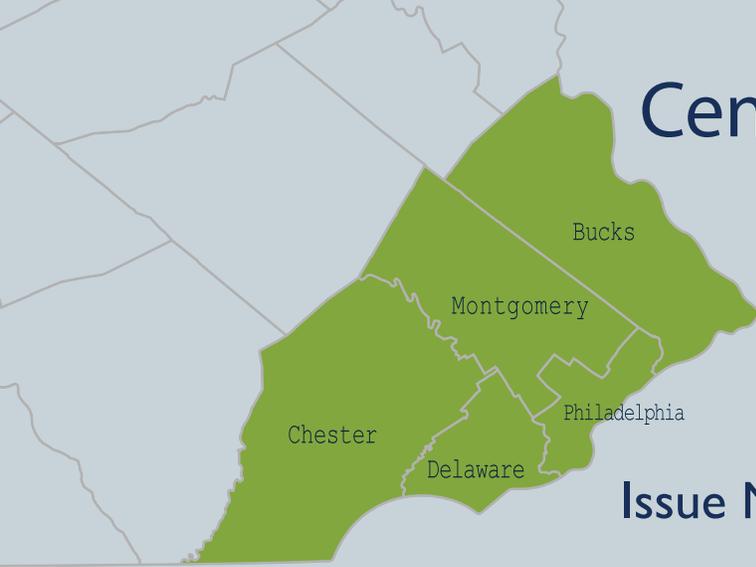


# Center on Regional Politics



## Issue Memo | Number 1 | September 2012

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### The Problem of Funding Pensions

Pennsylvania state government and the Commonwealth's school districts and municipalities, like many of their counterparts across the nation, face enormous increases in the cost of funding the pensions and other benefits of their employees and retirees in the years ahead. Unless there is a miraculous economic recovery or new revenues are raised, meeting these costs will almost certainly require added cuts in public services already hard hit by the effects of the recession.

Finding ways to address the increasing burden of public pensions seems certain to be a dominant issue in the next session of the Pennsylvania General Assembly. In recent testimony, Charles Zogby, secretary for budget, projected that employer contributions to the two state systems will have to increase by over 40 percent in FY 2013-14. It also will be a continuing challenge for hundreds of school districts and municipalities whose budgets are strained by these obligations. Given the interdependence of the federal government and the states for program support and implementation, the issue also will complicate congressional efforts to reduce federal deficits, promote economic recovery, and meet the health care and retirement-income needs of an aging population. Indeed, as argued by economist Teresa Ghilarducci and others, funding state and local government pensions is simply one facet of the much larger problem of providing an adequate retirement for all Americans.

This issue memo describes the public pension funding problem, explores its underlying causes and implications for public services, summarizes what we know about public understanding of the problem, and identifies remedies that have been tried elsewhere or are being advocated in Pennsylvania.

#### How Public Pensions Are Funded

Public pension plans typically are funded from three sources: (1) contributions by public employers usually through annual appropriations by their legislative bodies but sometimes through dedicated revenue streams, such as taxes, (2) contributions from public employees, usually as a percentage of their wages deducted from their paychecks, and (3) earnings from investments of the funds in the pension accounts managed by the pension fund's administrators under the oversight of a publicly appointed board. Typically, in a mature defined benefit (DB) plan, investment earnings provide by far the largest contribution, followed

by employee and employer contributions that vary in relative size from plan to plan.

Unlike the defined contribution (DC) plans prevalent in the private sector, most public pension systems provide a guaranteed, or defined, benefit (see definitions of plan types on the following page). This means the projected benefits of public plans (their obligations to current and future retirees) are relatively stable and predictable. Similarly, contributions from active workers are relatively stable and fixed by law or union contracts. Earnings from investments vary, sometimes dramatically, depending on the performance of the fund's investment portfolio, which is

influenced by the performance of the economy. Actuaries determine to what degree a pension fund's current assets match its predicted liabilities. A pension fund whose assets meet only 75 percent of its predicted liabilities is said to have a funded ratio of 75 percent.<sup>1</sup>

Pension funds adopt multiple actuarial assumptions based on projected economic and demographic trends such as salary and employment growth, mortality of plan members, and an expected rate of increase from investment earnings. If the investments fail to attain the actuarial assumption in any year, public employers are expected to make up for the shortfall to cover the fund's "normal cost" (the additional amount needed to pay projected benefits for current employees during the current year) and to move the fund toward being 100 percent funded by a full-funding date. If investments outperform the actuarial assumption in a given year, public employers have shown a tendency to reduce their annual contribution. Essentially, in DB plans, public employers bear the investment risk (but also benefit from gains) whereas in DC systems, employees bear the risk (and benefit from gains), and the plans never have unfunded liabilities.<sup>2</sup>

Although historically many public pension funds have over the long run averaged earnings above their actuarial assumptions, over the last decade, with its two recessions, they have generally failed to achieve their targets, even after some plans adjusted their assumptions downward. If investment portfolios were marked to market, funding ratios would be substantially lower and unfunded liability substantially higher. Similarly, as discussed elsewhere in this report, under new guidance just published by the Government Accounting Standards Board (GASB), state and local governments will be required to show unfunded pension liabilities as debt on their balance sheets. For some governments with troubled plans, this accounting presentation of "net pension liability" will be based on more conservative earnings assumptions that take into account recent portfolio performance averaged over shorter time horizons. Although not required until 2015, these changes will raise unfunded liabilities for many governments, in many cases substantially. They will not per se require governments to increase their pension contributions, but they may well raise borrowing costs for capital projects and other forms of debt, thus putting additional pressure on public services and tax levels.

**Defined Contribution (DC)** systems vary in structure. Typically, they provide each worker with a portable retirement fund supported by contributions from employers and the employee, as well as the earnings these funds accumulate through investments. Not all DC plans provide for an employer match, however, and the employer match may be subject to change. Further, some DC plans are mandatory (all employees must join), and some are optional. Funds available upon retirement are limited to the amount accumulated in each worker's individual plan and therefore cannot accumulate an unfunded liability for employers. About 70 percent of private sector employees who have retirement benefits have defined contribution plans.

**Defined Benefit (DB)** plans are funded by workers and employers but are centrally administered and guarantee each worker a retirement benefit based on his or her years of service and level of compensation and a multiplier. Courts have regarded these plans as contracts with employees, prohibiting changes in benefits for current workers and retirees. When actuaries determine that a plan's assets fall short of the net present value of its future liabilities and that the plan therefore may not be able to meet 100% of its obligations to future retirees, plans are said to have an unfunded liability. Almost all state and local government, and school district employees in Pennsylvania have defined benefit plans.

**Hybrid Plans** have many variations. Typically they provide newly hired workers a DB plan that is less generous than provided to current employees and retirees and a mandatory or optional DC plan. Unlike traditional DC plans, however, the amounts contributed by each employee and his or her employer are pooled and centrally managed, although plan members can often make decisions among types of investments for their own accounts. A "cash balance" hybrid plan is essentially a DB plan that provides workers with a lifetime defined benefit supplemented by the "cash balance" in their accounts. The cash balance consists of their own contributions, those of their employer, and the earnings on those assets. The cash balance can be paid in a lump sum or, more typically, converted to an annuity.

