



Testimony of
David E. Durbin, Executive Director
Pennsylvania State Employees' Retirement System
before the
Public Employee Retirement Commission
regarding
Pennsylvania's Public Pension Systems
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Good morning Mr. Salomone, members of the commission, Mr. McAneny, staff, and guests. I am Dave Durbin, executive director of the Pennsylvania State Employees' Retirement System (SERS). I am pleased to be a part of this session because I think the work you are doing here today is extremely important.

Before I begin, I would like commend the commission for dedicating so much time today and over the coming weeks to provide all stakeholders with opportunities to share their concerns and ideas about the commonwealth's public pension systems. This issue is significant to tax payers, homeowners, school districts, governments, public employees, retirees and others. The stakes are high.

Few know better than you how far-reaching Pennsylvania's public pension systems really are. SERS alone currently serves approximately 115,000 retired, 107,000 active and 6,000 inactive/vested members—that's roughly the equivalent of the populations of Allentown, Lancaster and Harrisburg combined. When you add those served by the Public School Employees' Retirement System, the Municipal Employees' Retirement System, and the scores of independent plans, well over a million Pennsylvanians are members of public pension plans.

First, a few facts that are already widely understood and reported:

- Typical SERS members pay 6.25% of their salary over their careers and the typical SERS benefit at normal retirement age is about \$24,500 per year.
- SERS has an unfunded liability of about \$14.7 billion.

- The liability is for benefits that have already been earned by employees and is largely the result of making retirement benefits more generous without funding (Act 120 has since reversed many benefit enhancements); employer contributions of \$0 for a number of years; changing the actuarial recognition of gains and losses; and suffering unprecedented investment losses associated with the Great Recession.
- The driver of the commonwealth's rising employer contribution rate is the liability, not the cost of current benefits. The current employer cost of benefits is about 5.1% of payroll for SERS members hired on or after January 1, 2011.
- Any attempt to reduce the liability by reducing benefits or increasing contributions of existing employees is likely to face litigation and, based on judicial precedent, may be stymied by constitutional issues.

There's nothing new in this information; you've heard it before. These facts help us frame the problem but they don't necessarily help us figure out what to do about it.

There is no shortage of ideas; many have been discussed already today. Among those I have heard or read about include, for example:

- Let Act 120 play out, allowing SERS to regain fully funded status in about 40 years.
- Create additional tiers of defined benefits for new employees with higher employee contributions, lower multipliers, longer vesting, different final average salary calculation, etc.
- Change future benefits for current employees.
- Look at above-the-baseline benefit enhancements to see if they can be rolled back.
- Alter assumptions of current plans, including amortization schedules, assumed rates of return, salary growth, etc.
- Identify revenue and/or dedicate a government funding stream.
- Commit budget surpluses to the pension systems.
- Move to a defined contribution plan.
- Start a cash balance or other hybrid plan.
- Issue pension obligation bonds.

The list goes on.

Policy makers, academics, financial professionals, labor leaders, advocates, citizens, employees, retirees and others have well-informed, well-intentioned perspectives. In fact, over the past year, I've had the good fortune to interact with a wide array of smart, reasonable people, all working in good faith to solve this serious cash-flow problem. What I believe I have found is that people are proposing and evaluating ideas on different principles.

The most common principles I have come across so far seem to be:

- 1) actual cost to provide the benefit
- 2) current and projected employer contribution rates
- 3) employee vs. employer risk
- 4) public/private sector parity
- 5) benefit adequacy

Given how long this debate has been underway and how many people are involved, I believe that it is clear that no single proposal can address all of these principles to everyone's satisfaction. If there were, we would already have a solution in place.

No system is inherently good or inherently bad and there can be wide latitude within different kinds of systems. So what combination of solutions—and to what extent of each—will be acceptable and effective in Pennsylvania?

What I would like to submit today is a framework for people—policymakers, stakeholders and citizens—to evaluate various pension reform proposals as they emerge. I suggest that each person consider these issues in light of the commonwealth's fiscal realities and his or her personal values:

- *Actual cost to provide the benefit.* While there are different classes of service, the normal cost—the cost to the employer to provide one year of covered service—for a typical new employee's SERS benefit is 5.1% of the employee's salary.

