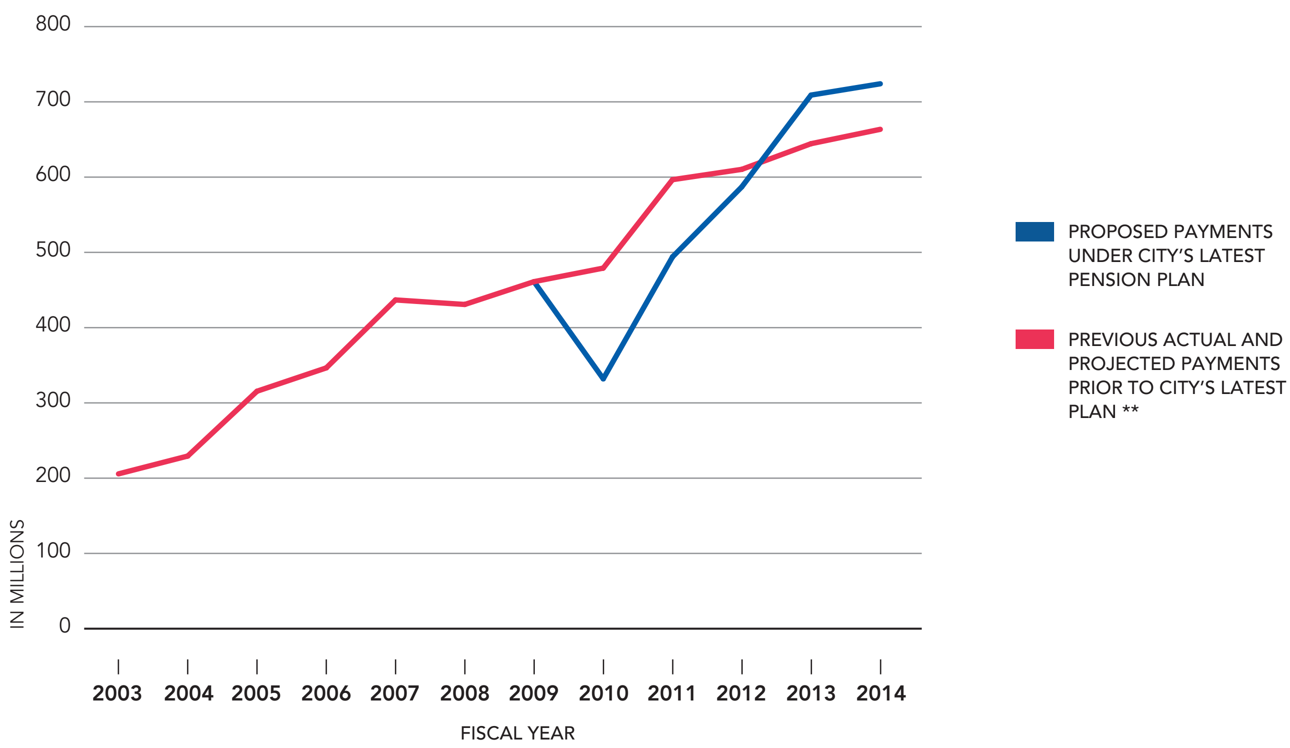
When the system's liability deepens, it's not just red ink on a ledger. Credit-rating agencies closely watch all the debt and the city's actions and may downgrade the city's financial status, driving up its cost of borrowing for other purposes. In 2007, Philadelphia's general-credit worthiness was downgraded by Fitch Ratings (to BBB+) and S&P (to BBB) in relation to its general-obligation bonds.[28] Those weak ratings, in turn, contributed in preventing the Nutter administration this year from pursuing a pension-rescue plan it pondered in late 2008: a new $3 billion pension obligation bond to replenish the fund. The city could not find a bond-buyer willing to accept an interest rate low enough to make the deal worthwhile for the city.[29] In June, Fitch affirmed its low Philadelphia rating and repeated its concern about "weakened" pension funding.

This cycle—minimal city payments that fall short of liabilities, thus leading to ever-bigger liabilities—is very difficult to break. In fiscal 2008, the city's expenditure for pensions and pension bond repayments consumed 11 percent of general fund expenditures. That slice rose to nearly 12 percent this year, is projected to fall to 9 percent next year, then leap to 17 percent by 2013 under the new payment plan that requires state legislative approval.[30] Even without approval, the payments would rise in coming years, though at a flatter trajectory. Either way, this steadily rising obligation makes it ever harder for the city to get ahead of the situation on its own.

