COMMONWEALTH OF PENNSYLVANIA
HOUSE OF REPRESENTATIVES

STATE GOVERNMENT COMMITTEE HEARING

STATE CAPITOL
HARRISBURG, PA

IRVIS OFFICE BUILDING
ROOM G-50

TUESDAY, MAY 1, 2012
9:00 A.M.

PRESENTATION ON HB 418, HB 551, HB 552,
HB 1676, HB 1677, AND HB 2200
PENSION REFORM

BEFORE:
HONORABLE DARYL D. METCALFE, MAJORITY CHAIRMAN
HONORABLE JIM COX
HONORABLE LYNDA SCHLEGEL CULVER
HONORABLE GEORGE DUNBAR
HONORABLE ELI EVANKOVICH
HONORABLE MATT GABLER
HONORABLE GLEN R. GRELL
HONORABLE SETH M. GROVE
HONORABLE MARCIA M. HAHN
HONORABLE ROB W. KAUFFMAN
HONORABLE JERRY KNOWLES
HONORABLE TIMOTHY KRIEGER
HONORABLE T. MARK MUSTIO
HONORABLE BRAD ROAE
HONORABLE JERRY STERN
HONORABLE BABETTE JOSEPHS, DEMOCRATIC CHAIR
HONORABLE EDDIE DAY PASHINSKI
HONORABLE TONY J. PAYTON, JR.
HONORABLE STEVE SAMUELSON
HONORABLE STEVEN J. SANTARSIERO

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ALSO IN ATTENDANCE:
HONORABLE SCOTT W. BOYD
HONORABLE SCOTT A. PETRI

COMMITTEE STAFF PRESENT:
SUSAN S. BOYLE
MAJORITY EXECUTIVE DIRECTOR
CATHERINE M. WADDINGTON
MAJORITY ADMINISTRATIVE ASSISTANT
AMY C. HOCKENBERRY
MAJORITY ANALYST
JOSIAH M. SHELLY
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KIM A. HILEMAN
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DEMOCRATIC RESEARCH ANALYST
LA TASHA C. WILLIAMS
DEMOCRATIC RESEARCH ANALYST

I N D E X

TESTIFIERS

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P R O C E E D I N G S

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MAJORITY CHAIRMAN METCALFE: Good morning. This hearing of the Pennsylvania House State Government Committee is called to order.

Before we start and before we take the roll, if we could all rise, and I'll ask Representative Santarsiero to lead us in the Pledge.

(The Pledge of Allegiance was recited.)

MAJORITY CHAIRMAN METCALFE: Thank you, Representative Santarsiero.

If I could ask our Secretary to call the roll.

(Roll was taken.)

MAJORITY CHAIRMAN METCALFE: Thank you, Representative Grove.

Today's hearing that we're going to be having with the House State Government Committee is going to be centered on pension reform and specifically on several pieces of legislation that have been introduced -- HBs 418, 551, 552, 2200, 1676, and 1677.

As has been the practice of the committee during my time as Chairman, we've asked the sponsors of the legislation to share with us a few of their thoughts on their legislation. So we have a couple minutes' worth of testimony from each of the prime sponsors. We won't be questioning our prime sponsors today, but at a future meeting, we would expect to. But today's meeting is just to have them share their thoughts on their legislation and then to receive testimony on pension reform from the testifiers that we have lined up today.

And just as a reminder for our Members -- and also for our guest Members that are here today testifying, Representative Petri and Representative Boyd, you are both welcome to join the committee during the time of testimony.

But the way that we conduct the hearings is we have invited the testifiers as our guests to testify and share their expertise with us related to this topic, and certainly questions from the Members will be appropriate. But we didn't bring the testifiers here today to debate with them. We will debate with one another at some future meeting on this topic. But today's hearing is to gather testimony, and appropriate questions to gather that information that the Members would desire would be certainly what we're looking to have occur today during the 10 minutes of Q and A.

So the testifiers have been asked to deliver 10 minutes' worth of testimony and then leave 10 minutes for each testifier that we can have questions from the Members.

And with that, we'd like to open up with Representative Scott Boyd. If he could take the microphone. And we'll have Scott start with sharing his legislation with us, which I think your legislation might be the thickest piece of legislation we have here today.

REPRESENTATIVE BOYD: Thank you, Mr. Chairman, Madam Chairman.

I appreciate an opportunity to share with you briefly. HB 1676 and HB 1677 are companion pieces of legislation, one amending the PSERS Code, one amending the SERS, State Employees' Retirement System, Code.

Many of you know, historically, when I came into the Legislature 10 years ago and I had less than gray hair, I talked about pension reform from the very beginning, particularly having the public system moved to more of a private sector-type program of a 401(k) or a defined contribution-type pension benefit.

In doing a tremendous amount of research and work, and I want to give credit to both the SERS and PSERS boards and their staffs who worked with me and put up with a lot of questions and whys, and through the years I came to a really brief conclusion, but this is the bottom line.

The IRS Code requires that if a public pension program is changed for future hires to a defined contribution-type program, that the current defined benefit, pension benefit, has to be fully funded in 10 years. Currently, and I don't know them -- the boards are here; they'll give you the exact numbers -- but the last time I communicated with them, we had about a $30 billion unfunded liability in the two pension systems together.

So that means that if we would totally shift to a defined contribution pension program for future hires, that $30 billion would need to be fully funded within a 10-year timeframe, even though the benefit would be paid out, arguably, over conceivably another 50-year time, even longer, a 60-year timeframe, and that's in the IRS Code.

So the conversation that we got into in some meetings was, how can we come up with a defined contribution type of a product that would still allow the DB benefit program to continue into the future? And the idea was to create a new tier within the defined benefit program called a cash balance plan.

So 1676 and 1677 are the result of those conversations, and the general concept would be that all new hires after a certain date, their pension benefit would be a cash balance program. In essence, it would be a contribution from the employee, a contribution from the employer, and they vary depending on whether it's a SERS benefit or a PSERS benefit. And on top of those two contributions, there would be a 4-percent guaranteed interest rate that would be applied to that account, and at the employee's retirement, they would receive that cash balance paid out in an annuity over time. And that's the essence of what these two pieces of legislation do.

As you hear testimony on benefits, you'll hear certain terms, and those terms would be, what's the "normal cost"? In essence, the normal cost of this system is zero. It is probably the most cost-effective methodology that we can adopt for the employer, and in this case, the employer is the taxpayer. And the idea would be that the gains of the market, the interest, in essence, that the funds would generate, would actually exceed the benefit paid out to the employee; conceivably in up years in the marketplace and over time actually benefit, or not benefit, but market returns could pay off some of the unfunded liability. That's the essence of this design.

So the bills have worked -- with the lawyers from both PSERS and SERS, I believe the bills are technically sound, and I look forward to working on this type of a concept in the future with the committee.

Thank you, Mr. Chairman.

MAJORITY CHAIRMAN METCALFE: Thank you, Representative Boyd.

Representative Petri, would you like to take the microphone?

REPRESENTATIVE PETRI: Thank you, Mr. Chairman.

And I want to thank the committee for what is going to be a heavy lift. There is no doubt that this is probably the single toughest issue to deal with, and I think that's important for people to know, but it's also important to tackle the issue.

I've said for a long time, and I wholeheartedly believe, whether it's Federal, State, or local, the traditional pension plans are no longer affordable. We can talk about the problems, but the problems, really, that created this situation we're in are in the past now. And unfortunately, we can't undo some of the things that occurred, but some of those problems have been very low employer contribution rates in good times, and so we now have the opposite end of that, we have the spike. So I think there is the economic issues that you're going to have to work through with these various bills.

I introduced my legislation the first session, just like Scott did with his, and, you know, the criticism we had at that point was that that benefit actually would have cost the taxpayer more money, and that's probably even true, I suspect, as we sit here today. But soon, as that curve raises, the level, the flat-level funding, comes to a point where it starts to equal.

The other criticism that you'll often hear about any plan is, well, you know, as you move through -- because as

Scott indicated, you can't really go directly to a defined contribution plan -- it's going to take time to unwind where we are. My response to that is, though, had we started roughly 9 years ago, we'd be 9 years down the cycle.

So I think it's important that the committee not get lost in some of the rhetoric about, well, we can't do this now; we have to wait for a future date. That future date will end up being delayed, which will delay that next date and delay the next date. So I think it's important that you make decisions about how to move forward.

And then I think there is, you know, the public-perception side of this, which is that people believe that pension plans are a benefit that they don't have. So the committee is going to have to work through that and work through the legislation and with our experts. My guess is that ultimately, you're going to be looking at some sort of hybrid plan for a period of time in moving through.

There's also the constitutionality argument we've always heard about that you can't change any benefits, and the question is, can you freeze those benefits? I say we probably have an obligation to do it and see what happens. If somebody wants to challenge a plan, let them challenge it. If it's not clearly unconstitutional, then, you know, then I think you need to proceed.

So I'm not going to really get into the merits of one plan or another. What I wanted to do more was encourage the committee to really take a hard look at this to try to deal with what the Governor called our legacy costs. I know sitting on Appropriations with some of you, this year's budget, very difficult because of the pension increase. Next year's budget is even worse. So you have a tall task.

The last thing I would say is, I think for State government, ultimately a defined contribution makes sense because you can actually budget it. You can predict it. You don't have to deal with all those losses and, you know, are they mark-to-market? Were they amortized over 3 years? 5 years? all of that voodoo economics that, you know, gets us in trouble in the end.

Yes, it may be sound actuarially, but is it prudent public policy planning or would it be much better to be able to predict sitting here today exactly what you have to pay next year and the following year so that we can create a balanced budget and get through this process a lot easier?

So I want to commend the committee and the Chairman for taking this issue up. I would certainly wish you the best, and any feedback we can give you once you hear from your experts, I'd appreciate it. I've heard them in the appropriations process, and my head always spins, and I'm sure yours will be spinning as well afterwards. So good luck.

MAJORITY CHAIRMAN METCALFE: Thank you,

Representative Petri.

Representative Krieger.

REPRESENTATIVE KRIEGER: Thank you, Mr. Chairman.

Previous commenters, I think, have amply illustrated the serious nature of the problem we face. The focus of my bill is more narrow, however. HB 418 would shift just Members of the General Assembly, the House and the Senate, from the present system to a defined contribution 401(k)-like plan, similar to what we see in the private sector. And under HB 418, presently serving Legislators, that is both those presently serving and future Legislators, would be shifted as of the effective date of the legislation from a defined benefit plan to a defined contribution plan. Now, obviously my bill does not purport to be a systemwide fix.

Now, one objection, and it has already been alluded to, would be that such a plan would violate Article I, Section 17, of the Pennsylvania Constitution by impairing contracts. I think there are legal arguments to be made pro and con on that issue. At this time, I will limit my comments on that issue to two points.

First, under the law, any person can waive a constitutional right. Given the grave nature of the situation we face, I think it would be appropriate for the House and Senate to consider waiving whatever rights they may have under Article I, Section 17.

Secondly, I think the General Assembly constitutionally has a unique constitutional authority over its own operations and over the compensation benefits of its Members. I think it's worth asking whether any General Assembly can authorize a pension contract with its own Members that a future General Assembly cannot alter if the best interests of the Commonwealth require it.

Another way to ask this question is, what is the nature of the contract between the Members and the Commonwealth? I think it's reasonable to conclude that any contract between the Commonwealth and the Members of the General Assembly includes an implied condition. That is, that a future General Assembly may alter that compensation or benefit payable to a Member if it deems such change to be in the best interests of the Commonwealth of Pennsylvania.

