Stopping the Sinkhole
Lessons for Pension Reform in Pennsylvania
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Lessons for Pension Reform in Pennsylvania

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Executive Summary

Pennsylvania’s two pension programs, the State Employees’ Retirement System (SERS) and Public School Employees’ Retirement System (PSERS), are in desperate need of reform. Pennsylvania’s unfunded liabilities have been steadily rising, presenting significant risks to the state’s economy and promising to burden businesses and taxpayers. Governor Tom Corbett’s 2013 pension reform recommendations would shift new employees to a 401(a) defined contribution plan (similar to the 401(k) of the private sector) and adjust compensation formulas for current employees. If implemented, his recommendations could save Pennsylvania $12 billion in employer contribution costs and $40 billion in plan costs over the next 30 years.¹

Such reforms, while politically contentious, are not new in the private or public sectors. Difficult financial conditions and changes in employee and employer attitudes towards pensions have forced thousands of private sector firms to modify their pension programs over the past 30 years. Members’ plans have typically shifted from defined benefit (DB) towards defined contribution (DC) plans, a trend greeted with skepticism by many employees and hostility by unionized workers. However, much of the concern stems from a general lack of knowledge about DC programs and resistance to change.

A growing body of work by economists and financial experts suggests significant benefits for firms, public sector entities, and employees that shift from DB to DC programs. Employees gain greater clarity about their actual retirement benefits and workers are not punished for frequent job changes, as they would be in DB programs. Further, employers benefit from a greater ability to project DC program costs. Likewise, taxpayers have to pay less for public pensions as unfunded liabilities become manageable and, in the long run, are completely eliminated.

Over the past 30 years, solutions to pension problems have shifted towards DC programs. This transition, while disruptive for employees, provides the following important benefits to key stakeholders in both the private and public sector:

- **Portability.** The Bureau of Labor Statistics estimates that the average worker changes jobs more than ten times in his or her career. Such churn means employees risk not becoming vested and losing significant DB benefits. In contrast, DC programs are paid directly to workers and allow accumulated funds to be carried with the worker across jobs and across states.

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- **Fully funded status.** By definition, DC plans are fully funded. All of the funds promised to an employee, which are typically based on a percentage of salary, are paid up front and become the employee’s property. Firms or public sector entities never risk carrying a funding liability.

- **Ownership.** Workers with higher risk preferences can actually pursue their own investment strategies without DB restrictions, which often overinvest in fixed income and “safe” asset classes at the expense of higher returns.

- **Potentially higher returns.** A growing body of evidence suggests that a lifetime of DC retirement investments produce higher returns than individuals cashing out of a DB program. Financial economists have performed thousands of simulations that take into account key features of a person’s years in the labor force. The simulations consider employees leaving one job for another, employees leaving the public sector for private sector, employees retiring at different ages, etc. One main finding from these simulations is that when compared to public sector defined benefit plans, DC plans invested in a diversified portfolio consistently result in a larger lifetime nest-egg for people than the wealth accumulated in a DB plan.

- **More predictable costs.** Rather than being dependent on unknowns, such as life expectancy, stock market returns, and the financial conditions of firms or state economies, DC plans make the employer responsible for a specified contribution each year. These contributions are easily predictable and less variable than DB contributions, making businesses more efficient and protecting taxpayers from public sector budgetary shocks.

Evidence from the private sector and some reformed public sector pension programs shows that pension reform is possible and creates significant savings to firms in the private sector and taxpayers in the public sector. Private firms, while enjoying more flexibility than public pension programs when reforming, still face many of the same challenges as public sector pensions. Therefore, as Pennsylvania considers reform, it is useful to examine the pension reform trend for insights about possible costs of reform and understand the “best practices” of pension reform.

**Pennsylvania’s Pension Funding Crisis**

Public sector pension plans across the United States are in crisis. According to official statistics, total unfunded liabilities for US public pensions have grown to $944 billion. However, that estimate falls on the low side compared to others. Economists and nonpartisan government agencies using “fair market valuation” accounting methods place the total unfunded liabilities of US public pension plans through 2011 at roughly $4.6 trillion, and average funding ratios are just 41 percent, instead of the officially

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reported figure of 72.6 percent.\(^3\) Even with optimistic assumptions about stock market returns, pension liabilities across the US will grow because of excessive benefit promises, longer life expectancy, weak economic growth, and less taxpayers.

