Good afternoon Chairman Metcalfe and the members of the State Government Committee. My name is Stephen Herzenberg and I have a PhD in economics from the Massachusetts Institute of Technology (MIT). I have been the Executive Director of the Keystone Research Center since its creation in the mid-1990s. KRC is an independent, non-partisan economic research and policy organization or “think tank,” the mission of which is to promote a more prosperous and equitable Pennsylvania. A core focus of KRC’s research is on the performance of the Pennsylvania economy from the perspective of typical families. One component of this research is on retirement security, in both the private and the public sectors. I appreciate very much the opportunity to testify before you today on this important issue.

This committee is currently considering several proposals to transfer some current or potential future members of the state defined benefit (DB) pension plans for state employees (the State Employee Retirement System or SERS) and public school employees (the Pennsylvania School Employee Retirement System or PSERS) into 401(k)-typed defined contribution (DC) individual retirement savings accounts.

- HB 413 would transfer all members of the Pennsylvania General Assembly to a DC plan.
- HB 716 would transfer new members and staff of the General Assembly to a DC plan.
- HB 240 and 242 would provide participants in SERS and PSERS with the option of participating in 401(k)-type defined contribution savings plans.

The Governor’s pension proposal would more dramatically restructuring state and school retirement plans, placing all new state or school employees in a defined contribution plan beginning in 2015. Since HB 413 and HB 716 would impact only a small fraction of current or potential future SERS participants, most of my remarks relate primarily to HB 240 and 242 and to the Governor’s proposal. Many of the points made here about these specific proposals to transfer all or a significant number of new employees to DC plans would also apply to any proposal that transfers all or a large fraction of new employees to DC plans.

One last preliminary: my testimony today relies in significant part on a series of Keystone pension primers, released over the past six or seven weeks, three before today and one that to be released later today. Our aim in releasing in a series of short primers rather than one larger report is to break down into more comprehensible pieces the multi-faceted and often technical pension issue. We hope by doing this to help policy makers, the media, advocates, and members of the public understand more clearly the implications of alternative pension proposals. All of our primers, and other materials, can be found on Keystone Research Center’s pension “issue page,” online at www.keystoneresearch.org/pensions
• Pension Primer #1: Digger a Deeper Pension Hole: Transitioning to Defined Contribution Plan Brings Higher Pension Debt and Taxpayer Costs.
• Pension Primer #3: Long-term Savings in 2010 Pension Reform Law Hard to Beat.
• Pension Primer #4: There You Go Again: Governor’s Proposal Delays Public Pension Payments, Repeating Short-Sighted Practices That Drove Up Pension Debt.

I will turn now to specific comments on the proposals before this committee and the Governor’s pension proposal.

Paying more for less: existing defined contribution plan proposals would increase the cost of pensions for employees in these plans. Act 120, the Pension Reform Act of 2010, lowered the employer (hence taxpayer) cost of pensions for future employees to a projected 2.2% for PSERS and 5.1% for SERS—3% on average across the two plans (closer to the stand-alone PSERS number because it is much larger plan and thus more weight in the average). HB 240 and HB 242 would provide an employer contribution twice as large—6%—although its costs would be mitigated to the extent that new employees opt for the current SERS and PSERS plans.

The Governor’s proposal would also increase the cost of pensions for new employees by one third—to 4% of payroll rather than 3%. As detailed in KRC Pension Primer #2, by the time the Governor’s proposal is fully phased in, the annual pension cost increase to taxpayers would be $189 million dollars, $112 million of this incurred by school districts. (Since HB 413 and HB 761 cover only a small number of participants in SERS, their impact on costs would likely be small.)

Digging a deeper pension hole: any proposal that closes or substantially shrinks the number of new employers entering the SERS and PSERS defined benefit plans—including the Governor’s proposal and possibly including HB 240 and HB 242—would increase Pennsylvania’s current pension debt. It is by now fairly well understood that no proposal to funnel new employees into a defined contribution pension plan reduces the outstanding (or “unfunded”) liabilities of Pennsylvania’s retirement systems—the widely cited $41 billion pension debt. In fact, as detailed in KRC pension primer #1, any proposal that shifts large number of new employees into individual accounts will increase the state’s current pension debt.1 These existing plans would become closed-end funds with the average age of members increasing as the plans wind down. Plan assets would have to be invested more conservatively as plan participants grow older and retire as a group. PSERS and SERs investment earnings would fall below current projections of 7.5%. With investment earnings paying for less of existing pension benefits, taxpayers would have to pay more. Since these proposals would increase the cost to taxpayers of paying off Pennsylvania’s unfunded liabilities, these proposals are not “better than nothing,” “good for taxpayers,” or “pension reform.”

