

Readying for Future Fiscal Challenges

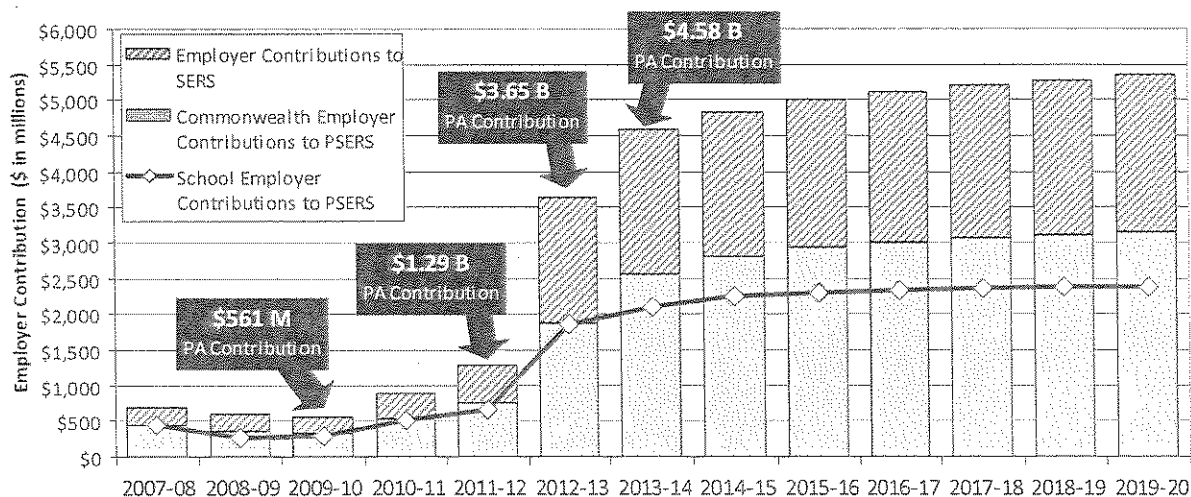
The Pension Rate Spike – A Huge Increase in Employer Contributions is Due in 2012

In 2012-13 the commonwealth will face a sharp increase in employer contributions to the Public School Employees' Retirement System (PSERS) and to the State Employees' Retirement System (SERS). Implementing an effective response to this challenge will be critical in preserving Pennsylvania's progress out of the economic downturn.

For PSERS, under current law and using the system's annual earnings assumption (8 percent per year), the commonwealth contribution is projected to increase from \$758 million in 2011-12 to \$1.88 billion in 2012-13. That represents a single-year increase of \$1.13 billion. School district costs for retirement will also spike, with their contribution increasing from \$658 million to \$1.86 billion.

For SERS, also assuming 8 percent investment returns between now and 2012, employer contributions are forecast to increase from \$531 million in 2011-12 to \$1.77 billion in 2012-13, a single-year increase of \$1.24 billion.

Projected Employer Contributions to PSERS and SERS Under Current Law



The rate spike is a result of retirement benefit enhancements approved by the General Assembly before Governor Rendell took office, actuarial adjustments to both systems enacted in 2002 and 2003 that postponed large short-term increases in employer contributions, and significantly lower-than-anticipated stock market returns in 2001-02 and in 2008-09.

The Plan to Mitigate the 2012-13 Rate Spike

The 2010-11 budget proposes a pension funding method that will insulate the commonwealth and school districts from the employer rate spike in a manner that still recognizes the need for state and school employers to contribute significant additional funds to both systems over the next decade. The proposal would require the commonwealth to adopt a new policy to determine the annual pension contribution rate for SERS and PSERS. The objectives of this proposal are to:

- 1) Take the first steps to returning the pension systems to actuarial soundness this year by funding significant increases in employer contributions over 2009-10 levels;

- 2) Mitigate the projected 2012-13 rate spike;
- 3) Deliver a funding schedule that makes contribution increases more incremental and predictable, allowing time to absorb the impact of changes in retirement costs; and
- 4) Retain features of the current law wherever possible, including the five-year smoothing of actuarial gains and losses, as well as level-dollar contributions.

The plan consists of two interrelated components: a "fresh start" for the pension systems' liabilities and an incremental phase-in to higher contributions.

In the same way as refinancing a mortgage, a fresh start would allow the commonwealth to start anew and begin an incremental upward ascent in funding retirement costs. Based on their most recent actuarial valuations, the retirement systems would undertake a fresh start that would reamortize liabilities over 30 years. The systems would retain both their more-conservative level-dollar amortization schedules and

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their ability to recognize each year's investment gains and losses incrementally over five years.

