Beneath the Surface

Pennsylvania's Looming Pension & Healthcare Benefits Crisis

Richard C. Dreyfuss

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Executive Summary

Pennsylvania government employee-benefit plans operate in a vacuum. In a world where private-sector benefit cutbacks and cost reductions occur on a daily basis, state government in Harrisburg has not responded in similar fashion. In fact, instead of reducing the potential for financial disaster, actions in recent years have served to accelerate the coming crisis.

The absence of a long-term employee-benefit strategy, other than assuming the perpetual life of the public entity (the taxpayer), is fiscally irresponsible at best. Although there will certainly continue to be minor differences in the construct of private and public benefit plans, there should be no differences in governance, benchmarking, or in the desire to control costs. In the Commonwealth of Pennsylvania, this is not the philosophy or the practice in managing its public-sector benefits plans.

The actions and inactions of policymakers should raise profound concerns about the current and future fiscal health of Pennsylvania. Logic suggests that as the private sector must continue to evolve in an ever-changing economic environment, so too must the public sector. After all, the health of the public sector is entirely dependent on a healthy private sector, not the other way around. Therefore, the best demonstrated practices exhibited within the private sector must also permeate the policies developed in the State Capitol.

Private sector plans are generally designed and managed to achieve both short and long-term business objectives. Pennsylvanians have seen key industries fail because they could not achieve predictable and affordable costs. The looming crisis in the long-term commitments made by policymakers on behalf of taxpayers is reflected in the rapid 615% increase in expected state pension contributions from $584 million in FY 2004-05 to more than $4.2 billion in FY 2012-13 for the State Employees Retirement System (SERS) and Public School Employees Retirement System (PSERS). Without significant actions affecting plan design, the Commonwealth of Pennsylvania will likely be facing unaffordable costs, some of which have yet to be fully quantified.

For example, what will be the impact of Government Accounting Standards Board statement No. 45 when it takes affect in 2007? This accounting requirement will force state and local governments to begin to recognize (but not necessarily fund) future retiree healthcare liabilities over the working lifetime of the

employee (as is currently done in the private sector under FASB 106). Shedding light on heretofore hidden costs will only further reveal Pennsylvania's looming pension and retiree healthcare benefits crisis.

Daily news reports and recent surveys reveal the negative impact of these obligations in the private sector. Such costs should be no more affordable in the public sector. Government employee benefit costs, like all operating expenses, need to be actively managed. However, in response to initiatives to achieve greater fiscal discipline within state and local government (such as "spending limits" on the state government budgeting process or "voter referendum" on local school district spending), some policymakers are seeking to exempt pension and healthcare costs from such limits or taxpayer control. Such exemptions would only further distort the true cost of government to Pennsylvania taxpayers.

Long-term benefits costs cannot exceed the state's long-term revenue growth rate, otherwise plan design and/or staffing reductions will be needed to avoid a fiscal disaster. The state must adopt a long-term benefit strategy to control costs rather than assuming "the perpetual life" of the taxpayers' ability to pay if it hopes to properly govern, benchmark and manage the long-term pension and healthcare liabilities.

Many of these same issues apply at the local government level as well where counties, municipalities and school districts sponsor pension and retiree healthcare plans.

Summary of Findings

- A 2004 state pension report and recent actuarial valuations of assets and liabilities indicate the Pennsylvania taxpayers' costs to support SERS and PSERS, assuming an annual investment return of 8.5%, will increase from $584 million in Fiscal Year 2004-05 to an estimated cost of
    - $693 million in Fiscal Year 2005-06
    - $1.000 billion in Fiscal Year 2010-11
    - $4.346 billion in Fiscal Year 2015-16
    - $5.583 billion in Fiscal Year 2020-21

- Legislation passed in 2001 and 2002 which improved pension benefits for actives and retirees generated $10 billion in additional unfunded liability and increased taxpayer contributions by $1.2 billion annually. This, coupled with unfavorable asset performance in these same years, weakened the fiscal solvency of SERS and PSERS. Prior to 2004, these plans exhibited a surplus (based on valuation assets over accrued liabilities). Legislation in 2003 refinanced much of these costs over a 30-year period.

- A Joint State Government Commission study suggests that any reductions in pension benefits are prohibited by the Constitutions of the United States and the Commonwealth of Pennsylvania. Pension benefit enhancements, however, are acceptable and immediately deemed irrevocable.

- By 2007, under GASB No. 45, Pennsylvania state government will be required to annually recognize future retiree healthcare costs. Subsequent to 2007, smaller government entities such as cities, municipalities and school districts will be forced to adopt this change in accounting practice. [Similar requirements in the private sector under FASB No. 106 in 1993 have forced many private-sector companies to amend, restrict and even eliminate their benefits programs through cost-sharing, eligibility changes and other coverage reductions.]

- SERS and PSERS members (which include legislators, members of the judiciary, public school employees and other state employees) participate in a pension plan with provisions more generous compared with other state plans and far more generous than a representative group of major private employers in Pennsylvania.

- Cost-of-living-adjustments (COLA) for SERS and PSERS retirees are being considered in the General Assembly despite the significant liabilities inherent in the current pension system. The COLA in 2002 increased plan liabilities by $1.75 billion. This is in an environment where these same retirees pay little, if any, premium for lifetime healthcare coverage paid by taxpayers, which should be viewed as an annual "healthcare COLA" given the annual rise in healthcare costs.

- State retiree healthcare benefit programs are also very generous and surpass that found in any Pennsylvania company studied for this analysis.

- The philosophy and practice of Pennsylvania's public pension and healthcare benefit plans demonstrate no evidence of outside benchmarking to the private sector or a long-term strategy to control costs or create public/private parity. Clear trends exist in the private sector affecting defined-benefit pension plans and retiree healthcare plans resulting in changes which yield predictable and affordable costs including greater risk/cost-sharing between employee and employer.

- The benchmarking for the design and affordability of these plans does not reflect the best demonstrated practices within the private sector.

- Legislators are legally entitled to a pension of 3% of final average pay multiplied by years of service, and are able to receive an unreduced benefit at age 50 with 3 years of service. This provision is generous (even within the already generous SERS benefits), expensive and not found in any of the 43 Pennsylvania private-sector companies studied for this analysis.

- A state legislator first elected in 2006 at age 40 and serving 20 years with pay increases of 3.3% per year would receive an annual pension of approximately $77,700, assuming no COLAs or election to leadership positions (which would increase this amount).

- Retired legislators receive benefits more generous than that of most public employees, giving them one of the best pension packages in one of the best pension systems in the nation.

- Legislators pay no premium for their active healthcare benefits, while private-sector employees pay an annual average of approximately 16% of their premium ($610) for single coverage and approximately 27% ($2,713) for family coverage, according to a 2005 national survey.

- Certain members of the judiciary participate in a higher level benefit category within SERS providing them with 4% of final average pay for the first 10 years and 3% for years thereafter. This formula yields an annual benefit of 100% of pay after 30 years, provided they are age 60.
    - These judiciary members are also eligible to participate in a voluntary supplement to provide additional pension benefits for earnings over the Social Security Wage Base (which are already considered in the primary SERS pension benefit). This voluntary supplemental plan results in a net cost to taxpayers even after considering the required employee contributions. Therefore, it is no surprise that over 90% of eligible employees participate in the plan.

Recommendations

- Identify and implement a benefits cost strategy which is predictable and affordable within a responsible fiscal budget for the Commonwealth. There should be no budget exemptions or any other special considerations for state pension or GASB No. 45 costs. If these costs are deemed unaffordable, then significant plan design changes must take place.

- Obtain private-sector input and improve the oversight of these programs.

- Amend Act 9 of 2001 and Act 38 of 2002 to provide benefits which are affordable.

- Create less reliance on defined-benefit plans for retiree income. Adopt defined-contribution plans with an employer match as a replacement (in part or in whole) to the defined-benefit plans.

- Benchmark from the geographical areas comprising the labor pool. Consider benchmarking design and cost sharing to an "index of benefits" provided from a representative set of major private-sector companies based in Pennsylvania. Benchmarking only to other public plans, while perhaps an interesting academic exercise, is an attempt to ignore the realities of today's world.

- Increase cost-sharing for active healthcare plans.

- Reduce coverage, adopt tighter age and service eligibility requirements, and implement premium caps for the retiree healthcare plans.

- Curtail any future pension cost of living increases for retirees. Consider how much of an "increase" a retiree receives each year through their healthcare plan.

- Address the question of whether elected officials should participate in any state retiree healthcare or state pension plan.

The purpose of this report is to raise public policy questions that need answers regarding the governance, proper benchmarking, and fiscal management of taxpayers' long-term pension and healthcare liabilities. The long-term commitments and liabilities made by policymakers on behalf of taxpayers are unsustainable, particularly given the difficult economic environment facing both the public and private sectors in Pennsylvania.

Beneath the Surface

Pennsylvania's Looming Pension & Health Care Benefits Crisis

Introduction

This analysis began as an examination of the pay and employee-benefit programs provided to Pennsylvania state legislators, a topic which has generated significant public interest, especially with the recent actions increasing legislators' pay. The initial focus of this study was to fully examine this total compensation package, in particular, the long-term obligations in the area of pension and retiree healthcare benefits provided to legislators. These results would be presented together with the generally well-understood cash compensation and state-sponsored active health care programs. While it is common knowledge that retirement benefits exist, the quantification of these future liabilities has not been presented with that of the basic compensation package to provide a complete picture of the total costs.

While this study presents profiles of legislators' total pay packages, and the pension benefits packages of other state employee groups as a basis of comparison, the research also surfaced more fundamental issues regarding the long-term obligations provided to Pennsylvania public employees as a whole.

This study is not intended to be a comprehensive review of the total pay packages for all public employees in Pennsylvania; rather the purpose is to raise questions regarding governance, proper benchmarking and the fiscal management of these long-term liabilities in the context of the difficult economic environment facing both the public and private sectors.

