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PA PENSION BENEFITS DON'T ADD UP FOR TEACHERS AND TAXPAYERS

A PENNCAN RESEARCH REPORT

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Introduction

When discussing pensions, the average person has to stretch his/her sense of scale because the numbers are staggering: In 2016, teacher pension liabilities nationwide exceeded half a trillion dollars, an increase of $17 billion in just two years. Nationwide, more than two-thirds of every dollar contributed by employers to teacher retirement systems goes toward servicing pension liabilities.[1] Today, just seven states have teacher pension systems that are funded at 90 percent or higher.[2] Unfortunately, Pennsylvania is not one of them.

As of June 2016, the value of Pennsylvania's Public School Employees Retirement System's (PSERS) assets was $50.2 billion and its liability was $94.6 billion, which means PA's unfunded liability was $44 billion.[3] By way of comparison, PA's overall state budget is a little over $30 billion. According to the National Association of State Retirement Administrators, PA's pension system is the second most underfunded in the country.[4]

These numbers are not just signs of a looming fiscal crisis in PA; they are signs of a looming education crisis. PA's educators and other school personnel deserve retirement security and students deserve adequately funded public schools. It is increasingly clear that neither of these goals can be achieved unless significant changes are made to PA's public pension system.

Pension Liability
The term pension liability refers to the amount of money that a pension plan has to account for in order to make future pension payments.

PSERS
PA's Public School Employees Retirement System is the public pension retirement system for public school employees. All full-time school employees are part of PSERS and certain part-time employees are eligible. There are more than 260,000 active members in the plan. Charter schools have the option to opt out of PSERS, which means some but not all charter school employees participate in PSERS.

Unfunded Liability
The extent to which future payment obligations exceed the value of funds available to pay for them. In a pension plan, the way to calculate the unfunded liability is to subtract the value of the actual assets from all the obligations projected to be owed to beneficiaries. For example, if a plan has $10 billion in assets and future payment obligations of $15 billion, the plan would have an unfunded liability of $5 billion.

PA's Pension Crisis Is Not Unique

The good news is that PA isn't alone in facing these problems and can look to other states as proof that it's possible to tackle such a complex issue.

Over the past decade, states have moved away from traditional pension plans and adopted retirement benefits that include defined contribution options or hybrid models. Major and notable pension system reforms have occurred in: Alaska, where the state added a defined contribution plan for new employees;[5] Rhode Island, where then-state treasurer Gina Raimondo helped alter the benefits earning structure for new employees and existing workers, as well as augment the state's

Defined Contribution
A retirement plan where employers contribute a defined amount to an employee's retirement account, such as a 401(k), and the actual retirement benefits are based on the gains and losses of the account's investments.

Hybrid Models
A retirement plan that incorporates some elements of both a defined contribution and defined benefit plan.

system with a 401(k)-style plan;[6] and Utah, where a new variable hybrid benefits retirement system was approved for new public employees.[7] Additional information about how other states are dealing with the increasing cost of public sector pension plans can be found in Appendix A.

401(k)
The most common type of defined contribution plan in the private sector. These plans allow an employee to take cash or defer a percentage of their income to an account, sometimes matched by the employer.

Money Is Increasingly Being Redirected From The Classroom To Fund Pensions

In 2012, Governor Pat Quinn of Illinois introduced a mascot named Pension Python to increase awareness of how pension debt was strangling the state budget.[8] In 2013, economist Robert Costrell and education finance expert Larry Maloney released a paper, called *The Big Squeeze: Retirement Costs and School District Budget*, outlining how increased pension costs will hurt school districts' bottom line.[9] In 2016, a pension expert from the Manhattan Institute released a paper with the subheading: "Pension Costs are Crowding Out Education Spending."[10]

Whether you call it a "squeeze" or "crowding out" or use the metaphor of a snake "strangling" an economy, the meaning is the same: school districts are being forced to make a trade-off between meeting their pension obligations, and investing in programs and services that benefit students.

School boards are making these difficult decisions across PA despite an increase in the state's contribution to basic education. Since taking office, Governor Wolf has made education funding a priority and total state spending on k-12 education has increased by $465 million.[11] Education advocates, like the Campaign for Fair Education Funding (CFEF), have celebrated this increase and Governor Wolf will likely point to these increased investments as his signature achievement during his reelection campaign.

However, what this narrative fails to address is that more than half of every new state dollar going to education is not actually going into classrooms.

FIGURE 1 **Pensions as a Share of New Pre-k–12 Education Spending—Governor's 2017–18 Proposed Budget**

Total New Education Spending
$458 Million

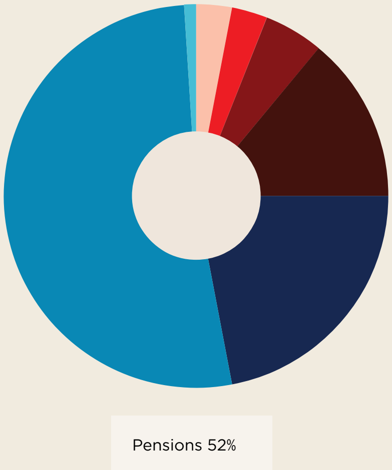
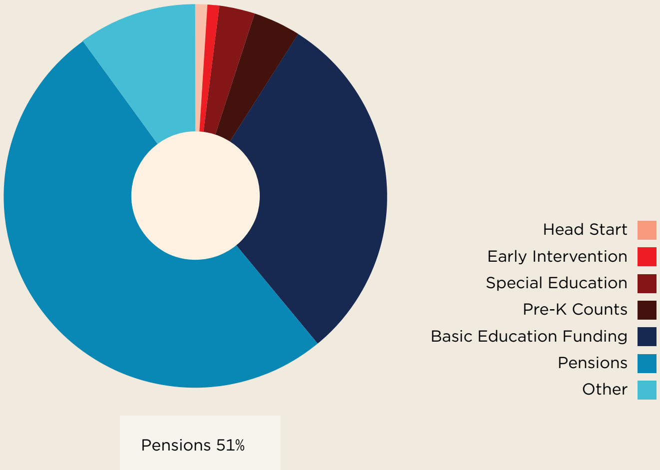