As far as I know, the Supreme Court of Pennsylvania has never been presented with this argument and thus has never ruled on it, so I think it's an open question and I think it's something we need to consider.

Thank you, Mr. Chairman.

MAJORITY CHAIRMAN METCALFE: Thank you, Representative Krieger.

The final Member to speak on his legislation as part of the package we're considering under this hearing today is Representative Evankovich.

REPRESENTATIVE EVANKOVICH: Thank you, Mr. Chairman and Members of the committee.

I introduced HB 2200 as primarily a lead-by-example measure. HB 2200 affects only the General Assembly and staff.

Very simply, HB 2200 directs for the creation of a defined benefit plan, a 401(k)-style plan. It establishes that Members of the General Assembly and staff of the General Assembly hired after November 2012 are only eligible for the defined contribution plan and not eligible for the defined benefit plan. It also strictly prohibits existing Members from joining the defined contribution plan if they currently participate in the defined benefit plan.

It's a healthy 401(k)-style plan. It mimics many of the defined contribution plans that we see in the private sector.

Again, as I said, I believe that all this legislation does is it follows the lead that many private-sector job creators have taken over the last few decades. As the other presenters have said, testifiers have said, you know, many companies looked at the facts and figures and figured out long ago that they weren't going to be able to make the pension obligations in the future. So their course of action was to establish a date certain, that from that point on, only the new employees would only be able to participate in a defined contribution plan.

And I think a key point of my legislation is this: that while we look for a statewide solution, while we look for a solution to all of our pension problems, HB 2200 gives the Legislature the option of leading by example in this effort.

As other presenters or testifiers have said, our pension crisis is real. We need to fix it. A few weeks ago, this committee heard very helpful testimony from PSERS and SERS, and I believe that we really need to highlight two elements of that testimony.

The first element is this: that every single dollar that enters pension plans begins in the hands of a taxpayer. So therefore, any solution to resolving the solvency of those pension plans comes from the taxpayer.

The second thing I think we need to highlight is that we not only need to focus on the long-term solvency within our pension systems, but we also need to address the critical question of what appropriate retirement benefits are for Legislators and public-sector employees across the board.

I'd just like to leave the committee with a simple analogy to the way that I've come to think about our pension plans. I own a boat. It's not exactly a boat to be proud of, but I've put a lot of work into it. And last summer I took my boat out on the lake, and as a proud captain, I pulled away from the dock and I realized very quickly that my boat was taking on water. And I realized what I had done: I had forgot to put the plug back in the bottom of the boat, and I lifted up the engine compartment and my boat was full of water. So I stopped the engine, I dove off the boat, I put the plug in the back, and then I climbed onboard and I started bailing the water out. I think our pension plans are taking on water every single day, and we need to begin to plug the hole before we start to bail the water out.

Thank you, Mr. Chairman.

MAJORITY CHAIRMAN METCALFE: Thank you, Representative Evankovich, and thank you to you and the other Members who are diving in, so to speak. So we appreciate your leadership with introducing these proposals.

Our first testifier is Mr. Antonio Parisi, Deputy Director for Policy and Legislation from the Public Employee Retirement Commission.

And while he takes the microphone, we have had several Members join us since we started the meeting: Representative Payton, Representative Kauffman, Representative Mustio, Representative Gabler, Representative Knowles, Representative Dunbar. Did I miss anyone? Representative Grell.

Thank you for being with us today, sir, and you can start when you're ready.

MR. PARISI: Well, thank you, Chairman Metcalfe.

Good morning. Chair Josephs, Honorable Members of the committee, I am Tony Parisi. I'm with the staff of the Public Employee Retirement Commission, and on behalf of the commission, I'd like to thank you for inviting me here to speak today.

As you may know, under the Public Employee Retirement Commission Act, the commission has two main responsibilities.

MAJORITY CHAIRMAN METCALFE: Could you pull your microphone down just a little bit closer there, sir?

MR. PARISI: I'm sorry.

MAJORITY CHAIRMAN METCALFE: Just for the benefit of the audience, and they are taping this and Webcasting, so that everybody can hear you. Thank you.

MR. PARISI: Testing one, two, three.

MAJORITY CHAIRMAN METCALFE: That's a little bit better.

MR. PARISI: Now is the time for all good men to come to the aid of their countries. Can everyone hear me? Good.

MAJORITY CHAIRMAN METCALFE: A little bit closer.

MR. PARISI: Okay.

MAJORITY CHAIRMAN METCALFE: It's good that you did that test.

MR. PARISI: All right. I'm almost touching it, so.

MAJORITY CHAIRMAN METCALFE: There you go.

MR. PARISI: Okay.

Again, under the Retirement Commission Act, we have two main responsibilities. One is to attach the mandated actuarial notes to pension bills prior to their having second consideration in the house of origin. And the second is a policy study and advisory role where the commission is to study on a continuing basis matters of public pension policy and to study and report on the actuarial conditions of the Commonwealth's pension systems, including municipal systems.

Today I've been asked to discuss in general terms the major retirement system plan designs employed in the public sector, and time permitting, I'd like to take the opportunity to share some recent research of the staff in this area.

As the sponsors of some of the legislation that is being reviewed today have indicated, there are really three categories of pension plan in the public sector. We see defined benefit plans, the most common; defined contribution plans; and then there are hybrids that generally combine both elements.

So the two main approaches are defined benefit and defined contribution, and the approaches differ in regard to the aspect of the pension plan -- and that is defined or fixed -- in the plan's governing document.

In a defined benefit plan, it's the benefit that's defined by formula, generally in statute, and it's the funding that is variable. In a defined contribution plan, it is the contribution that is defined, and the benefit varies depending upon the performance of the market. And in defined contribution plans, of course, participants bear the full risk of market activity.

Now, in a defined benefit plan, because the benefit is calculated using a formula, it's not dependent on an individual's account balance. Members of DB plans are largely insulated, unlike DC members, from both favorable and unfavorable investment performance.

And again, by contrast, in a DC plan, the contributions to be made over the period of employment are defined, while the pension benefit to be provided is variable based upon pension fund performance.

The employer contributes a fixed amount of the defined contribution, which is usually expressed as a percentage of the employee's payroll, and an employer match of the employee's contributions up to a certain limit is usually included, but not always.

The employee chooses how to invest the assets in a DC plan, usually selecting from a menu of investment options offered by the employer. Upon retirement or separation from the employer, a DC plan participant is generally entitled only to the balance standing to the credit of the individual's retirement account. Market performance directly impacts, again, the value of an individual's account.

So the distinction between the DB and DC approaches is most significant in the placement of investment risk. The fixed benefit in a DB pension plan means that the investment experience impacts the employer contribution requirements, increasing them when investment earnings are lower, lower than anticipated, and decreasing them when earnings are greater than anticipated.

The fixed contributions in the DC pension plan mean that investment experience impacts on the benefit amount, increasing it when earnings are higher and reducing it when earnings are lower. Therefore, the employer, as contributor, bears the investment risk in a DB plan, and the employee bears the investment risk in a DC plan.

For most employees, defined contribution plans are generally regarded as more valuable for those in the early stages of their careers or for those who are employed in careers that require great mobility. Defined contribution accounts are generally completely portable and readily move with the employee as that employee moves from employer to employer.

In contrast, defined benefit plans are relatively more valuable for those employees who tend to remain with one employer for a long period of time and for employees in the later stages of their careers, because the value and cost of the defined benefits earned each year increase significantly as employees approach retirement age.

As a means to provide a concise summary of the major differences between the DB and DC approach, we've included a table, which I believe in your copy begins on page 2 and extends over to page 3, where we describe the general characteristics of the two plan types.

Now, a third category is the hybrid plan, which some of the committee members alluded to. In the context of pension plan design, the term "hybrid" is generic, and there are many variations on a theme. Typically, hybrid plans combine both defined benefit and defined contribution elements. Hybrid plan designs usually require some level of mandatory participation by employees, often pool all or a portion of assets for investment purposes, require both employer and employee to share responsibility for funding the plan, guarantee a certain level of benefits to employees, and also share investment risks between employee and employer.

There are several different types of hybrid, the most common being the DB, or defined benefit, and DC, defined contribution, hybrid. This is a combined defined benefit/defined contribution which can be thought of as two plans that sit side by side.

Plan design specifics vary considerably. In some cases, participation in a DB plan may be mandatory while

DC plan participation may be optional, or participation in both the DB and DC plans may be mandatory.

Generally, the employer's contribution funds a smaller DB component which may or may not include an employee contribution component, while all or some portion of the employee's contribution is used to fund the DC benefit. Depending upon the plan, the employee may or may not have some rights to direct how the DC portion is invested.

Another category, and Representative Boyd alluded to this, is the cash balance retirement benefit plan. Now, in a cash balance plan, it's actually a type of what's considered nontraditional defined benefit plan. It has certain defined contribution-like funding and portability elements.

And a cash balance plan calculates benefits in a manner similar to a defined contribution plan. Under a cash balance arrangement, benefits accumulate throughout a worker's years of employment. However, the cash balance retirement benefit differs from the traditional defined benefit formula. Rather than receiving an annuity based upon a fixed benefit formula, usually accrual rate times years of service times final average salary, the cash balance benefit is simply equal to the value of all cumulated employee and employer contributions plus interest credited to the account.

A cash balance plan is classified as a "defined benefit plan," because like a traditional DB plan, the employer bears the investment risks and rewards along with mortality risk if the employee elects to receive benefits in the form of an annuity and lives beyond the anticipated retired life expectancy.

Unlike a traditional DB plan, a cash balance plan establishes allocations to a hypothetical individual account, the cash balance, for each participant. Individual account balances are usually segregated for accounting purposes only and pooled for investment purposes. Benefits under cash balance plans may be paid as a lump sum or annuitized over the retiree's expected remaining lifetime.

Similar to what tends to occur with DC plans, employees who move from employer to employer frequently or otherwise leave service early will tend to benefit more from a cash balance-type plan than a traditional DB plan, because the accrued benefits will tend to be greater than would be the case under the traditional defined benefit formula. Conversely, long-service employees will tend to benefit less from a cash balance plan arrangement as compared with a traditional DB plan, because the portion of the benefit accrued in the later years of service will tend to be less than under a traditional DB plan.

Cash balance plan designs have the potential to provide the plan participant with the benefit predictability and security of the traditional DB plan while providing budgetary predictability to the employer by limiting employer contribution requirements to a fixed amount, similar to a defined contribution plan.

Now, there are some recent trends. I'll just touch on this briefly. I think I'm going over my 10-minute time limit slightly. I apologize for that.

In December 2002, the commission issued a report in response to HR No. 266, which was adopted in the session of 2001-2002. As part of the commission's report entitled "Selected Issues Related to Governmental Defined Benefit & Defined Contribution Pension Plans," the commission's staff conducted a national review of statewide public employee retirement systems and identified the plans by plan type -- DB, DC, or hybrid.

In the course of their research for the 2002 report, the commission staff identified a total of 21 State-level public employee retirement plans in 16 States that were DC or had a DC component, a defined contribution component. Nearly one-quarter of these plans had been implemented during the 5 years immediately preceding the staff's review, suggesting that the strong investment returns of the late 1990s had influenced the increase in plans at that time.

Now, the staff has, at my request, updated the original 2002 review for today's testimony with an emphasis on retirement benefit plan changes that have occurred in recent years, and so here are the staff's findings:

On the pure defined contribution plan side, in 2002 the staff identified nine public employee retirement systems with pure defined contribution plans. Of these, four required employees to participate in the defined contribution plan and five made participation optional. As of 2012, the number of systems with pure defined contribution plans had declined from nine to seven. Alaska and Michigan remain the only States with retirement systems that require mandatory participation in a defined contribution plan. That's as of 2012. Also, West Virginia, which had transitioned to a mandatory defined contribution plan for public school employees in 1991, returned to a mandatory DB plan beginning in 2005, the only State to have done so.

