Senate Bill 1: Public Sector Pension Reform

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Chairman Metcalfe, Chairman Cohen, and members of the committee: Good morning, and thank you for the opportunity to testify on the topic of public sector pension reform. I cannot think of a more pressing issue facing the commonwealth, and I commend the committee for considering legislation to begin the process of solving our state's pension crisis.

I acknowledge the term "crisis" is thrown around liberally in the halls of Harrisburg, but no reasonable person could deny its application here. Over the past six years, pension payments from school districts have increased by $2 billion. This amounts to a $600 tax increase per Pennsylvania homeowner. And the pain is projected to continue over the next five years, in which school districts must contribute another $1.7 billion towards our pension debt.

This deluge of debt is placing a great burden on Pennsylvania's balance sheet. The Independent Fiscal Office estimates that pension payments in 2019-20 will represent 9.4 percent of the General Fund budget—up from 4.2 percent in 2011-12. As pension costs explode, government spending on welfare, public safety, and education are crowded out. Indeed, tens of thousands of public school teachers have already been laid off in recent years as a result of our rapidly accelerating pension crisis.

The situation in Pennsylvania is so dire that our pension funds may soon lack sufficient assets to fully pay current retirees. According to a study from the Mercatus Center at George Mason University, PSERS has only a 31 percent chance of meeting its obligations by 2030 without additional contributions. Mercatus authors project that SERS' probability of sufficient funding is even worse at only 16 percent.

Of course, $53 billion in unfunded liability does not accrue overnight. In addition to multiple economic downturns since 2001, our current pension crisis is the culmination of poor policy—in the form of retroactive benefit increases—and mismanagement—in the form of persistent underfunding.

It is important to note that our public employees—from school teachers to state workers—are not to blame for this crisis. They've paid, and continue to pay, into the state pension systems. But it was—and continues to be—the leaders of the government unions from PSEA, AFSCME, SEIU, UFCW and others who supported all of the bad policy decisions of the past fourteen years.

There's little reason to further belabor these root causes. But it is important to understand how we got here in order to avoid mistakes of the past and better secure our future.

For more than a decade, we at the Commonwealth Foundation have advocated for pension reform that moves the state out of the defined benefit business and into providing a defined contribution system—much like the private sector has done over the last twenty years.

Senate Bill 1 is a good step in that direction for Pennsylvania. By establishing a defined contribution retirement plan for new hires, underfunding future plans becomes impossible. Taxpayers will no longer be on the hook for unpredictable, open-ended costs. A 401(k)-style plan is always fully funded—it carries no debt—and it offers current and predictable costs.

The open-ended nature of defined benefit pensions is an Achilles heel for state taxpayers. Under a defined benefit plan, the real costs are ultimately unknown. Actuaries can provide estimates, but when they err—or when projections are based on unrealistic, rosy assumptions—Pennsylvania taxpayers are stuck with a higher tax bill. Shifting new hires to a defined contribution plan would provide a level of protection for taxpayers, since they will only be responsible for fixed and known costs.

What's more, SB 1 shields school districts from "pension spikes" that force annual property tax increases beyond Act 1 thresholds. Rising pension costs were the justification for some 98% of exemptions recently granted to school districts to raise taxes above inflation.

Teachers, school and state employees are also treated fairly under SB 1. The law is carefully crafted to provide a secure and attractive retirement to public employees, who should not have to worry if government will make good on its pension funding promises. The overwhelming majority of private sector employees maintain a 401(k)-style plan where the worker owns his retirement and maintains long-term control over his investments. It is reasonable to ask new state government hires to join their private sector counterparts in the transition to defined contribution plans.

Public employees should be empowered and entrusted with full ownership over their retirement future. Personal ownership over one's retirement account is of paramount importance at a time when the average worker changes jobs 10 times in his or her career. According to research from the Pew Foundation, an employee who switches jobs or moves to another state will fare better under a defined contribution plan than the status quo.

The defined contribution plan under SB 1 would also correct the bias against new employees. Currently, benefits for long-term workers are partially paid at the expense of those who leave the public sector early. For example, fewer than 25 percent of Pennsylvania's teachers become vested in the pension system, compared to a national median of approximately 45 percent.

Another positive element of SB 1 is that it follows the "first, do no harm" principle by avoiding the temptation of pension obligation bonds, which would worsen the state's fiscal position. From state to state and city to city, pension obligation bonds have failed to improve government pension plans. Gambling that stock market returns will outpace interest payments on borrowed money does not safeguard the best interests of the taxpayers. In fact, the primary shortcoming of pension obligation bonds is that they fail to remove politics from pension management. This approach encourages the same mistakes of the past—specifically, increasing benefits and deferring payments in perpetuity.

SB 1 requires Pennsylvania lawmakers to move into a defined contribution plan upon election or reelection in 2016. This may seem like a symbolic gesture, but it is truly substantive that legislators lead by example as the only current employees who would move into a defined contribution plan. No one could accuse this body of crafting a benefit they themselves would not be subject to—and that's a good thing.

At this point, I'd like to specifically address the myth embraced by Gov. Wolf that pension reform is unnecessary; that we should "let Act 120 work." The reality is if our pension systems continue on their present trajectory, there is no disputing that some combination of the following will occur: increased layoffs, deeper program cuts, or stifling tax hikes. Ignoring these realities will not make them go away. It is far better to begin addressing them proactively rather than having to deal with them like the city of Detroit has been forced to do—harming both public employees and taxpayers in the process.

Another myth typically cited to defend Pennsylvania's pension systems is that "transition costs" will be prohibitively expensive upon shifting to a defined contribution plan. This argument has been repeatedly debunked by credible pension experts, and it has certainly not deterred the private sector from making such a shift. If moving from defined benefit to defined contribution plans truly cost more money, the private sector would have abandoned such schemes a long time ago.

The means by which our state addresses the pension crisis are sure to be contentious, but we should all agree that preserving the broken status-quo is not a feasible option. That's why I'm encouraged to see pension reform as a top priority for this legislature.

Surely no one in this room wants to reach the tipping point where programs are cut, benefits are slashed, and thousands of public employees lose their jobs. But that's exactly where our state is headed without significant reform. Fortunately, SB 1 provides a good first step.

Thank you again for the opportunity to testify. I welcome any questions at this time.