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Governor's Pension Reform: Does It Have a Chance?

Well, it is here; the Governor's plan to stop the impending budget calamity created by unfunded pension liabilities. To be sure, the far reaching proposals face a very uncertain future in the Legislature.

A little background. In the fall of 2012 the Pennsylvania Office of the Budget released "The Keystone Pension Report" detailing the steps that have produced a $41 billion unfunded liability for the state's pension plans covering state workers (SERS) and school employees (PSERS). The report also offered suggestions as to how the state might begin a process of addressing the enormous unfunded liability.

Although no specific reforms were recommended by the report—a pension reform proposal was to come, and did, as part of the FY 2013-14 budget address—there was a five point framework for change:

1. Taxpayers would be put first.
2. Retirees who had earned their pension would see no changes.
3. Current employees would not have their accrued benefits touched but "components of current employee's prospective benefit" could be altered.
4. The costs should not be shifted to the future.
5. Experience from other states should be studied.

The Governor's reform proposals, as spelled out in the 2013-2014 Executive Budget, match up fairly closely with the framework set out by the Keystone Report. Explicitly, there was no mention of a tax increase to fund pensions, so point one was clearly satisfied. The benefits earned by retirees would remain unchanged and the benefit plan for current SERS and PSERS members would remain the same until 2015. However, at that point, a lower multiplier for pension benefits, 2 percent times years of service, would be used instead of 2.5 percent unless the employee elected to contribute an amount sufficient to keep the multiplier at 2.5. An average of the last five years of compensation would determine the basis of pension payments. Further, pensionable compensation would be capped at 110 percent of the average salary of the prior four years when determining final average earnings. Then too, the Governor's proposal would place a cap on the pensionable income at the maximum Social Security income on which contributions are made and benefits calculated. Thus, the reform plan has largely adopted points two and three of the framework with much detail on the changes to future pension benefits for current employees.

To point four, the Keystone Report stated "…any short-term prospective budget relief should be paid for by long-term reforms…" The same year when the alterations to future benefits for SERS

and PSERS members are to go into effect all new hires will be enrolled in a defined contribution plan with SERS members contributing 6.25 percent of pay and PSERS members putting in 7.5 percent. Basically, the state would be closing enrollment in the defined benefit plans offered by the systems (as of 2011 there were a combined 589,000 active, retired, and vested but inactive members) and placing new hires in a 401(a) system. As members of the defined benefit plan retire and new employees come in the hope is that the costs of the pension system come down, albeit gradually.

Lastly, the Keystone Report looked at reforms made in other states in 2010, 2011, and 2012 and classified them along the lines of "strategy" (whether the state was asking for higher employee contributions, raising retirement age or service time, and switching from a defined benefit plan to a defined contribution or hybrid plan) and who the reform(s) affected: new employees or both new and current employees. Much of that analysis came from the National Conference of State Legislatures which has for many years detailed statewide pension reform plans. In 2012, Louisiana, Kansas, and Wyoming among others set into motion plans that would close existing defined benefit plans to new employees or create new tiers with higher age and service requirements for new hires.

Interestingly, not all change is happening at the state level. In 2012, the California cities of San Diego and San Jose both had local ballot measures to amend their city charters' language on retirement benefits. In San Diego, voters approved a ballot question that (1) would put all new hires, with the exception of police officers, into a defined contribution plan, (2) permit the City to seek limits on what constitutes employee compensation (through bargaining and negotiation) for pension calculations, and (3) eliminate the ability of current and former employees to vote to change their benefits. The San Diego Councilman who spearheaded the reform movement argues strongly that only base salary should figure in pension benefit calculations while factors such as overtime, longevity pay, etc., should play no role in pension benefits.

In San Jose, voters approved a question that would require employees to pay more into their pensions or voluntarily move to a plan with reduced benefits, limit benefits for new hires, and require voter approval for increases to future pension benefits. The reforms, even though receiving a comfortable majority, face court challenges.

Keep in mind that this is just the proposal stage and that the Governor has stayed true to the ideas laid out in the Keystone Report. It is up to the General Assembly to debate, modify and possibly enact the proposals. Then Pennsylvanians will see what, if any, the reforms can look like. Would the General Assembly decide to put the issue of pension reform in front of Pennsylvania voters such as happened in cities in California? The last time a ballot question related to pensions went before the voters was in 1981 when voters were asked if the state Constitution should be amended to allow spouses to partake of increases to benefits so long as the finances of each system extending the benefits were actuarially sound. It was defeated.