1 Pension primer #1
KRC Pension Primer #1, on the negative impact of closing (or sharply shrinking) a defined-benefit plan, contains an annotated bibliography of studies in 12 states that have considered a shift to defined contribution plans, along with links to most of those studies—allowing members of the committee or their staff to conduct their own independent evaluation of the research literature. The actuarial consensus of this literature is clear: a shift from defined benefit plans to defined contribution plans has a large transition cost.

The idea that switching to a defined contribution plan will increase costs to taxpayers is not just theory. It is the experience of the states that have moved in that direction. There are three states that have closed off their defined benefit plans and put all new hires in 401(k)-type plans: West Virginia (1991), Michigan for its state employees (1997), and Alaska (2006).

**Michigan**: Michigan began enrolling all new state employees in a 401(k)-type plan in 1997. Since then, the system’s unfunded liabilities have skyrocketed, from $697 million in 1997 to $4.078 billion in 2010. This increase partly reflects inadequate employer contributions to pay for the unfunded liability. (Michigan has not made its annual required contributions suggested by the Governmental Accounting Standards Board (GASB) in nine of the last 10 years.)

**Alaska**: Alaska adopted a 401(k)-type plan for both new state and public school employees that became effective in 2006. Although sold as a way to reduce the employer contribution rates, these rates have increased. For state employees, the actuarially determined employer contribution rate required to pay off the unfunded liabilities increased from 12.39% of salary in 2006 to 22.48% in 2012. For teachers, this rate increased from 24.57% to 36.04%. Across the two plans, the unfunded liabilities associated with the closed defined benefit plans have increased from $3.8 billion in 2006 to $7 billion in 2011 (the latest year for which data are available).³

---


³ The analysis in this paragraph is based on data in Alaska Department of Administration (ADA), Division of Retirement and Benefits (DRB), Public Employees’ Retirement System (PERS), *Comprehensive Annual Fiscal Report for the Fiscal Year Ended June 30, 2012*, pp. 117-118, online at http://doa.alaska.gov/drb/pdf/pers/cafr/2012PersCafr.pdf; and ADA/DRB/PERS, Teachers’ Retirement System Comprehensive Annual Financial Report For the Fiscal Year Ended June 30, 2012, pp. 110-11, online at http://doa.alaska.gov/drb/pdf/trs/cafr/2012TrsCafr.pdf. There is a three-year lag in Alaska between the actuarial determination of required employer contribution rates and their application. It could therefore be argued that rather than comparing the 2012 and 2006 rates, we should compare the 2014 (which is based on 2011 financial data) and 2009 rates (based on 2006 financial data when Alaska switched to defined contribution plans). During this alternate period, the employer contribution rate for unfunded pension liabilities has increased from 21.5% to 24.19% for state workers; for teachers the rate has increased from 34.8% to 43.51%. Thus, the qualitative finding remains that employer contribution rates to pay off the unfunded liabilities have increased since the switch to a defined contribution rate. (Note also that employer contributions to pay off the unfunded liabilities in Alaska continue to be imposed on total salaries, including those of new employees.)
West Virginia: West Virginia adopted a 401(k)-type plan in 1991, but reversed course in 2006, reopening its defined benefit plan to all new hires in 2005 and allowing the members of the 401(k)-type plan to switch into the defined benefit plan. There were several reasons cited for the switch back, including a study done by West Virginia’s Consolidated Public Retirement Board. The study found that the average investment return for employees with individual accounts equaled 3.39% from 2001 to 2006, compared to 6.13% from the teachers’ defined benefit retirement system. In addition, for five out of six members over age 60 with individual accounts, the average account equaled $23,193. With many individual accounts not on track to generate adequate retirement income, the defined contribution plan was perceived to be driving up taxpayer costs for means-tested public programs.4

