

# **SECTION I**

## **THE FINANCING OF FRINGE BENEFITS**



During the past decade, fringe benefits have become *the* financial issue for Milwaukee County. In 2000, fringe benefits represented a modest share of overall expenditures. By 2008, they had grown to be one of the largest items in the county's budget. Given the size of these costs and the way they are budgeted, the financing of fringe benefits will play a key role in any county organizational change.

Fringe benefits typically are defined as compensation in addition to salaries and wages. For this analysis, our discussion of fringe benefits refers exclusively to pension and health care, the costs of which constituted about 98% of the \$179 million spent by the county on fringe benefits in 2008. The county also spent about \$1.7 million for life insurance benefits and \$543,000 for employee transit passes net of employee contributions.

It is critical to understand that the county's fringe benefits expenditures are comprised of health care and pension costs both for active employees and retirees/inactive employees. Retiree fringe benefit costs often are referred to as "legacy costs," which county fiscal officials formally define as the "cost of retiree benefits Milwaukee County is legally committed to pay, but has not yet funded."<sup>1</sup> This report contains considerable discussion about these two distinct components of the fringe benefits budget and their impacts on existing county functions and potential alternative governance structures.

The county's \$179 million expenditure on fringe benefits obviously is a major cost driver in the \$1.4 billion county budget, and it is particularly noteworthy when one considers that fringe costs have nearly tripled since the beginning of this decade. In previous decades, fringe benefit costs were a part of budget building, but they were not a primary concern. In contrast, as fringe benefit costs have skyrocketed in recent years, the county has had to draw resources from other areas and cut positions and services. No part of county government remains unaffected by this insistent fiscal force.

Why have these costs risen? Will the past trend continue and, if so, how can fringe benefit costs best be controlled and managed? Such issues are now central to Milwaukee County's finances and its future. The county, of course, has been aware of this problem and, in recent years, has undertaken efforts to curtail costs. Some of these measures have been effective, while others have created further difficulties and had unforeseen consequences. In addition, two factors over which the county has no control have had a major influence upon rising costs: the price of health care has increased dramatically throughout Wisconsin and the United States; and the stock market fell precipitously from October 2007 to March 2009, causing a serious decline in the value of pension assets. In short, the factors at play in fringe benefit financing are complicated, but the issue does yield to analysis and is essential to this report.

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<sup>1</sup> Milwaukee County Department of Administrative Services, "Presentation to Long Range Strategic Plan Steering Committee," December 14, 2009.

## OVERALL GROWTH IN FRINGE BENEFITS

The two tables below show the combined rise of total pension and health care costs for Milwaukee County (for both active employees and retirees) and their relationship to overall expenditure and revenue changes in the past decade. As demonstrated in **Table 1**, fringe expenditures grew most rapidly in the first half of the decade, but the 26.5% increase from 2004 to 2008 still is substantial.

**Table 1: Milwaukee County Expenditures for Pension and Health Care, 2000 to 2008 (in millions)**

Year	Pension	Health care	Combined expenditures
2000	\$0.9	\$65.6	\$66.5
2001	\$3.3	\$72.5	\$75.8
2002	\$3.6	\$84.4	\$88.0
2003	\$18.1	\$88.7	\$106.8
2004	\$37.8	\$103.6	\$141.4
2005	\$37.5	\$124.9	\$162.4
2006	\$29.1	\$129.1	\$158.2
2007	\$51.0	\$128.0	\$179.0
2008	\$40.9	\$138.0	\$178.9
<b>2004-2008 Difference</b>	<b>\$3.1</b>	<b>\$34.4</b>	<b>\$37.5</b>
<b>2004-2008 % Change</b>	<b>8.2%</b>	<b>33.2%</b>	<b>26.5%</b>
<b>2000-2008 Difference</b>	<b>\$40.0</b>	<b>\$72.4</b>	<b>\$112.4</b>
<b>2000-2008 % Change</b>	<b>4444%</b>	<b>110%</b>	<b>169%</b>

**Table 2** compares fringe benefit expenditures with property tax revenue and salary/wage expenditures for the past decade. Given their inexorable growth, it is not surprising that fringe benefits represent an increasing share of the county's property tax levy. The eight-year rise in fringe benefits of \$112 million was more than double the increase in levy revenues of \$53 million. The need to fund health care and pension obligations was a major cause of cutbacks in personnel and flat salary and wage expenditures. As a result, fringe benefits expenditures (on both active and retired/inactive employees) grew from 25.3% of salaries and wages expenditures in 2000 to 67.7% in 2008.

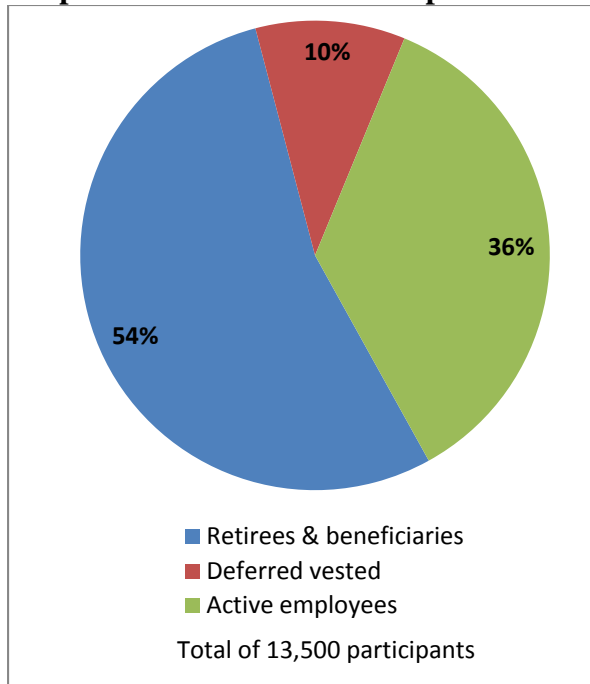
**Table 2: Combined Health and Pension Expenditures as a Percentage of Salaries and Tax Levy, 2000 to 2008 (in millions)**

