

Retirement Security for All Pennsylvanians

Part 3: Include a COLA to Stimulate Pennsylvania's Economy

By Richard C. Rowland, Executive Director

It is simply not true that the statewide retirement systems are in financial trouble and cannot afford to provide a cost-of-living adjustment (COLA) to retired public school employees and state workers. Nor is it true that COLAs have required higher contributions to the retirement systems by the state and local school districts, i.e. state and local taxpayers. The truth is COLAs enacted for retired public employees produce significant economic benefits for all citizens of the Commonwealth!

COLAs are an essential component of ALL retirement plans

It is important to understand, first, that COLAs are an essential component of every retirement plan, whether the plan is a self-directed, 401 (k) style, defined contribution (DC) plan more prevalent today in the private sector, or defined benefit (DB) plan more prevalent in the public sector. Individuals simply must have a means to adjust or increase their retirement income to offset inflation, in order to maintain their standards of living in retirement. In DC plans, the individuals have complete control of their retirement savings and can adjust their withdrawals to meet their expenditure needs at will. In a DB plan, the assets are managed for the group as a whole and the individuals are dependent upon the plan sponsor to adjust their pension amounts periodically to account for inflation.

It is also important to understand that COLAs are a standard feature of every DB plan in which the employee is required to contribute a substantial portion of the funds required to pay for their retire-

ment benefits. Nearly all citizens receive COLAs in retirement. It is a standard component of Social Security—a DB plan to which everyone is required to contribute 6.2 percent of their wages/salaries throughout their working lives. All retired state and public school employees in DB plans across the nation receive COLAs, as all are required to contribute to pay for their benefits. Most receive adjustments every year and retirees in a handful of states receive adjustments every other year.

Pennsylvania is the only state in the nation that goes longer than two years before providing a COLA to its retirees. This is despite the fact that the percentage of salaries that Pennsylvania's employees are required to contribute to pay for their retirement benefits (6.5 percent for state workers, and 7.5 percent for school employees) are among the highest rates in the country. It has now been seven years since Pennsylvania's retired state and school employees received an increase—longer than any retired state and/or public school employees in the nation!

Pennsylvania's Retirement Systems CAN afford to provide a COLA

The fact that Pennsylvania enacts COLAs so infrequently relative to all other states has nothing to do with the funding status or financial well being of its retirement systems. The State Employees' Retirement System (SERS) and Public School Employees' Retirement System (PSERS) are among the most well funded retirement plans in the nation. DB plans are classified by all actuarial standards as "well funded" if they have 80 percent

or more of the assets on hand to meet all present obligations. PSERS reports at its most recent valuation to have an 86 percent funding level and SERS is expected to show at least a 92 percent funding level when its valuation is released later this month.

To be certain, the current recession has taken its toll on the market value of assets held by SERS and PSERS. As has always occurred in the past, however, the economy will rebound and the markets will recover to drive the market value of the retirement systems' assets much higher than they were prior to the economic downturn. As noted in our earlier publication, titled "Retirement Security for ALL Pennsylvanians: Eliminate the Pension Spike," it is important to maintain a long-term perspective when looking at benefits and funding of these retirement systems. These plans have indefinite life spans. The benefits payable and the funding required to meet the benefit obligations span several decades.

It should be noted, however, that the funding status of the retirement systems today is actually much better than it was on most occasions when the General Assembly authorized COLAs for retired state and public school employees in the past. Historically, since 1968 when the voters approved an amendment to the Constitution authorizing the General Assembly to grant COLAs, Pennsylvania was granting COLAs every 4-5 years.

The table on page 4 shows the funding status of the PSERS Fund in each of the years that the General Assembly authorized COLAs, since 1979 when the systems received broader authority to diversify investments and maximize returns. In reality, PSERS is in a stronger financial position to extend a COLA now than it was on most occasions when the legislature authorized increases in the past. The exceptions being when the past two COLAs were enacted, in 1998 and in 2002, when the system reported having assets well in excess of the amounts necessary to fund its obligations.