<sup>1</sup> As Mitchell (2011) notes, not all experts agree that DB public pension plans should be 100% funded. GAO suggested in 2006 that an 80% level "might be sensible" because state and local governments are unlikely to go out of business. Further funding at 100% or above "might be politically unwise" because "excess assets" could induce lawmakers to increase retiree benefits or divert employer contributions to other priorities rather than to accumulate them as a cushion against future downturns.

<sup>2</sup> Some DC plans may impose a legal obligation on the employer to provide a specified match to worker contributions, in which case there arguably is an unfunded liability on the part of an employer who fails to provide - or attempts to reduce - the match.

## How Big Are the Problems?

The total actuarial unfunded liability of Pennsylvania's state and municipal pension systems is almost \$48 billion. The state's three largest funds - the Commonwealth's plans for state employees and school teachers and Philadelphia's plan for city employees - account for almost \$46 billion of this amount (Table 1). Despite huge and legally required increases in employer contributions that will put enormous pressure on the ability of the state, school districts, and municipalities to maintain services, key financial data for these funds are heading in the wrong direction. Their actuarial unfunded liabilities are projected to be higher, rising to \$68 billion in five years (FY 2017). Their funded ratios are expected to be lower in five years. Their investment earnings have been falling short of their actuarial assumptions (Table 3). If their investment portfolios were marked to market, liabilities would be even larger.

### The Pennsylvania State Employees' Retirement System (SERS)

The funding status of public pension plans can vary from day to day based on the performance of their investments. As of December 31, 2011, SERS reported an unfunded liability of \$14.66 billion. Its funding ratio was 65.3 percent. Because the fund has not been achieving its assumed rate of return, which was dropped from 8 to 7.5 percent for calendar year 2012 going forward, the funding ratio currently is almost certainly lower than it was on the date of the last official report. Under pension reform legislation passed in 2010 (Act 120), SERS projects that the Commonwealth's contributions would need to increase from \$677.4 million in the current fiscal year, ending June 30, 2013, to \$1.959 billion in Fiscal Year 2017, assuming a 7.5 percent return on its investments. Even with this rate of return, its funded ratio would fall to 55.2 percent, and its unfunded liability would rise to \$20.87 billion.

Of these amounts, about 80 percent comes from agencies under the governor's jurisdiction and about 20 percent from the legislature, judiciary, Penn State and the state system universities, and from other independent agencies. Of the contributions from agencies under the governor, about 45 percent comes from the state's general fund and the balance from special and federal funds and other sources. Increased contributions from special funds and from independent agencies could indirectly affect the general fund.

<sup>3</sup> Altogether, PSERS members work for 773 employers, including community colleges, charter schools, state universities, and Penn State University, but school district employees constitute the vast majority of employers and account for the bulk of the non-Commonwealth employer contributions.

### The Pennsylvania Public School Employees' Retirement System (PSERS)

PSERS' unfunded accrued liability as of its last available annual financial report dated June 30, 2011 was \$26.5 billion. Its funding ratio was 69.1 percent. Because its earning did not achieve its assumed rate of return, which is 7.5 percent, in the past year, its funding ratio will be even lower when its status as of June 30, 2012 is reported. The Commonwealth has been funding about 56 percent of the employer cost for school employees, with the state's 500 school districts paying 44 percent of such costs.<sup>3</sup> As of June 30, 2011, PSERS actuaries projected that the employers' contributions would need to increase from \$1.77 billion in the current fiscal year, ending June 30, 2013, to \$4.2 billion in Fiscal Year 2017, assuming no benefit enhancements and that a 7.5 percent rate of return is achieved over the next five years. Under funding schedules imposed by Act 120 of 2010, even with those employer contributions and rate of return, the funding ratio will fall to 59.7 percent and the accrued unfunded liability will rise to \$41.9 billion.

### Impact on Local School Districts

The Pennsylvania Association of School Administrators recently reported that a mandated 45 percent increase in school district contributions to pension systems in FY 2012-13 was among the principal reasons that school boards were furloughing employees or leaving vacant positions unfilled, increasing class sizes, cutting courses and extracurricular activities, delaying capital projects and text book purchases, and reducing or eliminating supports for struggling students. In Southeastern Pennsylvania, educational program cuts have been particularly severe in Philadelphia and Chester Upland, both officially distressed districts with large populations in poverty, but they also are affecting middle-class districts such as Upper Darby and Bensalem.

### Municipal Pensions

Pennsylvania has 2,562 municipalities (boroughs, townships, and cities) and 1,534 public authorities, and together with 67 counties, these governments have 3,207 pension plans, or about 25 percent of the total number of such plans in the nation. Many of these plans have five or fewer active employees. Municipal pensions in Pennsylvania in 2011 had

**Table 1. PA’s Largest Public Pension Systems: Heading in the Wrong Direction**

	<b>PSERS</b>	<b>SERS</b>	<b>Philadelphia</b>
<b>Membership</b>			
Active Members	279,152	107,021	26,671
Retired Members	194,622	115,342	37,678
<b>Market Value of Assets</b>	<b>\$51.3 billion</b>	<b>\$24.4 billion</b>	<b>\$4.3 billion</b>
<b>Five Year Trends in Key Financial Data</b>			
Current Unfunded Actuarial Liability	\$26.5 billion	\$14.66 billion	\$4.77 billion
Projected Unfunded Liability in FY2017	\$41.9 billion	\$20.87 billion	\$5.25 billion
Current Funded Ratio	69.1%	65.3%	50%
Projected Funded Ratio in FY 2017	59.7%	55.2%	47%
Current Employer Contributions (FY 2013)	\$1.77 billion	\$677 million	\$629 million
Projected Employer Contributions in FY 2017	\$4.2 billion	\$1.96 billion	\$606 million
Projected Five Year Increase in Contribution	137%	190%	-4%

Notes: Actuarial data for PSERS is FY 2011, for SERS is CY 2011, and for Philadelphia is FY 2010.

For the Commonwealth retirement systems, employer contributions are from all sources, not just the state’s general fund. Approximately 56 percent of the PSERS employer contribution comes directly from the state’s general fund. The balance comes from 773 educational employers, of which 500 are school districts that represent by far the largest share of the non-state-government contributions. Approximately 80 percent of the SERS employer contributions come from agencies under the governor’s jurisdiction, and about 20 percent comes from the legislature, judiciary, Penn State and state system universities, and other independent agencies. About 45 percent of the contribution from the governor’s agencies comes from the general fund, with the balance coming from special funds, federal funds, and other sources. For both PSERS and SERS, in addition to this direct general fund impact, the required increases in employer contributions by school districts and independent agencies may indirectly put pressure on the state’s general fund to offset these higher costs, resulting in a greater burden than is now projected. For Philadelphia, the employer contribution includes the Minimum Municipal Obligation (MMO) plus payments on pension obligation bonds in the Five-Year Plan submitted to the Pennsylvania Intergovernmental Cooperation Authority (PICA) in July. The MMO is projected to peak at \$660 million in FY 2014 as it makes up for deferred payments in previous years.

employees. Municipal pensions in Pennsylvania in 2011 had an unfunded liability of \$6.8 billion, according to the latest report from the Public Employee Retirement Commission (PERC). In the aggregate, the municipalities covered by the PERC data had an average of only 66 percent of the funds needed to cover pension costs. Under state standards, municipalities with funded ratios below 50 percent are categorized as severely distressed, between 50 and 69 percent are moderately distressed, and between 70 and 89 percent are minimally distressed.

