PA Public Pensions & Politics:
- Managing "Generational Theft"
The Absence of Sound Public Policy Principles

Richard C. Dreyfuss
Business Consultant and Actuary
Senior Fellow - The Commonwealth Foundation

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Managing Pension Liabilities

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"… the fundamental problem is that public pensions are inherently political institutions."

"… the current public pension system simply isn't sustainable in the long run."

The Theme Continues in 2010

- The Governor's Funding "Reform" – reduces PSERS contributions by $12.4 billion over the next 10 years. (Funded ratio falls below 50%)
  - FY 2010-11 PSERS reduced by $349 M (Est. state share = $137M)
  - Proposed budget increases basic education funding by $335M
- PA has over 3,000 public pension plans so reform is much more than just a PSERS and SERS issue.
- Any true reform must reflect consistent and principled leadership focused on the taxpayer – such an effort is what needs to be collaborative.
- Otherwise, we will bankrupt ourselves and our children.

3 Factors Drive the Political Institution of Public Pensions

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

Sources of PSERS $15.7B Deficit: (Funded Ratio of 79%)

Based upon the June 30, 2009 Actuarial Valuation

- **43% due to investment losses**
- **21% benefit improvements**
- **21% underfunding**
- **13% changes in funding assumptions**

Public Policy Principle

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

- "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?

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

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- "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

Combined Estimated PSERS and SERS Employer Costs

	PSERS	SERS	TOTAL
FY 2010-11	$1.11B	$.34B	$1.45B
FY 2012-13	$4.2B	$1.8B	$6.0B
FY 2015-16	$5.3B	$2.1B	$7.4B

NOTE: PSERS costs are allocated ~55% at the state level and ~45% at the local level (school property taxes).

PSERS	Funded Ratio	Unfunded Liability
FYE June 2009	**79%**	**$15.7 B**
FYE June 2020 (est.)	**66.8% / 49.4% (Gov.)**	**$37 B / $57.2 B (Gov.)**

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

1. Funding must be <u>current</u>.
   - Benefits should be funded as they are earned and "paid-up" in the aggregate at retirement
   - Achieving a 100% funded ratio

2. Costs must be <u>predictable</u>.

3. Costs must be <u>affordable</u>.
   - 5-7% of payroll (net of employee contributions)

The Five Step PA Pension Reform Program – Statewide Pension Reform

1. Establish a unified DC plan for new members
   - Curtails open-ended liabilities ("quarantine")
   - Eliminates long-term commitments on behalf of taxpayers
   - SB 566 (Browne), HB 1174 (Boyd)

2. Prohibit pension obligation bonds or other post-employment benefit (OPEB) bonds

The Five Step Pension Reform Program

3. Mandate ongoing pension funding reforms (Not a complete list)

- Establish a maximum annual assumed investment return ceiling such as 6.0%
- For active members: limit the funding period to the working career of recipients.
- For retirees: 1-year funding period (no remaining working career).
- No benefit improvements permitted if the result of such improvements causes the funded ratio to fall below 90%.

The Five Step Pension Reform Program

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 pension COLAs and Deferred Retirement Option Programs (DROPs)

5. Only then consider funding reforms
   - This area is currently the singular focus of many "reform" efforts.

To omit steps 1,2,3,4 ≠ pension reform.

PA Non-Reform Reform Ideas

Reforms we don't need and can't afford…

Item	Detail	Why it is a problem
Pension Obligation Bonds	Floating bonds to fund pension plan deficits	Increases risk to taxpayers with a certain incentive to increase pension benefits
Optional DC plans for new hires - some with annuity payout options		Overall costs exceeding 5-7% will prove unaffordable
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"	Promotes generational theft
A new and reduced DB plan		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 hybrid plan	A new DB plan which where the accrued benefit is an account balance	Same design and funding problems associated with defined benefit plans

Some Final Thoughts — Implications for Effective Public Policy

1. 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?

2. Given all this, what are the financial incentives to live, work, or invest in Pennsylvania?

3. This debate is effectively one involving self-reliance while removing politics from pensions, protecting the taxpayer and stopping generational theft.

- "In any collaboration between two groups who hold different basic principles, it is the more … irrational one who wins."
- "When opposite basic principles are clearly and openly defined, it works to the advantage of the rational side."

One Final Thought ….
On "Generational Theft"
Thomas Jefferson Wrote in 1813

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