To put that number in perspective, according to the Commonwealth Foundation, "A good benchmark for government benefits is private companies, which typically provide retirement benefits that cost between 4% and 7% of salary per year."

- *Current and projected employer contribution rates.* As I have indicated, the current and projected employer contribution rates are being largely driven by the \$14.7 billion that is needed to pay for benefits that have already been earned by employees.

The commonwealth's current employer contribution rate for SERS pensions is 11.5% of payroll. This rate is set by the Act 120, which limits increases by 4.5% of payroll per year for a number of years. Were it not for Act 120, the actuarially required contribution necessary to pay for current benefits and to pay down the unfunded liability would be about 26.4%.

The 4.5% annual increase—from 11.5% this year to 16% next year, for example—is the basis for the "Pac Man" reference about the budget. Without additional revenues, state agencies must absorb the increase in pension-related personnel costs within their existing resources. (Collectively bargained salary increases and rising health care costs also contribute significantly to the growth of personnel costs.)

- *Employee vs. employer risk.* In traditional defined benefit plans, pre-set formulas determine how much retired employees are entitled to receive every month for the rest of their lives. If plan investments don't earn the assumed rate of return or if employees live longer than anticipated, for example, the employer is still obligated to pay the benefit. Thus, in the case of a defined benefit plan, the employer bears the risk.

In traditional defined contribution plans, employers contribute a certain amount to an account and employees contribute a certain amount to an account. Employees (whether sophisticated investors or not) make the investment choices. Upon retirement, employees gain access to whatever is in the account. If investments didn't earn a significant return (or incurred losses) or the retiree lives longer than anticipated, the retiree may run out of money. Thus, in the case of a defined contribution plan, the employee bears the risk.

A number of hybrid plans have found unique ways to share risk between employers and employees. And, to a lesser extent, Act 120 introduced risk-sharing to SERS' plan by creating a mechanism that increases the employee contribution rate if employers are meeting their payment obligations but SERS investments fail to achieve the assumed rate of return for a number of years.

- *Public/private sector parity.* Some feel that, if 401(k) plans are appropriate for private-sector employees, public-sector employees should not enjoy a different benefit—particularly a benefit which has been portrayed as more expensive and more generous.

Very often, this conversation also includes other distinctions between public and private sector benefits, such as overall compensation packages.

- *Benefit adequacy.* With care, any system can be crafted to provide an adequate retirement benefit, depending on what an employer is willing to require of employees and how much an employer is willing to pay. The current debate seems to look at adequacy in two ways:

From a fiscal perspective: At what point does a retirement benefit become too little to keep a senior from relying on other state programs and, thus, costing government more? At what point does the retirement benefit improve the commonwealth's overall bottom line by attracting and retaining high-quality employees?

From an ideological perspective: What's the appropriate benefit to acknowledge an employee's contribution to the workplace and ensure a safe retirement with dignity?

Different people will weigh and evaluate these principles differently – individuals may be willing to “trade off” gains in some areas for challenges in other areas. To use just the first principle as an example, some people may be not be willing to accept a higher cost of benefits for any reason. Others may be willing to accept a higher cost of benefits in order to shed employer risk. Others may be willing

to accept a higher cost of benefits to ensure that the benefit is adequate to safeguard other public resources.

Differences will occur on each point. These are all legitimate and appropriate policy conversations and, with hope, a common framework will allow us to more constructively work through the issues.

Thank you for allowing me to appear before you today. As you know, SERS has long held that it is our responsibility to ensure that the commonwealth's retirement plan is administered prudently and with integrity. We believe that the system and level of benefits provided to employees is the purview of the Governor and the General Assembly.

With that said, we take our fiduciary responsibility very seriously. We will continue to make ourselves available to share our expertise with and provide accurate data to anyone who requests our assistance.

Working together, I am sure that we can find a solution that respects our hard-working public employees just as it respects Pennsylvania's hard-working taxpayers.

I welcome your questions.