

# **PA Public Pensions & Politics:**

## **- Managing "Generational Theft"**

### **The Absence of Sound Public Policy Principles**

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# Managing Pension Liabilities

## THE WALL STREET JOURNAL

The Public Pension Crisis August 18, 2006; Page A14

“... the fundamental problem is that public pensions are inherently political institutions.”

“... the current public pension system simply isn't sustainable in the long run.”



# A Summary of the Problem

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- “In any collaboration between two groups who hold different basic principles, it is the more irrational one who wins.”
  - What good is an unprincipled bipartisan agreement?
  - In public pension “reform”, historically the taxpayer loses
- This helps explain the irrational pension legislation of
  - Act 9 (2001) – 25%/50% increase in pensions
  - Act 38 (2002) – Retiree pension COLA
  - Act 40 (2003) – Deferring unaffordable costs to 2012 and beyond
  - Act 44 (2009) – City of Philadelphia/municipal pension non-reform
  - HB 2497 (2010) – PSERS & SERS “reform” (Generational Theft Bill) – Now under consideration by the PA Senate

# 3 Factors Drive the Political Institution of Public Pensions

1. Poor Benchmarking
2. Poor Risk Management Practices
3. Politics

# #1 Poor Benchmarking

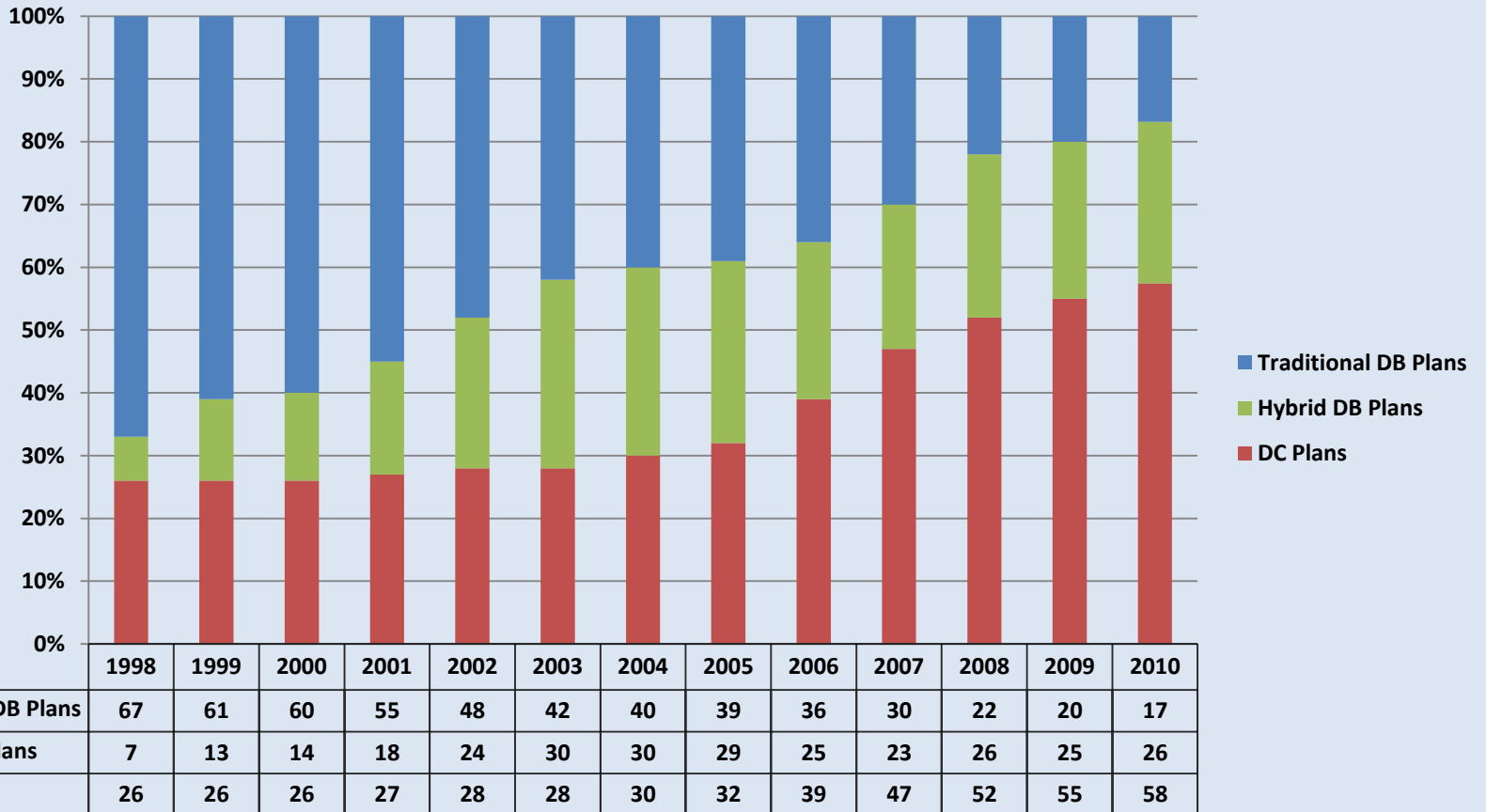
- Pennsylvania public pay and benefits are typically benchmarked only against other public plans rather than the entire marketplace
- Affordability and market trends in the private sector are directly relevant to the public sector
- 2010 Hewitt Survey: only 11 of 33 major PA employers sponsor defined benefit plans
  - **All sponsor 401(k) plans with an average employer match of 72 cents per dollar and an average matched employee contribution of 5.4 percent of pay.**

