Pennsylvania School Boards Association

Testimony Submitted
to the
Senate Finance Committee
Wednesday, May 29, 2013
by the
Pennsylvania School Boards Association

Thank you for the opportunity to offer written testimony to the Senate Finance Committee on behalf of the Pennsylvania School Boards Association (PSBA) regarding public pension reform and in particular the current structure and future restructuring of school employees' retirement benefits under the Public School Employees' Retirement System. PSBA appreciates the efforts and work of the Senate Finance Committee as it looks to reform one of the most pressing problems facing school districts.

PSBA is encouraged by the timing of this hearing. It comes at a time when overwhelming forces threaten actual educational programming of all schools. Depending on size, wealth and location, all school districts experience their unique problems. However, the public pension issue is a common problem for all districts whether they are rural, suburban or urban. Additionally, the current pension crisis represents one of the most challenging issues ever to have faced collective bargaining in the Commonwealth. When the pension problem is coupled with the escalation of healthcare benefit costs, which continue to outpace inflation and the Act 1 index by a substantial degree, a perfect storm for public education is created.

Time is of the essence. Pennsylvania's massive public pension crisis must be a top priority for the General Assembly in the coming weeks leading to the adoption of the 2013-14 state budget. It will not be an easy debate, but the need to deal with escalating costs related to rising pension costs for state and school employees is critical. If not addressed, the pension crisis will have a crippling effect on the state's economy and a devastating impact on local school district budgets. The current system is unsustainable, leaving taxpayers to feel the brunt of staggering increases unless a workable, long-term solution is enacted.

From PSBA's perspective, school districts have been in compliance with the law, but the system is unsustainable and must be fixed now. As the employer, school districts have been making the mandated required contributions to PSERS each year, despite the fact that increased pension costs are wreaking havoc on school district budgets. Short of action by the General Assembly to address this pension crisis or more state funding to offset these rising costs, school districts have no option but to cover these soaring costs at the expense of the rest of their budgets.

Briefly, PSBA has been engaged in pension reform many times over the years. Most recently, in 2006, PSBA created a pension study committee. It spoke with experts, advocacy groups and union officials from state and national organizations and associations and nongovernmental entities on this topic to determine the structure of state and local pension benefits and protections and investigate potential solutions. At that time, the pension crisis involved two major problems. As you know, the two statewide pension systems must establish an employer contribution rate each year to ensure pension benefits are adequately funded. This is known as the “normal cost.” When PSBA’s committee convened, employer contributions were facing a short-term spike and would increase by 72% in 2010-11; 25% in 2011-2012; and by a 170% in 2012-2013. At the same time, the funds faced and a longer term plateau in which the employer contribution rate would remain at abnormally high levels for decades and require huge infusions of cash by school employers and the Commonwealth, the bulk of which would likely come from taxpayers. PSBA’s pension study committee created long-term and short-term reform recommendations. (Attachment 1).

Based on those recommendations, Representative Glenn Grell and Senator Gene Yaw introduced legislation in 2010 on behalf of PSBA to reform the pension system. House Bill 2135 and Senate Bill 1185 would have transformed the PSERS system from a 100% defined benefit system to one that is a hybrid defined benefit/defined contribution system applicable to all members of PSERS who became members of PSERS after June 30, 2010. By reducing the defined benefit obligation, PSBA’s hybrid plan would cut employer costs. At the same time, the defined contribution part of the hybrid plan proposal would allow members of the system to invest a portion of their contributions in a manner they saw fit. PSBA’s proposal would have continued to provide a viable pension benefit to school employees. The bills also would have reduced the projected increases in the school district portion of the employer contribution by capping those increases at the Act 1 index. The Commonwealth would pay for the remainder of the increases over the cap. In addition to changing the system to a hybrid defined benefit/defined contribution plan, there were other changes to plan design that PSBA’s bills set forth including changing the period of vesting from five to ten years. It also permitted a modification of the mandated minimum employer contribution floor rate in the event the funded ratio of the PSERS fund reached 100% or greater. (A summary of the bill is attached as Attachment 2).

