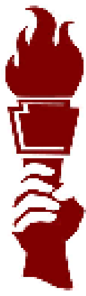

POLICY BRIEF

from the COMMONWEALTH FOUNDATION

Vol. 21, No. 01
April 2009

A Tale of Three Cities

Pennsylvania's Pension and Retiree Medical Liability Challenges

RICHARD C. DREYFUSS

Background

Pennsylvania maintains over 3,000 public pension plans at the state, city and municipal levels, the most of any state and approximately 25% of all such plans in America. Over 2,200 of these plans are of the often financially and politically problematic "defined-benefit" genre. According to the Pennsylvania Public Employee Retirement Commission (PERC), over 67 percent of these plans have fewer than 10 members.

Needless to say, there is vast opportunity for pension reform. However, reform must extend beyond merely achieving a common administrator. Any savings created through administrative changes have the potential to be eclipsed by costs generated from benefit enhancements and the lack of a standardized plan design. This is not to suggest that administrative savings are insignificant given employees often change jobs within the public sector, resulting in participation in various Pennsylvania public pension plans—all of which must be aggregated or bridged at retirement, which can be administratively cumbersome and therefore costly.

The real savings in pension reform will be achieved by designing a system in which taxpayer costs are current, predictable and affordable. Any discussion of pension reform is meaningless without these three parameters being defined.

Courts have ruled that our state and federal constitutions prohibit modifying the benefits of current public pension plan participants—even benefits yet to be earned. Thus, the focus must be on revamping the system for new hires.

To relegate Pennsylvania's need for pension reform to merely a need for more taxpayer funding is to ignore the underlying drivers of the problem and thus preclude a permanent solution. Many of the problems facing these pension plans can be traced to the institutionalized and political nature of the public pension system. Lawmakers are also reluctant to raise taxes, so their preferred approach to making pension costs affordable is to transfer burdens to future employees and taxpayers.

Compounding matters are improper benchmarking and poor risk management, which will likely leave current and future taxpayers exposed to significant financial liabilities—most likely after the policymakers leave office. Finally, ignorance among policymakers is pervasive in pension and retiree medical matters.

Introduction

This paper will briefly examine the problems facing sponsors of three Pennsylvania cities' public pension systems. A brief review of the defined-benefit plans in Allentown, Pittsburgh and Philadelphia illustrates that they are representative of the Pennsylvania pension system as a whole. While each city presents a different case study, the recurring theme of not having current, affordable, and predictable taxpayer costs is evident. One need not look any further than these cities to understand the enormity of the problems statewide.

The Auditor General's Office, the entity which audits pension funding compliance with state law, maintains that a number of plans throughout Pennsylvania are in violation of the law, and that it does not have statutory authority to enforce compliance, which leads to another set of issues beyond the scope of this report.

The closely related and parallel problem of retiree medical liability, which is computed under the Government Accounting Standards Board Statement 45 (GASB 45), is a topic also not well understood by policymakers. Those who do understand either neglect to fund the attendant obligations sufficiently (ostensibly due to budgetary constraints), or they adopt funding approaches disguised as being meaningful but which are merely intended to mollify the public and financial rating agencies. Such strategies effectively push costs to future taxpayers while keeping current costs artificially low. Such a strategy is evident in the state's GASB 45 funding policies.

It is noteworthy that GASB 45 remains as significant a problem as pensions given the lack of understanding of the issue. Compounding matters, factions are divided over how to best resolve the retiree medical unfunded liability crisis.

As a further example, the neighboring state of New Jersey recently enacted the deferral of the regular taxpayers' pension contribution to the state, county and municipal pension plans to avoid raising state taxes. Not making the required contributions, while appearing to save money, in reality only defers costs. Pension costs that are unaffordable now will be unaffordable with interest in the future. Such an approach also typifies the funding strategy for most retiree medical obligations.

