

Testimony
of the
Pennsylvania State Education Association (PSEA)

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By
James P. Testerman
PSEA President

Good morning, Chairman Browne, Chairman Ferlo, and members the Senate Finance Committee. My name is James Testerman. I am a middle school science teacher currently on leave from Central York School District while I serve my elected term as President of the Pennsylvania State Education Association (PSEA). On behalf of PSEA's 191,000 members representing all aspects of education services throughout Pennsylvania, thank you for inviting me to share our views on the critical issue of the Commonwealth's pension system for public servants.

In my decades of involvement with PSEA, I have never seen an issue motivate our members more than the issue of preserving retirement security now and into the future. I'll share with you four important truths that are motivating our members to speak out:

1. The current defined benefit pension plan is critical for recruiting and retaining quality public school employees, which benefits students, their families, and their communities.
2. The pending spike in employer payments is primarily the result of significant losses in investment returns and a lack of state and district funding.
3. School employees have never stopped making their pension contributions. But because of decisions made in previous legislative sessions, school districts and the state have not paid their fair share in any of the last 10 years.
4. Many of the "solutions" being discussed make for good sound bites but will do nothing to lessen the projected payment increase, and are actually long-term problems that will hurt the ability to attract and retain quality education professionals over the long term.

PSEA understands the seriousness of this issue and stands ready to assist you in developing a responsible plan to address the funding crisis and protect the solvency of the Public School Employees' Retirement System (PSERS) fund. There are no easy solutions, but one thing is clear: The state and school districts must keep their promise to fully fund school employees' pension plans.

My comments today will primarily focus on PSERS because the majority of our members are employed by local education agencies and therefore belong to PSERS. We also, however, have members who work for the Commonwealth and participate in the State Employees' Retirement System (SERS) so our comments will apply in large part to SERS as well.

The PSERS benefit plan encourages individuals to become and remain educators, thereby ensuring a stable and highly qualified workforce in our public schools. It promises public school employees a secure and predictable lifetime annuity in retirement that is based on their salary and years of service.

Funding for PSERS comes from three sources: (1) Employers, as represented by the Commonwealth, and school districts; (2) school employees, and; (3) earnings on investments. Prior to 2001, the Commonwealth, school districts, and employees each picked up about one-third of the cost. The combined employer pension rate averaged 12.67 percent between 1960 and 2001; and, the employee rate prior to 2001 was 6.25 percent.

The system was working well, and the General Assembly was even able to grant periodic cost-of-living adjustments to retirees, as well as a series of “30 and out” early retirement windows.

During the late 1990s, PSERS saw average earnings of 15 percent each year over a five-year period. This resulted in the system becoming 123 percent funded and a falling employer pension rate. As a result of the overfunding, PSERS indicated in December 2000 that the employer pension rate for the 2001-2002 school year would be zero, effectively eliminating one of the largest line items in the state budget.

The General Assembly passed Act 9 in May 2001. Act 9 increased the pension multiplier from 2 to 2.5 for all public school employees, and did so retroactively.

The cost of this benefit moving forward was to be paid mainly by employees with a 1.25 percent increase in the school employee contribution rate to 7.5 percent. The retroactive portion of the increase attributable to previous years of school service became part of PSERS’ unfunded accrued liability, but this cost was offset by the extraordinary investment gains in the late 1990s.

Like many other pension funds, PSERS suffered significant losses in 2001-2003 as the recession hit the nation. As a result, the employer pension rate was projected to return to its previous higher levels.

However, in 2002, and then again in 2003, the General Assembly passed legislation to push off paying pension liabilities in order to maintain an artificially low employer pension rate. This legislation also included a Cost of Living Adjustment (COLA).

The deferral of the rate hike and the COLA both added to PSERS unfunded accrued liability.

The problem continued to build, and the pension rate was set to spike even higher in 2003-2004. Then, in 2003, the General Assembly passed Act 40, which was intended to keep the employer contribution rate artificially low until 2012. Act 40 took the unfunded accrued liabilities associated with both Act 9 and the investment losses incurred in 2001 and 2002, and re-amortized them, along with any future changes in the unfunded accrued liability over 30 years. Meanwhile, the credits associated with investment gains in the 1990s were left on the books to be amortized over 10 years.

