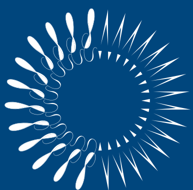
Philadelphia's Quiet Crisis:

The Rising Cost of Employee Benefits

by Katherine Barrett
and Richard Greene



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This study was commissioned
by The Pew Charitable Trusts and
the Economy League of Greater Philadelphia.

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The Economy League of Greater Philadelphia is an independent, nonpartisan, nonprofit organization dedicated to research and analysis of the region's resources and challenges with the goal of promoting sound public policy and increasing the region's prosperity.

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Foreword

Dear Reader:

A year ago, The Pew Charitable Trusts released a report written by consultant Basil Whiting entitled "Philadelphia 2007: Prospects and Challenges." In it, Whiting described a city that had made heartening progress over the last decade, contributing to a growth in civic optimism, but that still faced fundamental problems. Most of Philadelphia's liabilities were well known—high crime, high taxes, low educational achievement, a quarter of the population living in poverty. But Whiting also identified a "sleeper" issue that had received scant public attention—the soaring costs of pension and health benefits for city workers. One of Whiting's interviewees referred to these contractually mandated costs as "the Blob that will eat everything" in the city budget, restricting Philadelphia's ability to further reduce taxes and make necessary public improvements.

In keeping with Pew's overarching goal of "applying the power of knowledge" to help solve the major issues of the day, we thought it important to shine some light on this matter. Was the problem as serious as Whiting suggested? How did Philadelphia's situation compare with other major cities? What options were available to city leaders to bring "the Blob" under control?

We were pleased to partner with the Economy League of Greater Philadelphia, knowing of their strong track record of using rigorous analysis and a thoughtful approach to policy solutions to address the region's toughest challenges. Together we turned to Katherine Barrett and Richard Greene, two long-time consultants to the Pew Center on the States, who have a talent for making complex fiscal issues understandable to a lay audience. Barrett and Greene recently authored "Promises with a Price: Public Sector Retirement Benefits," which examined government pension and retiree health plans in each of the 50 states.

Supported by an able team of researchers from Econsult, a Philadelphia-based economic consulting firm, Barrett and Greene produced this report on what they called Philadelphia's "quiet crisis." Their findings are sobering. Both pension and health costs are growing at what seem to be unsupportable rates, and Philadelphia is in worse shape on these matters than most other comparable cities. There are no easy fixes here—these costs are largely mandated by contractual agreements, arbitrators' decisions or responsible fiscal practices. But the authors concluded that Philadelphia's new leadership needs to confront the rising costs of municipal benefits and find ways to slow their growth.

It is our hope that the publication of this report will increase public understanding of this serious issue and provoke discussion about ways to curb costs while honoring commitments to city workers. What kinds of benefit arrangements are just and reasonable in these times? A report of this nature cannot solve this "crisis." But it can make it a little less quiet.

Sincerely,

Donald Kimelman
Managing Director, Information and Civic Initiatives
The Pew Charitable Trusts

Dear Stakeholder in Philadelphia's Future:

The Economy League of Greater Philadelphia—an independent, nonpartisan, nonprofit organization dedicated to research and analysis of the region's resources and challenges—is pleased to support the following report, "Philadelphia's Quiet Crisis: the Rising Cost of Employee Benefits." It presents a revealing look at two issues, pension and employee benefit costs, that pose significant obstacles for the City of Philadelphia and offers recommendations to ensure that the city has the resources necessary to meet its needs today and in the future.

The Pew Charitable Trusts and the Economy League commissioned this study to understand why pension and health care costs are expected to overwhelm Philadelphia's budget in the near future, growing at a rate higher than inflation, to equal more than a quarter of spending by 2012. With its mission of promoting sound public policy and increasing the region's prosperity, the Economy League understands that addressing these issues is essential for simultaneously providing world-class municipal services and advancing a more competitive tax structure.

Based on independent and objective analysis of data from Philadelphia and nine other cities to place Philadelphia's experience in context, plus interviews with national and local experts in these areas, "Philadelphia's Quiet Crisis: the Rising Cost of Employee Benefits" provides the facts about the taxpayer dollars allocated to pension and health care costs and it identifies strategies for Philadelphia to

- improve data collection and analysis to guide future decision making;
- promote accountability and transparency; and
- reduce costs and redeploy resources to better serve the community.

Philadelphia has the potential to be a leader in the region and throughout the nation by proactively and creatively tackling employee benefit cost trends that are overwhelming large and small communities around the country. With the inauguration of a new mayor and upcoming contract negotiations between Philadelphia's management and workforce, the choices made in the coming year will affect generations of Philadelphians and the economic vitality of the entire region. "Philadelphia's Quiet Crisis: the Rising Cost of Employee Benefits" offers tactics to allow all participants in the negotiation process to work cooperatively to achieve the best outcome for Philadelphia.

The Economy League of Greater Philadelphia stands ready to support and encourage efforts to craft solutions that meet the needs of citizens and city workers. I look forward to participating in this process.

Sincerely,

Steven T. Wray
Executive Director, Economy League of Greater Philadelphia

Acknowledgements

We would like to express our appreciation to The Pew Charitable Trusts and the Economy League of Greater Philadelphia for the opportunity to explore the critical issue of employee benefits and the long-term pressures they put on the city of Philadelphia.

We would like to thank Don Kimelman and Suzanne Biemiller of Pew, and Steven Wray and Marisa Waxman of the Economy League, for their advice and assistance throughout the effort. We are also grateful to Susan Urahn, the managing director of the Pew Center on the States, for her continued guidance and for providing the time and resources for us to work on this special project. The project itself owes a debt to the Center for the ground-breaking research and data collection that took place over the last year on pensions and other post-employment benefits, leading to the state report, "Promises with a Price: Public Sector Retirement Benefits." "Philadelphia's Quiet Crisis" could not have been accomplished without this earlier work and particularly the help and assistance of the team that produced that report, including Lori Grange, Kil Huh, Ann Cloke, Alyson Freedman, and David Draine, and the advice of other staff, including Neal Johnson, Timothy Lynch, Mary Jo Waits and Michele Mariani Vaugn, as well as consultants Tim Maniccia, Eric Berman, Girard Miller, Don Boyd, and Walecia Konrad.

Of course, we are extremely grateful to the research team at Econsult for their dogged pursuit of the research and data that forms the backbone of this report. We'd especially like to acknowledge the insight and expertise of David Thornburgh and Stephen Mullin, and the research skills of Catherine Reddick and Sarina Chernock. The production of this report was greatly aided by the graphic work of John Tierno and copy editing by Colleen Gallagher.

Many individuals in Philadelphia and the greater pension community also gave substantial time and assistance to us and to the staff at Econsult over the last few months. We deeply appreciate the expertise offered by Keith Brainard, research director of the National Association of State Retirement Administrators, Elizabeth Keating and Alicia Munnell at Boston College and Olivia Mitchell of the Pension Research Council at the Wharton School at the University of Pennsylvania. Thanks also to Aon Consulting's Phil Peterson and Trion's Chris Veno who graciously reviewed the report and provided helpful feedback.

We appreciate as well the ongoing support of The Pew Charitable Trusts' Communications Department, including Deborah Hayes, Cindy Jobbins and Emily Cheramie Walz.

—Katherine Barrett and Richard Greene

Executive Summary

When Philadelphia's then mayor Ed Rendell took office in January, 1992, the city was nearly bankrupt: in September 1990, a proposed $375 million municipal bond market financing was rejected by investors. In fiscal year 1991, the city's cumulative deficit had reached more than $150 million, approximately 8 percent of general fund revenues; and the city had stopped making payments to its pension fund. Over the next year, Rendell eliminated 1,500 jobs, which equates to about one out of 14 city workers, and began to contract out many services. He also took a hard line negotiating with the city's unions, offering them a contract that would freeze pay for three years and cut benefits, including the number of paid holidays employees received.

Sixteen years later, as a new mayor, Michael A. Nutter, assumes office, Philadelphia has emerged from that crisis and currently enjoys budget surpluses. Revenue growth has held steady, despite decreases in wage and business taxes that were designed to put the city on a path to greater economic competitiveness.

Yet despite these improvements, trouble remains. Philadelphia's tax burden is still the second highest in the country behind New York City. Its poverty rate is a crippling 25 percent, and only 20 percent of its residents possess a college degree. The city budget tells the story of more and more money each year going into police and prisons as well as services to the city's most needy residents. Last year, a troubling study revealed that nearly 40 percent of students in Philadelphia's public high schools drop out. And the number of city jobs dropped by 3.4 percent between 2000 and 2007.

Moreover, even as the city's revenues have increased over the past eight years from $2.8 billion in 2001 to nearly $4 billion projected in 2009, the amount of money that the city pays into its employee pension fund, towards pension obligation bond debt repayment and for health care benefits has increased at even higher rates. In 1998, these three budget items cost $403 million, or 16 percent, of the city budget. By fiscal year 2005, they increased to $650 million or 19 percent. Unchecked, by 2012, these costs are projected to rise to 28 percent of the city's budget.

The growth in these costs has been little noticed by members of the general public, who understandably focus more on whether their garbage gets picked up, enough police are patrolling their neighborhoods and whether their recreation centers and libraries are open. Soon, however, the city will need to come to grips with the effect that the costs of these benefits have on its ability to pick up that garbage, pay for those police and buy new books for those libraries. Benefit costs will also make it far more difficult to further reduce the city's tax burden. This report, commissioned by The Pew Charitable Trusts and the Economy League of Greater Philadelphia, is meant to illuminate this "quiet crisis." What is the extent of the problem? How does Philadelphia's situation compare to other cities? And finally, what policy options exist to decrease projected costs, while remaining fair to the city's employees?

Key Findings

Pension Benefits

The following highlights are described in more detail in the report:

- The number of pension recipients is now higher than the number of active workers—33,907 claimants in 2006 versus 28,701 employees. And that disparity will only increase in the coming years as more and more city workers reach retirement age.

- The average annual city pension ranges from $29,000 for municipal employees to $42,000 for firefighters—comparable to other cities. But Philadelphia's employees contribute less of their own money into the pension fund than in other cities. Municipal workers hired in the last 20 years put in 1.85 percent of their salaries, while uniformed employees set aside 5 percent. In other cities examined, the percentages ranged from 4.0 percent to 9.1 percent, Baltimore being the notable exception.

- For many years in the 1970s and 1980s the city paid little to nothing into the pension fund, choosing instead to support current costs and allow the future liability to grow.

- These lapses in past contributions, combined with overly optimistic investment earnings assumptions, have caused the city's unfunded liability to increase to $3.9 billion, or nearly half of its $8 billion future pension obligation. This is a bigger proportionate bill than that in nearly every other city and state—of 126 large city and state funds included in the National Association of State Retirement Administrators' database, only seven had funding levels below 60 percent. (Philadelphia is not included in this database because the association's research director has been unable to get the city's financial information on a timely basis.)

- The city issued $1.25 billion in bonds in 1999 in a bold effort to sharply reduce the unfunded pension liability. But that gambit has driven annual costs even higher.

- As a result of these factors, annual pension costs are expected to rise from $252 million in 1998 to a projected $613 million in 2012, considerably outpacing the growth of the city's general fund revenues.

- Information about the city's pension fund and its investment activities is not readily available to the public. At the time this report was researched, the most recent report that breaks down the performance of various investment vehicles found on the Pension Board's Web site was dated December 31, 2004.

Health Care Benefits

- On a per capita basis, Philadelphia already had higher health care benefit costs in fiscal year 2006 than eight out of nine cities chosen for comparison (only Detroit was higher) and triple what the private sector paid in the mid-Atlantic region. Since then, arbitration awards have increased the city's costs dramatically. For fiscal year 2008, the average per capita employee benefit will be $13,030, an increase from $9,841 in 2006. Philadelphia's employee health costs are growing far faster than medical costs nationally.

- The city pays this money directly to each individual labor union, which in turn negotiates its own coverage with private health insurers. (The city also has its own plan for those employees who are not members of the four unions.) Philadelphia is unique in the fact that it does not directly control its workers' health care costs and thus cannot compel changes in coverage or fully undertake cost-saving measures put in place elsewhere. Project researchers could not locate a single other city or state where this occurs.

- Three of the city's four unions do not require their employees to make any monthly contribution for insurance coverage. Only members of DC47 (the city's white collar employees) pay a small portion of their HMO and PPO costs. By contrast, the Kaiser Family Foundation found that state and local governments on average ask employees to contribute 9 percent of the costs of single coverage and 20 percent for family coverage.