This paper was initially outlined in the summer of 2008, and since then the macroeconomic environment has deteriorated significantly. While it is acknowledged that the market works in cycles, such a phenomenon underscores the fact that there are excessive risks to the taxpayers. Moreover, superior investment earnings, even if achieved, will not remedy this risk imbalance.

Historically, any market gains provide an incentive to create new benefit liabilities, such as ad-hoc pension COLAs, while market deficits are often categorized as "underfunding by taxpayers." As an illustration, Pennsylvania legislators used accumulated pension surpluses as political capital to justify Act 9 of 2001 (providing a 25-50 percent increase in pensions) and Act 38 of 2002 (pension COLA for retirees). These acts led to $10 billion in new liabilities in the Pennsylvania Public School Employees' Retirement System (PSERS) and the Pennsylvania State Employees' Retirement System (SERS) combined. As of December 31, 2008, it was estimated these two plans will have combined unfunded liabilities of well over $10 billion. This is in addition to the numerous unfunded liabilities among the plans throughout the state.

Pennsylvania Case Studies

A bill to consolidate Pennsylvania's municipal pension plans for police officers was approved by the Senate Finance Committee in 2008. While the legislation sought to establish a common administrator, a careful review of the bill revealed significant benefit enhancements to certain participants, presumably in the interest of administrative efficiency and benefit uniformity. While not officially quantified by PERC, it is most likely this legislation would have actually increased taxpayer costs. For these and presumably other reasons, the bill stalled and did not proceed further.

Over the past few years, Philadelphia considered addressing its multi-billion dollar pension shortfall with an aggressive strategy to borrow its way to better funding. The formal vehicle is known as pension obligations bonds, which are borrowings outside the domain of a pension plan, with the proceeds used to fund it. The Philadelphia Inquirer reported on December 22, 2008 that the city borrowed $300 million at 7 percent interest to invest in the pension fund to hopefully earn at least that amount. This approach was panned in a Bloomberg.com article (May 1, 2008) titled, "'Dumbest Idea Ever' Used as Pensions Plug Deficits":

> Philadelphia fell into a similar trap when former Mayor Edward Rendell, now Pennsylvania's Democratic governor, sold $1.29 billion in pension bonds in 1999. John Street, a Democrat who succeeded Rendell, failed to make full contributions to the fund as he tried to balance the budget.
>
> The city has about 54 percent of the funds it needs to pay pension benefits over the next 30 years, about the same as in 1999 before it sold the bonds.
>
> Mayor Michael Nutter, a Democrat who took office in January 2008, said he wants to borrow as much as $4.5 billion to close the deficit, promising this time the city will make the necessary annual contributions.
>
> "We're going to be committed to making sure the fund stays well-funded," said Rob Dubow, Philadelphia's finance director.
>
> Illinois Governor Rod Blagojevich is making similar promises four years after selling $10 billion in pension bonds. The state still faces a $42 billion deficit and the governor asked the Legislature to approve another $16 billion of the securities.
>
> A study released last month [April 2008] by consulting firm Greenwich Associates in Greenwich, Connecticut, found that public pension managers expect to outperform market benchmarks by 1.46 percentage points over the next five years, an outcome it said was "probably not"' realistic.
>
> [The concept of Pension Obligation Bonds prompted] Jon Corzine, New Jersey Democrat Governor [and former chairman of investment bank Goldman, Sachs & Co.] to remark "It's the dumbest idea I ever heard. It's speculating the way I would have speculated in my bond position at Goldman Sachs."
>
> "It's lousy public policy," Corzine said.

Regardless of the intended wisdom of this investment arbitrage and the accompanying higher amount of risk assumed by taxpayers, the greatest risk is that over time the relationship between the fortified assets in the pension trust and the borrowed amount outside the plan becomes less apparent. This presents an artificial picture of the financial health within the pension plan. Not surprisingly, in most cases pension benefits are subsequently enhanced.

