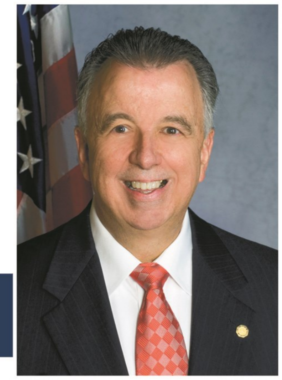
2014/15 BUDGET BRIEFING
Report on Key Issues
HOUSE APPROPRIATIONS COMMITTEE (D)
JOE MARKOSEK, DEMOCRATIC CHAIRMAN March 31, 2014



Gov. Corbett's Pension Plan: Short-Term Gain, Long-Term Pain

Gov. Corbett proposes in his 2014/15 budget to offset election-year spending increases by increasing DEBT in the state's two retirement systems by at least $13 billion over the next three decades. In the governor's proposal, he says that Pennsylvania "cannot kick the can down the road" and then proposes to do just that by artificially reducing the state's required payment (by "tapering the collars") for the next four years.

- ***IMPACT: The billions of dollars in debt the governor's proposal will add to the systems over the long term far outweigh any near-term savings.***

Additionally, when the new artificially suppressed payments expire after four years, the state and school districts would be required to pay an even higher payment to account for the additional burden from underfunding the systems for four years.

- ***IMPACT: Paying higher payments would reduce the long-term debt of the governor's proposal to roughly $5 billion. However, if past history is any predictor of the future, we do not have much confidence the state and school districts will be able to pay even larger payments. Under either scenario, billions of dollars in additional pension debt is deeply troubling.***

The governor cloaks this massive debt increase under the guise of pension "reform", but offers no specific plan, other than to say he is open to legislative proposals.

- ***However, from media reports, we know he is talking about further reducing benefits for new employees, benefits that were already dramatically reduced under Act 120 of 2010. (See Act 120 of 2010 Retirement Benefit Changes for New Employees: Fast Facts.)***

Also, changes to new employee benefits may not have any significant near-term savings and will likely have long-term costs.

(Note: As of the date of this publication, the administration has not revealed details on its proposal.)

Short-Term Gain: Reduce the Employers' Required Payments

To provide short-term budgetary relief, Gov. Corbett's 2014/15 budget proposal includes artificially reducing, for four years, the required annual employer payment.

In 2014/15, the proposal artificially reduces the General Fund portion of the state's required payment by:

- About $410 million (from $1.52 billion to $1.11 billion) to the Public School Employees' Retirement System (PSERS), the teacher's pension system; and
- About $60 million (from $544 million to $484 million) to the State Employees' Retirement System (SERS).

In total, the governor's proposal is estimated to reduce the commonwealth's payments by roughly $2 billion over four years.

Public School Employees' Retirement System (PSERS)

For 2013/14, the legally required employer payment for PSERS is 16.93 percent (i.e. the employer contribution rate) of payroll. Current state law mandates an employer contribution rate increase of 4.5 percent to 21.4 percent of payroll for 2014/15. However, the governor's proposal cuts this increase in half (a 2.25 percent increase rather than 4.5 percent), resulting in an employer payment equal to 19.15 percent of payroll. (Note: The figures will not exactly total due to a 0.03 percent reduction to the healthcare premium assistance program.)

Employer payments are shared between the school district and the commonwealth. The commonwealth contributes at least 50 percent of the employer share of the payments, with less wealthy school districts receiving a larger share (as determined through the aid ratio). On average, the state will contribute slightly more than 56 percent of the employer share of the retirement payment in 2014/15.

The proposed cut in the state payment in 2014/15 will result in school districts paying a total of roughly $132 million less than the current amount required by law.

One-Time Transfer from Tobacco Settlement Investment Board

Additionally, the governor's proposal reflects a one-time transfer of $225 million in ill-liquid, non-cash investments and cash from the Tobacco Settlement Investment Board to the PSERS, purportedly to supplement the state's employer payment.

However, this transfer would not have the same value as a cash payment. **In fact, the transfer would further stress the system's immediate cash flow needs** and the system could get saddled with low-performing investments that it cannot sell easily or quickly. Additionally, the state will be left scrambling next year to find a way to replace these misguided one-time funds.

