

Retirement Security for All Pennsylvanians

Part 1: Eliminate the Contribution Rate “Spike”

By Richard C. Rowland, Executive Director

Newspapers across the state have reported and editorialized extensively about what the employer contribution rates are projected to be in the year 2012 and beyond, for both the Public School Employees Retirement System (PSERS) and the State Employees Retirement System (SERS). The current projections are that the employer contribution rates for PSERS, which is split almost equally between the state and local school districts, will rise from approximately 4 percent of payroll in 2011 to nearly 30 percent of payroll in 2012. State contributions to SERS are similarly projected to rise from 4 percent to nearly 30 percent in 2012.

For PSERS, such an increase would require the state and school districts to contribute an additional \$3 billion annually to our retirement system and, undoubtedly, trigger massive tax increases at both the state and local levels. It is this fear of tax increases to fund school employee pension benefits that is prompting such opposition from the public toward granting retirees a cost-of-living adjustment (COLA). This fear is also driving many newspaper editors across the state to call for the elimination of guaranteed, defined benefit pension plans for public employees, replacing them with unsecured, defined contribution [401 (k)] type plans that are more prevalent today in the private sector.

Unfortunately, the public is under the impression that the projected increase in employer contribution rates for PSERS and SERS is due to the pension increases that the legislators granted themselves and to all future retirees in ACT 9 of 2001. This is NOT the case. When ACT 9 was passed both retirement systems had enormous surpluses. Also, the active employees had to agree to contribute an

additional one percent of their salaries to qualify for the higher pension formula. The surplus that existed at the time, plus the higher employee contribution rate going forward, were more than sufficient to fund the additional liabilities imposed on the retirement fund by ACT 9.

The real reason that such a dramatic increase in employer contributions is projected to occur in 2012 is because the employers (state and school districts) have not been contributing what is necessary to properly fund the retirement benefits that active employees were earning every year for the past eleven years. The legislature, at the request of Governor Schweiker in 2002 and later Governor Rendell in 2003, passed changes to the law that govern how the retirement systems measure assets and liabilities and determine necessary contribution rates each year. In short, the legislature has been prohibiting the retirement boards from setting state and local contribution rates at appropriate levels for over a decade.

In 2012, the legislative constraints expire and the boards will be required to increase the employer contribution rates and begin collecting the amount needed to fund the retirement benefits that active employees are earning each year, plus collect what was not contributed to pay for the benefits that were earned over the past twelve years. In PSERS' case, the amount that the state and school districts needed to contribute each year to pay for the employees' benefits was approximately 6.7 percent of total payroll. As the history of employer contribution rates shows in the table on page four, the state and school districts have not contributed to that level since 1998.

When ACT 9 was passed in 2001, the state and school districts were not being required to contribute anything to the retirement systems. Both SERS and PSERS were overfunded at that point. In late 2001 and on through mid 2003, the nation and state experienced a significant economic recession and the market value of the retirement systems' investments declined dramatically. The surplus that existed when ACT 9 was enacted evaporated overnight with the market declines and created significant unfunded liabilities.

With there no longer being a surplus, the PSERS and SERS Boards of Trustees needed to increase the state and school districts' contribution rates again to begin paying for the benefits that active employees were earning each year plus additional amounts to pay off the unfunded liabilities that materialized when the markets declined. Again, contributions were zero at that point and the proposed increase required to meet the normal cost obligations and reduce the unfunded liabilities was dramatic. The state and school districts were experiencing significant budgetary problems as a result of the recession and could not afford to increase contributions to the retirement systems at that time.

In 2002, at the request of Governor Schweiker, the General Assembly took action to change the way the retirement systems calculate the necessary contribution rates in order to prohibit the boards from raising the rates.

The recession lasted through 2002 and continued into 2003 when Governor Rendell took office. Rendell urged the General Assembly to take further actions prohibiting the boards from raising employer contribution rates, resulting in the passage of ACT 40 in 2003. It is ACT 40 that created the 2012 spike, essentially prohibiting the retirement boards from recognizing the systems' true liabilities and setting employer contribution rates to properly fund their liabilities until then.

Since the 2001-2003 recession, the markets rebounded dramatically as they have always done following economic declines. The rate spike projections, originally forecast when the General Assembly began imposed restrictions on the retirement boards to rise to 30 percent of payroll in 2012, fell to less than 9 percent of payroll. Now, of course, the nation has entered into another economic recession and the markets have declined dramatically once again.

The retirement boards, however, remain under the constraints imposed by the legislature in 2003 and are prohibited from raising contribution rates. In fact, these same constraints forced the retirement boards to reduce by 40 percent the contributions that the state and school districts are required to contribute in this current 2008-2009 fiscal year!

The spike was created by the legislature and can as easily be removed by the legislature. Until the legislature takes action to eliminate the spike that it created, the public will remain fearful that their taxes will be raised to bail out the retirement systems and continue to express opposition to any increases in public retiree benefits, including COLAs.

What is required is that the legislature reverse the retirement boards, reinstate proper actuarial funding methods, and establish temporary controls on the rate increases that may be set by the boards over the next several years as the systems fully implement the change back to proper funding methods.

What the Pennsylvania Association of School Retirees (PASR) is advocating is called a "fresh start" refinancing of the retirement systems. It would require that the boards recalculate their existing unfunded liabilities based upon its current measurement of liabilities and comparing it to the actual, market value of its assets as of its most recent actuarial valuation. In addition, we recommend that the systems be allowed to restore equal and consistent "amortization periods"—the periods of time over which the actuaries recognize annual gains and losses from investments and fund liabilities.

