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Pa. begins long climb back to adequate pension funding

Summary: This month newly hired state workers will choose from one of three pension benefit options, all containing a defined contribution element. This is a result of Act 5 of 2017, which will affect new public school employees starting later this year. While Pennsylvania's pension plans were once in strong funding shape, they fell relative to other states for reasons explained by a commission created by the same legislation.

Once upon a time, back in the early 2000s, the funding ratios of Pennsylvania's two state-level pension systems—the State Employees' Retirement System (SERS) and the Public School Employees' Retirement System (PSERS)—were in enviable shape. The combined assets of the plans exceeded the liabilities and the result was a funding ratio of over 100 percent.

Yet as of June 30, 2017, the combined ratio hovered around 58 percent. Based on a ranking of states based on the aggregate funding ratio of their pension plans, the Pew Charitable Trusts placed Pennsylvania 44th. The funding ratio was 20 points better than the combined seven plans administered by New Jersey, which was ranked last, as well as plans in Kentucky, Illinois and three other states but a far cry from the ratios in Wisconsin, South Dakota, Tennessee and New York, which were above 90 percent funded based on their ratios.

According to Pew pension data in years from the mid-1990s to the mid-2000s the state made 100 percent (or more) of the actuarially required contribution, but then the contribution fell to 50 percent and is now back to 100 percent as of 2017. Other well-funded states likely did not diverge from making required contributions. In 2009, while Wisconsin contributed 108 percent of its required contribution, Pennsylvania put in 31 percent.

So what happened? The reasons are well known by now but were recently articulated in a report of the Public Pension Management and Asset Investment Review Commission (the commission), created by Act 5. The report stated "the unfunded pension liability was not a sudden occurrence. Rather it was the direct and foreseeable consequence of past policy decisions, principally deferring actuarially determined contributions as well as investment

underperformance." Laws passed in 2001 (Act 9), 2002 (Act 38) and 2003 (Act 40) that provided a substantial increase in pension benefits, lowered the vesting period, gave a cost-of-living increase to retirees and capped employer contributions and spread out obligations are primarily pinpointed as a major cause of the current situation. The report shows that the largest contribution deficit came right at the time of the 2008 recession.

The commission, in analyzing the 2017 unfunded liability of $44 billion for PSERS, attributes $18.3 billion (41 percent) to "employer underfunding," $16.2 billion (37 percent) to "investment performance," $7.8 billion (18 percent) to "benefit enhancements" and $2 billion (4 percent) to "changes to actuarial components." Employer contributions for both PSERS and SERS totaled $5.8 billion in fiscal year 2016-17.

The thrust of Act 5 is to place new hires (with the exception of those classified as hazardous duty) of SERS (starting Jan. 1, 2019) and PSERS (starting July 1, 2019) into one of three pension tiers of the employees' choosing. Two are hybrid plans that combine aspects of both defined benefit and defined contribution plans and one is a pure defined contribution plan. For these employees there will be no standalone defined benefit plan. There will be a higher retirement age and a longer time period to calculate final average salary.

Based on an analysis for prospective SERS members, an employee who would work for 35 years with an average salary of $40,000 that chooses one of the two hybrid plans would retire with somewhere between a $14,000 to $17,500 annual pension and an investment lump sum of $165,244. One choosing the defined contribution plan would retire with a $330,448 lump sum.

Under current projections the funding ratios of SERS and PSERS are to reach into the 70 percent range by 2030 and to nearly 100 percent by 2040. Separate from the benefit changes the commission recommended changes related to funding, stress testing, transparency and investing and asset allocation. The commission members estimate implementation of the recommendations—whether through legislative, executive or pension board actions—would lead to savings of $2.8 billion to $3.4 billion on a present value basis over a 30-year period. That depends on whether the suggested actions are carried out.

Since states cannot declare bankruptcy and state courts have interpreted the Pennsylvania Constitution's language on contract impairment to apply to the pension benefits of employees once they commence service, the impact of pension benefit changes fall on new hires. Even if municipalities or school districts could enter into bankruptcy, the contract impairment provision would force them to make promised pension payments. Thus the biggest cause for contemplating bankruptcy, pension costs, would remain in bankruptcy.

Locally Pittsburgh, Allegheny County and the Port Authority have undergone changes to pensions and/or other post-employment benefits that solely affected new hires after a certain date of taking employment.

Too bad it took this long to get public employees of the state and school districts into pension plans that involve defined contribution. Hopefully the change will benefit taxpayers after several years, many of whom have seen their school districts raise taxes for several years to meet pension funding obligations. And tax hikes for 2019-20 are quite likely because of pensions and other benefits.

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