Hybrid defined contribution plans. In 2002, the staff identified 12 systems with hybrid defined contribution plans. Of these, seven were combined defined benefit/defined contribution plans, and one was a money purchase plan, which is a type of DC plan, and four used some other hybrid plan design. In 2012, the number of systems with hybrid defined contribution plans had increased to 16. Retirement systems in Georgia, beginning in 2009; Michigan for public school employees beginning in 2010; Utah, beginning in 2011; and Rhode Island, beginning in 2012, have all transitioned to mandatory hybrid defined benefit/defined contribution plans, but only Utah being an optional plan.

Cash balance plans. To our knowledge, Nebraska is the only statewide system to have adopted a cash balance plan, which they did in 2003. However, several other States, including Louisiana, Maryland, and Kansas, are considering cash balance proposals at this time.

And finally, defined benefit plans, the most common. The majority of legislative changes enacted in 2009, '10, and '11, largely in response to the events of 2008, remained within the framework of a traditional defined benefit retirement plan. These changes were implemented as cost-containment measures and generally took the form of reduced benefit tiers applicable to new employees. Here in the Commonwealth, such benefit reductions were implemented with the passage of Act 120 of 2010. From 2009 to 2011, a total of 40 States have implemented some form of defined benefit plan reduction.

On the final page, there is a table, Table II, that shows the current distribution of statewide plans by type. I won't recite that. I'll spare you the details. It's there for your review.

And finally, in conclusion -- I'll wrap this up quickly -- it appears that for State-level plans anyway, the majority of States have elected to retain the DB design in some form as the sole or primary retirement benefit plan but have implemented some type of benefit reduction in the interests of cost containment. Relatively few States rely solely on DC plans. However, in certain jurisdictions, there does appear to be interest in moving toward hybrid plans that combined DB and DC elements.

That concludes my testimony today. Chairman Metcalfe, Chairwoman Josephs, thank you very much. I'll answer any questions you may have at this time.

MAJORITY CHAIRMAN METCALFE: Thank you, sir.

And Representative Evankovich would have the first question.

REPRESENTATIVE EVANKOVICH: Thank you, Mr. Chairman.

Thank you, Mr. Parisi.

Very briefly, I thought you did a wonderful job outlining what other public pension systems have done---

MR. PARISI: Thank you.

REPRESENTATIVE EVANKOVICH: ---and we can only assume, I guess, that in large part those systems, the changes from traditional defined benefit and maybe benefits that were promised in years past, changed in some way in large part to try to tackle insolvency within those systems. And so again going back to my previous comments, you know, we need to remember, I guess, that tax dollars are the fix regardless. It's all tax dollars.

But my question is, have you guys been able to do any level of research regarding how many private companies, what private companies have done, large business, small business, across the State of Pennsylvania and across the United States regarding the same problem, insolvency within their pension plans and what their solution was going forward?

MR. PARISI: Well, going back many years, as you know, the defined benefit plan was the standard, even in the private sector. That really began to change with ERISA in 1974 and more rapidly beginning in the eighties.

I was just looking, we haven't done any specific research on that. It's actually a tough nut to crack, because I can call up SERS and PSERS and get all kinds of information. You have situations where you have very small employers; you have very large employers; you have employers that are operating here but are based in other States. That's a difficult -- that's a project I would love to embrace. It's a very difficult problem to crack, but it can be done.

Now, I was looking at some Bureau of Labor Statistics just the other day based on their latest census of the population surveys that they've done. It's interesting that since about 1975, the number of private-sector employees in defined benefit plans has declined 30 percent, according to their data. The number of DC plans have increased by -- wait for it -- 500 percent. And this has a lot to do, of course, as you know, with mobility in the workforce and controlling costs and limiting liability and so forth.

It's tough in the private sector to say you're going to provide a lifetime benefit to someone when the company could be acquired or go out of business or any number of things could happen. There are still large companies that do that, but you see that only with the very large companies on a very large scale. It takes a large member population to really support that. You don't see that. You will not see that in a company with 200 people or even a thousand people.

I hope that answered your question.

REPRESENTATIVE EVANKOVICH: Yes.

Thank you, Mr. Chairman.

MAJORITY CHAIRMAN METCALFE: Thank you, Representative Evankovich.

Representative Pashinski.

REPRESENTATIVE PASHINSKI: Thank you, Mr. Chairman.

And thank you very much for your testimony today. I have a two-part question here.

First of all, if the State was under defined contribution, would the administration costs of administering that package change as compared to defined benefit?

MR. PARISI: Well, it's hard to say precisely without a specific benefit design and without some plan experience, but typically the per-member administrative costs of defined contribution plans, I can't give you an exact number -- I know we could get that information for you -- they tend to be somewhat higher. There would be some transitional costs there. That's true.

REPRESENTATIVE PASHINSKI: Okay. So that would be higher.

And if the State---

MR. PARISI: In general.

REPRESENTATIVE PASHINSKI: In general.

And if the State in 2008 when we suffered the global financial collapse had instituted and had a defined contribution system, how would that have impacted that system compared to the defined benefit system that we had? I believe the defined benefit system lost $15, $18 million.

MR. PARISI: Oh, considerably more.

REPRESENTATIVE PASHINSKI: We would have lost a great deal more?

MR. PARISI: No. In a defined contribution plan, if the systems had been converted prior to that date to defined contribution plans---

REPRESENTATIVE PASHINSKI: Yes.

MR. PARISI: Now, again, the consensus has been that changing the benefits for current active members is an unconstitutional impairment of contract. Now, there may be ways to challenge that. However, that has been the consensus.

So in your hypothetical example, if we had had a DC plan in place for new employees on the magic date, those members would not have been affected. However, the legacy plan, the old plan, the DB plan and those remaining in it, would still have been affected. Or the funds would have been affected. The members would not.

REPRESENTATIVE PASHINSKI: Let's forget about whether we were DB. Let's just say we were DC, defined contribution.

MR. PARISI: Yes.

REPRESENTATIVE PASHINSKI: I want to know how the global collapse of 2008 would have affected a DC plan.

MR. PARISI: If the system, going back to the beginning, going back to the recodification of the codes in 1974, had been established as defined contribution plans, the employer, meaning the Commonwealth and school employers, would not have been affected. Only the members, as in any DC plan, as we see in the private sector in 401(k)-type plans, they would have suffered the losses of that event.

MAJORITY CHAIRMAN METCALFE: Thank you---

REPRESENTATIVE PASHINSKI: Thank you.

Thank you, Mr. Chairman.

MAJORITY CHAIRMAN METCALFE: Thank you, Representative Pashinski.

Representative Grell, for our last question.

REPRESENTATIVE GRELL: Thank you very much.

Mr. Parisi, do you have any information with you on the actuarial impact of Act 120 of 2010?

MR. PARISI: No, Mr. Grell, I did not bring that with us.

REPRESENTATIVE GRELL: Okay.

MR. PARISI: Today I was asked to speak only on the different plan types.

REPRESENTATIVE GRELL: Okay. I'm looking ahead at some of the future testimony here today, and it looks like we're going to need that actuarial note from 2010 to get at a fair representation of what Act 120 did. So if you could provide that to the committee.

MR. PARISI: I would have to collect that and bring that to you later today.

REPRESENTATIVE GRELL: That's fine. It doesn't need to be today. If you could just provide it to the Chairman---

MR. PARISI: Oh, certainly.

REPRESENTATIVE GRELL: ---to share with the rest of the committee.

Thank you. That's all, Mr. Chairman.

MAJORITY CHAIRMAN METCALFE: Thank you, Representative Grell. And if you could provide the information as Representative Grell requested, we'll share it with the Committee Members.

Thank you, sir, for your testimony today.

MR. PARISI: Thank you, Mr. Chairman.

MAJORITY CHAIRMAN METCALFE: Have a great day.

If Mr. Seldomridge, Director of Administrative Services from the Conestoga Valley School District, could join us at the microphone, and you can begin your testimony when you're ready, sir. Thank you for joining us today.

MR. SELDOMRIDGE: Thank you.

My name is Kim Seldomridge. I am the Director of Administrative Services for Conestoga Valley School District.

And first of all, I do want to thank the committee and Representative Boyd for inviting me. I consider it an honor to be here, and I only hope that what I bring to you today is beneficial for you in the decisionmaking process. My response is more of a visceral type of response, but I want you to understand the current impact to schoolchildren and to public education and hopefully also provide you some things to think about and some information to get us out of this current dilemma.

I'm going to bring you the specific impact of basically one suburban school district. Sometimes when you consider the consequences to the entire Commonwealth, it's almost too large to even comprehend.

Since Act 1 of 2009, Conestoga Valley School District, composed of approximately 500 employees and 4,000 students, has seen pension costs rise from $240,000 to a current cost of $2 million. It is expected to climb to over

$8 million by 2018-19 and stay at that staggering level until the year 2035. Another way of looking at it is that it has gone from basically a half a percent of our budget to 12 percent of our budget.

When Act 40 was passed in 2003, it underfunded the system for 10 years. Act 40 has had a huge impact, as it created a mismatch of the amortization of PSERS' actuarial gains and losses. It was soon thereafter that pension spikes were being forecasted for the year 2013. Instead of reducing costs by blending the current multiplier and changing to a defined contribution plan or a hybrid plan, which would have immediate results on the PSERS liability act, Act 40 simply kicked the can down the road.

Conestoga Valley School District is, as measured by your market value of personal income aid ratio, one of the wealthier districts in the Commonwealth. It's a conservative district, a district that plans for the future. But no matter how well you plan and how wealthy you are, the decisions that were made in 2001 and 2003 created a tsunami that has affected every child in the Commonwealth.

Conestoga Valley School District began saving for the tsunami in 2006 by cutting back on programs and raising taxes gradually. Conestoga Valley School District did not bury its head in the sand or count on the cavalry to rescue us. Despite the heaviness of the ominous PSERS forecast, the district saved over $5 million to offset the increasing costs of the pension system for the next 6 years. We did this through a combination of cutting positions through attrition and programs and by raising taxes.

Here is a list of items Conestoga Valley cut in the past 7 years to prepare for the pension spike starting with 2012-13: a high school guidance counselor, a subject area supervisor for music, a subject area supervisor for foreign language, a subject area supervisor for tech ed. We eliminated the early childhood and reading coordinator. We eliminated a part-time reading support teacher. We eliminated a family consumer science teacher. We eliminated a part-time music teacher, a part-time foreign language teacher, a learning support teacher, assistant computer manager, eliminated a geography teacher. We eliminated middle school junior varsity sports. We eliminated a summer library enrichment program. We eliminated field trips. We eliminated intramural programs. We eliminated the plant manager. We eliminated some paraprofessional positions.

In 2009, we reduced health-care benefits to all our employees and raised contribution levels to 11 percent. In 2011, we froze salaries and salary schedules of all employees in the district. We have also eliminated a sundry of services and equipment, reducing our cumulative costs by millions of dollars.

On the revenue side, the accumulative effect of raising taxes to our taxpayers over the period of the pension increase is $240 annually to the average single family residential home valued at $162,000, and this is the net cost subtracting out the State's share of the pension. When you consider that State money is also taxpayer money, the cost to the pension system for the taxpayer is really $480 annually at Conestoga Valley.