Pennsylvania has one of the worst public pension funding ratios and unfunded liabilities per capita. The two separate state pension systems, the State Employees’ Retirement System (SERS) and the Public School Employees’ System (PSERS), have official unfunded liabilities of $17.9 billion and $32.6 billion respectively; their actuarial funding ratios of 59.1 percent and 59.8 percent respectively are also significantly below the US average for public pensions.\(^4\)

Pennsylvania’s funding ratios make pension reform inevitable. By 2019, pension costs will consume 9.8 cents of every state General Fund dollar (vs. 4.2 cents in 2013), crowding out essential government services such as public education, public safety, and transportation.\(^5\)

As we can see in Table 1 below, PSERS and SERS have experienced a steady decline in funding over the past 12 years.

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Poor pension performance will mean higher taxes, lower credit ratings, and higher interest on municipal debt. Economists Robert Novy-Marx and Joshua Rauh calculated that to achieve full funding of state and local pension systems in the US over 30 years would require $1,385 per household per year in new taxes.\(^6\)

An aging population and slow population growth compounds the problem in Pennsylvania. From 2000-2010, Pennsylvania was 40\(^{th}\) out of all 50 states in population growth, enjoying just 3.4 percent population growth and 421,000 new residents over the first full decade of the 21\(^{st}\) century.\(^7\) Since the 2010 census, the trends of slow economic growth and difficulty in attracting new businesses and residents have continued, making SERS and PSERS payouts increasingly difficult.

Most DB plans expect an employee contribution, and SERS and PSERS have fairly standard contribution rates of 6.25 percent and 7.5 percent for most employees.\(^8\) Along with the employee contribution, an actuarial valuation is required, which determines the employer contribution necessary to cover liabilities. For 2012, the “annual required contribution” (ARC) from employers was $1.04 billion for the SERS fund and $2.4 billion in 2011 for the PSERS program; yet, actual contributions were just $563 million and $647 million respectively, requiring larger payments in the future.

Today, Pennsylvania faces a $50 billion shortfall between what should have been set aside to pay future pension benefits and what has actually been reserved. Liabilities total about 1.75 times Pennsylvania’s entire state tax revenue in 2012, which was $28.6 billion in 2012. In the absence of massive cuts in benefits or increases in contribution rates, robust economic growth is the only escape from Pennsylvania’s pension woes.

**The Failure of Defined Benefit Plans**

Almost all public sector pension plans in the US offer employees DB retirement packages. Employees and employers typically share in the contribution expenses. The total average contribution for all pensions in the United States is slightly above 15 percent and will rise gradually in the years ahead.\(^9\) This average, of course, masks vast differences across the US: Louisiana, for example, has total contributions near 30 percent; meanwhile, pension plans in Alabama require 17 percent total contributions, with the employee paying 7.5 percent.

The aim of DB plans is to provide for old age through savings and redistribution to long-serving members. The DB plans require workers to give up significant chunks of their current earnings for

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\(^8\) There is some variation in rates for employees under both plan based on first employment date, classification, etc., but 6.25% and 7.5% capture the large majority of employee contribution rates.

guarantees of income in the future. However, because of their design, DB plans create perverse incentives for workers to retire early (with generous benefits), which in turn makes such plans unsustainable and unaffordable in the long run for taxpayers.

A guaranteed payout is provided in DB pensions based on a set formula, which is typically based on a member’s pay and years of service. The typical DB program in the private sector has a payout of around 1.5 percent per year of service. The typical DB public pension plan, meanwhile, is near 2 percent per year of service. Pennsylvania has several “classes” of beneficiaries (e.g., T-C, T-D, T-E), and the different classes have slightly different retirement payouts: 2.5 percent for most workers hired in 2010 or before and 2 percent for most workers hired after 2010. In general, though, the formula for their plans is the following:

\[
\text{Yearly Benefit} = (2 \text{ or } 2.5\%) \times \text{Final Average Salary} \times \text{Years of Credited Service}
\]

The final average salary is typically based on a member’s highest three years of earnings. A concrete example would look something like the following for an employee (age 60 at retirement) with a 2 percent benefit factor, with 30 years of service, and with highest three years’ salary of $95,000, $100,000, and $105,000.

\[
(2\%) \times $100,000 \times 30 \text{ years of service} = $60,000 \text{ yearly benefit}
\]

If an employee in a DB program that requires 10 years of service to be vested leaves in just 6 years, he will only receive his original contributions back (plus some nominal interest). The substantial employer contributions plus forgone market returns on the individual’s investment dollars are lost; thus, he has gone over a pension cliff by leaving the firm early. Such discrete jumps in pension programs reward long-serving members and while punishing workers who leave after a few years of service.