- As one might expect given the high costs per capita for health insurance coverage, city workers enjoy generous benefits, such as low co-payments for doctors' visits and minimal charges for prescription drugs.

- The budgetary impact of health insurance costs is significant—the total price tag rose 80 percent from fiscal year 2002 to fiscal year 2007 and another significant jump this fiscal year brings the total costs to $374 million or nearly 10 percent of the city's total budget.

Retiree Health Care Benefits

- Philadelphia provides health care coverage to retired employees for five years following their retirement. In doing so, it keeps its total costs much lower than in most other cities and states. But with an average retirement age of 57, Philadelphia's coverage occurs before Medicare benefits begin. Thus its costs per retiree covered are $9,150, the highest of the cities studied.

Overall Compensation

- Pension and health care benefits cannot be usefully examined without considering a city's overall employee compensation package. That total package affects a city's ability to recruit and retain good workers. Philadelphia's employees, according to the study, appear to be well compensated in comparison both to comparable cities and the private workforce. Demand for city jobs is high.

Policy Options

Confronting and containing health benefit and pension costs is far from easy, but the growing costs impose a daunting challenge for the city's future. These complex issues cry out for attention. To begin, solid policy solutions must be built upon far better information than is currently available in Philadelphia so that leaders have a clear sense of the long-term impact of their decisions.

As the following report details, the city would be well served by taking the following actions:

On Pensions

- Set a funding schedule and then stick to it, establishing a clear long-term plan that increases the ratio of assets to liabilities over time.

- Through collective bargaining agreements, increase current employee contributions to pension plans, particularly for municipal workers.

- Examine the city's investment practices to see how they stack up against comparable cities. Determine whether policies are providing optimal returns with appropriate risk given the cash flow needs of a pension system in which there are more claimants than active employees.

- Institute easily understood and timely public reporting to gauge investment manager performance and the value added by active investment practices.

- Review the structure of the board of trustees to achieve better balance in membership between people who have a personal interest in the system because they collect benefits and truly independent observers. Doing this would require a change to the city charter.

- Institute more rigorous requirements for education and training of board members.

- Establish policies for pension governance that will clearly delineate the role of board members and ensure that full, easily understandable and timely information is available to leaders, employees and citizens.

- Engage in a top-to-bottom audit of the pension system to make sure that money is not leaking out in ways that may be avoidable. Other governments, for example, have found that some individuals find ways to inflate their "final salary" to garner higher pension benefits than they would have been entitled to. Disability pensions have also been vulnerable to abuse in other cities and states.

- Explore ways in which pension costs for future employees might be reduced. This can be accomplished through hikes in the retirement age, for example, or through the development of hybrid pension plans, which contain some elements of both defined benefit and defined contribution plans and which can shift some risk to employees. Every proposal for change should have a clear estimate of long-term dollar savings attached.

- Re-examine Philadelphia's Deferred Retirement Option Plan (DROP) to make sure that it is serving the purpose for which it was intended—keeping experienced employees on the job longer—in a way that is cost-neutral for the pension system. Many questions have been raised, both nationally and locally, about the efficacy and cost of DROP.

- Make sure that every decision that impacts pension benefits—for example, the implementation of a cost of living increase—is accompanied by a rigorous study to determine the impact on long-term liabilities.

On Health Benefits

- Establish a joint labor-management project with a concrete goal of reducing the growth in health costs without compromising health care quality.

- Negotiate a change in compensation practices so that the city has more control over health spending rather than simply providing a per capita payment for each employee to his or her union. With greater control, the city (and its taxpayers) can bring about—and benefit from—management reforms that have worked to bring down costs in other cities.

- Aggressively pursue wellness programs, consolidation of health management, health claims analysis, and a variety of prescription drug practices that have helped businesses and other governmental entities bring down health costs.

- Consider cost-sharing options. A modest contribution from employees to their own health insurance premiums has become standard practice, as are employee co-pays on medical costs. Increasing co-payments and premium contributions will not be popular with employees, but can help the city defray what are now unsustainable growth rates in health costs.

On Compensation Practices Generally

- Institute regular surveys to benchmark Philadelphia's total compensation—salary and benefits—against other governments and regional employers.

- Consider policy shifts to the compensation package in light of their impact on recruitment and retention.

- Make sure that any change in any element that contributes to total compensation—whether it's salary, pension, sick days or anything else—is considered as part of a total package and not in isolation.

Background

The Quiet Crisis

Philadelphia is an aging city, with high built-in costs and escalating needs. In 2007, there were 392 homicides in the city (the highest per capita rate among the country's 10 largest cities), more than $100 million in unfunded infrastructure needs, and the city's public schools were rarely discussed in print without the appellation "underfunded." Some 35,000 jobs left the city between 2000 and 2005, and while the unemployment rate dropped from 7.6 percent during the recent recession to 6.2 percent in August 2007, it is still well above the national figure of 4.6 percent. While population declines have slowed, each year there are fewer Philadelphians than there were the year before.

As these problems grab headlines, a "sleeper" issue threatens to sap the very resources the city needs to tackle its many challenges: pensions and health care for city employees have grown so costly that, as noted in a report last year by Basil J. Whiting for The Pew Charitable Trusts, they have the potential to "crowd out necessary and desirable budgetary expenditures." These costs also make it harder for the city to keep trimming business and wage taxes to attract private-sector jobs to Philadelphia. Combined, these two budget items in 1998 took up $403.7 million, or 16 percent, of the city budget. By 2005, they had increased to $572.9 million. By 2012, their bite is projected to consume more than a billion dollars.

When it comes to health care, Philadelphia spends more per capita than most cities. In FY 2006, city government spent $9,841 per employee, considerably higher than the Bureau of Labor Statistics' $8,456 average for state and local governments—which, in turn, is about twice the average in the private sector. Arbitration awards, which the city has chosen not to appeal, increased the average cost for all Philadelphia employees to $13,030 per person in FY 2008.

With pensions, the problem is not one of generosity. The city's basic benefit formula is on par with other cities and the average annual pension ranged from $29,011 for municipal workers to $42,391 for firefighters in fiscal year 2006. (Uniformed retirees do not receive Social Security benefits for their time as city employees.) But poor decisions made decades ago have put Philadelphia way behind in funding its pensions. More recently, the decision in the late 1990s to borrow money in the bond market to defray these liabilities could not have been more poorly timed.

There is more: The city already has more claimants than active workers—33,941 retirees, survivors and disability claimants in 2007, compared with 28,701 active employees—and the number of retirees is growing more quickly than the number of active workers. The city's total pension liability was $8 billion in 2006 and its unfunded liability was $3.9 billion—$223 million worse than the year before. None of the 50 states has such a high percentage of its pension liabilities unfunded, and, of comparison cities around the country, only Pittsburgh is in worse shape. It is important to note that these liabilities are for services delivered decades ago. The city is making payments to fulfill obligations to sanitation workers who picked up garbage in 1983 and to police detectives who apprehended muggers in 1977.

The time to confront these issues is now, and it will not be easy. The city cannot just throw more money at pensions and health care without raising taxes or immediately strangling other services. But letting the problems slide on into the future means that the percentage of the city's budget devoted to pensions and health care will continue to grow, leaving less money, each year, for schools, roads or public safety. Further, with a heavy debt load—$4,912 per capita, the highest level among the nation's 20 largest cities, according to a 2006 report from Standard & Poor's—the city cannot borrow its way out.

With some 82 percent of the city's municipal workforce in unions, change is unlikely to come easily. New mayor Michael Nutter has voiced a strong commitment to put Philadelphia on a better financial footing, establish reserves, and continue incremental tax cuts to help Philadelphia compete with the suburbs and other metropolitan areas in attracting major employers. He confronts a significant test: all

four of the city's labor contracts are due to be signed by July 1, and both pensions and health care benefits are likely to be a significant part of those negotiations.

As Mayor Nutter and his administration confront the challenges before them, every resident of the city will feel the results. Success or failure will translate directly into the city's quality of life. Pension and benefit costs—mandated by legal obligations and negotiated contracts—have the potential to hamstring the new mayor in his efforts to make Philadelphia competitive. Is this outcome unavoidable, or are there fair-minded steps that can be taken to ameliorate the problems?

Research Methodology

It was with all this in mind that The Pew Charitable Trusts and the Economy League of Greater Philadelphia commissioned this in-depth look at pension and benefit costs for city workers. As a starting point, the project took advantage of many of the research findings of the Pew Center on the State's recent report, "Promises With a Price: Public Sector Retirement Benefits," which was released in mid-December and explored in depth the impact of pensions and retiree health coverage on all 50 states. It also drew on comparative databases of information on city and county pension funds, such as the Public Fund Survey, which includes 126 large pension plans in the public sector, compiled by the National Association of State Retirement Administrators; the 2006 and 2007 reports on city and county retirement systems by Wilshire Consulting; and summaries of Pennsylvania's local pensions from the Pennsylvania Public Employee Retirement Study Commission.

A key part of the research involved an effort by a team at Econsult to get behind the numbers to evaluate Philadelphia's health benefits and pension systems relative to nine cities chosen for comparison: Atlanta, Baltimore, Boston, Chicago, Denver, Detroit, Phoenix, Pittsburgh and San Francisco. The Econsult team obtained data from each city's comprehensive annual financial reports, as well as information from Philadelphia's most recent Five-Year Financial Plan, from past reports on these issues written by the Pennsylvania Intergovernmental Cooperation Authority (PICA) and a number of other resources (a complete list can be found at the end of this report). The team also interviewed a number of local and national employee benefits and municipal finance experts to gain their insights into the numbers.

(It should be noted that an effort was made to reach out to the presidents of Philadelphia's four municipal unions as well as the executive director of the city's pension system, but all declined to be interviewed for this study.)

Complicating the research team's analysis were gaps in the data as well as the many fine distinctions in how governments handle benefits. Financial reporting was sometimes tardy and reports that should have been instantly accessible to citizens on the Internet were often hard to find. On the Philadelphia Pension Board's Web site, for example, the most recent annual report is easily available, but the sole document detailing the city's pension investment results comes from December 2004. The team was able to get more recent documents, but they were not publicly posted.

Even as the research team explored the costs faced by the city, it was mindful of the importance of benefits as a component of total compensation. Benefits, no less than wages, help the city retain good people, and have traditionally been a significant factor in the competition to recruit employees. Any efforts to trim or change benefits need to be considered in light of how the city can remain competitive in its hiring.

Benefit Obligations Past, Present and Future

Back in 1999, a top Philadelphia finance official summed up the city's financial outlook for Pew's Government Performance Project, which was evaluating the management of the country's 40 largest cities: "If the economy stays healthy, we're okay. If there's a recession, we're dead."

In fact, the years immediately following were not happy ones for the city's finances. The dot.com bust, the 9-11 attacks, and the drop in the stock market led to massive budget problems for cities and states nationwide, and Philadelphia was no different. It had operating deficits between 2002 and 2004, ending that year $148 million in the red.

In the last three years, buoyed by the late-lamented housing boom and an ebullient national economy, revenues have picked up substantially. On June 30, 2007, Philadelphia had $297.9 million left in the bank—more than double the amount envisioned when the budget was approved a year prior.

But such flush days will not be around for long. The city's most recent five-year plan, which projects to 2012, envisions spending down the vast majority of that money over the next five years, assuming revenues continue growing modestly by about 3 percent a year.