Year	Health & pension expenditures	Salary funding		Tax levy funding	
		Total salary	Health & pension as % of salary	Total levy	Health & pension as % of tax levy
2000	\$66.5	\$263.2	25.3%	\$198.5	33.5%
2001	\$75.8	\$267.6	28.3%	\$209.1	36.3%
2002	\$88.0	\$267.0	33.0%	\$220.4	39.9%
2003	\$106.8	\$261.5	40.8%	\$221.3	48.3%
2004	\$141.4	\$249.6	56.7%	\$220.6	64.1%
2005	\$162.4	\$243.6	66.7%	\$228.6	71.0%
2006	\$158.2	\$248.2	63.7%	\$234.3	67.5%
2007	\$179.0	\$254.2	70.4%	\$243.1	73.6%
2008	\$178.9	\$264.1	67.7%	\$251.5	71.1%

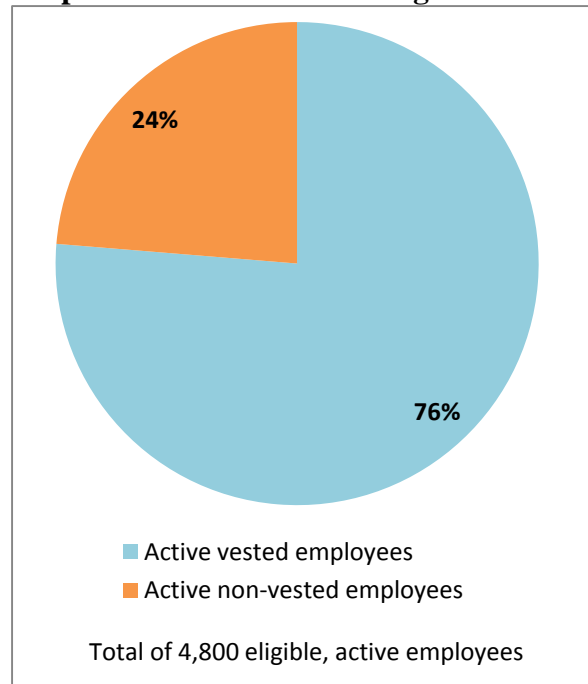
## PENSION FUNDING

Milwaukee County operates one of three public pension funds in Wisconsin. The State of Wisconsin and the City of Milwaukee operate the other two. Created in 1937 (and subject to state oversight until 1965), Milwaukee County’s Employees’ Retirement System is governed by a nine-member pension board. A “mature” fund, the number of retirees, disabled, and survivors participating in the fund (7,308 members in 2008) exceeds the number of active employee participants (4,837 members) and inactive but not-yet-retired vested members (1,397 members) combined. **Graph 1** shows the breakdown of the approximately 13,500 pension fund participants, while **Graph 2** shows the percentage of current eligible county employees who have achieved vested status, which now occurs after five years of service.

**Graph 1: Pension Fund Participants**



**Graph 2: Current Pension Eligible Workforce**



The county's \$2 billion fund is modest in size compared with major public funds. It is about half the size of the city's fund and only about 2.5% of Wisconsin's Employment Retirement System. The *Public Fund Survey*—which collects data from 125 of the nation's largest public pension funds—reports that in 2008, the average pension system participating in its survey had about \$20 billion in assets.

Milwaukee County's pension fund is known as a defined *benefit* plan, as are the funds of most local and state governments. While many private companies once had these types of plans, many have terminated them and have moved toward defined *contribution* plans for their employees' retirement needs. Under a defined benefit program, an employer legally binds and commits itself to providing current employees with specific benefits in their retirement. Under defined contribution, an employer agrees to manage employee pension savings and may provide a discretionary matching contribution. The amount an employee draws in retirement depends upon the accumulation of savings in his or her personal account. A 401(k) program is a type of defined contribution fund.

A defined benefit fund is attractive to employees since their retirement benefits are predictable and secure. Historically, local and state governments' ability to recruit high-quality employees has rested in part upon the strength of such benefits. The defined benefit approach is less advantageous to the employer, however, who must assume the financial risk.

In addition, under a defined benefit approach, the variability of investment earnings makes the employer's future fiscal position hard to predict. Pension projections require actuarial calculations based on multiple assumptions, such as the length of the average employee's working years, final average salary and years in retirement. If changes occur that do not correspond to such assumptions—such as a change in the customary age of retirement or in the rate of return of investments—the fund balance is affected. When actuarially determined assets do not meet actuarially determined liabilities, an unfunded liability is identified and the employer is expected to contribute sufficient funds to address the liability.

Each year, the county pension board's actuary produces an actuarial calculation of fund assets and liabilities that indicates the amount of the Annual Required Contribution (ARC) needed to bring the fund into balance. The ARC includes the so-called "normal cost," which is the projected growth in the present value of benefits generated by active employees in the upcoming year; as well as any payment required to address the unfunded liability. The pension board transmits the ARC to the county executive and county board, which act on this recommendation in the annual budget.

During the past decade, the county experienced a significant deterioration in the condition of its pension fund, which contributed to a precipitous increase in unfunded liabilities. As shown in **Table 3**, assets exceeded liabilities by \$171 million in 2000. However, by 2005, the tables had turned and liabilities exceeded assets by \$455 million, a net decline in fund balance of \$626 million in just five years. Put another way, the pension fund had an "overfunded" status in 2000, as the value of its assets calculated as a percentage of liabilities was 111%. By 2005, however, it had dropped to a serious level of "underfunding," with assets comprising only 76% of actuarially projected liabilities.

