Pennsylvania Pension Facts: Beware of False Reforms

Beware 'reforms' that ignore the real problem, add billions in new costs, and threaten the retirement security of workers

Keystone Research Center • 412 North 3rd St., Harrisburg, PA 17101 • 717-255-7181

KRC Pension Primers: *As policymakers, members of the media, and citizens evaluate pension proposals, the Keystone Research Center's "pension primers" seek to demystify the often-complex details of the pension debate. This is the pension primer #11* **March 13, 2015**

With budget season in full swing, some Pennsylvania lawmakers are dusting off plans to eliminate the state's secure public pension system and shift new state and school employees into 401(k)-style retirement accounts. Rep. Warren Kampf, R-Chester/Montgomery, is sponsoring one such proposal.

Readers who have been following the Pennsylvania debate over the past few years may react to this news by saying, "Wait a minute, haven't we been down this road before?" And well they might.

Switching all new public employees to individual defined contribution savings accounts is what former Gov. Tom Corbett proposed in 2013. As a result, the Kampf and similar proposals have already been the subject of close – and recent – scrutiny by pension experts. It therefore makes sense to start the discussion of proposals to switch new employees to 401(k)-style plans with a simple step: reminding ourselves what we already know about the consequences of such a switch from research done two years ago.

Based on the still-fresh research on switching new Pennsylvania public employees into individual defined contribution savings plans that was done in response to Gov. Corbett's proposal, we know that this switch would:

- add billions in pension costs for taxpayers,
- make no progress on the existing pension debt and achieve no savings for the budget this year or in any year,
- switch new employees to a less efficient type of pension (with higher costs and lower returns than the existing pension plans), and
- threaten the retirement security of teachers, nurses, emergency responders, and other public servants.

The rest of this primer briefly elaborates on these points and provides sources where media, lawmakers, and members of the public can find whatever level of detail they want on the impact of closing the existing defined benefit plans and why it is a demonstrably bad idea for taxpayers, public employees, and public employers.

Digger a Deeper Pension Hole

Closing Pennsylvania's public pension system to new workers **will cost taxpayers about $42 billion**, according to actuarial estimates done for the state's pension systems when Gov. Corbett introduced this proposal in 2013.[1]

Why? Because the workers who remain in the pension plans will grow older and retire, prompting fund managers to invest in less risky and more liquid assets. This lowers returns and requires taxpayers to make higher contributions to meet pension obligations.

Budget Savings? What Savings?

Some lawmakers say pension savings must come before they will consider any new revenues in the state budget. The problem? Switching employees to defined contribution plans does not save any money. The existing debt still has to be paid off – and, as noted, would actually grow.

Higher Costs for New Workers' Pensions

Not only does a switch to a 401(k)-type savings account result in an estimated $42 billion cost for the "transition" from defined benefit to defined contribution; it also **increases the taxpayer cost of retirement benefits** for future school and state employees.[2] Do the math:

- Pennsylvania enacted the Pension Reform Act in 2010, which reduced the cost of pensions for new public employees by more than 20 percent. The estimated long-term cost (or "normal cost") of providing new employees with pensions under the current system is roughly **3.5 percent of payroll**.

- The Kampf proposal shifts new employees into individual 401(k)-type accounts and requires the commonwealth to contribute **4 percent of payroll** for their retirement benefits.

Switching to Defined Contribution Plans Didn't Work in States that Tried It

Real-life experience in three states also raises red flags about a switch to defined contribution.[3]

- **Alaska** closed its public pension system to new hires in 2005. **Pension debt more than doubled** by 2013, and the state had to make a $3 billion contribution in 2014 to address it.

- **Michigan** replaced its public pension plan for new employees with individual savings accounts in 1997, when it was 109 percent-funded. The closed pension plan now has a **debt of $6.2 billion**.

- **West Virginia** was an early adopter, swapping its public pension plan in favor of 401(k)-style plans in 1991. **By 2003, the state switched back** to a defined benefit pension after a study found it would be less expensive.

Less Bang for the Buck

401(k)-type savings accounts come with high administrative and financial fees. They often deliver lower investment returns since employees, not professionals, make investment choices. Studies indicate employees will see retirement benefit cuts of a third to a half with the same total contributions from employees and employers.[4]

Hidden Future Wage Costs and a Revolving Door

Pennsylvania and its school districts will have a tougher time recruiting and retaining high-quality employees if their retirement benefit is much smaller. This is in part because public-sector salaries are far lower than in the private sector for the college-educated employees, such as teachers and nurses, who make up more than half the public-sector workforce. If pensions no longer compensate for inferior public-sector salaries, public employers will have to offer higher wages — at higher costs to taxpayers — to attract and keep great public servants in key positions. Even so, cutting retirement benefits and eliminating the incentive to work in public service for a career, will lead more of the best mid-career teachers and state workers to leave for higher-paid jobs in the private sector.

