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The Honorable John Eichelberger, Chair
The Honorable John Blake, Minority Chair
Pennsylvania State Senate Finance Committee
169 Main Capitol
Harrisburg, Pennsylvania 17120

April 15, 2015

Chairman Eichelberger, Chairman Blake, and Members of the Senate Finance Committee:

Thank you for the opportunity to provide testimony on the public pension challenges and legislative proposals currently being considered by policymakers in Pennsylvania.

Pew has been working to provide information and analysis to policymakers in Pennsylvania for two years and welcomes this opportunity to be of assistance to the Committee. My comments today will include a brief introduction to our work on public pensions, a summary of our analysis on Pennsylvania's state pension systems, and a proposed framework for policymakers to evaluate paths forward.

The Pew Charitable Trusts is a non-profit, non-partisan research and public policy organization. Currently, we have more than 40 active, evidence-based research projects examining a wide range of issues including public safety, immigration, elections, transportation, pensions and state tax incentives.

Pew released its first research report on public pensions in 2007. Today, in addition to conducting 50-state research, the Public Sector Retirement Systems project offers policymakers information to develop retirement systems that are fiscally sustainable and help put public workers on the path to a secure retirement. Our approach is to provide objective and data-driven analysis, and we recognize that there is no one-size-fits-all solution.

In Pennsylvania, we have closely examined the historical factors that have contributed to the state's current $58 billion unfunded pension liability, and analyzed the projected impacts of the 2010 pension reforms.

Causes of the Unfunded Liability

As you all know, the funding level for PSERS and SERS went from a $20 billion surplus in 2000 to a $58 billion deficit by 2013.[1] The data show this $78 billion dollar swing had three primary drivers: shortfalls on annual contributions, unfunded benefit increases, and lower than expected investment returns during the volatile financial markets of the 2000s. By now, you're all familiar with these issues, but I'll take just a moment to describe each of these three factors and refer you to my written testimony for additional details.

[1] PSERS unfunded liability grew by 7.6 percent in 2014. 2014 data is not yet available for SERS.

The largest factor driving this unfunded liability has been shortfalls in funding. For example, between 2005 and 2013, Pennsylvania paid an average of just 39 percent of its annual required payment, or ARC, ranking it 49th among states.

The unfunded benefit increases in 2001 and 2002 have also had substantial impacts, which included a 25 percent retroactive increase in the multiplier used to calculate pension benefits for state workers and teachers - from 2.0 to 2.5 percent of salary for each year of service.

We estimate that these two factors – which reflected choices made by policymakers – account for more than half and approximately $41 billion of the recent increase in the state's pension debt.

Our research indicates that lower than expected investment returns account for about $25 billion of the increase in unfunded liabilities between 2000 and 2013. This, of course, is a direct result of the financial market volatility that had an impact on all public pension funds during the 2000s – specifically the dotcom market downturn of 2001 to 2002, and the onset of the Great Recession in 2008 to 2009.

Reform Efforts to Address Causes of Fiscal Challenge

Act 120 of 2010 sought to address each of these three drivers of fiscal challenge. The reform provided an aggressive funding plan to steadily ramp up to full annual ARC payments within seven years. The benefit increases of 2001-2002 were essentially reversed – although only for workers hired after 2010. Finally, it included a cost sharing provision requiring that new workers make additional contributions if investments fall short of the plans' targeted rate of return in the future. These reforms were all important steps towards improving the fiscal health of the systems, but they also have limitations.

The states' progress on pension funding has been nothing short of dramatic – an increase of more than $3 billion, or 300 percent, in annual pension contributions between fiscal years 2011 and 2015, the largest increase in plan funding for any of the 50 states over that same time horizon. We commend policymakers in the state for sticking with the payment plan. But, in the absence of new revenue, this has come at a cost to the state's other budget priorities.

The benefit reductions will also help to improve plan health over the long-term. But because these changes only apply to new workers, the savings from benefit reductions will take decades to fully materialize. The cost sharing feature can also be expected to have a positive although relatively modest impact on plan health. For example, our analysis of this policy indicates that higher employee contributions would cover approximately 15 to 20 percent of additional plan costs if returns were only 6 percent as compared to the plans' assumed rate of return of 7.5 percent.

