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## **Beneath the Surface: The Pennsylvania Public Pension Saga—Ten Years Later**

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*“Pennsylvanians should rest assured that Pennsylvania is not the Titanic, and there are no icebergs in our pension fund's future,” wrote AFSCME Council 13 ten years ago.* Yet, since that statement, the combined SERS and PSERS unfunded pension liability grew 730% while the market value of assets declined by almost 10%.

My 2006 paper, *Beneath the Surface*, analyzed the perilous state of Pennsylvania’s public pension debt using the metaphor of an iceberg on the horizon. Quoting from the paper’s opening paragraph:

Pennsylvania government employee-benefit plans operate in a vacuum. In a world where private-sector benefit cutbacks and cost reductions occur on a daily basis, state government in Harrisburg has not responded in similar fashion. In fact, instead of reducing the potential for financial disaster, actions in recent years have served to accelerate the coming crisis.

Like AFSCME, the Pennsylvania State Education Association chose to deny the impending pension crisis. [In 2007, PSEA noted the following on its website:](#)

- There is no crisis in the Pennsylvania state pension plans. PSERS and SERS are among the strongest Pension Plans in the nation.
- Warnings of a “spike” in the employer contribution rate in 2012-2013 are proving to be overrated.
- The [*Beneath the Surface*] report was used by many to call for major changes to PSERS and SERS. In reality, the report used inaccurate and out-of-date data and was unnecessarily alarmist.
- The report used old data and questionable methods. It would earn an F in any college research class.

In 2012, following years of further neglect coupled with the insufficient pension reforms of Act 120 of 2010, [Governor Tom Corbett noted we are indeed facing an iceberg.](#) “Does anybody here see the economy growing fast enough just to cover the pension increase?” Corbett asked. “So we have a problem. We have an iceberg right in front of us.”

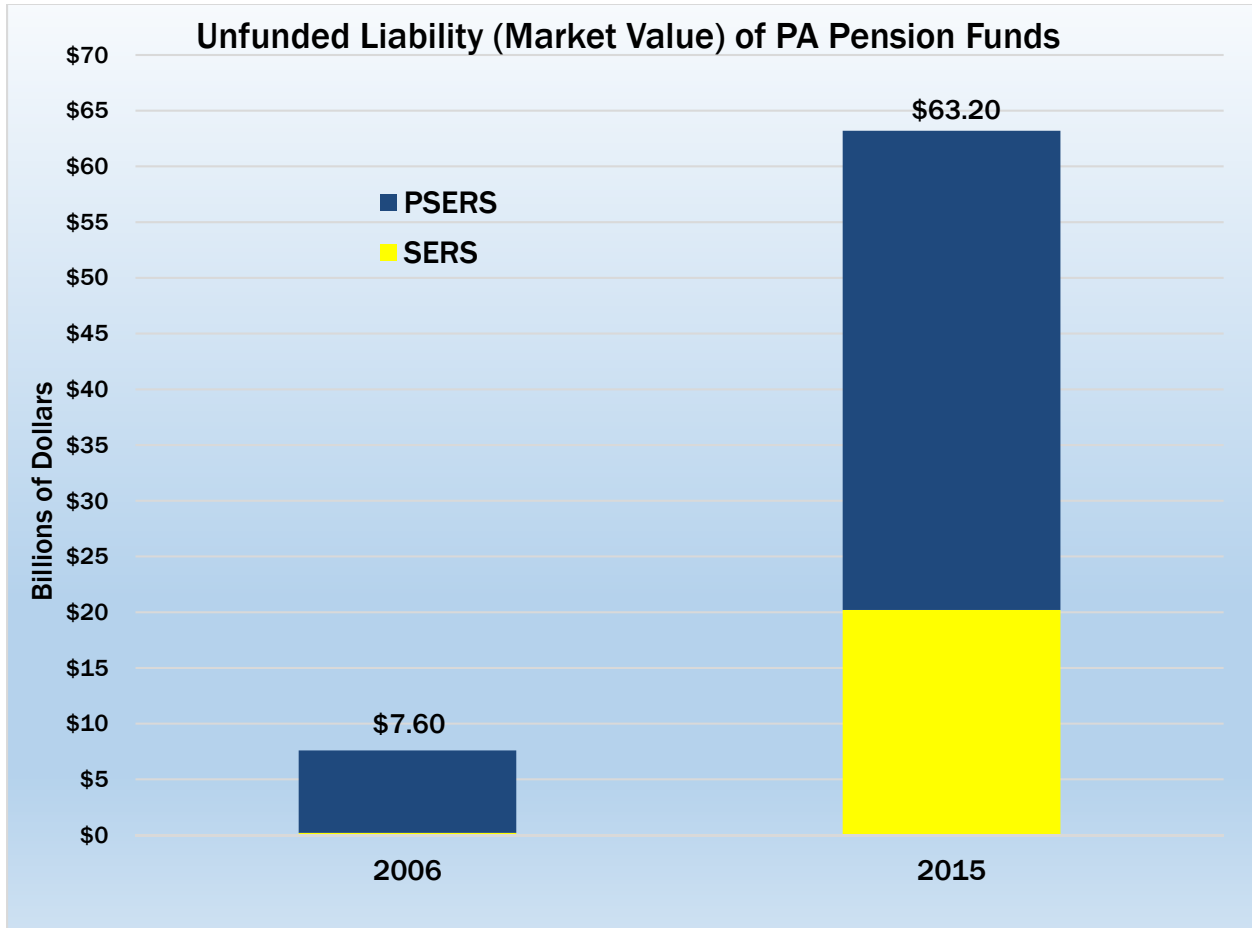
Subsequent to Governor Corbett’s statement, the AFSCME and PSEA postings were removed from their websites.