This issue poses, really, the fundamental question of what is the value the taxpayer is getting for his or her money? Is he getting better teachers? Is he getting better support staff? better administrators? Are they getting more programs? All I can say is that when I began working for public schools in 1983, I did not take into consideration in my decisionmaking process whether or not to accept the position based on whether or not my multiplier for retirement was 2 or 2.5. In fact, it was 2 when I took the job.

I can say with great confidence that the fact that you changed the multiplier from 2 to 2.5 did not increase the quality of our pool of candidates for teachers, secretaries, custodians, or administrators. In fact, Pennsylvania produces so many teachers that it is an exporter of teachers to other States. Has it increased the quality of the pool of our politicians? Has the taxpayer gained any value for the $480 they are paying annually in increased taxes and/or decreased services? Have the students gained anything from it? The obvious answer is a resounding no when you consider the list of cuts mentioned previously.

Certainly before the multiplier was changed in 2001, the Commonwealth had a top-notch and affordable pension system that provided an adequate level of retirement benefits. The bottom line is, there is no time left to address the significant 2012-13 employer contribution rate. So what are your options?

You could convert PSERS and SERS to a hybrid plan. A hybrid plan, as you know, is typically a combination of both a defined contribution plan and a defined benefit plan. Another option is to repeal Act 9 of 2001 and return the multiplier to 2 and increase employee contributions. Each of these would have a limited impact on the current funding issues, because it could only be done prospectively for new employees. However, each would reduce the long-term liability of the system and thus reduce the plateau sooner.

However, to provide immediate relief, what are some of your solutions? Well, you could sell the State liquor stores and use that one-time revenue source as an infusion to the pension system. It is estimated this would have an immediate impact on the current rates, but very minor.

You could eliminate the right for teachers to strike. PSEA has far too long had the upper hand on individual school boards made up of volunteers. They're outgunned and outmaneuvered when it comes to negotiating salaries and benefits. This will help school districts keep salaries down and thus keep the pension liability down.

I know these are not popular decisions, but real jobs are being lost because of the pension system, and real programs that are being eliminated are having a negative impact on our current generation.

Just to go off script a little bit, a lot of the things that we've heard, what you've heard, deal with the future -- deal with defined contribution plans, deal with employees that are going to retire 35 years from now. The current crisis is the pool of employees that are going to retire between now and 2035, and so something has to be done with the current system.

I understand, I've heard that it's unconstitutional to change an existing contract, but I think that is really where you need to look. I think you need to challenge the constitutionality of changing a current contract. I guess I don't understand that if I was hired in 1983 with a multiplier of 2 why that can't be changed back to 2.

And I also understand that the judges are also part of this system. I don't understand how they can impartially make a decision that personally affects them. Maybe this is a process that needs to be taken outside of Pennsylvania somehow.

There are other States that have been successful in eliminating their current liabilities, and I think you need to take a look at how do we do that? How do we currently limit the system?

Personally, I plan to lead by example. I plan to retire with a penalty so that when I retire, my pension equals pretty much what I would have gotten in 1983 when I took the job at 2.0.

I want to thank you for your time, and I'd be glad to address any questions that you might have.

MAJORITY CHAIRMAN METCALFE: Thank you very much, sir, for your testimony today.

Members with questions?

Representative Pashinski.

REPRESENTATIVE PASHINSKI: Thank you, Mr. Chairman.

And thank you very much, sir, for your testimony, and also for all the cost-cutting measures you've had to take in order to provide a quality education and keep your school operational.

Have you seen any other increases in your costs in operating your school other than the Employees' Retirement System?

MR. SELDOMRIDGE: Yes. Obviously there are increases in health-care costs, although the past 3 years our health-care costs have dropped for the first time in our long history. So our health-care costs are going down. Our salary costs this year have also pretty much plateaued or stayed even because of our salary freeze and salary increases.

The other costs that are going up significantly or continue to rise significantly are special education costs, and that's due to increased population of our special education students.

REPRESENTATIVE PASHINSKI: That's a pretty difficult one to control.

MR. SELDOMRIDGE: It does seem to be a difficult one to control. Our student population, a few years ago we probably had about 10 percent of our special education students that comprised our student population. We now have about 13 percent. And when a diagnosis is made, when an IEP is developed, you really lose control over those costs.

REPRESENTATIVE PASHINSKI: How about utilities -- heating? lighting?

MR. SELDOMRIDGE: The past few years we've embarked upon energy-saving programs. We've been able to keep our utility costs pretty flat, and they've even dropped in some areas.

REPRESENTATIVE PASHINSKI: Transportation and food?

MR. SELDOMRIDGE: Transportation continues to rise at probably the CPI index.

Food is a separate proprietary fund. That doesn't affect the general fund. We expect our food service to be able to be self-funded, or to fund itself. So when we need to raise prices for lunches, we do that, and that's where that money comes from.

REPRESENTATIVE PASHINSKI: Okay. So you've done that. All right.

Now, the heating costs, you said you've taken some cost-saving measures. Could you tell us what they are?

MR. SELDOMRIDGE: One of the big things that we've done is we've taken all of our halide gym lights and converted those to T5s. We've taken all of our HVAC systems that are operated through a computer program and we've optimized those. We've participated in demand-response programs through PPL. Those are just a couple of the things that I can think of off the top of my head.

MAJORITY CHAIRMAN METCALFE: Thank you, Representative Pashinski.

REPRESENTATIVE PASHINSKI: Okay. Thank you very much.

MAJORITY CHAIRMAN METCALFE: What percentage of your budget for the school district is salary and benefits, in round figures?

MR. SELDOMRIDGE: Salary and benefits is probably 65, 66 percent, somewhere around there.

MAJORITY CHAIRMAN METCALFE: Thank you.

Representative Roae has a question.

REPRESENTATIVE ROAE: Thank you, Mr. Chairman.

How would it work as far as like say a school district, you know, has to furlough employees. If those employees come back, would they be a new employee if they came back after a certain amount of time and they could be in a new defined contribution plan, you know, if we made a change, or would they still be considered an existing employee or whatever? Do you know how that works?

MR. SELDOMRIDGE: That's a good question and I'm not sure of the answer to that. Fortunately, we haven't had to furlough any staff. We've been able to do everything through attrition. So when an employee is furloughed, I would assume that if they were furloughed under the old system, they would come back under the old system. But I'm not sure of the answer to that.

REPRESENTATIVE ROAE: Okay. Thank you.

MAJORITY CHAIRMAN METCALFE: Representative Santarsiero.

REPRESENTATIVE SANTARSIERO: Thank you, Mr. Chairman, and thank you for your testimony today, sir.

Are you familiar with Act 120 passed in 2010?

MR. SELDOMRIDGE: Yes.

REPRESENTATIVE SANTARSIERO: Okay. That did reform the system for new employees, including on the multiplier.

MR. SELDOMRIDGE: Yes.

REPRESENTATIVE SANTARSIERO: And in fact I know there was a question earlier, and the gentleman before wasn't prepared to answer it, but I remember from our last hearing when we had the Executive Directors of both SERS and PSERS here that the net savings from Act 120 going forward was about $3 billion at the time.

MR. SELDOMRIDGE: Correct.

REPRESENTATIVE SANTARSIERO: My question, I guess, is a simple one: What was your district on a percentage basis contributing toward the pension fund between 2001 and 2008?

MR. SELDOMRIDGE: Well, if I understand your question, in 2001 we were contributing about 1 percent of payroll, and in 2008 it was up to about 4 or 5 percent of payroll.

REPRESENTATIVE SANTARSIERO: All right.

MR. SELDOMRIDGE: And the problem with Act 120, again, is it's a good -- I mean, it's a good act in the sense that it deals with the future liability, but it doesn't deal with the current $39 billion-plus current unfunded liability that you have.

REPRESENTATIVE SANTARSIERO: Right; right.

MR. SELDOMRIDGE: And that's the issue, is how do you deal with that current unfunded liability? Act 120 did a great job, you know, that in 2035 I'm sure everybody will be happy, those of us that are still here, but it doesn't do anything with the $39 billion current unfunded liability that we have.

REPRESENTATIVE SANTARSIERO: Right, and that's something we had a lengthy discussion about at our last hearing on this issue generally. And that really is the issue, and it gets back to the point that you raised earlier, which is the Pennsylvania Supreme Court decisions that say fairly bluntly and directly, both with respect to PSERS and SERS, that for existing employees, those contracts cannot be impaired.

So while the bills that have been presented this morning, each of them, you know, are interesting bills, they really I don't think get to the issue of how we deal with that unfunded liability.

One bill that I have, that unfortunately hasn't been brought before the committee, is to create a bipartisan commission to look at that problem. Because as I said at the last hearing we had, that if we're going to deal with this problem comprehensively, it is a difficult problem, as Representative Petri said in his testimony previously, and I think the only way we're going to come up with a real solution to fund that liability is through a bipartisan approach.

MR. SELDOMRIDGE: Don't those judges also benefit from the same pension system?

MAJORITY CHAIRMAN METCALFE: They do.

REPRESENTATIVE SANTARSIERO: Yeah, but---

MR. SELDOMRIDGE: So I guess my question is, how can they rule on something that they're personally affected by?

MAJORITY CHAIRMAN METCALFE: That's a good question.

Thank you, Representative Santarsiero.

REPRESENTATIVE SANTARSIERO: It is a good question, but at the end of the day, they are the final arbiter of Pennsylvania law. And I'm not going to sit here and question their integrity in terms of trying to construe Pennsylvania law, whether they have a conflict of interest or not, but we as a Legislature I think have to deal with the results of their decision, and we're constrained by those.

MAJORITY CHAIRMAN METCALFE: Thank you, Representative Santarsiero.

Another point on the judges is, we do elect judges in Pennsylvania. So at some point in time when the people of Pennsylvania decide they want to change the court so the court will actually rule against self-interest, then maybe that'll make a change in the way this is seen also.

But the judges have in the past cherry-picked their pay raise when we rescinded the pay raise, and years before I got here, they also allowed themselves to have a higher pension than the Legislature. They said the Legislature couldn't have it but that they could. So the courts have acted in a way that many of us would consider a conflict of interest.

MR. SELDOMRIDGE: And I understand all that. I'm just raising the legal issue. You know, if the judge has a personal interest in a decision, normally they would recuse themselves from it.

MAJORITY CHAIRMAN METCALFE: Right.

MR. SELDOMRIDGE: And I guess that's just something I don't understand.

MAJORITY CHAIRMAN METCALFE: Our last question from Representative Grove.

REPRESENTATIVE GROVE: Thank you.

Thank you for your testimony. It was very forward and gave a great insight into what you're dealing with, especially dealing with pension costs.

I appreciate the opinions. Are you close friends with our Majority Leader at all by chance?

MR. SELDOMRIDGE: Representative Boyd?

REPRESENTATIVE GROVE: No, Representative Turzai. You mentioned selling the liquor stores---

MR. SELDOMRIDGE: Oh, no, I don't know him at all.

REPRESENTATIVE GROVE: ---and that's something he's adamant about, so I didn't know if you had a conversation with him.

MR. SELDOMRIDGE: I don't think we're related. That sounds Italian to me, that last name.

REPRESENTATIVE GROVE: All right.

MAJORITY CHAIRMAN METCALFE: He mentioned stopping teachers strikes also, so.

REPRESENTATIVE GROVE: Yeah.

Again, I appreciate the testimony, and I think you hit on the hard shape school districts are in because of the pensions, and there's a lot of stuff that happened in the past that we need to ensure we do not repeat into the future while trying to turn this ship before we kind of hit the iceberg. Since this is the 100th anniversary year of the sinking of the Titanic, hopefully we don't get to that point in State government.