So while these were significant steps toward improving the fiscal health of the systems, there are still remaining challenges.

Policy Framework for the Path Forward

These analyses and the focus of more recent reform proposals highlight three key considerations for policymakers as they examine potential paths forward: maintaining a commitment to fully fund pension promises, improving cost predictability, and helping put public workers on a path to a secure retirement.

Maintaining a Commitment to Full Funding

If the state stays the course under Act 120, it will achieve 100 percent of ARC payments by FY18 and is projected to reduce unfunded liabilities each year going forward. Reducing pension debt – also referred to as positive amortization – is analogous to reducing principal on a mortgage each year and a clear sign that the state is turning the corner on fiscal discipline.

Our most recent research shows that only 19 states are making full ARC payments across their states sponsored plans, and a smaller number are achieving positive amortization. As a result, Pennsylvania is on a path to go from 49th to the top half of states on plan funding over a seven year time period, and to directly addressing the concerns that have been raised by bond rating agencies.

Improving Cost Predictability

Government sponsors of public pension plans have two options to improve cost predictability within their pensions systems: reduce risk within the pension fund investment portfolio or change the design of benefits offered to workers. Reducing the risk of plan investments, however, typically requires lowering the plans' expected rate of return on investments and increases the cost of annual pension contributions from the state budget.

When considering plan design changes to improve cost predictability, two messages from our previous analyses bear repeating. First, changes to new workers are not going to have a meaningful impact on the state's existing unfunded liability. The data shows that service costs for new workers represent only three to six percent of total pension costs over the next 10 to 20 years. As a result, the near-term budget impact of plan changes will not move the needle on the state's pension debt.

Second, that cost predictability can be pursued through any plan design. Alaska and Michigan have implemented defined contribution plans, Arizona and Wisconsin have significant cost sharing features in their defined benefit plans, and more than a dozen states have implemented hybrid or cash balance plans.

Path to Secure Retirement

When considering providing retirement security, three principles can be applied to evaluate the effectiveness of any plan design:

- Professionally managed, low-fee, pooled investments with appropriate asset allocations.

- Access to lifetime income in the form of annuities.
- A combined benefit and savings rate that puts workers on a path to a secure retirement.

Professionally managed investments and access to annuities are central features of defined benefit plans that can also be provided through defined contribution, hybrid, or cash balance plans.

The federal government's Thrift Savings Plan – the DC component of its hybrid retirement plan – features well-designed investment options, offering workers five low-fee index funds and five target date funds with asset allocations specific to workers' retirement date. In Oregon, the public retirement system manages DC assets directly for participants in the state's hybrid plan. Similarly, annuitization is a required feature of cash balance plans and a component of many public sector defined contribution plans, including the optional defined contribution retirement plan offered to employees of Pennsylvania State University.

We encourage policymakers in Pennsylvania to carefully consider and evaluate whether the combined benefit and savings rate provided to workers in plan design proposals is sufficient to meet the state's goals to attract and retain a skilled public workforce.

Adoption of defined contribution plans, for example, typically has three key considerations. First, investment risk would be shifted to workers, leaving retirement savings and income less certain. Second, younger and mid-career workers who change jobs would likely see an increase in retirement savings. Third, in the absence of increased employer contributions, there would likely be a significant reduction in retirement income for career workers – in the case of the most recent House defined contribution proposal, for example, this impact could be as much as 40 percent. Finally, while some suggest that transition costs are another key consideration, I would remind the Committee that in prior hearings, we expressed our view that the impact of transition costs is prone to overstatement.

