

PA Public Pensions & Politics:

- Managing "Generational Theft"

The Absence of Sound Public Policy Principles

Richard C. Dreyfuss

Business Consultant and Actuary

Senior Fellow - The Commonwealth Foundation

Lebanon Valley Chamber of Commerce

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Managing Pension Liabilities

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“... the fundamental problem is that public pensions are inherently political institutions.”

“... the current public pension system simply isn't sustainable in the long run.”



A Summary of the Problem

- “In any collaboration between two groups who hold different basic principles, it is the more irrational one who wins.”
 - What good is an unprincipled bipartisan agreement?
 - In public pension “reform”, historically the taxpayer loses
- This helps explain the irrational pension legislation of
 - Act 9 (2001) – 25%/50% increase in pensions
 - Act 38 (2002) – Retiree pension COLA
 - Act 40 (2003) – Deferring unaffordable costs to 2012 and beyond
 - Act 44 (2009) – City of Philadelphia/municipal pension non-reform
 - HB 2497 (2010) – PSERS / SERS Generational Theft

3 Factors Drive the Political Institution of Public Pensions

1. Poor Benchmarking
2. Poor Risk Management Practices
3. Politics

#1 Poor Benchmarking

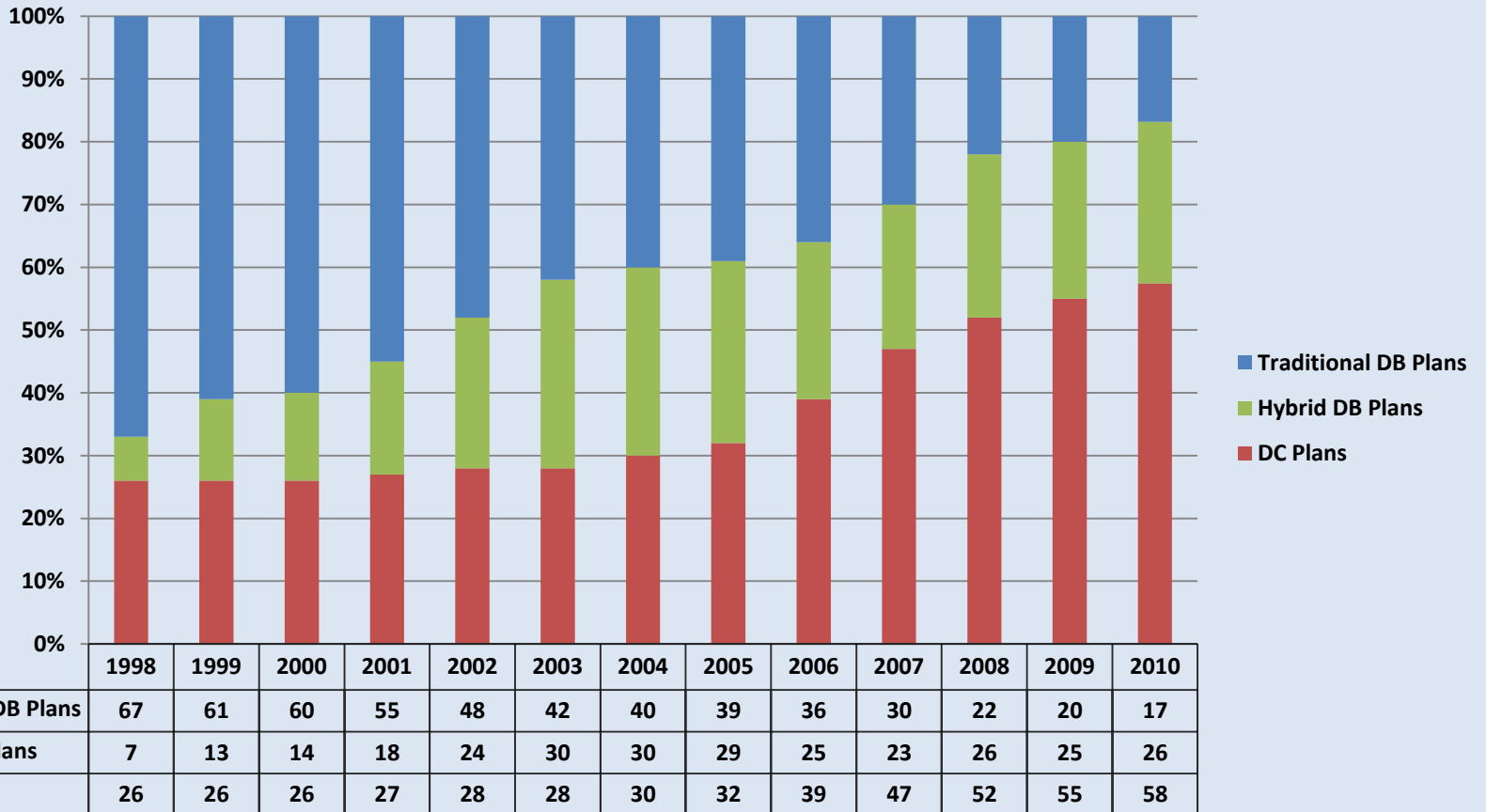
- Pennsylvania public pay and benefits are typically benchmarked only against other public plans rather than the entire marketplace
- Affordability and market trends in the private sector are directly relevant to the public sector
- 2010 Hewitt Survey: only 11 of 33 major PA employers sponsor defined benefit plans
 - **All sponsor 401(k) plans with an average employer match of 72 cents per dollar and an average matched employee contribution of 5.4 percent of pay.**