But the Chairman mentioned, questioned you on how much percentage is salaries and benefits. Has that changed over the years? The salaries and benefits of the employees, has that been a shrinking amount of your overall budget year by year?

And what I'm trying to get at is your cost drivers of the school district. Are there other cost drivers that are now taking over those salaries and benefits, which traditionally are usually the larger, and, you know, in the past I've heard, you know, 85, 90 percent of school budgets were salaries and benefits. Now, we're down to about 65. So can you kind of address those other cost drivers?

MR. SELDOMRIDGE: I'm sure for bigger districts, urban districts, it has changed a lot more drastically.

Because we've been able to plan over a period of time, ours hasn't changed that much. The cost drivers, you know, in any district, including ours, still continue to be salary and benefits. That's the major cost.

The only other cost, again, is special education, which is something that we have little control over. Again, once you hit that IEP process, you know, you just don't have a say in the costs. You could send -- you know, depending who moves into your district, you can have a child that needs to go to a school that tuition is $80,000, $90,000 a year.

But no, salaries and benefits and especially the pension continue to be the driving force. The only reason, again, that we've been able to keep our percentage relatively the same is because we're systematically eliminating staff along the way.

Hopefully that answers your question.

MAJORITY CHAIRMAN METCALFE: Thank you.

Thank you, sir, for your testimony today. We appreciate your making the trip to Harrisburg and sharing your thoughts and your expertise on this issue. Thank you.

MR. SELDOMRIDGE: Well, thank you for hearing me. I know you have a very tough decision to make, and I wish you the best.

MAJORITY CHAIRMAN METCALFE: Have a great day.

Now we'll be joined by Mr. David Fillman, the

Executive Director from AFSCME Council 13.

You can take the microphone, sir, and begin when you're ready. The last time you and I were at microphones, we were on opposite sides of the table on PCN and debating. We won't be doing that today, but we appreciate your joining us and sharing your thoughts on the issue.

MR. FILLMAN: I still had a wonderful time that night, by the way.

MAJORITY CHAIRMAN METCALFE: I did, too.

MR. FILLMAN: Thank you, Chairman Metcalfe and Co-Chair Josephs and the rest of the committee, for this opportunity to address the various pension bills that are before you.

You don't have my written testimony. I was told about a week ago to appear today, which I gladly did, but I had an annual convention just for the last 4 days. But I can get it to you in the next day or so, okay?

My name is David Fillman. I'm the Executive Director of the American Federation of State, County and Municipal Employees, AFSCME, Council 13. Council 13 represents over 65,000 members in Pennsylvania, of whom 45,000 are employees of the Commonwealth of Pennsylvania and 20,000 members work for various counties, townships, boroughs, cities, authorities, school districts, and nonprofit employers.

We do represent a majority of Commonwealth of

Pennsylvania employees who are members of the State Employees' Retirement System, SERS, as well as thousands of school district employees who are members of the Pennsylvania School Employees' Retirement System, PSERS. Your package of bills may affect all of them.

I also serve as a Governor-appointed trustee to SERS and have probably done so since my original appointment in the year 2000, and last year was just re-appointed by Governor Corbett. In that position, I help to monitor our investments and benefits for Commonwealth employees, which are represented by over 20 different labor organizations, management employees, the Governor, as well as all of you sitting before me, including the Judiciary of Pennsylvania.

I am also the Chairman of the Coalition for Labor Engagement and Accountable Revenues, CLEAR Coalition. This is a group of eight labor organizations representing over 1.1 million members, many of whom represent public employees who would also be affected by these bills.

I testified before a similar committee in March 2010, so some of my points today are no different than in 2010, but I will bring up more topical points.

First, I know we've discussed today about the Constitution. I hope we can all agree that due to litigation that brought the Pennsylvania Constitution into the pension system issue, it does prohibit any changes of the contractually-owed defined benefit pension to all current members of SERS as well as PSERS, both current annuitants and current eligible employees who will be future annuitants.

With the funding coming due for the benefit enhancements of 2001, members of the CLEAR Coalition started working with the Legislature, and some of you in this room, and then Governor Rendell beginning in 2010, to help relieve the long-term funding issues that we're approaching in 2012. We all know -- we call it the 2012 spike -- it was actually being reduced considerably in the mid-2000s until that stock market collapse in 2008 where everyone's investment, not just public pensions but worldwide, took a nosedive.

To add to that difficulty of the stock market, the Commonwealth took a perfectly legal holiday on their contributions as the returns on our investments on the good days prior to 2008 were well into the double digits and including 20-percent returns on some of our investments.

For SERS, the Commonwealth paid little or no contribution for years by taking advantage of the high rates of return. However, our members in SERS continued to pay their 6.25 percent and PSERS at 7.5 percent in good times and bad. In fact, we probably wouldn't be having this hearing if the returns were still as high as they were. And there have been investment losses in the years of the existence of SERS, which has been in operation since 1920. However, we were not that lucky.

So the CLEAR Coalition, with the largest State and school district employee unions in harmony, we worked to help support what is now called Act 120 that was signed by Governor Rendell in November of 2010. So for new employees of SERS effective January 1 of '11 and new employees of PSERS on July 2 of '11, we rolled back all the benefit enhancements from 2001, yet new employees are paying the higher contributions, the 6.25 or the 7.5.

New employees can get the post-2001 enhancements at their cost with a contribution of 9.3 percent and 10.3 percent for SERS and PSERS respectively. New employees would have higher vesting and higher retirement ages. There's an elimination of the Option 4, which is the lump-sum payment, that current employees in the system have but new employees do not. Plus, there's a sliding scale shared-sacrifice formula that new employee contributions would rise even further if investments do not meet expectations, but with a caveat that employers would not have contribution holidays as they did before.

Now, one of the issues, as we all know what happened in Wisconsin with the State employees' battle, there was a lack of employee contributions in their pension and health care. Here in Pennsylvania, State and school employees have paid into their pension plans for years, as well as State employees paying for health care that will raise to 5 percent of their pay by 2014.

Also, one important issue that is fairly unique to only a handful of States, in which Pennsylvania is one, in that Act 120, for all current and future annuitants, are they entitled to a cost-of-living increase? Although many State and school or municipal employees in other States have received COLA annual increases, the Commonwealth of Pennsylvania has saved millions, if not billions, in pension costs by denying this benefit to our pensioners for now, I believe, over 8 years.

All six bills that you're considering, diverting significant funding away from the DB plans to various forms of either DC plans, hybrids, or cash balance plans, the six bills you're considering do nothing to bring relief to the DB plan that helps 112,000 annuitants in SERS and in fact it exasperates the condition by diverting funding from the DB plan to thousands of individual accounts that need separate maintenance.

According to the National Institute on Retirement Security, even after accounting for all the significant advantages of a DB retirement system over DC accounts, research shows that DB plans are more economically efficient than DC plans. DB pensions can deliver the same level of retirement benefits at nearly half the cost of the DC plan.

Keep in mind, SERS pays out $2.5 billion in pension benefits each year to 112,000 annuitants. The average SERS pension is only $23,500 a year. Eighty-eight percent of our pensioners still live in Pennsylvania, so that's 88 percent of $2.5 billion that stays right here in Pennsylvania to buy goods from local merchants and to pay local, school, and State taxes. In fact, Mr. Chairman, in your home county of Butler, pension benefits for State employees alone return $28.8 million to primarily their local economy.

The costs. For every dollar of that $2.5 billion, 10 cents is from the employers or the taxpayers, we admit that; 18 cents is from the SERS members, so they have more skin in the game; and 72 cents has been from SERS investment income.

Finally, all of us as public employees didn't come into public service seeking high wages, stock options, or golden parachutes. Many of our public jobs come with inherent physical demands as well as physical hazards, many more so than the private sector. OSHA laws don't cover Pennsylvania public employees. Direct-care nursing jobs are plagued with back and other injuries from clients that have acted up. Or a correctional officer or a law enforcement officer who protects us from the worst of the worst. Or a highway worker who is injured by a car crashing into a work zone. And don't forget the 100 AFSCME PENNDOT workers who have lost their lives making the roads safer for the driving public.

A DB plan has what no DC plan has -- disability retirement. After subjecting Commonwealth employees to life-threatening or debilitating injuries, the least we can do is provide them with a reasonable return for their sacrifices.

Additionally, the Commonwealth has reduced its workforce on numerous occasions by offering early retirement options. These savings helped keep down the general operating budget, yet this would not be possible under a DC, a hybrid, or a cash balance plan.

Other programs that the budget provides have grown considerably more than our pension obligations. As an aggregate today, nationwide our public pension system spending was 3.8 percent versus our pension spending in the 1980s that was 5 percent. Our level of Commonwealth employees in Pennsylvania has been in the lowest bottom States in the nation.

As a SERS trustee, I can say that the SERS board is doing everything possible in asset allocation and administration to help raise investment revenues and reduce costs in present and future funding issues, but the six bills today do nothing to help in the near and future obligations.

I thank you for the opportunity to speak to you today, and I'll be happy to answer any questions.

MAJORITY CHAIRMAN METCALFE: Thank you, sir, for your testimony.

Representative Evankovich would have the first question.

REPRESENTATIVE EVANKOVICH: Thank you, Mr. Chairman.

Thank you, Mr. Fillman, for your testimony today, and I appreciate the work that you've done coming to the table on the pension reform changes that were made in 2010.

In your testimony, several times you mentioned the package of bills that we're talking about today. Have you had an opportunity to review HB 2200, which is the bill that I've introduced?

MR. FILLMAN: I know there are two that address the Legislators; two that address, I think, school districts; and two, State employees.

REPRESENTATIVE EVANKOVICH: Yeah. And the reason I bring it up is that my bill wouldn't affect any AFSCME or any represented employees in the entire State. It would simply be for the General Assembly Members and staff. So I just wanted to point that out, that, you know, the bill that I've chosen to introduce and one -- actually, two of the bills that the committee is considering don't have any effect on existing Members or staff of the General Assembly in mine and don't affect anyone outside of the General Assembly and staff in both.

One of the questions that I had was, would you be willing to advocate for further pension changes for the represented employees that you represent? Would you be willing to consider anything down the road that changes the current benefit, the current benefit structure? For instance, at least would you advocate for providing an option for new members of your represented workforce such as allowing them to have the option of a 401(k) versus a defined benefit plan?

And I know the retort is always that, you know, you're underfunding the existing pension plan further when you do that, and all I would simply point out is that regardless of whether those folks are joining a defined contribution plan or not, what's going into the existing pension plans and whatever fix is introduced to fix the underfunded liability, it comes from the taxpayers. It's taxpayer dollars no matter how you cut it. So whether it's a direct contribution out of the General Fund or whether it's through contributions over time, they are tax dollars going into the fund.

So that was just one of the questions I had, and I just have one follow-up question.

MR. FILLMAN: Well, the dilemma that I mentioned in my testimony is that our members have contributed the 6 1/4 percent to the SERS all this time. Would we be still sitting here talking about this if the Commonwealth had continued to pay what they were supposed to be paying over this time and not taking those holidays? Maybe, maybe not.

Could we argue now that in 2001 we made the right choices making the enhancement to the benefits? Well, I guess, you know, we thought the market, which was doing good at that time, would continue doing that.

I agree with your assessment that, you know, once we start relieving folks from that pool, it exasperates the problem, and that's why part of the Act 120 discussion was keeping the folks in a DB plan but making them contribute more, reduce the benefits, so for the long term there would be some savings.