This effectively subsidized the employer contribution rate, keeping it at an artificially low level until the credits rolled off the books in 2012.

Four years of positive investment returns followed Act 40, providing false hope to some that PSERS could grow its way out of the problem. In fact, on June 30, 2007, near the height of the financial markets, the market value of assets at PSERS was about equal to its liabilities. The unfunded accrued liability was reduced by PSERS’ strong earnings.

However, the current economic downturn hit hard, with PSERS suffering significant investment losses over the last two years. PSERS’ unfunded accrued liability has increased to new levels.

And, as a result of this series of actions, we are sitting here today with a rate spike projected for 2012 that has grown to nearly 30 percent.

PSEA has been concerned about the situation since talk of a pending crisis of underfunding for PSERS and SERS arose. In fact, members of the Committee who have been here for a few years might remember PSEA's previous testimony that raised two giant warning flags.

The Joint State Government Commission indicated in 2004 that without contributions set at a rate to cover normal costs, funding pressures would increase. In addition, a performance audit conducted by Pennsylvania's Auditor General found that PSERS and SERS were professionally administered, but warned of "looming deficits by 2012 if steps are not taken to shore up their finances."

Despite these and other warnings, the employer pension rate has averaged 3.53 percent from 2001 to today. As a result, PSERS funding level has dropped from 123 percent to less than 80 percent, as employers have continued on a "pension holiday," and there were no reserves built up to help sustain the system during the recent market crash.

All pension plans, public and private, are dealing with the impact of investment losses in 2008 and 2009.

This was, after all, the biggest collapse in the financial markets since the Great Depression. Most plans are facing increased employer rates, and the situation is worse in those states that have historically underfunded their pension systems.

While Pennsylvania is not the only state facing a pension funding crisis, Pennsylvania's situation in 2012 is worse than in most other states because our state deferred any pension rate increases following the 2001-2003 recession until 2012. We now have to deal with the cost of two recessions, plus the impact of employer underfunding, all coming due at one time. This problem is unique to Pennsylvania. It was legislatively created and not a function of standard pension accounting.

It is important to understand and remember these facts and this history as we work together to find solutions to the challenges of today.

So what are the options?

We have heard solutions that fall into three categories:

1. PSEA believes that the Commonwealth must keep its promise to keep its public pension funds solvent and strong for current and future retirees. However, we recognize that, particularly in this economy, it is unlikely that the full payment can be paid in one year, as was contemplated by a previous General Assembly.

2. The General Assembly could abandon the current system for a defined contribution plan, or slash benefits in the current plan.

These are “silver bullet” solutions that make good sound bites, but would have absolutely no impact on the pension spike. Even if retirement benefits were totally eliminated for all new school employees – mind you not something I am advocating - the pension spike would still exist. It is caused by costs that have been deferred by previous General Assemblies and still must be paid.

In particular, any potential savings from putting all new employees in a defined contribution plan would be 30 years away, but the costs of running two separate plans would start immediately.

I urge you to consider the unintended negative costs to the education profession and the Commonwealth, which would start immediately accruing. Defined benefit pension plans are not just better for the employees you represent, they are also better for employers. Investment returns in a defined benefit plan cover a large portion of retiree pension obligations. These plans also cost half as much to administer as defined contribution plans; reduce turnover, which contributes to a stable learning environment for children; and provide employee dollars for the Pennsylvania economy, business, and job creation.

3. The General Assembly could further defer liabilities.

In discussing unfunded accrued liabilities, we need to remember it is a case of pay the bill now or pay it later. We are sitting here today mainly because previous General Assemblies decided to pay the bill later. While PSEA has serious concerns over further deferring liabilities, we are also realists.

We urge you to look closely at several changes that comply with government accounting standards to reduce the level of contributions necessary in 2012. These range from extending the smoothing period used to determine the actuarial value of assets to the reamortization of PSERS unfunded liabilities, which would be much like refinancing your home to get some cost savings by extending the terms of payment. We are aware that PSERS has looked at many of these options, and a combination of them can substantially lower the level of the 2012 spike.

PSEA urges the Senate Finance Committee to do some work on these solutions, assess them, and examine the impact on the pension spike. We expect that any final plan will probably include some changes in each area.