FIGURE 2

PHILADELPHIA'S ANNUAL PENSION BILL

*The city has proposed a new schedule of payments into its pension fund that would delay until fiscal 2012 about $230 million in payments currently owed in 2010 and 2011. Legislators in Harrisburg must approve the plan. In this chart, the proposed new payments from the general fund are represented by the blue line (top line at year 2014). The city's historic and current projected general fund payments are represented by the red line (bottom line at 2014).**



* All figures include pension bond payments. Calculated using the city's Minimum Municipal Obligation Method and Assumptions as of June 2009.
** Projections as of March 2009, City of Philadelphia Five-Year Plan 2010-2014, Appendix IV.

SOURCE: City of Philadelphia Five Year Plans; revised and proposed projections from City of Philadelphia Office of the Finance Director.

A new set of projections

In recent years, Philadelphia has opted to make high and arguably unrealistic projections of its pension fund's investment returns, largely in order to make the city's budgeting task easier. For the last four years, the Pension Board set an assumed annual return at 8.75 percent. Last year, that percentage was higher than all the comparison cities and higher than the 8 percent used by the largest number of public pension funds.[31]

The problem comes when the money doesn't materialize as planned. The city Pension Board calculates its yearly return on an annualized basis over five years, a practice called "smoothing" that is used by most investment funds. Over the last five years, on a smoothed basis, the city exceeded 8.75 percent per year until 2008. By a small margin, the fund outperformed several benchmarks including an aggregate of other pension funds over that same period, indicating that the fund has not been poorly invested.[32] But actual returns each year have varied widely and have been negative since 2007. Gross returns—which include interest, dividends and changes in asset value but exclude expenses—were down 24 percent by March 31 this year from a year earlier, although the decline has leveled out since then.[33] The shrinkage of the fund due to losses in the market added millions of dollars to the city's annual required contribution last year and will do so again this year.

The 8.75 percent target also gives fund managers reason to take greater risks than they might otherwise take, exposing the fund to greater potential losses. In the words of the Pension Board's chief investment officer, Christopher McDonough: "You have to take risks to make a return. And the higher the target, the more risk."[34]

Actuarial changes approved by the pension board this year though not yet implemented, would, among other things, lower the investment assumption to 8.25 percent and double the period in which the fund can average out losses or gains to 10 years from five years. These important moves carry costs for the city. The Pension Board has estimated that lowering the return rate from 8.75 to the proposed 8.25 could force the city to make around $25 million in additional contributions per year.[35]

Across the country, the stock market downturn had sharply reduced the values of assets held by many state government pension funds as of June 2008, the last date for which numbers are available, and the plunge has worsened dramatically since then.[36] At the same time, the recession has socked municipal budgets everywhere. Nearly every one of the comparison cities was struggling on the pension front. Baltimore proposed to strip a lucrative benefit from police and fire pension plans, then scrapped it in the face of opposition.[37] Atlanta wants to refinance its deeply-indebted fund.[38] Pittsburgh last December had just 29 percent of the assets it needs to pay retirees and is weighing a hike in employee contributions.[39]

Some local governments have concluded they must put off long-term pension remedies in order to get through the short-term crunch. Gov. Jon Corzine in New Jersey, for example, has proposed letting municipalities forego part of their contributions to the state pension system, a form of budget relief that has evoked heated backlash.[40] Others have decided that the situation offers the opportunity for long-term change. In New York, Gov. David Paterson, in exchange for scrapping proposed layoffs, got unions to agree to a new pension plan for future hires, one with higher employee contributions, a later retirement age and a requirement that individuals work ten years instead of five to qualify for benefits. The new system will apply to state workers and all local workers outside New York City, where Mayor Michael Bloomberg would like to see similar changes.[41]

This year may turn out to be when many local pension funds fall into critical condition and consider radical solutions, assuming cities aren't able to pour additional money into their funds. That's the view of James McAneny, executive director of Pennsylvania's Public Employee Retirement Commission, which monitors more than 3,100 local pension plans in Pennsylvania: "The [funds] that are less than 50-percent funded are not going to come back. It's a totally unrealistic assumption. You'd have to get a bubble like the one we just rode and have it last for 20 years. It just isn't going to happen."[42]

HEALTH BENEFITS

At a time when fewer private employers are offering health insurance, and those who do are reducing coverage and shifting a greater portion of costs onto their employees, state and local governments continue to provide broad coverage, paying more of the costs and maintaining higher levels of benefits than in the private sector.[43,44]

Now, as cities across the country face budget pressures brought on by the recession, some mayors are trying to get labor unions to agree to lower health care costs in exchange for avoiding or reducing layoffs. Earlier this month, New York City announced a tentative agreement with its unions to reduce health care benefits, producing $400 million in savings over two years and preserving, at least temporarily, the jobs of thousands of employees.[45] Reducing health care costs is a priority of the Nutter administration in its negotiations with the municipal unions.