Beneath the Surface is essentially the convergence of a number of themes which are often discussed in the public domain, but are generally presented and discussed as mutually exclusive subjects. Pennsylvania's public employee pension and retiree healthcare programs must be considered in view of the increasing costs of government to taxpayers and Pennsylvania's generally unfavorable business environment. Only then will policymakers be able to appropriately benchmark public benefit plans and adequately address the related concerns regarding the volatility and magnitude of long-term employee benefit costs; and develop a better understanding of the financial mechanics of taxpayer-funded, defined-benefit pension and retiree healthcare plans.

This report examines certain areas within defined-benefit pensions and retiree healthcare plans which typically do not receive appropriate public scrutiny. This topic raises fundamental questions relating to a rational approach to operating state government while responsibly managing the short and long-term costs of public-sector benefit plans.

As will be shown, many of the market forces and oversight processes which are present in the private sector do not appear to exist (or at least function effectively) in the Pennsylvania public sector. This is not to suggest the private sector works properly 100% of the time. However, it appears many decisions involving the management of long-term liabilities would not be made by prudent individuals or entrepreneurs running responsible businesses in the private sector. Sound fiscal discipline and basic business principles appear to be have been ignored, and as a result, significant future costs exist which are not well-known or fully understood. This raises many fiduciary issues. Fundamentally, legislators are not only charged with effectively managing their own pay systems, but also have responsibility and accountability in the proper structure and fiscal management of the Pennsylvania public-sector employee benefit plans as a whole.

Section 1: Legislator Compensation Philosophy

One of the more significant events took place on July 7, 2005 when legislators voted themselves (and others) a significant pay increase ranging from 16-54% and created a formula establishing future annual pay increases. As a consequence of this legislation similar increases in annual pensions were created, since pensions are a function of pay. Despite the repeal of that legislation following four months of public controversy, the issue only served to highlight the need for reform.

The legislative action on July 7, 2005, raised significant issues as it violated three longstanding principles of the business model against which it should be compared:

- First, the marketplace (supply and demand for labor) determines the going rate for a position.
- Second, total compensation costs are predicated on the customers' (in the public sector, the taxpayers') ability to pay.
- Third, an individual should never be the final authority on one's own pay package.

It is useful to analyze the compensation and benefits costs of a legislator, particularly since the cost of future benefits such as pensions and retiree healthcare are not well understood. This report identifies these total compensation costs raising some important questions for the taxpayers underwriting these current and future costs. This analysis focuses only on pay and benefits and excludes all other employee-related costs, including travel allowances and expense accounts.

To establish a reference point, 43 Pennsylvania corporations with 1000 or more employees were studied from available sources to analyze the benefit plans provided to their salaried workforce. As a basic rule, smaller businesses generally provide limited, if any, active group insurance coverage and often only offer a basic defined-contribution plan as the primary retirement program.

Most companies have a compensation strategy in which they attempt to determine market pay or a "going-rate" for a given position. This approach allows a business to actively manage its cost. A fundamental principle is that the marketplace determines what a business can afford. With respect to pay practices, major corporations do not rely on "comparable worth" (such as comparing an accountant with a salesman) to determine pay practices since it is too subjective and not a reliable indicator of market pay. While many in the private sector use established surveys to determine market rate, they also predicate any pay structure on the firm's ability to pay. This fact is ever-increasing in the area of active health care costs, retiree healthcare and pensions, where companies are reducing coverage or sharing risk with employees and retirees to mitigate short-term costs and long-term volatility. Ultimately, much of this is reconciled in the annual wage increases afforded employees in both the private and public sectors.

A basic truism is the ever-increasing cost of government must be supported by the taxpayers of the Commonwealth of Pennsylvania. True cost cuts in absolute dollars (compared to a reduction in projected costs) are rarely seen in the public sector. These dynamics eventually impact the costs of goods and services and also define the business environment in which individuals work. In essence, they affect the quality of life for all.

While the market approach to defining value and costs may not be a perfect system, several of the many remedies to "improve" the system ultimately result in trading one set of problems for another.

Section 2: Pennsylvania Public Sector Compensation Analysis

Legislators

In this analysis, a legislator is profiled at various ages of hire occurring in the year 2006. The tables present the annual cost of current programs such as salary and healthcare. Other benefits while payable in the future, such as pension and retiree healthcare, are shown in terms of what an employer (the taxpayer) would theoretically have to set aside in order to accumulate sufficient funds to have the benefit "paid-up" at an assumed retirement age.

The assumptions were selected either to conform to those used in determining state pension costs and are otherwise chosen in an effort to avoid overstating costs with consideration also given to simplicity. The results are intended to illustrate concepts more than engaging in a discussion on the precise assumptions or alternative methodologies which could be used to define certain costs.

Assumptions:

- A newly hired legislator in 2006 at $72,200 at ages 30 and 40.
- A group insurance package valued at $13,000 (clerks in the House and Senate report that annual healthcare coverage in 2005 was $14,282 and $13,040 respectively, according to the *Pittsburgh Tribune-Review*, "Free lifetime health care will be costly," December 29, 2005).
- 3.3% Annual pay increase (current assumption used in estimating pension costs for legislators in Pennsylvania State Employees' Retirement System "SERS").
- 8.5% Annual investment rate of return (used in estimating pension costs in SERS).
- 8.5% Present value discount rate (author's estimate).
- 8.5% Annual Healthcare increase rate (author's estimate).
- Pension and retiree healthcare costs are expressed as a level annual premium over the employee's working career.
- After age 65 payable to age 85, Group Insurance Package is estimated at $5,000/yr. (author's estimate).
- Lump sum pension value based upon a single life annuity and does not include any cost-of-living increases post-retirement.
- Employee Contributions 7.5% of pay into the pension plan which are credited 4% interest by the plan.

Definitions and Notes:

(1) Base Salary – Salary used for pension purposes
(2) Group Insurance Package – Estimated value of benefits such as life, health and disability insurances
(3) Other Pay – Other non-cash compensation such as auto allowances. While these clearly exist in practice, for the purpose of this analysis the value of these programs has not been quantified and is not included.
(4) Total Current Compensation - (1) + (2)
(5) Level Annual Pension Accrual – Theoretical amount to be contributed into a fund on an annual basis to provide a sufficient reserve at retirement.
(6) Level Annual Retiree Healthcare – Similar to (5) except this annual amount is to fund Retiree Healthcare at retirement.
(7) Self Explanatory
(8) Self Explanatory
(9) Amount of Annual Pension Paid at Retirement.
(10) Estimated Reserve for Pension Benefits.
(11) Self Explanatory
(12) Self Explanatory

Table 1: Legislator hired at age 30 in 2006

(1)	Annual Salary	$72,200
(2)	Group Insurance Package	$13,000
(3)	Other Pay	$0
(4)	Total Current Compensation	$85,200

		Years of Service			
		20	25	30	35
(5)	Level Annual Pension Accrual (excludes employee contributions)	$11,500	$9,400	$7,100	$4,400
(6)	Level Annual Retiree Healthcare Accrual	$5,800	$2,800	$1,300	$500
(7)	Total Retirement Benefit Accrual (5) + (6)	$17,300	$12,200	$8,400	$4,900
(8)	Total Compensation Package (4) + (7)	$102,500	$97,400	$93,600	$90,100
(9)	Annual Pension at Retirement Age	$77,700	$114,300	$161,300	$217,700
(10)	Lump Sum Value of Pension	$823,000	$1.15 M	$1.50 M	$1.82 M
(11)	Estimated Salary at Retirement	$133,800	$157,400	$185,100	$217,700
(12)	Percentage of Final Salary replaced by Annual Pension (9) / (11)	58%	73%	87%	100%

Table 2: Legislator hired at age 40 in 2006

(1)	Annual Salary	$72,200
(2)	Group Insurance Package	$13,000
(3)	Other Pay	$0
(4)	Total Current Compensation	$85,200

		Years of Service			
		10	15	20	25
(5)	Level Annual Pension Accrual (excludes employee contributions)	$14,100	$11,900	$9,500	$7,100
(6)	Level Annual Retiree Healthcare Accrual	$19,100	$7,800	$3,300	$1,200
(7)	Total Retirement Benefit Accrual (5) + (6)	$33,200	$19,700	$12,800	$8,300
(8)	Total Compensation Package (4) + (7)	$118,400	$104,900	$98,000	$93,500
(9)	Annual Pension at Retirement Age	$28,100	$49,600	$77,700	$114,300
(10)	Lump Sum Value of Pension	$297,000	$497,000	$722,000	$958,000
(11)	Estimated Salary at Retirement	$96,700	$113,700	$133,800	$157,400
(12)	Percentage of Final Salary replaced by Annual Pension (9) / (11)	29%	44%	58%	73%

Other State Employees

This section provides additional pension illustrations as a basis of comparison to the legislators. Due to the fragmentation of retiree healthcare plans throughout the state, together with the difficulty in obtaining reliable data, the active and retiree healthcare components of the total compensation statement are not valued.

To facilitate the comparison to the legislators, a uniform annual salary increase of 3.3% is assumed for all future years. Also, while not all classes of employees in both plans can qualify for retirement benefits at age 50, the assumption used is a flat 6% per year reduction from age 60, would apply to approximate an annual pension benefit at that age. Table 3 below summarizes the major provisions within an Employee Class. Some Employee Classes contain exceptions applicable to certain subcategories.