To address this deficiency, the county’s Annual Required Contribution jumped from less than \$1 million in 2000 to \$25.2 million in 2003, \$52.4 million in 2007, and to a budgeted \$68 million in 2010. In most years, the county appropriated the requisite funds required to meet the ARC. However, in a few years, actual county funding was lower than this amount. In 2006, for example, the county provided only 53% of the \$52.5 million required contribution. According to county ordinances, any underpayment that occurs in a given year is repaid over the next five years.

In the face of estimates that the county’s ARC would continue to rise dramatically in future years, Milwaukee County issued \$398 million in Pension Obligation Bonds (POBs) in 2009 to finance its unfunded liability. The State of Wisconsin had enacted legislation that permitted this action contingent upon the county taking certain measures to lower bond risk. As shown in **Table 3**, the actuarial calculation at the end of 2008—made after the county authorized the issuance of POBs—determined that the anticipated issuance would eliminate most of the unfunded liability. However, the fall-off in the stock market lowered the value of pension assets, and a re-calculation of fund position early in 2009 concluded that the county’s unfunded liability was back to \$400 million. That number likely has been reduced because of strong investment returns during the remainder of 2009, but it also likely remains significant.

**Table 3: Milwaukee County Pension Funds, Assets, Liabilities, and Unfunded Liabilities, 2000 to 2008 (in millions)**

Year	Actuarial value of assets	Actuarial accrued liabilities	Unfunded liabilities	Percent funded
2000	\$1,670.6	\$1,499.0	\$171.6	111.4%
2001	\$1,620.2	\$1,492.0	\$128.2	108.6%
2002	\$1,446.9	\$1,542.0	(\$95.1)	93.8%
2003	\$1,446.7	\$1,708.0	(\$261.3)	84.7%
2004	\$1,424.9	\$1,782.9	(\$358.0)	79.9%
2005	\$1,454.3	\$1,909.3	(\$455.0)	76.2%
2006	\$1,525.5	\$1,931.2	(\$405.7)	79.0%
2007	\$1,627.3	\$2,024.9	(\$397.6)	80.4%
2008*	\$1,968.5	\$2,057.4	(\$88.9)	95.7%

\* Includes projected issuance of POBs (issued March 2009 for \$397 million)

Source: Milwaukee County, Annual Pension Board Reports

It should be emphasized that the issuance of POBs does not relieve the county of a pension cost, but rather provides an alternative mechanism for financing that cost. In effect, the county has exchanged a “soft liability” funded through annual budget deliberations for a “hard liability,” a legally binding obligation to pay bond holders. The county anticipates that the difference between the bond’s interest rate and the anticipated rate of return of invested POB proceeds will generate a surplus of about \$237 million when the 2009 POB debts are paid off in 30 years, assuming that the projected return rate is realized. Another advantage is that scheduled POB debt service payments are the same each year. In contrast, the ARC has varied considerably in recent years, exacerbating the challenges faced in each annual budget. From 2002 to 2003, for example, the ARC rose by \$17 million, and from 2005 to 2006 it climbed by \$15 million.

Because a substantial unfunded liability remains, the county projects that its pension funding requirements will continue to rise. **Table 4** presents the county’s most recent projection for pension costs for 2010 and in the next five years (which do not take into account 2009 investment performance). In addition to including the normal cost and amortization of the unfunded liability, these costs also now include approximately \$33 million annually for debt service on the POBs.

**Table 4: Projected Annual Required Contribution to County Pension Fund 2010 to 2015**

Year	Amount required
2010*	\$68,284,400
2011	\$79,548,900
2012	\$88,997,500
2013	\$98,018,300
2014	\$100,284,200
2015	\$102,633,900

\* Budgeted

Why have pension costs risen so rapidly that they now threaten Milwaukee County’s fiscal health? One factor was the significant pension enhancements adopted by the county in 2000 and 2001. Those enhancements included a change in the multiplier used to calculate each retiree’s benefits (from 1.5% to 2% for most county employees). At the same time, the county also approved two new pension benefits: a lump sum “backdrop” payment that employees could opt to receive at the time of retirement that provided a lucrative additional benefit for years worked past normal retirement age in exchange for a reduction in monthly pension income; and an extra 25% boost to final average salary for county employees hired before 1982. Those changes turned out to be very expensive and contributed significantly to a rise in unfunded liability.

As the decade progressed, the county also suffered a series of investment blows that weakened the fund’s financial position. From 2001 to 2003, for the first time since the second World War, the county’s pension fund sustained three consecutive years of investment losses. Contrary to expectations, the fund earned an average rate of return of only 4% for the first nine years of the decade. Many more county retirees also took backdrop payments than anticipated, and by 2008 the county had paid out \$142 million for that benefit. Finally, fear that the benefit would be withdrawn led to a spike in retirements from 2002-2004, further weakening actuarial assets and liabilities.

The county eliminated the backdrop benefit for non-represented county employees in 2002 and for represented employees between 2005 and 2007, but the elimination only applied to new employees. The county considered nullifying all of the 2000-01 pension enhancements shortly after the pension scandal erupted in 2002, but its legal counsel opined that a pension benefit once granted constitutes a property right that government cannot take away.

