The Keystone Research Center
412 North Third Street
Harrisburg PA 17101
www.keystoneresearch.org

TOP 10 FACTS WHY GOV. WOLF SHOULD VETO SENATE BILL 1

Senate Bill 1 (Amendment 02701) would remove future Pennsylvania state and school employees from the state's existing defined benefit pension (DB) plans. It would establish for each employee a 401(k)-style "defined contribution" (DC) savings account and a supplementary "cash balance" account. Below are 10 facts about SB 1, supported by data, actuarial studies, and other research, that show why Gov. Wolf should veto it.

Fact 1. SB 1 would cut retirement benefits up to 70 percent, according to Xerox, the Public School Employees' Retirement System's (PSERS) actuary (see Table 3 on the last page of the Xerox report https://goo.gl/MHElUs). Employees following three of six trajectories are projected to have a *pension of less than $10,000 per year under SB 1,* even with 25 or 35 years of work experience. Pew Trust projects smaller, but still large pension cuts (about 45 percent http://goo.gl/CWSE4V)[1], for long-term State Employee Retirement System (SERS) employees. Some atypical employees, who leave public service mid-career, might not see cuts, or could see increases, but typical teachers, nurses, and other public servants would receive deep cuts to their pensions.

Fact 2. SB 1 would make new employees pay down pension debt. SB 1 would force new employees to contribute to cash balance accounts and then skim off a large fraction of investment returns to pay down pension debt. As the Public Employee Retirement Commission (PERC) notes (p. 8 https://goo.gl/zluOqt), new employees "would be expected to be subsidizing the future costs of current members."[2] The miserly 3 percent return that new employees are expected to receive on their contribution to their cash balance accounts is less than the 4 percent that non-vesting employees currently receive on their pension contributions when they separate from public service.

Fact 3. SB 1's shift to individual accounts would not generate meaningful pension savings or reduce pension debt. After cutting benefits for new young workers and skimming off their investment returns, SB 1 would achieve savings of less than $1 billion from the pension plan redesign part of the bill – that's less than 2 percent of the current unfunded liability.[3] Even counting savings from lower benefits for current employees, *the amended SB 1 would increase the unfunded liability relative to current law* by $1-$1.8 billion in every year from 2017 to 2046.[4]

Fact 4. SB 1 would likely increase total taxpayer costs because of cost increases not included in the actuaries' projections. These costs include a transition cost from reducing the flow of funds for new workers into the existing pension plans – which could lead to lower investment returns. (For more on this, see p. 9 of this brief http://goo.gl/9TZHWL). In 2013, actuaries estimated a full switch to 401(k)-style individual accounts would cost $42 billion (on a cash-flow basis).[5] The pension system actuaries in their studies of SB 1 acknowledge that the bill could have a transition cost.[6] SB 1 would also likely have a hidden future wage cost. While Pennsylvania's public employee benefits are higher than the benefits of comparable private sector workers, their overall compensation is slightly lower because lower salaries more than offset good benefits (for the source, see pp. 2-3 here). Following evisceration of pension benefits for future employees, school districts and the state would likely have to increase salaries to keep overall pay plus benefits competitive.

Fact 5. SB 1's cuts in benefits would destabilize the public sector workforce and undermine the ability of schools and state agencies to attract and retain great staff.

Fact 6. 401(k)-type individual accounts cost more to deliver the same benefit. 401(k)-style savings accounts, into which SB 1 would deposit most contributions to retirement savings for new workers, deliver lower investment returns and have higher financial costs than DB plans. The National Institute on Retirement Security (http://goo.gl/lePBPd) estimates that, to achieve the same benefit, it requires up to twice as much in contributions to 401(k)-style savings accounts as to DB pensions. The inefficiency of DC accounts helps explain the "miracle" of SB 1's deep cuts in benefits for new employees without significant savings.

