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The Voters' Guide on How We Got a $70+ Billion Dollar Pension Debt in PSERS & SERS

RockTheCapital.com has reviewed the long-term pension crisis which currently sits at $70 billion in unfunded liabilities based upon the market value of assets.This behemoth has already reduced our credit rating. Crippling debt will potentially impoverish the state, leading to bankruptcy. The three main drivers of this crisis are the underfunding of the state's pension contribution, the underperforming of investments, and the unfunded increase in pension benefits.

This problem was an entirely man-made crisis because the pension scheme was overfunded as recently as 2001. But politicians used this surplus to retroactively increase pension benefits for government workers, especially for themselves, in the belief that there would never be another economic downturn. When the economic downturns of 2001 and 2008 came, policymakers had no political will to properly fund these benefits, a practice that has continued for over a decade. This helped fill the budget gap for those years but skyrocketed the combined pension unfunded liabilities. These budget fixes dramatically increased the state's pension unfunded liabilities leading to a consistent downgrading of our credit rating.

The pension crisis is going to have significant long-term ramifications. The taxpayers' burden will be increased, and/or state programs like education and infrastructure will be slashed. The main reason for the constant delaying of a solution is that the people who benefit most from this are the politicians who increased their own personal pension payout by 25% more than the typical government employee. That means even though none of these benefits were paid for there is a huge disincentive to fixing the problem because politicians would have to reform their own pensions. This voting guide summarizes the bills that got us into this mess.

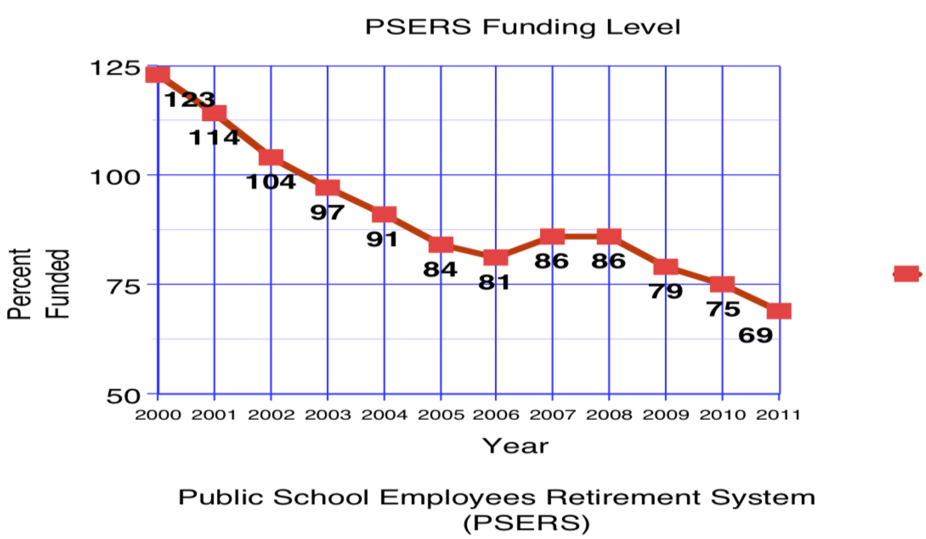
<u>The Bills</u>

Act 9:

This bill was signed into law by governor Tom Ridge in 2001 with overwhelming support from the legislature. Act 9 changed the pension multiplier by 25% from 2 to 2.5 for teachers and state workers while it changed the pension multiplier by 50% from 2 to 3 for legislators and judges. It also lowered the years necessary to get vested from ten years to five years, which increased the future number of employees who would be guaranteed full benefits.

At the same time this was happening, legislators reduced their own payment contributions to their pension from 8.75% in 97-98 to 1.06% in 01-02. This payment holiday established the underfunding of the system. This bill also retroactively gave benefits to employees for years they have worked before this bill had been passed.

The combined increase in the pension multiplier, retroactive benefit enhancement, an economic downturn and the payment holiday all increased the unfunded liability dramatically. In under six years since signing this bill into law, the pension fund went from 123% funded (23% more than needed at the time) down to only 81% funded.



Act 38:

Act 38 was designed to cap employer contributions at 1.15% and to give a cost of living increase to public employees who did not qualify for the Act 9 increase in pension. This further increased the unfunded liability. It was passed in the hope that any economic downturn would be short-lived.

Act 40:

This bill reduced the employer contribution rate to ease the financial shock of underfunding the pension schemes. However, this increased the unfunded liability to $5.9 billion. Although the pay holiday freed up dollars for the general budget, it absolutely crushed the pension fund.

Act 120:

Act 120 was the proposed solution that was signed into law in 2010 by Governor Rendell. It put collars on the recommended contributions of the employers, essentially extending the payment holiday because they were not contributing to the pension fund. This limits the pension component of employer contribution rate until it caps out at 4.5% from 2014 onward.

This bill also reduced new employee benefits by switching them into two different type classes of pensions. The first class is the T-E class which has a pension multiplier of 2% with a base contribution of 7.5% that fluctuates from 7.5%-9.5%. The next class is the T-F class, with a pension multiplier of 2.5% and a base contribution rate of 10.3%, that fluctuates between 10.3%-12.3%. The years that it takes to get vested now is switched to ten and the retirement age is raised to 65. This bill also eliminated the lump-sum withdrawal in order to create more predictability.

Act 120 also added a shared risk provision for new employees. It says that if the actual return on investment is less than 1%, the projected return on the contribution will increase by .5%, and if the actual return on investment is equal to or exceeds the projected investment, the contribution will decrease by .5%. This did reduce benefits for future employees and shifted some of the investment risk away from the taxpayer, but created collars for the contributions, which increased the liabilities.

SB 1071 (Tobash):

SB1071 was designed to reform the benefits by putting new employees on a combination 401k plan and a traditional hybrid. The defined benefit plan has a 2% accrual rate with a 6% employee contribution. The vesting period is 10 years and the entire benefit is earned after 25 years of service. The defined contribution plan has a 1% contribution for employees and .5% for employers for all money earned under $50,000. For money earned over $50,000 the employee contribution is 7% and the employer contribution is 4%. All employee contributions are vested immediately and all employer contributions are vested after 3 years.

This hybrid plan does not address the immediate underfunding of the pension system. This also exempts police officers and most uniformed public employees, which makes the reforms at best small. SB 1071 also adds increased complexity due to the different contributions for different wages and the multiple classes or plans. The majority of the claimed $15.1 billion in savings is after 15 years even though the system is in crisis right now. These reforms do shift some risk from the taxpayer but add complexity costs, exempt a significant number of government employees, and are far too small to save the system from bankruptcy.

HB 900:

HB 900 handles all the pension liabilities by increasing the contribution the government makes to the pension fund, in the short run, to make up for the pay holiday and underfunding that has been going on for years. This increases the current funding rate which is just below ten percent of the federal budget, to over 15% in the short term. The intent is to not just match the recommended funding levels, but also to start to pay down the principal and reduce the interest.

Over time, HB 900 will allow the pension liabilities to go down. Also, in the long-term the percentage of the budget that will be dedicated to pensions will decrease significantly. This initial jump of $1.5 billion in pension funding in the short term may seem like a problem, but by meeting the pension obligation and paying down the principal over time, the interest goes down and payments as a percentage of the budget are much lower.

These numbers will have to be adjusted because the overall liability has increased to $70 billion dollars but the principle of the plan still works. By starting to olve the problem now, the long-term costs and proportion of the budget that the public pension scheme entails is significantly reduced.