FIGURE 2 **Pensions as a Share of New Pre-k–12 Education Spending—2016–17 Enacted Budget**

Total New Education Spending
$673 Million



As Figure 1 illustrates, in Governor Wolf's proposed 2017–18 budget, pension costs are estimated to increase by $240 million, which would consume 52 percent of all new pre-k-12 spending.[12] The 2016–17 budget was even more generous towards schools with a $200 million increase in the Basic Education Funding line item. On top of that, there were increases in special education ($20 million) and pre-k ($25 million), bringing the total increase in education spending to $673 million.[13] Yet once again, as Figure 2 shows, more than half of those dollars went to pensions.

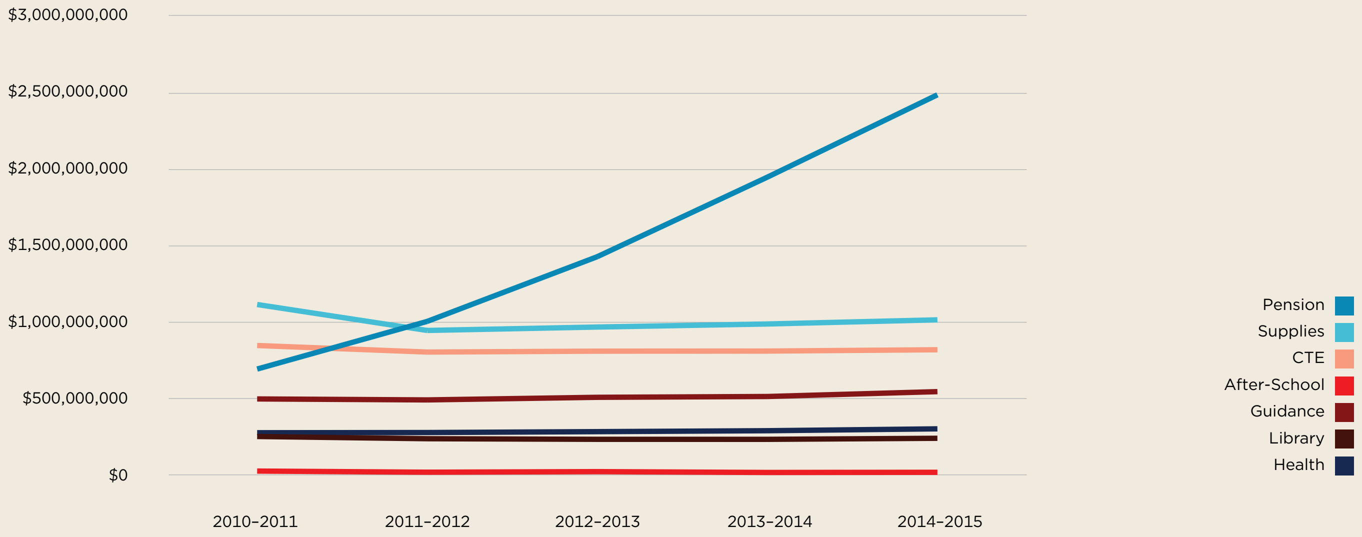
From the perspective of a district, when mandated costs exceed new revenue, the result is a net loss. According to the Pennsylvania School Boards Association, school districts have had net losses every year since 2011 despite significant increases in revenue.[14]

Pension costs are increasing as instructional spending decreases

Simple arithmetic would tell you that if school districts are experiencing net losses in revenue, then they must find other areas of their budget to cut or raise taxes. Unfortunately, many of the discretionary items in a district's budget are instructional expenses, which means students and teachers are bearing the brunt of these new budget realities.

FIGURE 3 **Growth Over Time—Pension vs. Other K–12 Education Expenditures**

The total expenditures for each category are the product of every school district's spending



Nationally, spending on instructional supplies decreased by 10 percent between 2000 and 2013, and teacher salaries were stagnant over the same time period.[15] Here in PA, the situation is even worse. As depicted in Figure 3, since 2010–11 pensions have continued to trend upward while other education spending has remained flat or decreased.

From 2010–2015, pension costs increased by $1.8 billion (261 percent).[16] In that same period, funding for supplies fell by 9.3 percent, career and technical education spending fell by 3.8 percent, library funding fell by 6.2 percent, and after-school programming fell by 47 percent.[17]

Some critics argue that the school districts are simply making poor spending decisions, suggesting that the pension crisis is actually a management problem. This argument ignores two important facts. First, unlike salaries and healthcare, pensions are not a benefit negotiated as part of the collective bargaining agreement; it is a mandate from the state. Second, school districts are shedding jobs. Statewide, from 2010–2015, the number of full-time school employees dropped from 158,000 to 147,000, a decrease of 6.9 percent.[18] This explains the seemingly contradictory data in Figure 4, which depicts salaries going down as pension costs increase.