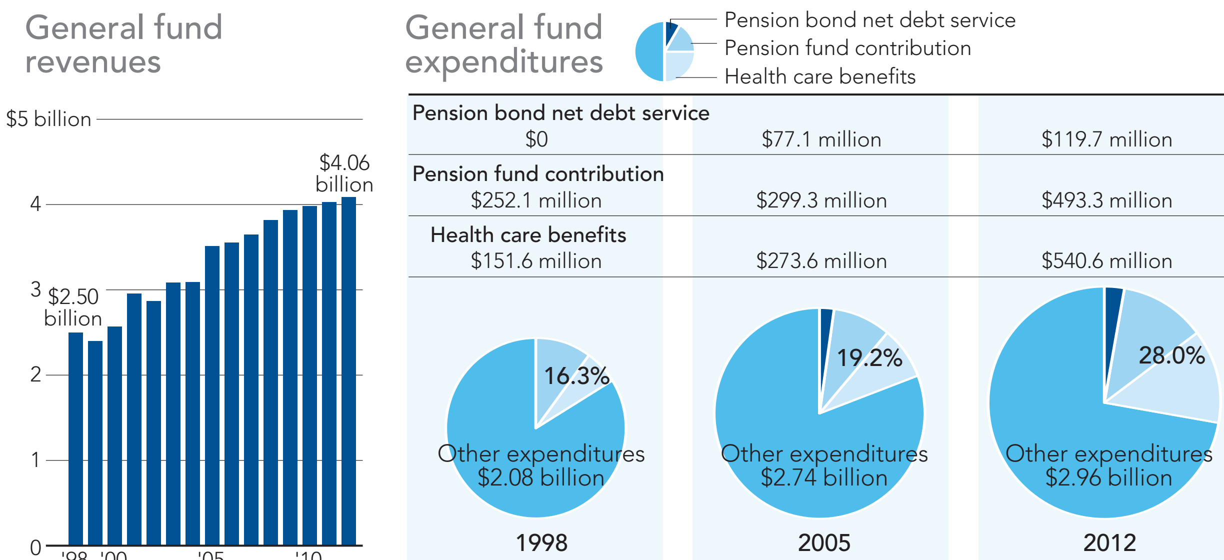
Moreover, the bond rating agencies express serious concerns about the city's finances. Moody's Investors Service, which gives the city a low Baa1 bond rating, comments that Philadelphia shows "improving, though still weak, demographic and economic trends, modest property value growth and a heavy burden of tax supported debt." Standard & Poor's, meanwhile, gives the city a BBB rating, pointing out the "very high" debt per resident necessary to pay for past projects such as the Eagles' and Phillies' stadiums. It also notes that future budgets are based, in part, on yet-unbuilt casinos, payments from the troubled Philadelphia Gas Works, and flat wages for city workers in upcoming contract negotiations.

Today, as in 1999, a great deal depends on the continued strength of the economy. For a city like Philadelphia, with its many obligations, multiple needs and very few reserves, there is little ability to roll with the economic punches. Exacerbating this problem is the fact that unfunded pension liabilities often grow when the economy suffers. The reason? All the calculations of what the city owes on its pension are based on the assumption that, as a whole, the fund will earn a bullish 8.75 percent on its investments over time. (To clarify, the pension board invests the city's funds in any number of different investment vehicles. Some will perform better than 8.75 percent while others—bonds, for example—will have lower rates of return. The objective is for the entire fund to obtain a growth rate of 8.75 percent over time.) This is a projection made by the city's actuaries. If its investments do poorly, as many did in the early years of this decade, the city must increase its own contributions to its pension fund to keep up.

Even absent weak earnings, the pressures that pension and health care benefits place on the budget as a whole should not be underestimated. Altogether, the portion of general fund revenues that go to pay investors in the city's pension bonds, health obligations and pension payments to retirees is projected to grow from $650 million in 2005 to more than $1.15 billion in 2012.[1]

TAKING A BIGGER CUT

By 2012 Philadelphia's revenue is projected to reach over $4 billion, an increase of nearly 64% since 1998. However, the amount the city is paying for health and pension costs is increasing at a faster rate, absorbing ever-larger portions of the budget.



NOTE: Data for 2008 and beyond are projected. Contribution is, historically, the actual amount contributed. Projected is the amount budgeted for "personal services - pensions".

SOURCES: City of Philadelphia Five-Year Financial Plans, Fiscal Year 2004–Fiscal Year 2008 and Fiscal Year 2008–2012, Appendix II; Philadelphia Authority for Industrial Development Pension Funding Bonds (City of Philadelphia Retirement System) Series 1999A - 1999C Official Statement, January 21, 1999, 3.

1 City of Philadelphia Five-Year Financial Plan, Fiscal Year 2008–Fiscal Year 2012 (including Fiscal Year 2007), Fiscal Health, 41.

Compensation: The Total Picture

The rule of thumb when looking at compensation paid by large cities is pretty simple: since total compensation includes a number of factors like pay, health care plans for active employees, retiree health plans, pensions and more, it would be a mistake to look at any one of these in isolation. Simple comparisons between cities that focus on just one factor can be misleading.

This is particularly true in Philadelphia, where some elements of compensation are reasonably low, while others are relatively high. Its health coverage per capita for current employees is more expensive than in many other large cities, for example. This spending is negotiated with labor representatives on a per capita basis, and then the dollars are handed over to the city's four unions to provide health coverage.

Different unions have negotiated different amounts, ranging from $10,271 per person in FY 2007 for white-collar employees represented by the American Federation of State, County and Municipal Employees, to $15,192 for the city's International Association of Fire Fighters. Thus the average for all employees was substantially higher than the national average of $9,082 for state and local governments.[2] Because Philadelphia has elected to not appeal a recent arbitration case, health costs per capita are increasing this fiscal year to $11,709 for blue- and white-collar employees, $15,636 for police officers and $17,328 for firefighters.

Philadelphia's retiree health costs, by contrast, are lower than in other cities with retired workers covered for five years. After five years, retirees are on their own. This is substantially less generous than what many cities and states pay. Current costs for retiree health benefits in Philadelphia were $43.5 million in 2006, or 1.5 percent of general fund expenditures, compared with 3.7 percent in Boston, 5.4 percent in Atlanta and a whopping 11.2 percent in Baltimore.[3]

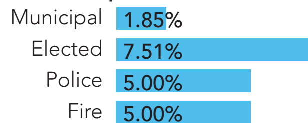
As for pensions, the average annual payments made to retirees do not appear to be unusually high: in 2006, on average, retired firefighters received $42,391; police officers were paid $34,393 and all other municipal workers earned $29,011. But the portion that employees must contribute to their pensions is

EMPLOYEE PENSION FUND CONTRIBUTIONS

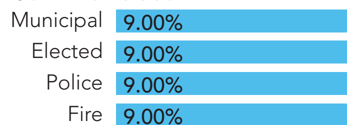
Philadelphia workers contribute less to their pension plan than do workers in comparison cities.

Employee contributions as a percentage of annual salary

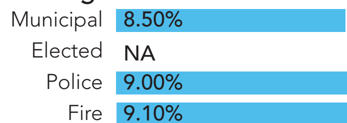
Philadelphia[1]



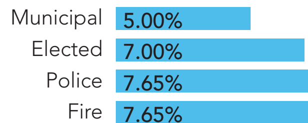
San Francisco



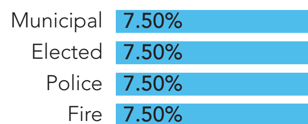
Chicago



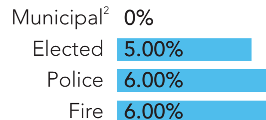
Phoenix



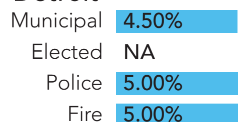
Boston



Baltimore



Detroit



SOURCES: Most recent available audited financial statements.
[1] For workers hired after 1987.
[2] Workers hired before 1979 pay 4%.

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2 Bureau of Labor Statistics, 3rd Quarter 2007, ECEC, Office of Labor Relations.

3 Funding to cover the current cost of retiree health benefits and general fund expenditure information was collected for this report from 2006 comprehensive annual financial reports in each of these cities.

relatively smaller compared to that of peer cities. Municipal workers hired after 1987 contribute 1.85 percent of their annual salaries to their pensions. Of the cities surveyed that had such information publicly available, only Baltimore was lower with employees hired after 1979 making no personal contributions. Toward the high end, Chicago employees pay 8.5 percent.

One important point: coming to any firm conclusions about Philadelphia's compensation structure is hobbled by the fact that the city itself lags in developing data in this area. Each year, Philadelphia's five-year plan contains a section on the workforce, which includes a few comparisons and benchmarks on different aspects of salaries and benefits. However, this information is inconsistent from year to year and broad-brush in nature.

A more useful approach would be to collect and present data consistently each year to create a picture of labor costs over time, including total compensation costs as well as figures for each component of compensation. To truly be an effective planning tool, the five-year plan should at the same time show the fiscal consequences of the prior year's compensation choices.

Pew's Government Performance Project has examined fiscal issues in states, cities and counties, and strongly recommends that governments regularly gather and analyze this kind of information.[4] Sally Selden, a professor of human resource management at Lynchburg College and a principal investigator for the project says: "The reason that governments in general need to be gathering this kind of information on a regular basis is to make sure that they're in line with the market in general. This is important not just for recruiting, but also for retention. With a large number of upcoming retirements in most cities and states, governments are going to have to have the means to know they're competitive at all levels of compensation. If they're not benchmarking, they run the risk of placing themselves at a significant disadvantage."

Based on the information that does exist, three significant conclusions emerge:

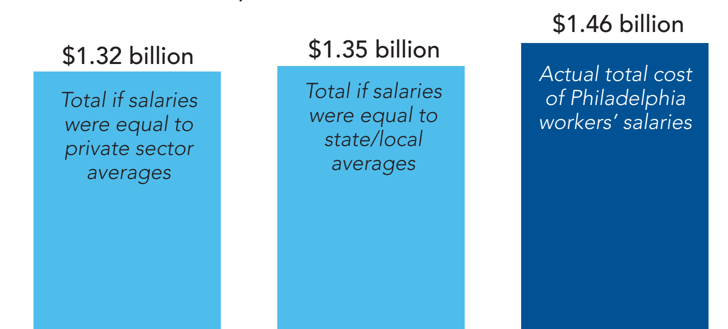
- Philadelphia workers appear to be well compensated. Judging from publicly available comparisons, city workers appear to be compensated more generously than regional private sector employees and higher than workers employed by comparable cities. According to Philadelphia's current five-year plan, "Notwithstanding the restructuring negotiated in 1992 and maintained in subsequent agreements and awards, Philadelphia's total compensation package remains highly competitive in the context of the regional marketplace."[5]

CITY WORKERS' SALARIES COMPARED

Philadelphia municipal workers salaries are about 10 percent higher than private employee averages.

Worker group	Number of employees	Average earnings	Total cost (millions)
IAFF (Fire)	2,270	$62,162	$141.1
FOP (Police)	6,851	60,795	416.5
AFSCME DC 47	3,360	55,496	186.5
AFSCME DC 33	10,000	40,424	404.2
City-administered plan	6,220	50,282	312.8
City totals	**28,701**	**50,907**	**1,461.1**
State/local averages		46,937	
Private sector averages		45,995	

Total cost of Philadelphia workers' salaries



SOURCE: The City of Philadelphia Five–Year Financial Plan, Fiscal Year 2008–Fiscal Year 2012 (Including Fiscal Year 2007), as approved July 25, 2007, 82-86, City of Philadelphia Personnel Department, PICA; comparison data is from the Bureau of Economic Analysis 2006 data released August 2007.

4 The next version of the Government Performance Project's report card on state governments will be released in March 2008 and will be available at pewcenteronthestates.org. The last city report card was released in February 2000 and is available at governing.com.

5 City of Philadelphia Five-Year Financial Plan Fiscal Year 2004–Fiscal Year 2008, 95.

- The city has little problem attracting employees. Many city positions—especially police officers, firefighters and entry-level clerks—are in high demand (in spite of the city's strict residency requirement for city workers). Philadelphia is not experiencing difficulties in attracting candidates. According to Tanya D. Smith, director of human resources for the city, some 15,000 people applied for 120 spots that recently opened in the police academy. Citywide, 25,841 job applications were received in FY 2007, out of which 11,303 took and passed the civil service test and 2,146 were hired or promoted.

- Annual employee turnover has historically been only about 2 percent, though it has jumped in recent years to 9 percent. Part of this sharp increase is due to the city's DROP program (see box on page 15), which allows workers to retire and then be rehired. But the increase is also due to a shift in how young workers generally view employment. Public and private employers around the country have observed in recent years that younger workers tend not to stay in one job as long as their predecessors. This suggests, in turn, that making pension benefits more portable—an advantage of defined contribution plans such as a 401(k) and some hybrid plans—may have an appeal for younger workers.

Philadelphia Workforce Facts

- Entry-level employees make up 58% of the city's workforce.

- 73% of entry-level jobs require only high school diplomas or less.

- 82% of the city's workforce belongs to one of four union bargaining units.

Source: Tanya D. Smith, director of Human Resources; Econsult interview, City of Philadelphia, November 19, 2007.

Pensions

The Roots of the Problem

Philadelphia's pension problems didn't suddenly arise. Today's pressures have their roots in the 1970s and early 1980s, when Philadelphia minimally funded its pension plan. Most retiree pension payments were paid from concurrent tax dollars, since little money had been saved for those costs during employees' working years.