Towers Watson Survey

Average DC Employer Cost - 5.77%

<http://www.towerswatson.com/united-states/research/2106>

Fortune 100 Companies - Trends in Retirement Plans



Public Policy Principle - #1

Seven Principles of Sound Public Policy Remarks before the Economic Club of Detroit By [Lawrence W. Reed](#) | Oct. 29, 2001



- “Government has nothing to give anybody except what it first takes from somebody.”

- “Government that's big enough to give you everything you want is big enough to take away everything you've got.”

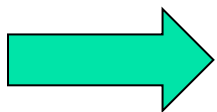
#2 Poor Risk Management Practices

- Few absolute metrics defining the affordability or reasonableness of pension costs given the “perpetual life of the government entity”.
- Entire defined-benefit (DB) funding system is based upon annual investment assumption in the 8% range.
- Little consistency in funding assumptions and funding methods making comparisons most difficult.
- Private sector pension plans must fund their plans in accordance with The Pension Protection Act of 2006 which requires lower interest rate assumptions, market valuation of assets and shorter amortization periods.

Financial uncertainty highlights need for employers to manage benefit plan risk

Mercer Survey (116 Companies) – August 25, 2010

- 93% of respondents said DB plans pose a potential risk to the company's business strategy
- 81% said the plans pose a financial risk
- 93% said the plans are a source of risk to the company's reputation



Consider the risk to current and future taxpayers from the public-sector DB plans

Public Policy Principle - #2

Seven Principles of Sound Public Policy Remarks before the Economic Club of Detroit By [Lawrence W. Reed](#) | Oct. 29, 2001

- “What belongs to you, you tend to take care of - what belongs to no one or everyone tends to fall into disrepair.”
 - Who owns the investment risk in the public pension system?

#3 Politics

Pensions as political capital

- Pension Fund **Surplus** = Benefit Improvements for Participants
- Pension Fund **Deficits** = Underfunding by Taxpayers
- Maintaining or Improving Benefits = **High** Political Rate of Return
- Reforming and Properly Funding Plans = **Low** Political Rate of Return

Public Policy Principle - #3

Seven Principles of Sound Public Policy Remarks before the Economic Club of Detroit By [Lawrence W. Reed](#) | Oct. 29, 2001



- “Sound public policy requires that we consider long-run effects and all people, not simply short-run effects and a few people.”
 - We are 180 degrees out of phase

Politics

Pensions are not well understood

- Abundance of half-truths
- Benefit commitments can be over 50 years
- Funding is easily manipulated
 - Easy to (re)defer costs to the next generation
- Local and city pension shortfalls are becoming political problems for the state
 - Philadelphia, Pittsburgh, Allentown, Erie and Reading