FIGURE 4 **Growth Over Time— Pensions vs. Personnel Salaries**

The total expenditures for each category are the product of every school district's spending

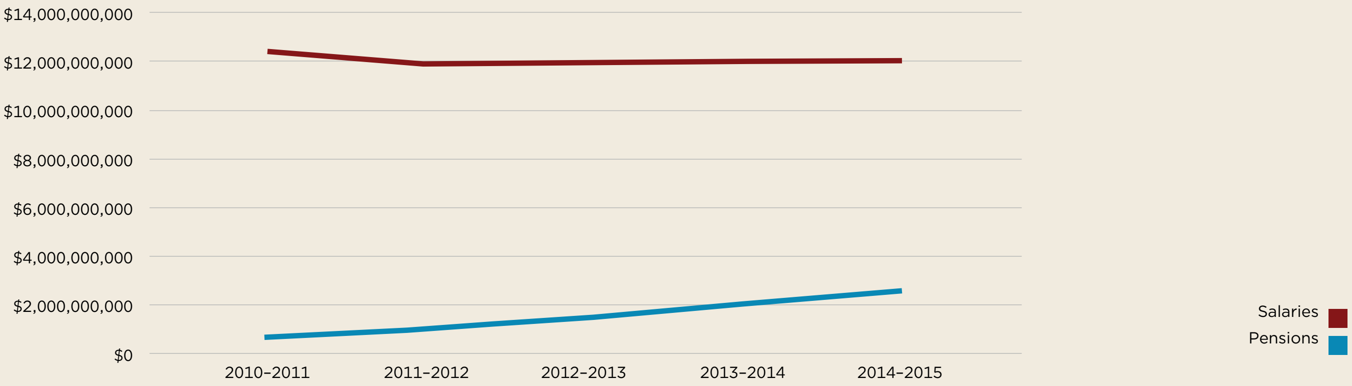


FIGURE 5 **How Do Pensions Compare to Other Education Cost-Drivers**

Expenditure data is from the 2014–15 school year

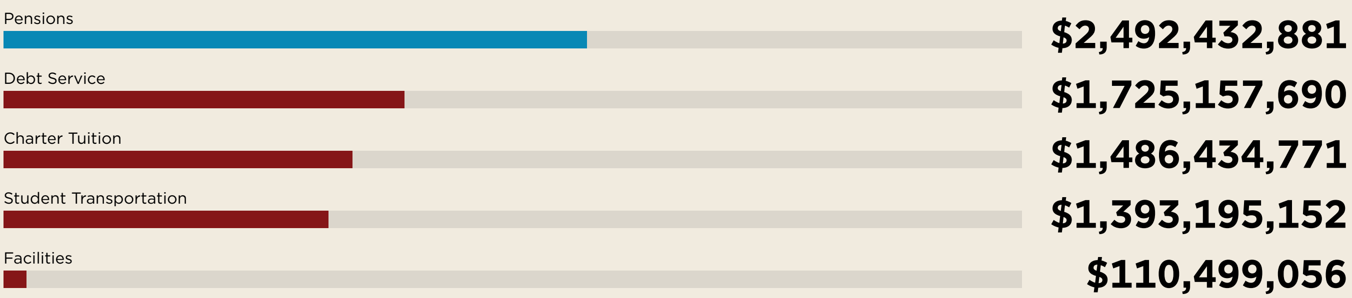
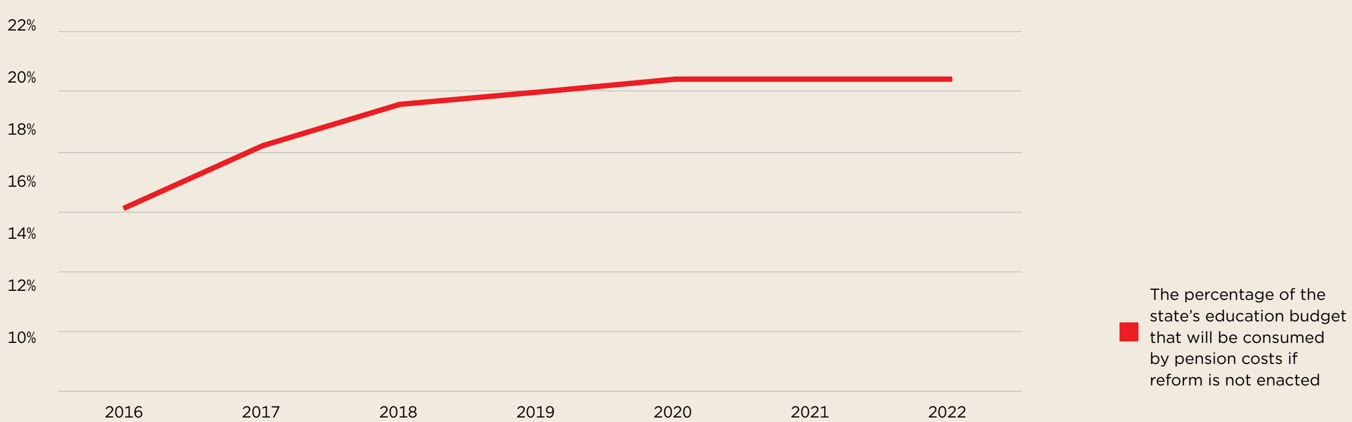