This was no accident. It took many years of poor policy choices to get here. Leaving retiree costs for the future allowed the city to balance its budget in the short term, while sowing the seeds for poisonous fiscal fruit in the decades to come.

By the mid-1980s, it became clear that the city could no longer continue paying pension benefits out of operating income. In 1988, the Pennsylvania General Assembly passed Act 205. This law addressed pension problems statewide. It classified the severity of municipal pensions' distress, mandated that all of a city's pensions be combined into one aggregate fund, reduced some benefits, and required municipalities to develop plans to eliminate liabilities if they wished to qualify for state assistance. In 1999, Ben Hayllar, Philadelphia's former city finance director, wrote in an article for *Government Finance Review*:

> The cities of Pittsburgh and Philadelphia were the most severely distressed with liabilities of 83 percent and 95 percent respectively. Encouraging compliance with supplemental aid from state insurance taxes, the state required municipalities to develop a plan to pay off their liabilities over 40 years. Philadelphia chose a payment schedule that was low at first but would rise 5 percent each year until the liability was paid off in 2020.
>
> After almost 10 years of payments to reduce its deficits, Philadelphia's pension still had a $2.7 billion liability, representing almost 50 percent of what the fund would need to pay all benefits from investment earnings.[6]

Thus, in 1999, Philadelphia decided to raise $1.25 billion by issuing bonds, which cut the unfunded liability substantially. The city stopped short of going into debt for the whole obligation, Hayllar writes, in large part because "city officials were not convinced that the market would efficiently absorb more than $1.25 billion of taxable Philadelphia debt." But it did bring the city to a 77 percent funding level by 2000.

City leaders hoped that this pension bond issue would be the beginning of the end of the city's pension woes. This did not turn out to be the case, mostly because of unfortunate timing.[7]

Any city that sells bonds to fund a pension (going into debt to pay another debt) is counting on earning more interest by investing the bond proceeds than it pays out to bond holders. Philadelphia's bonds were issued at 6.61 percent interest, and the city gambled that it would be able to beat that percentage with its investments. But shortly after the city borrowed the money, the stock market began to tumble as the tech bubble burst. In fact, in 2001 and 2002, the pension fund had negative returns, and even as the stock market recovered, the rates of return have not kept pace with expectations. The full story of the success or failure of the bond issue, however, won't be known for some years.

Even after going into debt, the city slid further into underfunded territory over the next several years until the pension fund reached a 51.6 percent funding level in 2006, a little lower than it had been before the city borrowed money in an attempt to get on a better footing.

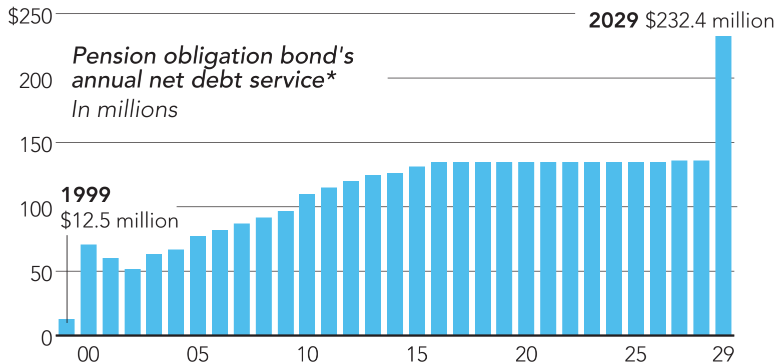
The injection of bond dollars thus did nothing to relieve the pressure to make annual contributions. Each year, actuaries calculate how much is required to pay for the benefits that current employees earn and to make up for the large unfunded liability in the past. As the funding level dropped after 2000, those requirements got bigger, escalating from $167.6 million in 2001 to $394.9 million in 2006.

6 Ben Hayllar, "Addressing Unfunded Pension Liability: Pension Bonds in the City of Philadelphia," *Government Finance Review*, December 1, 1999.

7 The choice to issue bonds to cover pension obligations is essentially a bet regarding market timing. Detroit, for example, sold bonds to fund some of its pension obligations in 2005 when interest rates were moderate and the market was entering a healthy period. Thus far, as a result, Detroit has had a much more positive experience.

THE PENSION BOND'S COST

Philadelphia's pension obligation bond will cost the city nearly $3.5 billion by the time it is paid for in 2029.



* Includes original principal amount of Series 1999B Bonds, accrued interest on the Series 1999A Bonds, capitalized interest on the Series 1999A Bonds and Series 1999C Bonds and accreted interest on the Series 1999B Bonds at maturity.

SOURCE: PIDC/PAID 1999 Official Statement, 3.

Meanwhile, Philadelphia was stuck with new debt service costs. The bond issue was structured so that the city started out owing $12 million in payments to bond holders the first year, but these payments escalated to $63 million in 2003 and $91 million in 2008, with more increases to come in future years.

How Philadelphia Stacks Up

Misery loves company, and it might be tempting for Philadelphia citizens to jump to the conclusion that many cities and states share the problems it faces in dealing with its legacy of pension problems.

But this is not the case. The U.S. Government Accountability Office recently analyzed the condition of the nation's state and local pension systems. The conclusion was relatively positive. The September 2007 study concluded that most of the largest state and local public pension plans were well funded and on track to manage future pension obligations.[8]

The National Association of State Retirement Administrators keeps a regular watch on large state and local pension plans in the United States. Its most recent summary of data found that more than three-fifths of the plans were at least 80 percent funded, the level considered healthy by most experts. Of the 126 large city and state funds included in this database, only seven had funding levels below 60 percent.[9] (Philadelphia was not included in this survey, says the association's research director, Keith Brainard, because in the past he has been unable to get financial information from the city on a timely basis.)

As the tables on page 9 show, Philadelphia's funding level is the second lowest of the cities examined in this report. Pittsburgh is in the worst shape. Five of the other nine cities achieved a desirable 85 percent funding level, and three are at 90 percent or more.

But the devil is in the details. Philadelphia's pension situation is in some ways worse than the funding ratio reveals. For example, until recently, Philadelphia assumed it would earn 9 percent from its investments, more than just about any other large city and all of the states except for New Hampshire. (Its investment assumption now stands at 8.75 percent, still relatively high.)

If its earnings assumption was closer to the 50-state median—8 percent—its unfunded liability would be even larger. If the real earnings turn out to be lower than the assumption, it means that the pension fund has fewer assets than had been estimated and higher payments are then needed to ensure future obligations are covered. This check against reality is vital. As the pension's 2006 annual report noted, Philadelphia had underestimated both the number of retirements and the lifespan of retirees. On the other hand, the assumed wage growth (5 percent) was a little higher than salary increases actually have been. And all of these assumptions—right and wrong—affect the city's current and future payment obligations.

To make this point more clearly, let's use real numbers. Because investment returns totaled 6.1 percent in fiscal year 2006, instead of 8.75 percent, the pension fund's unfunded liability grew by $112 million. Because

8 U.S. Government Accountability Office, "State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections and Fiscal Outlook for Funding Future Costs," report to the Committee on Finance, U.S. Senate, September 2007.

9 National Association of State Retirement Administrators, "Public Fund Survey Summary of Findings for FY 2006," prepared by Keith Brainard, research director, October 2007.

PENSION HEALTH SUMMARY TABLE

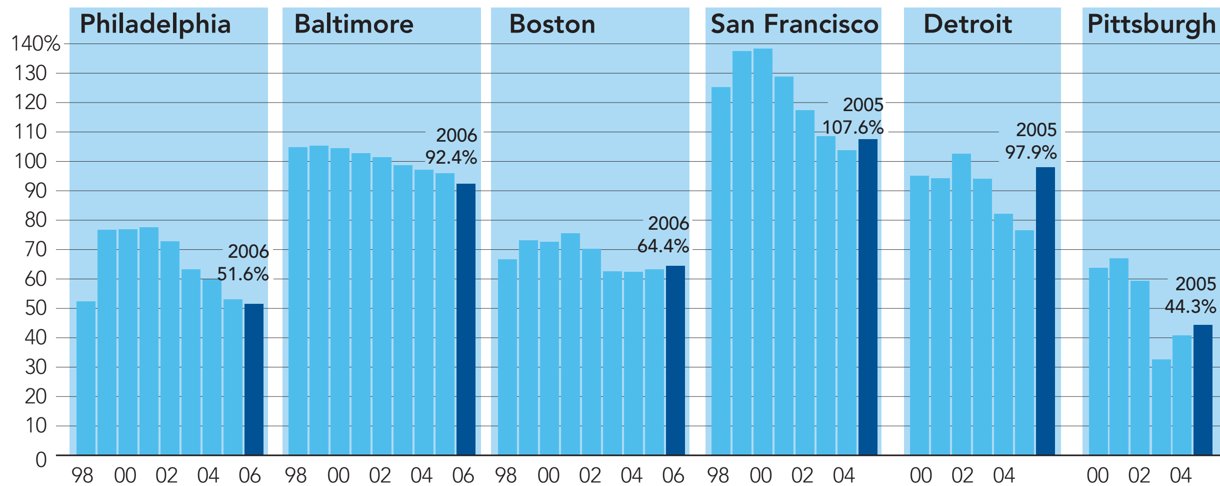
Category	Philadelphia	Atlanta	Baltimore	Boston	Chicago
% funded at end of latest available fiscal year	52%	55%	92%	64%	64%
Unfunded actuarial accrued liability (UAAL)	$3,915,200,000	$1,275,249,000	$321,425,000	$2,120,566,000	$5,197,000,000
Covered payroll	$1,319,400,000	$307,778,000	$578,409,000	$1,168,808,000	$2,056,000,000
UAAL as a % of covered payroll	297%	477%	56%	181%	253%
City population	1,448,394	486,411	631,366	590,763	2,833,321
UAAL per capita	$2,703.13	$2,621.75	$509.09	$3,589.54	$1,834.24
City personal income	$27,409,408,056	$14,007,187,149	$13,126,730,506	$16,820,193,441	$66,584,884,977
UAAL as a % of personal income	14%	9%	2%	13%	8%
% of workforce in law enforcement pensions	30%	40%	35%	n/a	n/a

Category	Denver	Detroit	Phoenix	Pittsburgh	San Francisco
% funded at end of latest available fiscal year	97%	96%	88%	44%	108%
Unfunded actuarial accrued liability (UAAL)	$47,296,000	$124,994,000	$425,368,000	$469,774,143	-$893,961,000
Covered payroll	$495,285,000	$390,594,000	n/a	$174,255,411	$2,052,862,000
UAAL as a % of covered payroll	10%	32%	59%	270%	-44%
City population	566,974	871,121	1,512,986	312,819	744,041
UAAL per capita	$83.42	$143.49	$281.14	$1,501.74	-$1,201.49
City personal income	$15,052,025,752	$11,658,439,332	$32,990,303,412	$6,418,299,966	$31,051,807,094
UAAL as a % of personal income	0%	1%	1%	7%	-3%
% of workforce in law enforcement pensions	n/a	34%	n/a	54%	16%

NOTE: Percentages are rounded.

SOURCES: Most recent available audited financial statements; U.S. Census data for city population and personal income

PENSION FUNDING LEVELS *For Philadelphia and selected cities*



SOURCE: City comprehensive annual financial reports, various years.

retiree mortality was less than assumed and the number of retirements was greater, the liability increased by $68 million. But lower than anticipated salary growth created a $7 million offset to these increases. All told, the unfunded liability increased by $173 million in 2006 because of faulty assumptions. (A smaller contribution to the fund that year caused the unfunded liability to increase by an additional $57 million for a total increase of $223 million.)

By counting on high returns on its investments, Philadelphia may be pushing to pursue a more aggressive investment strategy than is warranted. Philadelphia has a mature pension system, one in which the number of retirees exceeds the number of active workers. Some pension experts suggest cities in such circumstances should invest more conservatively and assume more modest returns. For example, in 2006, the Pension Protection Act tightened up many

pension practices in the private sector. "It said you have to pick an interest rate assumption that is related to the cash flows that you are paying. So if you are having a lot of retirees right now, you should use a lower interest rate than if people aren't going to retire for a long time," says Olivia Mitchell, the executive director of the Pension Research Council at the Wharton School of the University of Pennsylvania. "The closer everyone is to retirement, then you have a much bigger nearer-term cash flow and you should be using a lower interest rate."

The city's choices with regard to assumptions and the level of pension funding are not just bookkeeping entries. They have real-world implications for the city's finances.

