Pew’s Advocacy for Hybrid Off Base
You Still Can’t Save Money With Less Efficient Retirement Plans

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The information and analysis below is subject to change pending the final details of the proposal. Keystone Research Center is available to discuss the material with any policymaker. Contact: Stephen Herzenberg, sherzenberg@keystoneresearch.org; 717-805-2318

In materials shared with the General Assembly on Monday, four actuaries and Pennsylvania’s Independent Fiscal Office (IFO) found that the proposed three-way hybrid pension does not save meaningful amounts of money but would cut retirement benefits deeply for future state and school employees. In addition, a Keystone Research brief released yesterday based on the actuarial and IFO analyses suggested that, in the long run, the hybrid pension would increase the compensation costs of the state and school districts because of three factors not included in the actuarial models (but acknowledged by one or more actuaries in two of three cases).

Contrary to the findings of other analysts, the Pew Trust yesterday circulated to members of the General Assembly a one-page FAQ sheet strongly advocating for the three-way hybrid. Below we respond to Pew’s main points which were based in part on Pew’s own model runs. To our knowledge, unlike the actuarial analyses, the full details of Pew’s modelling and assumptions have not yet been made public (albeit, in the case of the IFO Actuarial Note, made public only 48 hours in advance of a potential vote).

A larger point of this response to Pew is that the complexity of the pension issue, and the sensitivity of findings to critical assumptions, warrants slowing down and upgrading the General Assembly’s deliberations. Pew itself has argued for a bipartisan, bicameral, and executive branch process, with experts in the room. Such a process could produce the best compromise for all stakeholders—Pennsylvania taxpayers, the commonwealth and schools as employers, and Pennsylvania employees of the future. Our only amendments to that Pew recommendation are that the experts be diverse and that the process should rely on independent actuaries and modeling (i.e., not take up Pew on its offer of free model runs). Now to our response to Pew’s main points.

Pew overstates the fiscal savings from the hybrid plan, which judged against the size of Pennsylvania’s unfunded liabilities and the potential future cost increases, are not meaningful. Even before considering the reasons the hybrid will increase costs

- the plan reduces the “normal cost” of pensions for new employees by less than a percentage point across the two pension systems; and
- saves an amount equal to less than half a percent of the current unfunded pension liabilities.

In an email to legislators, Pew maintained total fiscal benefits from the hybrid of $8.2 billion. This amount included $2.6 billion in “cash flow” savings the present value of which (i.e., discounted to the equivalent of dollars in hand in 2017) the IFO and actuaries estimated at $209 million. Pew also points to an additional $5.6 billion reduction in unfunded liabilities in 2049. Converting that to present value—which is necessary to compare the sum to current unfunded liabilities—this amounts to $553 million. Adding up both these amounts, you get $762 million, which is only 1.3 percent of the $58 billion unfunded liability. We estimate that this would reduce annual employer contributions to pay down the unfunded liability by roughly one third of one percent of salary. This is a scale of savings likely to be exceeded by the increased costs outlined below.
**Pew understates the cuts in benefits.** Actuaries for both systems and the IFO independently evaluated benefit cuts under the three-way hybrid.

- For the career trajectories and hybrid variations examined, the found the hybrid plan would cut retirement benefits for future school and state employees by at least 15 percent, by a third or more on average across all variations examined, and by 50 percent or more for employees choosing a straight DC retirement plan.
- Pew does not compare the hybrid to the current Act 120 benefits for career workers, instead pointing to a “replacement rate” for take-home pay. If that replacement rate is for the first year of retirement, it fails to take account of the fact that Pennsylvania DB benefits (and possibly the annuity purchased with DC savings) have no inflation protection. Assume, for a moment, the accuracy of Pew’s 90 percent replacement rate with Social Security for a 30-year employee retiring at age 65. If that 90 percent includes 30 percent Social Security with inflation protection and 60 percent hybrid benefit without inflation protection, then by the time that person turns 85, assuming 3 percent inflation, the replacement rate is 63 percent.
- The lack of inflation protection is a main reason Pennsylvania’s SERS and PSERS Act 120 benefits are among the least generous of the largest 100 public pension plans in the United States.