FIGURE 6 **The Increasing Burden of Pensions on the State Budget**



Pensions are the biggest cost-driver in public education

As pension costs rise, they will continue to become a greater share of overall per-pupil spending in education. Referencing data from school districts' Annual Financial Reports, it is possible to calculate the per-pupil cost of pensions relative to other key school expenditures. As Figure 5 shows, using the most recent available data, total school district pension costs in 2014–15 were $2.5 billion, or $1,470 per-pupil.[19]

Absent reform, the per-pupil cost of pensions will continue to rise. According to calculations conducted by economists Robert Costrell and Larry Maloney, Philadelphia will end up spending as much as $2,361 per-pupil on pensions by 2020.[20]

If left unfixed, pension debt will consume an even greater percentage of the state's education spending

Previously, we explained that more than 50 percent of every *new* dollar spent on basic education in 2016 went to pensions. As a share of *overall* education spending, pensions already consume 16 percent of the state's education budget and are projected to grow. The Independent Fiscal Office (IFO) released a five-year projection in 2016. The IFO is an independent agency that was created as part of Act 120 in 2010 to conduct economic analyses of state budgetary issues. Figure 6 illustrates the IFO's projections, which show that pension obligations will rise every year until it levels off in 2020.[21] At its peak, one in five education dollars will go to pensions. To put it in real numbers, in 2020, the projected cost of pensions is $2.6 billion, compared to the state's projected education spending of $12.9 billion.

PA's Current Pension System Is Not Benefiting The Majority Of Teachers

Teachers don't stick around long enough to benefit from PSERS

Traditional defined benefit plans, like PSERS, provide very generous returns to educators who spend their entire careers teaching in one state. The problem is that the overwhelming majority of teachers leave either the profession or the state before accruing real value in

Defined Benefit
A retirement plan where eligible employees receive a guaranteed benefit when they reach retirement.

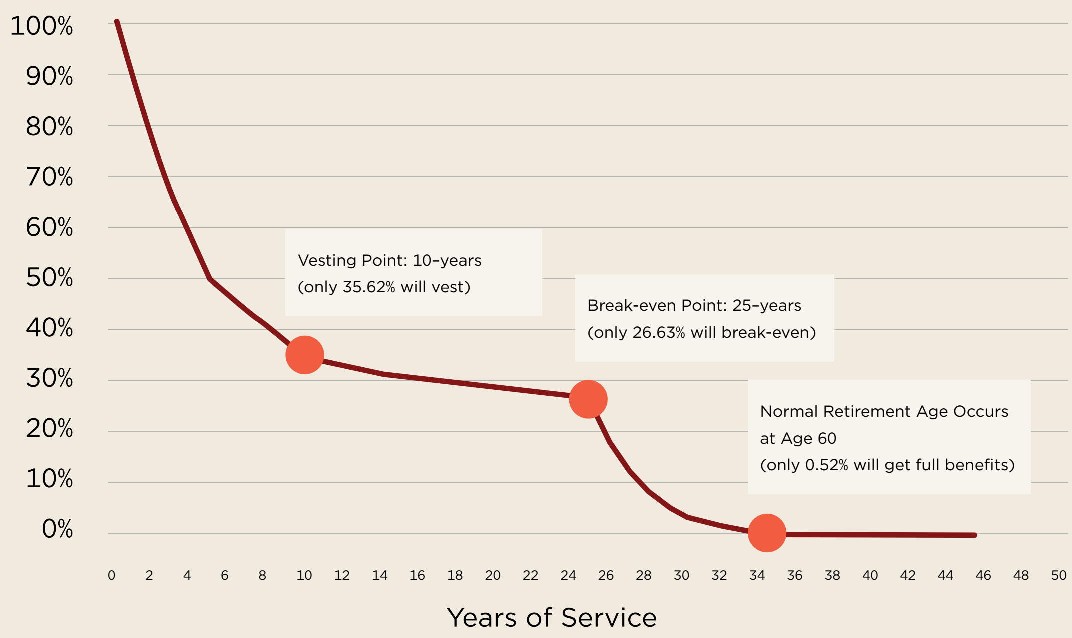
their retirement savings. PSERS, like nearly all defined benefit plans, requires employees to make annual contributions to the plan, and the benefits are structured in a way that backloads real earnings towards the end of a person's career. However, many teachers never reach a point where the value of their future retirement earnings exceeds their contributions. In essence, the teachers that leave are subsidizing the ones who stay.

Nationally, it is estimated that three in 10 teachers leave the profession within five years.[22] In PA, we don't have to estimate the retention figures because, by law, PSERS must annually publish a report that measures the extent to which the system is fully funded. In order to calculate the actual liability, PSERS must determine what percent of teachers are likely to withdraw from the system at any given point in their career. The actuaries use historical turnover data to arrive at this projection.