And how will members react when hearing from public sector unions, who, not surprisingly, have decried the proposals in the strongest terms? A state employee union stated in a press release that by proposing a defined contribution system for new hires the Governor is "…trading the promise of retirement security for retirement insecurity" and wants to give the Act 120 legislation more time to work. The teachers' union stated that the "…proposal includes costly, unconstitutional changes that won't solve the pension crisis, but will reduce your pension benefits and weaken the retirement security that you earned and you paid for." That statement is quite ironic in that the entire motivation for the reform effort is the huge increase in taxpayer funding that will be required to meet the pension obligations.

At this point it is important to ask whether the Constitution's language means that something passed in a prior legislative session can create a suicide pact for future ones. According to the Keystone Report the causes of the massive pension problem can be traced to promises made by laws passed in 2001, 2002 and 2003. What does the Constitution say about this predicament? Article 1, Section 17 prohibits the General Assembly from passing laws impairing contracts. Further language in Article 3, Section 26 says that "…nothing in this Constitution shall be construed to prohibit the General Assembly from authorizing the increase of retirement allowances or pensions of members of a retirement or pension system now in effect or hereafter legally constituted by the Commonwealth…"

So what does that mean? To the first section, the state's Municipal Pension Handbook notes that "the Pennsylvania Supreme Court has applied [this principle] to the rights of public employees in their pensions…as such, once a public employee has worked even a single day, he or she has not only earned that day's pay but a guaranteed right to such future pay that formed part of the employer's promise of compensation". On the second, the implication is that when times are good the Legislature could increase pensions but there is no language that allows for a decrease or a cut in a situation like the one faced by SERS and PSERS now. Obviously, the richer benefits should never have been granted because when the bill comes due as it has, the difficulties in undoing the damage will prove virtually insurmountable.

The question is: if it comes to a court battle, how will the judiciary interpret a plan in which the benefits earned up to a certain point are not reduced, but the pension benefits accruing based on future earnings beyond that point are reduced? Would the courts rule that the Constitutional sanctity of contracts has been trampled? If so, where do taxpayers go for relief from the ill-considered actions of earlier Legislatures? Protection of employees is important, but in the private sector, when the pension benefit costs are threatening a company's survival, relief can be sought through bankruptcy. State and local governments as well as school districts in Pennsylvania are effectively denied that option.

Moreover, if a Constitutional amendment becomes necessary to overcome the problem, it will almost certainly never get the required votes in the General Assembly to go on a ballot and voters have no right to petition the Commonwealth for a referendum. And even if the Constitution were to be amended, could the new language ex post facto overturn provisions in currently existing contracts or "employer promises"?

If the pension reform fails, the "Pac-Man" or "tapeworm", as the Governor's report characterizes the increasing share of the budget going to cover unfunded pension fund liabilities, will eat away at other portions of the state budget. If the reforms are enacted the proposal envisions that the employer contribution rates will be lowered from an expected 4.5 percent to 2.25 percent in 2013-14, rising by a half a percent per year thereafter. This is instead of rising 4.5 percent per year to top out at close to 30 percent by fiscal year 2016-17.

It should be incumbent on those persons and groups who view pensions as sacrosanct and inviolate to suggest areas of the budget that can be cut substantially in order to satisfy the pension plans' need for ever more finding.

One thing is certain, with the crucial funding requirements for highways and bridges demanding more tax dollars, and with the state's taxpayers already taxed heavily by state and local governments and school districts, asking for additional billions of dollars in revenue to cover pensions is simply not politically or economically prudent. If all meaningful reforms in the state's

two big pension plans are blocked and no significant reductions in costs are forthcoming, there will be no choice for the state and school districts but to begin slashing other personnel costs. Fewer employees, lower contributions to the generous health care benefits, fewer sick day allowances, heavier workloads, pay freezes, etc., will have to be on the table. Employees with the least seniority will take the brunt of the hits given the rules governing layoffs in most contracts.

There is no free lunch. Taxpayers cannot afford the massive additional pension burden that is coming and some relaxation of objections to all attempts to stem the tide of increasing pension fund allocations must be in the offing. Insistence on the status quo will lead to a raft of problems the opponents of reform will not like. The divisions between government employees and taxpayers will almost certainly widen and grow increasingly bitter.

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