To say where we would go at this point, I would, you know, be willing to listen to some issues. But, you know, quite honestly, our members have really done everything necessary, contributing some of the highest in the nation as far as contributions.

REPRESENTATIVE EVANKOVICH: Just one of the things to note would be that providing an option, some employees, in particular myself, I prefer a defined contribution plan. To vest now in the pension, you have to be in employment for 10 years. Some folks might not be on that time horizon.

But you had mentioned the breakdown of what percent, of how many cents on a dollar comes from who, and while I appreciate that, the employee is contributing a more substantial portion in today's dollars for the pension benefits they're receiving. My question, I guess, is, with that $39 billion unfunded component, where is the funding for that going to come from?

And going back to my boat example, which I'm glad that Representative Grove picked up on as well, do you agree with the assessment that, you know, we're taking on water and we have to stop taking on water in order to bail the water out? Do you have any sympathy for that argument at all, that we are currently, every dollar, every day, we're taking on more water and that we need to stop taking on water first?

MR. FILLMAN: Well, I think that's where the discussions were going with Act 120. You know, it passed the House, it passed the Senate, was signed by the Governor, and we were looking for some long-term relief.

Now, how significant can we, you know, make that number go down at this point? You know, we have limitations with the current workforce in what we can change. And that's not something I'm making up or you're making up; that's part of the litigation.

REPRESENTATIVE EVANKOVICH: And I'll just point out that when we had the testimony from PSERS and SERS, I specifically asked the question, every dollar that goes into the pension system every day, is every dollar underfunded, and the answer was yes. Every single employee that goes into the system, every new addition, everything is underfunded, and I think we have to get away from that.

Thank you, Mr. Chairman.

MAJORITY CHAIRMAN METCALFE: Thank you, Representative Evankovich.

For our last question, Representative Roae.

REPRESENTATIVE ROAE: Thank you. I know we're behind, so this will be real quick.

Mr. Fillman, would AFSCME support selling the State stores if that money would be used to go into the SERS pension plan to protect the pensions of State employees, and would AFSCME support getting rid of the prevailing wage laws so the State would save tax money on construction projects and use those savings for the SERS pension plan?

MR. FILLMAN: Absolutely not, sir.

REPRESENTATIVE ROAE: Thank you.

MAJORITY CHAIRMAN METCALFE: Thank you, Representative Roae.

Thank you, Mr. Fillman, for your testimony today.

MR. FILLMAN: Thank you.

MAJORITY CHAIRMAN METCALFE: Have a great day.

Our next testifier is Eileen Norcross, Ms. Eileen Norcross. If you could take the microphone, ma'am. She is the Senior Research Fellow with the Mercatus Center at George Mason University.

We thank you for making the trip here today and for taking time to share your expertise with us, and you can begin when you're ready, ma'am.

MS. NORCROSS: Chairman Metcalfe, Representative Josephs, and distinguished Members of the Pennsylvania Legislature, thank you for inviting me to testify today on the subject of pension reform in the Commonwealth of Pennsylvania.

Pennsylvania's two main pension systems, the State Employees' Retirement System and the Public School Employees' Retirement System, report a combined unfunded liability of $39.5 billion and funding ratios of 75 percent and 69 percent respectively. However, on an economic basis, the shortfall on these plans increases to a total of $116 billion, leaving each system funded at 34 percent.

In my testimony, I would like to begin by discussing the reasons why Pennsylvania's pension systems reached this point and the importance of accurate valuation in determining a funding policy for the current defined benefit plan and then deciding how to structure a reliable retirement system for Pennsylvania's public workers.

The crash in financial markets in 2008 is often cited as a leading cause for pension plan underfunding in the United States. However, the steep decline in markets is not a cause of plan underfunding. It is instead a demonstration of a fundamental flaw in how public plans have been valued, funded, and exposed to large amounts of risk.

The weakening of defined benefit plans is a direct result of a core assumption that is built into all public-sector plans in the U.S., and that is the discount rate chosen to value the pension obligation or the liability and thus the amount needed to fund that liability, or the annual required contribution, in order to secure benefit payments to retirees.

A public-sector pension represents a promise on the part of the government to pay an employee a certain sum upon retirement on a monthly basis. The payout is a certainty. As a government-backed plan, it is considered "A debt of the Commonwealth, backed by the full faith and credit of the Commonwealth." A public-sector pension is a liability to the government, a stream of cash flows that the government as employer must pay to its employees, much like a bond. In choosing the discount rate or the interest rate to convert the future value of that promise into a present value, what must be considered is the likelihood that the payment will be made to the retiree.

The pension is risk-free from the vantage point of the worker. It is a near certainty that the government will not choose to default on this promise. Thus, the correct discount rate to use is the one that matches the risk and timing of those payments. In this case, it is the 15-year yield on Treasury bonds, 15 years because that is the midpoint of that stream of cash flows. That is currently 2.5 percent. SERS assumes a discount rate of 8 percent and PSERS a rate of

7.5 percent. The result is that the lower discount rate requires a higher contribution in the present to fund the future benefit, presenting policymakers with a very intimidating budgetary reality.

It is important to note there is one liability, not many possible liabilities based on many possible discount rates. Accounting assumptions only serve to artificially suppress the underlying economic reality. In other words, the economics will eventually catch up with the accounting.

The flawed discount rate assumptions have had a negative effect on asset management, contribution policy, and defined benefit plan design.

Several behaviors result from valuing liabilities based on expected asset returns. First, plan managers have a greater incentive to take on more investment risk to realize high expected returns on plan assets. This can be seen in SERS' investment portfolio, which consists of 26 percent in alternatives.

This behavior, seeking out more risk in the asset portfolio, is a result of the accounting, which implies it is possible to guarantee a certain risk-free benefit with volatile investments. However, exposure to volatility lessens the likelihood that there will be enough in the plan to pay benefits when they are due.

The majority of a plan's obligations are payable over the next 15 years. Even if plans accurately predict market returns over a long period, they must pay out benefits over the short term when average market returns are more uncertain. There is a significant probability that a fully funded plan would be unable to make its obligations even if the plan accurately projected average market returns.

The second problem presented by valuing plan liabilities based on expected asset returns is that it produces an annual required contribution that is too low and insufficient to fully fund the benefit. That is, even when sponsors are contributing the full ARC, they are contributing too little. Since the liability is undervalued, so are the contributions and the normal costs needed to fund the benefit. In the case of Pennsylvania, Joshua Rauh and Robert Novy-Marx calculate that Pennsylvania's current actuarially-required contributions of $2.8 billion should really be $10.5 billion and that this will require an increased contribution of 35.8 percent of payroll, or 15.2 percent of tax revenue.

The mixing of plan assets and plan liabilities has produced another problem in funding policy. It has given sponsors the illusion that plans are overfunded in market boom years. Plan sponsors have set contribution policy according to market performance.

This is clearly seen in SERS. High investment returns in the 1990s triggered a downward trend in contributions from the employer. The contribution rate in 1984 was 18 percent of payroll. Strong asset returns tracked with a marked decline in contributions. As a result of historically high market returns in the late nineties, Pennsylvania zeroed out its annual contribution for 2 years. As SERS began to absorb the effects of the technology bubble bursting, plan contributions began to increase again, but only modestly.

A decision was made with Act 2010-120 to artificially cap contributions. The purpose was to lessen the immediate budgetary impact of rising costs and to push these costs into the future. But when you suppress costs, you only push them forward.

In considering a shift to a defined contribution plan, policymakers must first work with the right set of numbers. Otherwise, they're comparing apples and oranges. To begin, actuaries should estimate the true cost of the defined benefit plan based on a risk-free rate and then determine the true normal cost to fund the plan.

How do these costs compare to the costs of a DC plan? A 2002 study found that the annual costs of the defined benefit plan averaged 14.9 percent, much lower than the study's estimated 20 percent of payroll for a DC plan. However, this is a faulty comparison, as the normal costs of the defined benefit plan are underestimated based on a too high discount rate. Again, Joshua Rauh and Robert Novy-Marx estimate using the risk-free rate. The true cost to fund the defined benefit plan would require an increase to 35.8 percent of payroll.

In conclusion, I just want to mention a few principles to consider in benefit design.

Switching to a defined contribution plan does not save money in the short run, as both the defined benefit plan and the defined contribution plan must be funded.

Switching to a defined contribution plan does shift risk away from the taxpayers and onto workers who are participating in the DC plan. It also provides the worker with greater mobility, as retirement savings are portable in a defined contribution plan.

The government must make its annual contribution in a defined contribution plan, thus mitigating some of the problems we've seen in defined benefit plans with skipped contributions and capped contributions.

The annual contribution to the DC plan is not necessarily "more expensive"; it is simply "more transparent" than the defined benefit plan, as those costs are now being artificially capped and misestimated. This is only because currently, DB plans are misvalued, and the amount needed to fund the plans are underestimated. Unless economic valuation of the defined benefit plan is performed, which includes calculating the true normal costs, the defined benefit plans will appear cheaper.

Whether Pennsylvania chooses to stick with a defined benefit plan or shift to a DC plan, the benefit for the defined benefit plan must be funded. Underfunding presents a real risk to taxpayers and to beneficiaries. Policies that attempt to suppress contributions merely shift the bill forward and cause greater funding problems for the future.

Defined benefit plans can only function if the moral-hazard problems presented by the current accounting and the public-choice problems are eliminated, and that entails market valuation. One option to consider is shifting the management of the defined benefit plan and also to consider giving new employees an option to switch to a defined contribution plan.

Thank you, and I look forward to your questions.

MAJORITY CHAIRMAN METCALFE: Thank you, Ms. Norcross, for your testimony today. We appreciate it.

A question from Representative Grove.

REPRESENTATIVE GROVE: Thank you.

Thank you for your testimony. Pretty depressing, but very good information -- some realistic outlooks about what our true liability is of our pension plan.

Can you go into detail -- I know you didn't really hit on this, but pension obligation bonds, are you familiar with them?

MS. NORCROSS: Yes.

REPRESENTATIVE GROVE: How many States have issued pension obligation bonds? And, you know, there is obviously some inherent long-term risk with doing that, but can you go into a little bit about that? When we did Act 120 in 2008-2009, that was barred from doing that within the legislation, obviously -- easily repealed out. But can you go into pension obligation bonds a little bit?

MS. NORCROSS: They're a relatively new instrument starting in the nineties. About a dozen States have relied on them, and some have relied on them heavily, like Illinois. California has been another issuer.

They are -- I don't think they should be used as contribution policy in general, and that was the problem back in the nineties. It was this idea of, hey, we don't want to have to deal with the funding; we'll issue a bond. So as a general rule, it's bad discipline to issue debt for debt.

But what we're looking at now are these massive liabilities -- how are you going to pay for that? -- and that's where bonding then becomes potentially appropriate. If you close down the DB system, you've got this massive bill. One way is to say, hey, we're going to have to bond for this and pay for it.

But as a funding policy in general, I think some States have run into trouble with that and just skipped out on their obligations over time.

REPRESENTATIVE GROVE: One follow-up, if I could?

MAJORITY CHAIRMAN METCALFE: Representative Grove.

REPRESENTATIVE GROVE: Has Illinois or California done the pension obligation bond with switching over to a different plan like a DC plan or anything? They just literally stay within the DB plan?

MS. NORCROSS: That's correct. Illinois issued bonds simply just to make the payment, and so did California, just simply because they didn't want to have to make it out of general revenues that year. So they did not close down the system in those cases.

REPRESENTATIVE GROVE: Okay. Thank you.

MAJORITY CHAIRMAN METCALFE: Representative Pashinski.