According to the actuarial review by the Public Employee Retirement Commission (PERC), Senate Bill 1185 would not have had an effect on PSERS' unfunded actuarial accrued liability because the hybrid plan provided would affect new members of PSERS only. PERC's actuarial note of the Senate Bill noted that over time, the bill would have decreased employer contribution rates as an increasing number of the new class of PSERS member entered the system, because the cost of providing benefits under the hybrid plan is less than for current members. The note also projected that there would be some employer cost savings resulting from implementation of the reduced benefit tier under the bill, but the savings were relatively small, amounting to 1.75% of payroll in 2038.

Ultimately, PSBA's legislation did not move out of committee, but some of its provisions were incorporated into Act 120. This included a risk-sharing concept for employees hired after the effective date, when investment rates of return fell short of the assumed rate of return set forth by the PSERS board. It also made changes to the plan design for new employees including increasing the years required for vesting, increasing the superannuation rate by instituting a Rule of 92 and halting the Option 4 withdrawal of the employee's contributions in a lump sum, among others. PSBA supported these changes as a first step to Pennsylvania's growing pension problem.

For the past several months, PSBA has been engaged in ongoing discussions with legislators of both parties in an effort to develop a pension reform bill. PSBA strongly believes that comprehensive reform can only be attained by enacting a new source of funding for the system and reducing the pension benefits which must be paid out. With that in mind, PSBA's efforts are directed toward the following policy objectives:

1) Lower employer contribution rates to levels that are more manageable and predictable for school district budgets and the taxpayers that support them;
2) Improve the actuarial soundness and sustainability of PSERS including, ensuring that the employer contribution rate is not permitted to fall below the employer normal cost and actuarially appropriate adjustments to amortization of gains and losses;
3) Reduce the gap between private and public sector retirement benefits while maintaining an adequate retirement benefit;

4) Offer greater risk sharing of investment gains and losses to school employees;
5) Provide modified employee pension benefits in a manner so that school employers can continue to attract and retain high quality staff, and relieve the escalating financial burdens on the state, school districts and taxpayers.
6) Allow employees the portability and freedom to manage their own retirement accounts as they see fit through a blended hybrid or alternate system; and
7) Develop additional revenue sources.

During its discussions regarding these policy objectives, PSBA has emphasized that any new system must make sense fiscally for school districts and taxpayers and the solution to the pension crisis is likely not to be contained in a single proposal. Solutions need to be worked out or the pension tidal wave will wash over taxpayers and school districts leaving them angry and frustrated. Here are some of the key concepts being advanced so far.

Future Employees

Without ongoing plan design changes for future employees, pension costs will continue to overshadow local school district budgets. PSBA would support changes to the plan for future employees including the following:

1. Allowing employees who have purchased the benefit of a higher multiplier to keep their multiplier if they pay a higher contribution rate.
2. Capping pensionable income at the Social Security wage base, which is $113,700 for 2013.
3. Determining an employee's final average salary by averaging the employee's highest five years of compensation rather than the current 3 years.
4. Making the Option 4 lump sum withdrawal an actuarially neutral option.
5. Incorporating anti-spiking provisions.

In general, PSBA is also supportive of some of the public policy concepts including sharing financing of retirement benefits between employers and employees and the sharing of investment risk. Additionally, PSBA supports the policy concept of pooled assets and the investment of pooled assets by trained investment professionals, which we believe strengthen a state-run pension system. These concepts offer multiple advantages over individual, self-directed accounts. Combined portfolios have a longer investment horizon, which allow them to be better diversified and to sustain market volatility. According to NASRA, the professional asset management and lower administrative and investment costs in pooled arrangements lend themselves to higher investment returns.