As reported by PERC, Philadelphia’s retirement system accounted for about two-thirds of the statewide liability; it was underfunded by \$4.77 billion, or about 50 percent of its obligations, just qualifying as moderately distressed. Given failure of its investment portfolio to reach the 8.15 percent actuarial assumption (recently lowered from 8.5 percent), Philadelphia’s municipal system almost certainly has since fallen below 50 percent and would now be rated severely distressed, as it was in 2009. According to the Pennsylvania Intergovernmental Cooperation Authority

(PICA) and the City of Philadelphia, pension obligations, which consumed \$492 million, or about 13 percent, of the city’s general fund in the fiscal year ending June 30, 2011, are projected to reach more than \$600 million and consume 17 percent of the general fund in the fiscal year ending June 30, 2013, with another large increase projected for the following year. The City’s current Five Year Financial and Strategic Plan calls pensions, “perhaps the most significant challenge facing the City.” Health care for employees and retirees and other personal services consumes another 14 percent, so that 31 percent of the general budget supports benefits.

In addition to Philadelphia, 28 other municipalities in Southeastern Pennsylvania have moderately distressed plans, and 95 have minimally distressed plans, according to PERC’s report (Table 2). Even municipalities with minimally distressed systems may face significant pension funding challenges that will strain their budgets.

**Table 2. Southeast PA Distressed Pension Systems as of 2011**

	<b>Severely Distressed ( &lt; 50% funded )</b>	<b>Moderately Dis- tressed ( 50-69% funded )</b>	<b>Minimally Distressed ( 70-89% funded )</b>	<b>Total for County</b>
<b>Bucks</b>	0	5	19	24
<b>Chester</b>	1	6	19	26
<b>Delaware</b>	0	12	24	36
<b>Montgomery</b>	0	4	32	36
<b>Philadelphia</b>	0	1*	1**	2
<b>Total for Region</b>	1	28	95	124

\*City of Philadelphia Public Employees Retirement System

\*\*Philadelphia City Redevelopment Authority

Source: PERC

PERC reported Pittsburgh had an unfunded liability of \$380 million and a funded ratio of 62 percent, and the rest of Pennsylvania’s municipalities had a total unfunded liability of almost \$1.6 billion. Most (86 percent) of the remaining liabilities were in Scranton (\$134 million with a funded ratio of 34 percent) and in the state’s third-class cities (\$673 million with an average funded ratio of 76 percent). Although state subsidies have historically covered all or most pension costs for many smaller municipal plans, the value of those subsidies seems unlikely to keep pace with looming increases in actuarial funding demands.

**County Pensions**

County pensions have DB and DC features and in general are well funded. According to PERC’s January 2011 report, Bucks and Delaware Counties had assets equal to liabilities and hence no unfunded liability. Chester County’s plan had a funded ratio of 90.4 percent and an unfunded liability of \$27.8 million, and Montgomery County’s plan was 95 percent funded with an unfunded liability of \$26 million. As reported above, Philadelphia, which is both a city and county, had a huge unfunded liability.

**The Problem of Funding Other Post-Employment Benefits (OPEB)**

In addition to pensions, many governments provide health care and other benefits for retirees, which collectively are known as Other Post-Employment Benefits, or OPEB. The Pew Center on the States estimated the gap between combined pension and OPEB assets and liabilities for all 50 states at \$1.38 trillion at FY 2010. Pew projected the gap at \$757 billion for pension promises and \$627 billion for retiree health care. It estimated Pennsylvania’s gaps at \$29 billion for pensions and \$17 billion for health care. Health care benefits for Commonwealth retirees are paid by the Pennsylvania Employee Benefit Trust Fund, are financed on a pay-as-you-go basis, and are not guaranteed in the way

that pension benefits are. Nevertheless, these promises to retirees also threaten to strain future budgets. Pew said the state appropriated \$714 million for retiree health care in fiscal 2010 but should have appropriated \$1.2 billion.

**What Are the Causes of the Unfunded Public Pension Problem?**

The causes of public pension funding problems in Pennsylvania and across the country are multiple and generally go beyond the dramatic financial crisis of 2008. Without question, for DB plans, which require public employers to bear the risk of poor investment performance, enormous losses in many portfolios in the two economic downturns since 2002 help explain why public pension problems have come to a head simultaneously in so many states. Actual investment returns for Pennsylvania’s largest plans have fallen well below actuarial assumptions in recent years (Table 3). But other causes include:

- Years, and in some cases decades, of underfunding by public employers who did not make adequate annual contributions to keep public pensions actuarially sound;
- Labor contracts and legislation that expanded benefits -- such as increasing the multiplier for calculating retirement income, providing cost-of-living increases for current and future retirees, or allowing workers to retire with full benefits at an earlier age -- without funding those costs;
- In the case of many police and fire fighter pensions in Pennsylvania, binding arbitration awards that increased pension costs over the stated opposition of elected municipal officials;
- Refinancing pension debt over longer time periods to avoid short-term spikes in pension costs, which increased the long-term unfunded pension liability;
- An aging population and workforce. Retirees are living longer and there are more of them in mature plans. Those whose plans include post-retirement health care benefits also require more services. Both SERS and the

City of Philadelphia’s system now have more retirees than active members in their plans, and PSERS membership is trending in that direction.

--According to some local officials, the deliberate “spiking” of overtime compensation by local government employees nearing retirement to raise their final average

salaries, which under existing pension formulas raises their lifetime pension benefits. One pension expert has noted, however, that state law already prohibits spiking in third class cities but municipal officials sometimes fail to enforce this provision.

**Table 3. PA’s Largest Public Pension Systems: Actuarial Assumptions and Earnings History**

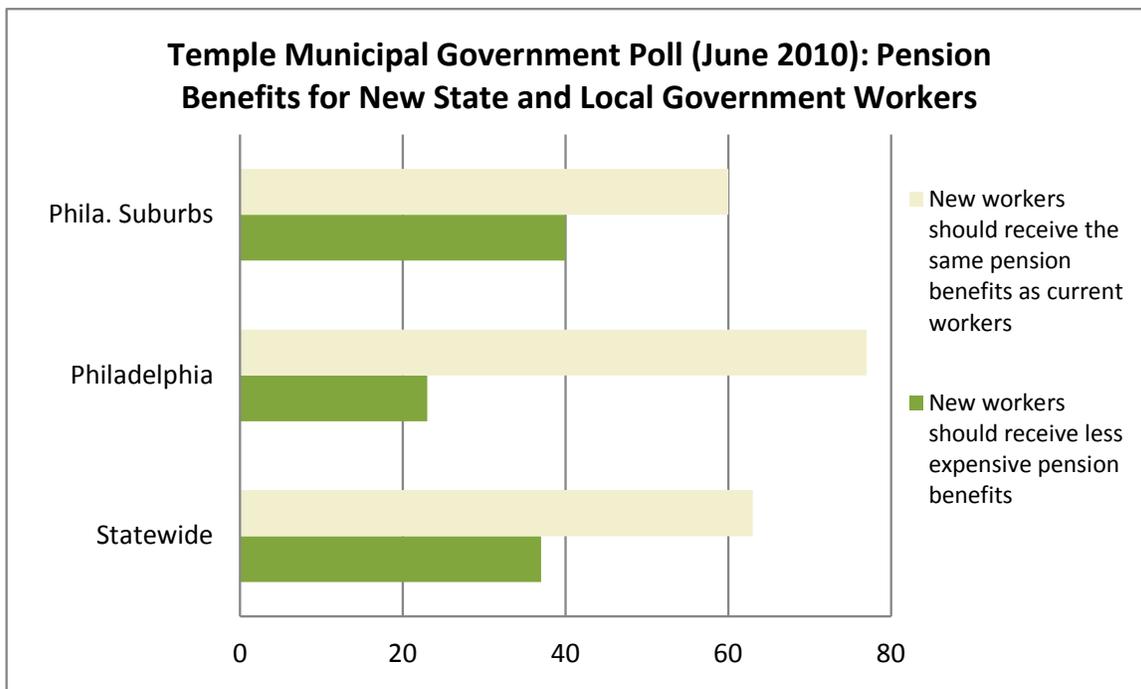
	<b>PSERS</b>	<b>SERS</b>	<b>Philadelphia</b>
<b>Actuarial Assumption Rate of Returns</b>	7.50%	7.50%	8.10%
<b>Actual Investment Returns Net of Fees</b>			
1 Year	3.43%	2.70%	0.50%
3 Years	12.57%	7.8%	11.15%
10 Years	7.19%	6.00%	6.26%
25 Years	8.42%	8.80%	7.51%*