The perverse labor market dynamics created by DB plans are well recognized in academic literature and at an anecdotal level. Unhappy employees stay at their jobs solely to reach their vesting threshold and then exit. As soon as the vesting threshold has been hit, employees focus on exiting the job they’ve been loyal to in search of another job that will boost their late-career earnings.

Young workers not intending to stay in the public pension system long-term and other public employees expecting to bank far greater earnings in their final years in the system are less inclined to take overtime pay and additional earnings opportunities. For these young workers, mandating pension contributions on all dollars earned acts as a reduction in current income without much—if anything—in return.

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In contrast to employees in DC plans, who know additional dollars earned lead to additional dollars in their 401(k), public employees have no way of knowing if their required contributions will be paid to them. This uncertainty creates less incentive to work. Pennsylvania’s inevitable higher employer contributions will make it more difficult to hire public employees; likewise, the equally expected higher employee contributions make work in the public sector less attractive. Together, declining labor demand and declining labor supply will make the problem of Pennsylvania pension solvency much more severe in the future.

The investment risks of SERS, PSERS, and all DB public pension plans are covered by the plan sponsors, i.e., taxpayers. Strong constitutional and legal protections against any benefit cuts to current plan members means all funding shortfalls are covered by additional contributions from employers, current employees, and future employees. The more the labor market worsens for public sector employees, the more taxes will have to be raised to maintain the benefits that attract people to public sector jobs and to ensure public pension funds are meeting their minimal payments.

Pennsylvania’s current liabilities are not unique. According to Pew, 19 states cut pension benefits, raised contribution rates, or did both in 2010 alone in response to weak funding. The cuts were in addition to a decade of pension reforms in 40 states. Such reforms, which have been advertised by reformers as stabilizing and permanent cures to different state pension problems, prove the current DB pension system is not working.12

Most reforms have either reduced benefits for new employees or increased contribution rates for current employees. However, such adjustments preserve the status quo and perpetuate the underfunding problem: As the plan’s funding status enjoys a brief improvement, steps are then taken to enhance benefits, triggering another future round of adjustments.

New Jersey is a case in point. In the early 2000s, their pension programs’ funding ratios had improved enough that lawmakers enjoyed temporary “overfunding” of programs. In other words, total assets exceeded total liabilities. Rather than sit on the excess funds or invest them, officials introduced a one-time pension “sweetener” that raised pension benefits by 9.09 percent across the board. New Jersey’s give-away immediately led to significant shortfalls in funding, and today it ranks among the five worst public pensions in the US.13

In 2011, Illinois raised its income tax rate from 3 percent to 5 percent and the corporate tax rate from 4.8 percent to 7 percent. Their large tax hikes were designed to help cover the state’s woeful pension funding. The taxes helped raise $18 billion in revenue. But, rather than shore up funding for

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their pensions, lawmakers instead spent the money. Now Illinois is in even worse financial shape as legislators consider raising taxes on the state’s highest earners from 3.75 percent to 9 percent. Such measures are guaranteed to slow growth, which makes the state’s public pension funding problem even worse in the future.

Generally, workers’ retirement benefits are backed by the full authority of the local or state government and cannot be changed or cut. However, recent bankruptcy proceedings in Detroit, Michigan are indicating that pension benefits could be far from guaranteed. In December 2013 court proceedings, US Bankruptcy Judge Steven Rhodes ruled that Detroit’s pension debt in its municipal bankruptcy case is indistinguishable from any other debt. With those words, Judge Rhodes opened the door for potentially massive pension write-downs, a landmark outcome in Detroit or anywhere.