Philadelphia offers health coverage to all of its full-time employees. Each of the city's four unions administers health care benefits for its members through a legally-independent trust fund. The city also operates its own plans for non-unionized employees and those who opt out of their union-affiliated plan, about 22 percent of the workforce in total.

In all of its funds, the city spent about $418 million in fiscal 2009 on health benefits. About 80 percent of the money went to cover active employees and about 20 percent to cover retirees, who get full coverage for five years. The average spending per active employee was $12,594.[46] Boston spent $11,044 per active employee.[47,48] Baltimore spent $10,002 per active employee for its highest level of coverage, according to city officials there. Boston and Baltimore both provide some form of health coverage throughout retirement, and they account for it separately.

City and union officials say their costs are high because the cost of health care coverage in Philadelphia generally is higher than in other regions, due to a lack of competition in the local health insurance market. To gauge whether health care costs here are higher than costs elsewhere, we reviewed two data sources comparing costs in various metropolitan areas: the Milliman Medical Index, which looks at average annual medical spending for a typical family of four in selected areas, and the Dartmouth Atlas Project,

FIGURE 3

HEALTH COSTS IN PHILADELPHIA PER PERSON

These numbers represent how much the city spent per employee for health coverage during fiscal 2009. Retirees get full coverage for five years.

	Health care spending per person per month	Health care spending per person per year
IAFF (Fire)	$1,270	$15,240
LEHB (Police and Sheriffs)	$1,165	$13,980
AFSCME DC 47	$976	$11,709
AFSCME DC 33	$976	$11,709
City-administered "flex" plan*	$994	$11,928
City-administered "fair share" plan*	$985	$11,824
Philadelphia	$1,050	$12,594

* "Flex" employees are not represented by unions and are not eligible for union health benefits. "Fair share" employees are represented by unions but have opted out of union health benefits.

SOURCE: City of Philadelphia Office of Human Resources.

which looks at Medicare spending in a broader range of regions. These two indicators show that health care is more expensive in Philadelphia than in the nation as a whole but costs about the same as in some other East Coast cities. Costs in Baltimore are almost identical to Philadelphia, according to the Dartmouth study,[49] while health care costs in Boston are about 5 percent higher according to Milliman and about 2 percent lower according to Dartmouth.[50]

There are several significant differences between Philadelphia's system and those of other cities. One is the low level of employee contributions toward the cost of care. Employees in three of Philadelphia's health plans have the entire cost of their health premiums paid for by the city through their union-affiliated health plans. Of the union-affiliated health plans, only District Council 47's health and welfare fund imposes as-needed payroll deductions on its members who opt for its highest level of coverage.[51] Members who select Preferred Provider Organization (PPO) coverage—which allows individuals to choose among a large number of doctors and hospitals—contribute $45.61 per month for single coverage and $129.09 for family coverage. The plans administered by the union funds also tend to have relatively low co-pays. Police officers and firefighters pay as little as $5 for office visits and $1 for generic drugs; officials from the firefighters' fund say that the low co-pays save money for the fund by keeping members healthy, encouraging them to stay on their medication and to visit their primary care doctors.[52] Enrollees in the District Council 47 plan pay $15 for office visits and $5 for generic drugs. Those enrolled in the city-run plans pay $20 for office visits and $10 for generic drugs.[53]

The plans administered directly by the city follow an approach more in line with the one many cities use for all of their employees—requiring workers to contribute at differing levels depending on their choice of coverage. In the city-run plan, participants choosing Health Maintenance Organization (HMO) coverage contribute $14.47 per month for individuals and $42.10 per month for families; for more costly PPO coverage, the monthly payroll deductions are $90.07 for individuals and $260.78 for families.

Many cities require employee contributions ranging from 10 to 20 percent toward premiums. On average, Boston covers 84 percent of the cost of health care; its employees cover the remaining 16 percent. Baltimore pays for 90 percent of HMO and 80 percent of PPO coverage. San Francisco covers 88 percent, and Denver and Phoenix cover 80 percent. On average, local governments contribute 91 percent of the cost of health insurance coverage for single coverage and 73 percent for family coverage. In the Mid-Atlantic region, state and local governments pay 92 to 94 percent of the cost of premiums.[54] Although the city provides no such percentages, Philadelphia's overall share would appear to be above 94 percent; it pays 100 percent of the premiums for the majority of its workers.