Let's Tackle the Real Issue: Pension Debt

Pennsylvania's pensions have a large debt primarily because the state and school districts contributed too little in the past 15 years. According to the Pew Trust, Pennsylvania has the third-worst record measured by how much it contributed to pensions since the early 2000s compared to what it should have contributed. Throughout this period, school and state employees contributed about 7 percent on average, every single paycheck.[5]

Since the root of the pension debt problem is inadequate employer contributions – and we've already cut pension benefits deeply, to the point that Pennsylvania's are among the least generous of all large public-sector pension plans in the United States – real reform on pensions requires the state to make more contributions, and lock in adequate contributions for the future. Moving employees into more expensive, less secure retirement plans with a transition cost of $42 billion does not constitute real reform.

Gov. Tom Wolf has proposed ideas championed also by some Republican legislators, such as buying down pension debt with pension obligation bonds and cutting fees paid annually to outside fund managers. He also wants to dedicate some revenues from liquor store modernization and sales taxes to reduce the pension debt, reassuring bond rating agencies that the debt will be paid. These are the types of strategies that Pennsylvania needs to tackle the pension debt.

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END NOTES

[1] A letter from Cheiron, the consulting actuary for the Public Employee Retirement Commission (PERC) to PERC, summarizes the transition costs of the Senate version (SB 922) of the Governor's 401(k)-type proposal based on the actuarial studies by the PSERS and SERS actuaries. Tables 5 and Table 6 of the letter show transition costs of $35 billion for PSERS and $7.2 billion for SERS, for a total of $42.2 billion (on a cash flow basis – i.e., in nominal dollars). See "Letter from Tony Parisi to James L. McAneny, Executive Director, Public Employee Retirement Commission, Re: Senate Bill No. 922 (Printer's No. 1252, as Amended by AO2498)," in Public Employee Retirement Commission, *Actuarial Note Transmittal, Senate Bill Number 922, Printer's Number 1252, as amended by Amendment Number 02498*, online at https://rlws.sers.pa.gov/apex/f?p=146:15:1837450920335::::P15_HIST_LEG_KEY:2726, pp. 21-35. (Warning: the complete PERC Actuarial Note Transmittal in which the Cheiron letter can be found is 583 pages.) See also Stephen Herzenberg, *A $40 Billion Dollar Oversight: Actuarial Studies Document High Cost of Governor's Pension Plan*, Keystone Research Center; online at http://keystoneresearch.org/publications/research/pension-primer-7-40-billion-dollar-oversight. This KRC brief was written based on actuarial studies of the House version of the Governor's 401(k) proposal, which also included unconstitutional cuts in benefits for current members. Nonetheless, the findings on the transition cost estimates are essentially the same as those summarized by Cheiron based on the actuarial studies of the Senate version of the Governor's proposal, without unconstitutional benefit cuts.

[2] For more detail, see Stephen Herzenberg, *Paying More for Less: Cost of New Employee Pensions Will Rise with Defined Contribution Plan, Undoing 2010 Savings for Taxpayers*, Keystone Research Center; online at http://keystoneresearch.org/publications/research/pension-primer-2-paying-more-less. Since this primer was published, the project "normal cost" of future workers defined benefit pensions within the current pension system has increased slightly; it remains below 4 percent.

[3] *Case Studies of State Pension Plans that Switched to Defined Contribution Plans*, National Institute on Retirement Security; online at http://www.nirsonline.org/index.php?option=content&task=view&id=879

[4] William B. Fornia and Nari Rhee, *Still a Better Bang for the Buck*, National Institute on Retirement Security; online at http://www.nirsonline.org/storage/nirs/documents/Still%20a%20Better%20Bang/bangforbuck_2014.pdf. See also Stephen Herzenberg, *Less Bang for Pennsylvania's Buck: Governor's Pension Proposal Would Force Taxpayers (and Employees) to Foot the Bill for Retirement Plans with High Fees, Low Returns*, Keystone Research Center; online at http://keystoneresearch.org/publications/research/pension-primer-6-less-bang-PA-buck

[5] The ratio of employer-to-employee contributions in Pennsylvania was about half in the 2000s whereas in most states it was about two.