PICA Fact Sheet: Philadelphia's Pension Fund

The City of Philadelphia just wants its pension costs to be normal. Not normal as in "typical" or "average" – Philadelphia's pension costs are in line with other large cities. In pension parlance, the *normal cost* is the Pension Fund contribution required to cover future benefits earned by employees in a given year. In FY24, the normal cost for the City's pension contribution is projected to be $205 million.[1] Instead of contributing just the normal cost, the City will contribute nearly $833 million. That's more than four times the normal cost and makes up about 13 percent of all General Fund expenditures.[2]

FY 24 Pension Costs	
Pension Contribution	$584,352,858
Sales Tax Revenue	$96,146,000
Debt Service on Pension Obligation Bonds	$152,182,142
Total Pension Expenditure	**$832,681,000**

Why are Philadelphia's pension costs such a big portion of General Fund spending?

Philadelphia's pension costs are four times higher than the normal cost of future benefits because the City is working diligently to resolve decades of underfunding (and bad timing) that has created a high level of unfunded pension liabilities.

Pension liabilities are a fixed cost that cities must pay. When a city *must* pay for pension liabilities but has limited discretionary funds and a low fund balance, payments towards those unfunded liabilities will likely come from operating revenues, reducing the funds available for spending on day-to-day services. If a city is consistently unable to budget for and fund pension liabilities, credit rating agencies take notice. That kind of attention tends to result in ratings downgrades and increased borrowing costs. Conversely, consistent and adequate pension funding can improve credit ratings, as has recently been the case in Philadelphia.

There are two primary ways that pension fund liabilities grow larger and faster than the assets they are tied to:

1) *Investment loss* - Pension funds are investment funds. They invest contributions hoping to generate positive returns and bolster the fund. But as with any investment, success is not guaranteed. When investments lose value, the fund's unfunded liabilities increase.

    - *In 1999 the City of Philadelphia issued $1.25 billion in pension obligation bonds, borrowing from capital markets to make a massive one-time investment in the Pension Fund hoping to take a chunk out of the unfunded liabilities.[3] Shortly thereafter the dot com crash and 9/11 drastically eroded the value of the Fund's investments.[4]*

2) *Imbalanced contributions* – Pension funds are sources of retirement benefits. Employees enroll in pension plans that define the terms of those retirement benefits. For a pension fund to be fiscally stable – and able to pay out promised benefits – it should be structured so expected investment earnings on contributions will meet or exceed anticipated future benefit needs.

    - *In the 1970s through early 1980s the City of Philadelphia made minimal contributions to the Pension Fund. Retirement benefits were often paid using current revenue due to lack of savings and investment in the Pension Funds. In 1985 the City of Philadelphia's pension liabilities were only 38% funded.[5]*

What is the City doing to lower its pension costs?

Since the late 1980s, the City has put in place a series of pension policy changes to balance contributions with benefits and pay down the unfunded liability over time.

Plan Design

Pension plans available to consecutive generations of City employees have shifted to adjust the balance between contributions, investment earnings, and benefits. Previously, ample defined benefit plans presented policy makers with a difficult choice between committing an increasing amount of discretionary funding towards future pension benefits, or deferring investment in future pension benefits to balance a budget in the face of receding federal support. Many chose the latter. The City, working with its labor unions, has structured more recent plans to minimize the opportunity for such lose-lose trade-offs. Plan 16, the most recent plan, is a hybrid defined benefit/defined contribution plan. It continues to provide the increasingly rare traditional government pension to City employees for salaries up to $65,000 and offers an optional defined contribution program with 50% City matching up to 1.5% of the salary over $65,000. In 2019, a study by the Pew Philadelphia Policy and Research Initiative found that increased enrollment in Plan 16 will result in increased fiscal stability of the City's Pension Fund and Retirement System.[6]

Funding Policy

Rather than continuing to kick the can on pension liabilities and place greater burdens on future budgets, the City has opted over multiple mayoral administrations to make reforms, including using criteria and formulas to set the level of annual payments needed to help the City catch up.