Current Employees Future Accrued Benefits

With regard to plan design changes for current employees, Pennsylvania, like other states, provides some constitutional protection for its pension plans. In some states, this protection takes the form of a specific guarantee of the right to a benefit. Pennsylvania's Constitution provides that the legislature cannot diminish or impair the state's contractual obligations.[1] Pennsylvania courts have recognized SERS and PSERS plans as contracts subject to the limitations of this Constitutional prohibition. Thus, a 1984 challenge to a requirement that employees pay an increased contribution to fund existing pension obligations succeeded because it required members of the pension system to pay more for each pension dollar earned. (T*he Association of Pennsylvania State College and University Faculties, et al v. State System of Higher Education, et al.,* 505 Pa. 369, 479 A. 2d 962 (1984). ("APSCUF")). In APSCUF, the Court noted that members' pension benefits are deferred compensation, earned for service actually rendered in the past. Many have taken this to mean that **all** changes to these pension plans must be limited to employees hired after the effective date of the change. Certainly, changes to benefit plans for new hires will survive Constitutional challenges, but they will not solve the problems facing our pension systems for years to come. If the structure of the pension system is not changed to address future benefits of current employees, the normal cost of employer contributions will rise precipitously and remain at an untenable rate for years, which in our case, is likely to seriously erode the quality of public education in Pennsylvania.

PSBA suggests that there is one possible way to address current employees' future pension benefits by applying our experience with the Public Employee Pension Forfeiture Act. 43 P.S. § 1311, *et seq.* The Pension Forfeiture Act provides that public employees or public officials elected or appointed to any public office or public employment, including current members of the retirement system, would forfeit their public retirement benefit except for a return of the contribution paid into the pension fund, without interest upon commission of specified crimes. In *Shiomos v. State Employee's Retirement Board,* 533 Pa. 588, 626 A. 2d 158 (1993), the Supreme Court held that the act applied to a judge who was elected to a second term of office after the effective date of the Pension

[1] Article 1, Section 17 of the Pennsylvania Constitution provides: No ex post facto law, nor any law impairing the obligation of contracts, or making irrevocable any grant of special privileges or immunities, shall be passed.

Forfeiture Act. Judge Shiomos then retired from the bench, took his lump sum pension contributions and statutory interest and began collecting his monthly pension benefit. Unfortunately, when he assumed senior judge status, he was convicted of extortion, a crime that calls for pension forfeiture. The Court noted the act provides, "Each time a public officer or public employee is elected, appointed, promoted, or otherwise changes a job classification, there is a termination and renewal of the contract for purposes of this act." 43 P.S. §1313(c). When Judge Shiomos took office for his second term, he was on notice that the act applied to individuals in his position. At that point, he accepted all of the provisions of the Pension Forfeiture Act and he forfeited his right to all benefits arising from his public employment, including those accrued prior to his second term of office.

PSBA suggests the state could survive an impairment of contract challenge if it uses the reasoning of *Shiomos* to structure pension reform as it applies to current members of the retirement system. It is crucial to understand that this can only work if a change to future benefits results from a triggering event which creates a new or amended contract between the public employee or official and the Commonwealth. Public employees and officials would have to be put on notice, through the law, that their current defined benefit plan would remain intact *only to the date a triggering event occurs*. Some of these "triggers" recognized in the Pension Forfeiture Act as creating an amended or renewed pension contract include acceptance of a promotion, a new position, and election to a new term of office. PSBA suggests that with advance notice, an employee or official who accepts a new deal in other ways may be required to accept changes to the pension contract between the employee and the Commonwealth. Essentially, the General Assembly would create a plan so that an employee is deemed to accept the new rules and trigger applicability by accepting a promotion, new position, some kind of new benefit, or even a pay raise (or step movement on a salary scale). Entering into a successor collective bargaining agreement could be a triggering event. Arguably, an employee could avoid the new rules only by self-imposing a perpetual pay freeze and accepting no further job transfers or promotions. Although, changes to current employees' future benefit will be challenged in the courts, fear of litigation should not result in inaction. PSBA would support changing future accrued benefits for current employees based on occurrence of a defined, future triggering event.

Tapering of Existing Employer Rate Collars

At issue in the forthcoming debate in addition to the appropriate level of the contribution rate, plan design for current employees as well as new employees, is the tapering of the collar as proposed by Governor Corbett from 4.5% to 2.25%. There are divergent views represented on the one hand by those who argue that a reduced state and local contribution to PSERS is fiscally prudent with the benefit of millions of dollars in savings to the taxpayers of the Commonwealth. The alternative view is that the reductions are fiscally irresponsible and a prelude to a longer-term consequence. PSBA recognizes the merit of such arguments, but from a policy perspective believes that efforts to begin paying down PSERS' liabilities need to continue and reducing the employer contribution simply delays that effort. Reducing the collars this year even more will add costs to the system in the long-term.