Until the Detroit case, municipal bankruptcies in places like Stockton, California and Scranton, Pennsylvania had moved forward without any real modification to pension liabilities. Such liabilities were treated as different, constitutionally protected, and separate from other debt obligations. But, the Detroit case has swung the door open on pensions being part of a municipality’s overall debt; as such, they are vulnerable to write-downs and far from the guaranteed source of retirement income generations of pensioners expect.

At the time of this writing, Detroit’s bankruptcy reorganization plan remains unsettled. While the original proposal by emergency manager, Kevyn Orr, called for a 34 percent cut to general city retiree pensions, and 10 percent cuts to police and fire retirees, cuts were scaled back significantly to just 4.5 percent for general workers and zero cuts for police and firefighters. Such cuts, while small compared to Orr’s original proposal, are among the first cuts ever to public pension benefits, and they will set a new precedent—if upheld in the courts—for treatment of pension benefits in other struggling municipalities and states going forward.

**The Benefits of Defined Contribution Plans for Workers and Employers**

Job turnover makes DC programs, which are portable across jobs and state lines, a more attractive option for employees. According to a Bureau of Labor Statistics survey, late “baby boomers” born in the 1957 to 1964 period changed jobs 11.3 times between age 18 and age 46. Separation rates in 2012 were 41.3 percent for private sector workers and 16.1 percent for government workers. As Figure 3 below indicates, job turnover rates in the private and public sector have been quite constant over the past decade, and the rates reflect changing economic conditions and worker preferences to change jobs.

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17 http://data.bls.gov/cgi-bin/surveymost
The idea of staying with one firm long enough to become vested in a traditional DB plan is foreign to the average worker in the private sector. Even in the public sector, where nearly one in five people separated from their job in 2012, the long-term, back-loaded benefits of DB pensions are out of step with current labor market dynamics. Most employees fall off “vesting cliffs” instead of reaching the goal of being vested, and, because their money has been trapped in a DB program, they fail to even earn market returns on their retirement contributions. In all, DC plans are becoming the better investment for the average worker, who will change jobs somewhere between six and 14 times during his or her career.

Poterba, Rauh, Venti, and Wise\(^\text{18}\) ran a number of simulations comparing DB and 401(k) returns. They found significantly higher returns for 401(k) participants, but there was also a small risk of very low returns from 401(k) simulations. The DB returns, while safer, were lower. For workers wanting higher risk and reward, then, the shift to DC plans better serves their needs.

Figure 4 below comes from data in Poterba, Rauh, Venti, and Wise. Their 2007 study is one of the first and most carefully calibrated studies of its kind. The authors ran painstakingly accurate simulations that attempt to compare the true benefits a DB retiree stands to capture relative to participants in DC programs. The authors make a number of reasonable assumptions about labor force turnover, retirement age, market returns, and average contribution rates to DC plans. The results prove the benefits of DC plans: Low-skilled and high-skilled workers with typical experiences in the labor market enjoy far greater average plan balances than DB plan participants.

The simulations take into account various factors, such as typical job market turnover and contribution rates. In all cases, average plan balances are higher for DC programs. When the authors relax the assumption of standard stock market returns and assume 300 basis points per year less in return (i.e., a market return of 7 percent, for example, instead of 10 percent), DC returns still compare quite favorably. They are, in fact, higher for employees with high school degrees and some college experience and comparable for low-skilled workers. The “winners” in DB plans appear to be only those with greater educational attainment. Thus, the ostensible claim that DB plans are needed to protect some of the least-well off public employees does not hold up well to empirical scrutiny.

The Poterba, Rauh, Venti, and Wise simulations assume that DC investors will pursue “life cycle” investments that include an appropriate balance of stocks and nominal bonds. If we relax this assumption, some of the simulations—a 100 percent nominal government bond simulation, for example—perform worse than public DB plans, while other simulations perform much better.

A DC portfolio of 100 percent stocks, for example, has average (unadjusted) plan balances of $628,000, $919,000, and $1,183,000 for the three educational attainment levels already highlighted. Such returns greatly exceed the $227,000, $317,000, and $545,000 average returns of DB plans. But, of course, with the added reward comes added risk: participants in DC plans face about a 10 percent chance of having $88,000 or less in a 100 percent stock portfolio randomly generated by the simulator.