A Political Problem: Leading PA Pension Half-Truths

Contention	Fact
<p>➤ The fiscal problems typified by SERS and PSERS are simply a matter of underfunding by taxpayers.</p>	<ul style="list-style-type: none"> ■ 1990s required little if any taxpayer contributions due to surplus – this is a common result ■ According to a PSERS report – only 21% of the deficit is due to underfunding, 43% investment losses, 21% benefit increases, 13% changes in funding assumptions.
<p>➤ DC plans are more costly than defined benefit (DB) plans.</p>	<ul style="list-style-type: none"> ■ DC costs are actual and final ■ DB costs are simply estimated deposits based upon actuarial assumptions ■ 2009 ICI study revealed DC administrative costs ranging from .35% to 1.72% of assets
<p>➤ DB plans become unstable and overall costs increase when new members join a DC plan.</p>	<ul style="list-style-type: none"> ■ An unfounded claim

HB 2497 - Doubling-Down on Generation Theft without Solving the Political Problem (Passed: PA House 6/16/10)

Impact of change versus current schedule of contributions

Taxpayer Contribution Impact:	PSERS	SERS	Total
FY: 2011-2025	-\$15.3B	-\$4.3B	-\$19.6B
FY: 2026 -2040	+\$36.8B	+\$9.6B	+46.4B
Total 2011-2040	+\$21.5B	+\$5.3B	+26.8B
Net Present Value @ 8%	-\$5.0B	-\$1.5B	-\$6.5B
Future Value @ 8%	+\$59.1B	+\$17.9B	+\$77.0B

Funded Ratios and Unfunded Liabilities for PSERS & SERS

Assuming an 8% Annual Investment Return

Source: PERC Actuarial Note 6/15/2010

	PSERS Current Law	PSERS HB 2497	SERS Current Law	SERS HB 2497
2009	79.2% /\$15.7B	79.2% /\$15.7B	84.4%/\$5.6B	84.4%/\$5.6B
2015	56.7%	57.8%	69.8%	61.8%
2020	66.8% /\$37B	51.9% /\$54B	75.5%	63.9%
2025	77.0	56.1	81.4	87.4
2030	86.5	64.0	88.0	73.2
2035	93.8	74.4	93.4	82.3
2040	97.9	87.7	97.4	94.8



HB 2497 – Fatal Flaws in a New Plan Design

- **Any DB plan will be subject to the politics of over-promising and underfunding. This includes the potential for future ad-hoc and/or retroactive benefit improvements.**
- **8% interest assumption underlying all calculations with potential for extended funding periods (amortization).**
- **What are the assurance that costs will be current, predictable and affordable? What is the reform strategy to the related problem of retiree medical liabilities?**
- **PA has over 3,000 public pension plans, therefore reform is much more than just a PSERS and SERS issue.**

Actuarial notes accompanying

HB 2497 (Emphasis added)

- *...[I]t must be noted that the temporary collared contribution rates proposed in the bill do not follow generally accepted actuarial standards of practice.*
- *The short-term effect of the bill would be to defer the payment of actuarially required contributions to both PSERS and SERS, resulting in the underfunding of both retirement systems.*
- *This underfunding will permit the continued growth of the Systems' unfunded liabilities resulting in a steady decline in the funded ratios of both PSERS and SERS.*

How much should taxpayers be contributing to PSERS? (FY 2009-10 rate = 4.78% of payroll or \$617M)

Unfunded Liability = \$15.7B : Using Actuarial Value of Assets (6/30/09)

Unfunded Liability = \$32.5B : Using Market Value of Assets (6/30/09)

Item	8% Investment Assumption	6% Investment Assumption
PSERS Rate Certified December 2009	8.22% / \$1.11B	
Final State Budget Rate : FY 2010-11	5.64% / \$762M (\$121M transfer from Tobacco Endowment Fund)	
Normal Cost (NC)	8.08% / \$1.09B	
NC + 15 Year Payoff (\$15.7B)	~21% / ~ \$2.8B	
NC + 30 Year Payoff (\$15.7B)	~18% / ~ \$2.4B	
New DB Plan Taxpayer Rate	2.85%	~ In the 5% to 7% range (based upon no change in employee contributions)



Recent Reporting on the Consequences of Underfunding PSERS (or any other public pension plan)

- **Indiana PA Gazette: 7/11/2010: *"Federal funds still the wild card for school budgets, pensions"***

Steve Nickol – PSEA : “You can't realistically expect the districts in the state to come up with that amount of money as currently projected.”
“If they did, there's no way at the bargaining table they (teachers) would be able to get any increases. They're going to get pushed back as they have in recent years over health care and reductions in their benefit package.”