The data in Figure 7 is the projected withdrawal rates for a 25-year-old female. After one year, she has an 87 percent likelihood of remaining in PSERS.[23]

FIGURE 7 **PA's Teacher Retention Rate**

Data is for 25-year-old female entrants

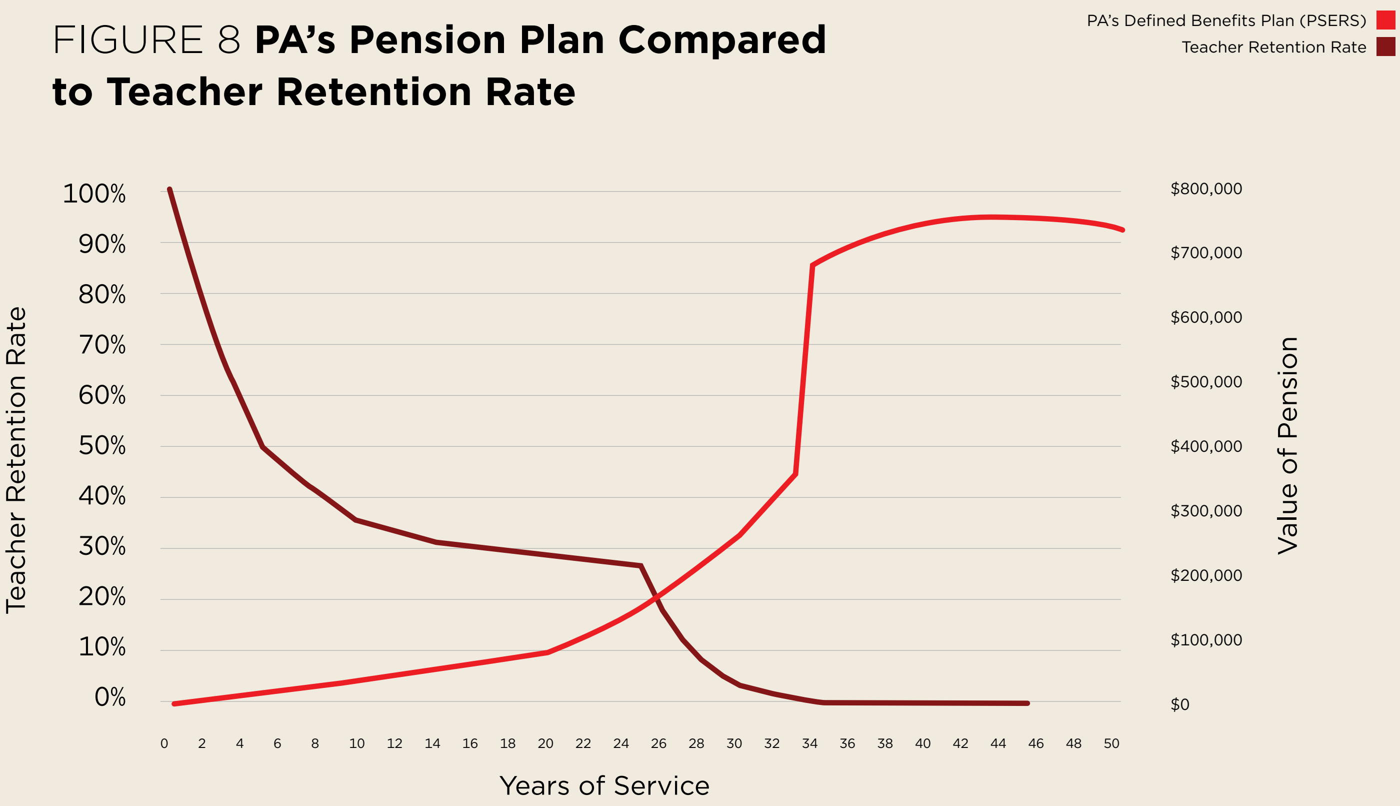


The first major milestone for a teacher in PA, as it relates to retirement, is making it to 10 years. Since Act 120 of 2010, the vesting period for public employees increased from five to 10 years for new employees. Once a teacher vests, he or she is eligible for an annual annuity at the time of retirement. Prior to vesting, the value of a teacher's retirement is simply his/her own contributions with no interest. Teachers who leave prior to vesting are basically providing a no-interest loan to the retirement system. Unfortunately this is the case for 65 percent of teachers because only 35 percent of teachers make it to 10 years, as depicted in Figure 7.[24]

The next major milestone is remaining in the system until the break-even point. That's the amount of years a teacher must work for their retirement benefits to be worth more than their contributions plus interest.[25]

In PA, a teacher must work 25 years to break-even, something only 27 percent of teachers will achieve.[26] In other words, a teacher leaving the profession after 24 years assumes more risk but is still likely better off keeping and investing their employee contributions than participating in PSERS.

