POLICY BRIEF
An electronic publication of
The Allegheny Institute for Public Policy

April 5, 2010 **Volume 10, Number 18**

Are Public Pensions Becoming a Financial Suicide Pact?

Here are two hard and uncomfortable truths about public pensions that will undoubtedly play an enormous role on policy and legislative decisions by the state and local governments in coming years:

First, the PA constitution prohibits the unilateral removal of pension benefits by statute, ordinance, or similar action. That means the General Assembly and myriad local councils cannot simply pass a law to eliminate or reduce the burden of unfunded liabilities accumulated as a result of past contractual promises. The "Municipal Pension Handbook" for Pennsylvania notes that "once a public employee has worked even a single day, he or she has not only earned that day's pay but also the guaranteed right to such future pay that formed part of the employer's promise of compensation". Unless done so by voluntary means— through a collective bargaining agreement—or by the commission of a crime punishable under the Public Employee Pension Forfeiture Act, the benefits cannot be taken away.

Second, even by closing or freezing membership in an existing defined benefit plan and offering a defined contribution plan to all new employees does not mean that the long-term obligations will be lowered. Here's how the Manhattan Institute's urban policy center Cities on a Hill described the issue:

> *"A [401k] plan does not reduce the legacy costs of the traditional pension system. The disturbing but inescapable bottom line: in the short term, even after closing the plans to new entrants, there is no fiscally prudent way for cities and states to avoid higher defined benefit pension bills in the near future without unfairly shifting a massive burden to future taxpayers and jeopardizing their own financial stability and growth in the process"*

This is demonstrated locally by the City of Pittsburgh's decision to end retiree health care coverage for those police and fire personnel hired after January 1, 2005. There are no new employees eligible for retiree health benefits, yet the City still reports an unfunded liability of $360 million with no assets set aside to cover the expense.

The problems associated with public pensions are not limited to Pennsylvania, they are becoming serious issues in states and municipalities across the country for the same reasons they are becoming one of our most pressing policy problems.

We have already started to see the product of these two public pension truths: Philadelphia was able to gain state permission to levy an additional point on its 7 percent sales tax for pension funding; Pittsburgh is engaged in a lease process to turn its parking garages over to a private lessee in order to get an up front lump sum for its pension liability. If Pittsburgh's efforts are successful (the funds need an infusion of about $200 million to get to 50% funded) they can increase the parking tax for pension purposes; if they are not successful the state of Pennsylvania will take over administration of the plans.

That's the status of the state's two largest municipalities: there are many others that have underfunded pensions that are in trouble. But bear in mind the looming issues with the school teachers' pension plan (PSERS) and state workers' pension plan (SERS) that are expected to experience spikes in taxpayer contribution in a couple of years.

The remedies? Either stretch out the time period in which losses materialize (that option has been used and may no longer be viable), enact new or higher taxes for pension payments, or move to a uniform pension plan for all classes of employees that is based on a 401k model, all the while realizing that, as mentioned above, the new model will not eliminate existing liabilities and will relieve the problem only after several years.

That does not mean it is not useful but rather that it is not a magic bullet. Indeed, there are cases where the situation worsened as contributions from new employees were not available to shore up the funds. As pointed out in a March 15th article in *Barron's* "a dozen or so states…are attempting reforms such as raising retirement ages, cutting pension benefit formulas, boosting employee contributions, curbing income 'spiking' and partially switching employees to less costly defined contribution plans. But these changes affect almost exclusively new employees and do little to solve the existing funding gap".

So the double bind that exists in Pennsylvania—pension benefits that are essentially guaranteed and no pain free way to get out from under obligations—can present a dilemma for government. Do they pledge fealty to public pensions above all else, including day-to-day services? Said another way, do they tax themselves out of existence in order to pay for pensions?

Realizing some additional facts in this matter is also important. One, public sector unions will vehemently resist any type of incremental change that moves the pension system toward a defined contribution model (as just happened this past fall when there was a movement to reform municipal pensions) or requests for benefit givebacks. Two, the General Assembly is not likely to enact a new pension policy, or push for a Constitutional amendment that removes the language that makes pension benefits sacrosanct. Three, all that remains is Chapter 9 bankruptcy and a readjustment of debts including dealing with retirement obligations.

Under current Pennsylvania law, school districts cannot file for Chapter 9 (bankruptcy procedures flow through Act 47, which only applies to municipalities) and they will bear a significant burden of the PSERS contribution spike being forecast. The statutorily prescribed method for municipal entry into bankruptcy is to be first declared distressed under Act 47, and then with approval of the DCED Secretary and/or the Governor the municipality could file for bankruptcy.

With pension driven fiscal crises looming on the horizon, it appears the time has come for the Legislature to consider granting schools the bankruptcy option and to streamline procedures municipalities must use to file for bankruptcy. Kicking the metaphorical can down the road will only make the eventual solution more painful.

Having the option of bankruptcy more readily accessible could provide municipalities with the bargaining power necessary to obtain concessions from employees sufficient to prevent debilitating tax increases or deep service cuts. So, what's it going to be?

Eric Montarti, Senior Policy Analyst **Jake Haulk, Ph.D., President**

For more information about this and other topics, please visit our website:
www.alleghenyinstitute.org

Allegheny Institute for Public Policy
305 Mt. Lebanon Blvd.* Suite 208* Pittsburgh PA 15234
Phone (412) 440-0079 * Fax (412) 440-0085
E-mail: aipp@alleghenyinstitute.org