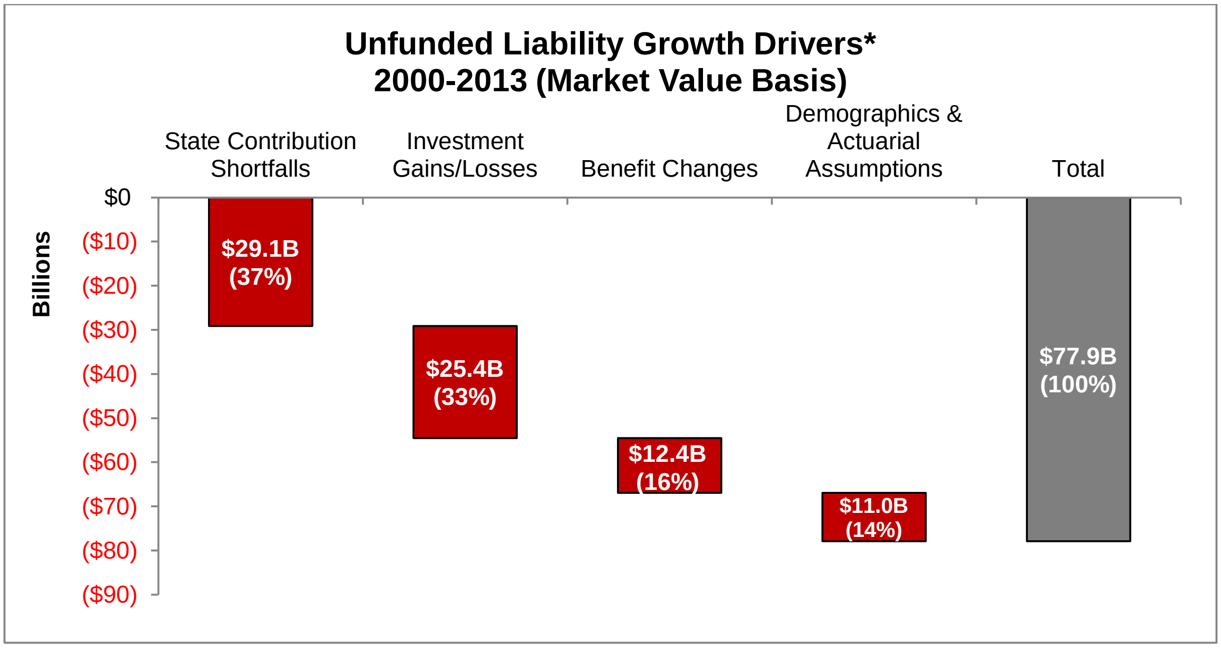
All of these considerations only highlight the fact that the value of any plan to participating employees and employers depends on design. Any well-designed plan can mitigate the challenges that I raised today and help put employees on a path to a secure retirement and provide greater cost certainty for plan sponsors.

Thank you for the time and we look forward to questions.

Greg Mennis
Director, States' Public Sector Retirement Systems
The Pew Charitable Trusts