More recently, the city has proposed a number of initiatives to effectively defer the funding of the plan. These changes include first reducing the assumed rate of return from 8.75 to 8.25 percent to more realistically anticipate asset returns. Such a change increases the plans' contribution requirements since lower expected investment returns must be offset by higher taxpayer contributions. The second change includes increasing the asset averaging period (used in determining taxpayer contributions) from five to 10 years. The third proposed change seeks to increase the amortization period of any unfunded liabilities from 30 to 40 years. The latter two changes will require legislative approval.

The second and third funding proposals are manipulative, given they serve to misalign pension benefits being earned with the actual funding of these same benefits. This simply further defers costs onto the next generation of taxpayers and is symptomatic of the politics inherent in these plans.

Philadelphia is also considering a hybrid pension plan design for new hires. Hybrid plans are defined-benefit plans replete with the funding and political shortcomings which have plagued many existing defined-benefit plans. The term hybrid is reflective of the benefit formula resembling certain optics associated with defined-contribution plans. Nonetheless, these plans are defined-benefit plans although the Philadelphia Inquirer on March 20, 2009 ("Pension Proposal a Big Test") referred to this proposal as "… a public-sector version of a 401(k)."

In Pittsburgh, based on the 2007 Comprehensive Financial Report, the three major pension plans (police, firemen, non-uniformed) had combined unfunded liabilities of $523.8 million, and were only 42 percent funded. Since that point in time, the financial positions of these plans has deteriorated, particularly during the latter half of 2008. In addition, in 2007, the city reported a separate retiree medical unfunded liability under GASB 45 of over $300 million.

Many of these pension plans receive state subsidies based upon a statewide formula involving premium taxes from out-of-state fire and casualty insurers. These aggregate revenues are divided by the number of *active* pension participants (uniformed count as two units and non-uniformed count as one unit) among all qualifying plans statewide receiving subsidies to arrive at a per-unit subsidy. As a reference point, in 2002, the unit value was $1,871, and in 2007 it was $1,949. Pittsburgh's mayor and his counterparts in other cities are claiming the state subsidy formula is flawed and outdated, thus contributing to the pension crisis in many Pennsylvania cities.

Such an assertion raises two substantive counterpoints. The first relates to the truism that any subsidy masks the true cost of the programs and logically incents even higher subsidies. Conceptually, one must question why a subsidy even exists. Former Budget Secretary Michael Masch said it best ("State budget: Pittsburgh City Council looking for pension help," Pittsburgh Post-Gazette, February 7, 2007):

> The rest of the state is not going to agree to correct over-promises made by rightfully elected members of the city of Pittsburgh. … We cannot simply erase bad decisions that former leaders of Pittsburgh made. But we can better manage the city going forward so there's a brighter future than the recent past.

The second point relates to the fundamental actuarial principle that pension costs are designed to be fully funded during the working years of the employee. Ignoring this rule is a poor funding practice resulting in unfunded costs continuing into the post-employment years. While one could conceptually oppose a subsidy on principle, the reality is the formula is working in accordance with sound actuarial principles—one that is based only on active headcount.

The reality is the fiscal integrity of these pension plans was compromised by prior officials in Pittsburgh (and many other cities)—but such is hardly a rationale to make this a statewide taxpayer problem, or to suggest a revised funding formula.

Before any funding modifications are considered, new employees should be placed in a statewide "defined-contribution" program, preferably without any state taxpayer subsidy.

Allentown sponsors three pension plans for fire, police, and municipal employees. These plans are also supported by pension obligation bonds. In 2004, then- Mayor Roy Afflerbach negotiated a special early retirement incentive with the Allentown Police union to reduce headcount. Among the special incentives was a provision that pension benefits would be based upon the final 30 days pay (including overtime) rather than the existing final three-year average. The city was targeting up to 12 officers accepting the offer, and more than 50 agreed to retire, some with pensions of up to 154 percent of final pay. Some retirees were as young as 37 years old.