Table 3: Major Classes of Active Employees in SERS

Employee Class	Number of Active Members (as of Dec. 31, 2002)	Percentage of Active Members	Employee Contribution Rate	Benefit Multiplier	Superannuation Age
Class A - State Police officers hired on or after March 1, 1974, members of the judiciary who have not elected class E-1 or E-2, legislators elected before July 1, 2001 who have not elected class AA or class D-4 and class A employees hired before 2001 who remained in class A.	5,876	5.29%	5.00%	2.0%	Age 60 with 3 years of service or 35 years of service regardless of age
Class AA - All eligible employees, except State Police officers, members of the judiciary and legislators, hired after June 30,2001; employees hired before July 1, 2001 who elected class AA by December 31, 2001	103,944	93.59%	6.25%	2.5%	Age 60 with 3 years of service or 35 years of service regardless of age
Class C - Liquor law enforcement officers and other officers and certain employees of the State Policy who have been members and employees continuously since prior to March 1, 1974	140	0.13%	5.00%	2.0%	Age 50 with 3 years of service
Class D-3 - Legislators who have been members and employees continuously since prior to March 1, 1974	6	0.01%	18.75%	7.5%	Age 50 with 3 years of service
Class D-4 - Legislators coming into service after June 30, 2001 who elect to be SERS members, and legislators who elected class D-4 before July 1, 2001	215	0.19%	7.50%	3.0%	Age 50 with 3 years of service
Class E-1 - Judges who elect class E-1	401	0.36%	10% first ten years, 7.5% thereafter	4% for the first ten years, 3% thereafter	Age 60 with 3 years of service or 35 years of service regardless of age
Class E-2 - District Justices who elect class E-2	477	0.43%	7.50%	3.0%	Age 60 with 3 years of service or 35 years of service regardless of age

Source: Material Supplied by SERS; HayGroup, Sers 2002 Actuarial Report, 37

Table 4: State Employee (SERS Class AA) hired at age 30 in 2006

(1) Annual Salary	$35,000	
(2) Group Insurance Package	NV	(Not Valued)
(3) Other Pay	$0	
(4) Total Current Compensation	$35,000	

		Years of Service			
		20	25	30	35
(5)	Level Annual Pension Accrual (excludes employee contributions)	$700	$2,900	$2,900	$2,000
(6)	Level Annual Retiree Healthcare Accrual	NV	NV	NV	NV
(7)	Total Retirement Benefit Accrual (5) + (6)	$700	$2,900	$2,900	$2,000
(8)	Total Compensation Package (4) + (7)	$35,700	$37,900	$37,900	$37,000
(9)	Annual Pension at Retirement Age	$12,600	$39,200	$65,200	$89,400
(10)	Lump Sum Value of Pension	$133,000	$393,000	$605,000	$750,000
(11)	Estimated Salary at Retirement	$64,900	$76,300	$89,800	$105,600
(12)	Percentage of Final Salary replaced by Annual Pension (9) / (11)	19%	51%	73%	85%

Table 5: State Employee (SERS Class AA) hired at age 40 in 2006

(1) Annual Salary	$35,000	
(2) Group Insurance Package	NV	(Not Valued)
(3) Other Pay	$0	
(4) Total Current Compensation	$35,000	

		Years of Service			
		10	15	20	25
(5)	Level Annual Pension Accrual (excludes employee contributions)	$1,000	$2,800	$3,900	$2,900
(6)	Level Annual Retiree Healthcare Accrual	NV	NV	NV	NV
(7)	Total Retirement Benefit Accrual (5) + (6)	$1,000	$2,800	$3,900	$2,900
(8)	Total Compensation Package (4) + (7)	$36,000	$37,800	$38,900	$37,900
(9)	Annual Pension at Retirement Age	$4,500	$14,000	$31,400	$46,200
(10)	Lump Sum Value of Pension	$48,000	$140,000	$292,000	$387,000
(11)	Estimated Salary at Retirement	$46,900	$55,100	$64,900	$76,300
(12)	Percentage of Final Salary replaced by Annual Pension (9) / (11)	10%	25%	48%	61%

Table 6: State Employee (SERS Class AA) hired at age 30 in 2006

(1) Annual Salary	$72,200	
(2) Group Insurance Package	NV	(Not Valued)
(3) Other Pay	$0	
(4) Total Current Compensation	$72,200	

		Years of Service			
		20	25	30	35
(5)	Level Annual Pension Accrual (excludes employee contributions)	$1,500	$6,100	$6,000	$4,200
(6)	Level Annual Retiree Healthcare Accrual	NV	NV	NV	NV
(7)	Total Retirement Benefit Accrual (5) + (6)	$1,500	$6,100	$6,000	$4,200
(8)	Total Compensation Package (4) + (7)	$73,700	$78,300	$78,200	$76,400
(9)	Annual Pension at Retirement Age	$25,900	$80,965	$134,500	$184,500
(10)	Lump Sum Value of Pension	$274,000	$811,000	$1.25 M	$1.55 M
(11)	Estimated Salary at Retirement	$133,800	$157,400	$185,100	$217,700
(12)	Percentage of Final Salary replaced by Annual Pension (9) / (11)	19%	51%	73%	85%

Table 7: State Employee (SERS Class AA) hired at age 40 in 2006

(1) Annual Salary	$72,200	
(2) Group Insurance Package	NV	(Not Valued)
(3) Other Pay	$0	
(4) Total Current Compensation	$72,200	

		Years of Service			
		10	15	20	25
(5)	Level Annual Pension Accrual (excludes employee contributions)	$2,100	$5,700	$7,900	$5,900
(6)	Level Annual Retiree Healthcare Accrual	NV	NV	NV	NV
(7)	Total Retirement Benefit Accrual (5) + (6)	$2,100	$5,700	$7,900	$5,900
(8)	Total Compensation Package (4) + (7)	$74,300	$77,900	$80,100	$78,100
(9)	Annual Pension at Retirement Age	$9,400	$28,900	$64,800	$95,300
(10)	Lump Sum Value of Pension	$99,000	$290,000	$602,000	$798,000
(11)	Estimated Salary at Retirement	$96,700	$113,700	$133,800	$157,400
(12)	Percentage of Final Salary replaced by Annual Pension (9) / (11)	10%	29%	48%	61%

Table 8: Superior or Commonwealth Court Judge hired at age 30 in 2006

(1)	Annual Salary	$150,000	
(2)	Group Insurance Package	NV	(Not Valued)
(3)	Other Pay	$0	
(4)	Total Current Compensation	$150,000	

		Years of Service			
		20	25	30	35
(5)	Level Annual Pension Accrual (excludes employee contributions)	$3,900	$16,500	$15,700	$8,300
(6)	Level Annual Retiree Healthcare Accrual	NV	NV	NV	NV
(7)	Total Retirement Benefit Accrual (5) + (6)	$3,900	$16,500	$15,700	$8,300
(8)	Total Compensation Package (4) + (7)	$153,900	$166,500	$165,700	$158,300
(9)	Annual Pension at Retirement Age	$75,400	$228,800	$372,000	$452,400
(10)	Lump Sum Value of Pension	$798,000	$2.29 M	$3.46 M	$3.79 M
(11)	Estimated Salary at Retirement	$278,000	$327,000	$384,600	$452,400
(12)	Percentage of Final Salary replaced by Annual Pension (9) / (11)	27%	70%	97%	100%

Table 9: Superior or Commonwealth Court Judge hired at age 40 in 2006

(1)	Annual Salary	$150,000	
(2)	Group Insurance Package	NV	(Not Valued)
(3)	Other Pay	$0	
(4)	Total Current Compensation	$150,000	

		Years of Service			
		10	15	20	25
(5)	Level Annual Pension Accrual (excludes employee contributions)	$8,600	$17,700	$22,800	$16,000
(6)	Level Annual Retiree Healthcare Accrual	NV	NV	NV	NV
(7)	Total Retirement Benefit Accrual (5) + (6)	$8,600	$17,700	$22,800	$16,000
(8)	Total Compensation Package (4) + (7)	$158,600	$167,700	$172,800	$166,000
(9)	Annual Pension at Retirement Age	$31,100	$88,187	$188,400	$269,100
(10)	Lump Sum Value of Pension	$330,000	$884,000	$1.75 M	$2.26 M
(11)	Estimated Salary at Retirement	$200,900	$236,300	$278,000	$327,000
(12)	Percentage of Final Salary replaced by Annual Pension (9) / (11)	15%	37%	68%	82%

Table 10: District Court Judge hired at age 30 in 2006

(1)	Annual Salary	$65,000	
(2)	Group Insurance Package	NV	(Not Valued)
(3)	Other Pay	$0	
(4)	Total Current Compensation	$65,000	

		Years of Service			
		20	25	30	35
(5)	Level Annual Pension Accrual (excludes employee contributions)	$1,600	$6,500	$6,400	$4,400
(6)	Level Annual Retiree Healthcare Accrual	NV	NV	NV	NV
(7)	Total Retirement Benefit Accrual (5) + (6)	$1,600	$6,500	$6,400	$4,400
(8)	Total Compensation Package (4) + (7)	$66,600	$71,500	$71,400	$69,400
(9)	Annual Pension at Retirement Age	$28,000	$87,500	$145,300	$196,000
(10)	Lump Sum Value of Pension	$296,000	$876,000	$1.35 M	$1.64 M
(11)	Estimated Salary at Retirement	$120,500	$141,700	$166,700	$196,000
(12)	Percentage of Final Salary replaced by Annual Pension (9) / (11)	23%	62%	87%	100%

Table 11: District Court Judge hired at age 40 in 2006

(1)	Annual Salary	$65,000	
(2)	Group Insurance Package	NV	(Not Valued)
(3)	Other Pay	$0	
(4)	Total Current Compensation	$65,000	

		Years of Service			
		10	15	20	25
(5)	Level Annual Pension Accrual (excludes employee contributions)	$2,300	$6,200	$8,600	$6,400
(6)	Level Annual Retiree Healthcare Accrual	NV	NV	NV	NV
(7)	Total Retirement Benefit Accrual (5) + (6)	$2,300	$6,200	$8,600	$6,400
(8)	Total Compensation Package (4) + (7)	$67,300	$71,200	$73,600	$71,400
(9)	Annual Pension at Retirement Age	$10,100	$31,200	$70,000	$102,900
(10)	Lump Sum Value of Pension	$107,000	$313,000	$650,000	$862,000
(11)	Estimated Salary at Retirement	$87,100	$102,400	$120,500	$141,700
(12)	Percentage of Final Salary replaced by Annual Pension (9) / (11)	12%	31%	58%	73%