REPRESENTATIVE PASHINSKI: Thank you, Mr. Chairman.

Thank you very much for your testimony.

Have you done any projections based upon Act 120? Assuming that the $39 billion was paid for -- let's just assume that for a moment.

MS. NORCROSS: Yes.

REPRESENTATIVE PASHINSKI: Would the fund under the present Act 120 be strong, viable, financially solvent, and for long term?

MS. NORCROSS: You're electing to pay more in the future. You're pushing those costs forward on the amortization. So the answer is actually no, because it's still very underestimated in terms of the amount you'll need to contribute.

I have not run the numbers myself, but what I would recommend you do is perform a market valuation and then recalculate what those costs will be, both the normal costs and the amortization over the next 30 years.

REPRESENTATIVE PASHINSKI: But I'm saying if the $39 billion was taken out---

MS. NORCROSS: Oh; it was taken out.

REPRESENTATIVE PASHINSKI: ---you don't have that obligation now. I want to know, would the system be viable? Would it be fiscally prudent, and yet would it be healthy to last for a long time under Act 120? Eliminate the $39 billion.

MS. NORCROSS: I have not run the numbers, so I don't know. I can't tell you.

REPRESENTATIVE PASHINSKI: That's the one that we need to have, because it worked up until the point that the markets collapsed and the people---

MS. NORCROSS: Well, only if you use the risk-free rate, because what's going on using the higher rate, saying we're going to use the return on assets to see what our funding policy should be, there will always be underestimation built into the model. So I'm thinking that no.

REPRESENTATIVE PASHINSKI: Well, with a large portion of the fund invested, I mean, that is going to go up and down.

MS. NORCROSS: Yes.

REPRESENTATIVE PASHINSKI: But we do have historical markers that demonstrate a certain percentage of increase over a period of time.

MS. NORCROSS: Well, the hazard there -- and economists and actuaries are at war over this, this principle. Some actuaries agree that when you value your liability based on market returns, you're going to always experience volatility. So there's always the short-term risk that you are underfunded, and what the economists are saying is, don't even look at your asset portfolio. Put that here and say, I'm valuing a bond on the liability side; it must be low-risk, and then you have to use a separate set of criteria to determine how to invest the asset side.

REPRESENTATIVE PASHINSKI: The only problem is that we wouldn't do anything if it was strictly dollar for dollar. I mean, we're going back to 1910 where you didn't buy anything unless you had enough money to buy it.

MS. NORCROSS: Right.

REPRESENTATIVE PASHINSKI: And then the business model indicated that the proper loan vehicle would allow you to expand and grow while paying off your debt in a regimented, disciplined manner.

Thank you.

MAJORITY CHAIRMAN METCALFE: Thank you. Thank you, Representative Pashinski.

Representative Krieger.

REPRESENTATIVE KRIEGER: Thank you, Mr. Chairman.

Thank you for your testimony. I just wanted to clarify a couple of points in your testimony.

My understanding is the accrued outstanding liability is about $39 1/2, $40 billion. You mentioned a $116 billion figure. Can I assume that's using the risk-free rate of return, which I assume is about 2 or 3 percent, instead of the 8 or 7 1/2 percent rate of return? Is that correct?

MS. NORCROSS: Yes.

REPRESENTATIVE KRIEGER: Assuming the real rate of return of what we could expect in the markets, do you know what percentage of our tax revenues would need to be applied to these pension obligations to fully fund them on a year-on-year basis?

MS. NORCROSS: I have cited the work of Joshua Rauh and Robert Novy-Marx. They ran numbers a few years ago, so these are a couple years old. They think it would cost about 15.2 percent of your revenues -- an increase of 15.2 percent of revenues. So the way to know for certain is really to update that with, you know, have your actuaries run the scenario with the risk-free rate and then figure out what portion of the budget would have to go towards it.

REPRESENTATIVE KRIEGER: And to make sure I understand what you're saying, you're saying that assuming what the market will yield, we would need to pay every year 15.2 percent of our total tax revenues that year just to fund the pension obligations? Is that correct?

MS. NORCROSS: Correct.

REPRESENTATIVE KRIEGER: Now, pension obligation bonds were mentioned here, and I certainly understand the attraction of that, but isn't it the case that whether you move it off the SERS or PSERS books, you're still paying debt service on those bonds? So while it looks like the system is solvent, you've just moved that debt obligation to the Commonwealth's General Fund. Is that correct?

MS. NORCROSS: That's correct. Yes.

REPRESENTATIVE KRIEGER: I guess one last question. Here's the difficult one.

Based upon these projections of tax revenues, do you foresee from a financial perspective any possible way of dealing with this, just dealing prospectively with plan benefits?

MS. NORCROSS: I think it has to be a combination of your portfolio and also benefit management going forward. It's going to have to be a mix of things. You want to pay out as much as you can that has been earned by the worker while, you know, trying to ring-fence this liability. So there may be higher contributions, of course, on the part of the State. The reduced benefit accrual may be something. But it might not be enough, and that's why the only thing you really can do is run that scenario, a very conservative scenario, and say, what are our policy options and what is tenable in a legal framework to deal with this liability? Is a bond more appropriate or tax revenues to pay it down?

REPRESENTATIVE KRIEGER: All right.

And, Mr. Chairman, I would just like one last comment. I'm sorry.

I think we all recognize, as did Mr. Fillman, that we understand the employees' frustration, and there's certainly lots of blame to go around over the last 10 years. Some of it's this General Assembly. Some of it's, frankly, some of the public employee unions that went along with this. We recognize that, and we've got a problem. I think we need to look forward, and it's going to require some sacrifice on all our parts.

But again, thank you, Mr. Chairman.

MAJORITY CHAIRMAN METCALFE: Thank you, Representative Krieger.

Representative Mustio.

REPRESENTATIVE MUSTIO: Thank you, Mr. Chairman.

Thank you for your testimony.

How does the private sector, the publicly traded companies, how do they account for their pension obligations? Do they use the risk-free rate?

MS. NORCROSS: They use a slightly modified rate. They use the right principle, and they are valuing their pensions as though they're guaranteed but at a slightly higher rate because there's still some risk involved. These are private companies, and there's the risk that they will go under, although they're backed by the Pension Benefit Guaranty Corporation. They're using a slightly modified Treasury rate. So they're using the right principle. They're not picking the discount rate based on how the assets perform but based on what does this pension liability represent. So it's about -- it's a little bit higher than the 2 1/2 percent.

REPRESENTATIVE MUSTIO: So is the theory -- I don't remember the gentlemen's names -- is their theory basically then that because it's not market risk, these are public dollars, that's why it should be more conservatively looked at?

MS. NORCROSS: It's because it's guaranteed by the State, and it should be considered like a debt of the State, a bond. Depending on the legal framework -- in Illinois, these benefits are constitutionally protected and in New York State. Depending on what the law says, if you have every intention of paying this out and it's risk-free to the worker, then it should be valued using a risk-free rate of return.

REPRESENTATIVE MUSTIO: So that would impact both the employees and the employer contributions when the plan is established, if it's decided to look at it that way.

MS. NORCROSS: Correct.

REPRESENTATIVE MUSTIO: And then that would also impact the type of benefit, I would assume, that would be generated.

MS. NORCROSS: Right. And it would also eventually impact the asset side. Although they're independently considered, there are a few things to look at. Intergenerational equity -- you want to spread this bill out over the generations so you're not giving too much of it to the future. And you want to design a hedging portfolio so that you're managing this in a way that says, hey, we know we have to pay this out; we're not going to be investing in high amounts of alternatives or real estate or foreign equities.

REPRESENTATIVE MUSTIO: Do any of the plans or any of their theory, I guess, fluctuate the benefit based on the increase perhaps in that risk-free rate?

MS. NORCROSS: The portfolio, again, it's an independent consideration, so they're not going to look at -- the rate you're using to value the liability is simply on the 15-year time horizon and it is risk free. And then on the asset side, you will want to manage that benefit with intergenerational equity and a conservative outlook in mind.

REPRESENTATIVE MUSTIO: Thank you.

MAJORITY CHAIRMAN METCALFE: Thank you, Representative Mustio.

For our last question, Representative Grell.

REPRESENTATIVE GRELL: I'll pass.

MAJORITY CHAIRMAN METCALFE: Thank you, Ms. Norcross, for sharing your expertise and for making the trip here today. We appreciate it.

MS. NORCROSS: Thank you.

MAJORITY CHAIRMAN METCALFE: Have a great day.

Our next testifier is Mr. Brent Mead, the State Government Affairs Manager for the National Taxpayers Union.

Thank you for joining us, and you can begin when ready, sir.

MR. MEAD: Chairman Metcalfe, Members of the committee, my name is Brent Mead. I'm the State Government Affairs Manager for the National Taxpayers Union. We are the nation's oldest and largest grassroots advocacy organization. We're dedicated to lower taxes and limited government at all levels. I'm honored to testify before you today on behalf of NTU's 17,000 members in Pennsylvania, all of whom share our common beliefs.

Thank you for allowing us the opportunity to participate in this hearing on pension reform. Since our founding in 1969, our members and staff have learned firsthand that few issues can match the complexity or controversy of government employee compensation. It is a matter at once affecting the livelihood of thousands of workers across the Commonwealth, the personnel policies of public and private entities, the State government's long-term finances, and, of course, the well-being of taxpayers.

Before outlining what NTU believes should be the guiding principles for reform, it is vital to note several important trends.

Pennsylvania's largest, most generous public employee pension plans are severely underfunded and are in need of serious reform. In fiscal years 2009-2010, Pennsylvania taxpayers paid $843 million toward the Public School Employees' Retirement System and the State Employees' Retirement System. That number will jump to $6.1 billion by 2016-2017, an increase of about 700 percent. For taxpayers, this represents a burden of almost $500 per person to meet these new obligations. Furthermore, the actual funding ratio for the two plans is expected to dip to 60.1 percent for the SERS and 50.9 percent for PSERS. Worse still, the plans assume unrealistic rates of return on investments of 8 percent and 7.5 percent respectively.

Now, I just say that if any of the Members of the committee over the last 5 years during this economic downturn have had similar rates of return, I would love to meet your investment advisor. It cannot be stressed enough, as with the previous testimony, these are simply unrealistic.

And while the recent economic downturn exacerbated the strained finances of the pension systems, they are not the cause of this crisis. Economic difficulty simply exposed fundamental structural flaws in the system. For too long, Pennsylvania promised overly generous benefit packages to government workers that are not sustainable in the long run. The bill was going to come due eventually. Recent events merely shifted the timetable.

Further complicating the funding picture were proactive efforts by the General Assembly in the past decade that have made the situation worse. Starting in 2001-2002, Pennsylvania increased the size of benefits to employees, notably by boosting the cost-of-living adjustment and they also increased the actual benefit packages for Legislators and State employees.

Act 40 in 2003 deferred unaffordable costs into the future, with "the future" being 2012-2013, by changing how the asset losses in the plan were going to be scored, whether it was a 10-year window or a 30-year window.

And finally, Act 120 in 2010, as you're well aware, again deferred some payments into the future, giving the illusion of plan solvency without decreasing benefits or raising taxes, and as you're no doubt aware, this game is just about up.

So while the State has managed to use these methods to hide the true nature of the problem, local entities have not had that luxury. For example, according to a report issued last month, Susquenita School District, which serves about 1,700 students, will increase its PSERS payments from $1 million this year to $3.3 million by 2017-2018.

