Long-term Savings in 2010 Pension Reform Law Hard to Beat

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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 third installment in that series* **March 5, 2013**

Pennsylvania policymakers made good progress on pension reform with the passage of the "Pension Reform Act" in 2010. As a result of this law (officially known as Act 120 of 2010):

- Pennsylvania achieved low-cost pensions for new school and state employees by cutting benefits by over 20%;
- Taxpayers were protected with a "risk sharing" provision that increases employee contributions if an economic downturn reduces pension fund investment returns; and
- Pennsylvania public employees continue to contribute more to their own pensions than public employees of most other states.

Pennsylvania Already Has Low-Cost Pensions for New School and State Employees

The Pension Reform Act substantially lowered the cost of pensions for new employees hired in 2011 or later, saving money for the state, school districts, and ultimately taxpayers.[1] "Normal pension costs,"[2] which represent the price of pension benefits earned by employees in a given year, are low under the law. According to the Governor's "Keystone Pension Report," the normal cost of pensions each year for new school employees equals 2.2% of employee salaries. For state employees, the normal cost equals 5.1% per year.[3] The average for all employees across the two systems (weighted by the size of each system) equals 3%—closer to the figure for school employees since that pension plan counts many more members than the state pension plan.[4] As explained in more detail in Keystone Pension Primer #2, pensions for future employees under the Pension Reform Act cost less than the 4% of employee salaries which taxpayers would pay under the Governor's proposed defined

[1] Changes in the law went into effect after January 1, 2011 for employees in the State Employee Retirement Systems (SERS) and after July 1, 2011 for employees in the Pennsylvania School Employee Retirement System (PSERS).

[2] For a technical definition of "normal pension costs," see Public Employee Retirement Commission (PERC), *Funding and Reforming Public Employee Retirement Systems*, p. 235. In the text, we paraphrase the technical definition to make it more accessible to the lay reader.

[3] The estimates of normal costs for SERS and PSERS are from 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*, p. 5, online at http://www.portal.state.pa.us.

[4] The Public School Employee Retirement System (PSERS) has 279,000 active members and the State Employee Retirement System (SERS) has 107,000. (PA Office of the Budget, *The Keystone Pension Report*, p. 2.) The average of the two plans' normal costs weighted by their employment shares is exactly 3%. Weighted by each system's share of the combined *salary* of schools plus the state, the average would be below 3% because school employees have higher salaries on average (and education levels) than state employees.

contribution plan.[5] Fully phased in, the Governor's plan would cost taxpayers $179 million more per year than under the Pension Reform Act, with school districts paying $112 million of the higher cost.

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 have contributed 7% of every paycheck, on average, to their own pension. Even with good benefits, 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 by requiring 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 year an amount equal to the current pension debt ($40 billion) because the richest 1% garner a bigger piece of the overall economic pie than in the 1970s.

Pennsylvania Achieved Low-Cost Pensions with 20% Benefit Cuts For New Employees

The Pension Reform Act lowered the cost of pensions going forward by reducing pension benefits for new employees and increasing the share of pension benefits future employees pay for themselves.

- Pension benefits are calculated by multiplying an employee's years of service by a set percentage, known as the "pension multiplier." This determines what percentage of salary a worker will receive in retirement benefits. The multiplier for state and school employee pensions was reduced by one-fifth from 2.5% to 2% of salary per year of public service.[6] That means that a retiree with 25 years of service will earn a pension worth 50% of their final average salary, as opposed to 62.5%.[7] As a result, the Pension Reform Act reduces the employer costs of pensions for the state and school districts—and ultimately taxpayers.

[5] *Paying More for Less: Cost of New Employee Pensions Will Rise with Defined Contribution Plan, Undoing 2010 Savings for Taxpayers*, Keystone Research Center, February 26, 2013, online at http://keystoneresearch.org/publications/research/pension-primer-2-paying-more-less.

[6] To retain a 2.5% multiplier, new SERS/PSERS employees now have to pay the full cost increase above a 2% multiplier: PSERS participants contribute 7.5% of their own salary to receive a 2% multiplier and 10.3% to receive a 2.5% multiplier; SERS participants contribute 6.25% of their own salary to receive a 2% multiplier and 9.3% to receive a 2.5% multiplier.

[7] Since Pennsylvania does not have an automatic cost-of-living adjustment (or COLA) for retiree benefits, inflation will erode the purchasing power of workers' final average salary over time. If a worker retires at 62 and inflation is 3%, for example, the real value of the workers' pension will be 25% of their final average salary by the time they are between 82 and 83.

- A cap was placed on the maximum pension benefit an employee can receive: retirees with long years of service cannot earn more than their final annual salary.
- The vesting requirement—the number of years of employment required for employees to receive a pension—increased from five to 10 years. Thus, employees who end up with between five and 10 years of service no longer receive a public pension, eliminating the employer pension cost for these individuals.
- The age and years of service required to retire with full benefit was increased substantially.
- The option for pension plan members to withdraw their employee contributions when they retire (known as "Option 4") was ended.

Over the next 30 years, the savings from the Pension Reform Act are estimated at $24.7 billion in the Public School Employee Retirement System (PSERS) and another $8.3 billion in the State Employee Retirement System (SERS).[8]

Employee "Risk Sharing" Protects Taxpayers If Pension Investment Returns Drop

Pennsylvania was one of the first states in the nation to require employees hired in 2011 or later to pay an additional "risk sharing" contribution (of up to 2%) if public pension assets do not meet their earnings assumptions (currently 7.5% annually). In the event of an economic meltdown, the state and school districts would have to make corresponding increases in employer contributions in order to activate the risk premium increases in employee contributions. This feature provides a strong disincentive for state and school employers to repeat the past mistake of making no or low contributions when the economy and financial markets flag. **The risk premium feature of the Pension Reform Act makes it unlikely that Pennsylvania will ever accumulate large unfunded liabilities for post-2010 employees, even in the event of a future financial market crash**.

Pennsylvania Public Employees Continue to Make High Contributions to Their Pensions

The Pension Reform Act strengthened an already distinctive feature of Pennsylvania pensions: the high rate of employee contributions. Even while employer pension contributions were dipping to zero in some years in the last decade, Pennsylvania employees contributed 7% of their salary on average to their pensions every paycheck. School and state employees in Pennsylvania contribute more to their retirement benefits than public employees in most other states.[9] Over the past decade, employees have contributed almost twice as much as employers (and taxpayers)—paying for 19% of the value of Pennsylvania benefits compared to the 10% contributed by employers. Investment returns account for the other 71% of the value of Pennsylvania pension benefits.[10]

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[8] These estimates come from SERS and PSERS. Act 120 also increased costs—by $23.3 billion for PSERS and by $6.95 billion for SERS, in significant part by deferring payments to each pension fund. But that does not alter the fact that the savings achieved in benefits for future workers will be hard to beat.

[9] According to the National Association of State Retirement Administrators (NASRA), Pennsylvania's employee contribution rates are higher than average even before taking account of the risk premium feature that could increase Pennsylvania employee contribution rates a further 2%. The main PSERS 7.5% contribution rate is 24% above the average employee contribution rate for school pension plans in the 38 states in which school employees also participate in Social Security. The main SERS 6.25% contribution rate is 16% above the average employee contribution rate for state pension plans in the 40 states in which state employees also participate in Social Security. Calculations based on *Employee Contributions to Public Pension Funds*, NASRA Issue Brief, January 2, 2013

[10] See Pennsylvania Office of the Budget, *The Keystone Pension Report,* Exhibit 2, page 2.