Table 12: Classes of Active Employees in PSERS

Employee Class	Number of Active Members (as of Jun. 30, 2002)	Percentage of Active Members	Employee Contribution Rate	Benefit Multiplier	Superannuation Age
Class T-C - Public School Employees hired prior to July 22, 1983, who have not elected class T-D	388	0.16%	5.25%	2.0%	Age 62 with one year of service or age 60 with 30 years of service or 35 years of service regardless of age
Class T-C - Public School Employees hired on or after July 22, 1983, who have not elected class T-D	9,316	3.84%	6.25%	2.0%	Age 62 with one year of service or age 60 with 30 years of service or 35 years of service regardless of age
Class T-D - Public School Employees hired prior to July 22, 1983, who elected class T-D by July 1, 2001	55,802	23.00%	6.50%	2.5%	Age 62 with one year of service or age 60 with 30 years of service or 35 years of service regardless of age
Class T-D - Public School Employees hired on or after to July 22, 1983, who elected class T-D by July 1, 2001; and all public school employees hired on or after July 1, 2001	177,100	73.00%	7.50%	2.5%	Age 62 with one year of service or age 60 with 30 years of service or 35 years of service regardless of age

Source: Material Supplied by PSERS

Table 13: Public School Employee (Class T-D) hired at age 30 in 2006

(1)	Annual Salary	$35,000	
(2)	Group Insurance Package	NV	(Not Valued)
(3)	Other Pay	$0	
(4)	Total Current Compensation	$35,000	

		Years of Service			
		20	25	30	35
(5)	Level Annual Pension Accrual (excludes employee contributions)	$0	$2,600	$2,500	$1,700
(6)	Level Annual Retiree Healthcare Accrual	NV	NV	NV	NV
(7)	Total Retirement Benefit Accrual (5) + (6)	$0	$2,600	$2,500	$1,700
(8)	Total Compensation Package (4) + (7)	$35,000	$37,600	$37,500	$36,700
(9)	Annual Pension at Retirement Age	$8,800	$39,200	$65,200	$89,400
(10)	Lump Sum Value of Pension	$93,000	$393,000	$605,000	$750,000
(11)	Estimated Salary at Retirement	$64,900	$76,300	$89,700	$105,600
(12)	Percentage of Final Salary replaced by Annual Pension (9) / (11)	14%	51%	73%	85%

Table 14: Public School Employee (Class T-D) hired at age 40 in 2006

(1)	Annual Salary	$35,000	
(2)	Group Insurance Package	NV	(Not Valued)
(3)	Other Pay	$0	
(4)	Total Current Compensation	$35,000	

		Years of Service			
		10	15	20	25
(5)	Level Annual Pension Accrual (excludes employee contributions)	$0	$1,600	$2,800	$2,500
(6)	Level Annual Retiree Healthcare Accrual	NV	NV	NV	NV
(7)	Total Retirement Benefit Accrual (5) + (6)	$0	$1,600	$2,800	$2,500
(8)	Total Compensation Package (4) + (7)	$35,000	$36,600	$37,800	$37,500
(9)	Annual Pension at Retirement Age	$3,200	$11,600	$27,600	$46,200
(10)	Lump Sum Value of Pension	$34,000	$116,000	$257,000	$387,000
(11)	Estimated Salary at Retirement	$46,900	$55,100	$64,900	$76,300
(12)	Percentage of Final Salary replaced by Annual Pension (9) / (11)	7%	21%	43%	61%

State Employees Participating in SERS

State legislators participate in the Pennsylvania State Employees' Retirement System (SERS) under a category identified as Class D-4. According to the most recent SERS valuation, there were 246 active legislators participating in the state system.

Table 15: Active Legislators Participating in SERS

Legislators	Males	Females
Active Participants in SERS	213	33
Average Age	52.99	55.85
Average Years of Service	15.12	11.97
Average Salary	$72,117	$70,688

Source: SERS valuation date December 31, 2004

Key features of Class D-4 benefit classification include:

- 3% of final average 3-years pay multiplied by years of service.
- Employee contribution of 7.5% of pay.
- Participation in an unmatched, defined-contribution plan.

For a 30-year employee hired in 2006 and retiring at 65, the formula generates a pension of approximately 87% of final pay. Given the employee is contributing 7.5% of pay to the plan, the net employer component for a new hire is estimated to be about 50% of final pay, which is in the target range for private-sector companies that continue to provide a traditional defined-benefit pension plan.

There are, however, features which are above reasonable private industry guidelines. For example, a legislator may retire upon reaching age 50 with 3 years of service without any reduction for early retirement, a benefit provision that does not exist in private-sector pensions or for most other SERS participants. Legislators' pensions are among the most generous within SERS. In addition, retiree healthcare includes comprehensive lifetime coverage with no retiree cost-sharing.

Certain other SERS members are permitted to retire as early as age 50 with 3 years of service on an unreduced basis. They include enforcement officers, corrections officers, and officers of the Delaware River Port Authority. However, these groups receive benefit multipliers below the 3% afforded to legislators.

In 2001, with the passage of Act 9, the annual pension multiplier for the D-4 class increased from 2% to 3% of final pay on a retroactive basis. However, the increase in the required employee contribution from 6% to 7.5% of pay was not retroactive.

Expectations remain that additional pension cost-of-living-adjustments to retirees will be forthcoming.

Judges identified in the E-1 category receive a pension of 100% of pay after 30 years with a required contribution of 10% of pay for the first ten years and 7.5% thereafter. Certain members of the judiciary may also elect to participate in a voluntary supplement to provided additional pension benefits for earnings over the Social Security Wage Base (which are already considered in the standard SERS pension benefit.) This voluntary supplemental plan results in a net cost to the taxpayer even after considering the required employee contributions. Therefore, it is no surprise that over 90% of eligible employees participate in this plan based on the JSGC's February 2004 report.

Most SERS participants are in the Class AA category with a benefit rate of 2.5% and a required employee contribution of 6.25% of pay. Normal retirement is defined as either age 60 with 3 years of service or 35 years of service with no age requirement.

Section 3: State Pension and Retiree Healthcare Benefit Plans

Given the legislators' participation in the SERS, part of this analysis involved examining the status of this pension plan. To understand the provisions of SERS and its counterpart plan for school employees, the Pennsylvania Public School Employees' Retirement System (PSERS), it is useful to review a February 2004 analysis conducted by the Joint State Government Commission entitled, "The Funding and Benefit Structure of the Pennsylvania Statewide Retirement Systems: A Report with Recommendations" (available online at http://jsg.legis.state.pa.us/PENSIONS.PDF).

The 245-page study, hereafter referred to as the JSGC Report, is extremely comprehensive in terms of outlining and providing an in-depth understanding of the state's two major pension systems: SERS and PSERS. It also identifies the principles supporting the structure of the state pension system.

The JSGC Report benchmarks the state pension system to that of other states (see Table 16). It is curious as to why the study did not also benchmark the Pennsylvania state pension plans against private sector plans. This question is relevant since both sectors compete in the marketplace for labor. The benchmarking question likely answers itself as the SERS benefits are considered among the most generous in the nation. In addition to Pennsylvania state legislators' pensions surpassing those found in private industry, particularly in the area of early retirement, the benefits afforded retired lawmakers are some of the most generous provisions within SERS itself. Judges in the E-1 Class have a superior benefit formula for longer service compared to that of legislators.

Table 16: PA Retirement Systems v. Other State Retirement Systems

Feature	PSERS	SERS
Normal Retirement	Strict years of service requirement; liberal mixed requirement	Strict years of service and mixed requirement; liberal age requirement
Early Retirement	Among the most liberal requirements	Among the most liberal requirements
Social Security Coverage	Similar to most	Similar to most
Employee Contribution	Among the highest for Social Security covered plans	Somewhat higher than most
Vesting Period	Same as most	Same as most
Benefit Multiplier	Among the highest	Among the highest
Final Average Salary Period	Same as most	Same as most
Benefit Limitation	Same as most	Same as most
Postretirement Increases	Less favorable than most	Less favorable than most
State Income Taxation	More favorable than most	More favorable than most
Withdrawal Option of Employee Contributions	Among the most favorable	Among the most favorable

Source: JSGC Report, page 50

Moreover, to benchmark only against other state plans ignores Pennsylvania's economic and business environment, in which the plans operate. In addition, it ignores the fact that individual and business taxes are the primary source of funding for the plans. Therefore, as will be shown, it is not surprising that legislators' pension and healthcare packages far exceed those found in private industry.

The state's approach to pensions and retiree healthcare plans is reflected in the JSGC Report's frequent citations of two publications from the 1970s: Robert Tilove's *Public Employee Pension Funds* (New York: Columbia University Press, 1976), and Howard E. Winklevoss and Dan McGill's *Public Pension Plans: Standards of Design, Funding, and Reporting* (Homewood, Ill.: Dow Jones-Irwin, 1979). These pension experts' points were highly relevant in a 1970-1980 pension environment. However, the economy has changed in profound ways over the past 25 plus years, and one would reasonably conclude this should affect the state's approach to post-retirement benefits planning.