Since 2012, the financial profiles of the state’s two largest pension systems, PSERS and SERS have only grown progressively worse.

### Growing Unfunded Liabilities

The following chart compares the accrued liabilities and assets of PSERS and SERS from 2006 to 2015. In 2006, the combined PSERS and SERS unfunded liability was \$7.6 billion.

Approximately ten years later, the combined unfunded liability based upon the market value of assets (used by the Government Accounting Standards Board and Moody’s) was \$63.2 billion.



During this period, accrued liabilities grew by over 50% while the market value of assets actually fell by almost 10%.

	<b>PSERS 6/30/06</b>	<b>SERS 12/31/05</b>	<b>Total</b>	<b>PSERS 6/30/15</b>	<b>SERS 12/31/15</b>	<b>Total</b>
<b>Accrued Liability</b>	\$64.7B	\$28.9B	\$93.6B	\$94.7B	\$46.3B	\$141.0B
<b>Assets (Market Value)</b>	\$57.3B	\$28.7B	\$86.0B	\$51.7B	\$26.1B	\$77.8B
<b>Unfunded Liability</b>	\$7.4B	\$0.2B	\$7.6B	\$43.0B	\$20.2B	\$63.2B
<b>Funded Ratio</b>	88.6%	99.3%	91.9%	54.6%	56.4%	55.2%

These unfunded liabilities are required to be reflected on the sponsoring employer's balance sheet. Such obligations are in addition to the retiree medical unfunded liabilities both at the state and school district levels and facing our various municipalities.

Non-political rating agencies Moody's, S&P and Fitch have downgraded the state's credit ratings on multiple occasions over the past several years. Their recurring and unmistakable message relates to the state's continued inability to properly manage down these ever-growing and unsustainable unfunded liabilities.

One noteworthy example is from [Fitch Rating Services in 2013](#) (Emphasis added):

The funding levels of the commonwealth's pension systems, which have been historically adequate, have materially weakened, with **annual contribution levels remaining well below actuarially required levels.**

[Together, Pennsylvania's problems] **signal an inability or unwillingness on the part of political leaders to make difficult fiscal decisions.**

### **Need for True Pension Reform**

My 2006 paper described the imperative of properly managing the FY 2012-13 projected and sustained "spikes" in the employers' pension contributions. This is an essential component of any credible pension reform effort. Instead, a 2010 bipartisan agreement resulted in reducing benefits for new hires while opting to *continue and extend* the practice of deferring employer contributions into already underfunded plans. [Such concerns were identified and summarily ignored in 2010 as HB 2497 was being considered.](#) This bill ultimately was signed into law as Act 120.

Even today, we continue to hear the talking point of "let Act 120 work." Such a proclamation ignores the legislation's failed fiscal realities as taxpayers witness the ever-increasing financial risks of plan insolvencies projected over the next 15 years.

While the FY 2016-17 state budget process presents many challenges, accentuated by election year politics, there continues to be a very significant "political-lift" in adopting proper pension funding standards as either part of the budget or related to other pension reform efforts.

Based on the pension funding standards developed in [the 2014 Report of the Blue Ribbon Panel on Public Pension Plan Funding](#), an independent panel commissioned by the Society of Actuaries, Pennsylvania policymakers should be annually budgeting sustained incremental contributions of \$2 billion to \$3 billion towards PSERS and SERS combined. This exceeds amounts currently scheduled.

This is in an environment in which many school districts are seeking legislative relief from unsustainable pension costs.

While paying the pension obligation promised to workers must remain a funding priority, lawmakers should also protect taxpayers from unaffordable tax increases. Commonwealth Foundation has [elsewhere identified spending reforms and ideas for prioritizing how tax dollars are spent.](#)

Pennsylvania is already the 15th highest-taxed state in terms of per-capita share of state income, with a net out-migration of its citizenry. We must avoid adding to this burden while enacting budget and tax policies that will properly fund our pension systems and pay off the state's unfunded pension liability.

## **Pension Solutions**

Comprehensive and sustainable pension reform requires two integrated strategies and should follow the best-demonstrated practices of the private sector.

### **1. Plan Design Reforms**

The first step is to enact a defined contribution plan for **all new hires**, with an employer cost of 4% to 7% of payroll.

### **2. Pension Funding Reforms**

This is comprised of adopting the funding reforms consistent with the 2014 Report of the Blue Ribbon Panel on Public Pension Plan Funding.

These two strategies should not be decoupled. Given these plans are experiencing an ever-increasing risk of insolvency in the coming years, the time for incremental reforms is past.

All current forecasts are predicated on a dubious 7.5% annual investment return expectation. Of note, SERS recently found it necessary to increase its portfolio risk, lest it deal with the political and financial consequences of lowering its annual asset return assumption. Reducing this annual expectation by a mere 50 basis points would likely increase the combined PSERS and SERS unfunded liability by more than \$6 billion.

In fact, a recent study [summarized in the \*Wall Street Journal\*](#) suggests pension funds must shift to riskier portfolios to maintain the current assumed rate-of-return.

It is noteworthy that in the most recent publicly-available actuarial reports for PSERS and SERS, the number of active members listed is 259,868 and 105,186 respectively. Within this total of 365,054, almost half these members have less than ten years of service. Had these members entered a DC plan ten years ago consistent with the recommendations of my 2006 report, the reduction in the current unfunded liability would be significant.

Instead, the shortcomings of Act 120 still exist, and the lessons learned should apply to many of the pseudo reforms currently being considered. Most of these proposed plans are unnecessarily complicated and exclude many employer groups while having little, if any, resemblance to the best-demonstrated practices of Pennsylvania's private sector.

As this saga continues, the iceberg is growing. We cannot afford another 10 years of inaction on adopting pension reform solutions.