TESTIMONY OF MARTIN M. BERGEN, CPA
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PENNSYLVANIA DEPARTMENT OF THE AUDITOR GENERAL

House Finance Committee Hearing on Senate Bill 961
August 18, 2008

Chairman Levdansky, Chairman Nickol, Honorable Members of the House Finance Committee, good afternoon.

My name is Martin Bergen. I am the Director of the Department of the Auditor General's Bureau of Municipal Pension Audits. Our Bureau is responsible for auditing over 2,500 municipal pension plans throughout the Commonwealth. Our audits are conducted pursuant to the Department's authority under Section 402(j) of the Municipal Pension Plan Funding Standard and Recovery Act (Act 205 of 1984, as amended) and in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States. The objective of our audits is to determine if pension plans have been administered in compliance with applicable state laws, regulations, contracts, administrative procedures, and local ordinances and policies.

I am pleased to represent the Department of the Auditor General at today's hearing on Senate Bill 961 of the 2007-08 legislative session. I wish to emphasize at the outset of my remarks that, due to the Department's role as an independent audit agency, I am not here today to opine as to the merits of the proposed legislation. Instead, I intend to provide an analysis as to what effect the legislation would have on the Department's recent audit of the City of Hazleton's unauthorized usage of proceeds from a special municipal tax levied by the City under the authority of Act 205.

On August 3, 2006, the Department released the report of an audit that it had conducted of the City of Hazleton Aggregate Pension Fund. A copy of Finding No. 1 of the audit report is attached to my testimony. Finding No. 1 cited the City for an improper expenditure of special municipal tax proceeds. Pursuant to authority granted by Section 607(f) of Act 205, the City of Hazleton levies a special municipal tax of 0.4% on earned income and net profits to be used exclusively for funding the City's pension plans. Section 607(f) states that "[t]he proceeds of this special municipal tax increase shall be used *solely* to defray the additional costs required to be paid pursuant to [Act 205] which are *directly related* to the pension plans of the municipality." (emphases added)

However, our audit found that, during the years 2003, 2004 and 2005, the City improperly used proceeds from this special municipal tax, in the total amount of $1,426,656, to fund post-retirement health care benefits for police officers and firefighters who retired after January 1, 1999. Prior to 2003, those expenses were paid through the City's general fund. In addition, the City used $166,466 of special municipal tax proceeds in 2003 to buy back unused vacation and sick leave from employees who accepted an early retirement incentive offered by the City.

As a result of the improper expenditure of special municipal tax proceeds for post-retirement health care benefits and unused leave buy-backs, the funds were not available to pay authorized pension plan expenses or for investment purposes in accordance with Act 205.

Our audit report contained a recommendation that the City either reimburse the Act 205 special municipal tax account for the $1,593,122 of improper expenditures or deposit that amount into an eligible pension plan, with interest compounded annually at a rate earned by the pension plan. We further recommended that the City discontinue paying for post-retirement health care benefits with special municipal tax proceeds or assets of the aggregate pension fund. The City disagreed with our finding and recommendations.

The Department has the legal authority to enforce its pension audit findings, through the Department's responsibility under Act 205 for distributing annual state pension aid from the Commonwealth. Accordingly, due to the City's noncompliance with our recommendations, the Department subsequently issued an Order To Show Cause, pursuant to which the Department would withhold the City's allocation of state pension aid for calendar year 2007 and all future years unless and until the City complied with the report's recommendations.

The City requested an administrative hearing within the Department governed by the General Rules of Administrative Practice and Procedure. However, the parties have agreed to continue the administrative hearing in order to allow time for a mutually satisfactory resolution of all or part of this dispute, including, but not limited to, the passage of the legislation we are discussing today. Because the administrative hearing has not yet occurred, the parties agreed last year that the Department would distribute the City's 2007 state pension aid; the parties are in the process of finalizing a similar agreement regarding the 2008 aid.