Officials at the Law Enforcement Health Benefits Fund, which administers health coverage for the city's police, maintain that they have been able to slow the rise in the fund's premium rates and avoid imposing payroll deductions on their members by aggressively managing their claims through wellness programs, disease management and member education and involvement. They also have conducted performance audits to catch bogus claims, identify fraud and remove ineligible members from the rolls.[55]

District Council 47's Health and Welfare Fund has committed $2 million for wellness programs to improve health outcomes and forestall future treatment costs. Under its contract with Independence Blue Cross, the local's health and welfare trust fund may enjoy a 2 percent decrease in annual premiums and other savings if it succeeds in increasing certain wellness measures, such as smoking cessation and diabetes testing.

The city-administered plans for non-union employees have taken a number of cost-cutting measures, but officials did not provide estimates of savings. The other two health care funds—the International Association of Fire Fighters' fund and AFSCME District Council 33 Health and Welfare Fund—did not provide details of cost containment measures.

Other cities negotiate with their unions over what type of health care the city will provide and administer. But Philadelphia negotiates a flat dollar amount per employee and then turns it over to the employee's union health and welfare funds. And the funds provide the coverage. In 2009, the per-employee per month rates for both District Council 33 and 47 remained the same as the previous year at $975.76 ($11,709 per year) and slightly below the costs of the city-run plans. The monthly rates for police decreased from $1,303 ($15,636 per year) to $1,165 ($13,980 per year). Rates for firefighters fell from $1,444 ($17,328 per year) to $1,270 ($15,240 per year). Both rates are set through arbitration.

It is not clear whether or how much this structure increases costs. According to latest filings with the Internal Revenue Service, administrative costs were 1.4 percent for the police fund, 1.8 percent for the firefighters' fund, 2.8 percent for the white-collar union (District Council 47), and

2.9 percent for the blue-collar workers (District Council 33).[56,57,58,59] The city has not provided similar figures for the administrative costs of the health care programs that it manages.

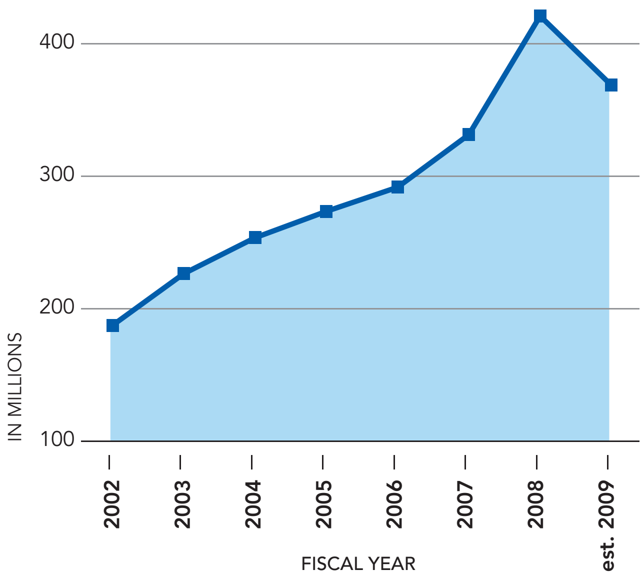
In the past, the city has proposed consolidating the health funds as a way to contain administrative costs. This option has not been on the table in the current negotiations. Proponents of consolidation also have argued that consolidation would allow the city to pool its purchasing power. Three of the four union-affiliated plans already benefit from joint purchasing by participating in the Delaware Valley Health Care Coalition, an association of union-benefit funds that negotiates prescription drug discounts. In 2008, the city and the unions created a Joint Labor-Management Healthcare Evaluation Committee with representatives from the city and each of the union-administered funds to "explore ways to maximize the quality and competitiveness of benefits at an affordable price" and examine "best practices."[60] The committee has not released any findings.

In April, the Philadelphia Research Initiative asked Philadelphians whether city workers should pay more for their health benefits. Fifty-two percent of those questioned said "no," and 41 percent said "yes."

FIGURE 4

TOTAL HEALTH COSTS

Philadelphia's spending on health care for employees and retirees had been rising steadily until last year, when it declined due to reductions in payments to the health and welfare funds covering police officers and firefighters.



SOURCE: City of Philadelphia five-year plans.

RETIREE HEALTH BENEFITS

In addition to pensions, many public-sector employees earn post-retirement health care benefits during their years of service. In some cities, these benefits, known as other post-employments benefits (OPEB), take the form of a flat yearly contribution toward the cost of post-retirement health care premiums, while in other cities, employees can expect full family coverage for the rest of their lives. Philadelphia offers its employees five years of post-retirement health care coverage; they get the same level of coverage, at the same cost to the city, as active employees. The city has proposed reducing this benefit to three years, while at least one municipal union has proposed increasing it to six years.