Furthermore, the Department of Education issued 197 exemptions from the school tax referendum exemption. Of those, 194 expressly called for higher taxes to pay for pension obligations. By a dollar amount, about half of the $159 million in exemptions was for pension costs. So taxpayers already face higher burdens at the local level due to these policy decisions. Without action, this crisis is only going to deepen at the State and local levels.

Government employee compensation and associated pension costs are among the most politically challenging issues that you're going to deal with, but difficulty does not excuse inaction. Going forward, Pennsylvania should adhere to a couple basic guidelines to avoid repeating mistakes and improve the future financial stability of the State's pension programs.

First and most importantly, and this is something NTU shares with the Commonwealth Foundation here in the State, is that the State should shift to a defined contribution plan for all new hires, and they should seek to unify that plan.

One of the major problems when we look at it is that there are about 3,200 local plans in addition to the two large State ones. So any major broad-based reform affecting both State and local plans becomes incredibly difficult to analyze and accurately assess what the costs are going to be when you have 3,200 local plans.

The second point is again one that has been made this morning, and that is the General Assembly must stop deferring payments into the future. This has created this long illusion that the current defined benefit plan is fiscally sustainable when it's not. It's just pushing the tax bill into the future. It's what we're seeing with the pension spike over the next 5 years. It's largely due to actions in, like I said, 2001-2002 and Act 120.

When Act 120 was being debated, I'll just read very briefly what NTU wrote to the General Assembly: "HB 2497...defers pension payments well into the future. By putting off payments, HB 2497 does not fix the plans' underlying problems or save taxpayers money; it only makes the problem worse. In 14 years, taxpayers will have to pay substantially more to sustain the system due to HB 2497's risky assumptions about plan returns. In short,..." this "will force the children and grandchildren of Pennsylvania's current taxpayers to pay for fiscal irresponsibility they did not cause."

The third point is that there has got to be better transparency and data on these plans. Designing a sustainable and fair retirement system requires more comprehensive comparisons with the entire private sector, not an inflexible adherence to government-only benefit benchmarks. It's critical to incorporate the best practices and evolutionary experience of the private sector in the design of any public-sector compensation package, as ultimately the private-sector workforce shoulders a portion of this burden.

Furthermore, State and local plans must use more realistic rate-of-return targets. In 2011, Wilshire Associates studied 126 State and local plans in Pennsylvania, including the two large State plans, and found that none would meet their assumed rates of return. If a private-sector company used an 8 percent expected rate of return, as SERS does, it could face serious penalties for financial fraud. Continuing to peddle such unrealistic numbers in the public sector only perpetuates a fraud on taxpayers as well as government employees.

And then finally, and we understand the political difficulty, but the sheer reality is that at some point, the General Assembly is going to have to consider modifying benefit packages for not only new hires but current enrollees who are not yet retired. This will obviously involve serious legal issues that must be weighed carefully. But switching new employees only to a defined contribution plan will not yield adequate savings, in our estimation, to avoid a serious tax increase on your constituents. So unfortunately, I don't have any magic bullets of how this should be done, but, I mean, it's something that must be considered and, in order to avoid the sorts of tax increases we're looking at, must be done.

With that said, I'll just briefly outline our views on the six pending bills for this hearing.

HB 418, which would shift Legislators onto a defined contribution plan, this is something we support. We don't think it goes far enough in that it only impacts the Legislature. But I'm sure you're well aware, I mean, Pennsylvania has received national press for some of the abuses of the old legislative plan, which one Legislator in particular pulled an annual pension of over $250,000 a year, which, when you look at Federal employees, that's more than any single Federal employee made in any given year.

HB 551, we generally support the idea of transitioning all new employees to defined contribution plans. However, it's a small step in that it's an optional shift. NTU views that this should be mandatory.

Similarly with 552. Keeping these plans only optional, you really have to have a strong incentive package to get the employees to shift. It really should be mandatory if you're going to yield the sort of savings that you need.

HBs 1676 and 1677. We have serious concerns with these two bills. While we like the idea of trying to create these segregated worker accounts that actually track how much has been paid into their pension on both a State and individual level, this is just a modified defined benefit plan when you really look at it. A better thing would be going toward something like an individual worker savings account. That said, there are some good things in there for, I mean, young workers like myself. I'm probably not going to be in this job until I'm 55 and retire, so it is a good thing to allow these workers to be able to pull out the full of their pensions when they move into a new position.

And then finally, 2200 we view as an improvement over HB 418 in that it applies to the entirety of the legislative branch. Again, it's something we support. We just wish it was for all new hires across the State.

So with that said, Mr. Chairman, again, thank you for the opportunity to testify today, and I'm happy to answer any questions.

MAJORITY CHAIRMAN METCALFE: Thank you.

Our first question is from Representative Samuelson.

REPRESENTATIVE SAMUELSON: Thank you, Mr. Chairman.

You testified that the rates of return in the two plans are unrealistic. Now, I guess my question is, what would you suggest as more realistic rates of return? We received data from our State Employees' Retirement System, and granted, the 1-year rate of return was 2.6 percent in the middle of the recession. But they also do a 10-year rate of return, 6 percent a year; a 20-year average, 8.2 percent; and a 30-year average, it's 10.2 percent. This is data from our State Employees' Retirement System. And, of course, over the last 30 years we've had recessions; we've had boom times. So why shouldn't we use a longer average, as they have done?

MR. MEAD: Mr. Chairman, I guess the easiest way to think about why we have concerns with that is that during the boom years, you would see, I think '05-06, there was actually a double-digit rate of return on one of the plans. But the problem is, during the recession when that asset balance took a 10-percent hit, if the plan had investment returns of 10 percent the next year equal to that loss, you're still at a negative balance over the 2-year window.

So the concerns we have is that when you assume these 8-percent returns, you're going to have more than one recession over a 30-year period. I mean, it's just the historical data. So even if you get this 8-percent return for 24 of the 30 years, and it can even be 9 percent, 10 percent, but when you take those 4- or 5-year hits where you actually lose balance, you're just not going to be caught up. And I think a more realistic rate of return would probably be, I mean, definitely over the 2 1/2-percent risk-free rate, but something like the S&P at 6 percent, that would be fine, which is what the S&P 500 has gained over the last 40 years, I think.

But, I mean, as the study showed last year, none of these State and local plans are expected to get that 8-percent return. A 7 1/2-percent return probably won't happen. I'll be the first to admit I'm not a mathematician, so I don't know what the exact number is. I just know, looking over the charts, that 8 percent is not realistic, and because it's assumed right now, there is a huge unfunded liability that's not currently accounted for.

MAJORITY CHAIRMAN METCALFE: Thank you, Representative Samuelson.

Representative Grell.

REPRESENTATIVE GRELL: Thank you.

Thanks for your testimony.

I want to direct your attention to page 2 where you're talking about the impact of Act 120 of 2010, and you said that that was deferred payments "without decreasing benefits or raising taxes." What does that mean?

MR. MEAD: In our analysis of the bill, there was no accompanying actual tax increase on our constituents. And I will also preface this---

REPRESENTATIVE GRELL: Well, but I'm talking about the decreasing benefits. It decreased the benefit for every new employee coming into either system.

MR. MEAD: I'll defer to that, and I apologize if that's incorrect.

REPRESENTATIVE GRELL: Well, that's very incorrect.

And the statement on page 3 is also incorrect where you're saying that all this did was push the can down the road, et cetera, et cetera. I would suggest that you look at the actuarial note on the bill as finally passed. Every dollar of deferred payment was more than compensated for in long-term benefit because of the reduction in the benefit, the multiplier, and the increase in the employer contribution.

MR. MEAD: Well, that---

REPRESENTATIVE GRELL: So over the term of this actuarial note, Act 120 actually saved the taxpayers $1.3 and $1.5 billion respectively. So I'd ask you to adjust your testimony and future testimony.

MR. MEAD: Mr. Chairman, if I can respond.

When we look at this, in the later version, we had received an analysis. Again, it was from the Commonwealth Foundation that the final version had an increased unfunded liability of $27 billion. I mean, I realize that the employee contribution levels went up and that there was a slightly higher employer contribution level, but there is still an unfunded liability due to Act 120. And it also pushes the payments down the road by doing this asset smoothing, where losses are smoothed over a 10-year window instead of a 5-year window.

So, I mean, with that, it's possible that the General Assembly doesn't actually know what the true loss of the recession is, because those losses have actually been pushed forward into the future.

REPRESENTATIVE GRELL: Well, that's why we have a Pennsylvania Employee Retirement Commission that does these analyses, and they use their actuaries. A net of everything you just said, Act 120 actually saved the taxpayers and put these plans in better condition than before that was enacted.

Maybe, maybe this quotation was taken from a prior version of the bill, but that does not reflect what was enacted into law and signed into law by the Governor in 2010.

Thank you, Mr. Chairman.

MAJORITY CHAIRMAN METCALFE: Our next question will be from Representative Grove.

REPRESENTATIVE GROVE: Thank you, Mr. Chairman.

In your testimony you mentioned Susquenita School District. They're going to see PSERS payment increases from $1 million to $3.3 million. Will they be able to fund that increase through their Act 1 index and pension exceptions, or are they going to have to go to voter referendum or do further cuts to meet that PSERS payment?

MR. MEAD: Representative, when we had talked with them, that was unclear. My understanding is that they will probably have to seek an exemption to the referendum exemption, that they will not be able to raise that difference of -- it'll work out to be about $600,000 a year when they add in their other inflationary costs, that they won't be able to meet that cost alone without an exemption to the referendum.

REPRESENTATIVE GROVE: Will the exception be included in that?

MR. MEAD: Yes.

REPRESENTATIVE GROVE: Would they be able to make their pension payments through the Act 1 index and the pension exception?

MR. MEAD: Again, I think that question would be better directed at the school district. When we had talked with them, that was not made clear to us whether or not they could do it.

REPRESENTATIVE GROVE: Okay.

MR. MEAD: I mean, what they did, they just gave us their raw budget numbers of, this is what's coming to us in the future. They did not share with us how they planned to account for it and pay it.

REPRESENTATIVE GROVE: Okay. So in the scheme of things, Susquenita School District, the taxpayers, because of reforms we did in Act 1, you know, to say that they're going to get hit with huge property tax increases because of pensions, not the case? is the case?

MR. MEAD: I mean, I think that there will be a property tax increase there, that there's not going to be -- that in order to make up that balance, they will have to and they're going to have to raise taxes. That's between that and other just ongoing inflationary costs, whether it be payroll costs, school upgrades, or bonded debt, that they're going to have to -- my guess would be that they'll have to approach their taxpayers for an increase.

REPRESENTATIVE GROVE: And that's not clear whether it's for a referendum or---

MR. MEAD: Right. They did not make clear to us.

REPRESENTATIVE GROVE: Okay. And out of the 194 exceptions that were approved by the Department of Education, how many of those school districts are actually going to utilize them?

MR. MEAD: Again, that data was not made clear from the Department of Education. That was just the raw data we pulled from the department that they had issued 197 of these, 194 cited pension costs as one of the reasons, and those pension costs accounted for just over $80 million of the $159 million in exemptions.

MAJORITY CHAIRMAN METCALFE: Thank you.

Thank you, Representative Grove.

The hour of 11 o'clock being here, we appreciate your testimony. Thank you for traveling to share that with us today. We appreciate your advocacy on behalf of the taxpayers.

I'll take a motion to adjourn from Representative Grove, seconded by Representative Mustio.

Everyone have a great day. This meeting is adjourned.

(The hearing concluded at 11:00 a.m.)

I hereby certify that the foregoing proceedings are a true and accurate transcription produced from audio on the said proceedings and that this is a correct transcript of the same.

Debra B. Miller
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