\* Philadelphia’s returns are averaged from July 1, 1988.

**Public Opinion and Pension Issues**

State and national opinion polling demonstrate that the public is fairly divided on pension reform issues, although the trend is toward greater support for controlling pension costs. A review of several national and state polls reveals that the wording of questions related to government employee pension reform, salience of the topic in the respondent’s own state, timing, and locality appear to have an impact on the opinions expressed by those who are surveyed. Pennsylvania surveys predate the increased public attention paid to this issue, but are reported here as well.

A January 2011 national survey conducted by CNN and the Opinion Research Corporation (ORC) found that 61 percent felt that reducing the federal deficit was a more desirable policy option than preventing significant cuts to pensions and benefits for retired government workers when given a choice between the two options. A subsequent CNN/ORC poll in March 2011 found that 47 percent supported decreasing DB benefits either “a little” or “a lot” to help reduce the federal deficit. Meanwhile, a July 2011 CNN/ORC poll found that 30 percent said they favored “cutting pensions and benefits for retired govern-



ment workers” as a specific proposal for reducing government spending.

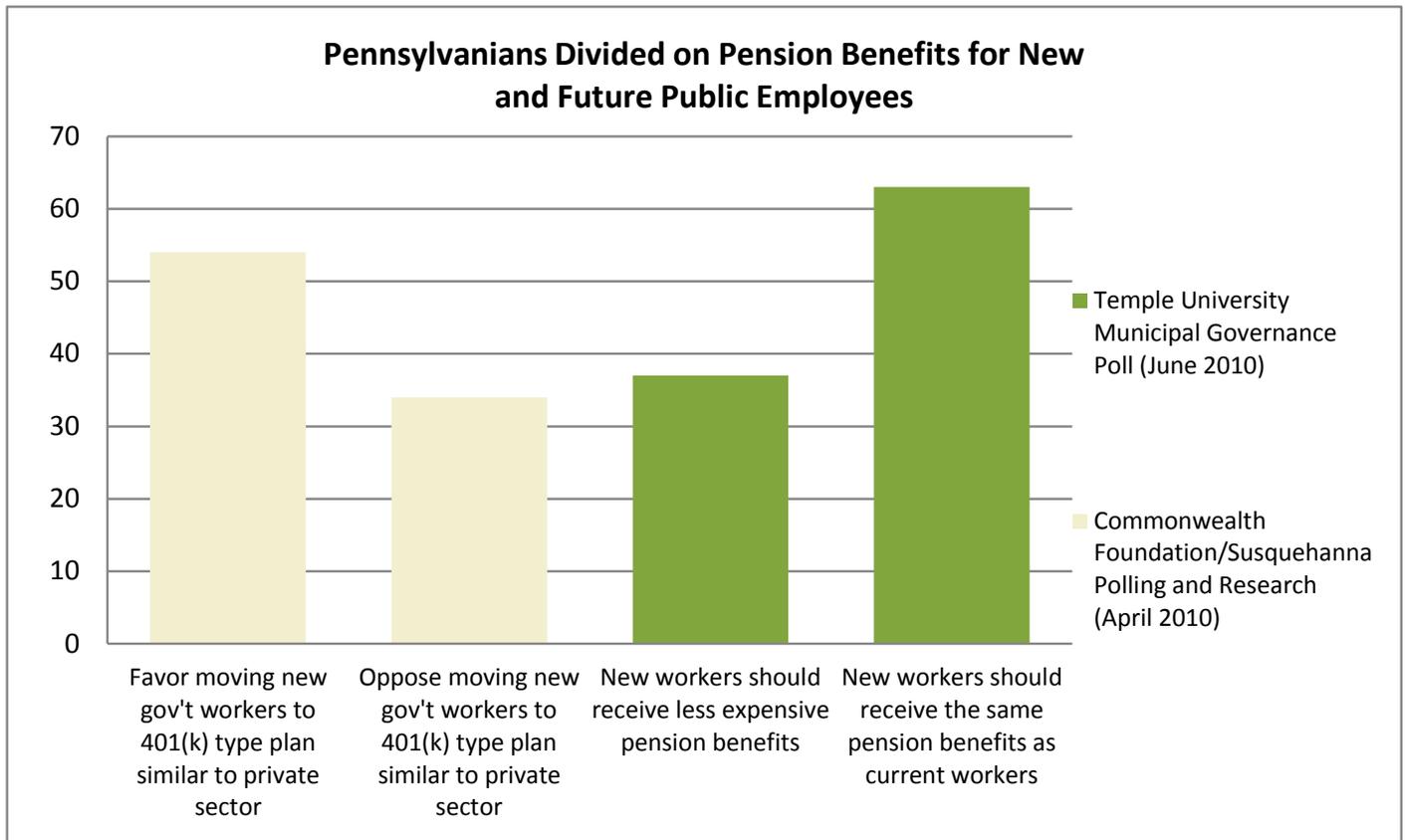
State polling data from both Rhode Island and California are noteworthy because these states, with Democratic governors and legislatures, recently tackled unfunded liability problems in their public pension systems. An April 2011 USC Dornsife/LA Times poll found support for capping pensions of current and future public employees in the Golden State stood at 70 percent, while the majority of respondents —68 percent to 22 percent—backed Governor Jerry Brown’s proposal to increase the share public workers pay into their own pension plans. They also favored by 66 to 22 percent a plan to replace current public employee pension plans with a 401(k)-style system.