Until recently, cities paid for these benefits on a year-to-year basis without fully accounting for future obligations. In June 2004, the GASB announced new standards to capture the full cost of retiree health care.[61] The new reporting requirements took effect as cities prepared their 2008 financial statements and required them to list both their "pay as you go" cost —the amount they paid to current retirees for health care benefits in the past year—and the amount they will owe to current workers when they retire, less the value of assets set aside to pay for these costs.

The effect of these new standards can already be seen. Some cities, including Denver and Phoenix, have set aside substantial funds or revamped their benefits to reduce their future liabilities, while others, Philadelphia included, have not begun to pay down this obligation.[62,63] Philadelphia spent $75.8 million on retiree health care in 2008, which amounts to 1 percent of its total operating budget expenditures, and it faces a long-term liability of $1.1 billion.[64] Baltimore has a long-term liability of over $2 billion, Boston $3.1 billion.[65]

Although behind in funding its future liability, Philadelphia faces smaller total costs for retiree health care than many other cities because it offers only five years of retiree health care as opposed to the lifetime coverage offered elsewhere. The city includes its year-to-year retiree health care spending in its five-year budget plan.

THE ROAD AHEAD

Quiet no more, the crisis in Philadelphia's employee benefits system has generated a raft of proposed changes in the past year, particularly regarding the pensions system. In June, the city and unions were engaged in negotiations over health care and pension costs, with the recession-wracked government saying it needed concessions to avoid layoffs.

On the pension front, the Nutter administration has proposed increased contributions by employees. It also has proposed a new, hybrid pension plan for future hires that would have a defined-contribution element, like a 401(k).[66] In addition, city negotiators are looking for savings in health care. Union officials have said they have no interest in concessions.

Aside from what is happening in negotiations, the city has proposed withholding roughly $230 million in required pension contributions from all of city government in 2010 and 2011. Without that money to invest, the pension fund could see its funding ratio fall as low as 41 percent until the city starts paying the money back in 2012, with 8.25 percent interest a year, totaling about $65 million in interest payments just on the deferred amount over five years.[67] By the middle of 2014, after two years in which required general fund payments would exceed $700 million annually (including payments on the pension obligation bonds), the money would be fully restored and the pension funding ratio would rise to a projected 45 percent—still below current levels.

Beyond that, the Nutter administration's deferral plan calls for the city to double the "smoothing" period—from five years to ten—it has used to balance gains and losses in the market. This would spread out losses and reduce the shortfall in bad years. Few cities extend their outlook so long, although many funds have been considering a longer period.[68] The city also proposes consolidating all of its past pension liabilities—which on average have 20 years left to pay off—under a single, new 30-year payback schedule. This would lower the annual payments at the expense of longer debt time and higher cumulative interest.

In addition, the city's plan is competing with a new plan from the state itself. In early June, the state Public Employee Retirement Commission, the body that monitors pensions across the state, proposed taking over roughly 75 severely distressed pension plans, including those of Philadelphia and Pittsburgh. The state would manage the investment portfolios, administer the benefits and bill the cities for their contributions, presumably on a strict leash. In return, the state would temporarily reduce the amount the city would have to pay each year, with the reduction phasing out over a number of years.[69] Pensions would be removed from collective bargaining, meaning employees would lose their ability to bargain for better benefits and the city could not demand givebacks or underpay its contribution. Future hires in the city would automatically go into a new, separate, state-run municipal pension, with benefit levels set by state officials.

The outcome of all of these proposals and negotiations will be pivotal for the city's fiscal future, for the workers and retirees who rely on these benefits and for the taxpayers who foot the bill.

Invaluable assistance in producing this report was provided by the Pew Center on the States. It is currently preparing a report, due in the fall, on retiree benefit systems in each state's largest city plus 10 additional large cities—60 cities in total. Its report will examine all state- and locally-run pension funds and other post-employment benefits plans that cover public employees in those cities. *Quiet No More* only looked at locally-run plans for general fund employees in municipal, police and fire services.

ENDNOTES

[1] Preliminary and quarterly Performance Summaries, City of Philadelphia Municipal Pension Fund.

[2] Nutter, Michael A. *Five-Year Financial and Strategic Plan for Fiscal Years 2010-2014.* City of Philadelphia, 2009. (Referred to as City of Philadelphia Five-Year Plan 2010-2014 from this point forward.)

[3] Barrett, Katherine; Green, Richard, "Philadelphia's Quiet Crisis: The Rising Cost of Employee Benefits," Pew Charitable Trusts, January 2008.