COLAs need not necessitate an increase in total employer (i.e. taxpayer) contributions to the retirement systems

Most public employee retirement systems across the country anticipate COLAs. Therefore, provisions are included in their funding structures to

accumulate and invest the funds necessary to pay for the benefit increases upon enactment. Pennsylvania does not. Instead, when the General Assembly authorizes a COLA, the funding required to pay for the increase is borrowed from the assets in the fund that are being accumulated to pay the basic pension benefits of those who will be retiring in the future. The actuaries, in turn, build into the employer contribution rates, the amounts required each year to reimburse the funds borrowed to pay for the COLA over a prescribed period, called an "amortization period."

Critics of COLAs claim the amounts added to the employer contribution rates to repay the funds borrowed for the retiree increases drive up costs to state and local taxpayers. Such critics, though, often ignore the fact that the employer contribution rates are also adjusted downward in most years to amortize higher than expected investment earnings over time. The fact is that the downward adjustments on the employer contribution rates as a result of investment earnings have, historically, more than offset the increases required from the extension of COLAs. As noted in the table on page 4, the total employer contribution rate for PSERS today is less than one third of what it was thirty years ago—despite the enactment of six COLAs, numerous early retirement incentive windows, and major improvements in retirement benefits applied prospectively for active employees at retirement.

As noted in our prior publication advancing ideas for eliminating the projected employer contribution rate "spike," the Commonwealth needs to restructure the funding methods currently prescribed in the retirement codes; reinstitute proper actuarial methods; and allow employer contribution rates to rise in a more gradual manner over time. Although an increase in state and school district contribution rates must occur, it does not have to occur in the form of a spike—a dramatic increase from one year to the next—as is currently required under the methods prescribed in state law.

Our suggestion is to change the law, extend the smoothing period used to calculate the actuarial value of assets to at least ten years, and impose temporary caps on employer contribution rate increases until the new smoothing period is fully implemented. This would allow rates to increase gradually. More importantly, it would allow time for the markets to rebound and the systems to

improve their funding levels with higher than expected investment earnings—as they have always done in the past and will again in the future when the economy improves.

We also believe that when the legislature directs a refinancing of the retirement systems, it should include provisions to extend a COLA to the existing retirees and incorporate funding for such in the refinancing plan. Very simply, the state has little choice but to direct a refinancing of the retirement systems because there is no chance that the markets will rebound fast and far enough to avert the dramatic increase in employer contribution rates set to occur under the existing provisions in the retirement codes. It makes sense to resolve all pension issues in a bill to restructure the funding methods of the retirement systems. A significant, retirees would say critical, issue that needs to be addressed is a COLA for those who have suffered significant erosion of their pension amounts from seven years of accumulated inflation!

Former Representative Steven R. Nickol (R-York) introduced the COLA advocated by PASR and all other state and school retiree organizations as HB 2379 during the previous legislative session. Representative Peter J. Daley (D-Fayette/Washington) is preparing to reintroduce this bill in the current session. This bill is modest in comparison to COLAs passed previously, generally providing increases that are a bit less than one-half the cumulative rates of inflation retirees experienced since the last COLA in 2002, and providing higher percentages to the eldest retirees. Actuaries determined the total liability for the COLA last session, for PSERS, to total \$3 billion.

While \$3 billion appears in isolation to be a very large amount, relative to the total liabilities and assets of the PSERS Fund, it really is not. The costs represent an increase in the funds' total liability of less than 5 percent, which is far less than the increase in liabilities authorized with most of the previous COLAs. Again, the funds to pay for the COLA would be borrowed from existing assets being accumulated to pay pension benefits to those retiring in the future. The employer contribution rates would be adjusted to include a provision to repay the monies borrowed over the next twenty years. If incorporated with the refinancing, as recommended by PASR, the increase in total contribution rates for the state and

school districts would be constrained each year until the systems fully implement the provisions of the new, actuarially appropriate funding methods.