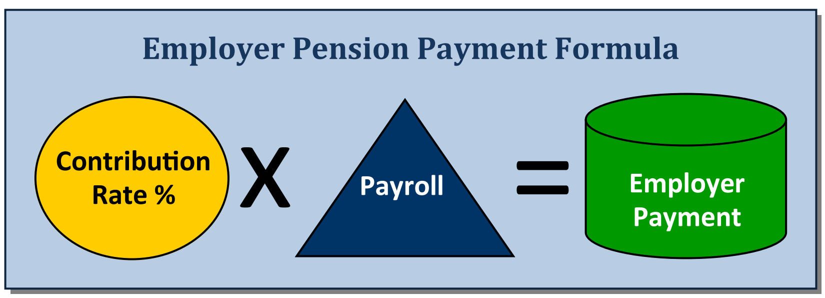
Eliminate Charter School "Double Dip"

The governor's budget also assumes that legislation will pass to eliminate the commonwealth's duplicate retirement payment to charter and cyber-charter schools ("double dip"); however, the state, not school districts, would reap the benefit from the change (an assumption worth $63 million to the state).

State Employees' Retirement System (SERS)

For 2013/14, the legally required employer payment for SERS is 16 percent (i.e. the employer contribution rate) of payroll. Current state law mandates an employer contribution rate increase of 4.5 percent to 20.5 percent of payroll for 2014/15. However, the governor's proposal cuts this increase in half (a 2.25 percent increase rather than 4.5 percent), resulting in an employer payment equal to 18.25 percent of payroll.

All agencies under the governor's jurisdiction assume these pension "savings" in their 2014/15 proposed budgets; therefore, if the General Assembly does not adopt the governor's proposal to "reduce the collars", additional funds will need to be added to the agencies' budgets or cuts will need to be made that could impact programs and services.



Public Employees Retirement Commission (PERC)

The governor's budget assumes level funding for the Public Employees Retirement Commission (PERC). PERC is non-partisan, independent commission charged with monitoring public retirements in the commonwealth and to assure their actuarial viability through a review of any proposed legislative changes to those plans.

Given the proposed pension changes, this agency will have a critical role and should be adequately funded to properly inform the General Assembly of the impact any legislative changes would have on the state's pension systems.

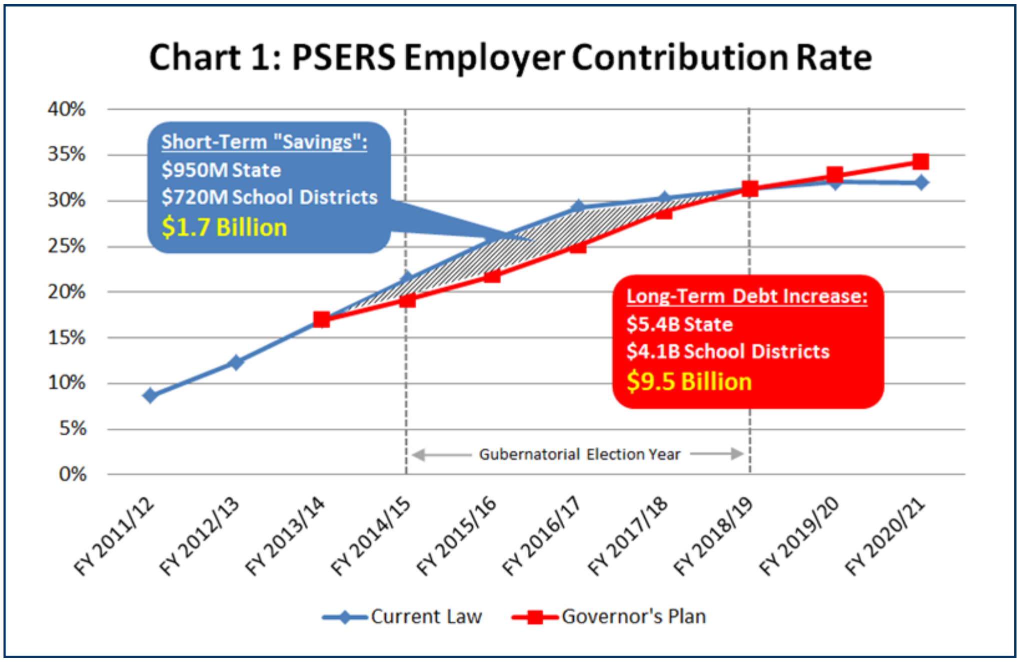
Long-Term Pain: $13 Billion in Additional Pension Debt

