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Chairman Eichelberger, Chairman Blake, and Members of the Senate Finance Committee: Thank you for the opportunity to provide written testimony on the public pension challenges being considered by policymakers in Pennsylvania.

As many of you know, the Keystone Research Center (www.keystoneresearch.org) is an independent, non-partisan economic research and policy organization, the mission of which is to promote a more prosperous and equitable Pennsylvania. We have addressed the issue of retirement security in Pennsylvania periodically in our 19-year history, including with a report in 2006 that supported a proposal then under consideration to require that the state's pension plans at least contribute each year an amount equal to the (normal) cost of additional benefits earned that year.[1] Since the beginning of 2013, we have released a series of pension primers, and other publications, that break down, and demystify, the complex issue of pensions for policymakers, the media and the general public. (Our pension web page – www.keystoneresearch.org/pensions – is a one-stop source for our research and analysis on Pennsylvania pensions.)

My testimony today draws from this prior research to offer some general guidance related to proposals under consideration in this legislation session. The end of my testimony provides some specific reform proposals that would build further on the legislative reforms in the Pension Reform Action of 2010 (Act 120).

Digging a deeper pension hole. With budget season now in full swing, General Assembly members in both the House and the Senate 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.

Those of us who have been following the Pennsylvania debate over the past few years find this year's proposals to put all new workers in 401(k)-style plans puzzling. Switching all new employees to individual defined contribution (DC) savings account is what Gov. Corbett proposed in 2013. Since it was proposed by Gov. Corbett just two years ago, this idea has been the subject of close and recent scrutiny by pension actuaries for SERS, PSERS, and the Public Employee Retirement Commission (PERC). These actuaries concluded that closing Pennsylvania's two public pension systems to new workers **would cost taxpayers about $42 billion dollars**.[2] 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. Some have questioned how big transition costs would be. The Pennsylvania studies, however, are

consistent with the actuarial consensus, as we documented in a February 2013 pension brief which included an annotated bibliography of transition cost studies in other states.[3]

Switching to DC Savings plans didn't work in states that tried it. As documented at length in a detailed new report by the National Institute on Retirement Security (NIRS), real-life experience in three states shows, at minimum, that a switch of new workers to 401(k)-style savings does nothing to address an existing pension debt – which is the real pension challenge in Pennsylvania.[4]

- **Alaska** closed its public pension system to new hires in 2005. **<u>Pension debt more than doubled</u>** by 2013, and the state had to make a $3 billion additional contribution in 2014.
- **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 **<u>debt of $6.2 billion</u>**.
- **West Virginia** was an early adopter, swapping its public pension plan for 401(k)-style plans in 1991. **<u>By 2003, the state switched back</u>** to a defined benefit pension after a study found that 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.[5] As testifiers from Pew point out in their testimony today, there are ways to mitigate the higher costs and lower returns of 401(k)-style savings plans. Even with an "ideal" 401(k)-style savings plan, however, NIRS estimates that the same benefit can be achieved with a defined benefit plan at 29 percent lower cost (or, to put it the other way around, achieving the same benefit with 401(k)-style savings accounts would cost about 40 percent more instead of twice as much).

Hidden future wage costs and a revolving door. Pennsylvania and its school districts will have a tough time recruiting and retaining high-quality employees if, with the adoption of 401(k)-style retirement accounts, these employees' retirement benefits are smaller and the retirement plan no longer provides an incentives to remain for a full career. A good pension is critical to attracting and retaining public servants because public sector salaries are far lower than private sector ones for college-educated employees who make up more than half the public sector workforce. With a less generous pension, public employers will likely have to offer higher wages — at higher cost to taxpayers — to attract and keep great public servants in key positions. Even with some increase in wages, without a defined benefit pension some of the best mid-career teachers and state workers are likely to leave for higher-paid jobs in the private sector.

Pennsylvania's problem is not overgenerous pensions. Although this is not widely recognized Pennsylvania does not have generous state pensions. The average retirement benefit for SERS and PSERS retirees is about $25,000. Comparing Pennsylvania's two pensions with 98 others that make up the 100 largest state pension plans, we also find that Pennsylvania's pensions are much less generous than typical. Pennsylvania's pension plans are among the one third of the 100 largest state pension plans that have no automatic inflation protection. Pennsylvania also

requires employees to contribute more to their pensions than do most of the other top 100 plans. Pennsylvania's 2.0 multiplier (i.e., pensions increase by 2% of final average salary for each additional year of public service) for new employees (and those hired since 2010) is in the middle. Using all three of these dimensions to rank the generosity of the top 100 plans, SERS is the 79th most generous plan out of 100 and PSERS the 89th most generous. (The difference reflects the higher contributions PSERS members make to their own pensions – 7.5% ordinarily – compared to SERS members (who contribute 6.25% ordinarily).)