There you go again: Delays in public pension payments would repeat the short-sighted practices that drove up Pennsylvania’s pension debt. A third reason that the Governor’s proposal would increase the taxpayer cost of employee retirement plans is by reducing state and school district pension contributions to SERS and PSERS over the next five years. The Governor’s own estimate is that lowering the “collars” that limit how much employer contributions can increase in any one year will increase the state’s pension debt by between $4 billion and $5 billion by 2019-20. The Corbett administration’s own legislative pensions briefing says that the adjustments to the collars “ Increases UAL [Unfunded Actuarial Liability], exacerbating PA’s long-term problem” and refers to this step as the “Proverbial kicking the can down the road.” We agree and suggest that the legislature therefore not take this stop.

Governor’s proposal could increase Pennsylvania’s pension debt $25 billion by 2046. Treasurer Rob McCord estimates that the Governor’s plan could increase the state’s pension debt by $25 billion by 2046, primarily as a result of the erosion of investment returns in SERS and PSERS but also because of the delays in pension payments.5 In sum, the Governor’s plan has a serious case of what might be called “pension deficit disorder.”

The rest of this testimony switches gears slightly: rather than addressing legislative or the Governor’s proposal directly, it some broader facts (or in some cases myths) about public sector pensions. Probably understood, these facts make clear that Pennsylvania is best served by staying the course with the reforms enacted in Act 120 of 2010, as well as potentially addressing the state’s need for revenue and the erosion of retirement security in the private sector.


5 Treasurer Rob McCord made this statement in a conference call with reporters that also included the author of this brief. For one of articles citing the Treasurer’s statement, see Jason Scott, “Pennsylvania Pension Debate: Where Do We Go From Here?” online at http://www.centralpennbusiness.com/article/20130301/CPB01/130309966/Pennsylvania-pension-debate:-Where-do-we-go-from-here?&template=art.
In recent years, Pennsylvania state and school employees contribute a LOT more to their pensions than the national average for state pension funds—three-and-a-half times as much relatively to what employers contribute. A consensus exists that one of the main reasons for Pennsylvania’s current pension debt is that employers—the state and school districts—contributed too little to pensions in the decade beginning in 2001. It is also well known that Pennsylvania school and state employees never took a contribution holiday, and contributed nearly 7% of their salary, on average, every single paycheck to pay for their own pensions. KRC Pension Primer #4, to be released later today, puts these two bits of information together: it compares the ratio of employee to employer contributions into state pension plans in Pennsylvania versus the rest of the nation from 2001 to 2009. The result is striking: Pennsylvania’s ratio of employee to employer contributions is 3.5 times the national average ratio. This overall ratio stems from the fact that while employers contribute nearly twice as much as employees to state pension plans on average across the country, in Pennsylvania from 2001 to 2009, this ratio was reversed—employees contributed twice as much as employers. If employer contributions had been high enough for Pennsylvania to achieve the national average for employer to employee contributions since 2001, our preliminary estimate is employer contributions would have been more than $20 billion higher—even before taking into consideration investment earnings on these additional contributions. In sum, we wouldn’t be here today if the state and school districts had contributed as robustly to state pensions as employees have. The clear implication of this is that Pennsylvania public employees did not create the pension debt and so should not be held responsible for it.

Pennsylvania’s public pensions are not especially generous. Some of the rhetoric and advocacy for modifying Pennsylvania’s public sector pensions is based on the claim that public sector workers earn outsized pensions. In fact, the current SERS and PSERS state pensions are not overly generous.⁶

Pennsylvania public sector workers earn lower wages and slightly lower wages plus benefits than comparable public sector workers. The most definitive research on public sector pay and benefits in Pennsylvania relative to private sector pay is a report by Rutgers economist Jeff Keefe, published in 2011 by the Economic Policy Institute.⁷ Adapting a methodology associated with Chicago school (conservative) Nobel-prize winning economist Gary Becker, Keefe shows that state and local government employees in Pennsylvania are paid substantially less in wages than private sector workers who have the same level of education, experience, and other characteristics that economists typically “control for” when examining relative wages. The public sector wage gap is particularly pronounced at the high end and among more educated workers. Controlling for education (but not other variables), Pennsylvania workers with a four-

