Testimony of Charles B. Zogby
Secretary of the Budget
Commonwealth of Pennsylvania
Senate Finance Committee

Good Morning. Thank you Chairman Brubaker, Chairman Blake, and the members of the Senate Finance Committee for holding this hearing to discuss the pension crisis burdening Pennsylvania. I appreciate the opportunity to speak today to explain the Governor's Pension Reform proposal, as introduced in SB 922, address several myths about the proposal, and answer any questions the committee may have on this issue.

First, it is important to understand the crisis we are facing. Taxpayers should be deeply concerned.

Pennsylvania's two public pension systems, the State Employee Retirement System (SERS) and the Public School Employees' Retirement System (PSERS), are severely underfunded. At the end of 2011, both systems had a combined unfunded liability of $41 billion. At the end of 2012, that had increased to over $47 billion. That increase amounts to $510 million each month, or nearly $17 million for each day that we do nothing to fix this problem. What's worse, unfunded liability is expected to grow to over $65 billion by 2018. Each Pennsylvania household's share of this debt is nearly $13,000.

In FY 2013-2014, General Fund contributions are expected to amount to $1.6 billion into SERS and PSERS. By FY 2017-2018, the taxpayers' bill to SERS and PSERS is expected to rise to $3.35 billion in General Fund contributions.

Mounting year-over-year pension contribution costs will continue to erode the ability to fund core government services and programs such as public safety, human services, and infrastructure improvements. This year, more than 60 cents of every new General Fund revenue dollar will be spent on employer pension contributions. This will force both the commonwealth and local school districts to make difficult choices, including reducing services or laying off employees just to make ends meet. According to the Pennsylvania Association of School Business Officials (PASBO): "Pension reform is a critical and immediate need in order to prevent more significant cuts to school programs and personnel… The Governor's proposal is an important step forward in addressing the pension crisis schools are now experiencing." This is evidenced by the fact that more than one in every three school districts have petitioned the state to raise property taxes above the inflationary rate this year just to cover pension-related costs.

Structural deficiencies in our public pensions threaten the long-term stability and sustainability of the systems, putting hard working public and school employees' futures at risk. Crushing pension debt will most assuredly result in the downgrade of the commonwealth's credit rating, costing taxpayers more to fund much needed infrastructure projects that keep Pennsylvania moving.

Recent analyses from the major credit rating agencies point to increased pension contributions and the growing unfunded liability in the public pension systems as major threats to Pennsylvania's economic recovery and future.

Fitch Ratings points to a negative rating outlook and reflects its concern with "expected significant growth in annual pension funding obligations". It also states that maintaining the current "AA+" rating will "depend upon the commonwealth's ability to stabilize the downward trajectory in pension funding levels while continuing a commitment towards fiscal balance and replenishing reserves."

Standard & Poor's notes that it has "the potential…to lower the state rating to 'AA-' in the next two years in the absence of meaningful pension reform efforts or significant economic growth that would help mitigate the impact of growing pension costs on Pennsylvania."

In short, if we do nothing about pensions now, the commonwealth will struggle in the future to do the things that will keep our communities competitive and vibrant places to live, play and work.

But today you will hear testimony that the plan put forth in SB 922 will do more harm than good. That it will cost the commonwealth more than the status quo, and that it will bleed the systems dry of crucial funding, leaving us in a worse position than we are now.

The arguments made by special interests in Harrisburg are intended to muddy the waters, instill fear and spread mistruths in the hope that enough noise against good public policy will stall its progress. They look to prevent responsible governing from happening in the first place.

The problem is that the status quo is no longer sustainable. Anyone who takes a serious look at the crushing costs associated with doing nothing regarding our pensions cannot honestly conclude our current path is the correct one.

Pennsylvania can no longer hedge its bets on the hope of a rebounding stock market to help us grow out of the problem. The mountain of pension debt we now have is expected to grow significantly. It is becoming increasingly difficult to balance the needs of the citizenry with the costs of our pensions. This legislation looks to curb both. In fact, its passage would result in less debt and that debt being paid off sooner than current law. It will save taxpayers nearly $12 billion in contributions and more than $40 billion in plan costs over the next 30 years. Equally as important, SB 922 will introduce reforms including a defined contribution plan for new employees that will ensure that current situation we face can never repeat itself again.

Given the mistruths currently being spread, I'd like to simply outline what SB 922 does and does not do.

What SB 922 **does**:

- New employees will be enrolled in a 401(a) defined contribution plan, ensuring an adequate retirement benefit for all employees while providing fiscal sustainability for the taxpayers moving forward. This plan will:

  - Provide employees with the tools and resources to make wise investment decisions.
  - Provide for mandatory and automatic enrollment to ensure all employees have an adequate retirement benefit.
  - Provide for a short-term vesting period that is fair to employees.
  - Provide a 4% employer contribution rate, with higher contributions for hazardous duty employees and the State Police, at 5.5% and 12.2% respectively.
  - Shift the risk away from the Commonwealth, and, most importantly the taxpayers, to prevent future unfunded liabilities.

- Future pension benefits for current employees will be adjusted through several reforms, including:
  - Adjustments to the calculation of pensionable income, placing a cap on pensionable income at the Social Security wage base, implementing a final average salary calculation based on 5 years, instead of 3, and holding the growth of pensionable income to a 110% average of the prior 4 years.
  - Ensuring the calculation of the current Option 4 withdrawal of employee contributions correctly reflects the full actuarial value of the funds withdrawn from the system, modifying the future monthly annuity payments. It will not impact the lump sum withdrawal.
  - Reducing the multiplier by 0.5% for all employees currently above the 2.0 level (except for those that bought up under Act 120). Employees will have the option to buy-up and retain the higher multiplier.

- The commonwealth will taper employer contributions over the short-term for budgetary relief and institute long-term reforms that will reduce commonwealth risk and address the unfunded liability of the pension systems. The rate increase by which the commonwealth's contribution is calculated will be reduced by 2.25% in 2013-14, increasing by 0.5% per year until it reaches 4.5% or until the rate is equal to the annual required contribution rate.

What SB 922 **<u>does not do:</u>**

- SB 922 will not impact the benefits of current retirees in any way. Not one penny.
- Current employees will not see any changes to benefits they have already earned.
- SB 922 will not put future employees' retirement benefits at risk.
- The defined contribution plan in SB 922 will not increase the cost of the system. In fact, our independent actuarial consultants have indicated that implementing the defined contribution plan for new employees will generate $2.6 billion in savings over the next 30 years.
- Introduction of a defined contribution plan will not cut off funding to the defined benefit plan. The reality is, we will continue to make billions of dollars in annual contributions to pay down the unfunded liability over the next several decades.

In addition, you will hear testimony later this morning regarding the use of pension obligation bonds (POBs). I will simply note that our proposal does not call for the use of POBs as a mechanism to deal with this crisis. Although the issuance of a POB could reduce the unfunded liability of the pension funds, it would negatively impact the general fund by significantly increasing required debt service payments. Issuing POBs in the hope that investment returns would outpace our debt service payments carries a significant level of risk that must be carefully evaluated.

The Governor and I have spent months traveling across this commonwealth, making the case for pension reform to the taxpayers of Pennsylvania. It has been well-received. I applaud Senator Brubaker, Representative Ross in the House, the SB 922 co-sponsors and the members of this Committee for having foresight and courage to tackle this mounting crisis. Together, we must act now.

Good governing is putting forth real solutions to difficult problems. And good governing must continue to be this administration's and this legislature's business and sole focus. Thank you. I'll be happy to answer any question you have.