Philadelphia's Quiet Crisis:

The Rising Cost of Employee Benefits

by Katherine Barrett
and Richard Greene

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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.