There You Go Again

Governor's Proposal Delays Public Pension Payments, Repeating Short-Sighted Practices That Drove Up Pension Debt

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Keystone Pension Primers: *As Pennsylvania policymakers, media, and citizens evaluate Governor Tom Corbett's pension proposal unveiled February 5, 2013, the Keystone Research Center will release a series of short "pension primers" to demystify the often complex details at the heart of the pension debate. This is the fourth installment in that series* **April 16, 2013**

Overview

Consensus exists that a major cause of Pennsylvania's current pension debt was a decade of low—or no—contributions from the state and school districts. In state budgets signed by three previous Governors, the state shortchanged Pennsylvania's pension plans for teachers, nurses, emergency responders, and other public servants—failing to make the financial contributions necessary to maintain pension fund health. Governor Corbett's pension proposal introduced in early February would repeat this pattern, lowering state and school district pension contributions from 2013 through 2019, a period coinciding with the maximum time the Governor could remain in office.

Lowering pension contributions below the increases within the Pension Reform Act of 2010 (Act 120) would increase Pennsylvania's pension debt by a total of between $4 billion and $5 billion by 2019, according to the Governor's own estimates. Lower near-term pension contributions along with other aspects of the Governor's proposal—primarily the costs of closing the state's defined benefit pension funds—could add $25 billion to Pennsylvania's pension debt by 2046, according to Pennsylvania Treasurer Rob McCord.[1]

As public employers in Pennsylvania scaled back their pension contributions, employees continued to contribute to their pensions paycheck after paycheck. Over the period 2001 to 2009, Pennsylvania state and school employees contributed an average of 6.7% of their salaries toward pensions, nearly twice as much as contributed by Pennsylvania employers (the state and school districts). Pennsylvania's ratio of employee-to-employer contributions flips the national pattern for public pensions; in the rest of the United States employers contribute nearly twice as much as employees. With unusually high employee contributions and unusually low employer contributions, the ratio of employee-to-employer contributions into Pennsylvania's public pension plans was about 3.5 times the national average (excluding Pennsylvania) during 2001 to 2009.

Pennsylvania needs to maintain the scheduled increases in annual state and school district pension contributions established by the Pension Reform Act of 2010, gradually restoring state pension funds to 100% funding and an equitable balance between employer and employee contributions.

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[1] Treasurer Rob McCord made this statement in a conference call with reporters that also included the author of this brief. For one of the 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/CPBJ01/130309966/Pennsylvania-pension-debate:-Where-do-we-go-from-here?&template=art.

Key Facts About Pennsylvania Pensions

While each "Keystone Pension Primer" focuses on one issue in the pension debate, lawmakers, members of the media, and the public should consider all issues in evaluating the Governor's proposal:

- **The Governor's proposal would increase Pennsylvania's pension debt (or "unfunded liability").**
- **The Governor's pension proposal would increase the cost of pensions for new employees** above the very low levels (3% for SERS and PSERS together) achieved in the Pension Reform Act of 2010.
- **The Governor's proposal does not make the responsible contributions to pensions required by the Pension Reform Act.** Diverting required pension contributions is a replay of the short-sighted political decisions that Governor Corbett has pointed to as helping create the current unfunded liabilities.
- **The Governor's proposal to cut current workers' pensions risks court reversal** for violation of a constitutionally protected contract. **It leaves the state uncertain of pension costs for years** and then with potentially higher pension debt.
- **Teachers, nurses, emergency responders, and other public employees contribute heavily to their own pensions and earn lower salaries than comparable private-sector workers**. School and state employees currently contribute 7% of every paycheck, on average, to their own pension—and contributed 3.5 times as much, relative to employers, as the average for public employees in other states pension plans from 2001 to 2009. In addition, even with good benefits, Pennsylvania public workers earn lower wages plus benefits than equivalent private workers.
- **The Pension Reform Act of 2010 reduced pensions for future employees by over 20%** and protects taxpayers through a unique "shared risk" feature that requires even higher employee pension contributions if financial markets plummet.
- **Pennsylvania's pension debt should be kept in perspective** compared to the overall budget and the rise of income inequality in the state. Pension debt is a small share of total state funding over the decades the state has to pay it off. In addition, Pennsylvania's "99%" lose each $40 billion each year—roughly the current pension debt—because the richest 1% garners a bigger piece of the overall economic pie than in the 1970s.