Fact 7. The taxpayer risk of future unfunded liabilities can be managed well without a switch to inefficient 401(k)-type pensions. One concern with traditional pensions is that taxpayers face a risk of future unfunded liabilities if investment returns fall below the assumed rate (now 7.5 percent). Pennsylvania began to mitigate this risk through provisions of Act 120 of 2010, which increase employee contributions if returns are consistently below 7.5 percent. This feature could be strengthened without abandoning DB pensions for 401(k)-style accounts. Other states have stronger risk-sharing provisions under which employers and employees split the cost of annual required contributions (see the end of this testimony http://goo.gl/k34uaw). A switch to DC savings accounts would amount to avoiding the risk of higher DB costs by accepting a guarantee of higher DC costs – which makes no sense.

Fact 8. Pennsylvania's public pension benefits are modest, and public employees in Pennsylvania contribute more than in most states. Based on data from the National Association of State Retirement Administrators, Pennsylvania's public pension benefits post-2010 rank 77th and 89th highest of the largest 100 public pension systems (http://goo.gl/R2iy1t). This is because Pennsylvania's retirees receive no cost-of-living adjustments and because employees here contribute 7 percent of every paycheck, on average, to their pensions.

Fact 9. SB 1 risks constitutional rejection. While the most likely unconstitutional part of the original SB 1 was removed from the amended bill, PERC still notes (p. 17) that the benefit modifications for current employees may be found unconstitutional. If they are, this would eliminate almost all of the bill's small savings and could leave Pennsylvania with more pension debt a few years down the road.

Fact 10. Pennsylvania's pension debt results from the state failing to make its required pension contributions. Pennsylvania stands out, compared to states that have DB pensions with less or no debt, in one simple way: We have the second-worst record for making required pension contributions (see the NASRA chart reproduced here http://goo.gl/KGdluV as Figure 2). THAT is what needs to be fixed.

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[1] Pew's unpublished estimates of benefit cuts for career employees under SB 1 are similar to those of the PSERS actuary – 55% to 65% without taking into account inflation. Personal communication with Katie Selenski, State Policy Manager, Public Sector Retirement Systems Project, the Pew Charitable Trusts.

[2] In a similar vein, the Pew Trust notes that SB 1 would provide new employees with a rate of return ("interest crediting rate") on their cash balance accounts that is not actuarially fair and that "..a substantial portion of expected returns would be retained by the state." SB 1 would also have an annuity conversion rate that Pew notes is "…not only substantially lower than the current assumed rate of the retirement system, it is also below what market providers are willing to provide." Pew Charitable Trusts, "Pension Policy Alternatives to Senate Bill 1," June 19, 2015.

[3] Xerox notes (p. 5 of its letter to PSERS) that "Generally, the savings due to the benefit changes included in Senate Bill No. 1 are attributable to reductions in current members' prospective benefit entitlements." The less than $1 billion figure is derived as follows: the PSERS savings from changing pension design are estimated at $653.6 million in present value (using a 7.5 percent discount rate) (Table 3, p. 11 in the PERC actuarial report https://goo.gl/SOFlMJ). Total SB 1 SERS savings are estimated at $606.9 million (Table 2 on the previous page) but do not break out the portion due to pension plan redesign from that due to the modification of the Option 4 cash out option for existing employees. Assuming the same ratio of Option 4 to pension plan redesign savings as with PSERS, the SERS savings from pension plan redesign would be $159 million. Adding that to the PSERS savings yields $812.6 million – i.e. less than $1 billion.

[4] In every year from 2017 to 2046, the unfunded actuarial liability is $1 billion to $1.8 billion higher under the amended SB 1 than currently. This is based on adding up the unfunded liability under current law vs. under the amended S B1 using Tables 6 and 8 in the PERC report https://goo.gl/JMBtuK.

[5] For this year's estimates showing transition costs of $2 billion to $31 billion see the actuarial studies of HB 727 (https://goo.gl/cXf1BU), including the table on p. 18 of Milliman's report. URLs for the 2013 actuarial studies showing a $42 billion cost are in here (http://goo.gl/rCzmfT).

[6]In their studies of the amended SB 1 (https://goo.gl/ojBCB1), the PSERS (on p. 6) and SERS (p. 8) actuaries repeat comments on transition costs from their studies of the original SB 1. Those comments are quoted in KRC pension primer #12 on p. 9 (http://goo.gl/hO0I65).