

Why escalating pension costs are unsustainable

The problem facing the state and school districts is the high employer contribution costs to sustain the current retirement system. These mandated expenses continue to increase each year, taking larger shares of already-stretched budgets. In the coming fiscal year, both the state and school officials must figure out how to pay pension obligations that continue to mount, with the total employer contributions for 2017-18 projected by the Public School Employees Retirement System (PSERS) at nearly \$4.4 billion. Beginning on July 1, 2017 the annual employer contribution rate that must be paid by the state and school districts will jump to 32.57%, up from 30.03% in 2016-17, and from the 2015-16 rate of 25.84%. The contribution will continue to climb over the next few years to a staggering 36.40% by 2021-22.

According to PSERS, those rising rates means that over the next five years the projected total employer contribution will surge from about \$4.4 billion to about \$5.2 billion, an increase of over \$864 million. While half of that amount is a state responsibility, the other half must be paid by school districts.

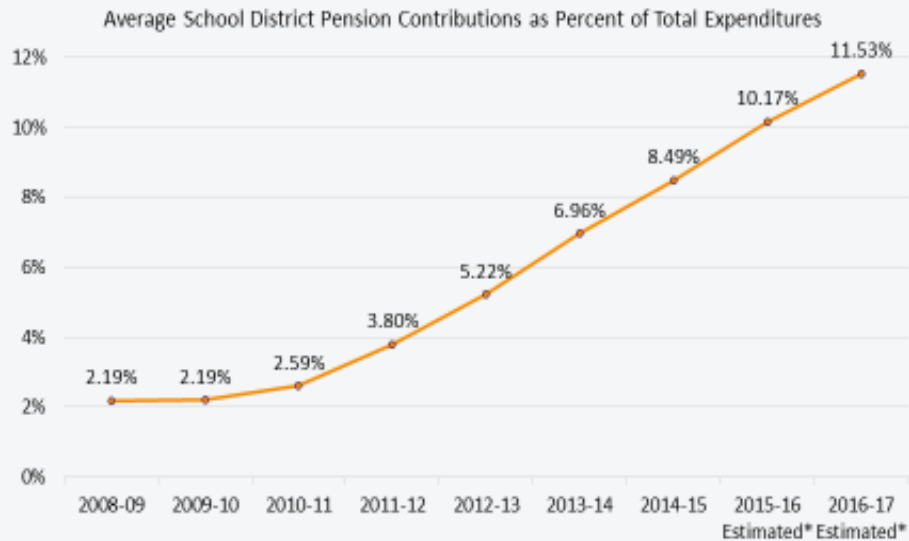
For school districts, pension costs are taking a greater and greater share of available state and local revenues, leaving less funding for true basic education costs directed toward student learning. In 2008-09, pension contributions were at about 2% of a district's total expenditures. In 2016-17, pension costs are estimated to climb over 11.5%. Districts have shaved all that they can from their budgets to meet pension obligations, and they know that pension hikes they know that the costs will continue to climb. The increase in mandated pension costs affects all districts across the state, and the right now the only option is to cover these soaring costs at the expense of the rest of their budgets.

Although various reform plans have been introduced, the General Assembly has not reached agreement on a specific approach. While some changes were enacted under Act 120 of 2010, they did not fully address both long-term and short-term concerns for the funding of the retirement system. State government is facing an unfunded pension liability of roughly \$53 billion to cover state and public school employees.

It is clear even to outside bond rating agencies that the Commonwealth pension crisis will impact the state's financial position in the future. In July, 2014, Moody's Investors Service downgraded Pennsylvania's credit rating, citing the state's "growing unfunded pension liabilities as Pennsylvania continues to underfund pension contributions" as one of the challenges leading to a lower rating. In August, 2016, Moody's continued to recognize the state's difficulties with "poorly funded pension plans and historical practice of underfunding," saying that Pennsylvania "is likely to struggle to balance its budget annually as its pension contributions ramp up and expenditures grow more quickly than revenues." Moody's also noted that that "substantial progress toward attaining stronger pension fund levels" could lead to an upgrade in the state's credit rating.