# Towers Watson Survey

## Average DC Employer Cost - 5.77%

<http://www.towerswatson.com/united-states/research/2106>

### Fortune 100 Companies - Trends in Retirement Plans



# Public Policy Principle - #1

Seven Principles of Sound Public Policy Remarks before the Economic Club of Detroit By [Lawrence W. Reed](#) | Oct. 29, 2001



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- **“Government has nothing to give anybody except what it first takes from somebody.”**
  
- **“Government that's big enough to give you everything you want is big enough to take away everything you've got.”**

## #2 Poor Risk Management Practices

- Few absolute metrics defining the affordability or reasonableness of pension costs given the “perpetual life of the government entity”.
- Entire defined-benefit (DB) funding system is based upon annual investment assumption in the 8% range.
- Little consistency in funding assumptions and funding methods making comparisons most difficult.
- Private sector pension plans must fund their plans in accordance with The Pension Protection Act of 2006 which requires lower interest rate assumptions, market valuation of assets and shorter amortization periods.

# Public Policy Principle - #2

Seven Principles of Sound Public Policy Remarks before the Economic Club of Detroit By [Lawrence W. Reed](#) | Oct. 29, 2001



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- **“What belongs to you, you tend to take care of - what belongs to no one or everyone tends to fall into disrepair.”**
  - **Who owns the investment risk in the public pension system?**

# #3 Politics

## Pensions as political capital

- Pension Fund Surplus = Benefit Improvements for Participants
- Pension Fund Deficits = Underfunding by Taxpayers
- Maintaining or Improving Benefits = High Political Rate of Return
- Reforming and Properly Funding Plans = Low Political Rate of Return

# Public Policy Principle - #3

Seven Principles of Sound Public Policy Remarks before the Economic Club of Detroit By [Lawrence W. Reed](#) | Oct. 29, 2001

- **“Sound public policy requires that we consider long-run effects and all people, not simply short-run effects and a few people.”**
  - **We are 180 degrees out of phase**

# Politics

## **Pensions are not well understood**

- **Abundance of half-truths**
- **Benefit commitments can be over 50 years**
- **Funding is easily manipulated**
  - **Easy to (re)defer costs to the next generation**
- **Local and city pension shortfalls are becoming political problems for the state**
  - **Philadelphia, Pittsburgh, Allentown, Erie and Reading**

# A Political Problem: Leading PA Pension Half-Truths

Contention	Fact
<p>➤ <b>The fiscal problems typified by SERS and PSERS are simply a matter of underfunding by taxpayers.</b></p>	<ul style="list-style-type: none"> <li>■ <b>1990s required little if any taxpayer contributions due to surplus – this is a common result</b></li> <li>■ <b>According to a PSERS report – only 21% of the deficit is due to underfunding, 43% investment losses, 21% benefit increases, 13% changes in funding assumptions.</b></li> </ul>
<p>➤ <b>DC plans are more costly than defined benefit (DB) plans.</b></p>	<ul style="list-style-type: none"> <li>■ <b>DC costs are actual and final</b></li> <li>■ <b>DB costs are simply estimated deposits based upon actuarial assumptions</b></li> <li>■ <b>2009 ICI study revealed DC administrative costs ranging from .35% to 1.72% of assets</b></li> </ul>
<p>➤ <b>DB plans become unstable and overall costs increase when new members join a DC plan.</b></p>	<ul style="list-style-type: none"> <li>■ <b>An unfounded claim</b></li> </ul>