While offering support in your efforts, we would like to offer a warning too. The members of PSEA cannot accept any resolution of the current problem that is similar to those adopted in 2002 and 2003 when pension costs were simply kicked down the road for someone else to pay.

Please keep in mind that the majority of our members have been contributing at a rate of 7.5 percent since 2001. Over the last 10 years, they have paid more than \$7.3 million into PSERS, while their employers, the state and school districts combined, have only paid in \$3.765 million, about half as much. This employer underfunding has helped to create the current pension crisis and will only serve to magnify it if it continues. Deferring pension liabilities within generally accepted accounting standards can be part of a comprehensive solution, but we cannot accept it as the full solution. The state and the school districts have to step up to the plate and begin to pay their share.

It is also important for you to know that our members see harm to the retirement security of future employees as harm to them and to our profession. Courts have ruled that our current members' pension benefits are constitutionally protected against impairment. But we know that a severe reduction in benefits for future employees would also have a devastating effect on current employees and our profession.

We have heard from PSERS and SERS that pension costs are projected to spike into the billions of dollars. Rates are now projected to start climbing before 2012. This will all hit at the same time that the federal stimulus dollars the state has received from the American Recovery and Reinvestment Act of 2009 are set to expire.

PSEA is well aware of the implications for our state, school districts, and taxpayers.

We stand ready to work with you to ensure that you fully consider the impact on school employees of any changes you adopt. Our members trust that you will make informed and responsible decisions about the future of the fund into which they contributed to achieve the promise of a secure retirement.

Thank you for the opportunity to testify on this important issue.

What happened?

Why are Pennsylvania's pension costs expected to increase in 2012?

The General Assembly made decisions in 2001, 2002 and 2003 that provided employers with an Employer Contribution holiday. School districts and the Commonwealth have not paid their fair share in any of the last 10 years, making the Pennsylvania Public School Employees' Retirement System (PSERS) vulnerable to downturns in the financial markets. **During this holiday, school employees never stopped contributing to PSERS – the pension fund that provides school employees with their retirement security.**

Now the holiday is almost over, and employer costs for are expected to significantly increase in 2012. Why?

The history of pension funding needs to be understood in order to craft an appropriate solution and to ensure that the same mistakes are not repeated. Some key points:

- 1) On June 30, 2000, PSERS was determined to be 123 percent funded, following five years in which PSERS investment returns averaged more than 15 percent every year. As a result of the overfunding, PSERS indicated in December 2000 that the employer contribution rate for the 2001-2002 school year would be zero, effectively eliminating one of the largest line items in the state budget.

Note: From 1960 until 2001, total contributions for PSERS were divided almost equally among the Commonwealth, districts, and school employees. During this period, the average employer contribution rate was 13.9 percent of payroll, with a high of 20 percent in 1985. In 2002, the employer contribution rate was zero percent and in 2003 it was only 0.18 percent of payroll. In comparison, the employee contribution rate increased 20 percent in 2001, and over the last decade school employees have contributed almost twice as much as school districts and the Commonwealth combined (\$7.35 million to \$3.76 million).

- 2) The General Assembly passed Act 9 in May 2001, which increased the pension multiplier from 2 to 2.5 for all public school employees, and did so retroactively. The prospective cost of the benefit was to be paid for by a 1.25 percent increase in the contribution rate paid by school employees. The retroactive portion of the increase attributable to previous years of service became part of PSERS unfunded accrued liability, but was offset by the extraordinary investment gains in the late 1990's. In fact, Act 9 benefit increases account for less than 10 percent of PSERS' unfunded accrued liability.
- 3) From 2001 – 2003, PSERS suffered significant investment losses as a recession hit the nation. With the growing unfunded accrued liability, the PSERS pension rate was set to spike higher, but the Legislature passed Act 38, which capped the rate hike for 2002-2003 and also granted a COLA. The deferral of the rate hike and the COLA both added to PSERS unfunded accrued liability.
- 4) Due to the growing unfunded accrued liability, the pension rate was set to spike even higher in 2003-2004. The General Assembly passed Act 40 of 2003, which took all the costs associated with Act 9 and the investment losses that were incurred in 2001 and 2002, and re-amortized them over 30 years. The credits associated with investment gains in the 1990's were left on the books to be amortized over 10 years. This effectively subsidized the employer contribution rate, keeping it at an artificially low level until the credits rolled off the books in 2012.
- 5) Four years of positive investment returns followed passage of Act 40, providing false hope to some that PSERS was growing its way out of the problem. In fact, on June 30, 2007, near the height of the financial markets, the market value of assets at PSERS was about equal to its liabilities. The unfunded accrued liability was reduced by PSERS strong earnings.
- 6) The current economic downturn hit hard, with PSERS suffering significant investment losses over the last two years and increasing PSERS unfunded accrued liability to new levels.