In order to fully appreciate the tables used in this report, some basic principles of pension funding—drawn from the recent Pew report, "Promises with a Price"—will be helpful:[10]

- The long-term costs of retiree benefits are based on a passel of variables, the future values of which are unknown. Actuaries try to pin down these variables through the use of best or at least reasonable assumptions and a professional methodology developed to manage multiple uncertainties. If all the actuaries' projections were correct over time, if governments funded benefits earned by employees every year and no new benefits were added, then pensions and retiree health benefits would be fully funded by the end of the amortization period.

- When a state has an unfunded actuarial liability, that means that its funding has fallen below 100 percent of its future obligations. This generally occurs, because, over time, the "ifs" referenced above did not happen. To pay for their unfunded liability, governments add another set amount of money to their annual contribution to spread the unpaid costs over the amortization period, which is usually 30 years (Philadelphia has until recently used a 34-year amortization schedule, though its payments the past four years have reflected a 40-year pay-down). Generally, when funding ratios decline, employer contributions need to increase.

- Overly optimistic assumptions about earnings, benefit increases, and lapses in contributions all put greater demands on government to meet future obligations.

- Even robust economic periods have their pitfalls. This occurred in the late 1990s, when most investments earned higher than anticipated returns, which prompted some governments to declare a so-called funding holiday and skip the payments their actuaries believed were necessary. However, as the stock market declines in the early part of this decade demonstrated, bad years often follow good ones and the contribution holidays only aggravated the impact of market losses.

- In a mature pension plan that is reasonably well funded, most of the yearly growth in assets will come from earnings on money set aside over decades. In a poorly funded plan, more growth must come from direct city contributions and from the same city coffers that fund education, economic development and health care.

The Ramifications of an Underfunded Pension

Decades ago, when state and local governments first began to provide pension plans for their employees, the world was a simpler place. The ratio of retirees to active workers was quite small. As a result, money collected from the contributions of employees far outstripped the money that needed to be paid out each year in benefit costs. Pensions could be treated like any other compensation, so there seemed to be no reason to set aside cash to fund them in advance. Governments took care of these obligations on a "pay-as-you-go" basis.

But as plans mature, and the number of retirees increases, a pay-as-you go system becomes increasingly expensive. So, over time, almost all pension plans—public and private—began to set aside money to cover future expenses.

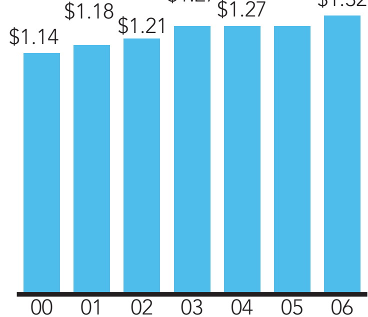
10 Pew Center on the States, Katherine Barrett and Richard Green, "Promises with a Price," 2007, 16.

NORMAL COST IS HOLDING STEADY

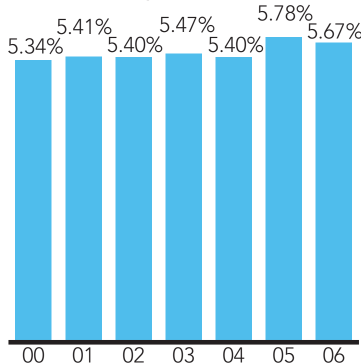
"Normal cost" is the cost of retirement benefits earned by current employees in a given year.

Covered payroll

In billions



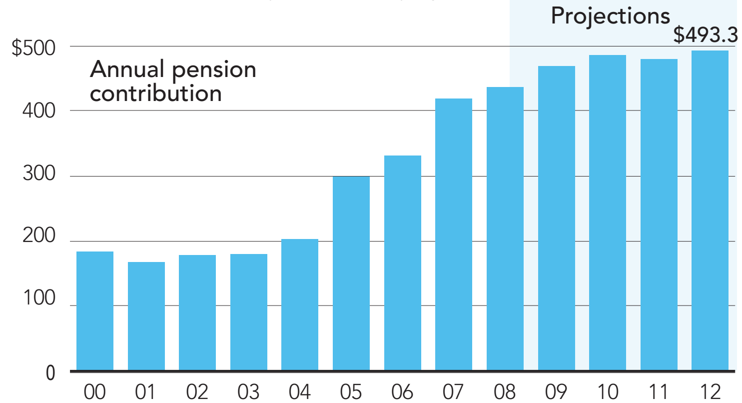
Normal cost as a percentage of covered payroll



SOURCE: City of Philadelphia Board of Pensions and Retirement Annual Report, various years.

PHILADELPHIA'S ANNUAL PENSION BILL

Philadelphia's annual required contribution to its pension fund, known as the ARC, jumped significantly in 2005, and are projected to stay at the elevated level. Since 2003, however, the city has been paying less than the ARC.



Note: Contribution is, historically, the actual amount contributed and projected, the amount budgeted for "personal services -- pensions"

SOURCE: City of Philadelphia Five-Year Financial Plan Fiscal Year 2008-2012, REVISED, Appendix III, 1, City of Philadelphia Annual Financial Report, various years.

The money to pay the benefits of current retirees generally comes from three sources: contributions from employees, contributions from employers, and returns on investments. Investment returns make up about 65 percent of an average pension fund's revenues, according to the National Association of State Retirement Administrators. (For Philadelphia, investment returns made up 54 percent in 2006.) "In a decently funded plan, the bulk of retirement benefits are financed with investment earnings rather than employee and employer contributions. If you don't seed the fund with sufficient contributions, the money never builds up to provide those investment earnings," says Keith Brainard, research director for the association.

Employees' contributions are set in advance, as a percentage of their salaries. As stated previously, Philadelphia's employee contributions range from 1.85 percent for municipal employees to 5 percent for uniformed employees for those hired in the last 20 years. For employers—in this case the city of Philadelphia using tax dollars—an annual required contribution is based on two factors: one part is the "normal cost," which pays for the benefits earned by employees in that year. Philadelphia keeps up with that portion of its payments, which have remained fairly stable, going from 5.34 as a percent of payroll in 2000 to 5.673 in 2006.

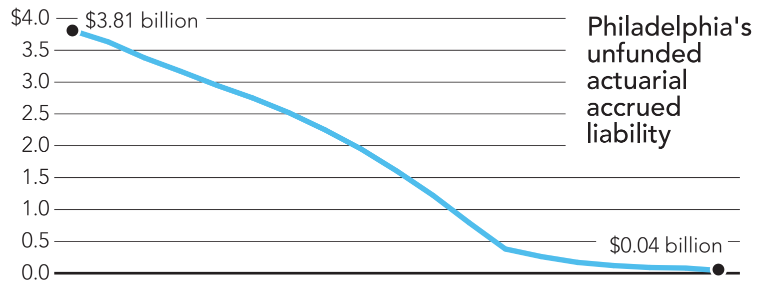
The other part of the formula adds in a sum to compensate for past lapses in contributions. This is where the city tries to atone for past administrations' fiscal decisions. Since it would be unfair to ask taxpayers to pay in a single year for many years of underfunded costs, the amount is spread over a long period. The Governmental Accounting Standards Board (GASB) has set the ideal amortization period as 30 years or fewer, though Philadelphia and a number of other entities with severely underfunded systems have chosen to use a longer period to reduce costs on a yearly basis. The sum total of the payments required to meet current and past obligations is called the "annual required contribution"—known by its acronym ARC.

Until four years ago, Philadelphia's pension funding policy used a 34-year amortization period and its ARC is still calculated as if that were the case. In 2003, however, these costs began to rise significantly—Philadelphia was reaching the hump on the camel's back, so to speak. The increases were caused not only by the investment losses incurred in the preceding years, but by the fact that more and more retirees were now entering the system, and that retirees were now living longer. Those "required payments" were projected to remain high for 11 years and then decline.

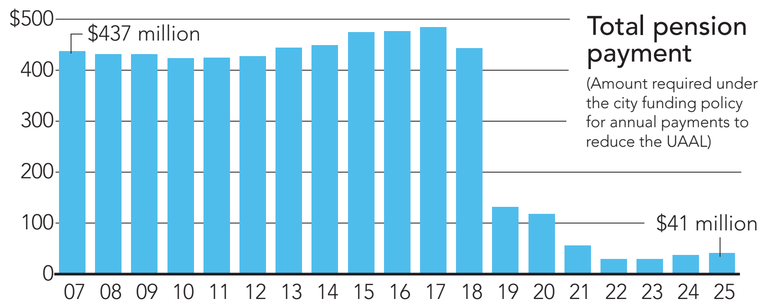
But, as a result of the large increases in the ARC, the city has opted these past four years to save dollars by instead following the funding practices laid out in Act 205, the Pennsylvania law that set standards to qualify for state pension assistance. Act 205's standards for pension funding are slightly less stringent than GASB's, allowing the city's annual "atonement" payment to be calculated using a 40-year amortization period. This amount is called the "minimum municipal obligation," or MMO, and since 2003, that's the amount that Philadelphia has chosen to pay.

GETTING OVER THE HUMP

Philadelphia can bring its pension-related debt under control ...



... as long as it can successfully make the next 10 years of high payments.



SOURCE: City of Philadelphia Board of Pensions and Retirement Annual Report, Fiscal Year Ending June 30, 2006, 21.

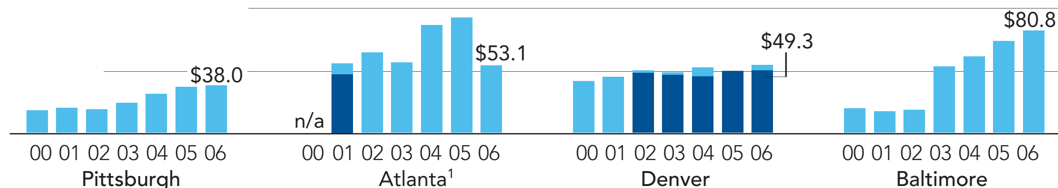
PAYING LESS ... BUT STILL PAYING MORE

Even though Philadelphia has opted for a lower pension payment that was approved by the state, its annual pension repayment is nonetheless rising rapidly. Among the comparison cities, Pittsburgh, Baltimore, Phoenix and Detroit all met their annual required contributions for the past six years but Atlanta paid less once and Denver paid a small amount less for the past five years.

Dark blue shading indicates percentage of ARC paid in years cities paid less than the ARC

Annual amount paid into pension fund
In millions.

NOTE: Detroit and Denver each "overpaid" once. Detroit paid 109% of its ARC in 2006 and Denver paid 103% in 2000.



[1] The 2006 amount for Atlanta is for six months due to an accounting change.

SOURCES: City comprehensive annual financial reports, recent and historical.

It is important to note here that decisions of whether to pay the annual required contribution are no different from a whole variety of policy choices cities face. Inevitably, when a city is faced with the question of whether it should pay its full ARC or spend the money on current needs, a collision occurs. Outside the world of government finance, few people will notice an underfunded pension plan, but a lot of citizens are aware when there aren't enough police on the streets, when fire houses are shut down or libraries and recreation centers restrict their hours. That being said, as Michael Masch, the state's budget director points out, "Philadelphia is compliant with the [funding] plan they submitted, but it's not actually going to reduce the unfunded liability. That's the minimum contribution to get state aid. It's irrelevant to what the city should be putting into the pension fund."

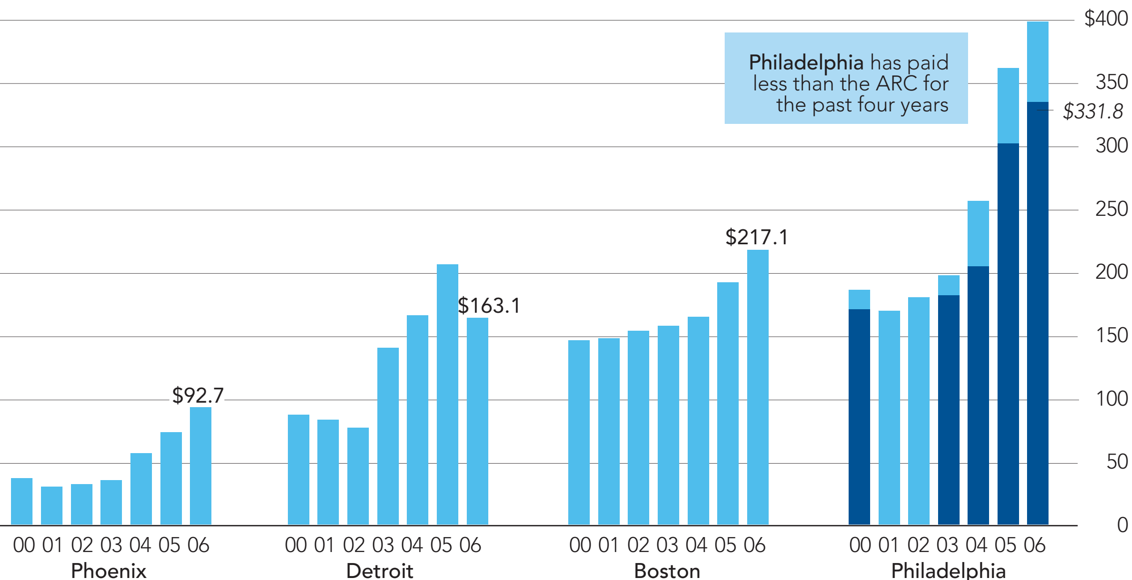
Most cities want to achieve a reasonable balance. And, to be sure, pension funding can be put off to a point. But as Brainard points out, "you can't eliminate a liability by ignoring it." When cities fail to put sufficient funds into their pension plans each year, the amount required simply grows for each year thereafter. At heart, the question is whether the near-term benefits of short-changing pensions to address other pressing needs outweighs the fact that, over the long-term, even more money will need to be paid, and will push aside other services at that point. Pension benefits are contractual obligations and must be honored.