FIGURE 8 **PA's Pension Plan Compared to Teacher Retention Rate**



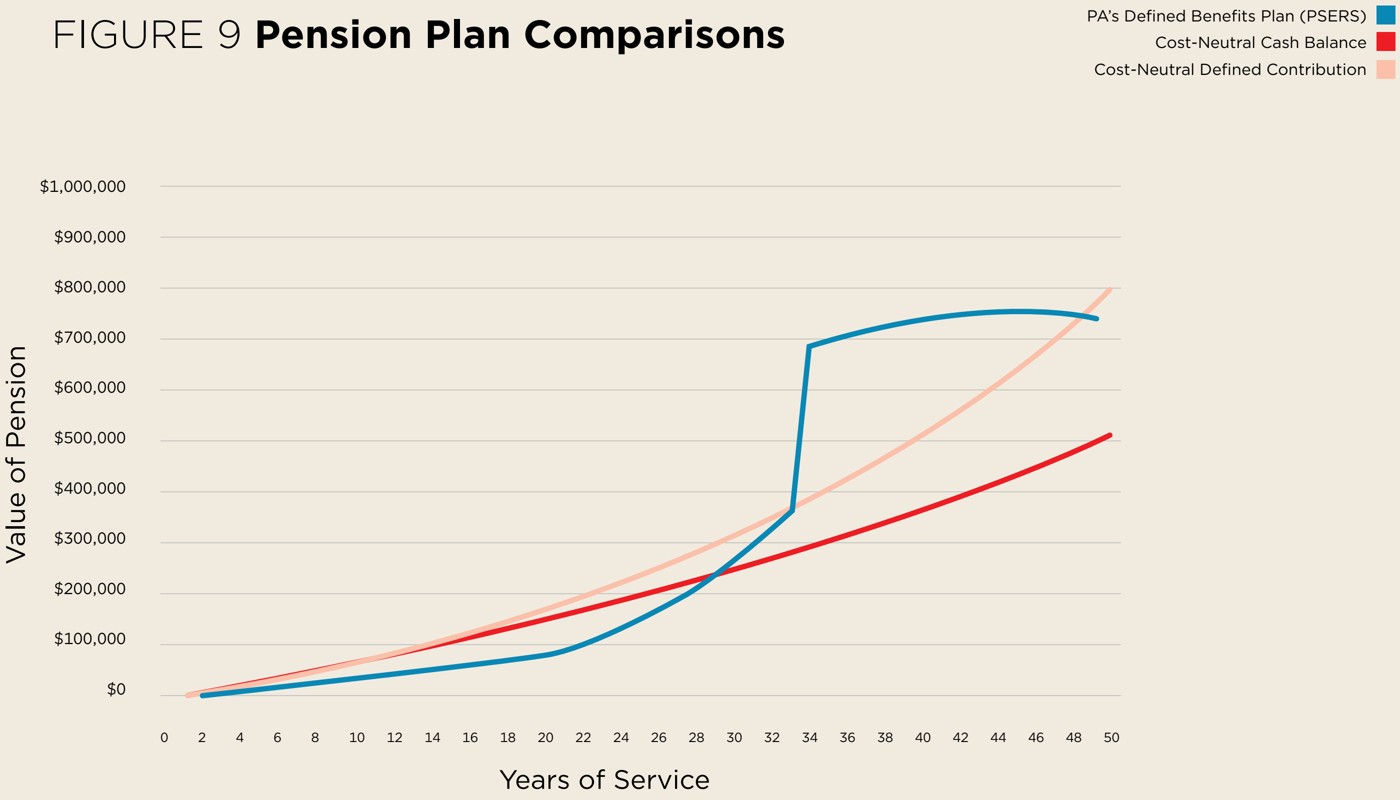
Finally, the significant retirement benefits for teachers happen when they reach normal retirement age. To be eligible for retirement, a teacher must either: Have a combined age and years of service equal to or greater than 92, provided you have at least 35 years of service; or be 65-years-old, provided you have three or more years of service.[27] For our hypothetical 25-year-old female, her normal retirement age would be 60.

PSERS offers a generous and valuable annuity for its retirees. There is only one problem: **Only .52 percent of PA teachers entering at age 25 are projected to remain in the system for 35 years.**[28]

The vast majority of teachers would benefit from alternate retirement plans

Due to the structure of PSERS' benefits, which are mainly accrued at the end of a 35-year career, a very small percentage of teachers will remain long enough to optimize their benefits. Figure 8 overlays PA's teacher retention rate with the value of PSERS' benefits over the span of an educator's career. Notice that by the time the accrued retirement

FIGURE 9 **Pension Plan Comparisons**



value finally exceeds the $100,000 threshold, less than a third of teachers are still in the system.[29]

What the majority of teachers today would benefit from is an alternative plan that provides flexibility and portability, which most private-sector employees enjoy. Two examples of common alternatives to PSERS are a cash balance plan and a defined contribution plan.

A cash balance plan has features of both a defined contribution and defined benefit plan. In a cash balance plan, the employer credits the employee's 401(k) with a percentage of his/her salary plus interest. But unlike a defined contribution plan, a cash balance plan guarantees a return on the investment, regardless of how the account actually performs. Since all the risk is borne by the employer, it is technically a defined benefit plan.

Figure 9 shows how PSERS stacks up to a defined contribution plan and a cash balance plan. For both plans, we assume the same employee (7.5 percent) and employer contribution (8.3 percent) as PSERS. For the cash balance plan, we assume a conservative 5 percent investment return. The defined contribution assumes a 6.5 percent rate of return, which is still less than the assumed PSERS rate of 7.5 percent. Since both plans have no vesting period, when a teacher leaves, the employee gets the full value of what is in the account including employee contributions, employer contributions and all investment returns.

As Figure 9 illustrates, PSERS is a better retirement plan for teachers who spend their entire career in the system. However, both the cash balance and defined contribution plans are better for teachers throughout most of their career. PSERS only outperforms the cash balance plan after 30 years and the defined contribution plan after 33 years.[30]

How PA Can Fix Its Pension System To Provide A Better Option To Employees And Cut Costs For Employers

As we think about the changes in public-sector pensions happening across the country, there are a handful of common initiatives and strategies that states are adopting: 1. Risk shifting and sharing; 2. Portable pension plans; 3. Adjusting unrealistic rates of return; and 4. Evaluating vesting periods.

1. Risk shifting and sharing
In the wake of the Great Recession of 2008, states have recognized the lasting effects of economic downturns on public-sector pension plans. States are exploring multiple ways to update their pension systems so that risk is either shifted away from taxpayers or shared between employees and their employers.

