Pennsylvania Pensions Reaching Crisis Levels

**Issue**

The most pressing fiscal challenge facing Pennsylvania’s long-term economic stability is paying for pensions and other post-employment benefits. Pension contributions at both the state and municipal government levels have skyrocketed over the past 10 years, and recently plateaued at very high levels. The state can no longer afford to ignore this issue.

**PICPA’s Analysis of Pennsylvania’s Financial Statements**

Pennsylvania publishes a comprehensive annual financial statement each year that shows the financial position of the state and the results of its operations for the year. The PICPA has summarized some key points to help frame the ensuing discussion. The following observations are based on an evaluation of the entire reporting entity (general fund, special revenue funds, enterprise funds, and the operating component units such as the Turnpike, Pennsylvania Higher Education Assistance Agency (PHEAA), and the Pennsylvania Housing Finance Agency (PHFA)), for the year ended June 30, 2016:

- First, Pennsylvania has adequate liquidity, or the ability to pay its bills in the short term. There is enough cash on hand to pay for combined operations for a little more than 100 days. Additionally, current assets exceed the current liabilities by more than 50 percent, providing assurance that obligations that are due within the next year can be paid.

- Second, if we take a long-term view that adds in long-term assets and liabilities, Pennsylvania’s unrestricted net assets (or equity available to spend) are negative $26 billion. If we add obligations for retiree medical benefits, long-term leases, and the state’s 50 percent share of the Public School Employees Retirement System (PSERS) obligations, to the liabilities booked on the state balance sheet, the unrestricted deficit grows to $69 billion, which represents almost a full year of operating revenues. The $69 billion deficit is principally a result of not accumulat-
ing appropriate resources to fund the pension obligation the state has to its employees. The cumulative unfunded State Employees Retirement System (SERS), PSERS, and Retiree Health Benefits in the analysis amount to $62 billion. The remaining unrestricted deficit primarily is made up of a $5 billion deficit at the Turnpike caused by resource transfers that allow Pennsylvania to maintain its infrastructure and another $1 billion self-insurance liability in governmental activities related mostly to employee disability obligations.1

• Third, we cannot ignore the 50 percent share of PSERS obligations for which local school districts throughout Pennsylvania are responsible. This adds another $22 billion to unfunded obligations that Pennsylvania taxpayers will need to pay.

The Problem

The pension obligation will significantly affect Pennsylvania’s budget for many years into the future (current estimates indicate for the next 20 to 25 years). School districts throughout the state will be similarly affected. These issues continue to be the focus of debate among policymakers in Harrisburg, but finding a widely acceptable legislative solution is elusive.

There has been a great deal of debate over potential movement from defined benefit to defined contribution pension plans. The state currently provides defined benefit pension plans to eligible employees. These plans are based on the principle that the benefits paid under the plan are defined at the time the benefits are earned. Funding for the plan is determined by actuaries based on assumptions, such as number of employees in the plan, age and projected age at retirement, projected longevity of all participants, plan sponsor funding rates, and assumed rates of return on assets held by the plan. Because of the assumptions, there is an element of risk that falls on the payer of the benefits – which would be Pennsylvania. Because of the uncertainties surrounding the assumptions and because benefit payments are due many years in the future for current plan participants, there has been a historical tendency for the state to not fulfill its fiduciary responsibilities and defer making actuarially sound payments. Shortfalls occur that must be made up in the future.

Defined contribution plans, by contrast, require contributions to be defined and funded each year, so there is no option for deferral. This type of plan does not guarantee benefit levels at retirement, although adequately funded plans invested in a risk-appropriate manner can be a sound way to save for retirement. In this type of plan, however, the risk falls on the plan participant. If the participant invests in a manner such that the assets in the plan lose value, or if the participant lives longer than expected, benefits may be less over the life of the payout than under a defined benefit plan. Additionally, a market timing risk is transferred to the participant: if the market is down when they are scheduled to retire it could have a significant impact on their economic well-being in retirement or their ability to retire.

Transferring a portion of the fiduciary risk from Pennsylvania and its taxpayers to the individuals who benefit from the retirement plans should be a component of any meaningful pension reform proposal. In the short term, if new employees are covered under defined contribution plans, it is possible that funding amounts will be greater in the short term as we transition to defined contribution for younger employees and less for older employees.

Long-term, defined contribution plans allow for a more predictable financial obligation. These plans can be designed to provide a flat percentage of compensation for employees covered. Employer contributions can match employees’ deferrals, be unmatched, or be some combination of both. In contrast, the employer contributions to defined benefit plans are based on assumptions that could be far off the mark from actual experience. Although near-term funding requirements might increase if defined contribution plans are adopted, we believe that the long-term benefits of having predictable retirement plan contributions will be worth short-term fiscal pain and will set the stage for both fiscal health of the pension plans in the longer term and fairness for Pennsylvania taxpayers.