In the worst case, the amounts required to feed the pensions can become mind numbing. Says Brainard, "It's like skipping a mortgage payment. You enjoy short-term gain but have longer-term pain." Philadelphia is already experiencing greater pain than are other cities, which have more-well-funded plans. In San Francisco, for example, the annual required contribution was 5.3 percent of general fund spending in 2006. In Philadelphia, it was 11.5 percent of the general fund.

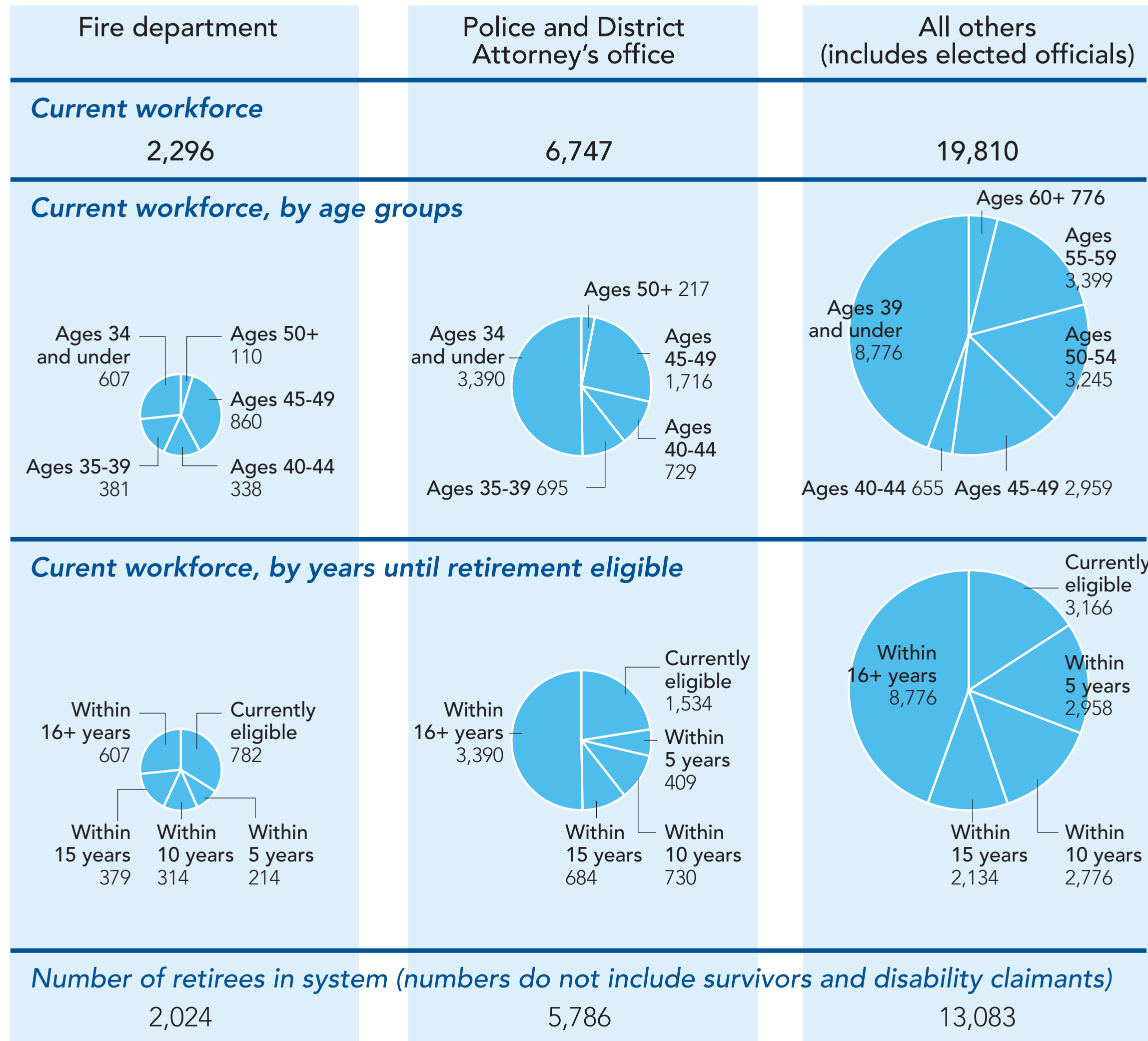
A look into the future is crucial for Philadelphia, so that the city knows clearly the consequences of delaying a fix for the pension fund. Pressing budget problems might justify simply treading water. The key is analyzing the tradeoffs. And the time to do so is now.

Consider the pressures placed by Philadelphia's demographics. With an average retirement age of 57,

- 19 percent of pension plan members are currently eligible to retire;
- 12 percent more will become eligible within five years;
- 13 percent more will become eligible within 10 years;
- 11 percent more will become eligible within 15 years; and
- 55 percent of current pension-plan members will be eligible to retire in the next 15 years.



PHILADELPHIA'S WORKFORCE



SOURCE: City of Philadelphia Personnel Department; City of Philadelphia Board of Pensions.

Though these numbers are more extreme in Philadelphia than in many other cities, they are not entirely dissimilar from much of the rest of the country. As "Promises with a Price" points out, the number of Americans over age 65 increased eleven-fold from 1900 to 1997. Steady increases have continued since then, but the growth in the elderly population will accelerate even more with the aging of the baby boom generation, with a projected increase of 80 percent between 2010 and 2030. By 2030, 71 million Americans—one of every five people—will be over 65, according to projections from the Social Security Administration. At the same time, retirees are living a lot longer. American life expectancy continues to rise, from 69.7 years in 1960 to a projected 79.2 years in 2015, according to the National Center for Health Statistics.[11]

Given the retirements that are projected, dealing with the unfunded pension liability will only get harder. As the ratio of benefit recipients to active employees worsens, more money will flow out to pay benefits, fewer dollars will come from employee contributions, and investment income will drop as more cash will need to be held in shorter-term accounts.

11 Barrett and Greene, 11-12.

DROP's Impact

Like many other governments, Philadelphia instituted a Deferred Retirement Option Plan (DROP) in 1999. The purpose was to stem the loss of experienced personnel—particularly those in uniform—at a time when greater numbers of employees were nearing retirement age.

Here's how it works: Eligible employees who decide to enter the DROP program agree to retire within four years of signing up. One must be vested in his or her pension plan to commit. DROP employees then remain on the city's payroll and can continue to take home pay increases. However, both the city and the employee stop making contributions to the pension plan, saving both parties money. While enrolled in DROP, the employee receives a pension check as if actually retired, but it is deposited into an escrow account that is guaranteed to earn at least 4.5 percent annually compounded monthly. When the employee finally retires, he or she receives those deferred pension payments as a lump sum.

The idea—to allow people to retire and be rehired—has an obvious allure for employees who continue to draw a salary while pension benefits are placed in escrow. But questions have been raised in Philadelphia and elsewhere as to how much cost they add to the pension system, particularly since high-paid senior and elected officials can participate, and whether the effort has in fact led to employees staying on the job longer.

To this latter point, the Office of the Controller in Philadelphia analyzed data in 2004, noting that before DROP, firefighters and police officers were all retiring at an average age of 53.3 years, while non-uniformed workers were staying on the job until 60.8 years. It determined that "after two years of DROP, firefighters were staying on the job a little longer, retiring at 53.9 years of age, while police officers were leaving earlier at 52.2 years of age. Non-uniformed employees were leaving their jobs almost a year-and-a-half earlier at 58.4 years of age. This is exactly the opposite of what had been intended."[12]

Moreover, DROP programs are intended to be cost neutral. One problem: when interest earned is less than guaranteed, the city must cover the losses, as it did in fiscal years 2002 and 2003 when the pension funds were -5.5 percent and -5.2 percent respectively. As the Office of the City Controller noted in 2004: "If the pension fund continues to earn less than 4.5 percent over the long term, the DROP's 4.5 percent guarantee will create a significant cost to the city in future years."[13]

12 Office of the City Controller, "2004 Mid-Year Economic and Financial Report," 86.
13 Ibid, page 88.

Health Benefits

Health Benefits: Is There a Better Way?

As health insurance has eroded in the private sector, state and local governments have begun to look like bastions of reliable coverage. Each year since 2000, the percentage of Americans who receive health coverage from their employers has dropped. The most recent figures from the Kaiser Family Foundation show only 56 percent of U.S. firms now offer health coverage to their employees.[14]

The public sector is simply different. Virtually all state and local governments offer health insurance to their workers.[15] In Philadelphia, all full-time employees receive health care benefits, unless they decline such coverage. Each of the city's four unions has its own health plan. Those who aren't represented by a union—18 percent—may enroll in a plan run directly by the city.

Few critics of Philadelphia's health care system would argue against providing health care coverage for employees. The United States faces a dramatic problem as the ranks of the uninsured grow—from 38.4 million in 2000 to 47 million in 2006.[16] Although the gap in coverage between the public and private sectors creates tension between taxpayers and government employees, many regard the public sector's approach as a model that private employers should follow.

The problem, then, for America's big cities, including Philadelphia, can be lumped under the broad rubric of "the unaffordable cost of good intentions."

"Rising healthcare costs are a detriment to every employer—public or private," San Jose city council member Pierluigi Oliverio wrote recently. The issues in the private sector are self-evident: rising prices for goods and services, lower profits, or fewer jobs. In the public sector there's a similarly alarming equation. As Oliverio cogently explained: "Higher healthcare costs equate to less city services."[17]

For Philadelphia, where city agencies have been gasping for fiscal breathing space for some years, the problem is acute. City leaders have been trying to improve economic competitiveness by lowering taxes without compromising on service delivery. This makes the inexorable rise in health insurance costs—which grew 80 percent from fiscal year 2002 to fiscal year 2007[18]—all the more difficult to deal with. Every dollar increase in health benefit spending leaves less available to solve the city's pressing problems.

While Philadelphia's issues with the cost of health care are not unique, they are extreme. With the exception of Detroit, Philadelphia's costs are higher than other major cities. At $9,841 a year per employee in fiscal year 2006, they were more than 40 percent greater than those in Phoenix, 27 percent higher than in Boston[19] and—perhaps most alarmingly—about 210 percent higher than that offered by private industry in the Mid-Atlantic region.[20] National figures show 29 percent growth in medical costs between 2001 and 2007, based on the Consumer Price Index.[21] The jump in Philadelphia to an average cost per employee of $13,030 this fiscal year seems likely to make the gap with other cities and private employers even greater.

14 Kaiser Family Foundation, "Percent of Firms Offering Coverage," statehealthfacts.org.
15 John P. Sommers, "Employer-Sponsored Health Insurance for State and Local Governments, by Census Division, 2005," Medical Expenditure Panel Survey, September 2007.
16 Elise Gould, "The Erosion of Employment-Based Coverage: More Working Families Left Uninsured," Economic Policy Institute, November 1, 2007.
17 Pierluigi Oliverio, "Walking Our Way to Lower Healthcare Costs," San Jose Inside, October 29, 2007.
18 PICA, "Health/Medical Benefits," 39.
19 Percentages are based on data provided in PICA, "Health/Medical Benefits," 5.
20 The City of Philadelphia Five-Year Plan 2008-2012, City Workforce Section, 87.
21 Bureau of Labor Statistics, 3rd Quarter 2006, ECEC, Office of Labor Relations.