- Minimum Municipal Obligation (MMO): *FY24 - $671.6M*
    - A state required minimum contribution level to keep the Pension Fund stable.
    - Created by Act 205 of 1984, which implemented statewide fiscal reforms to stabilize municipal pension funds.

- Revenue Recognition Policy (RRP): *FY24 - $742.8M*
    - Gradually implemented by the City between FY16 and FY18 to contribute additional revenue to pay down unfunded pension liabilities.
    - Provides additional revenue from a portion of Sales Tax revenue and increased employee contributions for certain current and future members.

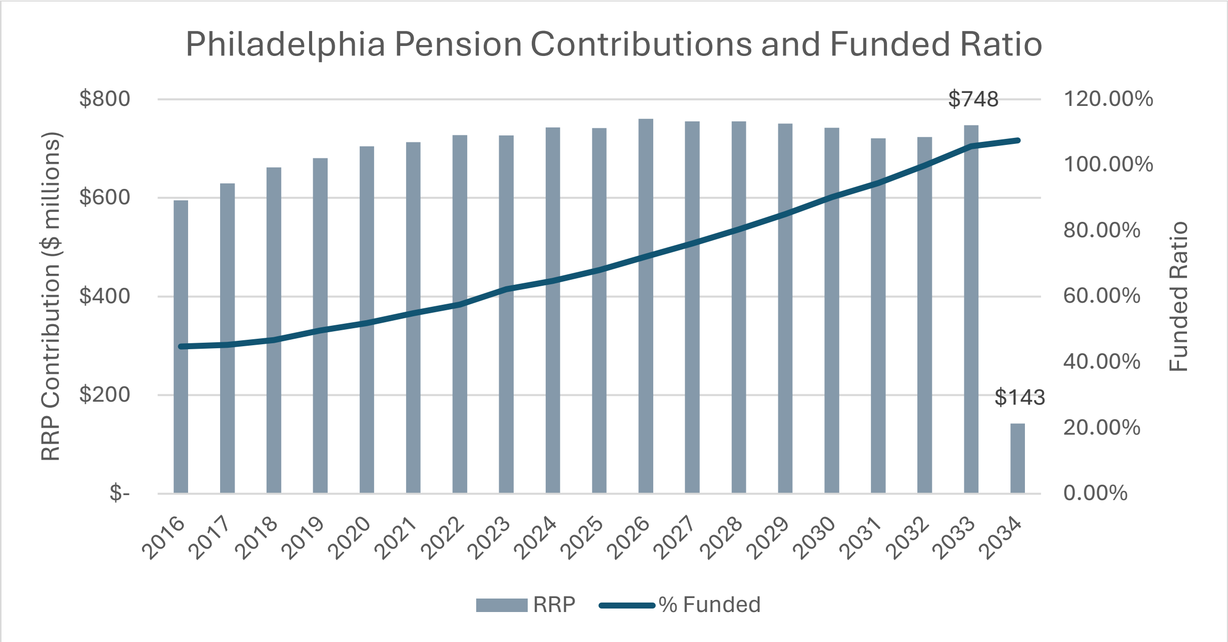
Since FY18 the City's Pension Fund contributions have followed the RRP, and sometimes gone above and beyond with even greater contributions when resources were available. Since adopting the RRP, the City's increased contributions have driven unfunded liabilities down significantly – even in years when investments have suffered along with the market at large. Following the RRP has reduced the Pension Fund's unfunded liabilities by $1.28 billion, or about 21% between 2018 and 2023.[7,8] Although the City's Pension Fund remains roughly 62 percent funded with a contribution equivalent to 13% of General Fund spending, consistency with the RRP will resolve the Fund's distress in the not-too-distant future.[9]

Normal by the 2030s

When the Pension Fund reaches 100 percent funded, the City's costs will finally be normal (in the actuarial sense)! Consistent increased contributions to the Pension Fund have changed its trajectory and reduced unfunded liabilities for consecutive years. As noted in the proposed FY25-29 Five-Year Plan, the Parker administration intends to continue making Pension Fund contributions in accordance with the RRP. In that scenario, the most recent available projections show the Fund reaching 80 percent funded by FY29, and 100 percent funded by FY33.