Here are three examples of how states are making these changes:

A. Defined benefit plans are designed to shift the risk from teachers to employers. However, this means that when defined benefit plans underperform, due to economic downturns or missed targeted investment returns, employers (essentially the taxpayers who are funding public schools) must increase their contributions to ensure guaranteed retirement benefits to teachers whose benefits are guaranteed. In 2010, Utah became one of the first states to enact major pension reform after the state's pension system lost 22 percent of its assets in 2008. The reforms established a defined contribution plan for new teachers to choose from, helping to shift the risk away from taxpayers for newly hired teachers.[31]

B. States like California have adopted risk mitigation strategies to help shift the risk away from taxpayers. Under this approach, the California State Teachers' Retirement System is making more conservative investments in holdings, like long-duration U.S. Treasuries.[32] This strategy allows state pension systems to reduce the impact of another major downturn by investing in more stable returns.

C. Other states have explored risk-sharing strategies as ways to respond to positive and negative market fluctuations. Teacher and employer contributions to the Wisconsin Retirement System change each year, based on investment performance and complex actuarial factors.[33] If the market is underperforming, plan participants are required to contribute a slightly higher percentage to help share in the risk, and when the market outperforms plan participants are required to contribute less as they share in the systems gains.

2. Portable pension plans

In an increasingly mobile world, public-sector pension plans should be fully portable, which is one of the biggest advantages of a defined contribution plan. Like individuals with employer-sponsored 401(k) plans, educators who move across state lines before reaching retirement eligibility should have the ability to rollover money into a new employer plan or individual retirement account (IRA). Teachers should not be penalized and have to start from square one in working toward a secure retirement if their teaching career takes them to another state. To date, seven states have portable pension options. Alaska is the only state with a highly portable defined contribution plan, in which teachers are entitled to 100 percent of their contributions after five years of service. Florida, Ohio, Michigan, South Carolina and Utah offer defined contribution plans as a choice for their teachers, and South Dakota's defined benefit plan has unique provisions that allow for flexibility when teachers leave the system.[34]

3. Adjusting unrealistic rates of return

State pension systems make economic assumptions about factors such as the rate of wage growth and the future expected returns on pension funds.[35] Unfortunately, the rates of return assumed by most states have been way too high.[36] In 2016, 41 states made their pension calculations based on a 7.5 percent or higher rate of return on investments, and 13 of those states set their expectations at an 8 percent or higher return. In a recent analysis of over 125 public pension plans, nearly 75 percent have reduced their investment return assumptions since 2010, resulting in a decline in the average return assumption from 7.91 percent to 7.52 percent.[37] State pension systems must take a more realistic approach when making economic assumptions, like Rhode Island did when the state tweaked its defined benefit formula after revised actuarial estimates included more realistic (and thus lower) assumptions about the state's expected rate of return on assets.[38]

4. Evaluating necessity of vesting periods

A vesting period is the time it takes teachers to be eligible for an employer contribution as part of a defined benefit plan. Teachers who leave before vesting are generally entitled to nothing more than their own contributions plus some interest. The average vesting period for teachers nationwide has risen from 5.7 years in 2009 to 6.6 years in 2016.[39] To date, only Arizona, Minnesota, South Dakota, Utah and Wyoming have vesting periods of less than five years—Arizona is the only state to offer immediate eligibility for its teachers. One of the key advantages of a defined contribution plan is there is no (or a minimal) vesting period, which means employees begin earning retirement savings immediately.

Conclusion

The rising cost of pensions is forcing school districts to shift resources away from the classroom, and the vast majority of teachers are not even staying around long enough to really benefit from PA's generous system. Education advocates who usually focus on issues such as revenue, governance, standards, and curriculum should be equally focused on ensuring PA has a pension system that ensures school districts are fiscally solvent, while also providing better retirement security to the majority of its teachers.

Fundamentally, this report shatters two myths about education funding and pensions. Myth 1 is that school districts have experienced a windfall over the past few years. The truth is that while state funding has increased, pension costs have increased even faster so school districts have actually experienced net losses. Myth 2 is that teachers are getting great benefits under the current system. The reality is that very few teachers do better under PSERS than they would under an alternate plan that provides flexibility and portability.

Other states provide a roadmap for how PA can move forward. The crisis is serious enough that a cosmetic fix will not suffice. PA made changes to PSERS in the past, yet the unfunded liability has continued to grow. (For a more detailed overview of the history of PA pension reform, see Appendix B.)

It's time to recognize that pension reform is education reform. PA must work to implement the four initiatives recommended in the previous section: risk shifting, making plans portable, adjusting rates of return, and evaluate the need for vesting periods in the wake of a possible departure from a defined benefits plan. The pension challenges facing PA are urgent, but they can be solved. PA has an opportunity to address this crisis through legislation being considered by the General Assembly. This legislation provides important reforms for PA's teachers, students and taxpayers.