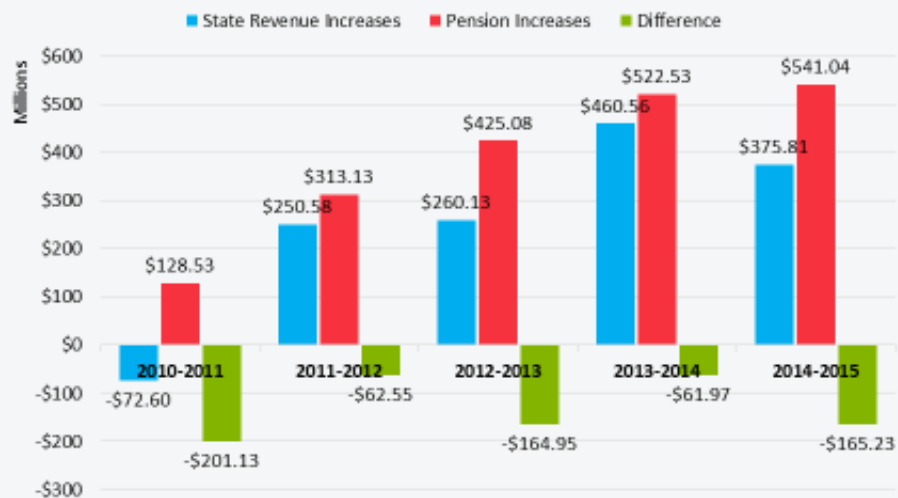
Pension Costs Taking Up More of School Budgets



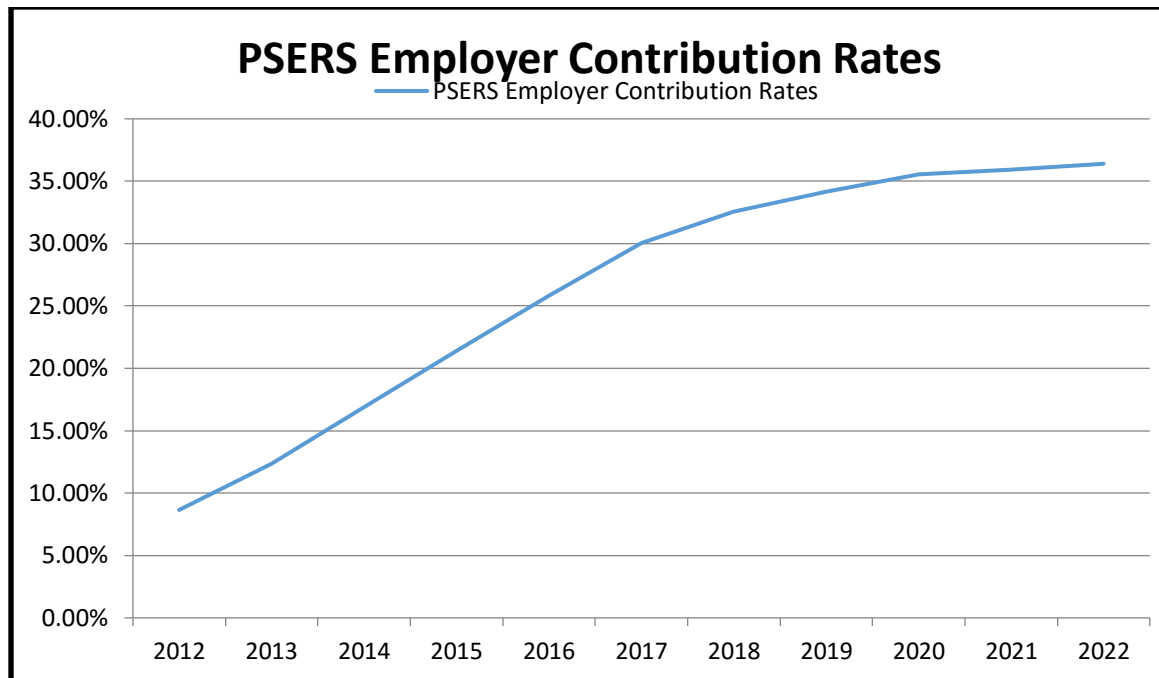
© 2016 Pennsylvania School Boards Association



Comparing State Revenue Increases to Pension Increases



© 2016 Pennsylvania School Boards Association



PSERS' PROJECTED EMPLOYER CONTRIBUTION RATES

(Presumes an 7.25% rate of return)

Fiscal year	Total Employer Contribution Rate %	Projected Total Employer Contribution (thousands) \$
2015-16	25.84%	3,456,100
2016-17	30.03%	4,068,765
2017-18	32.57%	4,316,593
2018-19	34.18%	4,569,239
2019-20	35.53%	4,794,454
2020-21	35.95%	4,892,886
2021-22	36.40%	5,005,091

How did we get to where we are today?

It is important to understand that the serious problem facing the pension system is the product of a combination of factors that have continued to build over several years. Among the prime factors contributing to these steep increases were generous improvements to member and retiree benefits created under Act 9 of 2001 that did not require a proportional employee match and investment returns that failed to meet projections. Investment earnings are the largest source of funding for PSERS, and these earnings directly impact the employer

contribution rate. During a down market, the employer contribution rate will rise when there is investment loss at the system.