The report frequently references an assumed constitutional right to pension benefits:

> *"Retirement benefits for members of the public retirement systems are protected under the provisions of the United States Constitution and the Constitution of Pennsylvania forbidding enactment of laws impairing the obligation of contracts. These provisions have been interpreted to render invalid any legislation that changes the terms of the retirement statutes adversely to active members or retirees. However, adverse changes that apply only to persons commencing membership in the system on or after the effective date of the change are constitutional." (JSGC Report, page 22)*

In addition to claiming Constitutional rights to taxpayer-funded benefits, the following statement further reveals the philosophy behind Pennsylvania's pubic pension plans:

> *"Full funding may be a necessary standard for a private plan, but it is not necessary for a public plan because a public entity can assume perpetual life." (JSGC, page 20)*

The long-term employee-benefit strategy of assuming the perpetual life of the taxpayer is not only troubling, but fiscally irresponsible.

SERS and PSERS Historical Performance

Pennsylvania's public employee retirement systems have transitioned from having a surplus (valuation assets exceeding accrued liabilities) to having an unfunded accrued liability (accrued liabilities exceeding valuation assets), as noted below from the Public Employee Retirement Commission Annual Report & the State Employees' Retirement System's December 31, 2004, Actuarial Valuation.

Table 17: PSERS Financial Data

Actuarial Valuation	Fiscal Year Ending	Valuation Assets ($ Billions)	Accrued Liability ($ Billions)	Ratio (A/L) (%)
6/30/1999	6/30/2000	44.6	37.5	119.0
6/30/2000	6/30/2001	49.3	39.8	123.8
6/30/2001	6/30/2002	54.8	47.9	114.4
6/30/2002	6/30/2003	54.3	51.8	104.8
6/30/2003	6/30/2004	52.9	54.4	97.2
6/30/2004	6/30/2005	52.1	57.1	91.2

Source: Commonwealth of Pennsylvania Public School Employees' Retirement System, Comprehensive Annual Financial Report , Fiscal Year Ended June 30, 2004, page 93.

Table 18: Historical Chart of Employer Contributions to the PSERS

Fiscal Year	Employer Normal Cost Rate (% of Payroll)	Unfunded Liability Rate (% of Payroll)	Employer Pension Rate (% of Payroll)	Health Care Premium Assistance (% of Payroll)	Total Employer Contribution Rate (% of Payroll)
1994-95	6.43	4.18	10.61	0.45	11.06
1995-96	6.43	4.67	11.10	0.62	11.72
1996-97	6.44	3.56	10.00	0.60	10.60
1997-98	6.44	2.17	8.61	0.15	8.76
1998-99	6.33	(0.44)	5.89	0.15	6.04
1999-00	6.40	(2.04)	4.36	0.25	4.61
2000-01	6.29	(4.65)	1.64	0.30	1.94
2001-02	5.63	(6.05)	(0.42)	1.09	1.09
2002-03	7.20	(10.03)	1.00	0.97	1.15
2003-04	7.25	(4.27)	2.98	0.79	3.77

Source: JSGC report, page70 (Buck Consultants, PSERS Actuarial Valuation, June 30, 2002, 19.)

Table 19: SERS Financial Data

Actuarial Valuation	Fiscal Year Ending	Valuation Assets ($ Billions)	Accrued Liability ($ Billions)	Ratio (A/L) (%)
12/31/2000	12/31/2000	26.1	19.7	132.4
12/31/2001	12/31/2001	27.5	23.7	116.3
12/31/2002	12/31/2002	27.5	25.7	107.2
12/31/2003	12/31/2003	27.5	26.2	104.9
12/31/2004	12/31/2004	26.9	28.0	96.1

Source: Commonwealth of Pennsylvania State Employees' Retirement System, 2004 Actuarial Report , Hay Group, April 27, 2005, page 19

Table 20: Employer Contributions to SERS

Fiscal Year	Employer Normal Cost (% of Payroll)	Unfunded Liability Rate (% of Payroll)	Employer Total Contribution (% of Payroll)
1994-95	10.23	(1.70)	8.53
1995-96	10.73	(0.46)	10.27
1996-97	8.49	(0.80)	7.69
1997-98	8.89	(1.61)	7.28
1998-99	8.99	(2.29)	6.70
1999-00	8.96	(3.96)	5.00
2000-01	9.02	(7.63)	1.39
2001-02	8.72	(10.36)	0.00
2002-03	8.64	(12.03)	0.00
2003-04	8.43	(7.39)	1.04

Source: JSGC Report, page 72 (Material supplied by SERS as compiled by Aon Consulting.)

The fact that SERS and PSERS were well-funded in the years 2000 and 2001 did not go unnoticed. The favorable investment returns experienced in prior years created experience credits which effectively lowered the normal cost of the plan to the point that employer (taxpayer) contributions were not required in certain years.

Faced with this financial situation, the action from those charged with oversight (the General Assembly) should have been to:

1. Use the favorable balance to continue to reduce the future employer cost of the plan.
2. Use the favorable balance as a reserve for unforeseen events.
3. Improve benefits based upon a competitive shortfall and a compelling business need.
4. Some combination of the above.

The Legislature, however, chose none-of-the-above and instead passed Act 9 of 2001. This action significantly improved benefits to active employees. The stated rationale, underlined below, is confounding. Act 9 also mandated this additional cost be spread over a 10-year period rather than 20 years. As noted in the JSGC Report:

> *The effect of the benefit enhancements for the active members was substantial. The changes in the benefit multipliers increased the monthly pension benefit of the predominant classes of state and school employees who elected to take advantage of the new classes by 25%. (For members of the General Assembly, the enhancement factor was 50%.) The benefit enhancements were defended in the findings and declarations that preceded the substantive amendments:*
>
>> *"Over the past two decades, both pension funds have experienced investment returns well in excess of expectations. As a result, State and school district contributions have decreased dramatically to less than 1% of payroll for the next year. At the same time, employee contributions range from 5% to 6.25% of payroll. The outstanding investment performance has resulted in the pension funds being over 123% funded, compared to current needs. The 4% statutory interest rate the employees receive on their pension accounts has consistently been eclipsed by the actual average rate of return on the funds over the last two decades and also has been less than available private market interest rates. <u>The fact that employees have been and are projected to continue to contribute at a rate that is materially greater than the employers due to the more than 100% funded status of the plans raises the issue of the extent to which employees should be provided additional benefits. The increase in benefits for State and school employees provided herein will in effect allow them for the first time to share in the outstanding investment performance of the funds. To date, that experience has only benefited the employers through reduced contributions to the funds</u>. Even with the increases in benefits provided herein, both pension funds are projected to maintain minimal employer contribution rates and at the same time maintain a fully funded status. For at least the next decade, members are projected to continue to contribute at a rate substantially in excess of that required from employers."*
>
> *The projections mentioned in this finding did not anticipate the protracted slump in market returns since the adoption of Act 9. Employer contributions are now projected to substantially exceed employee contribution rates.* (JSGC Report, page 37; emphasis added)

The impact of Act 9 of 2001 was significant, as shown in Table 21, next page.

Table 21: Increases in Costs Due to Act 9 of 2001

	PSERS ($ in millions)	SERS ($ in millions)	Total ($ in millions)
Unfunded Liability	5,020	3,214	8,234
Annual Payment on Unfunded Liability	412	234	646
Total Employer Cost	578	338	916

Source: JSGC Report, page 38 (PERC, "Act 9 Actuarial Note," 9, 10.)

In terms of percentage of payroll, Act 9 increased the total employer pension cost by 5.59% of the PSERS payroll and 7.08% of the SERS payroll.

However, the JSGC Report notes: "Following the enactment of Act 9, many retirees expressed disappointment at receiving no liberalization themselves. The last previous COLA had been granted by Act 88 of 1998, so that a COLA in 2002 would be consistent with the established pattern of granting an ad hoc COLA every four or five years." (page 39)

Act 38 of 2002 was the Legislature's response to the disappointed retirees. The major provisions of this Act, according to the Pennsylvania Employee Retirement Commission, included (JSGC, page 39):

1. *Cost-of-Living Adjustment*, which provided a two-part cost-of-living adjustment to annuitants of both systems commencing July 1, 2002, and July 1, 2003, respectively.
2. *Minimum Employer Contribution*, which set a minimum employer contribution rate for both systems equal to no less than 1 percent of employee payroll. In the case of PSERS, the contribution floor is in addition to the premium assistance contribution rate.
3. *Smoothing*, with respect to PSERS's assets, which set at five years the period over which all realized and unrealized investment gains and losses are to be recognized in determining actuarial asset value.

Table 22: Increases in Costs Due to Act 38 of 2002

	PSERS ($ in millions)	SERS ($ in millions)	Total ($ in millions)
Unfunded Actuarial Accrued Liability	1,102	652	1,752
Increase in Employer Annual Cost	208	99	307

Source: JSGC, page 40 (PERC, "Act 38 Actuarial Note," 7, 8.)

Between Act 9 and Act 38 the unfunded liability of SERS and PSERS increased by almost $10 Billion. The annual increase in employer cost was identified to be $1.223 Billion.

Unfortunately, the asset returns were poor in 2001 and 2002, and as a result Act 38 of 2002 mitigated the investment losses by spreading these losses as well as requiring any future investment gains and losses to be recognized over a 5-year period. However, the financial engineering continued into 2003 with the passage of Act 40.