PSBA wants to ensure school districts can provide a high quality public education and the association remains very concerned that the pension costs will impede the ability to do just that. Thank you for the opportunity to comment on this important issue.

Executive Summary

The PSBA Executive Board created an *ad hoc* Pension Study Committee to examine the rising cost of the Public School Employees' Retirement System (PSERS) and to formulate policy recommendations for the board's consideration. As a primary focus, the panel examined arguments in support of and in opposition to changing the type of plan PSERS operates from defined benefit (DB) to defined contribution (DC) as considered other related matters regarding public pensions. The committee recommends that PSBA support the following measures and develop cost estimates and implementation proposals to effect these reforms:

Long Term Reform

1. Establish a two-tier retirement system, one for current public school employees and another for those hired after a specified date, preferably as soon as possible.
   - Maintain the *existing DB plan* for all current active members of PSERS, with existing benefits remaining unchanged.
   - For public school employees hired after a specified future date, create a *new hybrid plan*, containing features of both a DB plan as well as a DC plan:
     - DB features: The multiplier would be lower, preferable 1%. The period for vesting would be restored to 10 years, up from the 5-year period created by Act 9 of 2001. Employees would be required to make a mandatory, fixed contribution. Employer contributions would be made in a manner similar to the existing plan but at a lower rate and subject to the limitations described in #2, below.
     - DC features: Employees would be mandated to enroll in the plan and to contribute a minimum percentage of their salary. Various investment alternatives would be offered, and "life-cycle" funds would be provided as a default option for those not making a selection. The employer contribution would match employee contributions, up to a fixed percentage of payroll, and would be subject to the limitations described in #2, below. Current school employees would be permitted to enroll in the new plan but, in so doing, would lose entitlement to re-enroll in the existing pension plan.
2. Cap the school district portion of the employer contribution rate for both pension plans at the Act 1 index; the Commonwealth would fund any remaining employer obligation. In the event that Act 1 would be repealed or changed, the employer contribution rate for both pension plans would be capped at a figure calculated in the same manner as the Act 1 index or successor index that may be enacted limiting the increases in school district taxation, whichever is less.
3. Oppose enactment of any new benefit enhancements for either plan.
4. Assign to PSERS responsibility to administer the benefits for both plans and to manage their assets.

Short-Term Reform

1. Require that the employer contribution rate floor for PSERS's existing plan be raised to the employer normal cost.
2. Implement the Fresh Start approach, which revalues PSERS's assets to market and reamortizes its current and future gains and losses over 30 years.

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THE PENSION CRISIS

2010 – Pension Hybrid Legislation – HB 2135, SB 1185

These bills call for the creation of a hybrid pension system for school employees, one that combines the advantages of a defined benefit and a defined contribution system

The bills would do the following:

- Create a new class of employees, T-E, comprised of individuals who join the system after June 30, 2010. These employees would be enrolled in the new hybrid system rather than the current defined benefit system.
- Class T-E employees would earn the benefits of a defined benefit system, albeit at a lower benefit level. Changes in the DB portion of the hybrid plan are:
    - Multiplier lowered from 2.5% to 1%
    - Vesting time increased from 5 years to 10 years
    - Employee contribution lowered from 7.5% to 3.25%
- Would create a defined contribution program to accompany the defined benefits portion. The defined contribution plan would:
    - Require a minimum 3% contribution on the part of school employees
    - Require a 2% maximum contribution on the part of school employers
    - Require PSERS to create a series of investment portfolios so that members could invest their contributions. At least one of the investment packages would be designated a default investment should a member not choose any specific investment
    - Requires PSERS to set the rules and regulations for investing in the D/C fund
- Sets a minimum employer contribution so that even when system is fully funded, the lowest the employer rate could go would be 4%
- Provides that increases in school district contributions to the pension system would be capped at the Act 1 index. Should the increase in the school district share of the employer rate exceed the current year Act 1 index, the state would pick up the difference between the new employer contribution rate and the index.