Based on the Department's analysis of the current version of Senate Bill 961 (Printer's Number 1168), and after consulting with staff from the Public Employee Retirement Commission, if enacted into law, Senate Bill 961 would resolve Finding No. 1 with regard to past improper use of special municipal pension tax proceeds. In other words, the City would no longer be required to comply with our recommendation to either reimburse the Act 205 special municipal tax account for the $1,593,122 of improper expenditures or deposit that amount into an eligible pension plan. If the City has continued making improper expenditures of special municipal tax proceeds since 2005, we would expect that this figure would be significantly larger and we would have to continue to issue findings and recommendations in future reports similar to Finding No. 1.

It is important to recognize that Senate Bill 961 merely amends the Local Tax Enabling Act (Act 511 of 1965, as amended) in order to provide retroactive legal authority for the City to have collected the taxes to fund the benefits at issue. The legislation does not, and should not, amend Act 205. Therefore, the City and other municipalities would still be prohibited from using special municipal pension tax proceeds to fund post-retirement health care benefits or vacation or sick leave buy-backs. We would have to review any actual or proposed changes to the current version of the legislation to determine their effect on this analysis.

Thank you for the opportunity to present this testimony on behalf of the Department of the Auditor General. Attached to my testimony is a summary of prior audit reports containing findings pertaining to unauthorized uses of Act 205 special municipal tax proceeds and the subsequent disposition of those findings.

I will be happy to respond to any questions.

<u>ATTACHMENT 1</u>

Finding No. 1 of
Audit Report of City of Hazleton Aggregate Pension Fund

released August 3, 2006

COMMONWEALTH OF PENNSYLVANIA

Department of the Auditor General

CITY OF HAZLETON AGGREGATE PENSION FUND

LUZERNE COUNTY

COMPLIANCE AUDIT REPORT

FOR THE PERIOD

JANUARY 1, 2003, TO DECEMBER 31, 2004

CONCLUSIONS - OBJECTIVE NO. 2

The second objective of the audit was to determine if the City of Hazleton Aggregate Pension Fund was administered in compliance with applicable state laws, regulations, contracts, administrative procedures, and local ordinances and policies. Our audit conclusions are presented below.

Our tests indicated that, in all significant respects, the City of Hazleton Aggregate Pension Fund was administered in compliance with applicable state laws, regulations, contracts, administrative procedures, and local ordinances and policies, except as noted in the findings listed below.

Aggregate Pension Fund

Finding No. 1 - Improper Expenditure Of Special Municipal Taxing Authority Funds

Condition: Pursuant to authority granted by Section 607(f) of Act 205, the City of Hazleton levies a special municipal tax of 0.4% on earned income and net profits to be used exclusively for funding the city's pension plans. During the years 2003, 2004 and 2005, the city improperly used proceeds from this special municipal pension tax, in the total amount of $1,426,656, to fund post-retirement health care benefits for police officers and firefighters who retired after January 1, 1999. Prior to 2003, these expenses were appropriated and paid through the city's general fund. In addition, the city used $166,466 of special municipal pension tax proceeds in 2003 to buy back unused vacation and sick leave from employees who accepted an early retirement incentive offered by the city.

Criteria: Section 607(f) of Act 205 states, in relevant part:

> **Special municipal taxing authority.** If the tax rates set by the municipality on earned income or on real property are at the maximum provided by applicable law, the municipality may increase its tax on either earned income or real property above those maximum rates. The proceeds of this special municipal tax increase shall be used *solely* to defray the additional costs required to be paid pursuant to this act which are directly related to the pension plans of the municipality.[1]

Cause: City officials maintain that the questioned use of these special tax revenues is authorized by Act 205.

[1] 53 P.S. § 895.607(f) (emphasis added).

CONCLUSIONS - OBJECTIVE NO. 2 - (Continued)

Finding No. 1 - (Continued)

Effect: As a result of the improper expenditure of special municipal taxing authority funds for post-retirement health care benefits and unused leave buy-backs, the funds were not available to pay authorized pension plan expenses or for investment purposes in accordance with Act 205.