The Poterba, Rauh, Venti, and Wise study is the gold standard for average comparisons between DB and DC plans. While they acknowledge the greater variance in returns for investors in DC plans, they also present a clear picture of how much better off long-term investors could be under a DC plan vis-à-
vis DB programs. The potential for far greater returns, along with the benefits already outlined—portability, a sense of ownership in one’s program, greater predictability—suggest that the perceived risks of DC plans are somewhat offset by many desirable characteristics.

In a forthcoming paper, Chingos and West\(^\text{19}\) dig into the issue of whether or not people will choose DC programs when given the option. They look at public school teachers in Florida from 2003 through 2008. During that period, teachers were given the choice of DC plans versus DB plans. About 30 percent of teachers hired during the period chose the DC plan, and the choice of DC was higher for teachers with advanced degrees, teachers with math and science backgrounds, and teachers in charter schools. Enrollment, meanwhile, was much lower for special education teachers and for black and Hispanic teachers. The evidence from Chingos and West suggests that while DC programs are not for everyone, when given the choice, a large fraction of public sector employees understand the risks and willingly choose the DC programs over DB plans.

In terms of market returns alone, DC plans are usually the better choice for labor market participants, making a compelling case for shifting to DC programs. When labor market turnover is added into the equation, the case becomes even stronger. But risk preferences of employees, labor mobility, employees’ subjective expectation of their own life expectancy, their 401(k) plan investment decisions, and a host of other factors make it a less than guaranteed that DC plans will be better for all employees.

That said, another consideration when evaluating the costs and benefits of DC programs vis-à-vis DB plans is the following: Participants in DC plans have their complete retirement information. DB participants, in the wake of Detroit and with other cities already nearing bankruptcy face a cloud of uncertainty about how much of their promised benefits will be there, whether their benefits will be protected, and whether or not they can really trust the promises being made by lawmakers now. This kind of uncertainty surrounding DB programs is a tremendous cost that is seldom accounted for, and it should tip policymakers a bit more towards DC programs.

The Private Sector Shift to Defined Contribution Plans

The trend towards more DC programs in the public sector seems to be a gradual reaction to changes we have seen in the private sector: Since the early 1990s, private sector DB pension plans in the United States have been phased out and replaced by DC plans (See Figure 4 below).

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Much like the public sector DB problems mentioned in the previous section, private sector firms have faced rising pension liabilities and health care costs for their employees, and these expenses created greater uncertainty and crowded out other investment opportunities. In August 2013, for example, Sears CEO Edward Lampert apologized to shareholders and customers for not improving their stores, and he pointed to the company’s rising pension obligations as the main reason for not investing:

It is not just in isolation what we want to do. We have got to manage a business with obligations to pensioners, obligations to our employees, obligations to vendors . . . We have got a lot of people who depend on a pension from Sears, which has hampered our ability to be more aggressive.

Or, as former CEO of Caterpillar, Glen Barton, told the New York Times in 2003, “Companies cannot commit to building new plants, launching new research projects or hiring new employees if that cash is needed to fund pensions.”

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Like the public sector, which is suffering less infrastructure investing and a reduced workforce, traditional DB plans have hampered many private sector firms. In 2012 alone, major reforms to private sector programs have occurred at recognizable US companies that include American Airlines, Bank of America, Comcast/NBC Universal, Genuine Parts Company, and Verizon. Verizon’s latest reforms involved fully funding some of their pensions, freezing the programs, and then selling the obligation to an insurance company. They are an extension of 2005 reforms, which shifted 50,000 managers from DB to DC plans. At the time of Verizon’s change, newly hired managers were automatically entered into a 401(k) and current employees had their DB plans frozen; future benefits to DB participants came in the form of DC payouts, and Verizon implemented a 6 percent match plus a one-time contribution equal to 18-months of DB payments.  

Of all US private sector employees with employer-provided retirement plans, just 11 percent had the option of DB plans in 2011 and 28 percent had some kind of blended option; these numbers are down from 60 percent DB and 23 percent blended in 1979. Meanwhile, DC-only plan options have increased from 17 percent to 61 percent over the same period for the same group. The trend towards more DC offerings is likely to continue over the next few years because many firms have gone the route of “freezing” their DB programs with the intent of either significantly modifying benefits or moving forward with a DC program only.