The Cost of Inaction

For years, Pennsylvania has turned a blind eye to underfunded pension obligations, threatening the ability to honor commitments made to active and retired employees. The situation has now reached a moment of crisis. The

funded ratio of Pennsylvania’s plans declined from over 100 percent in the early 2000’s to less than 60 percent today. Generally, when plans fall below 80 percent funding, sponsors begin to take aggressive action to offset the decline. The level of funding for PSERS and SERS is rapidly approaching 50 percent, and if more conservative assumptions about future investment earnings rates are used, future pension obligations would rise even higher and funding ratios would fall lower into the 40 percent range. This is not a problem the state can earn its way out of.

As trusted financial advisors, CPAs are frequently called upon to advise companies in economic turmoil. If Pennsylvania was our client, we would suggest extraordinary measures; solutions that would reduce discretionary expenditures and selectively increase revenues. An ongoing objective of managing the state’s financial position should be a balanced budget based on realistic estimates of revenues and meeting all obligations, including appropriate contributions to pension plans.

We urge drastic action to prevent the shortfalls growing to unmanageable levels that would crowd out other needed expenditures and burden our children and grandchildren with obligations they may not be prepared to face.

Over the past 10 years, the combined unfunded accrued liabilities of the PSERS and SERS pension plans increased from $14.2 billion to $62.2 billion. This staggering increase of $48 billion is the cost of inaction and continuing to kick the funding can down the road.

**Policy Options**

To make significant progress in reforming Pennsylvania’s pension plans, the PICPA recommends several policy options for consideration:

- Maintain the current defined benefit pension systems for all existing retirees, ensuring no change in the benefit levels.
- Challenge the concept and judiciary decisions that prospective benefits for current employees cannot be changed. If comparisons with private-sector employers indicate that benefits for current public employees are too rich, a realignment of benefits should be considered. Benefits already earned under current defined benefit plans for existing employees would not be changed.
- Calculate the retirement benefits on base compensation only, eliminating the disbursement escalation employees receive by working significant overtime in the final years of employment and getting paid for the overtime throughout their entire retirement. Changes could be implemented on a graduated basis, so those who have more years of service or are closer to retirement would be the least affected or not affected at all, while those who have fewer years of service or are further from retirement would have to make the most adjustment because they have more time to supplement their retirement savings through other means.
- Establish a defined contribution/benefit pension hybrid system for all new public school teachers, state employees, and lawmakers.
- Require benefits and funding to be subject to private- and public-sector best practices and to be compared with the total compensation package (salary and benefits) paid by the private sector for comparable services. Pension benefits and nonpension benefits should be included for purposes of comparison. For example, employee medical, dental, and vision benefits during employment, and those that continue after retirement, should be part of the benchmarking exercise. While state employees might continue to enjoy access to government health plans after retirement, the criteria for eligibility and the cost of participation borne by the retiree and the state should be benchmarked and compared to such benefits in the private sector.
- Prohibit pension obligation bonds or other funding mechanisms for actuarially recommended contributions in the future. Recommended contributions to the plans in the future should be paid currently and not deferred. The possibility of funding unfunded accrued liabilities
that currently exist with proceeds from future bond issues should be explored.

- Disallow the deferral of pension plan funding and require all annual actuarially determined plan funding requirements to be made using assumptions that would be allowed by ERISA.

Other Considerations

To accommodate the full pension funding expenditure within budgetary constraints, it is essential to explore significant cost savings in other areas. We recommend:

- Exploring the consolidation of the many layers of government and its duplicative overhead for significant cost-saving administrative services. There are ways this could be accomplished without losing the individual identities of each school district or municipality and its elected governance and local control.

- Continuing to explore the consolidation/re-organization of the state’s delivery of services such as those currently being proposed with the departments of Human Services, Health, Aging, and Drug and Alcohol.

- Leveraging new technology to improve service and lower the cost of administration including: big data analytics, and cognitive learning and digital labor.

- Updating the tax structure to ensure that the state is competitive at attracting and keeping businesses and skilled workers, and everybody is sharing the responsibility of paying for the operation of our critical government institutions.

- Evaluating the state’s assets and infrastructure to determine if anything should be sold, restructured, or repurposed.

PICPA would be happy to assist in developing and evaluating cost-saving recommendations.

For more information, contact the PICPA at governmentrelations@picpa.org or reach out to your CPA directly.

About Us:

The Pennsylvania Institute of Certified Public Accountants (PICPA) is a professional association of more than 22,000 members working together to improve the accounting profession and better serve the public interest. Founded in 1897, the PICPA is the second-oldest CPA organization in the United States. Membership includes practitioners in public accounting, industry, government, and education.

This report is the work of PICPA’s Fiscal Responsibility Task Force. In October 2010, PICPA Council established this task force to provide objective, non-partisan CPA expertise and perspective to help Pennsylvania’s policymakers address the state’s fiscal challenges. Pension funding has been the subject of each task force report.