Recommendation: We recommend that the city either reimburse the Act 205 special municipal tax account for the $1,593,122 of improper expenditures or deposit that amount into an eligible pension plan, with interest compounded annually at a rate earned by the pension plan. We further recommend that the city discontinue paying for post-retirement health care benefits with special tax revenues or assets of the aggregate pension fund.

Management's Response: Municipal officials believe that the department's position is not clearly provided by Act 205 or other pension statutes and, as a result, the only method of definitively resolving this issue is through litigation. In order to avoid such litigation, the city proposes to stop using the special tax revenues to fund its post-retirement health care obligations prospectively, effective January 1, 2007, and will attempt to find alternate sources of revenue to satisfy those obligations. However, in proposing this resolution, the city asserts that it is in no way changing its position that it has, at all times, acted in accordance with state law, nor is it waiving any of its rights, including the right to argue that position if it should become necessary in the future. The city also asserts that implementing the department's recommendation in full would compromise the city's ability to move towards a complete economic recovery.

Auditor's Conclusion: The department respectfully disagrees with the city's contention that its actions were in accordance with Act 205. Furthermore, we cannot accept as sufficient the city's proposal to take corrective action on a prospective basis only. As previously discussed, Section 607(f) of Act 205 explicitly states that the proceeds of the special tax can only be used to defray the additional costs required to be paid pursuant to the act which are directly related to the pension plans of the municipality. Such additional costs would include meeting Act 205's minimum funding standard and paying for the actuarial valuation reports a municipality must have prepared to meet such standards. No reference to post-retirement health care benefits or unused leave buy-backs is made in either Act 205 or the pension provisions contained in the Third Class City Code applicable to police officers and firefighters.[2] Therefore, the city's funding of these expenses with special municipal pension tax proceeds was improper.

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[2] *See* 53 P.S. § 39301 *et seq.* (police officers); 53 P.S. § 39320 *et seq.* (firefighters).

CONCLUSIONS - OBJECTIVE NO. 2 - (Continued)

Finding No. 1 - (Continued)

It is also important to note that, despite the city's claim now that post-retirement health care costs are legitimate expenses of a municipal pension plan, the city funded these expenses through its general fund – a proper source for such expenses – prior to 2003. Furthermore, the city does not include these expenses as benefits in the Act 205 actuarial valuation reports for the city's police and firefighter's pension plans. Consequently, they are not actuarially costed and funded in accordance with Act 205 funding standards. Accordingly, for all of the reasons cited above, the finding and recommendation remain as stated. It is our understanding that the Public Employee Retirement Commission shares our position on this issue.

Finally, with regard to the asserted impact of our recommendation on the city's fiscal condition, the city should apply to the Pennsylvania Department of Community and Economic Development (DCED) for acceptance into DCED's Early Intervention Program and work with DCED to find an appropriate way to take the corrective action recommended.

ATTACHMENT 2

Other Act 205 Special Municipal Tax Findings

DEPARTMENT OF THE AUDITOR GENERAL
<u>OTHER ACT 205 SPECIAL MUNICIPAL TAX FINDINGS</u>

<u>Municipality</u>: City of Butler
Pension Fund: Police Pension Plan
Audit Period: January 1, 2002, to December 31, 2003
Finding:

Unauthorized Use Of Special Municipal Tax Revenues

Pursuant to authority granted by Section 607(f) of Act 205, (codified at 53 P.S. §895.607(f)), the City of Butler levies a special municipal tax of 0.3% of wages to be used exclusively for funding its pension plans. We determined that the city improperly used proceeds from this special municipal tax to address general fund cash flow problems and to pay required member contributions to the police pension plan.