What Created Pennsylvania's Pension Debt?

Pages three to six of the Corbett administration's *Keystone Pension Report* explain how Pennsylvania accumulated an estimated $41 billion in pension debt since 2001. This "unfunded liability" is the amount needed to pay existing pension commitments to retirees and current employees in the state's two main pension funds—the State Employee Retirement System, or SERS, covering state employees, and the Pennsylvania School Employee Retirement System, or PSERS, covering school employees.[2]

The Corbett administration pension report highlights that one of the "primary drivers of the current pension crisis" was "nearly a decade of underfunding by state government and local school districts" (p. 3). The report adds (on p. 4) that "Act 40 [of 2003] resulted in the state's underfunding of both SERS and PSERS by more than $5.9 billion when comparing what should have been contributed…with actual state appropriations."[3] The report

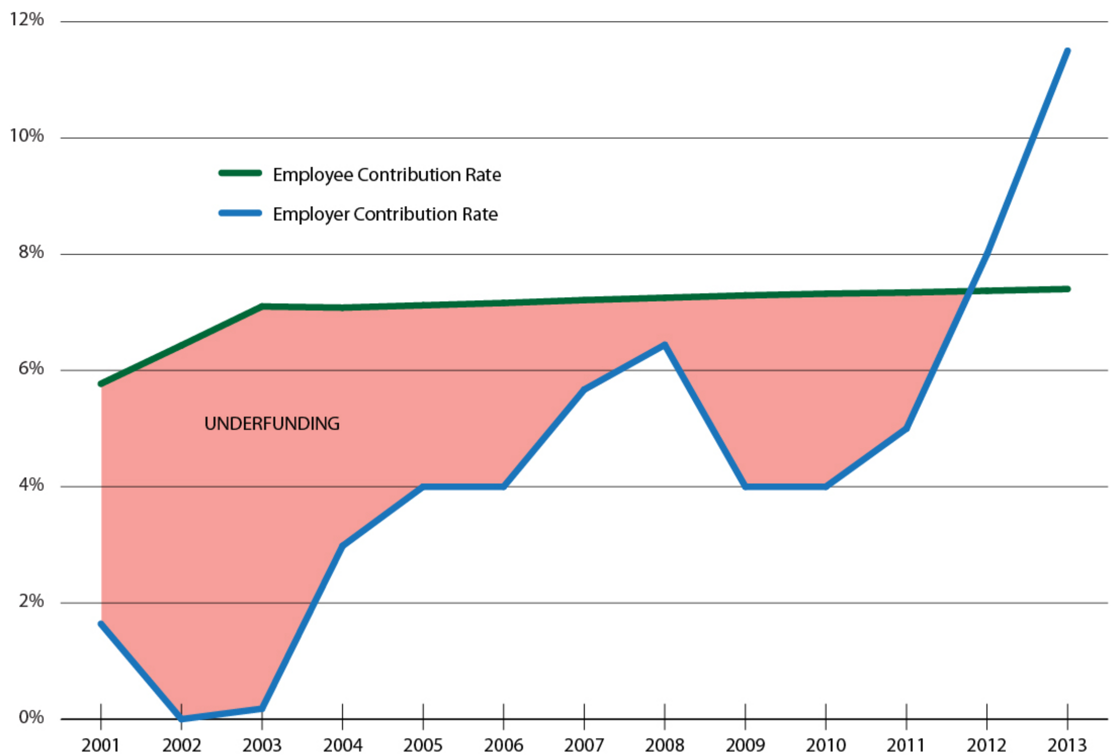
[2] Pennsylvania Office of the Budget, *The Keystone Pension Report: A Discussion of Structural Reform and Relief to Pennsylvania's Retirement System for Long Term Sustainability*, pp. 3-6, online at http://www.portal.state.pa.us.
[3] Exhibit 4 in *The Keystone Pension Report* details for SERS and PSERS the exact amount that funding fell short in each year. Consistent with the report's view that more "should have been contributed," the Keystone Research Center recommended in 2006 that the state legislature contribute annually to pension funds at least enough to pay for pension fund "normal costs" (the additional pension benefits earned that year by current workers accumulating an additional year of service.) See

notes, further, that "Act 40's underfunding of the pension systems had the effect of freeing up General Fund dollars that then became available to spend elsewhere. And spent they were." This led to what *The Keystone Pension Report* calls a "'robbing Peter to pay Paul' budget."