Act 40 of 2003

According to the JSGC report (page 40):

> *This statute modified the funding structure in order to address the issue of fluctuating employer contribution rates. For both systems, the act establishes a two-tier amortization schedule over either ten or 30 years, depending on the nature of the liability, and raises the minimum employer contribution rate from 1% to 4%.*
>
> *For PSERS, beginning July 1, 2004, the amortization period is extended from ten to thirty years for the outstanding balances of the accrued liability resulting from changes in benefits enacted by Act 9, the net actuarial losses incurred in FY 2000-01 and FY 2001-02, and future actuarial gains or losses. Ten-year level dollar amortization continues to apply to unfunded liabilities arising from legislation enacted before Act 9, from the five-year smoothing under Act 38, and from future benefit changes and COLAs. Also beginning July 1, 2004, the minimum employer contribution rate (not counting the premium assistance contribution) is increased from 1% to 4%.*

Faced with significant asset and liability problems, the resulting "solution" was as follows:

- The favorable surplus prior to Act 9 will continue to be recognized over 10 years.
- The cost of Act 9 will be "refinanced" from 10 years to 30 years since the 10-year cost was now clearly viewed as too significant.
- Investment losses occurring in 2001 and 2002, as well as any future experience gains and losses, will also be spread over 30 years.
- Act 38 costs will remain on a 10-year schedule.
- The JSGC report's executive summary (page 2) makes the following statement to explain the significant cost increases expected in the future:

> *The primary cause for the escalation of employer contribution rates is the poor performance of the equity markets from 2000 to 2002. However, the benefit enhancements enacted by Act 9 of 2001 and Act 38 of 2002 contributed toward making the systems more vulnerable to weak investment returns.*

To properly evaluate the statement above it would be useful to understand what the future employer costs would had been if Acts 9, 38 & 40 were never enacted. Under this scenario, could the state have considered increasing its employer contribution in the short term to offset the increased future costs related to the poor investment returns from 2000 to 2002?

Furthermore, if favorable investment returns justified the increased benefits created in Act 9, what should be the corresponding benefit levels in response to asset performance which was described as poor? What will be the asset to liability ratio necessary for the next pension retiree COLA?

Although these questions are neither asked nor answered in the JSGC report, the financial result of the pension engineering in the early 2000s is revealed in Table 23 (next page). The data is found on page 74 of the JSGC report and is predicated on an 8.5% annual rate of return on investments. The chart is amended with updated information from PSERS (June 30, 2004), SERS (December 31, 2004), and the author's estimates. It is noteworthy that the taxpayers' cost is projected to jump 672% in just 8 years, from $584 million in FY 2004-05 to $4.507 billion in FY 2012-13.

Table 23: Projected Taxpayer Contributions to PSERS and SERS

Fiscal Year	1 PSERS Contribution Rate (%) Payroll	2 PSERS Contribution Amount ($ in millions)	3 SERS Contribution Rate (%) Payroll	4 SERS Contribution Amount ($ in millions)	(2) + (4) Total Contribution ($ in millions)
2004-05	4.23	468	2.34	116	584
2005-06	4.69	540	3.00	153	693
2006-07	6.46	743	4.25	223	966
2007-08	7.15	845	5.15	278	1,123
2008-09	6.78	815	4.85	272	1,087
2009-10	5.83	716	4.35	252	968
2010-11	5.50	689	5.20	311	1,000
2011-12	5.46	698	10.90	678	1,376
2012-13	22.52	2,937	19.35	1,239	4,176
2013-14	21.57	2,872	22.40	1,476	4,348
2014-15	20.24	2,755	22.40	1,528	4,283
2015-16	19.89	2,770	20.99	1,576	4,346
2016-17	19.52	2,788	20.59	1,597	5,306
2017-18	23.39	3,433	20.20	1,620	5,370
2018-19	22.80	3,792	19.82	1,641	5,433
2019-20	22.23	3,842	19.46	1,664	5,506
2020-21	21.66	3,894	19.11	1,689	5,583
2021-22	21.10	3,949	18.76	1,713	5,662
2022-23	20.55	4,006	18.43	1,738	5,744
2023-24	20.02	4,066	18.12	1,764	5,830
2024-25	19.52	4,131	17.81	1,791	5,922
2025-26	19.03	4,197	17.51	1,819	6,016
2026-27	18.56	4,265	17.22	1,849	6,114
2027-28	18.13	4,339	16.94	1,878	6,217
2028-29	17.71	4,414	16.66	1,910	6,324
2029-30	17.29	4,487	16.40	1,942	6,429
2030-31	16.91	4,569	16.15	1,975	6,544
2031-32	16.54	4,653	14.14	1,786	6,439
2032-33	13.90	4,072	13.21	1,723	5,795
2033-34	12.71	3,879	12.73	1,716	5,595

Projected 615% increase in taxpayer costs in 8 years.

Source: JSGC Report, page 74 (Information supplied to JSGC by PSERS and SERS) & PSERS and SERS websites.
NOTE: These projections assume an 8.5% annual return on investments.

NOTE: The highlighted portions of this table are amended with updated information from PSERS (June 30, 2005 Valuation Results) and SERS (December 31, 2004 Valuation Results) and the author's estimates. The 2004-05 figures are the actual contribution rates and amounts.

Section 4: Pennsylvania Private-Sector Company Comparison

A review of salaried employee compensation and benefits practices of 43 large companies located within the Commonwealth of Pennsylvania is an appropriate benchmark from which to assess the state's benefits programs. The analysis reveals a significant divide between approaches in the public and private sectors.

Base Pay Philosophy

The cost of labor is governed by the laws of supply and demand. Moreover, the marketplace ultimately manages the number of units of labor. The theory of "comparable worth" equating the value of two unrelated positions on the basis of socio-economic value is not recognized as an appropriate business measure to evaluate the worth of a position since it is too subjective. Compensation increases are predicated on the business' ability to pay.

Therefore, a comparison of public-sector positions to private-sector positions is valid only to the extent one is comparing positions in demand by both sectors. While incentive pay does exist, generally it is based on competitive business benchmarking and is managed by an oversight group, such as a board of directors, who do not participate in the plans. While abuses and excesses can be cited in the private sector, these are the exceptions rather than the rule.

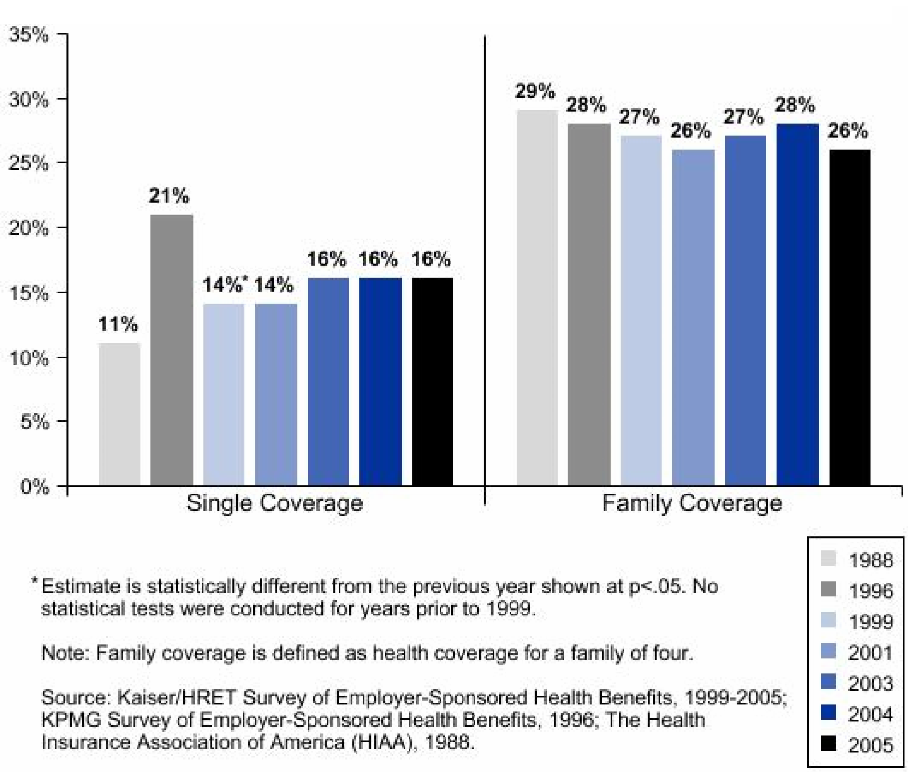
There are many philosophies which enter into the debate relative to pay for elected officials and related topics such as term limits and outside employment during public service. While these topics and all the related considerations are not a primary focus of this paper, it suffices to say that there was not a paucity of qualified candidates willing to run for public office prior to July 7, 2005. As such, the compelling business case supporting the pay raises for elected officials is still an unanswered question.

In the private sector, one does not approve one's pay. This is a major shortcoming of the existing legislators' pay system. The dynamics of political trade-offs in legislative affairs only further complicates the issue.

Private-Sector Healthcare Benefits

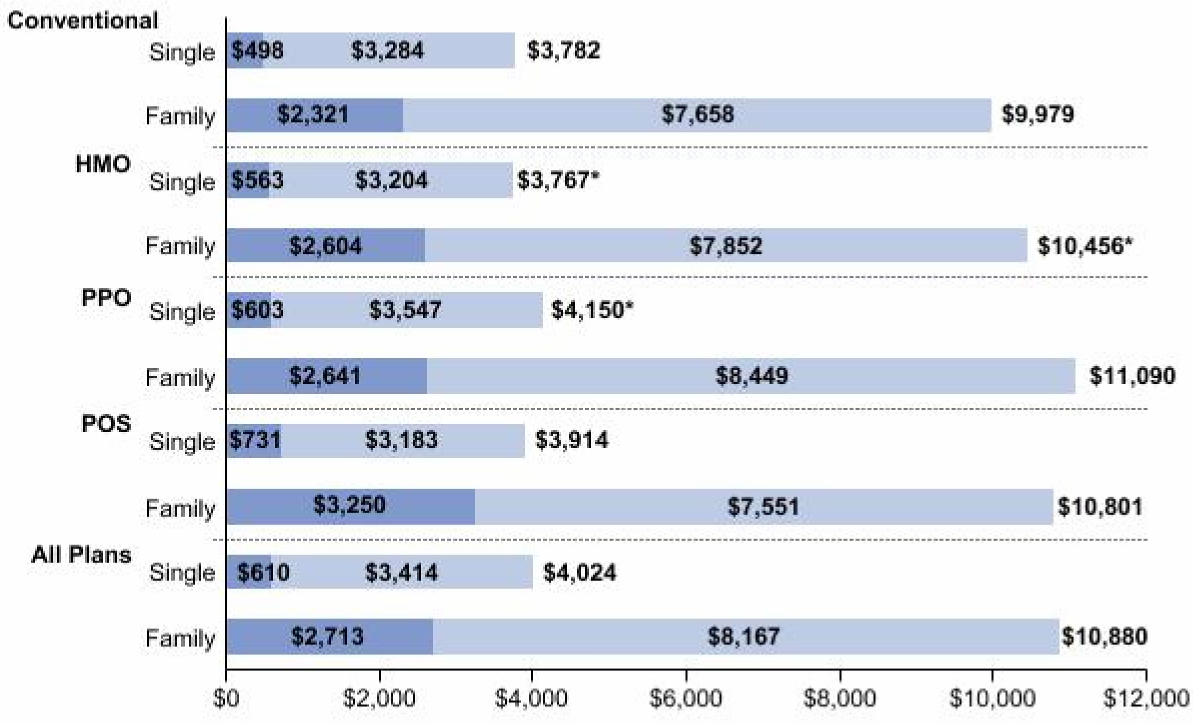
Pennsylvania companies are experiencing difficulties in effectively managing healthcare costs for active employees and retirees as shown in the accompanying charts. Current trends in established national surveys, such as that shown in Chart 1, indicate employees pay a significant