Prior to 2002, the city distributed the special municipal tax proceeds collected during each year to its pension plans at the end of the year in which they were collected. Beginning with the 2002 tax year, the city has deferred distribution of the proceeds of the special municipal tax to the pension plans until the year following the year in which they were collected reportedly to address the city's cash flow problems.

Additionally, during the prior audit period, the city eliminated members' contributions to the plan pursuant to an arbitration award effective July 1, 2000. At the time of the arbitration award, police officers were contributing 5 percent of wages to the pension plan. The elimination of members' contributions was subsequently overturned by the Commonwealth Court of Pennsylvania (*City of Butler v. City of Butler Police Dep't*, 790 A.2d 847, 849 (Pa. Cmwlth., 2001), *appeal denied*, 568 Pa. 620, 792 A.2d 1255 (2001)), on July 18, 2001. However, members' contributions were not reinstated until August 22, 2002.

Furthermore, at a meeting on February 27, 2003, Butler City Council approved the distribution of the 2002 special municipal tax levy for its distressed pension plans "...with a stipulation that $107,250.50 of the distribution to the Police Pension Fund will be designated as 'past due member contributions' pursuant to a finding in the State Auditor General audit of the Police Pension Plan for the period January 1, 2000 to December 31, 2001."

Recommendation:

We recommend that city officials develop and implement appropriate controls to ensure that, in the future, all special municipal tax revenues are appropriately segregated from other city revenues, separately accounted for and used exclusively for the purposes designated in Section 607(f) of Act 205.

Disposition:

City officials have developed and implemented appropriate controls to ensure that tax revenues are appropriately segregated from other city revenues, are separately accounted for, and used exclusively for the purposes designated in Section 607(f) of Act 205.

Municipality: City of Altoona
Pension Fund: Nonuniformed Pension Plan
Audit Period: January 1, 2002, to December 31, 2003
Finding:

Unauthorized Use Of Special Municipal Tax Revenues

Pursuant to authority granted by Section 607(f) of Act 205, the City of Altoona levies a special municipal tax of 0.2% of earned income and net profits to be used exclusively for funding its pension plans. We determined that the city improperly used proceeds from this special municipal tax to address general fund cash flow problems of the city. At December 31, 2003, the balance of the special pension tax fund included a receivable due from other funds totaling $2,277,187.

Recommendation:

We recommend that the city return $2,277,187 of the special municipal tax proceeds collected for the city's pension plans to the special pension tax fund and include applicable interest. We also recommend that city officials develop and implement appropriate controls to ensure that, in the future, all special municipal tax revenues are appropriately segregated from other city revenues, separately accounted for and used exclusively for the purposes designated in Section 607(f) of Act 205.

Disposition:

The city reimbursed $2,615,976 to the Special Municipal Tax Fund account, which represented the $2,277,187 owed from its general fund and $338,789 of interest.

Municipality: City of Aliquippa
Pension Fund: Police, Firemen's, and Nonuniformed Pension Plans
Audit Period: January 1, 2005, to December 31, 2006
Finding:

Unauthorized Use Of Special Municipal Tax Revenues

Pursuant to authority granted by Section 607(f) of Act 205, the City of Aliquippa levies a special municipal tax of 0.6% of wages to be used exclusively for funding its pension plans.. During the prior audits of the city's pension plans, it was determined that the city improperly used proceeds from this special municipal tax to fund general fund obligations. Based on records provided by city officials, during the years 2004 and 2005, the city collected $151,261 greater than the amount transferred to its three pension plans. The city subsequently obtained a tax anticipation note to cover the amounts due to the pension plans. During the current audit period, it was determined that the city applied the proceeds from the tax anticipation note to fund 2006 tax collections due to the pension plans. Therefore, the city still owes its pension plans $151,261, representing tax collections for the years 2004 and 2005.

Recommendation:

We recommend that city officials deposit the $151,261 collected for its pension plans from the special municipal tax for the years 2004 and 2005, plus applicable interest, into its pension plans.

Disposition:

Pending