The principal change imposed on the retirement boards in ACT 40 of 2003, was the creation of different amortization periods, requiring the actuaries to recognize the high investment gains from the late 1990s over a shorter, ten-year period and the liabilities created by ACT 9 over a longer, thirty-year period. Prior to ACT 40 both investment gains or losses and the funding of liabilities were recognized over equal, twenty-year periods. The expiration of the shortened, ten-year period for recognizing the investment gains from the 1990s is the major cause for the 2012 spike.

Restoration of equal, thirty-year periods for active member liabilities and recognizing annual gains and losses from investments would be

appropriate. Going forward, PASR is also advocating that PSERS and SERS extend the “smoothing method” that it uses to measure its assets every year. Using pure market values of assets every year would result in dramatic swings in the employer contribution rates, up or down every year, depending upon where the markets closed on the day that the assets are measured.

All states smooth out annual fluctuations in the markets by adding or subtracting a portion of the market value gains or losses each year to the actual market value on the valuation date, and determine what is called an “actuarial value” of assets. The actuaries then compare the actuarial value of its assets to its measurement of liabilities in order to determine the unfunded liabilities and, in turn, the necessary employer contribution rates for the succeeding year.

PSERS and SERS are required by law to use five-year smoothing methods. Given the volatility of financial markets, serious consideration should be given to extending this period. Ten-year periods would be more appropriate and would greatly reduce volatility in employer contribution rates once fully implemented. This would eliminate wild fluctuations in the employer contribution rates while the systems implement and fully transition to a new, ten-year smoothing method. We believe it would be appropriate for the General Assembly to institute temporary caps on annual rate hikes or decreases.

In short, the following changes advocated by PASR will eliminate the 2012 spike and remove the fear of tax increases from the backs of Pennsylvania’s taxpayers:

- (1) implement a fresh start recalculation of the systems unfunded accrued liabilities;
- (2) restore equal, thirty-year amortization periods for the recognition of annual investment gains and losses and for the funding of active member liabilities; and,
- (3) implement an extended, ten-year smoothing method (with temporary caps on annual rate changes over the next ten years).

Implementing these changes would allow the boards to raise employer contribution rates gradually, over several years, so that they are again able to meet the systems’ ongoing normal cost obligations and stop accumulating debts due to

underfunding by the state and local school districts. Most importantly, it will provide time for the systems’ investments to recover the losses experienced during this current recession when the economy begins to recover and the markets soar again—just as the markets did following the last recession and have done following every recession that this country has experienced in the past.

The spike, the fear it has created among taxpayers, and the opposition it has sparked toward COLAs was caused by legislative action and it must be fixed by legislative action. It is imperative that the legislators act on this matter, but that they do so appropriately—with careful consideration of the long-term nature and needs of the retirement systems, and not solely with their eyes on the short-term budgetary needs of the Commonwealth and its school districts.

PSERS has been in existence for more than 90 years. It has always been able to fulfill its fundamental purpose—providing steady and secure income to the systems’ retirees at minimal cost to Pennsylvania’s taxpayers—through both good and bad economic times. Through the Great Depression and every recession since, many as bad or worse than this current recession, PSERS has delivered the promised pension benefits to its retired members and done so at minimal cost to the taxpayers of Pennsylvania. That is what retirement plans are supposed to do.

Naysayers aside, the reality is that PSERS and SERS both have more than sufficient assets to meet their benefit obligations without requiring additional contributions from the employers during these difficult economic times. In fact, both plans are considered very well funded. Despite the record declines in investment values that occurred last year, PSERS has 86 percent of the assets it needs to pay its benefit obligations to all current and future retired members of the system. SERS is projected to have 92 percent of the assets it needs to meet all of its benefit obligations.

Defined benefit pension plans with indefinite life spans, like PSERS and SERS, are deemed “well funded” if they have assets on hand to pay at least 80 percent of their benefit obligations. It is very important to understand that these plans have indefinite life spans. It is simply not necessary for such plans to have assets on hand to pay 100

percent of the benefit obligations, because the benefits are not all due to be paid today. In fact, payment of all the current benefit obligations will occur over the next 50-60 years, when all the current retirees expire and all those working in the schools today complete their careers and live out their lives in retirement. In reality, if the systems were to be closed and stop accepting new members today, nearly 50 years would elapse before the systems ran out of money and the state would have to pay off the remaining obligations from General Fund tax revenues.

In 2002 and 2003, the legislature changed the funding methods in order to address short-term budget problems that arose during the last recession. In doing so, they created a long-term problem for the retirement systems and a false perception among the public that the systems are in imminent danger and in need of massive increases of taxpayer assistance to remain solvent. This is simply not the case. The systems are not in imminent danger and remain well funded. The long-term problem, making up for the underfunding that has occurred over the past twelve years, can and should be resolved over the long-term.

Twenty-Year History of Employer Contributions *(State and School Districts)*

Fiscal Year	% of Payroll	Total Amount
1988-89	19.27%	\$990 million
1989-90	19.68%	\$1,086 million
1990-91	19.18%	\$1,142 million
1991-92	14.40%	\$961 million
1992-93	13.74%	\$966 million
1993-94	12.92%	\$927 million
1994-95	10.61%	\$825 million
1995-96	11.10%	\$909 million
1996-97	10.00%	\$845 million
1997-98	8.61%	\$697 million
1998-99	5.89%	\$486 million
1999-00	4.36%	\$390 million
2000-01	1.64%	\$154 million
2001-02	0.00%	\$0
2002-03	0.18%	\$97 million
2003-04	2.98%	\$299 million
2004-05	4.00%	\$443 million
2005-06	4.00%	\$460 million
2006-07	5.67%	\$670 million
2007-08	6.44%	\$754 million
2008-09	4.00%	\$480 million