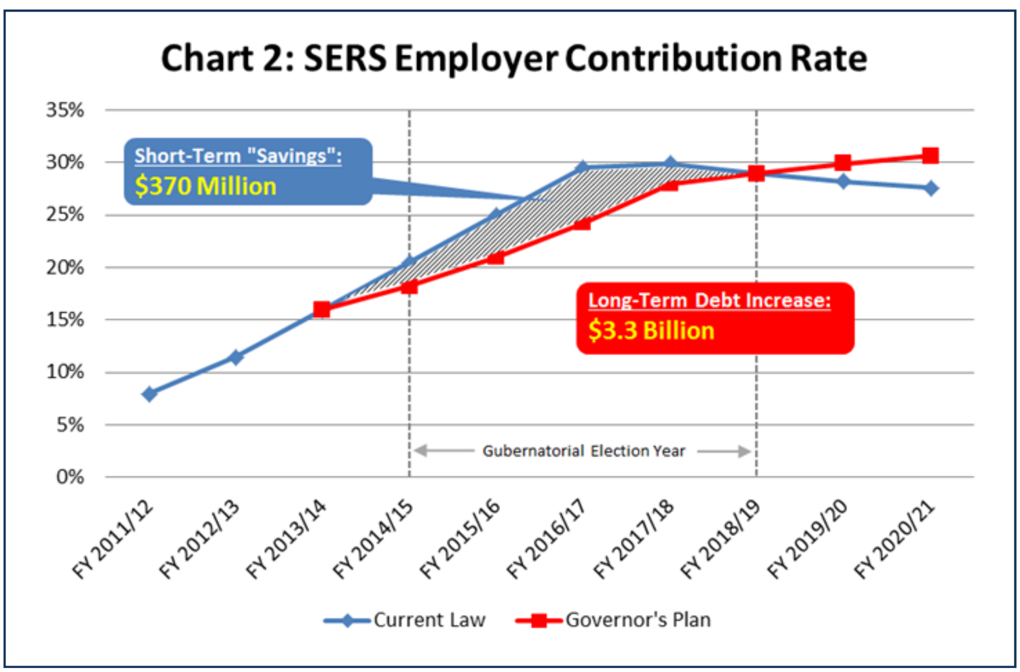
The governor's plan to borrow $2 billion from the pension systems over four years by reducing the General Fund employer payments will add roughly $13 billion in debt (also known as the "unfunded liability") to the two systems:

- $9.5 billion in debt over 24 years for the Public School Employees' Retirement System (PSERS), the teacher's pension system; and
- At least $3.3 billion in the debt over 30 years for the State Employees' Retirement System (SERS).

Charts 1 and 2 reflect the estimated fiscal impact this action will have on each pension systems' employer payment.

Additionally, when the new artificially suppressed payments expire after four years, the state and school districts would be required to pay even higher payments to account for the additional burden from underfunding the systems for four years. **Paying higher payments would reduce the long-term debt of the governor's proposal to a net amount of roughly $5 billion.**





Defined Benefit Plans

Defined benefit plans are designed to remain financially sound through regular funding each year from three sources: *employee* contributions, *employer* contributions and investment earnings.

When contributions are withheld, the value of that money is not merely its face value, but also what it *could have been if strategically invested*.

By allowing the power of interest earnings, compounded over time, to generate investment returns, much larger sums of money are available to furnish the contracted future benefits to the retirees. By withholding these dollars now, that money creates an even bigger hole that needs to be paid in the future.

The proposed shortage to the pension systems will require the legislature to change the current pension law.

The governor claims that under the current defined benefit pension system "taxpayers bear the full financial risk of the pension plans"; however, that is not the case because Act 120 of 2010 includes a shared-risk provision that requires employees to contribute more if investment returns are inadequate.

Chart 3 compares the $13 billion in additional debt to the $5 billion in debt if the state and school districts make higher pension payments (as assumed by the pension systems). During the House Appropriations Committee hearing in February, the governor's budget secretary cited a $2.2 billion debt figure; however, he did not provide any supporting details.

Charts 4 and 5 provide a visual representation of the short-term gain (savings in the near term) vs. the long-term pain (increased debt) for each of the pension systems if the General Assembly reduces the required pension payment, as the governor proposes.

The billions of dollars in debt the governor's pension "reform" proposal will add to the systems over the long term far outweigh any near-term savings.