Some of the final obstacles to reaching normal Pension Fund costs are close enough to be included in the Proposed FY25-29 Five-Year Plan. In FY29, the City will make a sizeable balloon payment on the 1999 pension obligation bonds before retiring them completely in FY35. Retiring that pension debt will increase funding available to pay down the remaining unfunded liability.

If the City stays the course as planned, and the Pension Fund is 100 percent funded by FY33, the City's normal cost will be less than $200 million annually. At that point the City will have the flexibility to set aside funds for incremental adjustments to improve the health and safety of the Pension Fund, while freeing hundreds of millions of dollars in revenue previously dedicated to fixed costs.



Bringing the Pension Fund up from 38% to 100% funded is one of the greatest fiscal challenges the City has faced in the last forty years. Stabilizing the Fund requires the City to contribute at a level that chips away at billions of dollars in unfunded liabilities and ensure the Fund brings in more than it pays out each year. This is an expensive undertaking, but the City can only stabilize the Pension Fund and reduce its fixed costs by paying down the unfunded liabilities that have accumulated over decades. For the last eight years the City has stuck to its stabilization plan, consistently following the RRP and seeing the Fund surpass 60 percent funding.

PICA commends City leadership, City employees, City Council, City unions, Pension Board members, and Retirement System staff, and the Pennsylvania State Legislature for the effort and resources that continue to be dedicated to stabilizing the Pension Fund. Should the City continue with the RRP and additional contributions as intended, the City will have hundreds of millions of dollars more each year to commit to other efforts to bolster the City's fiscal stability in the next decade.

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[1] City of Philadelphia Municipal Retirement System Actuarial Valuation Report as of July 1, 2022; Cheiron, April 2023; https://www.phila.gov/media/20230511134924/Actuarial-valuation-report-2022.pdf (accessed 4/5/24)
[2] City of Philadelphia Proposed Five Year Financial and Strategic Plan FY25-29; City of Philadelphia, 14 March 2024; https://www.phila.gov/media/20240315151607/five-year-plan-FY25-proposed.pdf (accessed 4/5/24)
[3] City of Philadelphia Municipal Retirement System Actuarial Valuation Report as of July 1, 1999; Cheiron, April 2000; https://www.phila.gov/media/20240315151607/five-year-plan-FY25-proposed.pdf (accessed 4/5/24)
[4] Philadelphia's Quiet Crisis: The Rising Cost of Employee Benefits; Barrett, Katherine and Greene, Richard for The Pew Charitable Trusts and Economy League of Greater Philadelphia, 2008; https://www.pewtrusts.org/~/media/legacy/uploadedfiles/wwwpewtrustsorg/reports/civic_initiative/philadelphiasquietcrisispdf.pdf (accessed 4/5/24)

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[5] City of Philadelphia Municipal Retirement System Actuarial Valuation Report as of July 1, 1985; Johnson & Higgins of Washington D.C. Inc., March 1986; https://www.phila.gov/pensions/PDF/1985%20Actuarial%20Valuation%20Report.pdf (accessed 4/30/24)

[6] A Stress Test of Philadelphia's Retirement System; Pew Charitable Trusts, April 2019; https://www.pewtrusts.org/-/media/assets/2019/10/philly-pension-stress-test_new-edits_9-23-19.pdf (accessed 4/30/24)

[7] City of Philadelphia Municipal Retirement System Actuarial Valuation Report as of July 1, 2018; Cheiron, April 2019; https://www.phila.gov/media/20210608075715/Actuarial-valuation-report-2018.pdf (accessed 4/30/24)

[8] City of Philadelphia Municipal Retirement System Actuarial Valuation Report as of July 1, 2023; Cheiron, April 2024; https://www.phila.gov/media/20240409125822/Actuarial-valuation-report-2023.pdf (accessed 4/30/24)

[9] City of Philadelphia Municipal Retirement System Actuarial Valuation Report as of July 1, 2022