By 2007, the year before the decision to issue POBs was made, the pension fund’s financial profile for the decade had taken on a different character than the state’s two other pension funds and, indeed, many other major funds nationally. As shown in **Table 5**, assets did not increase at all from 2000 to 2007, in contrast with other funds. Also, while the overall percentage rise in the

county's pension liabilities was similar to the general trend, liability increases occurred without any increase in payroll, normally a significant factor contributing to liability growth.

**Table 5: Changes in Pension Assets and Liabilities, and Payroll Milwaukee County, State of Wisconsin, and City of Milwaukee, 2000 to 2007\***

Year	Change in actuarial value of assets	Change in actuarial accrued liabilities	Change in unfunded liabilities	Change in payroll
<i>Milwaukee County</i>				
Difference	(\$43.3)	\$525.9	(\$569.2)	(\$10.8)
% Change	-2.6%	35.1%		-4.5%
<i>City of Milwaukee</i>				
Difference	\$990.0	\$970.0	\$20.0	\$73.1
% Change	23.6%	32.5%		15.9%
<i>State of Wisconsin</i>				
Difference	\$27,967.3	\$26,086.1	\$1,881.0	\$2,398.0
% Change	54.0%	48.3%		25.7%
<i>Public Fund Survey**</i>				
Difference	\$459	\$870	(\$411)	n/a
% Change	23.0%	43.9%		n/a

\* Dollars in millions except for Public Fund Survey, which are in billions

\*\* Survey of 125 major public pension funds; 2000 data not available, change is from 2001 to 2007

In light of the mounting problems facing the county's pension fund, a logical question is whether the pension benefits afforded county employees are competitive with other governments. **Table 6** compares 2008 Milwaukee County pension benefits with those of the State of Wisconsin and the City of Milwaukee for full-time, union-represented general government employees. This group constitutes about half the county's current workforce (or two-thirds when part-time employees are not included). A complete comparison of all employee groups would require separate study given the number of bargaining units and pension classifications. Nevertheless, this comparison is useful in part because the benefits offered to general employees are similar in broad respects to benefits provided most other groups, with the exception of protective services.

As **Table 6** shows, some county pension benefits, such as the pension multiplier (2%) and minimum retirement age (60 years), mirror the city's and are more generous than the state's. The county also permits a larger maximum retirement payment (80% of final average earnings) than the city or state (70% of final average earnings), and unlike the city, has no employee pension contribution. A study by the county's audit department in 2005 comparing the county's pension and health care benefits with public plans in Wisconsin and across the United States found the county benefits were "on the high end of the market" in regard to the pension plan's formula multiplier and minimum age of retirement. The report also found major components of the county's health care plan, such as employee premiums, deductibles and co-pays, were comparable to other public plans, although, as explained below, the county pays the entire health insurance monthly premium of most retirees, a costly benefit rescinded in 1994 for new hires.

**Table 6: Retirement Benefits Comparison of Milwaukee County, State of Wisconsin, and City of Milwaukee General Represented Employees Participating in Major Retirement Systems**

Characteristics	Milwaukee County	State of Wisconsin	City of Milwaukee
<b>Type of benefit</b>	Defined benefit based on employee's average earnings in final three consecutive years, years of service, and a formula factor	Defined benefit based on employee's average earnings in highest three years, years of service, formula multipliers and age at retirement. Money purchase paid if benefit based on contributions and investment earnings exceed formula benefit	Defined benefit based on employee's average earnings in three highest paid years, years of service, and formula factor
<b>Normal retirement age</b>	60 years of age (or when service + age = 75 if hired before 1/1/94)*	65 or 57 with 30 years of service	60 years of age or 55 with 30 years of service
<b>Minimum retirement age</b>	55 (with 15 yrs of service)	55	55 (w/15 years of service)
<b>Employee contribution</b>	Non-contributory	Employer contributes employee share	Employer contributes employee share except employees hired after 1/1/2000 pay 1.6% for first 8 years of service and employees hired after 1/1/2010 pay full employee share
<b>Vesting Period</b>	5 years	Immediate in most cases	4 years
<b>Benefit formula multiplier</b>	2%*	1.765% for pre-2000 service 1.6% for post-1999 service	2%
<b>Benefit limitation</b>	80% of final average earnings	70% of final average earnings	70% of average salary
<b>DROP benefit</b>	Option of lump-sum payment for a portion of pension payout, with reduced monthly payment thereafter, if hired before 2/1/07	None	None
<b>Yearly post-retirement increases</b>	2%	Depends on investment earnings (no guarantee)	1.5% after 12 months and after the 2 <sup>nd</sup> , 3 <sup>rd</sup> , & 4 <sup>th</sup> years, and 2% thereafter
<b>Paid health insurance premiums**</b>	If hired before 1/1/94 + w/15 yrs of service	No	Pre-Medicare retirees (at 55 yrs. w/30 yrs. of service or 60 yrs. w/15 yrs. of service) have no charge for HMO & pay \$30-\$60/month for the Basic plan (a type of PPO)

\* In December 2009, the county adopted a change for non-represented workers (except elected officials) that extends the normal retirement age from 60 to 64 for new employees and reduces the multiplier from 2% to 1.6% for new employees and future years of service for existing employees. Those changes have not yet been negotiated for represented employees.

\*\* County employees hired after 1993 and state employees can apply the value of unused sick leave at time of retirement toward health insurance premiums.

## HEALTH CARE FUNDING

Health care is Milwaukee County's most costly fringe benefit, with actual expenditures of \$138 million in 2008, nearly three times pension expenditures. In the early years of this decade, as shown earlier in **Table 1**, the county saw significant annual increases in health care expenditures, including increases of 16% in 2004 and 21% in 2005. In recent years, this cost trajectory has moderated due to a number of cost saving measures, some one-time in nature. To its credit, the county achieved cost control despite the fact that regional health care charges climbed 9% to 11% in recent years.