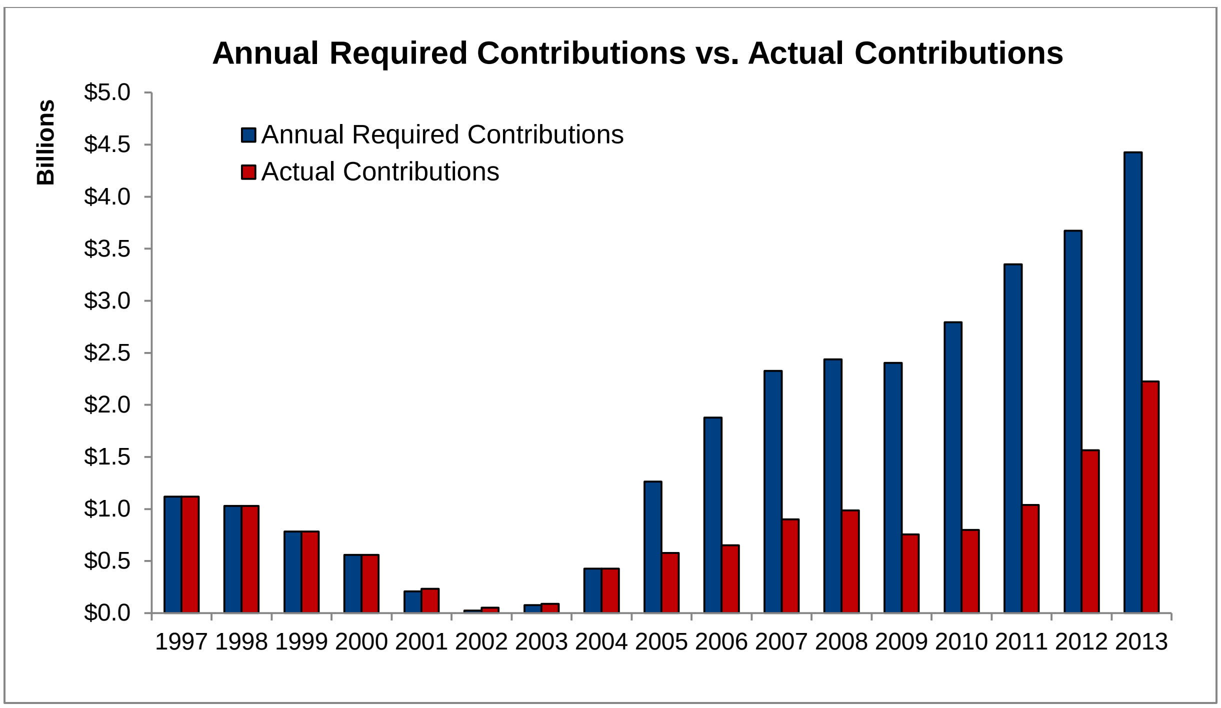
ATTACHMENTS

- **Causes of Unfunded Liability (SERS and PSERS Combined)**



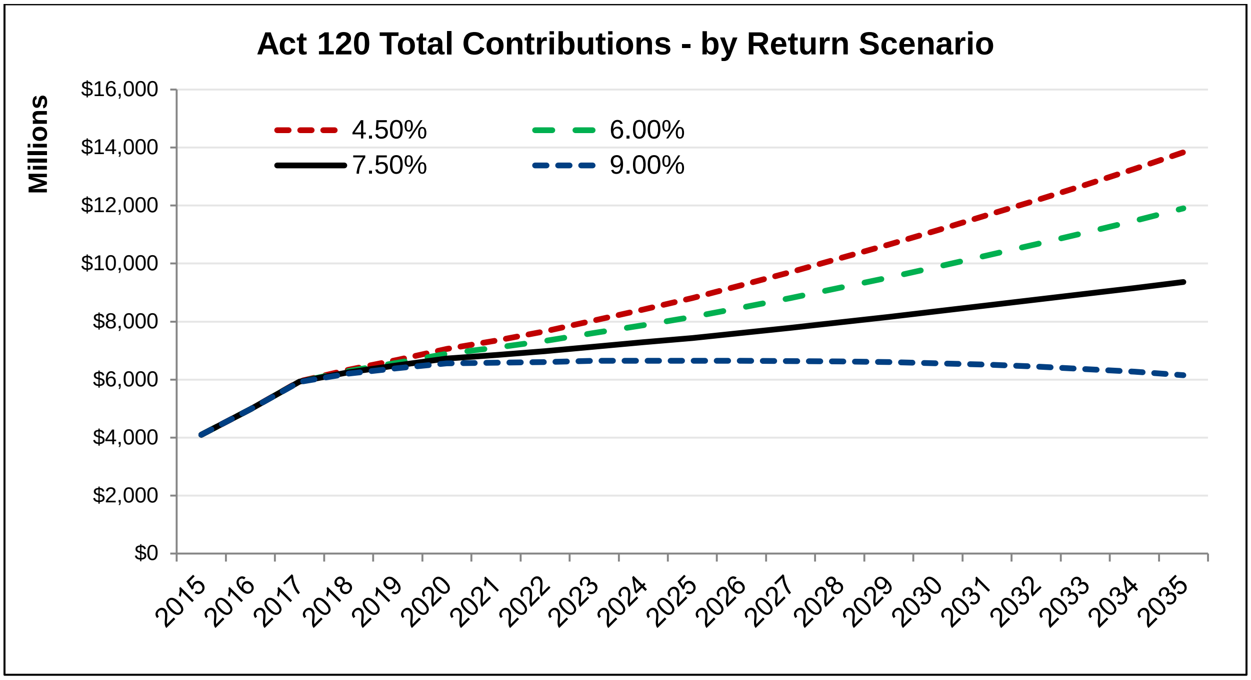
Source: Data from actuarial reports; analysis by The Pew Charitable Trusts and The Terry Group