Appendix A State Pension Reform Spotlights

Alaska Only Alaska provides teachers with a flexible and fair defined contribution plan; their plan is also highly portable, as teachers are entitled to 100 percent of employer contributions after five years of service.[40] The pension system in Alaska was reformed in 2005—when the state added a defined contribution plan for all new employees, but did not make changes to existing teacher pensions.[41] Alaska's pension plan has been recognized as not being perfect; however, it was recently rated as very stable and well funded, as well as providing pension neutrality (i.e. benefits accrue uniformly with each of year of work).[42]

Michigan As a new slate of legislators assumed office in January 2017, the speaker of the Michigan House indicated that fixing Michigan's "broken" teacher retirement system is one of his top three priorities for the 2017–18 session—as the current system is saddled with more than $26.7 billion in unfunded pension liabilities, up from $22.3 billion in 2011.[43] In 2010, Michigan introduced a hybrid pension plan choice for its teachers and, during the last legislative session, the state attempted to close the current pension system to new retirees and provide a 401(k)-style defined contribution benefit to newly hired teachers.[44] Although, Michigan is one of a handful of states that currently offer a hybrid defined contribution plan choice for its teachers and base retirement eligibility on age only, the state still has a 10-year vesting period and weak transparency when considering the system's standing and its future health.[45]

Rhode Island In late 2011, then-state treasurer Gina Raimondo helped Rhode Island enact one of the country's most aggressive statewide pension reforms to date. Raimondo persuade the state legislature to do "radical pension surgery" after a series of town hall meetings (where she said the state had promised its workers far more than it could deliver) and after a small city that had never joined the state pension system went bankrupt.[46] Rhode Island tweaked its defined benefit formula after actuarial estimates were revised to include more realistic (and thus higher) assumptions about life expectancy and more realistic (and thus lower) assumptions about the state's expected rate of return on assets. The state reduced the benefits earned by new employees and existing workers for future years of employment; they also augmented their system with a 401(k)-style plan.[47] Today, Rhode Island's pension plan is one of a handful of systems that are considered to have pension neutrality—uniformly increasing pension wealth with each additional year of work.[48]

South Dakota South Dakota has structured its defined benefit system so that it is financially sustainable and provides flexibility to teachers. The state is one of only two that has a fully-funded system; their system is also spotlighted for being one of a few states with a vesting period of less than three years.[49] The state provides teachers with an annual benefits statement, and a breakdown of the amount contributed by them and the amount contributed by their employer.[50] Additionally, even as the state recognizes the strength of its pension system, they have still been working on reforming it to accommodate longer life expectancies. In December 2015, a new retirement system was approved for new public employees beginning work after June 30, 2017—the new design adds variable hybrid benefits and is self-sustaining from the state's other model.[51]

Utah In March 2010, Utah became one of the first states to enact major pension reform. After the Great Recession of 2008, Utah's pension system lost 22 percent of its assets and is currently funded at 84 percent.[52] The reforms in Utah established a defined contribution plan or hybrid plan for new teachers to choose from; today, the plan has one of the lowest vesting periods (i.e. 4-years) and their defined contribution plan bases eligibility on teacher's age only.[53]

Appendix B
PA's Pension History

2001–02 The General Assembly voted to increase pension benefits for active and retired employees (Act 9 of 2001 and Act 38 of 2002).[54] As well as decreasing the amount of time an employee had to work for the state to be eligible for a pension.[55]

2003 Ed Rendell was elected governor and promised to increase k-12 education spending, and along with the General Assembly (which voted to artificially lower the payment rates—Act 40 of 2003[56]) invested in pet projects at the expense of properly funding the pension system.[57]

2008 Great Recession hit and deteriorated the value of the pension fund.[58]

2010 Gov. Rendell and the General Assembly passed Act 120, which reversed the 2001 increased pension benefits for any new hires back to pre-2001 levels. This reset lowered what is known as the "normal cost" that employers are expected to pay for their retirees' benefits.[59] Though Act 120 successfully saved the Commonwealth significant funds, it left the state with a defined benefits system that many believed, at the time, did not go far enough to fix the problem. Act 120 allowed new employees to buy into a more expensive pension plan but required that they foot the bill up front with higher paycheck deductions.[60]

Act 120 also established a schedule of yearly step-increase payments that the state and school districts are required to make to fill the gap in their pension obligations to pre-Act 120 workers. In 2010, the state was paying $1 billion into the pension system and, due to the requirements of Act 120, the state's contributions were up to $5 billion in 2016. Act 120 has not done anything to reduce the state's unfunded liability, which in 2010 was $21.3 billion and rose to $56.8 billion in 2016.[61]

Though most would agree that fully funding the pension system is necessary, it also means that the state has had to make difficult cuts to programs in order to scrape together the extra money for pensions and school districts have increased property taxes to offset their increased requirements.

June 2015 Acknowledging the need to make drastic changes to PA's pension system in order to maintain its viability for current and future employees, the Republican majority in the House and Senate passed

SB1 in June 2015. The changes contained in SB1 included establishing a hybrid defined contribution / cash balance retirement plan. Governor Wolf vetoed the bill over concerns that it would detract quality applicants to jobs with the state or in schools. Instead, he pushed his own plan to keep the pension benefits but float $3 billion in bonds to properly fund the system.[62]

November 2015 In the midst of a 5-month budget impasse, Senate Republicans took another shot at pension reform and passed SB1071, which essentially mirrored SB1, but failed to pass in the House.[63]

2016 In yet another attempt to find a compromise on pension reform, the House, in June 2016, voted to amend SB1071 with language that garnered bipartisan support. The Senate, however, refused to concur on the changes, which sent both chambers into a conference committee. With only a handful of session days left in the year, the committee voted to approve a conference report that contained proposed legislation in October. Though optimism was high, House leadership announced they couldn't muster up the 102 votes needed to pass the bill in their chamber.[64]

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About PennCAN

PennCAN: Launched in May 2012, PennCAN: The Pennsylvania Campaign for Achievement Now, is a 501(c)3 nonprofit education reform advocacy organization building a movement of Pennsylvanians with the political will to enact smart public policies so that every Pennsylvania child has access to a great public school.

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