Achievable Pension Reform in 2017

By Senator Pat Browne (R-16), Senate Republican Appropriations Chairman

The Commonwealth of Pennsylvania is currently insolvent – with total debt exceeding our assets – fundamentally because our collective risk profile is too high. There is no place where the state is struggling to manage it risks more than within its two retirement systems - state employees' retirement system (SERS) and public school employees' retirement system (PSERS).

The current unfunded pension debt – which has climbed to nearly $70 billion – is due to benefits that have already been earned by our workers and are not currently funded. This existing debt stays at projected levels if our pension systems are able to meet investment earnings assumptions – if they do not, existing debt will grow.

There have been many reasons given for the level of unfunded pension debt that Pennsylvania is carrying from underfunding to benefit escalation. However, all reasons given have at their core one simple fact – the challenge that Pennsylvania and many state and local governments have had in managing the capital market risk inherent in the maintenance of defined benefit plans. There is no reasonable way for changes in prospective benefits to address existing debt caused by benefits earned in the past. Therefore, the debt will need to be serviced like other commonwealth debt-on a manageable payment schedule over a reasonable period of time.

Over the next several decades, Pennsylvania government is facing enormous challenges of managing the risks associated with maintaining a competitive investment climate in a global marketplace while serving the escalating human service needs of a growing retired population. Working with the private sector, it will take all our energies and talents to accomplish this. Reflecting on our current financial condition, our experiences of the past and the challenging path that lies ahead, we simply cannot reasonably expect to accomplish these goals while continuing to manage the uncertainty and volatility of the capital markets inherent in our public retirement plans. We must come to the same realization that the private sector came to years ago and look for alternative means to provide retirement security for our state and school employees.

Beginning in the 1970's with growing uncertainty in their core markets, the private sector moved to a balance of risk in retirement benefits through the offering of defined contribution plans. This was not a move against the wellbeing of their workers but recognition of the danger of unmanageable risk on their enterprise and on the employment security of their labor force. By making this move, the private sector was standing up for their workers, not undermining them, ensuring that they would not have to lay off employees to cover escalating pension payments caused by unexpected underperforming plan investments.

Private sector owners and managers realized that the greatest threat to any worker's retirement security is not a proposal to change their retirement plan but a threat to their job security. Over the past decade, this threat has loomed over the public sector as well. The experience Pennsylvania government has had with managing investment risk over the past 20 years – with pension payments in excess of 30% of payroll – has led to thousands of unnecessary job losses in state government and in our school districts. This trend will continue if investment performance does not meet expectations.

Pennsylvania's public pension systems were reformed through Act 120 of 2010. These reforms will save the Commonwealth and school districts $30 billion in pension costs over the next 25 years projected through the year 2034. Act 120 was a good first step to start the Commonwealth on the road to protecting itself against unrealized market assumptions and economic downturns. It included a shared risk provision for new employees if investments underperform and set a pathway to achieve full funding of pension obligations. However, Act 120's primary achievement was to reduce the cost to taxpayers of benefits offered from greater than 9% of payroll to less than 4% of payroll.

Unfortunately, it only scratched the surface of addressing the risk of paying for the benefits-the primary source of the current debt and the reason payments now approach 30% of payroll. Therefore, there is significant work still needed in reforming our pension systems to protect the Commonwealth's financial future.

For the first time in 100 years, the General Assembly is advancing a measure for new employees that will balance a significant percentage of the risk of investment between the Commonwealth and its own employees. This balance is key to promoting greater sustainability of our retirement plans and the solvency of Pennsylvania as a whole.

Transitioning a significant part of the Commonwealth's pension portfolio to a defined contribution plan through the side-by-side hybrid plan will mitigate significant future risk which translates into tremendous risk transfer value for our taxpayers. An analysis of both systems shows that if all benefits are earned under a fully defined contribution model as compared to the existing plans, a 1% underperformance from assumed investment targets would result in a combined $52.8 billion in employer savings. Through transitioning to the side-by-side hybrid plan, the risk is mitigated by at least 50%, resulting in $26.4 billion in savings for taxpayers.

There has been concern regarding the quality of retirement plan benefits employees would receive under this proposal. The facts are that this new benefit, combined with an employee's social security benefit, will effectively replace 92 percent of what an employee receives on a take home basis while working. For example, if an employee received $58,640 in take home pay while in active service, with social security they would take home $53,848 under the new side-by-side system in retirement.

Pew Charitable Trust, an independent nonpartisan organization, said that passage and successful implementation of this side-by-side hybrid plan, combined with the state's continued and dramatic increase in pension funding provided through Act 120 of 2010, would result in a national model for reform and establish Pennsylvania as one of the brightest turnaround stories among states. To put into perspective the significance of this pension proposal, it would provide the most aggressive reform in the nation in managing the root cause of our pension problem – risk of investment loss – second only to Alaska.

In advancing Pennsylvania's place in the global marketplace for this and the next generation, the stakes and the risks could not be higher. Through its proposed defined benefit/defined contribution side-by-side design and its shared risk/shared gain provision between the taxpayers and school district/Commonwealth employees, the pending pension proposal will allow the Commonwealth to more effectively mitigate potential debt, provide a competitive benefit for our employees and build a solid platform for future fiscal health and opportunity.