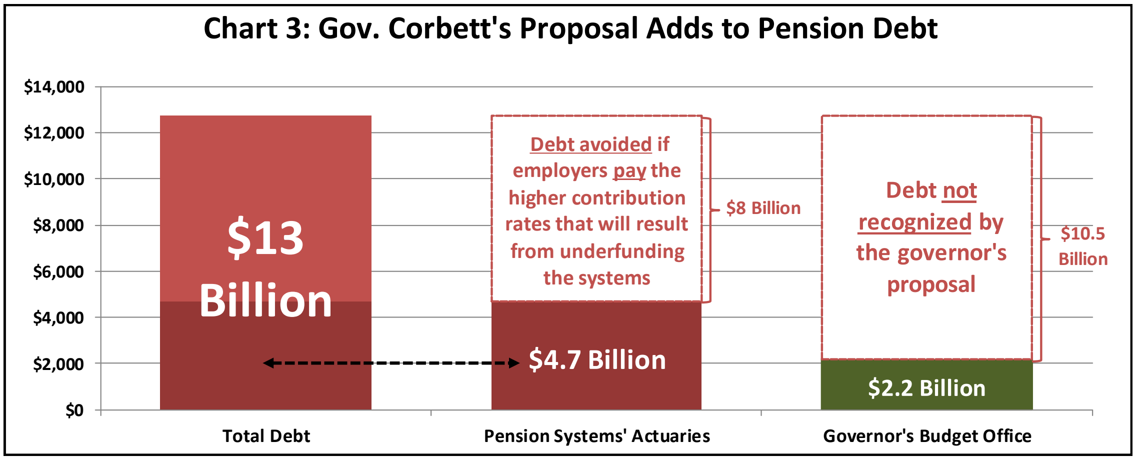


Chart 3: Gov. Corbett's Proposal Adds to Pension Debt

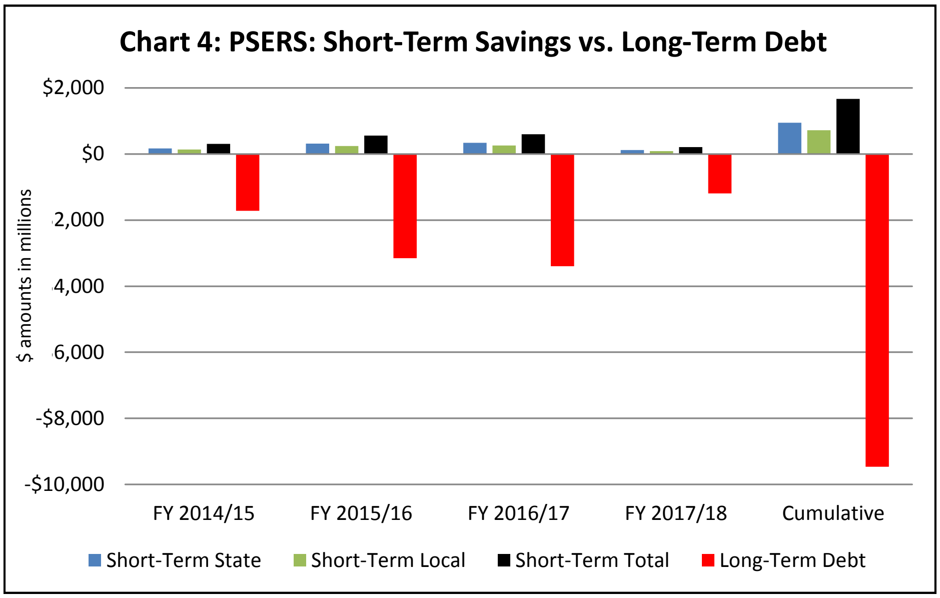


Chart 4: PSERS: Short-Term Savings vs. Long-Term Debt

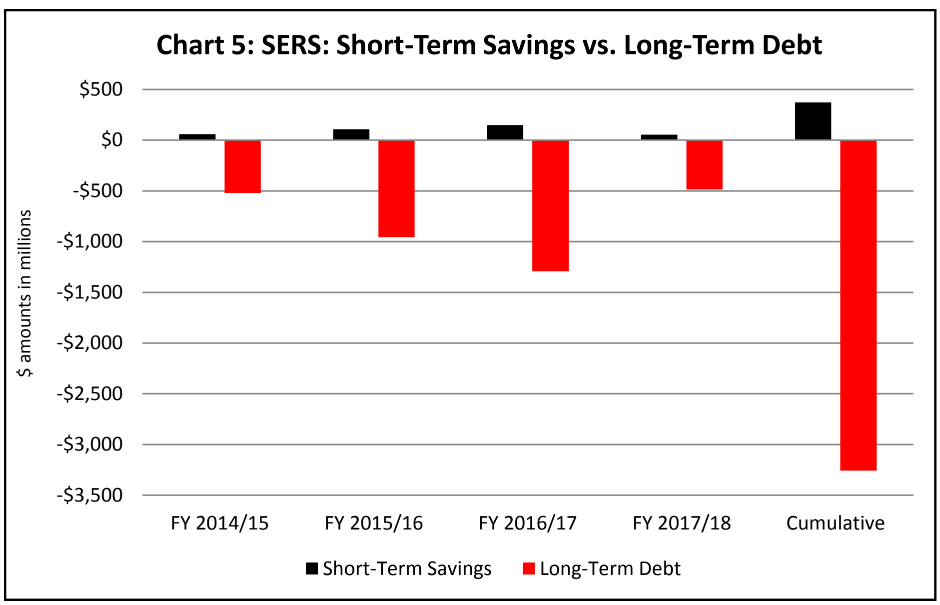


Chart 5: SERS: Short-Term Savings vs. Long-Term Debt

House Appropriations Committee (D)

Miriam A. Fox, Executive Director | Bernie Gallagher, Budget Analyst | Stephanie Weyant, Communications Director