In Rhode Island, a December 2011 Brown University poll found that the public was both actively following the pension reform issue and supported making changes to it. Almost 72 percent of respondents claimed to be devoting either “a lot” or “some” attention to the discussion of pension reform in their state. Almost 90 percent believed the issue of pension reform was “very important” or “important” to the state’s future economic well-being. Rhode

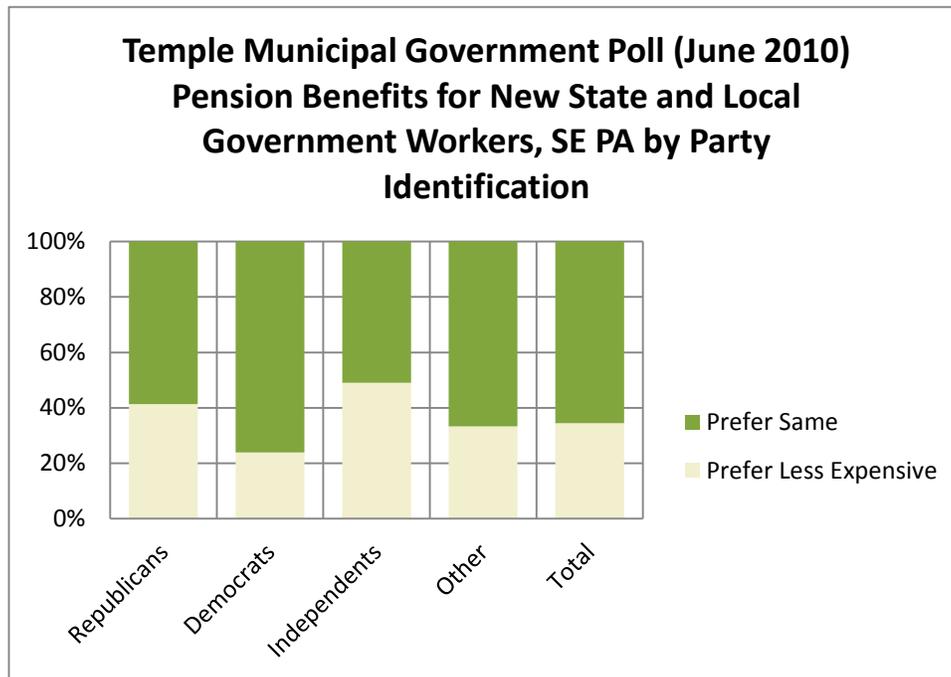
Island’s new law suspending automatic COLAs for retirees for five years, raising the retirement age for many state workers, and creating a hybrid retirement plan featuring a 401(k)-style approach received the support of over 60 percent of those surveyed.

Polling in Pennsylvania has produced mixed results. An April 2010 poll of 700 voters by the Commonwealth Foundation and Susquehanna Polling and Research found that Pennsylvanians favored moving newly hired public employees to a 401(k)-like pension plan similar to what is common in the private sector by 54 to 34 percent.

The Temple University Municipal Governance Survey conducted in June 2010 found that 63 percent of 1462 residents statewide believed that newly hired state and local public employees ought to be offered the same pension benefits offered to current workers and retirees. Regionally, 77 percent of Philadelphians and 60 percent of those in surrounding suburbs supported providing new government employees the same benefits as current employees. Taken together, 66 percent of Southeastern Pennsylvanians favored offering the same pension benefits to current workers as retirees.



The Temple survey question was: “Some people think that in order to avoid overburdening future generations, state and local governments should offer new employees less expensive pension benefits than their current workers and retirees are entitled to receive. Others say that if the pensions paid to government workers are cut, well-qualified people will be less willing to work for the state and local governments. What do you think? Should newly hired state and local government workers be offered less expensive pension benefits, or should they be promised the same benefits as current workers and retirees?”



**Bond Ratings, GASB Changes, and Pennsylvania Pensions**

On July 17, Moody’s downgraded Pennsylvania’s general obligation (GO) rating from Aa1 to Aa2 citing the Commonwealth’s “weakened financial position, and the expectation that large and growing pension liabilities and moderate economic growth will challenge the return to structural balance, contributing to a protracted financial recovery.” Moody’s rating report also noted a “seven-year history of significantly underfunding pension contributions,” and the fact that “rapidly growing pension contributions will absorb much of the Commonwealth’s financial flexibility over the next five years.” Following the GO rating decline, Moody’s downgraded Pennsylvania school districts benefitting from the state intercept programs resulting in a movement from Aa2 to Aa3.

Given low interest rates generally, the downgrade may not have a significant effect on the Commonwealth’s bond issues but it could raise borrowing costs for Philadelphia and other Southeast school districts most dependent on the state intercept. On July 19, Moody’s announced it was putting \$942 million worth of bonds issued by Pennsylvania’s state universities “on review for downgrade,” again citing the “high post-retirement liability” of the university system. While these are still considered high grade investments, the result is more expensive borrowing costs.

According to new rules introduced in June, public employers must begin reporting under the revised Governmental

Accounting Standards Board (GASB) guidelines for public pensions by 2015. The standards took more than five years to research and develop after complaints that current standards make pensions look cheaper than they really are. Some lament that the new rules will make bond ratings plummet, but others counter the ratings agencies are well aware of the problems with public pensions. With the goal of more transparent assessment of pension liability for accounting purposes, some of the key changes include:

1. Governments will be required to report their plan net position (PNP) on their financial statements for the first time. If the accrued pension liability exceeds the plan’s assets held in trust, governments will have to report their net pension liability (NPL). According to GASB, this will more clearly portray the government’s financial status because the pension liability will be placed on an equal footing with other long-term obligations.
2. For plans whose assets are projected to be depleted before all benefits are paid, governments will have to discount their post-depletion liabilities using a municipal borrowing rate, which will effectively increase the unfunded pension liability reported on their financial statements.
3. The practice of “smoothing,” or drawing out the recognition of market gains and losses, will be limited. Full recognition must occur within five years.

## Three Views on Public Pensions

### **Summary from the testimony of David Fillman, Executive Director, AFSCME Council 13**

#### **House State Government Committee May 1, 2012**

The Pennsylvania Constitution prohibits changes to the contractually owed DB pensions for all current SERS and PSERS members.

The so-called “2012 Spike” in pension funding was being reduced considerably under the Rendell administration until the stock market crash of 2008, when all investments, including pension funds around the country, tanked. Prior to 2008, the state took a few holidays from payments into pension funds as the economy was booming, a perfectly legal maneuver. Still, SERS and PSERS members paid their fair shares, at 6.25% and 7.5% respectively. Working with Governor Rendell in 2010, Act 120 set up the reformed pension guidelines effective in 2011 including new employee higher vesting and retirement ages, elimination of lump sum payouts, and a sliding scale for new employee contributions if investment returns don’t meet expectations, among other changes.

Current reform efforts do nothing to solve the problem of funding the DB plans, but instead divert funds to thousands of individual accounts through DC plans, all of which will need separate maintenance. The National Institute of Retirement Security found that DB plans are more economically efficient than DC plans, in fact, DB plans figure at half the cost.

The average SERS pension is but \$23,500/year and 88 percent of those pensioners stay in Pennsylvania to then put that money back into their

local economies and pay local and state taxes. For the physically demanding and sometimes dangerous work that PA public employees do, from road crews to nurses to law enforcement, DB plans offer what no DC plan does: disability retirement. Early retirement also works as an incentive when the state needs to reduce its General Operating Budget—an option not available with DC plans.