[4] Informal estimate from Office of Finance Director, City of Philadelphia. Excludes other city pensions, including Philadelphia Gas Works and Public School funds. This estimate, based on stock market performance, is likely to change. The formal actuarial calculation of pension funding level is done in July.

[5] Munnell, Alicia H.; Aubry, Jean-Pierre; Haverstick, Kelly, "The Funding Status of Locally Administered Pension Plans." Center for Retirement Research at Boston College, December 2008.

[6] Cities' pension valuation or audit reports for 2007, the last comparison year available. Philadelphia figures are for retirees hired before 1987.

[7] Based on proposed payments and current projected payments as of June 2009 from the city's general fund, as provided by Office of Finance Director, City of Philadelphia. Figures include the city's yearly minimum municipal obligation and its annual pension obligation bond payments.

[8] City five-year plans, various years. Nationwide trends according to the Kaiser Family Foundation's *Employer Health Benefits, 2008 Annual Survey*. Health care premiums rose about 40 percent between 2003 and 2008.

[9] Nutter, Michael A., *Five-Year Plan FY2010-2014 Appendix IV: Other Statutory Requirements - General Fund.* Budget, Philadelphia: City of Philadelphia, 2009, p.1, 2, 5. Health/Medical spending is listed as $368,777,854; of that, 20 percent goes toward retiree health care (approximately $73,755,570.80). Total compensation is listed as $2.386 million. To calculate the percent of an active employee's total compensation that comes in the form of health benefits, spending for retiree health care must be removed from both figures.

[10] 2009 Projected General Fund expenditures were $3,953,252,000; Project Health/Medical spending for active employees and retirees was $368,777,854. Based on 2008 actual spending, 80 percent of health care spending went toward health care coverage for active employees, 20 percent for retirees. We assumed the same relationship for 2009 spending.

[11] Dubow, Rob, Finance Director, City of Philadelphia; Interview May 21, 2009.

[12] City of Philadelphia Five-Year Plan 2010-2014.

[13] Almeida, Beth; Bove, Ilana; "Pensionomics: Measuring the Economic Impact of State and Local Pension Plans," The National Institute on Retirement Security, February 2009. This study documented the multiplier effect of state and local pensions on state economies, finding that in Pennsylvania $1 supported $1.49 in economic activity in the state. A similar, if smaller, multiplier is expected at metro levels.

[14] Cheiron Inc. "City of Philadelphia Municipal Retirement System, Actuarial Valuation Report." The Board of Pensions and Retirement. July 1, 2008. (Referred to as Pension Actuarial Valuation, various years, from this point forward.)

[15] The average benefit for employees hired after 1987 ranged from $10,357 to $14,808.

[16] Pension Actuarial Valuation Reports, 2007 and 2008: As of July 2008, the lower-benefit "1987 Plan" covered about 76 percent of active employees and 4 percent of retirees, proportions that will grow as more workers retire. The previous "1967 Plan" covered about 24 percent of active employees and 96 percent of retirees, proportions that will decrease with time.

[17] Latest Pension Actuarial Valuation Reports, various cities.

[18] Commonwealth of Pennsylvania, Act 205, Municipal Pension Plan Funding Standard and Recovery Act, 1984.

[19] Pension Actuarial Valuation Report, 2007.

[20] Estimates of the Pension Board and from city budgets. The 30-year bond carries an annual interest rate of 6.61 percent, meaning the city would have to generate consistent annual returns far above that level to cover the principal, interest, legal and administrative costs associated with the sale. Only after 30 years will it be determined whether the bond proceeds were worth the price.

[21] City of Philadelphia Five-Year Plan 2010-2014.

[22] Board of Pensions and Retirement Annual Reports 2005, 2006, 2007; Pension Actuarial Valuation Reports, 2007, 2008.

[23] The pension fund in 2008 recorded losses of $207.8 million as of July 2007, compared with a gain of $782 million as of July 2006. More recent figures were not available.

[24] Government Accounting Standards Board.

[25] Pennsylvania's Minimum Municipal Obligation (MMO), defined by state law, is roughly 20-25 percent less than the Annual Required Contribution (ARC) calculated by actuaries using previous city forecasts. The city is allowed to pick from either and, since 2003, has used the MMO.

[26] Pension Actuarial Valuation Report, 2008.

[27] Philadelphia and other cities Comprehensive Annual Financial Reports.

[28] "Fitch Ratings Assign BBB+ to Philadelphia," Agency Press Release, November 29, 2007; "Standard & Poors Ratings Service Assigned Its BBB Rating to Philadelphia," S&P Statement, November 30, 2007.

[29] Interviews with Dubow, May-June, 2009.

[30] Dubow and City of Philadelphia Five-Year Plan 2010-2014.