As a result, the active police members in the 2003 actuarial report totaled 215, which dropped to 164 in the 2005 report. The actuarial unfunded liability increased from $12.3 million to $48.4 million. While many pension amendment protocols were not followed and legal challenges were raised, coupled with the ensuing adverse taxpayer reaction, the incentive was fully implemented and upheld. Consequently, these enhanced pension liabilities will be a burden on taxpayers for many years to come.

Legislative Efforts in 2009

In Pennsylvania, whenever there is a crisis involving education, transportation, or infrastructure, inevitably one will find a latent pension disaster because policymakers divert funding from the latter to the former and are abetted by defined-benefit advocacy groups which believe an 80 percent funded ratio to be an acceptable standard.

In 2009, two major pieces of legislation were introduced. SB 566 was introduced by Senate Finance Committee Chairman Pat Browne (R-Allentown). This bill proposes the creation of a single plan for all new public employees encompassing all levels of Pennsylvania government at a cost of 6 percent of pay.

Sen. Browne is also the primary sponsor of SB 565, requiring all public entities to fund their GASB 45, also referred to as the OPEB (Other Post-Employment Benefits) liabilities over the working lifetime of the members.

While it is anticipated that all public entities will fully comply with the GASB 45 accounting standard, this requirement carries no mandate to fund such obligations. Therefore, a pay-as-you go cash outflow can continue as the liability grows on the balance sheet. This scenario can easily impact bond ratings and will significantly affect future cash flows as Pennsylvania has a growing number of retirees with higher annual medical costs.

Many private-sector Pennsylvania employers have established financial caps which limit the employer's retiree medical contributions. Other employers have redefined eligibility, retiree cost sharing formulas and increased plan co-pays and deductibles.

The key point is these reform measures are designed based upon the employer's ability to pay. Most private-sector employers establish the retiree's premium contribution as a percentage of cur-

rent premiums. This is in contrast to the feature often found within the Pennsylvania public sector, where a retiree's medical contribution is fixed based upon a percentage of the retiree's pre-retirement pay. Such a design ultimately transfers the full impact of future healthcare costs to taxpayers and is a significant factor in the unaffordable GASB 45 liability. It is important to clarify that there are considerable differences in coverage levels among and between public employees throughout Pennsylvania.

The (Non-)Funding of GASB 45 at the State Level

The GASB 45 unfunded accrued liability for employees and retirees participating in Commonwealth-sponsored, post-retirement benefit plans (other than pensions) has been disclosed to be approximately $10 billion, as of June 30, 2008. This figure is based upon the assumption of healthcare costs increasing at 5 percent per annum for the foreseeable future. Should actual costs prove higher, additional taxpayer funding will be required. In addition, any dedicated assets are assumed to earn 8.5 percent, a standard established at PSERS and SERS, the state's two largest pension plans. While PSERS is funding a separate GASB 45 liability within its plan, neither PSERS nor SERS are responsible for the investment of any assets dedicated toward funding this $10 billion liability. Any asset-to-liability shortfalls will be the responsibility of taxpayers.

In a related matter, PSERS has decreased its long-term investment assumption from 8.5 to 8 percent. The impact of such a change on the assumptions used in developing the state's GASB 45 liability is not clear at this time.

The state's proposed annual funding requirement under GASB 45 must also cover the current pay-as-you-go costs, which are approximately $600 million. The interest cost alone on $10 billion is $850 million. The budgeted amount for the fiscal years ending June 30, 2008 and June 30, 2009 is $705 million and $746 million, respectively. Despite this pre-funding attempt, the unfunded liability is actually expected to increase annually. In fact, every year the unfunded liability is re-computed and a "fresh start" occurs, which effectively establishes a perpetual 30-year amortization period.

Therefore, it is evident the state is not serious about reducing the unfunded liability, much less eliminating it over a period of 15 years—which is approximately the average remaining working period for active members. Such dynamics are not well understood by policymakers, the media or by taxpayers.

The only real reform, absent annually funding this obligation at approximately the $1.3 billion level, is to modify benefits and increase retiree contributions—a fiscal reality acknowledged many years ago by most Pennsylvania private-sector employers.