Public Pension Reform Case Studies

Michigan was one of the first states to make the shift when it changed its Michigan State Employees’ Retirement System (MSERS) from DB to DC; the Michigan Public School Employees Retirement System (MPSERS), the plan for teachers, was left untouched. Workers hired into MSERS on or after March 31, 1997, were placed into a DC retirement plan. Existing employees were given a four month window to choose between the existing DB plan or the new DC plan being offered to new workers. Many workers with less than 10 years of experience in Michigan—non-vested workers in the old DB plan—chose to switch to the DC program.

The Michigan case is fascinating as an example of a successful shift of public pensions from DB to DC. However, since the DB program in Michigan was fully funded in 1997, the issue of how to pay out future promises was not of central concern to reformers. The “transition cost” issue is a more complicated one when the following question must be taken into account: How do we convert to a DC plan when our current DB plan is not funded?

That’s the question Dan Liljenquist and reformers in Utah faced when reforming Utah’s DB public pension program in the 2010 legislative session. In part due to the financial crisis of 2008, Utah’s main state pension fund lost 22 percent of its asset value, and its funding ratio fell from near 100 percent in 2007 to 70 percent in 2009; their unfunded liabilities, in other words, went from near zero to $6.5 billion, and the state faced massive tax hikes to cover the shortfall.25

State lawmakers responded by first closing the DB plan to new employees. The $6.5 billion liability did not go away, but shifting all new workers to a DC plan at least helped to limit future costs to taxpayers and state budgets. New employees, meanwhile, were shifted to a generous, predictable DC program. The plan is comparable to the private sector with payouts per dollar earned of 10 percent on all employee earnings into a DC plan. For employees, the new program allows for greater ownership and portability of plans; for the state of Utah, total contribution rates were brought down from around 14 to 15 percent for local government and educators to 10 percent for the new DC plan members.26 Such savings will be significant for the state, and they protect against extreme increases in employer and employee contribution rates in the future.

More recently, Rhode Island responded to a massive $9 billion official unfunded liability with a series of reforms that should help to put the state on firmer financial footing. Lawmakers passed a series of state reforms in 2011 to address the problem, including increasing the retirement age to 67 for many workers, suspending cost of living adjustments (COLAs) until the pension system reached an 80 percent funding level, establishing a new DC plan to work in conjunction with a DB pension, and several other small steps to assure program solvency. As of this writing, though, the 2011 Rhode Island pension reforms, which have been lauded by organizations like the Brookings Institutions, have become politicized and taken up by mediators. After more than two months of mediation, reforms were softened, leading many reform advocates to express disappointment with the overall result.27

Finally, the federal government serves as another case study in pension reform. Since 1987, the Federal Employees Retirement System (FERS) has maintained a hybrid program, which has some DB features built in while giving workers a set of DC benefits that encourage savings, allow for portability, and can be allocated to a range of investments. This innovative retirement program at the federal level has helped reduce the burden taxpayers will face, and it has led to efficiency gains. In states where lawmakers do not have the political support to fully implement DC conversions, a program like the FERS reforms could be a beneficial compromise.

The lesson from these case studies is that pension reforms in the public sector are becoming more popular as cash-strapped states face ugly budget realities. But, the shift to DC plans is a bumpy one that

promises tremendous long-term benefits to many, yet also presents very real costs to some workers and also to established interests.

**Conclusion**

Pennsylvania’s public pension funding situation, while dire, is not unique. Firms in the private sector have been dealing with the inherent challenges of DB programs since pensions were first offered to workers in the late 19th century. Changes in demographics, financial conditions, market returns, employee preferences, and a host of other factors have all shaped program reforms at the company level throughout the 20th century. The big takeaway from more than a century of employer-provided pension programs is the lack of guarantees. The fact that retirement incomes cannot be guaranteed is seen in public sector cases like Detroit and Illinois.

The strongest case for shifting state pensions to DC plans is a financial one: There is no way a state like Pennsylvania will be able to put an end to its rising pension liabilities unless it learns from thousands of private sector firms and closes its current DB programs. Once the program is closed, the state should shift all new employees and any current employees that want to convert to DC plans. Such a shift is consistent with best practices in the private sector, and it is the only way to protect taxpayers while granting workers control over their own retirements.
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