[31] Interviews with pension actuaries and investment officers, including Christopher McDonough, Chief Investment Officer, Philadelphia Board of Pensions and Retirement, May-June 2009.

[32] Board of Pensions and Retirement Quarterly Flash Performance Report, April 23, 2009.

[33] "Flash report for the period ending March 31, 2009," Board of Pensions and Retirement Investment Committee memo, April 23, 2009. Interviews with McDonough and Dubow.

[34] Interview with McDonough, May 26, 2009.

[35] McDonough interview, May 2009.

[36] Foresti, Steven, "2009 Wilshire Report on State Retirement Systems," Wilshire Consulting, March 3, 2009. In an interview, Foresti said municipal funds likely suffered a corresponding drop.

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[38] Stirgus, Eric; "Atlanta in `a fight for our survival'," *Atlanta Journal-Constitution*, May 3, 2009.

[39] Boren, Jeremy, "Pittsburgh thriving, but pension concerns linger," *Pittsburgh Tribune-Review*, May 1, 2009.

[40] Benner, Katie, "The public pension bomb," *Fortune*, May 12, 2009.

[41] Edelman, Susan, "City is facing payout doom," *New York Post*, May 17, 2009.

[42] Interview with James McAneny, Executive Director, Pennsylvania Public Employee Retirement Commission, May 29, 2009.

[43] McDonnell, Ken. *Benefit Cost Comparisons Between State and Local Governments and Private-Sector Employers.* Notes, Washington, DC: Employee Benefit Research Institute, 2008.

[44] The Kaiser Family Foundation, *Employer Health Benefits, 2008 Annual Survey*. Annual Survey.

[45] von Zielbauer, Paul. "City Labor Unions Agree to Reductions in Health Benefits." *The New York Times*, June 3, 2009.

[46] Health care spending for all municipal employees provided by Maia Jachimowicz, Assistant Finance Director, City of Philadelphia.

[47] City of Boston. "Summary Budget, FY 10." April 2009.

[48] Data provided by Lynda Fraley, City of Boston, Office of Budget Management.

[49] Fisher, Elliot S., Julie Bynum, and Jonathan Skinner. *The Policy Implication of Variations in Medicare Spending Growth.* A Dartmouth Atlas Project Brief Report, Hanover: The Dartmouth Institute for Health Policy and Clinical Practice, 2009.

[50] Milliman, Inc. "2009 Milliman Medical Index." Research Report, May 2009.

[51] The AFSCME District Council 47 health and welfare trust fund said that by only imposing premium cost sharing for its PPO coverage, it has steered members to its less-expensive HMO option.

[52] The size of co-pays is a balancing act. Low co-pays can be beneficial, some experts say, to the degree that they encourage preventive care and the use of less-expensive, generic drugs. But higher co-pays, others say, have a positive effect as well, that of discouraging individuals from seeking unnecessary treatment.

[53] Data provided by Brian Alpert, Deputy Human Resources Director, Office of Human Resources, City of Philadelphia.

[54] Bureau of Labor Statistics. "Table 6. Medical plans: Share of premiums paid by employer and employee, State and local government workers, National Compensation Survey, March 2008." *Employee Benefits Data Tables: State and Local Government*. March 1, 2008. http://www.bls.gov/ncs/ebs/benefits/2008/ownership/govt/table06a.pdf (accessed June 1, 2009).

[55] Lamb, Tom, administrator, Law Enforcement Health Benefits Fund, testimony to arbitration panel, Philadelphia, May 27, 2009.

[56] AFSCME DC 33 Health and Welfare Fund. *Form 990 for 7/1/2006 – 6/30/2007*. Return of Organization Exempt from Income Tax, Philadelphia: IRS, 2007.

[57] AFSCME DC 47 Health and Welfare Fund. *Form 990 for 7/1/2007 – 6/30/2008*. Return of Organization Exempt from Income Tax, Philadelphia: IRS, 2008.

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[59] Law Enforcement Health Benefits, Inc. *Form 990 7/1/2006 – 6/30/2007*. Return of Organization Exempt from Income Tax, Philadelphia: IRS, 2007.

[60] City of Philadelphia Five-Year Plan 2010-2014.

[61] Governmental Accounting Standards Board staff. "Other Postemployment Benefits: A Plain-Language Summary of GASB Statements No. 43 and No. 45."

[62] Interview with Rich Harris, Denver Employees Retirement Plan, May 14, 2009. According to Harris, "As of January 1, 2008, . . . DERP's retiree health care benefit plan was approximately 75 percent funded. The plan sponsor and employees have consistently, in the aggregate, contributed the actuarially required contribution, so it is expected that we will eventually reach full funding."

