

PUBLIC EMPLOYEE RETIREMENT COMMISSION
PENSION REFORM TESTIMONY AND DISCUSSION
October 3, 2012

Good afternoon Chairman Salomone and members of the Public Employee Retirement Commission, I am Steven Nickol, Assistant Director of Retirement Programs with the Pennsylvania State Education Association (PSEA). On behalf of the 187,000 members of PSEA, I thank you for inviting our testimony on this issue of critical importance to our members and the Commonwealth.

With regard to my own background, I was a member of the House of Representatives representing a district in York and Adams Counties from 1990 to 2008, during which time I sat on the Public School Employees' Retirement System (PSERS) Board. Several months after leaving office, I was offered and accepted a position with the PSEA as a retirement consultant. I work with school employees on a daily basis to advise them on retirement-related matters.

PSERS dates back to 1917, and the State Employees' Retirement System (SERS) to 1923. These two pension funds have survived almost 100 years and weathered even the Great Depression, all without their sustainability being questioned until now. This underscores the point that the crisis facing the Commonwealth today in terms of pension funding is of recent vintage, manmade, and the result of a period of neglect for proper funding.

Ironically, the seeds of the present problem were sown in the best of times. As a result of the tremendous investment returns earned by the pension funds in the late 1990's, the pension rate at PSERS hit zero in 2001. Elected officials from the Governor on down to school director all rejoiced; but, what I recall most clearly are comments made by Joe Oravitz, one of my colleagues on the PSERS Board. Joe, who was the Executive Director of the PA School Boards Association, warned the Board, "you all may be celebrating this today, but you are going to regret it tomorrow. Once the rate goes this low, it will be almost impossible to ever get it back up to where it should be."

His comments were prophetic.

In 1998, the employer pension rate for PSERS fell below the cost of benefits earned by school employees during the year – the so-called employer normal cost rate. It has remained below this rate until just about 2 months ago. This means that employers have been paying in less than the cost of benefits for 14 years. The cost was deferred and added to the system's unfunded liability.

A normal rate floor that was included in Act 120 has now kicked, albeit about 14 years too late. Act 120 also greatly reduced the employer normal cost of benefits for new employees, producing a significant savings to employers as we move forward.

I would like to boil the challenge we are now facing down to what I believe are its base elements.

(Reach for white board and write “3%” on it)

When we are dealing with for all the bills presently before the General Assembly is the retirement cost for new employees – and by that I mean those subject to the provisions of Act 120 of 2010 - this is the current cost for the Commonwealth and school districts combined: 3%.

From this point forward, it is all simple math. Any new or alternate pension plan that does not beat this number, will not offer long-term cost savings to taxpayers or the Commonwealth.

(Now erase the “3%” and write: 21.43%
 6.95%
 + .63%
 29.06%)

The PSERS rate is projected to peak in 2020. Here is a breakdown of the rate in that year: 21.43% is the unfunded liability rate to pay off current debt, 6.95% is the average cost of benefits earned by both pre- and post-Act 120 employees in 2020, and the .63% is the cost of health insurance premium assistance.

(Strike out the 6.95%, .63% and 29.06%)

Even if you totally eliminate the future cost of benefits earned by school employees, and eliminate the health care premium assistance, the rate simply to pay off the debt that was allowed to accumulate over the last decade would be 21.43%. No plan can be called an alternative to the current plan if it does not address this problem.

PSEA fully appreciates the magnitude of the crisis that was brought to a head by the recent recession following a decade in which employers did not make their normal payment obligations. We understand the impact on the Commonwealth and school districts, and this is why we fully cooperated with key members of the General Assembly in the drafting of pension reform legislation in 2010.

We are not alone. As a result of the recent recession, no fewer than 43 states have made changes to their retirement plans counting from 2009. I have personally read many of the news clips as legislatures across this nation have struggled with making changes to their state retirement plans. Frankly, many of these states have

received major positive headlines for changes that are minor in comparison to what was accomplished here in Pennsylvania.

The General Assembly has not received nearly enough credit for passage of Pennsylvania's pension reform legislation: Act 120 of 2010. This is probably because many policymakers do not understand the full significance of the changes they made in terms of reducing the long-term cost of benefits.