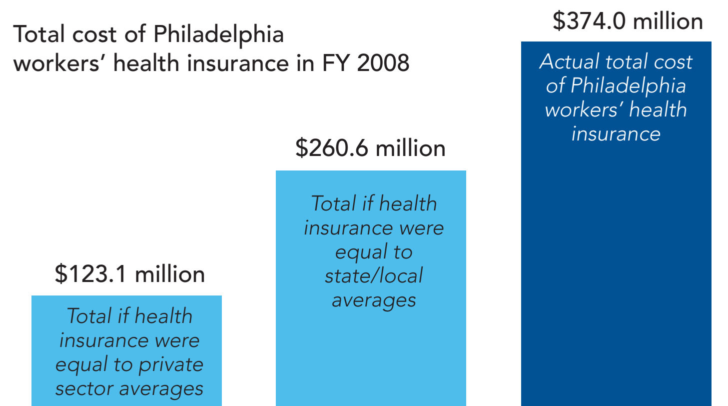
As the table below shows, if the city could bring down its health care costs to levels experienced elsewhere, the savings could be substantial. Coming down to the average cost for wages and health insurance for state and local workers would save the city $113 million. Pulling back costs to the average level in the private sector would free up nearly $251 million.

Not only are Philadelphia's numbers huge, but they continue to grow at an unsupportable clip. According to the city's 2008–2012 five-year financial plan, health care costs were projected to increase at least another 23 percent from fiscal year 2008 to 2012.[22] As a percent of the city's budget, these costs were estimated to increase from 6.5 percent in fiscal 2001 to 11.5 percent in 2011.[23]

HEALTH INSURANCE COSTS COMPARED

Philadelphia municipal workers' health benefits are costing the city about $113 million more each year than it would cost if their health benefits were in line with state/local government averages.

Worker group	Number of employees	Health insurance cost per person	Total cost (millions)
IAFF (Fire)	2,270	$17,328	$39.3
FOP (Police)	6,851	15,636	107.1
AFSCME DC 47	3,360	11,709	39.3
AFSCME DC 33	10,000	11,709	117.1
City-administered plan	6,220	11,430	71.1
City totals	**28,701**	**13,030**	**374.0**
State/local averages		9,082	
Private sector averages		4,292	



SOURCE: The City of Philadelphia Five Year Financial Plan, Fiscal Year 2008–Fiscal Year 2012 (including Fiscal Year 2007), as approved July 25, 2007, 82-86. Comparison data is from the Bureau of Economic Analysis 2007 data released September 2007.

But even those numbers were optimistic. As noted previously, arbitration awards to the police and fire unions, which the city decided not to appeal, will add to the projected growth. The awards retroactively increased payments to the police by almost 16 percent for 2006 and 10 percent for 2007, and gave the firefighters increases of 11 percent for fiscal 2006 and 14 percent for 2007 and 2008.[24]

Of course, the forces that drive health care costs do vary by region, yet we could find no recent analyses to suggest that Philadelphia was a high cost market. So, why does Philadelphia stand out from the pack? One potential answer towers above all the rest: the city funds its health care plans by negotiating a flat amount per employee with its unions, and then turns over the lump sum for the unions to administer. Result: the city is unable to compel any changes in health care coverage or fully undertake cost-saving measures that have been put in place elsewhere.

A significant difference between Philadelphia and other entities also stems from the cost-sharing asked of employees. In the private sector, employees contribute from their wages roughly 16 percent of the cost for individual health care coverage and 28 percent for family coverage. Nationally, the Kaiser Family Foundation and Health Research and Educational Trust found that state and local governments on average ask employees to contribute 9 percent of the costs of single coverage and 20 percent of family coverage.

In three of the four union plans in Philadelphia, employees pay nothing toward their premiums. Only DC 47 (white collar) workers pay a modest monthly contribution of $14.47 per individual and $40.97 per family for HMO coverage. Some co-payments are required, but across the board they are more modest than the national average, and for uniformed

22 City of Philadelphia Five-Year Financial Plan Fiscal Year 2008–Fiscal Year 2012 (including FY 2007) REVISED, 39.
23 PICA, "Health/Medical Benefits," 3.
24 Based on data from PICA, December 10, 2007.

City of Philadelphia Plans
Co-Pays

- **City Plan (Plan Year begins 1/1):**
  Primary Care Physician Office Visit: $15; Specialist: $25
  Rx: $5 generic; $15 preferred brand; $21 non-preferred
- **DC 47 (Plan Year begins 1/1):**
  Primary Care Physician Office Visit: $15; Specialist: $15 (HMO); $25 (PPO)
  Rx: $5 generic; $10 preferred brand; $15 non-preferred
- **DC 33 (Plan Year begins 12/1):**
  Primary Care Physician Office Visit: $15; Specialist: $15
  Rx: $5 generic; $10 preferred brand; $25 non-preferred
- **FOP (Plan Year begins 7/1):**
  Primary Care Physician Office Visit: $5; Specialist: $5
  Rx: $2 generic; 5% for brand & formulary up to a max of $20
- **IAFF (Plan Year begins 9/1):**
  Primary Care Physician Office Visit: $5; Specialist: $15
  Rx: $1 generic; $10 brand

Source: Public Financial Management.

workers they were only about 25 percent of the national average for office visit co-pays in 2007. (See chart above for more details.)

Further, any savings the unions achieve, they keep. In contrast, many other cities and states have actively sought to constrain costs by, for example, forcing employees to share more of the cost, implementing disease-management programs, shifting to generic drugs or more aggressively collecting pharmaceutical rebates.

While some cost containment measures may have been put in place by the city's unions, the current structure leaves Philadelphia and its taxpayers with a large bill over which it has minimal control.

Retiree Health Care Benefits

For about 50 years, many major cities have been making a very expensive promise to their employees: health care upon retirement. Increasingly, though, the question is being asked: How can cities continue to pay for these costs? This focus began to emerge back in June 2004. That was when the Governmental Accounting Standards Board (GASB)—the body that establishes accounting practices for all local governments—released a pair of new standards that mandated that public sector entities disclose the unfunded liability for these obligations.

These GASB standards finally galvanized the nation's cities and states to act. Although the reporting requirements don't kick in for large employers until they produce their 2008 financial statements, many have begun to try to figure out what they actually owe, after years of ignoring the matter.

Only a few of the cities studied for this report have come up with a figure for this unfunded liability. Philadelphia has not produced an actuarial valuation yet, but Baltimore is facing $2.9 billion in long-term liabilities, San Francisco weighs in with $4.9 billion and Boston has calculated its tab at $5.2 billion. Cities appear to be moving at a somewhat slower clip than the states in coming up with these numbers. All but six of the fifty states have now developed actuarially based estimates of their unfunded liabilities for post-retirement health care. Credit Suisse has estimated the total bill for state and local governments at $1.5 trillion.[25]

In many states and cities, health care coverage runs from the time employees retire until they die. (In general, after Medicare kicks in, the supplementary coverage provided becomes less costly.) In contrast,

RETIREE HEALTH COSTS ARE SMALL ...

The cost of Philadelphia retirees' health insurance takes a smaller percentage of city revenue than does health insurance for retirees in the peer group of cities.

City	Number of retirees	Total cost of retiree health insurance	Cost as a percentage of general fund expenditures
Baltimore[2]	19,976	$120,646,000	11.2%
Detroit[1]	22,451	$145,547,188	9.8%
San Francisco	20,798	$115,300,000	4.9%
Pittsburgh	2,900	$16,817,271	4.2%
Atlanta[1,2]	3,916	$20,578,637	4.1%
Boston[2]	12,600	$78,300,000	3.8%
Median	**9,498**	**$60,900,000**	**3.9%**
Chicago	24,400	$79,400,000	2.7%
Philadelphia	4,754	$43,500,000	**1.4%**
Phoenix	5,200	$11,681,151	1.3%
Denver	6,396	$5,264,244	0.7%

1. 2005 data.

2. Cost includes retiree life insurance.

SOURCE: City comprehensive annual financial reports, recent and historical.

... BUT COSTS PER RETIREE ARE VERY HIGH

While its overall costs are relatively low, Philadelphia spends more per retiree than all the peer cities.

City	2006 per employee cost
Philadelphia	$9,150
Pittsburgh	$9,110
Detroit[1]	$6,483
Boston[2]	$6,214
Baltimore[2]	$6,040
Median	**$5,792**
San Francisco	$5,544
Atlanta[1, 2]	$5,255
Chicago	$3,254
Phoenix	$2,246
Denver	$823

1. 2005 data.

2. Cost includes retiree life insurance.

SOURCE: City comprehensive annual financial reports, recent and historical.

25 David Zion and Amit Varshney, "You Dropped a Bomb on Me, GASB," Credit Suisse, March 22, 2007. Credit Suisse estimated the unfunded liabilities for states at $558 million (including calculations for teachers in some states). It estimated the liability for localities at $951 million to arrive at the $1.5 trillion figure.

Philadelphia provides health care benefits for only five years after retirement. This means that it is highly likely that Philadelphia's unfunded liability in this area is significantly lower than that of Baltimore, Boston or San Francisco. It is certainly lower on an annual basis. On the other hand, Philadelphia's average retirement age is 57, and the most expensive years are those before Medicare kicks in. Of the cities studied, Philadelphia had the highest retirement health care costs per retiree, at $9,150. In Baltimore and Boston, it is about two-thirds that amount.

Philadelphia obviously faces far less pressure to rein in its retiree health care bills than it does its pensions. But city leaders might think about whether they are offering retiree benefits in an optimal way: extensive coverage during the most expensive years followed by no coverage at all later.

Looking for Answers

Unfortunately, there are no magic bullets. Huge bills don't disappear without similarly huge cash payments.

That said, it is important to make the difficult choices today that will improve the city's future. There are options for taking the pressure off. None are particularly draconian. Some promise savings; others offer improved information in order to make better decisions. Some of these solutions may sound familiar: they have been advocated over the years by such observers as the Pennsylvania Intergovernmental Cooperation Authority.

Some of the following policy options would seem imperative for Mayor Nutter to implement now. Others involve trade-offs that must be carefully considered by the administration and by the public.

Pensions

Options for Decreasing the Unfunded Liability

Put aside enough money to both keep up with new liabilities and eat away at old ones on a schedule comparable to one used by most other cities. A speedier payoff of these decades-old debts would come from adhering to generally accepted accounting principles and meeting the annual required contribution each year as determined by actuaries. This would certainly save future generations from bearing an increasingly unsupportable weight. It would put more money in the bank sooner and in the long-term more of the bill would be paid from investment earnings. But the simple truth is that putting even larger sums into the city's pension plans today will increase the financial burden on the city in the short term. And that may not be practical when put into the context of other budgetary pressures and the ongoing commitment to reduce local taxes.

Pay off the pension liabilities over a longer time span. Philadelphia could simply accept the notion that it's going to take a longer time to pay down this bill. It could choose a 40-year amortization period instead of the traditional 30 or even the 34-year period that the city has used in the past. This is precisely what state law permits now, but it is a longer time period than the Governmental Accounting Standards Board recommends.

The logic behind the longer pay-off period? It would be much akin to taking a 40-year mortgage instead of a 30-year mortgage: it costs more over the long term, but it may be more affordable from year to year. If the money saved could be spent in ways that would make the city's economy more vital, it would have the added appeal of creating revenue growth that could ultimately be used to help defray pension and health care expenses.

There are two keys to success for this option: Philadelphia needs to do a great deal of analysis of the demographics of the pensioners, the expectations for coming retirements, and the impact that extending its contributions into the future will have on the system's financial health. Equally important is the assurance that, regardless of the time span, enough is put in each year to shrink the unfunded liability.

Reducing Future Costs

Adopt a hybrid of defined-benefit and defined-contribution plans for new employees. Most cities and states provide defined-benefit pension plans, in which a worker is guaranteed a specific payout over the years following retirement. Defined contribution plans—in which employers contribute a set amount but take no responsibility for the amount an employee eventually gets—have gained little traction among governments, as many employees fear the uncertainty that such an approach creates. Still, a growing number of governments offer them as an option, believing that they are attractive to younger employees, who may not be as inclined to work in a government job for as long as preceding generations did. These 401(k)-style plans, common in the private sector, offer portability of the assets to other jobs, and give employees some access to the cash before they reach retirement age.