Finally, the Governor's pension report adds that:

> "This same dynamic often repeated itself at a school district level, further contributing to the problem. Lower state contributions meant lower district contributions and, like the state, had the effect of freeing up dollars in local district budgets that could be and were spent elsewhere. Though some districts acted responsibly in putting funds into reserve accounts knowing a pension tsunami would eventually hit, many more regarded the lower contributions as new found money…No matter the final destination, the result was the same: an underfunding of pension systems while at the same time exacerbating future obligations."

Figure 1. Employer and Employee Contribution Rate (percent of payroll) to the Pennsylvania School Employee Retirement System, 2001-2013



Source. Keystone Research Center (KRC) based on Pennsylvania School Employee Retirement System (PSERS) data

Figure 1 shows the annual employer and employee contributions to the PSERS plan from 2001 to 2013, including the zero employer contribution in 2002 and the near-zero employer contribution in 2003. The chart also shows consistent contributions by employees in every year, averaging 7.08% in 2003 and rising to a peak of 7.4% this year. (The pattern of employer and employee contributions over time is similar for SERS as for PSERS.) The shaded area shows the gap between employee and employer contributions from 2001 to 2011.

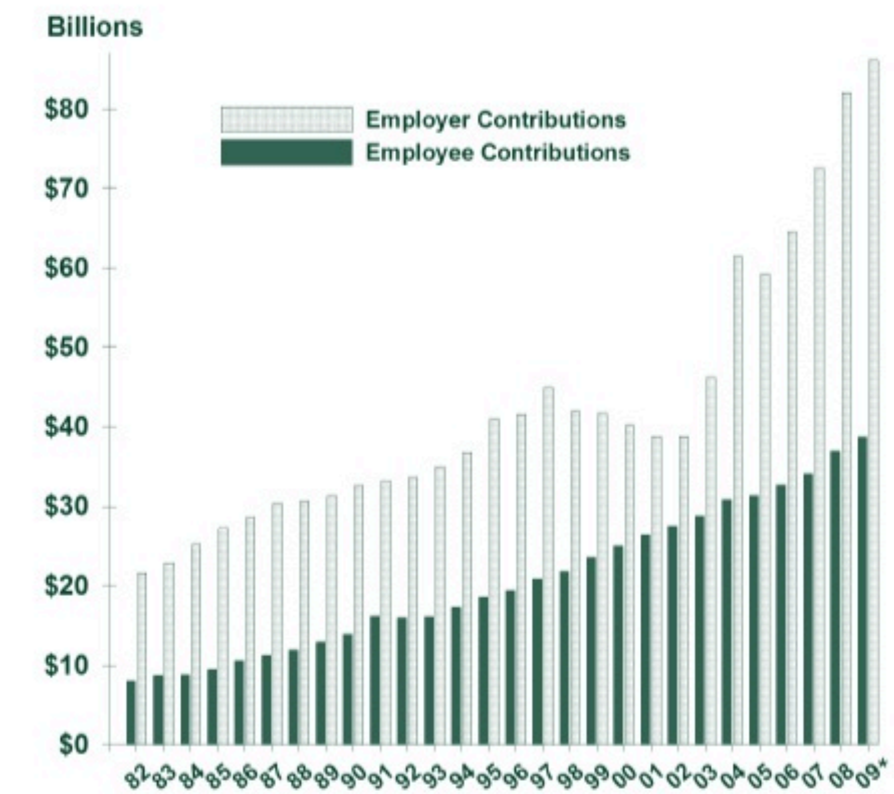
Christian E. Weller, Mark A. Price, and David M. Margolis, *Rewarding Hard Work: Give Pennsylvania Families a Shot at Middle Class Retirement Benefits* (Keystone Research Center, Harrisburg, and Center for American Progress, Washington, DC: October 4, 2006), online at http://keystoneresearch.org/media-center/press-releases/state-should-take-action-bolster-retirement-security-says-keystone-resea

PA Ratio of Employee-to-Employer Contributions 3.5 Times National Average, 2001-09

