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Step two of state pension reform commences

Summary: On July 1 the transition to new pension benefits for the Public School Employees' Retirement System (PSERS) took effect. Under the terms of Act 5 of 2017, new hires will be placed into a hybrid pension plan or can opt-in to a different hybrid plan or a pure defined-contribution plan.

Hybrid plans combine aspects of defined benefit (based on a formula that considers compensation, years of service and age) and defined contribution (based on money that accumulates in an account with contributions from employer and employee and investment performance) plans.

According to a study by the National Association of State Retirement Administrators, from 2009 to 2018 eight states, including Pennsylvania, created hybrid plans to apply to new state, local and/or public school employees. While Pennsylvania also created an optional defined-contribution plan, only Oklahoma mandated that type of plan for new hires.

New Pension Plans, 2009-18

State	State Employees	Local Employees	Public School Employees	New Hires Began Entering in...
UT	x	x	x	2011
MI			x	2012
RI	x	x	x	2012
TN	x	x	x	2014
VA	x	x	x	2014
OK	x			2015
AZ	x	x		2017
CT	x			2017
PA	x		x	2019

A Pew Charitable Trusts report noted that in 2017 eight states had a funding ratio of 90 percent or higher. The only states to overlap with new plans, and this level of funding health, were Tennessee and Utah. States that "consistently made full actuarial contributions in good financial times and bad and followed sound risk-management policies that allowed them to weather the volatility from investment and other risks" found themselves at the top of the list.

But not Pennsylvania. The Public Pension Management and Asset Investment Review Commission noted "the unfunded pension liability was the direct and foreseeable consequence of past policy decisions, principally deferring actuarially determined contributions as well as investment underperformance." For the last four years the full actuarial-required contribution has been made, a step that, along with employee contributions and investment income, "are all necessary sources of funds that will pay down the unfunded liability of the System," according to the 2018 PSERS actuarial report.

So what happens in the 2019-20 fiscal year for PSERS? The actuarially determined employer contribution rate is 34.29 percent which equates to an estimated $4.8 billion statewide. School districts pay the full contribution rate and then receive a minimum 50 percent reimbursement from the state.

In fiscal year 2017-18, when the contribution rate was 32.57 percent, the 43 districts in Allegheny County paid a total of $383 million in retirement contributions and received $199 million in total reimbursements. The dollar amounts will be higher this year. As the contribution rate grows school property tax increases can follow. Several of the 23 Allegheny County districts that raised taxes for this year noted the higher contribution rate as part of the reason for the hike.

The estimated employee contributions for 2019-20 are $1.0 billion and investment returns will provide the remainder of PSERS funding, which in fiscal year 2017-18 had a 9.27 percent rate of return.

According to a PSERS presentation, a new hire with a $40,000 starting salary receiving annual pay increases of 3 percent and working for 35 years would receive a total retirement benefit of $861,721 in the default hybrid plan. This is compared to $758,243 in the other hybrid and $748,243 in the defined-contribution plan. In other salary and longevity scenarios the defined-contribution plan produces a benefit greater than the second optional hybrid, mostly for those leaving after eight years.

It is too early to know what will happen with new PSERS members. But there is preliminary data on the new hires of the State Employees' Retirement System (SERS), who began entering under a similar arrangement in January. Data from the first three months of 2019 show that most stayed in the default hybrid or chose the other hybrid over the defined-contribution plan—1,900 to 36 new employees.

Existing employees of SERS were given a window of time to leave their defined-benefit pension plan and join one of the new options created by Act 5. Only 70 did (SERS has over 103,000 active members) with 65 choosing the defined-contribution plan. Of the 218 members of the General Assembly that take pension benefits, only 20 switched from the defined-benefit plan with all choosing to enroll in the defined-contribution plan. PSERS members who were hired prior to July 1 will have the same opportunity for a limited period of time to switch to one of the Act 5 options.

Too bad it took so long for Pennsylvania to get public employees into pension plans that involve defined contribution. We have long advocated for such a change for new hires. Over the longer term, fiscal stability should be achieved—absent tinkering that reverses any progress.

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