# **“Pension Magic” in Florida (and elsewhere)**

**Orlando Sentinel – July 7, 2010**

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- **“Warren Buffett would close down his shop and give his money to the city of Orlando” if it could get 8 percent, says Edward Siedle, a former federal securities lawyer and president of Benchmark Financial Services in South Florida.**
  
- **Cities like Orlando have three choices, Siedle says.**
  - 1) **“They can cut benefits, with is politically unacceptable”,**
  - 2) **“They can increase contributions from the employer and employees, which is politically unacceptable.”**
  - 3) **“The third choice is called magic. That's what public pension funds across the country are doing, coming up with magic.”**

# HB 2497 - Doubling-Down on Generation Theft without Solving the Political Problem (Passed: PA House 6/16/10)

## Impact of change versus current schedule of contributions

<b>Taxpayer Contribution Impact:</b>	<b>PSERS</b>	<b>SERS</b>	<b>Total</b>
FY: 2011-2025	-\$15.3B	-\$4.3B	-\$19.6B
FY: 2026 -2040	+\$36.8B	+\$9.6B	+46.4B
Total 2011-2040	+\$21.5B	+\$5.3B	+26.8B
Net Present Value @ 8%	-\$5.0B	-\$1.5B	-\$6.5B
Future Value @ 8%	+\$59.1B	+\$17.9B	+\$77.0B

# Funded Ratios and Unfunded Liabilities for PSERS & SERS

## Assuming an 8% Annual Investment Return

Source: PERC Actuarial Note 6/15/2010

	<b>PSERS Current Law</b>	<b>PSERS HB 2497</b>	<b>SERS Current Law</b>	<b>SERS HB 2497</b>
<b>2009</b>	79.2% /\$15.7B	79.2% /\$15.7B	84.4%/ \$5.6B	84.4%/ \$5.6B
<b>2015</b>	56.7%	57.8%	69.8%	61.8%
<b>2020</b>	66.8% /\$37B	51.9% /\$54B	75.5%	63.9%
<b>2025</b>	77.0	56.1	81.4	87.4
<b>2030</b>	86.5	64.0	88.0	73.2
<b>2035</b>	93.8	74.4	93.4	82.3
<b>2040</b>	97.9	87.7	97.4	94.8



# HB 2497 – Fatal Flaws in any New DB Plan Design

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- **Any DB plan will be subject to the politics of over-promising and underfunding. This includes the potential for future ad-hoc and/or retroactive benefit improvements. We must take politics out of the system.**
- **8% interest assumption underlying all calculations with potential for extended funding periods (amortization).**
- **What are the assurance that costs will be current, predictable and affordable? What is the reform strategy to the related problem of retiree medical liabilities?**
- **PA has over 3,000 public pension plans, therefore reform is much more than just a PSERS and SERS issue.**

# How much should taxpayers be contributing to PSERS? (FY 2009-10 rate = 4.78% of payroll or \$617M)

Unfunded Liability = \$15.7B : Using Actuarial Value of Assets (6/30/09)

Unfunded Liability = \$32.5B : Using Market Value of Assets (6/30/09)

<b>Item</b>	<b>8% Investment Assumption</b>	<b>6% Investment Assumption</b>
PSERS Rate Certified December 2009	8.22% / \$1.11B	
Final State Budget Rate : FY 2010-11	5.64% / \$762M (\$121M transfer from Tobacco Endowment Fund)	
Normal Cost (NC)	8.08% / \$1.09B	
NC + 15 Year Payoff (\$15.7B)	~21% / ~ \$2.8B	
NC + 30 Year Payoff (\$15.7B)	~18% / ~ \$2.4B	
New DB Plan Taxpayer Rate	2.85%	~ In the 5% to 7% range (based upon no change in employee contributions)



## Recent Reporting on the Consequences of Underfunding PSERS (or any other public pension plan)

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- **Indiana PA Gazette: 7/11/2010: *"Federal funds still the wild card for school budgets, pensions"***

Steve Nickol – PSEA : "You can't realistically expect the districts in the state to come up with that amount of money as currently projected."  
"If they did, there's no way at the bargaining table they (teachers) would be able to get any increases. They're going to get pushed back as they have in recent years over health care and reductions in their benefit package."