There is a middle ground: hybrid plans that combine a traditional defined pension with a defined contribution plan. The U.S. Government Accountability Office recently reported that Oregon's adoption of a hybrid program of this type in 2003 contributed to $400 million in pension savings. Elements of these hybrids provide more flexibility to employees while limiting the city's own long-term investment risk. One type of hybrid, called a cash-balance plan, for example, guarantees employees a minimum return on some of the city's contributions to their pension (like a defined-benefit plan). The employee takes on the investment risk for the remainder (like a defined-contribution plan).

Reduce pension benefits for new employees. Many cities and states have begun offering newly hired employees slightly lesser benefits than those given to employees hired earlier. The last time Philadelphia made a change of this kind was in 1987. There are many ways in which benefits for new employees could be reduced: by changing vesting requirements, for example, or reducing the multiplier that's used in the formula to calculate pension benefits. The very high number of applicants for city jobs and the competitiveness of the current compensation system suggests that the city could make such a move without impairing its recruitment of new workers.

Raise the retirement age for new employees. The Social Security Administration is beginning to recognize the longer life span enjoyed by Americans and is slowly raising the age of retirement so that individuals born after 1967, for example, will not be eligible for Social Security until they reach age 67.

Kansas, Mississippi, North Dakota, Rhode Island and Colorado have raised their retirement ages. Studies in some states have shown substantial savings from this step.

The retirement age in Philadelphia is 50 for uniformed employees who have served at least 10 years and 60 for others with the same longevity. The personnel department reports that the average age of retirement is 57. Philadelphia could start this discussion by studying just how much it could save by raising its retirement age.

Increase the employee contribution to pensions. Philadelphia employees contribute less to their own pensions than do their counterparts in many other cities. As PICA pointed out in a December 2005 report, the city's contribution to the benefits earned every year (the normal cost) and employee contributions add up to 9.04 percent of payroll, which is far below the median of 14.02 percent for the cities it surveyed. A fair approach might be to increase these contribution levels for both employee and employer.

Any increase in employee contributions would wisely be accompanied by an analysis of the level of benefits received in Philadelphia so that it could be measured against other cities in more than an informal way. This should be part of a consistent effort to gather information on total compensation offered to city employees, and to compare it with compensation paid in comparable cities and the region, since no single element of compensation should be considered in a vacuum. Comparative pension studies often ignore the interplay between the many aspects of a pension system that go into determining the relative level of benefits.

Re-evaluate the Deferred Retirement Option Plan (DROP). Philadelphia turned to DROP to stem the loss of experienced personnel at a time when many employees are reaching retirement age. DROP programs are supposed to be cost-neutral, but concerns have been raised that the earnings the city has promised on the pension funds held in escrow may not be achievable, and the high lump payments made to some officials have certainly raised questions. Moreover, DROP does not appear to be retaining experienced workers at the levels intended.

Based on experiences in other cities and states, Philadelphia's leaders might want to ask: Is the current DROP program actuarially sound? Have its projections about its use been accurate? Is it serving the purpose that was intended?

Governance

Aggressively keep tabs on the accuracy of the assumptions the city is making. Philadelphia's 2006 annual report shows a $223 million increase in the city's unfunded liability between 2005 and 2006 and attributes it, in no small part, to the fact that the city had assumed it would get an 8.75 percent return on its investments, when they actually earned 6.1 percent overall. Assumptions on mortality and retirement rates were also incorrect, resulting in losses.

It may be tempting for the city to bring down short-term costs by clinging to assumptions that, on paper, reduce rather than increase the unfunded liability. But over the long haul, inaccurate assumptions will simply cause unwanted surprises and increase the pension burden over time.

Reconsider the city's approach to investing.

The city's investment strategy could use some serious study. Some speculate that the high rates of return the city is assuming may be putting too much pressure on the city to put money in potentially risky investments. This may be a particularly worrisome practice in a city that has many retired employees and many workers approaching retirement. Some pension experts believe that any city with a large number of current and soon-to-be retirees should probably be more conservative in its investments. Also, does the city have a sensible number of investment managers? Are the fees it pays reasonable, with active investment practices delivering the value that is expected? Does Philadelphia have adequate standards in place to monitor the performance of its investment managers? Answers to these questions proved difficult to find when writing this report—and they shouldn't be.

Consider what the city's pension philosophy is.

Historically, the idea behind pensions was that they should replace only a portion of pre-retirement income, because one's cost of living is lower in retirement. Most financial advisers suggest that Social Security plus pensions should replace 70 percent to 80 percent of one's final years of pay. Little study has been done to see what the proper total replacement ratio should be and whether employees are at or exceed that level. This kind of study would help inform any other reforms taken.

Reform the Pension Board of Trustees.

Many pension systems are reconsidering the composition of the board of trustees of their pension systems to include individuals with investment expertise and to re-balance the membership of the board so that it is not completely made up of members of the retirement system and ex officio members who serve by virtue of the office they hold within city government. (In Philadelphia, board composition is spelled out in city charter and includes the director of finance, the managing director, the city solicitor, the personnel director, the city controller and four members who are elected by the Civil Service employees of the City of Philadelphia.)

Even if no restructuring takes place, numerous experts on pension governance suggest that education and training requirements for board members should be enhanced and pension governance policies established.

Transparency and Checks on Abuse

Publicize pension fund performance.

This should include setting guidelines for assessing annual performance and regular reporting of five- and 10-year rates of return for individual funds. The success of the city's investments should be reported against industry averages in a way that is clear and understandable, and the city should take a look at methods under development elsewhere to get a good sense of the value added by active investment practices. Better public reporting of the fund's performance would subject the earnings assumptions the city makes to a high degree of public scrutiny.

Indeed, greater transparency of reporting is vital for Philadelphia's pension system. As noted, the most recent detailed investment information on the Philadelphia pension Web site is from 2004. Although cities in general tend to fall behind states in the transparency of their pension reporting, there are a number that stand out as doing a good job (Austin provides a good model for the city). It would be desirable to post the minutes of board meetings, publish reports that make pension data understandable to citizens and employees, and provide ongoing timely analysis of the pension fund's financial status and the accuracy of assumptions.

Check the pension system for leaks.

Audits around the country have found ways in which individual pension benefits may be inflated. How final salary figures are calculated is particularly problematic. Philadelphia uses a three-year average and permits the inclusion of overtime for municipal workers, which is considered a questionable practice in many states.

Similarly, are law enforcement pensions, which allow members to retire at a much lower age, reserved for individuals whose duties genuinely preclude their working past age 50? Or have these age limits expanded to include workers who may not face the same dangers or physical requirements? Is there good oversight for disability pensions?

Health Care Benefits

Seize greater control over health spending.

Right now, Philadelphia has direct control over health coverage for only about 20 percent of its workers. For the rest, negotiated agreements establish per capita payments—which far exceed public and private averages—to unions to provide coverage to their members. This arrangement, which appears to be unique to Philadelphia, constricts the city's ability to bring down costs. To say that this is an opportunity to find some future savings would be an understatement.

Short of the city wresting control of its employees' health care from union management, the city and unions should consider entering into a joint labor-management effort, an idea first suggested by PICA in an October 23, 2006, report. Some potential money-savers: wellness and other prevention programs; disease-management techniques; programs to review insurers' billings and analyze claims; higher co-pays and deductibles, and more careful bidding out of vendor contracts. A dependent eligibility audit should also be performed along with a check for other leaks. PICA suggested that a key starting point would be to put someone in charge of managing health insurance costs and to work closely with joint labor-management boards that oversee health funds.

Savings through consolidation.

Localities can save large sums when they bundle plans under a single administrative umbrella. Explains the "Promises with a Price" report, "This can have an immediate benefit because when risk is spread over a larger population, premiums tend to decline. Also, the so-called 'big pencil' approach makes it far easier to bargain effectively with health care providers. Groups of employees can potentially also lower administrative costs as investment costs and overhead decline per member." For example, Missouri has actively worked to consolidate health management among its local governments. As of February 2007, Missouri's consolidated plan claimed about 24 percent of all government workers in the state. Its medical costs grew only 1.7 percent from fiscal year 2005 to fiscal year 2006 and operating expenses grew 3.3 percent during that time.[26] Philadelphia's fragmented approach to health coverage flies in the face of a trend to consolidate management. The city should work with the unions to consolidate the numerous municipal health care plans into one managed package.

Wellness programs.

Many governments are promoting smarter choices for employees and retirees in four categories: health assessments and monitoring; health insurance incentives; healthy work environment initiatives; and physical fitness programs. Philadelphia could use similar programs to lower costs and get beneficiaries more involved in managing their care. Further, in order to maximize the return on investment related to these programs, a sound reporting structure must also be in place. Only through focused data mining will the city know what initiatives yield the greatest return.

Aggressive health care management.

About four years ago, the Massachusetts Group Insurance Commission (GIC) started the Clinical Performance Improvement Initiative, a database of more than 150 million claim lines supplied by the six health plans providing coverage to GIC members. GIC's health plans analyze the data to rank their doctors on quality and efficiency. The health plans use modest co-pay differentials as incentives to encourage members to use more efficient and effective providers.

Philadelphia could avail itself of any or all of these ideas. But unless the city is able to gain control of the way union plans are managed, its efforts will affect less than one-fifth of the workforce. Absent that control, the city might well insist at the bargaining table that these measures be implemented and that the per capita expense be lowered.

Compensation

Regularly benchmark employee compensation.

The city should regularly gather and analyze its total compensation figures to regional averages for similar jobs. In that fashion it can weigh economies in wages and benefits against its ongoing need to attract and retain a quality workforce.

Conclusion

The changes outlined above won't be easy. But Philadelphia will serve its employees and citizens well by confronting the difficult puzzle of how to reduce long-term costs before more time passes. The worst option is to ignore the problem or to put off the search for solutions. The escalation of costs for employee benefits will only become more severe over time unless it is addressed now.

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26 Barrett and Greene, 58.

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Glossary

Actuarial Accrued Liability (AAL) – The total value of pension benefits owed to current and retired employees or dependents, based on past years of service.

Amortization Period – The span of time set to fully pay for actuarial accrued liabilities. To adhere to generally accepted accounting principles (GAAP), 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. Some states, which are not in compliance with GAAP, choose longer periods for funding purposes to reduce current contributions.

Annual Required Contribution or Actuarially 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" (sometimes referred to as "service cost")—the cost of benefits earned by employees in the current year—and an additional amount that will enable the government to reduce unfunded past service costs to zero by the end of the amortization period.

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. These estimates, of factors such as investment returns, inflation rates and retiree life spans, are used by actuaries to calculate the AAL and 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 that sets standards to qualify for state pension assistance, allows cities to use a longer (40-year) amortization period to calculate its pension payments. The resulting amount is called the MMO.

Normal Cost – The cost of benefits earned by employees in any given year. (Also called "service cost.")

Other Post-Employment Benefits (OPEB) – Benefits other than pension benefits 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.

Pay-as-you-go – A method of financing pension benefits or OPEB in which the amount contributed by the employers or employees each year is approximately the amount needed to pay the benefits currently due and payable to retirees (or the premiums currently due and payable to provide for health care coverage or other non-pension benefits for retirees for the current period). Under this method, the source of financing for current benefits often is the employer's current collections.

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 use methods of determining the actuarial value of plan assets that average out the effects of increases or decreases in market values each year 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.

Unfunded Actuarial Accrued Liability (UAAL) – The difference between the actuarial accrued liability and the actuarial value of plan assets on hand. This is the unfunded obligation for past service.

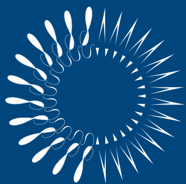
About the Authors

Katherine Barrett and Richard Greene

Katherine Barrett and Richard Greene are a writing team known nationally for their work on state and local government. They have worked with the Pew Center on the States on a variety of projects focusing on tax policy, pensions, post-employment health benefits, outsourcing and research and development funds. They also remain involved with the Government Performance Project, which they helped develop nearly 10 years ago.

In addition to their work with Pew, Barrett and Greene are correspondents and management columnists for *Governing* magazine, and founding editors of the B&G Report, a monthly e-newsletter. They are authors of *Powering Up*, a *Governing* Management Series book about information technology in the public sector, and have served on advisory panels for a number of groups, including the Governmental Accounting Standards Board and the Urban Institute.

They have won multiple journalism awards, including the Amos Tuck award from Dartmouth College, the Award for Excellence in Financial Journalism from the New York State Society of CPAs; the Children's Choice Award from the International Reading Organization; the Washington Monthly Journalism Award; the Folio Editorial Excellence Award and the Excellence in Health Care Reporting Award from the National Institute of Health Care Management.



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