In short, the contribution rates would not rise any more than what the restructuring plan calls for, in terms of temporary caps on employer contribution rates, whether or not a COLA is included with the restructuring that ultimately has to occur. Therefore, we strongly encourage the General Assembly to include a COLA, fix all of the festering pension problems at once, and put these systems back on sound footing in terms of both actuarial funding and benefit provisions typical of DB plans of this type.

A COLA will stimulate Pennsylvania's economy during this critical time

Another very important reason the General Assembly should consider authorizing a COLA for all state and public school retirees, is that doing so will help stimulate the state's economy. A COLA would benefit all citizens of the Commonwealth, not simply the public retirees themselves.

The National Institute on Retirement Security (NIRS) recently published the results of a study quantifying the economic impact of public employee pension disbursements in all fifty states. The study, titled "Pensionomics: Measuring the Economic Impact of State and Local Pension Plans," is available online at nirsonline.org. The study concludes, here in Pennsylvania as in most every state, public employee pension benefit disbursements provide more economic benefits to the citizens of the state than what the taxpayers were asked to contribute to produce those benefits.

Public employee pension disbursements are a huge engine in Pennsylvania's economy. With over \$6 billion disbursed annually to more than 350,000 retired state and public school employees, more money is injected into the economy each year than what is being provided by the state's mining, agriculture, forestry, fishing, hunting, arts, entertainment, and recreation industries combined. In addition, the benefits are derived at very low cost to taxpayers. For every dollar disbursed in pension payments, less than ten cents came from taxpayer contributions to the retirement systems. The rest came from employee contributions and, most

significantly, from investment earnings generated from the employee and employer contributions.

When retirees receive their pension checks each month, very few stuff their checks under their mattresses. With an average annual pension amount of only \$20,523 per year, most checks are cashed and spent for goods and services in the retirees' local communities—every local community in the Commonwealth. Retirees' expenditures then become another person's income, producing additional spending, generating additional consumer demand, and creating jobs. This economic "ripple effect" is significant, particularly so in Pennsylvania. According to the NIRS study, public retiree expenditures in Pennsylvania supported 70,891 jobs that paid \$4.4 billion in wages and salaries to state residents, and produced \$564 in tax revenues for the state and local governments. Every dollar invested by Pennsylvania's taxpayers in its public employee pension plans produces \$9.46 in total economic activity in the state. That is a phenomenal rate of return on taxpayers' investments, benefitting all residents of Pennsylvania!

Very simply, increasing the expenditures to retirees with enactment of a COLA will stimulate additional consumer spending and provide much needed income to all residents across the Commonwealth. Give retirees additional money to spend and they will spend it; unlike giving additional money to employed people who may fear loss of their jobs and tend to save the additional money.

In conclusion, Pennsylvania's retirement systems remain well funded and can certainly support the enactment of a COLA. A COLA can be enacted as part of a refinancing of the retirement systems without imposing greater obligations on Pennsylvania's taxpayers. All state residents will benefit and profit from the extension of a COLA to every state and public school employees.

PSERS Historic Data: Funded Status, Employer Contribution Rates

FY Ending	Assets		Total Liabilities	Funded Ratio		Employer Contribution Rates		
	(Actuarial)	(Market)		(Actuarial)	(Market)	Pension	Health	Total
1979	\$4.5	N/A	\$8.0	56.20%	N/A	13.31%	N/A	13.31%
1984	\$6.5	\$6.1	\$12.3	52.97%	49.71%	19.31%	N/A	19.31%
1989	\$13.6	\$14.7	\$26.9	50.56%	54.65%	19.68%	N/A	19.68%
1994	\$24.5	\$24.8	\$28.3	86.57%	87.63%	11.10%	0.62%	11.72%
1998	\$40.0	\$39.4	\$36.1	110.80%	109.14%	5.89%	0.15%	6.04%
2002	\$54.3	\$43.6	\$51.8	104.83%	84.17%	0.18%	0.97%	1.15%
2008	\$57.2	\$63.9	\$66.6	85.80%	95.95%	4.00%	0.76%	4.76%

Data Source: All data for fiscal years 1979 through 2008 are contained in PSERS' Comprehensive Annual Financial Reports for those years. All Dollar Amounts in billions.