---

⁶ My House testimony, on pages 8-11, also contains a discussion of the adequacy of pension benefits for new employees under a proposed cash balance plan based on an analysis of HB 1677. The analysis there concludes that HB 1677 would lead to a significant additional cut in benefits relative to the Act 2010 changes which already cut pension benefits for new employees by 20%.  
year college degree or more earn 27% to 59% less in annual wages than similarly educated private-sector workers.\textsuperscript{8} At the very top end of the wage distribution, the two highest-paid CEOs in Pennsylvania earned more in 2010 than the highest-paid 100 public sector workers combined.\textsuperscript{9} There is a reason people do not say “I’m leaving the private sector to go make more money.”

When you take into account benefits, the compensation (wages plus benefits) gap between the private sector and the public sector in Pennsylvania shrinks: but public sector workers are still paid slightly less in wages plus benefits, on average, when you control for education and other individual characteristics.\textsuperscript{10}

\textit{The 2010 Act 120 reforms made Pennsylvania public sector pensions substantially less generous} to employees and less costly to employers. As members of this committee know, the Act reduced the future cost to state government of SERS and PSERS pensions in many ways:

- The pension multiplier, which helps determines what percentage of salary workers will receive in retirement benefits, was reduced by 20 percent, falling from 2.5 percent to 2 percent per year of service.
- The vesting requirement was increased from five years to 10 years;
- A cap was placed on the maximum pension benefit, so that retirees with longer years of service cannot earn more than their final salary;
- There were substantial increases in the age and years of service required to retire at full benefit;
- The option that allows members to withdraw their own contributions when they retire was eliminated.
- The basic contribution rate was effectively raised, because new hires are paying the same amount for a reduced level of benefits; and,
- Pennsylvania was the first in the nation to require new hires to pay an additional “shared risk” rate of up to 2 percent if SERS/PSERS do not meet their earnings assumptions. So instead of just the employer rate going up following an economic meltdown, employees too will directly share in the pain. (As noted in KRC Pension Primer #3, shared-risk increases in employee contributions require employers to also increase contributions, a powerful disincentive to underfunding after a future market meltdown. Such a shared risk feature would have gone a long way to maintaining an appropriate balance between employer and employee contributions in the period since 2000, avoiding the accumulation of a large pension debt.)

\textsuperscript{8} Keefe, \textit{Public Versus Private Employee Costs}, Table 2, p. 5. Including benefits, the total compensation gap (wages plus benefits) for workers with a college degree or more is almost as big, ranging from 21% to 57%.

\textsuperscript{9} For details and sources, go to \url{http://thirdandstate.org/2011/april/ceo-pay-soars-while-workers%E2%80%99-pay-stalls}.

\textsuperscript{10} Keefe, \textit{Public Versus Private Employee Costs}, Table 4, p. 9. The annual wage and compensation gaps are still statistically significant: public compensation trails private sector by 5.4%. When examining compensation per hour, the gap shrinks to 2.1% for all public employees and 3.8% for state government employees, neither of which is statistically significant.
PSERS and SERS pensions provide adequate but not generous retirement income. To fully assess the generosity of PSERS and SERS pension plans requires complex models beyond the scope of this testimony. Back in 2006, however, in a report jointly published by my organization and the Center for American Progress, economist Christian Weller reported the results of some simulations aimed at gauging the generosity of SERS and PSERS pensions.\footnote{Christian E. Weller, Mark A. Price, and David M. Margolis, \textit{Rewarding Hard Work: Give Pennsylvania Families a Shot at Middle Class Retirement Benefits} (Keystone Research Center, Harrisburg and Center for American Progress, Washington, DC: October 4, 2006), pp. 11-12; online at \url{http://keystoneresearch.org/media-center/press-releases/state-should-take-action-bolster-retirement-security-says-keystone-resea}.} Weller assumed (based on the actual characteristics of SERS employees) that a “typical” SERS worker has 15 years in a SERS job, 15 years in another job, and then retires at 62. He assumed that a “typical” PSERS employee has 30 years of experience and retires at 62. Based on his models, a typical PSERS employee had retirement income equal to 78% of pre-retirement income with 52% of that income coming from their DB pension and the rest from Social Security. A typical SERS employee had retirement income equal to only 51% of pre-retirement earnings, which only 31% of that coming from their SERS DB pension.

