Paying More For Less

Cost of New Employee Pensions Will Rise with Defined Contribution Plan, Undoing 2010 Savings for Taxpayers

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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 second installment in that series.* **February 26, 2013**

Governor Tom Corbett's plan to establish 401(k)-type retirement accounts for future state and school employees would increase the taxpayer cost of pensions for new employees by a third—1% of payroll. As more new employees are hired each year, the portion of payroll subject to this increase would grow, adding an estimated $5 million in costs each year until the annual cost eventually reaches $179 million per year, $112 million of which would be paid by school districts and get passed onto local property taxpayers.

The Governor's Pension Proposal

On February 5, Governor Corbett and Budget Secretary Charles Zogby outlined proposed changes to Pennsylvania's pension plans for state workers and public school employees, including the creation of a "defined contribution plan" for "all future employees."[1] Starting in 2015, all new employees would be enrolled in a plan akin to a 401(k) retirement account.

Under this plan, new employees will contribute to their individual accounts the same amounts most current employees contribute to the existing defined benefit plans—6.25% of salary for state workers and 7.5% for school employees. Employers will contribute 4% to new employees' individual accounts, according to Budget Secretary Zogby, with the state paying the full amount for state employees, and splitting with school districts the contribution made to school employee individual accounts.

New Employee Retirement Plans Will Cost State and School Districts More

The 4% of salary contributed to individual accounts under this plan exceeds the cost of Pennsylvania's current defined benefit pension plans for new employees. According to the Governor's pension report, the "normal" cost of pensions for new employees each year under the state's existing system for school employees is 2.2% of employee salaries. For state employees, the normal cost equals 5.1% per year.[2] The average for all employees across the two

[1] The quote is from the "Budget Day Pension Briefing," online at http://www.portal.state.pa.us/portal/server.pt/document/1320360/2013_pension_slide_presentation_pdf

[2] Normal cost is the cost of paying additional benefits earned as a result of employees' additional service earned during the year. See Public Employee Retirement Commission (PERC), *Funding and Reforming Public Employee Retirement Systems*, p. 235.

systems (weighted by the size of each system) equals 3%—closer to the figure for school employees since this plan includes many more people than the state pension plan.[3]

The low cost of Pennsylvania's current defined benefit pension plans for new employees reflects the sacrifices made by employees in the Pension Reform Act of 2010. This Act cut pension benefits for new hires by more than 20% while maintaining the same level of state and school employee contributions to their own pensions (7% of salary on average). At an annual cost of 4% of new employee payroll, the Governor's pension proposal increases the cost of pensions for new employees in Pennsylvania above the cost under current law.

Key Facts About Pennsylvania Pensions

While each "Keystone Pension Primer" focuses on one issue in the pension debt, 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 today than in the 1970s.

[3] The Public School Employee Retirement System (PSERS) has 279,000 active members and the State Employee Retirement System (SERS) has 107,000. (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. 2 online at http://www.portal.state.pa.us.) 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.

A $179 Million Annual Cost Increase for State and Local Taxpayers

Initially, if the legislature adopts Governor Corbett's proposal for new-employee pensions, only a small share of state and school employees will be participating in the new defined contribution plan. Therefore, the cost to employers of a 1% increase in their pension contributions to new employees pensions will be modest—roughly $5 million in year one, $10 million in year two, $15 million in year three, and so on.[4] Eventually, once all employees participate in the defined contribution plan (which will take roughly 35 years), the Governor's proposal **would increase pension costs each year for school districts and the state by $179 million annually.**[5] An estimated $112 million of this increase would fall on school districts, and $67 million on the state.[6]

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If the Governor's pension plan is enacted, the state and school districts will ultimately contribute nearly $200 million more each year, every year, to employee pensions. By raising the cost of retirement benefits for new employees, the Governor's proposal would undo progress made reducing these costs in the Pension Reform Act of 2010.

In addition to increasing costs to taxpayers, the Governor's proposal for new employees would also erode retirement security for new employees, according to the research literature. For example, a report by the National Institute on Retirement Security estimates that "the cost to deliver the same level of retirement income to a group of employees is 46% lower in a DB [defined benefit] plan than it is in a DC [defined contribution] plan."[7] The greater cost-effectiveness of defined benefit plans results from lower administrative costs, higher investment returns, and pooling of longevity risk.[8] A more detailed analysis of the impact of the Governor's defined contribution proposal on retirement security requires more information than currently available on the Governor's plan.

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[4] We assume in these estimates that 2.86% of employees are new each year with schools and the state. In addition, for simplicity we freeze the SERS and PSERS payroll at the projected 2015 level, the year in which the Governor proposes to establish a new defined contribution pension for new employees. While SERS and PSERS have payroll projections all the way to 2049, when we project all employees would participate in the defined contribution plan, the annual increase in payroll is roughly 3%, the rate of inflation. By using the 2015 payroll number, we effectively keep all our cost-increase estimates in today's dollars.
[5] This estimate is based on SERS and PSERS projections for employee salaries in 2015.
[6] According to PSERS, on average across all school districts, the state pays 56% of employer retirement contributions for school employees and school districts pay 44%. The state share of the increase in school district pensions for new employees tops out at $142 million; this is offset by savings of $74 million on state worker pensions. The overall increase in state worker pension costs is $67 million.
[7] Beth Almeida and William Fornia, *A Better Bang for The Buck: The Economic Efficiencies of Defined Benefit Pension Plans* (Washington DC: National Institute on Retirement Security, online at http://www.nirsonline.org/index.php?option=com_content&task=view&id=121&Itemid=48
[8] With a large pool of pension plan participants, it is possible to predict the average number of years participants will receive benefits before passing away and thus the cost of providing benefits. With individual defined-contribution accounts, if individuals who retire use the lump sum in their accounts to buy an annuity (a promise of a specific annual sum until death), the seller of the annuity does not know how long the individual will live and will thus provide a lower sum as insurance against the possibility of a long life.