The county currently offers two health care options for its employees and retirees: an HMO-type plan that has no deductibles and limited out-of-pocket costs but requires members to use a specific network of providers; and a Preferred Provider Option (PPO) plan that features comprehensive benefits with deductibles and co-pays at both in- and out-of-network providers. **Table 7** shows monthly and annual premium costs for the two plans, including the shares paid by employees and the county.

**Table 7: Employee and County Shares of Health Insurance Premiums in 2009**

	Employee monthly	Employee annual	County monthly	County annual	Total monthly	Total annual
<b>Active HMO comparable plan:</b>						
Single	\$35	\$420	\$485	\$5,824	\$520	\$6,244
Family	\$70	\$840	\$1,387	\$16,642	\$1,457	\$17,482
<b>Active PPO comparable plan:</b>						
Single	\$75	\$900	\$905	\$10,866	\$980	\$11,766
Family	\$150	\$1,800	\$1,476	\$17,713	\$1,626	\$19,513

Milwaukee County's health care costs are driven by a variety of factors, including the per-employee premium rate, health care utilization, plan provisions (such as deductibles and co-pays) and administrative costs. From 2006 to 2009, the county made a number of management changes that reduced the rate of cost increases. The county achieved the greatest savings, amounting to more than \$20 million, by shifting from a fully-insured to a self-insured health insurance model for the PPO and HMO plans. Other savings resulted from changes in labor agreements, negotiation of deeper discounts with health care and pharmacy providers, and creation of a new Division of Employee Benefits to devote additional staff resources to controlling health care costs. In January 2009, the county signed a contract with a new third-party administrator that is expected to yield significant annual savings. In December 2009, the county credited its new administrator for keeping health care expenditures about \$8 million below budgeted levels.

The health insurance premiums paid by county employees are roughly similar to those paid by the city and higher than those paid by state employees, with the employer in each case picking up the lion's share of the total insurance charge. County employees currently pay \$35 to \$75 per month toward individual insurance premiums and \$70 to \$150 per month for family premiums. City employees pay from \$20 to \$75 for individual premiums and \$40 to \$150 for family premiums. More than 98% of state employees pay an individual rate of \$31 or a family rate of \$78.

Across the United States, public and private employers vary widely in their required employee health insurance contributions. According to the Employer Health Benefits 2008 Summary of Findings from The Kaiser Family Foundation and Health Research and Educational Trust, the average monthly insurance payment made by public and private employees last year was \$60 for single and \$280 for family coverage.

A striking portion of the county's budgeted health care cost is for retired employees. The county recently estimated, for example, that 49% of its actual health care expenditures in 2009 were attributed to retirees. According to the county's Employee Benefits Division, of the 10,318 subscribers to county health care plans, 5,996 (58%) are retirees. If dependents are included, 9,121 (46%) of the total 19,666 county health care recipients are retirees or their family members.

The significant proportion of retiree expenditures is due to several factors in addition to the sheer number of retired plan participants, including the following:

- All workers who began employment before 1994 and have accumulated 15 years of service receive fully-paid health insurance premiums for themselves, their spouses and eligible dependents during retirement. Hence, the cost to the county of insuring those individuals is not offset with any corresponding revenue other than co-payments and deductibles. While the county ended this free health care benefit for new employees 15 years ago, most retirees were hired before that date. In addition, the audit department reports that as of the end of 2008, 2,054 active county employees were eligible for this benefit.
- The mix of retirees in the county's PPO plan versus its less expensive HMO plan is almost the reverse of the mix for active employees. Of the 5,996 retired county health care subscribers, 4,272 (71%) subscribe to the PPO plan. Conversely, of the 4,322 active subscribers, only 815 (19%) subscribe to the PPO. This dynamic is attributable both to the fact that the significantly lower premium contributions for the HMO hold no attraction to retirees, who do not have premium contributions; and the fact that many retirees wish to retain the ability to utilize out-of-network providers, even if those providers cost more. Until the county switched to a nationwide HMO network a few years ago, another factor was that those retirees who lived outside of Milwaukee County did not have access to the HMO network.
- The biggest problem for the county from a fiscal perspective is insuring the subset of "early retirees" who retire prior to reaching the age of Medicare eligibility. When such a retiree becomes eligible for Medicare, the county provides a less expensive supplemental insurance plan that essentially pays the difference between Medicare coverage and the cost of services provided under the county plan. Up until that time, the county pays the entire health care premium cost for a large population of individuals who are predominantly enrolled in its more expensive health care option. Of the 5,996 retired health care subscribers, 2,091 (35%) fall into this "early retiree" category.

The county will be paying the cost of this retirement benefit for many decades. An actuarial analysis conducted on behalf of the county by Cambridge Associates indicates costs will not reach their peak for about another 15 years, growing over this period by two to four million dollars per year. **Table 8** provides Cambridge Associates’ estimate for retiree health care costs for the next five years. Cambridge projects these payments will gradually begin to decline in the 2020s and end in about 2065.

**Table 8: Projected Health Care Costs For Retirees, 2011 to 2015**

Year	Health care costs
2011	\$91,956,800
2012	\$95,310,700
2013	\$98,318,500
2014	\$101,105,600
2015	\$103,691,200

*Source: Cambridge Advisory Group, 2009*

The explanation for the long life of these costs lies in demographics. An employee who joined the county in 1992, works for 30 years, and then draws retirement for another 30 years, will continue to receive this benefit until 2053. This dynamic also speaks to the early age of retirement of county employees, many of whom have taken advantage of the “Rule of 75” (allowing for retirement when combined age and years of service equal 75) to retire in their late 40s or early 50s. While the Rule of 75 was phased out during the 1990s and earlier this decade, the department of audit estimates that more than 2,300 active employees still qualify for this provision.