Summary and Conclusions

The cardinal rule in pension and retiree medical liability management relates to the ability of public entities to completely fund obligations during the working careers of the employee. If this principle was observed, Pennsylvania would be in control of the financial dynamics of an aging workforce. Since the rule is habitually violated, the result is that significant legacy costs are transferred to the next generation of employees and taxpayers. Such poor public policy is conveniently justified in benchmarking with other states exhibiting equally poor financial profiles and funding practices.

All public entities studied in Pennsylvania do not follow this principle and even proposed retiree ad hoc pension COLAs seek to further compromise this principle. Pension COLAs assign the costs to future employees and future taxpayers, who have the dual task of recognizing the cost for the active members replacing these same retirees. Such legacy costs are sometimes found in the worst-demonstrated practices in the private sector, such as that of the Big Three automobile makers.

It makes no sense to embark on resolving a pension crisis on the notion that it is a result of a shortage of taxpayer dollars when the problem is of an institutional, political nature and sustained by poor benchmarking and improper risk management.

The prerequisite for addressing any funding strategy for current participants is to first establish a unified defined-contribution plan for all new PA public employees. Any other "solution," particularly the universal allure of increased funding, will inevitably lead to a repeat of the same problem resident on the next generation. Any GASB 45 funding issues are simply a variation on this same theme.

Many defined-benefit plan defenders point to practices in other states to justify maintaining poor practices or simply frame the issue as one of underfunding. It is also ironic to hear defined-benefit plan defenders speak of investment optimism and describe the cyclical nature of capital markets, yet these same pundits describe defined-contribution plans as being, by definition, universally too risky in an investment horizon filled with pessimism.

Another noteworthy phenomenon is a trend among certain public employers to consider early retirement at ages 50-55, with unreduced pensions and varying levels of lifetime healthcare. A version of this is the Deferred Retirement Option Plans (DROP), which also increases pension costs. Such an early retirement trend exponentially increases costs and shortens the funding period. While burn-out or the physical demands of a job may require a position or career change at a certain age or tenure, providing an unreduced pension at such a relatively early age, coupled with retiree medical benefits, is an unaffordable proposition.

Policy Recommendations: Pension Changes

- Consider any funding reforms only after plan design reforms.
- Adopt a unified defined-contribution plan such as that proposed in SB 566.
- Manage annual taxpayer pension costs in the range of 5 to 7 percent of pay.
- Allow but do not require SERS and PSERS to invest defined-contribution assets.
- Adopt life-cycle funds as the default employee investment option.
- Outlaw pension obligation bonds or other funding mechanisms that create liabilities outside the domain of the plan.
- Require funding of any unfunded liabilities to be over a period not to exceed the average remaining working careers of the recipients. This is generally less than a 15-year period. Any funding for the complete present value of any new benefit enhancements for non-active members must be fully funded in one year.
- Remove state subsidies in the newly proposed defined-contribution plan. All costs are to be borne by the entity which compensates the member.

Policy Recommendations: Retiree Medical Changes

- Adopt funding approaches such as those proposed in SB 565.
- Benchmark plan design and retiree premium contribution levels to common practices within the entire PA labor market.
- Modify plan design and retiree premium contribution levels to achieve affordable levels considering expected revenue growth in the state budget.
- Adopt retiree premiums based upon a percentage of premiums rather than a fixed level of pre-retirement pay.
- Outlaw "Other Post-Employment Benefits" obligation bonds or other funding mechanisms that create liabilities outside the domain of the plan.
- Require funding of any unfunded liabilities to be over a period not to exceed the remaining working careers of the active workforce. This is generally less than a 15-year period. Any funding for the present value of any new benefit enhancements for non-active members must be fully funded in one year.

About the Author and the Commonwealth Foundation

Richard C. Dreyfuss, an actuary and pension expert formerly with the Hershey Foods Corporation, is a Senior Fellow with the Commonwealth Foundation.

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