### **Excerpted testimony of Charles B. Zogby, Secretary of the Budget**

#### **Public Employees Retirement Commission September 5, 2012**

“As we begin planning for the 2013-14 budget cycle, the commonwealth confronts the same dynamic of increasing pension costs as in the current fiscal year. Under the provisions of Act 120 of 2010, the commonwealth’s share of the employer contribution to PSERS is projected to increase from the aforementioned \$856.1 million in the current 2012-13 budget to \$1.23 billion in 2013-14. This is a staggering increase of \$373.9 million, or 44 percent. Our school districts will see a similar increase, further constraining their capacity to retain staff and maintain manageable class sizes. The employer contributions to SERS are projected to increase from the aforementioned \$677.4 million in the current 2012-13 budget to \$971.3 million in 2013-14, an increase of \$293.9 million or another 43 percent. Increases of these magnitudes are projected to recur in each of the next several fiscal years.

“The projected annual increases in pension costs for the commonwealth and our school districts are clearly not sustainable. Neither the common-

wealth’s budget, nor the budgets of our school districts, can continue to withstand such increases. Therefore, the only option that can be considered off the table is to ‘do nothing.’ As stated, the Corbett administration is reviewing options to propose a pension reform plan in the Governor’s 2013-14 Executive Budget. We look forward to reviewing the testimony the Commission receives during its upcoming hearings and working with the General Assembly to chart a course for real and sustainable reform of our public pension systems.”

### **Excerpted testimony of Brian K. Jensen, PhD Executive Director, Pennsylvania Economy League of Greater Pittsburgh**

#### **Public Employees Retirement Commission September 5, 2012**

“Why are so many of the Commonwealth’s cities, boroughs and townships struggling to maintain financial health? I would submit the problem stems fundamentally from outdated and intrusive state laws. State law hamstringing municipal financial health by artificially and counterproductively increasing costs.

“For example, Pennsylvania law requires cities to offer defined benefit pension plans to police and fire fighters: they are not authorized to offer hybrid systems that would introduce defined contribution plans into the retirement mix. While Americans now live longer, healthier lives and frequently elect to continue to work into their 60s and 70s, cities are required to offer retirement to police and fire fighters at age 50 with 20 years of service regardless of the health of the city’s police and firefighters or the city’s public safety and financial needs.”

**What Steps Have Been Taken in Pennsylvania and Are Being Tried in Other States?**

Pennsylvania and many of its school districts and municipalities will see large pension funding increases despite legislation enacted in the last session of the General Assembly. In 2010, the legislature adopted several changes for new employees effective January 1, 2011 for SERS and July 1, 2011 for PSERS, including:

- lowering the benefit multiplier from 2.5 percent to 2 percent (with an option to maintain the 2.5 percent multiplier if the member contributes at a higher rate),
- increasing the vesting period from 5 to 10 years, and
- increasing the normal retirement age for general employees from 60 to 65.

Pennsylvania also capped increases in employer contribu-

tion rates to both systems at 3 percent for fiscal year 2011-12, 3.5 percent for fiscal year 2012-13, and 4.5 percent thereafter. The state also adjusted the actuarial methods for both systems, re-amortizing SERS liabilities over 30 years and re-amortizing PSERS liabilities over 24 years using a different actuarial method.

In 2009, the General Assembly also enacted legislation that allowed municipalities to defer a portion of their pension payments for either two or four years, depending on their level of distress. Philadelphia was permitted to levy an additional one percent sales tax (from 7 to 8 percent) and required to use the revenues for pension fund payments. Philadelphia was required to repay pension deferrals with interest when the tax expires in Fiscal Year 2014.

**Table 4. Pension Changes in the States**

Type of Change	State Example	Details of Change
<b>Alteration to Employee Contributions</b>	Alabama	Required employee contribution for general employees and teachers reduced from 7.5% to 6%, possible because of increased age and service requirements and an increase in the period for calculating FAS from 3 to 5 years and a reduction in the benefit factor from 2.1025% to 1.65%.
	Kansas	Tier 1* members will choose between 1) accepting an increased contribution rate from 4% to 5% in 2014 and 6% in 2015 to preserve 1.85% multiplier; or 2) accepting a reduction in the multiplier to 1.4% for future service and keeping current 4% contribution rate.
	Virginia	All local government employees will contribute 5% of salary to their retirement plan (previously employer provided), offset by a salary increase of 5% that can be phased in over 5 years.
<b>Higher Age and Service Requirements</b>	New York	Tier 5: Normal retirement at 60, benefit base from the highest three years; Tier 6: normal retirement at 62, benefit base from the highest 5 years. Multipliers vary with length of service.
	Wyoming	Normal retirement moved from age 60 to 65, benefits calculated from highest 5 years (previously 3), and multiplier changed from 2.125% for the first 15 years of service and 2.25% for additional years to 2% for all service.
	California	Starting in 2013: increased retirement age for new employees depending on position; cap on annual payout at \$132,120; new employees will have to automatically contribute 50% of pension costs (most already do) with a 5 year window for local government labor union negotiations.
<b>Replacement of DB Plans</b>	Utah	Closed its DB plan in 2010 and in 2011 offers new employees a DC plan or combination of a DB plan and a mandatory 401(k).
	Rhode Island	Will transfer all members of the DB plan (except judges and public safety) to a hybrid plan in 2012.
<b>Cash Balance Plans**</b>	Kansas	As of 2015 for new members: employee contribution of 6%, varying level of employer contribution depending on years of service (3%-6%), a guaranteed interest credit of 5.25%, vesting at 5 years, balance is annuitized and members may withdraw up to 30% of the balance at retirement.

\* "Tiers" typically are cohorts of workers hired before or after certain dates and thus vary from state to state.

\*\* Individual accounts are created with contributions from the employee and employer but with no choice on the investment particulars of the plan on the part of the employee. Members are guaranteed a return that could grow depending on market performance. An annuity is distributed upon retirement.

**Table 5. Proposed or Enacted Municipal Pension Changes**

City	Proposals/Enactments
Chicago	5 year increase in retirement age up to 67 for most employees, 60 for public safety workers; suspension of annual cost-of-living increases for current retirees for 10 years; 1 percent yearly increase in contributions from current employees for 5 years, up to 14 percent; offering new hires a choice of a DB plan or a 401(k) plan; no additional taxpayer contribution to pensions until changes are enacted.
San Diego	A 2006 ballot initiative passed to put all increases in public pensions and benefits to a public vote; by July 2009, all new city employees are placed in a hybrid plan; Proposition B, approved in June 2012, ends pensions for all future employees moving them to a 401(k) system (except for police), and freezes salaries until 2019 for pension calculation purposes of current employees.
New York	New employees (Tier 6) must pay higher contribution rates depending on salary; increase in retirement age to 63; vesting after 10 years; limits the amount of overtime than can be used to determine pension and eliminates unused sick time and vacation time from calculation of average final salary; a 401(k) option for non-union employees with salaries above \$75,000; any salary above the governor's (\$179,000) does not count for pension calculation. Public safety employees are largely exempt from these provisions.
Allegheny County Port Authority	The Allegheny County Port Authority reached a labor deal in late August agreeing to a two year wage freeze, increasing pension payments from 5.5% to 10.5% of salary, and other benefit reductions to attain \$15 million in savings. Also included was \$30 million in annually recurrent state funds pledged by Governor Corbett. Press reports suggest that under this deal the union has the right to revert back to its previous contract if more than five percent of the authority's workers are laid off during the new contract period.

**What Can Be Done about Pensions?**

Ideas for dealing with the public pension funding crisis include:

**--Fully fund pension costs through appropriations.** Governments could simply step up to these rising pension costs, but that may require many governments to make deeper cuts to public services than have already been made necessary by the recession.