Retiree health insurance is a so-called Other Post-Employment Benefit (OPEB) that the county budgets on a pay-as-you-go basis. Unlike its pension liability, there is no obligation for the county to fund annually any portion of the actuarially projected OPEB liability (except the small portion attributed to enterprise fund departments). In 2004, the Governmental Accounting Standards Board (GASB), concerned that many state and local governments were failing to set aside funding for future OPEB liabilities, issued GASB Rule #45, requiring governments to include in their financial statement “the total amount that will be owed to all employees when they retire.” The purpose of GASB #45 is to shine a light on this serious problem and stimulate local governments to address their unfunded retiree health care costs.

Since issuance of GASB #45, Milwaukee County has contracted for two independent analyses of its unfunded OPEB liability. The Cambridge Advisory Group conducted an actuarial evaluation in June 2009 that calculated unfunded OPEB liabilities at \$1.5 billion. In a 2006 analysis, the firm had estimated this amount at \$1.3 billion. Cambridge determined that the county would need to allocate an additional \$54 million per year – above the annual amount spent on a pay-as-you-go basis – for 30 years to pay off this unfunded liability. A 2008 Wisconsin Policy Research Institute report found that Milwaukee County has the second largest unfunded health care liability of local governments in southeastern Wisconsin—behind the Milwaukee Public Schools at \$2.2 billion and ahead of the City of Milwaukee at \$806 million.

Most local and state governments address their unfunded OPEB costs in one of three ways: eliminate or reduce the benefit; issue a variation of pension obligation bonds to fund the liability; or continue to pay only the costs incurred in a particular budget year.

In 2003, the State of Wisconsin issued \$600 million in bonds for unfunded retiree health care costs (unrelated to health insurance premiums), becoming the first state to bond for this purpose. Milwaukee County could seek to reduce the amount and duration of its OPEB costs by issuing bonds as well. However, the debt service payments would exceed \$50 million annually and would continue for 30 years. The alternative is to continue pay-as-you-go for the life span of the retirees. This practice spreads county costs but maintains the funding of a defunct benefit for a very long period of time.

With regard to the question of eliminating or reducing the benefit, county attorneys previously have opined that because the free health insurance benefit is contained in the section of the county ordinances that stipulates pension benefits, this benefit similarly is considered a “property right” for those who already are receiving it and therefore cannot be legally changed. According to a 2006 article in the *Milwaukee Journal Sentinel*, county officials did consider attempting to eliminate the benefit for future retirees, but feared another huge spike in retirements and certain litigation.<sup>2</sup>

The county does have the ability to attempt to reduce retiree health care costs by providing a lower level of health care benefit (such as increasing co-payments or deductibles or providing more limited coverage). The legal opinion of county attorneys in that case, however, is that retirees must have access to the same health care plans and coverage as active employees. Consequently, any such changes would need to similarly apply to represented workers and would need to be negotiated as part of collective bargaining.

Finally, the county could attempt to make changes to its health care offerings and co-payment and deductible structure that would make the HMO option more attractive to pre-Medicare retirees. These options are somewhat limited in light of the fact that adjustments to premium contributions are not possible, and any such changes would have to apply to active employees and be negotiated with county labor unions. Still, the county has been discussing options with its unions that may result in less discrepancy between the number of retirees and active employees subscribing to the less expensive HMO plan.

Overall, one of the county’s major success stories in recent years has been its ability to control health care expenditures. This success has resulted largely from its decision to retain expert consultants and hire employee benefits professionals to better manage its health care program. The more troublesome news, however, is that the county’s ability to control costs by overhauling the structure of its health care operations – as opposed to modifying its health care benefits – has been largely exhausted. Consequently, county expenditures likely will approximate the future rate of health care cost increases in the region barring significant changes in plan design. In light of the \$138 million health care budget, that could mean annual increases of at least \$10 million to \$15 million annually for the foreseeable future.

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<sup>2</sup> Avrum D. Lank and Dave Umhoefer, “Retiree Benefits Drain Finance,” *Milwaukee Journal Sentinel*, May 7, 2006.

## BUDGETING FRINGE BENEFITS

Milwaukee County's procedures for budgeting fringe benefit expenditures at the departmental level have substantially impacted the overall operating condition of the county. Customarily, fringe benefits are included in a department's budget. The reason for this practice is that department managers should have responsibility and accountability for their full administrative costs. Indeed, it is difficult to properly manage a department's finances without such control. If fringes are not part of a department's budget, a department administrator might not set user fees that adequately support some costs of operations. Or, he or she might be unable to properly advise elected officials about the fiscal effects of proposed program and personnel changes.

This textbook approach to budgeting fringe benefits assumes that fringe costs are part of program operations. How should fringe benefits be budgeted, however, when they are not related to this purpose but are benefits guaranteed to retirees? The question is not theoretical. The county's controller estimated in mid-2009 that Milwaukee County's total fringe benefit costs in that year would total \$178 million, with \$76 million of that amount attributed to unfunded obligations to retirees.

The county's response to this question has been to choose to allocate *all* fringe benefit costs to departments, including legacy costs related to those no longer working for county government. The allocation is based on a formula that assigns each department a flat fringe amount for each of its full-time-equivalent employees (FTEs).

Because of differences in the composition of departmental revenues, fringe benefit financing impacts some departments differently than others. Departments supported by fees and contracts are favored since their budgetary revenues are more easily raised in accordance with rising costs, or because they have a smaller proportion of personnel costs to other costs. In contrast, departments supported primarily by property taxes and with a high proportion of FTEs have a more difficult time. Many property tax levy-supported units have cut back on programs and personnel to a substantial degree in order to finance their active and legacy fringe costs. As these fiscal pressures continue from year to year, they shape the overall structure and composition of Milwaukee County government itself.