Retirement experts regard the threshold retirement income for maintaining one’s standard of living in retirement as about 75-to-80 percent of pre-retirement income. Based on this threshold, our “typical” PSERS employee meets the threshold while the “typical” SERS employee falls short. Of course, employees that work much more than typical may end up with more generous pensions but the anecdotal exceptional employee is not a basis for a fact-based assessment of the generosity of pensions. Keep in mind that Weller’s analysis was for SERS and PSERS prior to the Act 120 changes, which, in effect, cut pensions by at least 20%.

One major reason that Pennsylvania public sector pensions are not especially generous, and automatically become less generous for already-retired workers every year, is that benefits are based on the employees top salary years \textit{unadjusted for inflation}. Since Pennsylvania SERS and PSERS benefits are not automatically adjusted for the rising cost-of-living, unlike Social Security, these benefits are eroded by inflation each passing year. For example, anyone who retired in or before 2002, since which there has been no ad-hoc cost-of-living adjustment for retirees, has seen the real purchasing power of their pension eaten away 21.4% by inflation. Taking this inflation into consideration, the multiplier for retirees in 2002 and earlier has effectively been reduced from 2.5 to 1.96—and falling every year.

\textit{For future employees, since pension benefits aren’t generous, cuts in pensions won’t save money because wages will have to increase to attract and retain qualified workers.} The slight public-sector disadvantage in total compensation (wages plus benefits) compared to the private sector means that it won’t be possible for the state or school districts to save money by cutting pensions for future employees without having difficulty attracting and retaining qualified workers. Particularly for the most underpaid (relative to the private sector) public sector employees—such as teachers and professionals in state government with a college degree—cuts in pension will have to be followed by compensating increases in salary. (Keep in mind that
53% of state and local government employees have a college degree or more and, given that more educated workers earn more, this 53% probably account for about two thirds of the total wage bill of for government. Moreover, with a switch to a DC pension plan that eliminates economic incentives for experienced workers to stay with state government or schools, government might no longer be able to get away with the current amount of underpayment of the most educated half of public sector workers: market forces could force an increase in salary that increases costs by even more than any reduction in state or school district contributions to employee pension plans. In sum, given the need to offer an overall competitive compensation package to attract and retain good employees, there would be no savings for state government by reducing pensions. (This holds true even before you consider the inefficiency and high cost of DC pension plans—which is considered below.)

*For current employees and existing retirees, since pension benefits aren’t generous, cuts in pensions would be unethical.* Setting aside the legal prohibitions on cutting pension benefits for workers already in the SERS or PSERS retirement systems, the slight public-sector disadvantage in total compensation (wages plus benefits) compared to the private sector has another implication. It underscores that good pensions are compensation for wages and salaries well below private-sector levels, on average. Many existing workers and retirees might have taken different jobs in the first place, or left public service earlier, if they knew in advance that pension commitments that compensate for lower public sector wages were not going to be honored. Thus, lowering pensions for existing retirees and plan participants is not just legally and constitutionally a violation of a contract it is also unethical. Since public sector employees didn’t get a sweet deal in the first place, cutting their pension benefits would be a raw deal.

**Paying more for less, part two: DC plans are not cost-effective retirement plans.** Another important part of your deliberations should address the relative cost of managing the existing SERS and PSERS DB plans compared to proposed alternatives. The combined administrative, financial management, marketing, and trading fees of 401(K) type plans are substantially higher and, moreover, these costs can eat away a substantial share of plan participants’ retirement security. For example, the National Institute on Retirement Security estimates that DC plans only provide about half as much retirement income as DB plans for any given level of (combined employer plus employee) contributions—this is a BIG difference.  

**DC plans represent a transfer from Main Street to Wall Street.** Based on the higher costs of managing DC plans, our conclusion is that DC plans represent a transfer from Main Street to Wall Street. Public-sector employees get less retirement security for any given amount of

---

employee and employer contributions and financial services firms expand their market and their profits. Why is this a good idea?