“... in hindsight, the proper way to have done it would have been to fully fund the system to start with.”

- **Patriot News: 8/23/2010: Cornwall-Lebanon School Board, teachers approve new contract, salary increases average 3.5%**



Rasmussen Poll – July 7, 2010

http://www.rasmussenreports.com/public_content/business/general_business/july_2010/most_americans_not_willing_to_pay_higher_taxes_for_public_employees_entitlement_programs

- 37% say they are willing to pay higher taxes to increase the number of police and firemen in their communities, 52% say they would not
- 34% say they are willing to pay higher taxes to provide funding for public education, but 54% say they are not
- 22% would pay higher taxes to prevent cuts in entitlement programs for low-income Americans, 63% would not
- 19% would be willing to pay higher taxes to avoid layoffs of state employees, 69% would not

Here's your question – what is X?

- X% would be willing to pay higher property taxes plus additional state and local taxes to reduce the unfunded pension liabilities.

True Pension Reform Must Satisfy Three Basic Principles – Using Realistic Funding Assumptions

1. Funding must be current.

- Benefits should be funded as they are earned and “paid-up” in the aggregate at retirement
- Achieving a 100% funded ratio
- Significant private sector pension reforms occurred in 2006. (Lower investment assumptions $\sim 6\%$, funding periods <15 yrs., market value of assets)

2. Costs must be predictable.

3. Costs must be affordable.

- 5-7% of payroll (net of employee contributions)

Five Step Pension Reform Plan

- 1. Establish a Unified Defined Contribution plan for new state and local government workers, school employees, judges, and legislators (SB 566)**
 - Curtails open-ended liabilities; Eliminates long-term commitments on behalf of taxpayers
 - Removes politics from pensions
- 2. Prohibit pension obligation bonds or other post-employment benefit (OPEB) bonds**
 - Prevents “generational theft” – deferment of liabilities
- 3. Mandate minimum funding reforms for any newly created liabilities resulting in both pension and OPEB plans**
 - Prevents “generational theft” – deferment of liabilities
- 4. Consider modifying unearned pension benefits** (if legal and feasible)
 - Reduced formula; Redefinition of eligible earnings; Increasing the normal retirement age; Curtailing early retirement subsidies; Eliminating COLAs and Deferred Retirement Option Programs (DROPs)
- 5. Consider funding reforms only after prior steps are achieved**

Omitting steps 1,2,3,4 ≠ pension reform

PA Non-Reform Reform Ideas

Reforms we don't need and can't afford...

<u>Item</u>	<u>Detail</u>	<u>Why it is a problem</u>
Pension Obligation Bonds	Floating bonds to fund pension plan deficits	Increases risk to taxpayers with a certain incentive to increase pension benefits
Optional DC plans for new hires - some with annuity payout options		Overall costs exceeding 5-7% will prove unaffordable
An early retirement incentive plan		Enhances already generous benefits. Long amortization periods. Only works if backfill rate is below 40%
"Fresh start" of PSERS and SERS unfunded liability up to 30 years	Creates a new "mortgage" HB 2497	Increases generational theft An easy political solution
A new and reduced DB plan	HB 2497	Even a new DB will not escape the politics of public pensions. Consider PSERS and SERS - 10 years ago – lessons of history. Doubles-down on the status quo.
A new hybrid plan or a reduced set of new DB & DC plans	A new DB plan which where the accrued benefit is an account balance	Same politics and funding problems associated with defined benefit plans



Some Final Thoughts — Implications for Effective Public Policy

1. Exactly how does deferring unsustainable pension liabilities make future liabilities sustainable? Why is ignoring standard actuarial principles while contributing less into already underfunded plans considered reform? How is a system based upon 8% investment assumptions deemed sustainable?
2. We have implicitly over-leveraged our pension system - now the challenge is to finally restore proper funding while offsetting these increased costs elsewhere within the state budget without increasing overall spending (or borrowing).
3. Given all this, what are the financial incentives to live, work, or invest in Pennsylvania?
4. This debate is effectively one involving self-reliance while removing politics from pensions, protecting the taxpayer and stopping generational theft.



One Final Thought

On “Generational Theft”

Thomas Jefferson Wrote in 1813

- **“We shall all consider ourselves unauthorized to saddle posterity with our debts, and morally bound to pay them ourselves.”**