"... in hindsight, the proper way to have done it would have been to fully fund the system to start with."

- **Patriot News: 8/23/2010: Cornwall-Lebanon School Board, teachers approve new contract, salary increases average 3.5%**

# True Pension Reform Must Satisfy Three Basic Principles – Using Realistic Funding Assumptions

## 1. Funding must be current.

- Benefits should be funded as they are earned and “paid-up” in the aggregate at retirement
- Achieving a 100% funded ratio
- Significant private sector pension reforms occurred in 2006. (Lower investment assumptions  $\sim 6\%$ , funding periods  $<15$  yrs., market value of assets)

## 2. Costs must be predictable.

## 3. Costs must be affordable.

- 5-7% of payroll (net of employee contributions)

# NJ Gov. Christie's Proposed Pension Reforms for State & School Employees

**Current Unfunded Liability of \$46B**

(Not a complete summary)

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- **Key Proposals:** Rollback of benefit formula, increased normal retirement age, eliminated pension COLAs, standardized employee contributions, annual investment assumption reduced from 8.25% to 7.50%
- **Remaining Challenges :** No defined contribution plan, significant future cost issues (predictable, affordable and current), projected funded ratio of 90% in 2041 with an unfunded liability of \$23B

# Five Step Pension Reform Plan

- 1. Establish a Unified Defined Contribution plan for new state and local government workers, school employees, judges, and legislators (SB566)**
  - Curtails open-ended liabilities; Eliminates long-term commitments on behalf of taxpayers
  - Removes politics from pensions
- 2. Prohibit pension obligation bonds or other post-employment benefit (OPEB) bonds**
  - Prevents “generational theft” – deferment of liabilities
- 3. Mandate pension and OPEB liability management reforms for current and any newly created liabilities.**
  - Goal is to achieve an employer cost of 5% to 7% of payroll after using more conservative actuarial assumption and shorter amortization periods
- 4. Consider modifying unearned pension benefits (if legal and feasible)**
  - Reduced formula; Redefinition of eligible earnings; Increasing the normal retirement age; Curtailing early retirement subsidies; Eliminating COLAs and Deferred Retirement Option Programs (DROPs)
- 5. Consider funding reforms only after prior steps are achieved**

Challenge is to do this without increasing taxes or through new borrowing

**Omitting steps 1,2,3,4 ≠ pension reform**

# PA Non-Reform Reform Ideas

## Reforms we don't need and can't afford...

<u>Item</u>	<u>Detail</u>	<u>Why it is a problem</u>
Pension Obligation Bonds	Floating bonds to fund pension plan deficits	Increases risk to taxpayers with a certain incentive to increase pension benefits
An early retirement incentive plan		Enhances already generous benefits. Long amortization periods. Only works if backfill rate is below 40%
"Fresh start" of PSERS and SERS unfunded liability up to 30 years	Creates a new "mortgage" <b>HB 2497</b>	Increases generational theft An easy political solution
A new and reduced DB plan	<b>HB 2497</b>	Even a new DB will not escape the politics of public pensions. Consider PSERS and SERS - 10 years ago – lessons of history. Doubles-down on the status quo.
A new DB plan with optional DC plan for new hires - some with annuity payout options		Long-term taxpayer costs will not be current, predictable or affordable
A new hybrid plan or a reduced set of new DB & DC plans	A new DB plan which where the accrued benefit is an account balance	Same politics and funding problems associated with defined benefit plans



# Some Final Thoughts — Implications for Effective Public Policy

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1. Exactly how does deferring unsustainable pension liabilities make future liabilities sustainable? Why is ignoring standard actuarial principles while contributing less into already underfunded plans considered reform? How is a system based upon 8% investment assumptions deemed sustainable?
2. We have implicitly over-leveraged our pension system - now the challenge is to finally restore proper funding while offsetting these increased costs elsewhere within the state budget without increasing overall spending (or borrowing).
3. Given all this, what are the financial incentives to live, work, or invest in Pennsylvania?
4. This debate is effectively one involving self-reliance while removing politics from pensions, protecting the taxpayer and stopping generational theft.



# One Final Thought ....

## On “Generational Theft”

### Thomas Jefferson Wrote in 1813

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- **“We shall all consider ourselves unauthorized to saddle posterity with our debts, and morally bound to pay them ourselves.”**