The original idea behind the fringe methodology undoubtedly was to encourage departments to undertake program efficiencies and propose new sources of revenue as a way of addressing the county's escalating pension and health care costs. Department heads arguably are best placed to identify cost efficiencies and to develop alternative revenue sources that might sustain rapidly increasing expenditures. It also could be argued, however, that the level of expenditures on fringe benefits soon went beyond what program efficiencies or fee increases might sustainably support.

The Forum's March 2009 evaluation of Milwaukee County's fiscal condition demonstrated how fringe benefits had grown and affected departmental budgets over a five-year period from 2003 to 2007. In **Table 9**, this information is updated for select departments. As shown, all units have experienced increases in their fringe costs over this seven-year span. Fringe costs vary among the departments because of differences in personnel. Some departments, such as the county

parks, employ seasonal workers who receive lesser fringe benefits, and other departments have a greater share of non-personnel expenditures, such as contract costs.

**Table 9: Fringe Benefits as a Proportion of Total Expenditures, 2003 to 2009**

Department	2003		2009*	
	Fringe benefits	Fringe %	Fringe benefits	Fringe %
County Board	\$1,172,500	24.8%	\$2,196,800	33.1%
Procurement	\$192,900	23.7%	\$259,600	29.1%
County Ex--General Office	\$272,900	28.3%	\$400,400	29.6%
Corporation Counsel	\$618,300	38.6%	\$937,700	50.7%
Human Resources	\$1,078,200	25.1%	\$1,149,900	38.0%
Fiscal Affairs	\$984,100	30.2%	\$1,816,900	43.7%
Combined Court Related Operations	\$5,608,200	15.1%	\$10,367,000	20.3%
County Treasurer	\$146,900	12.0%	\$299,200	19.3%
Register of Deeds	\$783,900	18.9%	\$1,444,400	33.8%
Sheriff**	\$28,036,200	25.5%	\$33,430,700	35.9%
District Attorney	\$3,068,800	23.1%	\$5,694,100	27.7%
Department of Human Services	\$12,688,700	7.9%	\$25,434,400	12.8%
Department of Parks	\$5,997,500	14.9%	\$9,630,800	22.0%
Zoo	\$2,073,000	11.1%	\$4,366,300	18.3%
Behavioral Health	\$15,795,100	11.5%	\$28,440,500	16.6%

\* Budgeted

\*\* Includes House of Correction

The Forum's March 2009 report showed that one of the major consequences of the county's budget strategy was to reduce the purchasing power of small and/or administrative units that rely almost exclusively upon property tax revenue. The report found that, after subtracting fringe benefit expenditures from total expenditures, some departments had suffered a major cut to their expenditure budgets, including key central services departments that are critical to the performance of every county function. These included procurement, corporation counsel, fiscal affairs, and human resources.

**For the purposes of this report, which is focused on governance reform, the county's fringe benefit methodology creates a certain impetus toward the status quo and against large-scale change.** While perhaps unintended, embedding legacy costs in departmental budgets has made governance reform more difficult. Reform proposals that would establish new authorities for transit or parks, or that would shift responsibilities for judicial or social services from the county to the state, also now must resolve retiree fringe benefit financing issues.

Problems arise because it is assumed, and probably rightfully so, that the new organizational home of a transferred program would be unwilling to assume responsibility for liabilities attributed to former employees. As a result, it seems likely that program operations and related revenues and expenditures would transfer to the new governing body, but the parts of the department's budget now dedicated to retiree benefit costs would remain the responsibility of the county. The county then might have to budget these legacy costs across fewer departments, further exacerbating their budget pressures.

While doing nothing to reduce the cost of legacy obligations, a methodology in which retiree benefit costs were isolated in a distinct part of the county budget at least would lead to a simpler analysis of the true costs associated with each county function. Later sections of this report discuss this issue in more detail.

## CONCLUSION

During the past decade, fringe benefit costs have overwhelmed the Milwaukee County budget. Combined annual pension and health care expenditures climbed from \$67 million in 2000 to \$179 million in 2008 despite a dramatic decrease in the size of the county workforce. It is anticipated that fringe increases will continue to accumulate in future years, driven by unfunded pension liabilities and the rising cost of health care.

As a result of those increases and its other fiscal pressures, Milwaukee County has made major budget cuts and edged closer to a full-blown fiscal crisis. While the county has sought to curtail fringe benefit costs, its measures have not proved equal to the task, in part because outside events such as the fall in the stock market have worsened the problem and undermined solutions. Proposed changes in the 2010 budget may indicate the county is headed in a new direction.<sup>3</sup> Nevertheless, prudence and a decade worth of experience suggest that escalating fringe benefit costs will continue to be a major contributor to the county's structural deficit.

It is important to note that there have been times in the county's history when it was able to shoulder significant retiree benefit costs. In the 1980s, for example, the county made substantial contributions to its pension fund that exceeded the amount it is contributing today when adjusted for inflation and considered as a percentage of total county property taxes. Prior to this decade, however, the county enjoyed much larger average annual returns on its pension fund investments, much greater elasticity in its state revenue streams, and a much larger workforce across which to spread its retirement benefit costs. It is the county's current fiscal condition and prospects that necessitate consideration of changes to its retirement benefits structure.

The county also should strongly consider a change in budgeting philosophy and methodology with regard to retiree benefits. The linkage of legacy costs to departmental operations has seriously weakened many functions of county government in a non-strategic manner. An alternative approach in which budget allocations are driven instead by clearly articulated priorities is needed.