**--Reduce benefit levels, raise worker contributions, extend the retirement age, or change to a DC plan for newly hired workers.** This approach does not face the same legal challenges that changes to plans for current employees or retirees would face. Changes for new hires may need to be won, or raised, in collective bargaining negotiations. Even if accomplished, however, such changes may offer long term relief to pension plans but raise short term costs, because fewer workers would be contributing to the system's existing debt.

**--Reduce benefit levels for current workers and retirees.** Attempts at such changes have historically been

regarded by courts in Pennsylvania and some (but not all) other states as impairments of contracts and therefore unconstitutional. Changing to DC, hybrid, or cash-balance plans for current workers or even requiring higher contributions by current employees is arguably a diminishment of the net benefit of their pensions and would seem to be vulnerable to legal challenges. Yet, the legacy costs of current retirees and workers constitute by far the largest component of the funding problem. As noted above, some states and jurisdictions are attempting to find legal strategies to lighten the burden of obligations to current employees and retirees. According to the newsletter *Moody's MuniMonitor*, a key legal question is whether constitutional protection extends to all benefit earnings of vested members or only those earned to date.

**--Amending the Pennsylvania Constitution to define pension debts as exempt from Article I, Section 17's prohibition on impairment of contracts.** But can a contract obligation incurred under one set of constitutional rules be changed retroactively?<sup>4</sup>

<sup>4</sup>With overwhelming bipartisan support, the New Jersey legislature has placed on the November ballot a constitutional provision specifying that judges can be required to increase contributions to their pensions to overcome a Supreme Court ruling that the existing constitutional prohibition against reducing compensation for sitting judges precluded such changes.

--**Negotiate labor contracts that address the pension funding crisis.**<sup>5</sup> Pennsylvania's laws providing public employees with collective bargaining rights affecting pensions are among the strongest in the nation. Some public employee unions in Pennsylvania (see testimony by David Fillman on page 9) and elsewhere have agreed to higher worker contribution rates, lower benefits for future workers, later retirement ages, and other changes to avoid layoffs of current workers and reduce incentives for privatization. Philadelphia's contracts for police officers included a voluntary DC plan for future hires; its contract for prison guards included a mandatory hybrid DB/DC plan for new hires. Although the city is appealing the compensation and work rule provisions of the recent arbitration award for fire fighters, it is not appealing the pension provisions, which also include a voluntary DC option for future hires.

--**Improve investment performance.** Although the performance of pension fund earnings can be expected to improve once the economy recovers and may over the long run return to historic levels, future earnings would have to be unrealistically high in the short run to regain all of the lost ground and make other painful remedies unnecessary.

--**Consolidate municipal pension plans.** PERC has estimated that significant administrative savings, and perhaps improved investment returns, could be achieved by consolidating municipal pension plans. A related idea would be to prohibit the use of state subsidies to pay pension fund administrative costs, which would arguably free up funds to deal with pension liabilities and simultaneously incentivize plan consolidation.

--**Achieve off-setting savings in pension administrative costs or other post-employment benefits (OPEB) programs, such as for health care, that are not constitutionally protected.** Although the Commonwealth and Philadelphia provide health care to retirees with long public service, in general health care benefits are subject to statutory revision but may in some cases require revised collective bargaining agreements. A consultant engaged by the General Assembly's Legislative Budget and Finance Committee concluded in a 2004 report that as much as \$585 million could be saved by consolidating health care plans for current school employees into a single system, as has been done with their pensions. In 2008, the House Education Committee reported legislation (HB 1841) that attempted to move in this direction, but it

was not brought to a vote on the floor. State Representative Bernie O'Neill, R-Bucks, has introduced similar legislation (HB 2080) in the current session.

--**Dedicate an existing revenue stream to pay down pension debt.** Although this step could reduce, and perhaps in some cases eliminate, the appropriations required to meet pension costs, for many governments it would have a similar effect to addressing the problem through increased appropriations alone, namely higher taxes or deep cuts in public services previously supported by the lost revenue stream. Dedicating an existing revenue stream by statute or ordinance to unfunded pension liability reduction (as opposed to supporting the fund's normal costs), would represent a long-term commitment to eliminating the system's legacy debt. Pittsburgh's City Council transferred the ownership of future parking revenues to the trustee for city pension funds to avoid a state takeover in the wake of Pennsylvania's 2010 municipal pension legislation. Although this step helped raise the city's funded ratio from below 30 percent to 62 percent, the viability of such an approach requires that the long-term projections for the revenue stream exceed the long-term projections for required contributions to reduce the actuarial debt. Otherwise, barring alternative remedies, the funded ratio will begin falling again, which is happening in Pittsburgh.

--**Raise and dedicate new tax revenues or fees to reduce unfunded pension liabilities.** This approach would be subject to the same caveats cited above for existing revenue streams. Although dedicating new revenues to pension costs signals a longer term commitment to pension debt than higher annual appropriations, such statutes or ordinances could always be changed by a subsequent legislative body. Also, tax increases are always politically unpopular. It should be noted that Pennsylvania municipalities with distressed pension systems already have authorization in Act 205 of 1984 to raise local taxes beyond statutory limits to address pension obligations, but few if any have done so.

--**Issue pension obligation bonds.** In some circumstances, it may make sense for governments to issue pension obligation bonds, invest the proceeds, and use the earnings on the investment to pay down their pension debts. Such steps can backfire, however, if earnings from the invested bond proceeds fail to match the interest rates due on the bonds, effectively locking the issuer into higher costs than would otherwise be available.<sup>6</sup> Unlike most

<sup>5</sup> Unlike SERS and municipal pension benefits, PSERS pension benefits are not subject to collective bargaining.

<sup>6</sup> According to a September 4, 2012 report in *The New York Times*, Stockton California's pension obligation bonds proved unaffordable and contributed to the city's bankruptcy.

state and local bonds for capital projects, the earnings from pension bonds are fully taxable, making it more difficult to demonstrate the financial advantage of taking this approach. Further, the bonds have to be supported either by current revenues, in which case they may require offsetting cuts in public services, or by new revenues. Because bonds are contracts with lenders, they do remove uncertainty about whether the issuing government will follow through with pension debt reduction. Currently, Pennsylvania law prohibits the use of pension obligation bonds for the SERS and PSERS funds.

**--Privatize assets or revenue from certain operations.** Governments can sell or lease on a long-term basis physical assets or revenue streams from specific functions -- such as highway tolls -- to private sector firms and use the proceeds to reduce pension debt. Simultaneously, future liabilities can also be reduced if public sector employment and pension obligations are reduced. Theoretically, such a step would make sense if the private sector could operate the facility or perform the function more efficiently than the government has been doing. The City of Philadelphia is currently exploring the potential privatization of the Philadelphia Gas Works with the goal of reducing its unfunded pension liability. Such strategies face significant political challenges, however, as evidenced by opposition to the Commonwealth's efforts to privatize liquor sales and toll roads. Public employee unions and their legislative supporters have argued that privatization will lead to higher fees charged to the public, deterioration of public facilities and service quality, and layoffs or lower compensation levels for the public employees involved. As

noted above, Pittsburgh's City Council recently dedicated revenues from parking garages and meters to pension debt reduction. In so doing, the City Council rejected a \$453 million bid -- well above the \$150 million minimum the city said it would accept -- from J.P. Morgan for a 50-year lease on the revenues. Another risk is that elected officials, responding to political pressures, will use the proceeds from asset sales or leases to plug holes in their operating budgets. Chicago put almost \$1 billion in proceeds from the privatization of parking meter revenues into its operating budget rather than using the proceeds for capital projects or to reduce pension debt. Yet Chicago still faces \$19 billion in unfunded pension liabilities and a \$650 million operating budget deficit.