CHART 1: Average Percentage of Premium Paid by Covered Workers for Single and Family Coverage, 1988-2005



share of their healthcare premium. According to Chart 2, single workers are paying an average of $498 to $731 toward their premium, while workers with family coverage are paying an average of $2,321 to $3,250. In addition, many private-sector employees are paying an ever-increasing share of their healthcare premiums. Conversely, Pennsylvania legislators have their entire premium paid for by taxpayers.

CHART 2: Average Annual Premiums for Covered Workers for Single and Family Coverage by Plan Type, 2005



* Estimate of total premium is statistically different from all plans by coverage type shown at p<.05.

Note: Family coverage is defined as health coverage for a family of four.

Source: Kaiser/HRET Survey of Employer-Sponsored Health Benefits, 2005.

Retiree Healthcare

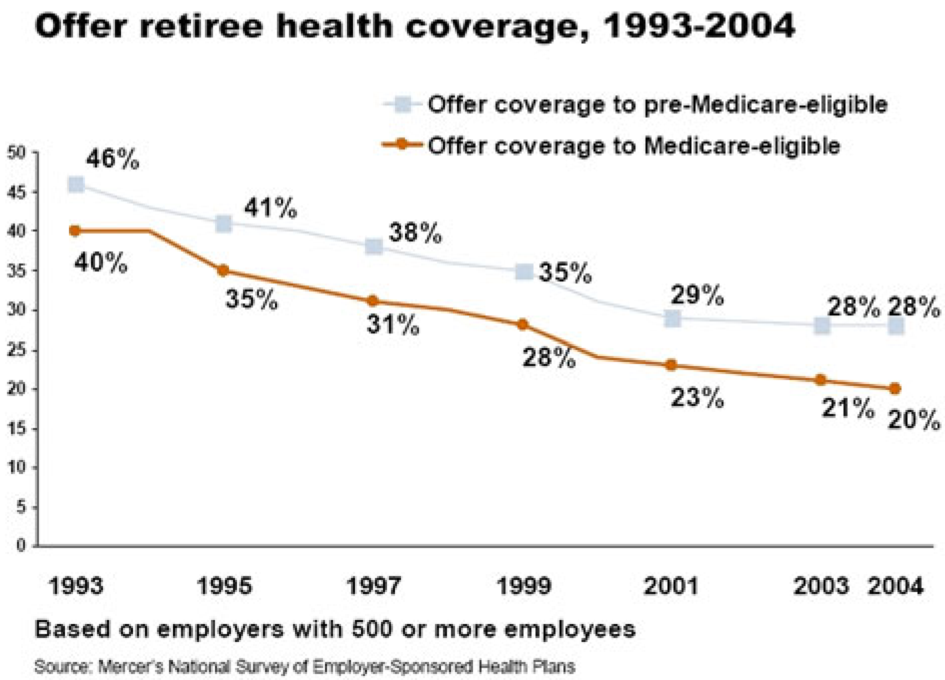
"Retiree healthcare" should be analyzed as two distinct programs under this one broad heading. These programs are commonly referred to as "Pre-65" and "Post-65." Pre-65 is generally a continuation of the active employee healthcare program. Since healthcare usage generally increases with age, this program is significantly more expensive to the employer compared with the same plan offered to a younger active workforce. The Pre-65 cost is somewhat reduced by the likelihood of fewer covered dependents on the contract as a retiree.

Post-65 coverage is different in that it works in connection with or as a supplement to Medicare at age 65. While the employer cost is significantly reduced compared to Pre-65, the duration of coverage, given growing life expectancies, presents significant liability issues.

Chart 3 shows the trends within private industry relative to the presence of retiree healthcare coverage.

Of the 43 Pennsylvania companies analyzed for this report, 21 (49%) offered Pre-65 Medical Coverage to their retirees and 18 (42%) offered Post-65 coverage. Most companies charge retirees at least at the rate charged to active employees and many companies have imposed premium caps and other provisions to limit employer costs in the long-run. For example, in 2005, General Motors, Ford and Hewlett-Packard announced major cutbacks to their retiree healthcare plans due to cost pressures.

CHART 3: Employers Offering Retiree Health Coverage, 1993-2004



Moreover, the accounting for these plans is problematic as most state programs recognize retiree healthcare costs as they are incurred on a pay-as-you-go basis. In 1993, the Financial Accounting Standards Board issued FASB No. 106 requiring private entities to recognize these future costs over the working lifetime of the employee. In response, many companies reexamined their plan designs and either curtailed or established premium caps to limit their future liability. This accounting change did not require pre-funding of the plans, only a systematic recognition of these future liabilities.

Similar changes will apply to the public sector in 2007 under the Government Accounting Standards Board (GASB) statement No. 45. This will dramatically change state budgets in that current income will be charged for these future costs in a manner somewhat similar to pension plans. The illustrations shown earlier for state legislators indicate how these costs can be recognized during the working lifetime of an employee. A major factor in developing these costs is the actual assumptions to be used, such as future healthcare cost trend rates or the assumed retirement ages for the workforce.

Private-Sector Pension Plans

Traditional Pension Objectives

With respect to defined-benefit pension plans, most salaried plans exist to replace a targeted percentage of income at retirement. Traditionally, most defined-benefits were designed together with Social Security benefits to replace 70-80% of final pay at age 65 for a full-service career of 30 years. This is generally believed the standard needed to allow one to maintain their standard of living into retirement.

The 70-80% should be considered a sliding scale with 70% applicable to those above the Social Security wage base (currently $90,000) and 80% applicable to those making $30,000 to $40,000. Points within this range would be scaled proportionately.

Most private pension plans traditionally did not require employee contributions, although employers frequently "took credit" for the employer's FICA contribution through a variety of means within a pension formula thereby "integrating" the plans with Social Security.

With the exception of certain features such as age 62 with 30 years of service, most private plans impose an early retirement reduction of 3-5% per year for individuals retiring early. Stated differently, retirement benefits are designed to be paid at a "normal" retirement age such as 65. Payments before this age (as early as age 55) generally result in a reduction of 3-5% per year from the normal retirement age to reflect the longer expected payout stream. Plans that do not reduce benefits are effectively subsidizing early retirements. This subsidy is an added cost to the plan.

As an example, a typical actuarial reduction of 30-50% would apply to a benefit commencing at age 55 compared with the benefit payable at a "normal" retirement age such as 62 with 30 years or 65. For the record, Social Security retirement benefits can be taken as early as age 62 at a reduced level.

Given the retirement target income goal of 70-80%, if one were to remove the Social Security benefit of 20-40% of final pay, this would leave a "net" employer-provided benefit at normal retirement age of about 40-50%. Using 45% as an average within the interval and the assumption of a 30 year employee, this would equate to an annual benefit rate of approximately 1.5% of final pay (45% /30) per year.

As a general guideline, the on-going cost of these types of plans tends to be between 5-7% of payroll. This does not include the cost of other liabilities such as plan amendments. Also, retiree cost-of-living adjustments would occur in an ad-hoc manner based upon the employer's ability to pay. The above design took place in an era of lower inflation and well before 401(k) plans and double-digit retiree healthcare increases.

Plan designs which were popular even five to ten years ago no longer exist due principally to the volatility and level of costs seen by employers. Long-term commitments such as those seen in defined-benefit pension and retiree healthcare plans present employer risks which are viewed as unreasonable. Company cultures have changed from being paternalistic to one of risk sharing between employer and employee. Job security can no longer be

Table 24: Factors Threatening Employer Retirement Plan Sponsorship: Top Three Threats to Defined-Benefit and Hybrid (Cash Balance) Plans

(163 Respondents)

Employer Concerns	Threat #1	Threat #2	Threat #3
Volatility of costs	33%	15%	13%
Level of overall costs	19%	9%	12%
Cash balance litigation and lack of regulatory certainty	13%	15%	8%
Lack of long-term/permanent interest rate relief and general congressional lack of support	12%	12%	15%
Possible accounting rule changes	7%	20%	16%
Employee perceptions and lack of appreciation	7%	5%	12%
Administrative/regulatory complexity	6%	12%	13%
Workforce mobility and decreasing appropriateness of defined benefit approach	2%	11%	10%

Source: Current Retirement Plan Challenges: Employer Perspectives 2003, Hewitt Associates, (October 2003).

taken for granted in an era of cost pressures with future uncertainties. As a result, defined-contribution pension plans have grown in popularity together with reductions in retiree healthcare plans. Table 24 (previous page) provides some insights into the concerns and actions of private industry leading to these actions.