Finally, it is important to recognize that the financing of fringe benefits is inextricably connected to large-scale organizational reform. Potential governance changes that would place certain county functions under independent governing authorities or state government must take into account the legacy costs of those departments. No governance reform can occur unless and until it is decided how those costs would be financed under alternative governance arrangements. The following chapters will discuss those costs and policy options.

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<sup>3</sup> The 2010 county budget includes several fringe benefit changes, including a reduction in the pension multiplier from 2% to 1.6% for future service effective in 2010; an increase in the normal retirement age from 60 to 64 for new hires; and higher deductibles, out-of-network co-payments and premium contributions. Those modifications, however, are subject to collective bargaining for the roughly 85% of county workers represented by unions.

## CHANGES IN GOVERNANCE WILL IMPACT PUBLIC RETIREMENT BENEFITS IN COMPLEX WAYS

The county's legacy obligations not only have a considerable impact on its financial outlook, but those obligations also create complexities with regard to the potential transfer of county functions to other governments. Two relatively recent examples shed light on the nature of those complexities and how they might be addressed.

### *Transfer of assistant district attorneys to the state*

In January 1990, the state adopted legislation requiring the transfer of all Wisconsin prosecutors from county to state employment. Most Milwaukee County district attorneys were given the option to retain county benefits or take benefits from the state. Section 978.12 of the Wisconsin Statutes spelled out the specific options given prosecutors:

- All transferring district attorneys could choose to retain county health insurance. For those prosecutors who retained county health insurance, the state provides the county with a reimbursement payment that is equal to the cost incurred by the county or an amount equivalent to comparable coverage under the state insurance plan, whichever is less. The county is responsible for funding the difference between the state's payment and the actual cost of the county plan.
- All *vested* district attorneys could choose to remain in the county pension system. Those not vested in the county system were required to transfer to the state retirement system. For those prosecutors who retained county pension benefits, the state provides the county with a payment that is equal to the county's employer contribution rate or an amount equivalent to the state's employer contribution rate, whichever is less. The county is responsible for supporting the difference between the state's payment and the actual employer contribution made by the county on the prosecutor's behalf. Until recently, the state fully reimbursed Milwaukee County for the actual employer contribution made on behalf of prosecutors that remained in the county system. However, when the county's pension costs spiraled, the state capped its reimbursement to 14.3% of salary.
- All transferring Milwaukee County prosecutors that reached 15 years of service, regardless of whether those years accrued as a county or a state employee, were deemed eligible for free health care at retirement to be paid by the county.

Litigation arose out of the second provision above, regarding non-vested Milwaukee County prosecutors who moved to the state retirement system. Roughly 40 prosecutors were short of vesting in the county system at the time of their transfer to state employment but were not expected to forego their prior service credits. The question was who would pay for the liabilities already incurred by that prior service.

State legislation required Milwaukee County to transfer employer contributions made on behalf of those prosecutors from the county retirement plan to the state plan. That decision triggered a lawsuit from Milwaukee County, which charged that it violated the Fourteenth Amendment and unconstitutionally took funds intended for the benefit of vested county employees and retirees.

The case made its way to the Wisconsin Supreme Court, which ruled in 1996 that a pension fund's liabilities, assets, and annual contributions are managed collectively and in such a manner that if any fraction of any piece is removed, it could jeopardize the system's strength and is therefore generally prohibited. While the court opinion also recognized that there are certain situations where changes are needed and acceptable, such as when a fund is insolvent or financially strained, its ruling caused the state to establish a different mechanism for addressing prior service costs for non-vested district attorneys.

#### ***Transfer of the Milwaukee Public Museum from the county to a new non-profit organization***

In 1992, Milwaukee County peeled off Milwaukee Public Museum operations from county government and housed them instead in a new independent non-profit organization, Milwaukee Public Museum, Inc. (MPM). As part of that arrangement, the county and MPM established an agreement that required MPM to offer jobs to all former county museum workers and to provide benefits that were substantially equivalent to the benefits provided by the county.

Consequently, two pension plans were created: a new defined benefit plan for employees who had transferred from the county and had already vested in the county system; and a defined contribution plan for new workers and former county workers who had not yet met county vesting requirements.

Unlike the assistant district attorneys, vested county museum employees did not have the option of retaining county pension benefits, which meant that many of those employees would retire having vested in two pension systems. These cases are similar, however, in that the county pension system retained the prior service liability of anyone already vested in the system. Like the Wisconsin Retirement System, the MPM defined contribution plan did face some past liability in terms of recognizing the prior service of non-vested county employees. The county did not transfer any funds to MPM in order to support that cost.

In regard to retiree health care benefits, MPM was contractually bound to provide benefits similar to those of the county. Upon retirement, former county employees having 15 years of county service can choose whether or not to be part of the county health care plan or that of MPM. Employees who did not have 15 years of service as of the time of the transfer were required to receive health care through the MPM plan. The county supports the cost of eligible employees choosing county health care, while MPM supports those who opt into its plan.

#### ***Summary***

These examples provide insight into the types of benefits-related issues that would need to be resolved in any potential transfer of functions and employees from county government to alternative government entities. Issues that would need to be decided or negotiated would involve not only the retirement benefits already earned by active vested employees, but issues such as prior service credit of non-vested employees, and calculation and payment of differences in the value of health care plans.

In addition, the Supreme Court ruling that arose from the transfer of assistant district attorneys reflects the fact that Milwaukee County's pension system represents a collective property right, which ensures that any effort to transfer any of the fund's assets or contributions to other retirement systems would receive considerable legal scrutiny.