**--Declare bankruptcy.** Federal law and arguably their constitutional status as sovereign governments preclude states from declaring bankruptcy. Although hard pressed, the Commonwealth is not bankrupt. A school district can declare bankruptcy with the approval of the Department of Education, and conceivably, a bankruptcy court could then force the district's creditors, and perhaps even its unionized employees, to accept less than full payment of their contracts. Pennsylvania's 53 Third-Class cities are precluded from declaring bankruptcy by a state law that was specifically designed to prevent Harrisburg from seeking bankruptcy protection. The prohibition expires at the end of November 2012. Driven partly by spiking pension costs, a number of cities in California and elsewhere have declared bankruptcy.



### What Remedies Are Being Discussed in Pennsylvania?

Governor Tom Corbett has indicated that public pension reforms will be at the top of his agenda in the next session but has not yet recommended specific steps. Although legislative action in the remaining months of the 2012 session is unlikely, legislators in both chambers have signaled their interest in pursuing remedies. Senator Patrick M. Browne (R-Lehigh, Northampton, and Monroe) has introduced legislation, co-sponsored by Senate Majority Leader Dominic Pileggi (R-Delaware and Chester), establishing a defined contribution system for state and school district employees hired after December 1, 2012. In a May 24 press re-

lease, Senator Pileggi indicated that without such a change, the current DB plans administered by SERS and PSERS will become unaffordable to taxpayers. State Representative Warren Kampf (R-Chester and Montgomery) and other regional legislators have introduced similar legislation in the Pennsylvania House (HB 2453, HB 2454). In addition, the House Finance and State Government Committees have been holding hearings on pension bills, including HB551 and HB552 sponsored by State Representative Scott Petri (R-Bucks). PERC also has been holding hearings.

**Table 6. Public Pension System Legislation Filed in the 2011-12 Session**

<b>Bill Number</b>	<b>Sponsor</b>	<b>Short Description</b>	<b>Status as of 8/31/12</b>
HB 418	Krieger (R-Westmoreland)	Requires all current and future members of the General Assembly to enroll in defined contribution retirement plan	Hearing in House State Government Committee, 5/1/12 and 8/14/12
HB 551, 552	Petri (R-Bucks)	Establishes and administers optional DC retirement program for public school employees and state employees	Hearing in House State Government Committee, 5/1/12 and 8/14/12
HB 1676, 1677	Boyd (R-Lancaster)	Creates hybrid “Cash Balance” retirement plan for state employees and public school employees	Hearing in House State Government Committee, 5/1/12 and 8/14/12
HB 2200	Evankovich (R-Westmoreland)	Creates 401(k) pension plan for new members and staff of General Assembly as of 11/30/12	Hearing in House State Government Committee, 5/1/12 and 8/14/12
HB 2453, 2454	Kampf (R-Chester, Montgomery)	Establishes DC program for public school employees and state employees, offers incentives for current employees to move from current DB program to new DC system	Hearing in House Finance Committee, 8/14/12
HR 602	Milne (R-Chester)	Directs the Public Employee Retirement Commission to conduct a comprehensive study of the respective State-sponsored pension systems	Referred to House State Government Committee, 3/12/12
SB 1072	Costa (D-Allegheny)	Amends 2nd Class County Code (Allegheny County) by increasing length of service from 20 to 25 years for non-uniformed employees; retains 50 as retirement age for police officers and firefighters and 55 for sheriff’s deputies, probation officers, and prison guards; increases length of service required for vesting from 8 to 10 years; makes changes to requirements for securing survivor benefits	Discussed at Public Employee Retirement Commission Meeting, 11/17/11
SB 1540	Browne (R-Lehigh, Northampton, Monroe)	Creates a DC retirement system similar to a 401(k) or 403(b) plan for all state employees and public school employees hired on or after December 1, 2012	Referred to Senate Finance Committee, 6/25/12

**Final Thoughts**

Pennsylvania’s public pension funding challenges are not unique. A number of recent national studies have identified unfunded pension liabilities as one of the most critical issues -- if not the single most critical issue -- facing state and local governments and therefore the nation. These include the Pew Center on the States, the United States General Accountability Office, and the Report of the Task Force on the State Budget Crisis Task Force co-chaired by Paul Volcker and Richard Ravitch. The Volcker-Ravitch report estimates state and local pension debt at about \$1 trillion using official actuarial assessments and \$3 trillion using more conservative investment assumptions. Both Pew and Volcker-Ravitch estimate that the states face roughly another \$1 trillion in underfunded programs to provide health care for their workers and retirees.

Because of legislation enacted in the 2009- 2010 session, Pennsylvania has made some progress in attacking its state pension problems, which are not as foreboding as those in states like New Jersey, Illinois, and California. Nevertheless, the Commonwealth and many of its school districts and municipalities will have to make difficult decisions about higher taxes or deeper service cuts to meet the pension funding challenge. And like their counterparts across the country, Pennsylvania and its local governments will be making such decisions in the context of a national struggle to overcome an unprecedented financial collapse, an increasingly competitive global economy, the unfavorable tide of an aging population, and the erosion of existing public and private retirement programs, including Social Security.

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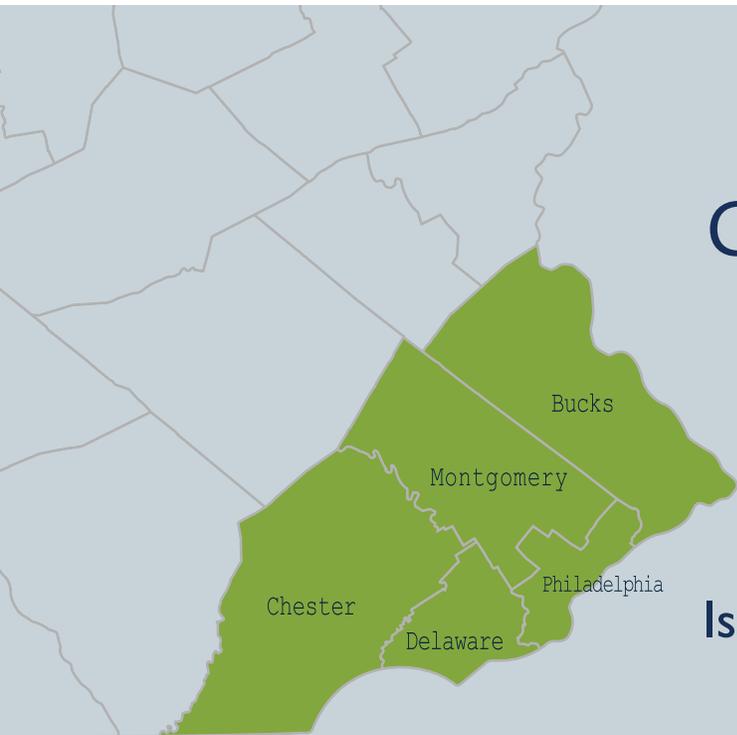
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