- **Historic ARC Payments 1997 – 2013 (SERS and PSERS Combined)**



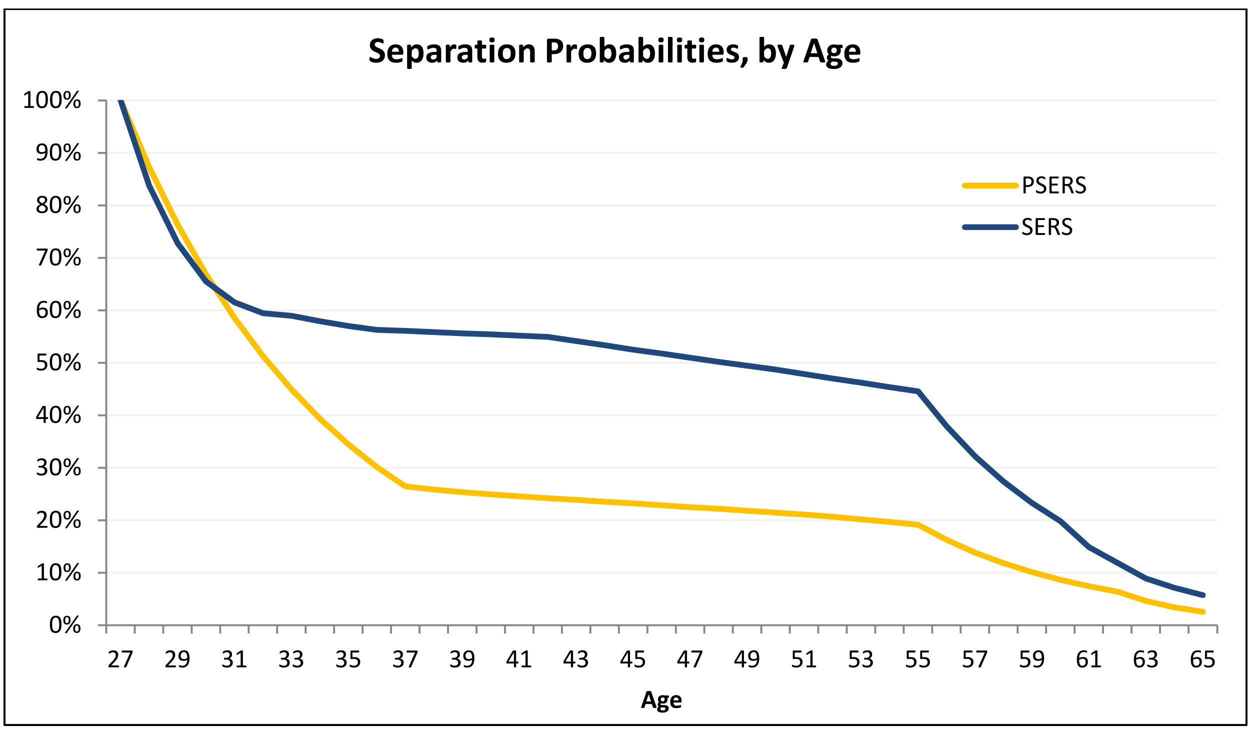
Source: Data from actuarial reports

- **Act 120 Cost Variability**



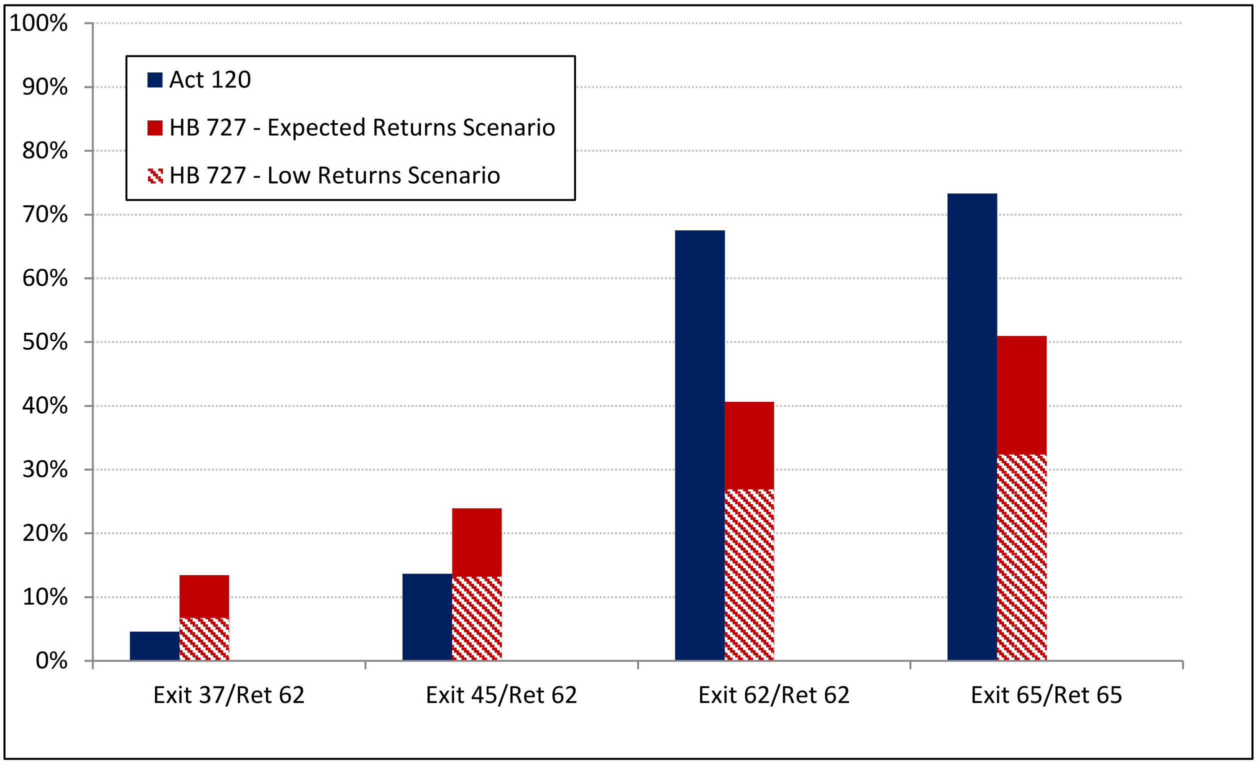
Source: Data from actuarial reports; analysis by The Pew Charitable Trusts and The Terry Group

- **PA Employee Attrition**



Source: Data from actuarial reports; analysis by The Pew Charitable Trusts and The Terry Group

- **PSERS Replacement Income Rate, by Exit Age – Act 120, DC (HB 727)**
  Percent of Final Salary Provided by Retirement Benefit
  (Not including Social Security; Employee starting at age 27)



Source: Data from actuarial reports; analysis by The Pew Charitable Trusts and The Terry Group

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Pension Promises in Other States – No One Size Fits All