Please allow me to quickly review the changes the General Assembly has already made for new school employees:

- The pension multiplier, which determines the final level of the retirement benefits, was reduced by 20 percent, and dropped from 2.5 to 2. An exception was made for those new hires that upon joining PSERS elect to pay the full cost difference for the higher multiplier, so that employers will not pay any of the additional cost.
- The vesting requirement was increased from 5 to 10 years;
- A cap was placed on the maximum pension benefit, so that retirees with longer years of service cannot earn more than their final salary;
- There were substantial increases in the age and years of service required to retire at full benefit;
- The option that allows a member to withdraw their own contributions when they retire was eliminated.
- The basic contribution rate was effectively raised, because new hires are paying the same amount for a reduced level of benefits; and,
- Pennsylvania was the first in the nation to require new hires to pay an additional "risk sharing" rate of up to 2 percent if PSERS does not meet its earnings assumptions. So instead of just the employer rate going up following an economic meltdown, employees too will directly share in the pain.

With the changes, the employer share of the cost of benefits earned by new employees was reduced by 60 percent from more than 8 percent to 3 percent of salary - the figure I referenced previously in my comments. These cost savings are not immediately obvious because employers in PSERS pay a blended rate based on the average cost for all members. The savings nevertheless are quite significant, and were projected by this commission in 2010 to total more than \$19 billion over the next 30 years as new employees gradually become a larger share of the workforce.

The cost savings are masked by the rate increases associated with paying off the debts that were allowed to accumulate over the last decade, long before the new employees whose benefits were cut were even hired. In fact,

with the employer normal cost of pension benefits at only 3 percent of salary for new hires, combined with the fact that these employees are chipping in at least 7.5 percent of their own salaries, it is the employees that are currently paying the lion's share of the cost of their own pension benefits.

Yet, the PSERS rate is continuing to climb despite Act 120 because previous legislatures "kicked the can down the road." For a decade the General Assembly made short-sighted decisions and did not properly fund the obligations it had to the pension systems. And I remind you that school district employees never stopped paying their 7.5 percent, even when the state was not paying any contributions at all.

The situation became critical with the investment losses in 2008 and 2009, and the bill is now coming due with interest. This is money that will need to be paid off regardless of what further changes are made to the pension system for future employees, current members, or even if the legislature abandoned the pension system altogether. In 2010, the legislature corrected these decisions by implementing a payment plan for its debt.

Here are some important points that are clear from a national comparison of PSERS and other similar state-sponsored pension plans where members participate in Social Security:

- The average school employee in Pennsylvania is paying 40 percent more toward her retirement benefits than public employees in other states.
- Employer contributions in Pennsylvania have been substantially lower than the national average over the last decade. In fact, in 2010, PSERS had the 2nd lowest percentage paid of the Annual Required Contributions (also known as the ARC and determined using GASB standards) in the entire United States. The average annual PSERS benefit payment is \$23,466.
- Nationally, employers contribute more toward retirement than do their employees. This has been the reverse here in Pennsylvania for more than a decade with employees paying more than the Commonwealth and district combined.
- School employees in Pennsylvania never missed one pension payment, and always paid the full amount required by law.

In addition to reducing the long term cost of benefits, Act 120 also:

- Eliminated the impending 2012 pension spike created by state law;
- Committed the Commonwealth and districts to a schedule of stepped-up payments to pay off the pension debt; and,

- Ended the Employer Contribution Rate Holiday where the employer paid less than the normal rate for more than a decade.

When the pension reform law was passed in 2010, the General Assembly adopted the rate collars and knew exactly how high the rate would climb. I think everyone involved realized that the rate increases would be painful; however, no one at the time realized that the rate increases would hit at the very same time school districts were hit by an \$800 million cut in school funding. In addition, no one thought the recovery from the recession would be so slow and continue to have such an impact on state and school district revenues.

Ironically, many districts had planned responsibly and established reserves to help meet the projected increases in the PSERS rate. Unfortunately, with the loss of state funding, these districts were forced to raid reserves to meet current costs, and so the PSERS rate hikes will hit them with more force than anticipated.

Unfortunately, there is no way magic way that I know of to deal with the hole created by these unfunded liabilities. They represent a debt that has already been incurred and has grown to the current level as a result of deferring payment. PSEA is more than willing to work with lawmakers to look again at these funding issues, but we are concerned that many of the solutions put forward to this point will actually dig the hole deeper and further increase costs in the long run.

Again, thank you for allowing me to offer this testimony.