[63] From an interview with and data provided by Cathy Gleason, Budget & Research Director, City of Phoenix, and Mary Kyle, Deputy Personnel Director, City of Phoenix, May 19, 2009. Phoenix has plans in place that, over time, will altogether eliminate their post-employment health care liability.

[64] Dubow, Rob, and Michael J. Kauffman. *City of Philadelphia 2008 Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2008.* Philadelphia: City of Philadelphia, 2009, p. 105, 123. This data only reflect the OPEB for municipal workers and not the full-range of OPEB plans to which the city contributes, which includes school, utility, and judicial systems.

[65] City of Boston Summary Budget, FY2010 and Fraley. Boston faces an OPEB liability of $3.1 billion on a pre-funded basis, and $5.6 billion as a pay-as-you-go liability.

[66] Philadelphia's current system is exclusively a defined-benefit plan, in which the city assumes the obligation of providing a guaranteed level of payment upon retirement. In a hybrid pension plan, new hires would pay more and taxpayers less. City officials have said that they will create the hybrid tier as soon as state officials re-certify the entire system as "severely distressed," a designation the system last received in 2003. Recertification was pending as of mid-June.

[67] Dubow interviews.

[68] Weller, Christian; Baker, Dean, "Smoothing the Waves of Pension Funding," *The Journal of Policy Reform,* June 2005.

[69] From interviews with and documents from James McAneny, Executive Director, Pennsylvania Public Employee Retirement Commission, June 2, 2009.

GLOSSARY

(Definitions taken from Philadelphia's Quiet Crisis: The Rising Cost of Employee Benefits)

Amortization Period – The span of time set to fully pay for actuarial accrued liabilities. To adhere to generally accepted accounting principles, governments must use a period of 30 years or less to calculate their net pension or other post-employment benefits obligation and their expense on an annual basis.

Annual Required Contribution (ARC) – The amount of money that actuaries calculate the employer needs to contribute to the plan during the current year for benefits to be fully funded by the end of the amortization period. (This calculation assumes the employer will continue contributing the ARC on a consistent basis.) The ARC is made up of "normal cost" – the cost of benefits earned by employees in the current year – and an additional amount for other costs unpaid or accumulated in the past.

Assets – The amount of money that a pension fund has on hand to fund benefits. The assets (also known as plan assets) build up over time, generally from three sources: employee contributions, employer contributions and investment returns. Plan assets generally are expended to pay pension benefits when due, refund contributions of members who leave the plan before qualifying for benefits and cover the plan's administrative expenses.

Assumptions – Estimates made by actuaries about the future behavior of various economic and demographic factors that will impact the amount of pension benefits owed over time, as well as assets to cover them. These estimates of factors such as investment returns, inflation rates and retiree life spans, are used by actuaries to calculate the ARC.

Defined Benefit Plan – A plan that promises its recipients a set level of benefits, generally for life. In the case of pension benefits, it is based on a "defining" formula that usually includes the number of years served and an employee's salary multiplied by a preset figure (e.g., 30 years x $40,000 x 1.75 percent). In the case of retiree health, the promised benefit is typically the payment of a portion of (or the entire) medical insurance premium. However, it can also be based on a defined formula much like a pension. In this case, a certain monthly income is promised that must be used for health expenses.

Defined Contribution Plan – A plan to which the employer, and often the employee, contributes a defined amount (e.g., 8 percent of salary) to an individual account in the employee's name while the employee is in active service, but which does not guarantee any set benefit. The amount available for retirement is based solely on the amount of money that has been saved, along with investment income credited to the employee's account. When these funds are used up by the retiree, the benefit is exhausted.

Minimum Municipal Obligation (MMO) – Act 205, the Pennsylvania law which sets standards to qualify for state pension assistance, allows cities to use a longer (40-year) amortization period to calculate its pension payments and to reduce obligations by other amounts.

Normal Cost – The cost of benefits earned by employees in any given year.

Other Post-Employment Benefits (OPEB) – Benefits other than pensions that an employer provides to former employees as a deferred form of compensation for their services. OPEB is defined by the Governmental Accounting Standards Board as including (1) post-employment health care benefits and (2) other types of post-employment benefits—for example, life insurance— if provided separately from a pension plan.

Smoothing – To counter the natural volatility of the stock market, the vast majority of states do not measure the funded status of pension benefits using the current market values of plan assets. Instead, most determine an actuarial value of plan assets by averaging out the effects of annual increases or annual decreases in market values over several years (generally four or five). The effect of this approach is to mute the immediate impact during a severe market drop or spike in growth and to spread it out over time.

INTERVIEWS AND SOURCES

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