A fresh start goes some way toward mitigating the rate spike, but still results in a substantial one-time increase in the employer contributions required for both pension systems. Therefore, the proposal adds to the fresh start solution a series of incremental steps that would limit annual contribution increases to sustainable amounts over a period of approximately 10 years. In conjunction with this incremental system, a fresh start could offer a meaningful medium-term solution for the commonwealth's pension challenges.

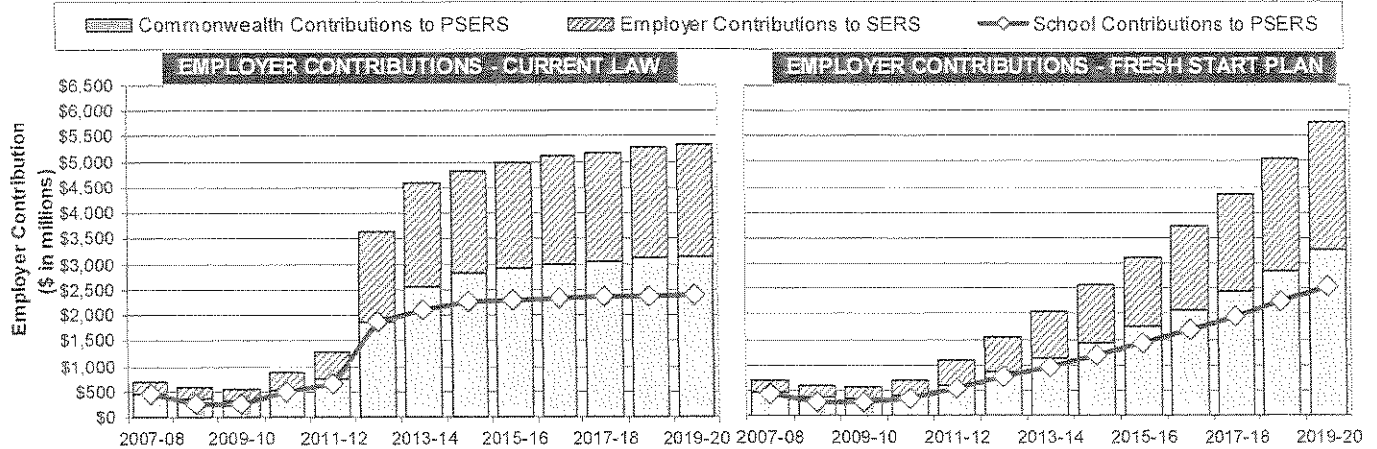
In 2010-11, the commonwealth and school district employers would begin to fund the incremental step-up in pension costs by increasing employer contribution rates to PSERS and SERS by 1 percent of payroll. This represents an additional all-employer investment in our pension systems of \$200 million – or 24 percent – over 2009-10 levels. Thereafter, contribution amounts would be scheduled to increase annually by a maximum of 3 percent of payroll.

The resulting funding schedule would introduce a new contribution schedule that increases the commonwealth's and school districts' employer contributions in a graduated and predictable manner over the next 10 to 11 years. Higher-than-expected investment returns would reduce the number of years of phase-in required. Finally, any increase in benefits, such as new cost-of-living adjustments, would add to the unfunded liability and would therefore require immediate additional employer contributions to be appropriated for the systems.

This pension funding strategy meets the immediate challenges facing the commonwealth's two statewide public pension systems head on. It offers a solution that both addresses the 2012-13 rate spike and provides a road map back to long-term actuarial soundness for the pension systems, providing greater security that the commonwealth and school districts will be able to meet all future pension funding obligations for both current and future retirees.

Projected Employer Contributions to PSERS and SERS Under the Fresh Start Plan

The 2010-11 budget will take the first steps to returning our pension systems to actuarial soundness, with \$200 million in additional employer contributions to the pension systems over 2009-10 levels. Future increases will be significant but incremental, allowing state and school district budgets to absorb the impact of increased pension costs over a period of 10 years.



A Road Map to Future Sustainability

Despite the balanced budget plan for 2010-11 and Pennsylvania's advancements over the last seven years, the commonwealth faces significant challenges in 2011-12 as a result of continued weaknesses in state revenue collections, unemployment at higher-than-average levels, a phase-out of federal fiscal relief and the spike in contributions to the two statewide pension systems that is due in 2012-13. Our collective response to these challenges will be critical in preserving Pennsylvania's progress in this new decade.