WA:
- 95% funded
- Optional hybrid plan started in 1978

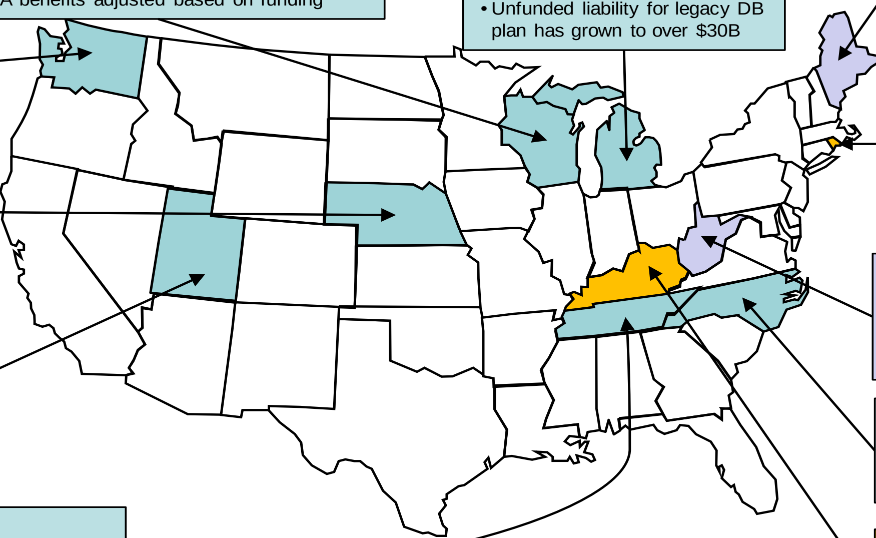
WI:
- 99% funded DB plan
- Full ARC payment made since 2003
- COLA benefits adjusted based on funding

MI:
- State employees are in a DC plan; teachers are in a hybrid
- Unfunded liability for legacy DB plan has grown to over $30B

ME:
- Constitutional amendment for full funding in 1997
- Improved funding from 63% to 80% since 1997

RI:
- 2011 reform transitioned workers to hybrid plan
- Underfunded despite making ARC payments in recent years
- Reform reduced pension debt by approximately $3 billion*

NE:
- Switched from DC to cash balance plan in 2002
- Change from DC was to improve worker retirement security



UT:
- Hybrid or DC option for new workers
- Fixed employer contribution of 10%

WV:
- From 1997 through 2013 put in more than required contribution
- Improved funding from 45% to 65% since 2000

NC:
- Final average salary DB plan.
- Funding dropped to 94% following Great Recession but now picking up

TN:
- 95% funded
- Hybrid plan for new workers
- Total employer contribution of 9%
- Strong funding practices and cost control features on DB

KY:
- State plan just 23% funded with a history of missed payments
- 2013 reform increased contributions
- New workers in cash balance plan

Twenty-two states have implemented a hybrid, cash balance, or defined contribution plan for some workers. Fourteen states have implemented alternative designs that are mandatory for certain groups of workers, while eight states have plans that workers may choose as an option to the traditional defined benefit plan.
**Aspects of the Rhode Island reform are being litigated..*

- **Provisions of Most Common Hybrid Plan Design**

	DB Multiplier	Employer Cont. to DC	Default Employee Cont. to DC	Number of Investment Options	Annuity Offered for the DC?
Georgia Employees' Retirement System	1%	3% matching (0% mandatory)	5% as of July 1, 2014 (optional)	21	No
TN Consolidated Retirement System	1%	5% (5% mandatory)	2% (optional)	26	No
Rhode Island Employee Retirement System (state and teachers)	1%	1% (1% mandatory)	5% (mandatory)	22	Yes
Virginia Retirement System	1%	3.5% matching (1% mandatory)	1% (mandatory)	21	Yes
Federal Government Retirement System	1%	5% matching (1% mandatory)	3% (optional)	10	Yes

Source: State and federal government plan documentation

- **Provisions of Defined Contribution Plans in Other States**

	Status	Default Employee Contribution	Default Employer Contribution	Total Default Contribution	Covered by Social Security	Vesting
Alaska Teachers Retirement Plan	Enacted 2006	8%	7%	15%	No	5 years, gradual
Alaska Public Employees Retirement System	Enacted 2006	8%	5%	13%	No	5 years, gradual
Michigan State Employees Retirement System	Enacted 1997	3%	7%	10%	Yes	4 years, gradual
Nebraska State Employees Retirement System	1967-2002	4.33% - 4.8%	6.75%-7.49%	11%-12%	Yes	5 years
Nebraska County Employees Retirement System	1967-2002	4%	6%	10%	Yes	5 years
West Virginia Teachers' Defined Contribution Retirement System	1991-2005	4.5%	7.5%	12%	Yes	12 years, gradual

Source: State plan documentation