Private-Sector Defined-Benefit Plans

As part of this study, the salaried defined-benefit pension plans of 43 Pennsylvania-based companies were reviewed. The reduction in defined-benefit plans is profoundly evident. Equally important, a significant number (11 of 25, or 44%) of companies with plans no longer provide benefits at the 40-50% pension target at age 65 for a 30-year employee. The following are the results of the reviewed companies:

<u>Plan Prevalence Among 43 Large Pennsylvania Companies</u>

- 12 companies did not have a defined-benefit plan
- 6 companies had frozen their plan
- Of the 25 companies having an active plan:
    - 9 companies had a "traditional" Final-Average 5-year salary plan
    - 2 companies had a "traditional" Final-Average 3-year salary plan
    - 2 companies had a Career Average Plan
    - 12 companies had a Cash Balance Plan (Variation of a Career Average Plan, which has certain features similar to a defined-contribution plan).

<u>Benefit Level Among 25 Defined-Benefit Company Plans</u>

- 13 of the 25 companies with pension plans yielded a pension ranging between 40-50% of pay at age 65 with 30 years of service. One (1) company was above this range at 60%. The remaining 11 companies were below this level.
- Early retirement without a reduction was generally afforded at age 65 or age 62 with a service criteria such as 30 years. Otherwise, a 3-5% reduction per year would apply. This means pension benefits normally payable at retirement would incur a reduction of 30-50% if taken as early as age 55.
- The concept of retirement prior to age 55 does not exist as a standard provision in the private sector, much less an unreduced pension at such an age.

Private-Sector Defined-Contribution Plans

All 43 companies had a defined-contribution plan such as a 401(k). Most plans required an employee contribution to qualify for the employer match. In addition, 13 companies had a stated level company match with the possibility of a greater match based upon company performance. All factors considered, the assumed long-term employer match (including the variable portion) was estimated to be approximately 5% of pay.

Private Sector Defined-Benefit & Defined-Contribution Plans Combined

Pennsylvania companies have moved from the traditional defined-benefit formula to an environment now placing a significant portion of the retirement income objective risk onto the employee. While it is reasonable to assume the objective may be exceeded, the final amount at retirement is not guaranteed. Of the 43 companies studied, 37% (16 total) will not meet the "traditional objective." (See Table 25, next page.)

The following salary replacement ratios for all 43 companies are estimated to be achieved at age 65 for an employee with 30 years of service. The figures in Table 25 include the employer portion of defined-benefit plans and accumulated defined-contribution employer matches, but exclude Social Security benefits.

Table 25: Pension Payout of 43 Surveyed Companies

Pension Payout	Number of Companies
Less than 40% of final pay	16
Greater than 40% and up to 50% (Traditional Objective)	5
Greater than 50% and up to 60%	10
Greater than 60% and up to 70%	9
Greater than 70% and up to 80%	3

Most companies require employees to contribute to these defined-contribution plans to qualify for a match. Amounts over the traditional targets together with the accumulated employee contributions likely will be needed to pay for healthcare needs into retirement given the industry trends in this area.

Overall, employer costs in these combined plans are more predictable and manageable. The combined plan costs are estimated to be approximately 8-10% of payroll.

The trend in the private sector is to transition from defined-benefit plans to defined-contribution plans in an effort to achieve predictability and affordability in future costs. These changes also reflect the realities of rising healthcare costs for active and retired employees.

For example, in January 2006, the International Business Machines (IBM) Corporation announced it is freezing its defined-benefit pension plan in 2008 in favor of an enhanced match to its 401(k) plan. The company says removing pension obligations will save billions and help it to remain competitive even as it increases its 401(k) contributions. As *The Wall Street Journal* reported on January 6, 2006:

> *"Beginning in 2008, the retirement benefits of the 117,000 IBM employees currently participating in its U.S. pension plans will stop building in value. The employees can take the money that has built up when they leave the company or retire, but they won't receive credit for additional years of work. Instead, IBM says it intends to increase the amount it contributes to its workers' 401(k) plans. The company's 125,000 retirees, and its former employees, won't be affected."*

In December 2005, Verizon Communications announced sharp cuts in its pension plans for managers, which the company says could save as much as $3 billion over 10 years. About 50,000 managers will no longer receive pension credits after June 30, 2006. Current retirees will not be affected and employees will retain pension benefits they have already earned. Verizon is planning to increase its contributions to the managers' 401(k) plans up to 5% if employees contribute 6% of their pay.

As Verizon Chairman and Chief Executive Ivan Seidenberg said: *"This restructuring reflects the realities of our changing world."*

Section 5: Recommendations

In general, the Pennsylvania public benefit programs do not reflect the best-demonstrated practices in the management of long-term liabilities. This is profoundly apparent in long-term benefit plans such as defined-benefit pension and retiree healthcare plans. As a result, additional revenues through higher taxes or cuts within other sectors of state and local government will be necessary to offset these increased costs in the future. Logic should suggest this is not a time to be passive in managing the state's pension and healthcare benefits costs.

Specific actions to be considered should include:

- Identify and implement a benefits cost strategy which is predictable and affordable within a responsible fiscal budget for the Commonwealth. There should be no budget exemptions or any other special considerations for state pension or GASB No. 45 costs. If these costs are deemed unaffordable, then significant plan design changes must take place.

- Obtain private-sector input and improve the oversight of these programs.

- Amend Act 9 of 2001 and Act 38 of 2002 to provide benefits which are affordable.

- Create less reliance on defined-benefit plans for retiree income. Adopt defined-contribution plans with an employer match as a replacement (in part or in whole) to the defined-benefit plans.

- Benchmark from the geographical areas comprising the labor pool. Consider benchmarking design and cost sharing to an "index of benefits" provided from a representative set of major private-sector companies based in Pennsylvania. Benchmarking only to other public plans, while perhaps an interesting academic exercise, is an attempt to ignore the realities of today's world.

- Increase cost-sharing for active healthcare plans.

- Reduce coverage, adopt tighter age and service eligibility requirements, and implement premium caps for the retiree healthcare plans.

- Curtail any future pension cost of living increases for retirees. Consider how much of an "increase" a retiree receives each year through their healthcare plan.

- Address the question of whether elected officials should participate in any state retiree healthcare or state pension plan.

Even with significant re-engineering, such as that mentioned above, the cost of public-sector pension and healthcare benefits plans will likely continue to grow faster than incomes of individuals or businesses in the private sector.

Section 6: Conclusion

Pennsylvania government employee-benefit plans operate in a vacuum. In a world where private-sector benefit cutbacks and cost reductions occur on a daily basis, state government in Harrisburg has not responded in similar fashion. In fact, instead of reducing the potential for financial disaster, actions in recent years have served to accelerate the coming crisis.

The absence of a long-term employee-benefit strategy, other than assuming the perpetual life of the public entity (the taxpayer), is fiscally irresponsible at best. Although there will certainly continue to be minor differences in the construct of private and public benefit plans, there should be no differences in governance, benchmarking or the desire to control costs to taxpayers. In the Commonwealth of Pennsylvania, this is not the philosophy or the practice in managing its public-sector benefits plans.

The actions and inactions of policymakers should raise profound concerns about the current and future fiscal health of Pennsylvania. Logic suggests that as the private sector must continue to evolve in an ever-changing economic environment, so too must the public sector. After all, the health of the public sector is entirely dependent on a healthy private sector, not the other way around. Therefore, the best demonstrated practices exhibited within the private sector must also permeate the policies developed in the State Capitol.

Private sector plans are generally designed and managed to achieve both short and long-term business objectives. Pennsylvanians have seen key industries fail because they could not achieve predictable and affordable costs. The looming crisis in the long-term commitments made by policymakers on behalf of taxpayers is reflected in the rapid 615% increase in expected state pension contributions from $584 million in FY 2004-05 to more than $4.2 billion in FY 2012-13 for the State Employees Retirement System (SERS) and Public School Employees Retirement System (PSERS). Without significant actions affecting plan design, the Commonwealth of Pennsylvania will likely be facing unaffordable costs, some of which have yet to be fully quantified.

For example, what will be the impact of Government Accounting Standards Board statement No. 45 when it takes affect in 2007? This accounting requirement will force state government to begin to recognize (but not necessarily fund) future retiree health care liabilities over the working lifetime of the employee (as is currently done in the private sector under FASB 106). Shedding light on heretofore hidden costs will only further reveal Pennsylvania's looming pension and retiree healthcare benefits crisis.

Government employee benefit costs, like all operating expenses, need to be actively managed. Long-term benefits costs cannot exceed the state's long-term revenue growth rate, otherwise plan design and/or staffing reductions will be needed to avoid a fiscal disaster. The state must adopt a long-term benefit strategy to control costs rather than assuming "the perpetual life" of the taxpayers' ability to pay if it intends to properly govern, benchmark and manage the taxpayers' long-term pension and healthcare liabilities.

About the Author

RICHARD C. DREYFUSS, a Senior Fellow with the Commonwealth Foundation, is a business consultant and actuary with extensive involvement in compensation and employee-benefit plans, and broad experience in Human Resources and Process Management.

Dreyfuss worked for The Hershey Company, formerly Hershey Foods Corporation, for 21 years and held numerous positions including Director, Compensation and Benefits prior to his retirement in 2002. He continues to be active in public policy matters having testified in Washington, DC, and Harrisburg, PA, and was Chair of The Pennsylvania Healthcare Cost Containment Council in 2001-02. His emphasis is in areas which include process re-engineering, human resources management, advocating policies to reform the pension and healthcare systems, and strategies to effectively manage long-term employee benefit costs.

Dreyfuss is a frequent speaker and has been quoted widely in publications including *The Wall Street Journal, The New York Times* and newspapers throughout Pennsylvania. He is a graduate of Connecticut College with a BA in Mathematics and Economics, and he earned a Masters Degree in Actuarial Science from Northeastern University.

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