



## Governor Corbett's Pension Plan a Step Backwards

*Plan drives up pension costs for the state and taxpayers, shorts state contributions to pensions yet again, and banks on savings likely to be undone by the courts*

[Keystone Research Center](#) • 412 North 3<sup>rd</sup> St., Harrisburg, PA 17101 • 717-255-7181

February 7, 2013

Contact: Stephen Herzenberg, 717-525-1448 or 717-255-7145, [herzenberg@keystoneresearch.org](mailto:herzenberg@keystoneresearch.org)

The Keystone Research Center has assessed Governor Tom Corbett's plan for school employee and state worker pensions based on criteria set forth in [a memo to news media](#) on February 4, 2013. We find that the Governor's proposal (summarized in Appendix 1) falls short on many levels:

- The proposal would increase the debt ("unfunded liability") of the current pension plans for state and school employees, increasing taxpayers' exposure and deepening the problem used to justify pension changes — this cure is worse than the disease.
- The proposal would *increase* the cost to the state (and to taxpayers) of pensions for new employees.
- For six years — until the end of the next gubernatorial term — the proposal would divert a portion of pension contributions required under Act 120 of 2010 to other purposes. Short-sighted diversion of pension contributions to other purposes helped create Pennsylvania's pension debts in the first place.
- The proposal banks on savings from reducing pension benefits for current workers that may be unconstitutional and could be reversed by the courts. By spending these potentially illusory savings in the first few years, the plan could leave the state with even higher pension debts down the road.
- The proposal imposes large costs on public employees who care for our aging parents and grandparents, teach our children, and protect all Pennsylvanians from crime and natural disaster. These public servants did not cause the pension debt and contribute heavily — about 7% of their salaries on average — to their pensions every paycheck.

In 2010, the state took major steps to address its pension liabilities. It lowered benefits by over 20% for new employees, a big long-term saving, and established a plan for increasing employer contributions to gradually restore the state and school pension plans to full funding. Governor Corbett's proposal would undo this progress and represents a step backwards.

### Evaluating the Governor's Pension Proposal

#### The Governor's pension proposal would increase Pennsylvania's pension debt (or "unfunded liability")

The Governor's proposal would increase Pennsylvania's pension debt in two ways:

- by lowering required employer contributions over the next six years — leading to a projected \$5 billion increase in the unfunded liability by 2019; and
- by transitioning new employees, beginning in 2015, into a new 401(k)-like pension plan (with individual accounts). This shift would mean that new employees no longer enter the existing defined benefit plans managed by Pennsylvania State Employees' Retirement System (SERS) and the Public School Employees' Retirement System (PSERS). As a result, the group left in the existing SERS and PSERS plans would gradually age, requiring pension plan managers to adopt a shorter investment horizon and switch to lower-risk, more conservative investments (just as individual investors do when approaching retirement). This switch would reduce the expected rate of return on fund assets. This, in turn, would increase the amount of

money needed to honor pension commitments to SERS and PSERS members, increasing the pension debt and the required employer contributions.<sup>1</sup> This sequence occurred in Alaska: the employer contribution rate for the Alaska teachers' defined benefit plan has increased from 16% to 39% since the plan stopped taking in new members in 2005.<sup>2</sup>

Only a small part of the increase in the unfunded liabilities of SERS and PSERS would appear on the books during the current gubernatorial term. This large and inexorable increase would appear, however, over the next several gubernatorial terms as participants left in the SERS and PSERS defined benefit plans age.

#### **The Governor's pension proposal would increase the cost of pensions for new employees**

The current employer cost of pensions for new employees is 2.2% of employee salaries for PSERS and about 3% for SERS and PSERS taken together (see the [pension memo](#) for sources and more detail). Any employer cost above 3% would increase the cost of pensions for new employees. While the Governor has not, to our knowledge, announced the employer contribution rates for his 401(k)-style plan for new employees, proposals of this kind last session cost between 4% to 7% — between one-third higher and more than twice as high as pension costs for new employees under Act 120.<sup>3</sup>

#### **The pension proposal does not make the responsible contributions to pensions required by Act 120**

The Governor's plan lowers state pension contributions this year to 2.25% from the planned 4.5%. In the next four budgets, the employer contribution would increase by 0.5 percentage points each year, reaching 4.25% in 2018-19 and 4.5% thereafter. Thus, the Governor's proposal repeats the shortsighted practices under the past three Governors that diverted pension contributions to other purposes and helped create the pension debt.

#### **The pension proposal may violate the Pennsylvania Constitution.**

The Governor's proposal includes cuts in the pensions of current employees. Pennsylvania courts are likely, based on past court precedents, to reject these cuts as a violation of a constitutionally-protected contract. These cuts risk court reversal that leaves the state uncertain of pension costs for years and then with potentially higher pension debt.

#### **The Governor's pension proposal treats current employees unfairly**

Pennsylvania public employees contribute more to their pensions than workers in other states, while the state and school districts have contributed less than in other states during the last decade. Pennsylvania public-sector workers also accept lower salaries than equivalent private-sector workers with the same education level and other characteristics.

<sup>1</sup> Nari Rhee and Diane Oakley, *Issue Brief: On the Right Track? Public Pension Reforms in the Wake of the Financial Crisis* (Washington, DC: National Institute on Retirement Security, December 2012), p. 12.

<sup>2</sup> State of Alaska Department of Administration, Division of Retirement and Benefits, *Teachers' Retirement System Comprehensive Annual Financial Report For the Fiscal Year Ended June 30, 2012*, online at <http://doa.alaska.gov/drb/pdf/trs/cafr/2012TrsCafr.pdf>.

<sup>3</sup> Proposed legislation to establish similar plans last session (House Bills 551 and 552 of 2011-12) would have required contributions of 6% from employers. Another approach to creating individual accounts proposed last session (House Bills 1676 and 1677 of 2011-12) would have required 5% employer contributions.

## Appendix 1

### Governor Corbett's Pension Proposal

Page A1.12 of the Governor's Executive Budget outlines the main elements of the pension plan:

- There will be no change to benefits for retirees.
- New employees will be enrolled in a new 401(k)-style plan (known as a 401(a) plan). Employees will be required to contribute at least 6.25% of their salary to their retirement. (The employer contribution is not specified.)
- Pension benefits earned by current employees for additional years of service will be reduced through a lower multiplier (from 2.5% of final salary per year of additional service to 2%).
- Current employees will have their final salary computed over their last five years of service as opposed to their last three years of service.
- Pensions will be capped at the federal limit for paying Social Security wages (currently \$113,500).
- If employees choose to withdraw their own contributions to their pension at retirement (this is known as "Option 4"), the formula used to calculate the impact of this withdrawal on their remaining defined benefit will change, reducing the defined benefit received based on employer contributions.