As a result of two historically bad market downturns from 2000-2003 and 2007-2009, coupled with the actions or inactions above, Pennsylvania faces a rate spike projected for 2012 that has grown to nearly 30 percent.

Defined benefit pensions work for Pennsylvania workers

There are two primary types of retirement systems' Defined Benefit and Defined Contribution. Enrollment in a Defined Benefit (DB) pension system such as the Pennsylvania Public School Employees' Retirement System (PSERS) means that retirees receive regular, stable benefits that do not depend on investment earnings. In a Defined Contribution (DC) system or 401(k)-type account, however, the amount employees receive when they retire depends directly on investment earnings.

PSEA believes PSERS is the most efficient and effective retirement system for school employees, school districts, the Commonwealth, and taxpayers.

PSEA has *significant* policy and philosophical concerns about the impact of moving public school employees into a DC or 401(k)-type system, shifting all risk to employees and undermining the promise of a secure retirement for those who have long careers of service to our Commonwealth's students. In addition to these concerns, PSEA believes it is critical that policymakers and the public understand that imposing a DC plan on future employees does *nothing* to reduce the predicted 2012-2013 "spike" or change school district and state obligations to fund PSERS benefits for current employees.

DB plans are considerably better than DC plans for employees because they provide a secure, stable income for retirement. But DB plans also have significant advantages over DC plans for school districts and the Commonwealth, including:

- investment returns cover a large portion of retiree pension obligations;
- cost half as much to administer as DC plans and offer contribution flexibility;
- reduce turnover, which contributes to a stable learning environment for children; and
- provide employee dollars for the Pennsylvania economy, business, and job creation.

Three states - Alaska, Nebraska, and West Virginia - moved to 401(k)-type plans for new school employees. Nebraska and West Virginia have already moved back to defined benefits plans due to the shortcomings of these plans, and legislation is under consideration to do the same in Alaska.

Case Study: No cost savings in West Virginia's 401(k)

West Virginia provides a good example of the failings of 401(k)-type plans. In the early 1990's, the West Virginia teachers' pension plan was the worst funded in the nation with a funded ratio of 14 percent due to a combination of historic underfunding by the state legislature and overly conservative investing practices (the state did not authorize investment in equities until 1998). The state needed to provide large injections of cash into the plan so benefits could continue to be paid.

In an attempt to stop the bleeding, West Virginia closed their defined-benefit plan to new teachers and created a 401(k)-type plan for them. The participants were required to contribute 4.5 percent of their salary into an account, to be matched by a 7.5 percent employer contribution.

A study conducted on the plan found that the average account balance was just \$33,944. Only a handful of teachers age 60 or over had been able to amass more than \$100,000 in their accounts. This was not enough to produce a final pension benefit of more than about \$8,000 a year.

How did this happen? Many teachers claim that they were improperly steered into low-yielding investments, even though the plan did offer more appropriate investment choices. Others say they received no guidance or education on such important topics as asset allocation and rebalancing. Even with expert advice, no individual would have been able to escape the two drastic market downturns, and the resulting negative portfolio impacts, experienced in the last decade.

The study found that the level of retirement benefits would be so low that many West Virginia teachers would eventually qualify for public assistance.

After the study shed light on the shortcoming of the DC plan, West Virginia reopened its defined benefit plan to new employees and allowed the employees in the DC plan to switch to the traditional pension plan. PSEA understands that 78 percent of them have done so.

The promised employer cost savings did not occur with the switch to a 401(k)-type plan, and the new plan failed to provide retirement security for employees.