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Rep. Daryl D. Metcalfe, Chair
Rep. Mark B. Cohen, Democratic Chair
State Government Committee

Dear Chairman Metcalfe and Democratic Chairman Cohen,

Thank you for allowing me to submit written testimony for the June 4, 2015 hearing on Senate Bill 1 pertaining to members of the Public School Employees' Retirement System (PSERS) and the State Employees' Retirement system (SERS). I am an economist at the Economic Policy Institute (EPI) focusing primarily on retirement. EPI is a nonprofit, nonpartisan think tank created in 1986 to include the needs of low- and middle-income workers in public policy discussions.

SB1 does three things:

- It reduces the value of defined benefit (DB) pension benefits for current employees three ways: by giving them a choice between a reduction in the accrual factor or an increase in the employee contribution; by reducing the value of lump sum distributions through a higher "actuarially neutral" discount rate; and by limiting the overtime pay that counts toward pensions (an "anti-spiking" provision).
- It reduces employer contributions for new hires and replaces the current final average pay DB pension with a hybrid defined contribution–cash balance (DC-CB) plan.
- It delays paying down legacy costs by extending the amortization period and because some employer contributions will be based on the lower cost of the new DC-CB plan rather than the cost of retirement benefits for all employees, including those remaining in the DB pension.

With insufficient time for a thorough analysis, a quick reading of the actuarial valuations suggests serious problems with the proposed legislation. Most of these points are elaborated in a recent EPI briefing paper, *Will Switching Government Workers to Account-type Plans Save Taxpayers Money*?[1]

1. Most of the savings from SB1 come from cutting the benefits of current workers, which will certainly be challenged in court. These workers directly contributed toward these benefits and accepted lower pay in exchange for what were assumed to be guaranteed benefits. Though the benefit reductions are framed as prospective cuts affecting only future accruals, benefits in final average pay DB plans are backloaded to encourage retention, so workers accepted lower pay in anticipation of benefits that the proposed legislation would cut. Not only is this unfair, it is unlikely to result in long-term cost savings as other forms of pay will have to be increased to offset cuts in retirement benefits (or public

[1] The paper is available online at http://www.epi.org/publication/will-switching-government-workers-to-account-type-plans-save-taxpayers-money/.

services will be degraded and human capital investment neglected as Pennsylvania is no longer able to attract and retain skilled and committed teachers, police officers, and other workers).

2. There is nothing inherently wrong with the *form* of the DB pension cuts if they applied to newly hired workers as opposed to workers who directly and indirectly paid for higher benefits. A pension accrual factor of 2 or more is adequate for most non-hazardous-duty workers covered by Social Security. Anti-spiking provisions and an actuarially neutral discount rate lead to a fairer distribution of benefits. The higher discount rate also improves retirement security by discouraging participants from taking out lump sums in favor of lifetime annuities.

3. Switching government workers to account-type plans does not save taxpayers money. Traditional DB pensions are more efficient than DC plans and most hybrid plans, including the proposed DC-CB plan, due to economies of scale and risk pooling. Changing plan types introduces transition costs, including the cost of administering more than one plan. It tends to result in lower investment returns as the investment horizon shrinks and employers have an incentive to invest pension fund assets more conservatively to minimize the cost of guaranteeing a minimum rate of return to cash balance plan participants.[2] Account-type plans also tend to increase turnover among prime-age workers while preventing some older workers from retiring due to inadequate retirement savings.

4. Secure and easy-to-understand pension benefits are popular with workers. Attempts to shift risk from employers to workers by moving workers into account-type plans are inefficient because workers are rationally more risk averse. By pooling the retirement savings of workers with longer and shorter lifespans and who retire in bull and bear markets, traditional DB pensions efficiently insure workers against the risk of outliving their savings. Public-sector workers have consistently shown a strong preference for secure and easy-to-understand pension benefits and a willingness to pay for these benefits directly and indirectly. The proposed cash balance plan is particularly difficult for workers to understand. Workers are likely to view it unfavorably, since it is wholly funded by the workers themselves, who have no say in how the funds are invested and are likely to view the interest credit as too low and retirement outcomes as unfair and difficult to predict (a problem exacerbated by the low and variable annuity rate).

5. It is irresponsible to put off paying down the unfunded liability. Though the principle of intergenerational fairness is sometimes invoked to justify measures that make all generations worse off, it is nevertheless irresponsible to saddle future generations with debts incurred by taxpayers who benefited indirectly from a failure to fully fund pension obligations.

Sincerely,
Monique Morrissey

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[2] Whereas employers currently balance risk and return to aim for a 7.5% *average* rate of return, as the cash balance tier replaces the traditional DB benefit employers will want to invest to maximize earnings *below* 7.5%, the threshold above which earnings must be shared with cash balance participants.