Let's tackle the real issue – today's pension debt. As Pew's testimony today shows, the biggest reason for Pennsylvania's pension debt is the failure of the state and school boards to make adequate contributions since 200. Pennsylvania's pension debt would be less than half its current size if the state and school districts had contributed the annually required contribution since 2000. Pennsylvania has the second-worst record out of the 50 states measured by how much it contributed to pensions since the early 2000s compared to what it should have contributed (this is according to both the National Association of State Retirement Agencies (http://www.nasra.org/files/JointPublications/NASRA_ARC_Spotlight.pdf) and to Pew (in its testimony today). Throughout this period, school and state employees contributed about 7 percent on average, every single paycheck.[6]

Since the root of the pension debt problem is inadequate employer contributions – and we've already cut pensions to put them in the least generous quarter of state pension plans – real reform on pensions must start with the state continuing to make the Act 120 required contributions. The state could build on Act 120 by making more contributions and/or by designating specific state revenues to paying down pension debt. Both of these steps would make the pension plans more sustainable and reassure bond-rating agencies.

Gov. Tom Wolf's budget includes several positive steps that would directly address pension debt. These include:

- a $3 billion bond that would buy down the state's pension debt slightly (first suggested by Republican Rep. Glen Grell);
- dedicating liquor modernization revenues to paying off the $3 billion bond; and
- cutting fees paid annually to outside fund managers by $200 million. (For years, former Republican legislator Kelly Lewis has been a voice in the wilderness championing reducing investments through more use of passive investment.)

These steps could help move the state and school boards more quickly to the light at the end of the pension tunnel – to the time at which increases in pension contributions level off, allowing lawmakers to focus instead on priorities such as education and jobs. Given the approaching light, the last thing in the world we want to do is move employees into more expensive, less secure 401(k)-style retirement plans with a significant transition cost. This misstep could plunge the state backwards towards the middle of the tunnel, with the light receding additional further into the future.

Let's tackle the second real issue – avoiding pension debt in the future but without throwing the baby out with the bath water (i.e., by switching to a less efficient pension plan design). In addition to the current debt, another driver of the push to abandon DB pensions is the desire to avoid running up an unfunded pension liability in the future. There are two obvious ways to do this while staying within Pennsylvania's current defined benefit design. One is to lock in a requirement that the state and school districts always contribute the ARC – annual required contribution – each year. Well how do you lock in that requirement, some will ask? We'll come back to that.

The second way to reduce the risk of a future taxpayer pension debt is to have employees as well as employers contribute more if financial markets underperform. Pennsylvania employees already do contribute as much as two percentages points more – about 9% on average – in this circumstance thanks to a little-known "risk sharing" provision of Act 120. According to Pew (again in its testimony today), this provision would result in employees paying 15% to 20% of the increase in contributions required if investment returns average only 6% instead of the projected 7.5%.

Some of the pension plans in a number of states (including Arizona, Wisconsin, and Missouri), however, have a simpler and more transparent risk sharing provision. In these pension plans, employees and employers "split the ARC" – for example, each party may pay half or public employers may pay $2 for each $1 paid by employees.

Now to get back to how we ensure that contributions equal to the ARC are made every year in the future: if public employers and employees "split the ARC" in some way, it's much more difficult for the state to welch on its contributions -- the two parties are, in a sense, joined at the hip with "kicking the can" down the road a political non-starter. Not surprisingly, as a result, the pension plans that "split the ARC" remained well funded despite the Great Recession. Both parties faced quick and sharp increases in contributions in the once-in-75-year financial market collapse from 2007 to 2010. But even this shock was absorbed fairly quickly, with peak employer contributions at levels such as 12%-14%, half or less of Pennsylvania's peak employer contributions, and contributions then quickly levelling of below 10% and even back down to half that much.

A thought experiment: if Pennsylvania used bonds and other reforms (e.g., savings from lower fees to investment firms) to buy down the maximum ARC (employee plus employer contribution) to around 30% (SERS is already at about this level), splitting the ARC one dollar from employees to two from employers would amount to contributions of 10% from employees and 20% from employers. This would be an additional 2.5 percentage points from employees initially (on average) and a larger reduction in contributions from employers (who would benefit from the bond and the investment fee reductions as well as increased employee contributions). Within a period of time, however, employee contributions would dip below the current 7% average.

In sum, the thought here is that splitting the ARC in some way, combined with other reforms advanced by Rep. Grell and Gov. Wolf could lead to a negotiated solution that includes current employees and allows all parties to declare victory, substantially relieves near-term budgets, and stabilizes Pennsylvania's efficient pension plans for the long term. Is it time yet to negotiate a solution to the pension problem that is fair and cost-effective?

END NOTES

[1] Christian E. Weller, Mark A. Price, and David M. Margolis, *Rewarding Hard Work: Give Pennsylvania Families a Shot at Middle Class Retirement Benefits*. Center for American Progress and Keystone Research Center: Washington, DC and Harrisburg, PA, October 4, 2006; online at www.keystoneresearch.org/sites/keystoneresearch.org/files/pa_pensions_report.pdf

[2] 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.

[3] See Stephen Herzenberg, *Digging a Deeper Pension Hole*, Keystone Research Center; online at http://keystoneresearch.org/publications/research/pension-primer-1-digging-deeper-pension-hole.

[4] *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

[5] 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

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