Between 2002 and 2011, the contributions of public employees provided almost twice as much revenue for PSERS and SERS as employer contributions, according to *The Keystone Pension Report*.[4] Nationally, by contrast, public employers contributed nearly twice as much as employees to public pensions from 2002 to 2009, as can be seen in Figure 2 below.[5]

Figure 2. Employers Nationally Contribute Twice as Much as Employees to State and Local Pensions

Employee and Employer Contributions, 1982-2009



Source. National Institute on Retirement Security, based on U.S. Census Bureau data

Another way to gauge employee and employer contributions in Pennsylvania compared to other states is to compare the *ratio* of employee-to-employer contributions. Nationally, excluding Pennsylvania, this ratio was 0.55:1 in the 2001 to 2009 period. In Pennsylvania during this period, the precise ratio was 1.95:1. Thus, the Pennsylvania ratio of employee-to-employer pension contributions was 3.56 times the national average from 2001 to 2009.[6] Even in 2010 and 2011, this ratio still exceeded 3: despite big increases in employee funding in state pension plans in some other states, Pennsylvania public employees *still* contribute significantly more to their retirement benefits than public employees in most other states.

How much higher would employer contributions in Pennsylvania have been from 2001 to 2011 if, employee contributions remained constant but employer contributions had been high enough to equal the national average ratio? The answer: over $16 billion. Taking into account investment earnings, a conservative estimate is that employer contributions high enough to bring the ratio of employer to employee contributions to the national average (including Pennsylvania) would have added another $23 billion to today's SERS and PSERS assets pool.

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[4] Exhibit 2 shows that employer contributions accounted for 10% of PSERS plus SERS revenue during 2002 through 2011, versus 19% for employee contributions. See Pennsylvania Office of the Budget, *The Keystone Pension Report*, p. 2.

[5] Based on analysis of Census Annual Survey of Public Pensions data, online at http://www.census.gov/govs/retire/. The employee and employer contributions totals are found under "Revenues."

[6] As noted in the text, the *Keystone Pension Report* states that the ratio of employee-to-employer contributions is equal to 1.9:1 (19% of total fund revenues vs. 10%) for the period 2002-11. Since employer contributions were very low in 2001 (1.64%) but higher in 2011 (4% and 5%) into PSERS, adding 2001 to the time span and removing 2010 to 2011 would change the ratio of employee-to-employer contributions to roughly 2:1 for 2001 to 2009.

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The Governor's plan lowers state pension contributions from the amounts set out in Act 120 by lowering the so-called "collars" that limit how much state (and school district) pension contributions can increase each year. The maximum increase in annual pension contributions had been set at 4.5% this year and the next several years. For 2013-14, the Governor's proposal reduces the maximum increase—or collar—to 2.25%. In the next four budgets, the collar would increase by 0.5 percentage points each year, reaching 2.75% in 2014-15, 3.25% the following year, 4.25% in 2018-19, and back to 4.5% in 2019-20 and thereafter. According to the Governor's February 22 legislative pensions briefing, the reduction in employer pension contributions from 2013 to 2019-20 increases Pennsylvania's unfunded pension liability by between $4 billion and $5 billion.[7]

Two text notes in the administration's slide on the impact of lowering the collars on Pennsylvania's pension debt say: "Adjustment to collars…Increases UAL [Unfunded Actuarial Liabilities], exacerbating PA's long-term problem;" and "Proverbial kicking the can down the road." We agree: the Governor's proposal repeats the shortsighted practices under the past three Governors that diverted pension contributions to other purposes and helped create the pension debt. Repeating one of the key mistakes of the past dozen years does not represent a sustainable plan for funding Pennsylvania's public-sector pensions.

The Keystone Research Center is a nonprofit, nonpartisan research organization that promotes a more prosperous and equitable Pennsylvania economy. Learn more: www.keystoneresearch.org.

[7] This is based on a chart in the Governor's legislative pensions briefing dated February 22, 2013. Since we are reading from a chart, it is hard to be more precise than between $4 billion and $5 billion. See "Pennsylvania Pension System Reform," Corbett Administration Legislative Pension Reform Briefing, February 22, 2013, slide 14. Our independent calculations of the increase in unfunded liability as a result of lowering the collars fall in the same range, taking into account both the lower contributions and the loss of investment earnings on these contributions.