**Pew ignores three costs likely to exceed the small savings.** By the second and third decade when the hybrid begins to generate savings, the hybrid is likely to increase costs by more than projected savings:

- If the state and school districts cut pension benefits for career employees deeply, they are likely to have to increase salaries to attract and retain great teachers and agency staff, particularly among the college-educated ranks that already make less than comparable private workers. A 1 percent increase in salaries for college-educated employees that make up the lion’s share of school and state wages and salaries would be over twice as big as a one-third of a percent savings on pensions.
- Elimination of early retirement options combined with reductions in pensions will likely lead many long-service employees who would have retired from 55 to 61 to stay until 62 to 67—leading to a significantly higher percentage of the workforce being paid at the top or higher steps of the salary ladder. The IFO actuary (*Actuarial Note*, Milliman, p. 17) says: “We would anticipate current retirement rates to decrease for...members between ages 55 and 61...Accordingly, we believe the cost estimates are undervaluing the cost of the hybrid plan, which would lead to reduced savings.” If reduced early retirement of career employees increased average salaries by, say, three percentage points that would be 10 times our estimate of the fiscal savings to which Pew points. Legislators should get an actuarial estimate of this unintended—but completely predictable—cost before they move forward.
- Third, although the actuaries have no consensus on this issue, the diversion to DC accounts of roughly half Act 120 contributions to the pension plans for new workers, and the aging of the pension obligations of the DB pensions, could require more conservative investment approaches in two or three decades, lowering investment returns and increasing costs.

**Pew exaggerates the risk mitigation from the three-way hybrid.** The IFO actuary (*AN*, Milliman, p. 23) estimates that the savings from the three-way hybrid would more than double if SERS and PSERS investment returns equal 6.5 percent rather than 7.5. But we estimate (bottom of page 5 of KRC brief) that this still amounts to present-value savings of less than 1 percent of current unfunded liabilities. This is not only small but, we think, smaller than the risk mitigation lawmakers achieved with the risk sharing of Act 120. (Lawmakers should have actuaries do this calculation.) Pew does its own estimates of risk mitigation, generating a larger savings than actuaries. But Pew does this using a 6 percent projected return based partly on the past 10 years for Pennsylvania’s pension plans. That period, which includes the Great Recession and record low interest rates, was one of the most difficult periods on record for investing. Over the longer term PSERS and SERS returns average around 9 percent annual returns.
Pew exaggerates the number of employees who would benefit. Pew says that “most workers who leave service with 20 years or less would receive a better benefit...” That claim is wildly at odds with the conclusions of the IFO and the system actuaries, who projected the biggest cuts for those with less than 20 years of service. Pew also says that “SERS/PSERS data show more than 75% of teachers and over 50% of state employees leave their jobs before 20 years.” Without a source—and without more time—we can’t fact check that statistic. But it’s distorting because a significant number of public employees, like private employees, separate from a new job within the first couple of years. Most public service is accounted for by employees with more than 20 years of service, as explained in this paper by U.C.-Berkeley’s Nari Rhee.

Take the Time to Get Pensions Changes Right

Part of a healthy political process is that groups such as Pew and the Keystone Research Center—who agree with each other about a surprising number of pension-related issues—hold each other accountable. In that spirit, KRC expects and welcomes Pew’s response to our response. An unhealthy political process short circuits a spirited back and forth informed by all available evidence and perspectives. If Pennsylvania’s legislature moves forward now with the three-way hybrid using an unhealthy, rushed, political process, KRC’s reading of the evidence is that it will saddle future Pennsylvania taxpayers with higher costs, lower retirement benefits, and greater challenges attracting great teachers and agency staff to “schools that teach” and “government that works.”

We urge the General Assembly to slow down and create a deliberative structure that allows lawmakers, Pew, KRC and stakeholders to confront each other with logic and evidence, and reach a consensus on a way forward. After four years debating pensions, surely we have time to get it right.