Even prior to 2001 Pennsylvania had a habit of taking “contribution holidays” – In 1985, the commonwealth reimbursed PSERS for a \$90 million debt owed from skipping payments in the 1970s and since 2001 forward the General Assembly consistently set the employer contribution rate well below what was called for. Clearly the fund has had its ups and downs some created by the legislature others forced upon it by the market. However, it must be noted that, from PSBA’s perspective, school districts have been in compliance with the law. As an employer, school districts have been making the mandated required contributions to PSERS each year, despite the fact that increased pension costs are significantly impacting school district budgets. While some changes were enacted under Act 120 of 2010, they did not fully address both long-term and short-term concerns for the funding of the retirement system. Act 120 was the first successful effort at curbing rising pension costs, but a deeper solution is needed.

Act 120 of 2010

On Nov. 23, 2010, then-Gov. Edward Rendell signed HB 2497, which became Act 120 of 2010. The law maintains the defined benefit plan for new and existing school employees. However, it introduced a shared risk element for all new employees that ties in PSERS’ investment performance to the employee contribution rate. Specifically, Act 120 provides that new employees must pay a shared risk contribution rate equal to 0.5% for every 1% that the actual rate of return is less than the assumed rate.

Effective July 1, 2011, new members of PSERS are required to become members of one of two membership classes, known as “Class T-E” and “Class T-F.” Most new members of PSERS are required to become members of Class T-E beginning July 1, 2011. Class T-E members are eligible for an annuity based upon an annual benefit accrual rate of 2% and have a corresponding employee contribution of 7.5% of compensation. As an alternative to Class T-E, an employee who becomes a member of PSERS on or after July 1, 2011, may elect Class T-F membership within 45 days of becoming a member of PSERS. A Class T-F member is eligible for an annuity based upon an annual benefit accrual rate of 2.5% with a corresponding employee contribution requirement equal to 10.3% of compensation.

There are also certain stop-gap measures incorporated into Act 120 pertaining to the shared risk contribution rate. They include implementation of a 2% cap on the shared risk contribution rate. This means that an employee in the T-E class sees a total combined employee contribution rate no less than 7.5% and no greater than 9.5%. For those individuals electing to be in the T-F class to obtain a 2.5% accrual benefit rate, the rate of their total employee contribution has a floor of 10.3% and a ceiling of 12.3%. The shared risk contributions in excess of 7.5% are used to reduce the unfunded accrued liability of PSERS. The legislation also provides that if PSERS’ actuarial funded status is 100% or higher, then the shared risk contribution rate will equal 0%, but the employee will still be required to pay either 7.5% or 10.3%. There are also other caps on the increases on the shared risk contribution rate.

Act 120 also puts in place a “Rule of 92” for determining superannuation age, requiring age 65 with at least 3 years of service or a combination of age and years of service totaling 92 with at least 35 years of accrued service. The bill requires employees seeking to purchase service to be made at the present value of the full actuarial cost of the increase. The exceptions to the purchase of service changes are: intervening and non-intervening military service. The legislation limited the defined benefit under the plan to 100% of the member's final average salary. It also established an Independent Fiscal Office.

Additionally, the law put in place an actuarial plan to deal with the unfunded actuarial accrued liability including re-amortizing the unfunded accrued liabilities over 24 years using a level-percentage of pay. It also extended from 5 years to 10 years the asset smoothing period beginning July 1, 2011 over which the fund's investment gains and losses are recognized. It also created "collars" or limits on the annual increases in the employer contribution rate. For the fiscal years beginning July 1, 2011, July 1, 2012, and July 1, 2013, the employer contribution rate increases did not exceed 3%, 3.5% and 4.5%, respectively of total compensation for all active members. Following the collar expiration, the bill resets the employer contribution rate floor at the employer normal contribution rate. It also prohibits the use of pension obligation bonds for funding liabilities. While the legislation was a successful first effort, it clearly did not solve all of the problems.

From PSBA’s perspective, school districts have been in compliance with the law by making the mandated required contributions to PSERS each year, but the system is unsustainable and must be fixed now. The changes enacted under Act 120 did not fully address both long-term and short-term concerns for the funding of the retirement system. Without pension reform, the costs just continue to climb. PSBA believes that allowing Act 120 to play out without further refinement is not a tenable solution.

Meaningful changes must involve identifying another funding source for PSERS, decreasing or cutting the costs and liabilities of the system, including benefit levels, and examining the possibility of adoption of a hybrid pension plan that would reduce employer costs over time. A hybrid plan combines elements of a defined benefit plan and a defined contribution plan in some manner. The state must enact meaningful school employee pension reform with the dual purpose of reducing projected employer contribution rate increases and reducing projected costs to school districts and taxpayers over the next two decades, while maintaining an appropriate pension benefit for school employees.