Revenue must be part of the discussion about addressing unfunded liabilities. We do need more revenues to help deal with unfunded pension liabilities and with the states other revenue needs—for investments in education and infrastructure and for essential services including health care. In the context of pension issues, a number of sources of revenue come to mind: a tax on high-end pensions, so that more affluent retirees can contribute to limiting poverty among other retirees; a portion of revenues from closing corporate tax loopholes, given that financial games contribute both to the erosion of pension security in the private sector and to corporations paying lower taxes than commensurate with their real profitability and operations in Pennsylvania; or a higher tax rate on some classes of non-wage income, such as capital gains, dividends, profits, and interest. (A higher tax rate on unearned income is legal under the state’s constitutional uniformity clause: wage income and each of the categories of unearned income are separate “classes” of income on each of which may be imposed different tax rates.) Higher tax rates on unearned income would lead to those with the greatest ability to pay contributing a bit more to protect retirement security for public sector workers after they leave their jobs. With regard to this last option, it is worth noting that from 2009 to 2011, the most recent estimates available, the highest-income 1% of Americans took home a stunning 112% of the total increase in U.S. income.13


The new study identifies six common elements of public sector defined benefit pension plans that remained well-funded despite two severe economic downturns:

1. Employer pension contributions that pay the full amount of the annual required contribution, and that maintain stability in the contribution rate over time;
2. Employee contributions to help share in the cost of the plan;
3. Benefit improvements, such as multiplier increases, that are actuarially valued before adoption and properly funded upon adoption;
4. Cost of living adjustments (COLAs) that are granted responsibly, for example through an ad hoc COLA that is amortized quickly, or an automatic COLA that is capped at a modest level;
5. “Anti-spiking” measures that ensure actuarial integrity and transparency in pension benefit determination; and

---

13This figure is based on an updated estimate by Emmanuel Saez and Thomas Piketty, as referenced online at http://gulzar05.blogspot.com/2013/02/piketty-saez-update.html. When the top 1% receives more than 100% of the increase in income in a period it means that the top 1% receives all of the increase in income and, on top of that, there was a transfer of some additional income from the 99% to the 1%—i.e., the incomes for the 99% actually went down slightly in the period.
6. Economic actuarial assumptions, including both the discount rate and inflation rate, that can reasonably be expected to be achieved over the long term.

Pennsylvania has the second of these best-practice features in spades, and since the COLA of a decade ago, the state appears to have learned the importance of the fourth feature. Pennsylvania does need to lock in feature 4 as well as strengthen features 1, 3, and 5.

The Real Retirement Security Crisis is the Lack of Adequate Pensions in the Private Sector. My final point is that the real retirement security crisis is the lack of adequate pensions in the private sector. Half of private sector workers in Pennsylvania (and a higher share nationally) have no retirement at all and most of the rest have only a 401(k)-type plan with very little money in it. In this regard, we noted last year with interest California’s passing of a law that would permit some private-sector employers to participate in a savings plan managed by the state’s public employee retirement system—while not as cost-effective as a DB plan, this would at least allow some benefits of pooling and lower-cost professional management. In a similar vein, we helped instigate, more than a decade ago, a Pennsylvania legislative proposal for the state to facilitate the creation of “universal savings accounts” (or “Pennsylvania Voluntary Accounts”) for those who have no pension at all in the private sector. We understand that there is some interest in reintroducing this legislation later this session.

In closing, we recommend a three-step process to Pennsylvania retirement.

• First, do no harm: in public policy as in medicine, this is a good principle. In the current retirement security debate, this principle suggests that lawmakers not enact proposals—such as a switch to defined contribution plans—that drive up the state’s pension debt or increase the cost of pensions for new employees.

• Second, address the overall need for revenue and refocus state policy and the state budget on increasing job growth, which will also increase tax revenue. You can’t cut your way to prosperity. One particular opportunity to stimulate growth (as well as save on health care costs) would be to accept the Medicaid expansion available under the Affordable Care Act.

• Third, after securing the state’s defined benefit public sector pension plans, refocus on the challenge of improving retirement security in the private sector.

14 For more detail on the erosion of retirement security in the private sector, see my testimony from August 2012 before the Joint House State Government and Finance Committees, online at http://keystoneresearch.org/media-center/press-releases/undermining-retirement-security-stephen-herzenbergs-testimony-pension-le