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House of Representatives
COMMONWEALTH OF PENNSYLVANIA
HARRISBURG

HOUSE DEMOCRATIC POLICY COMMITTEE HEARING
Topic: Retirement Security – A National Perspective
418 Main Capitol Building – Harrisburg, PA
June 4, 2015

AGENDA

1:30 p.m. Welcome and Opening Remarks

1:40 p.m. Diane Oakley
Executive Director
National Institute on Retirement Security

2:10 p.m. Hank Kim
Executive Director and Counsel
National Conference on Public Employee Retirement Systems

2:30 p.m. Cathie Eitelberg
Senior Vice President and National Public Sector Market Director
The Segal Group

2:50 p.m. Leigh Snell
Director of Federal Relations
National Council on Teacher Retirement

3:10 p.m. Monique Morrissey
Economist
Economic Policy Institute

3:30 p.m. Closing Remarks

Statement of Diane Oakley
Executive Director
National Institute on Retirement Security
PA House Democratic Policy Committee Hearing – June 4, 2015

Introduction

Thank you for the opportunity to share research conducted by the National Institute on Retirement Security, or NIRS. I am Diane Oakley, executive director of NIRS. Established in 2008, NIRS develops data-driven research on a wide range of retirement issues. We are a non partisan organization with a broad range supporters. Our vision is to help ensure a U.S. retirement system that simultaneously meets the needs of employers, employees, and the nation's economy.

Today, I would like to share the findings of two recent research reports. The first study offers case studies of other states that shifted from a defined benefit (DB) pension plan to defined contribution (DC) 401-(k) style individual accounts. The second compares the costs of DB pensions to DC accounts. I hope these data inform your consideration of the best path to cost efficient and sensible solution for the stakeholders here in Pennsylvania.

A Cautionary Tale: DB to DC Switches Increase Costs, Does Not Address and Actually Worsen Underfunding

The three states in the case study report that shifted retirement plans from DB pension plans to DC individual accounts experienced higher costs. Moreover, the current financial data indicate that the DB to DC switch in fact worsened the pension underfunding issues.

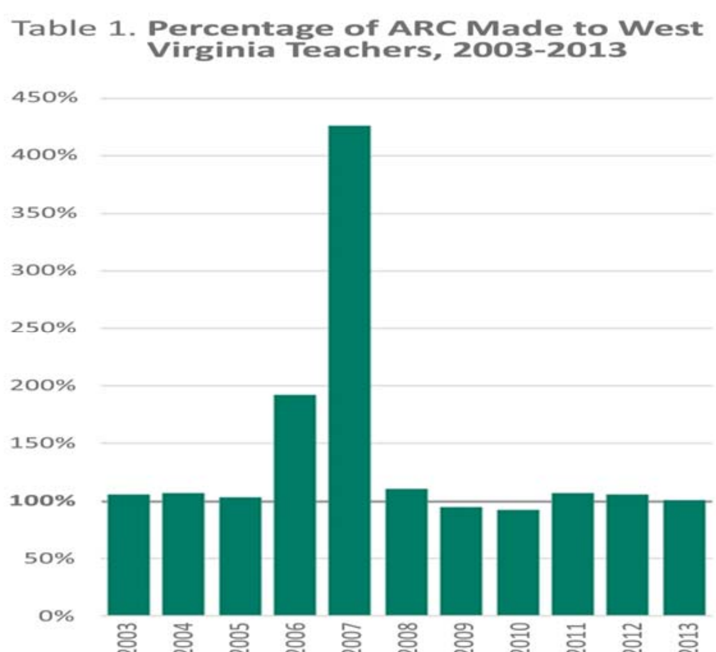
Some states have experimented with shifting employees from DB pensions to individual DC accounts. *Case Studies of State Pension Plans that Switched to Defined Contribution Plans*, presents summaries of changes in three states – Alaska, Michigan, and West Virginia – that made such a switch.

These case studies are important cautionary examples for policymakers. It's clear that closing a pension plan to new employees doesn't fill overdue funding gaps or reduce the cost of providing employees' pensions. In fact, it had the exact opposite effect of increasing costs to taxpayers.

The case studies indicate that the best way for a state to address any pension underfunding issue is to implement a responsible funding policy with full annual required contributions, and for states to evaluate assumptions and funding policies over time, making any appropriate adjustments.

The case studies provide in-depth details for the following states:

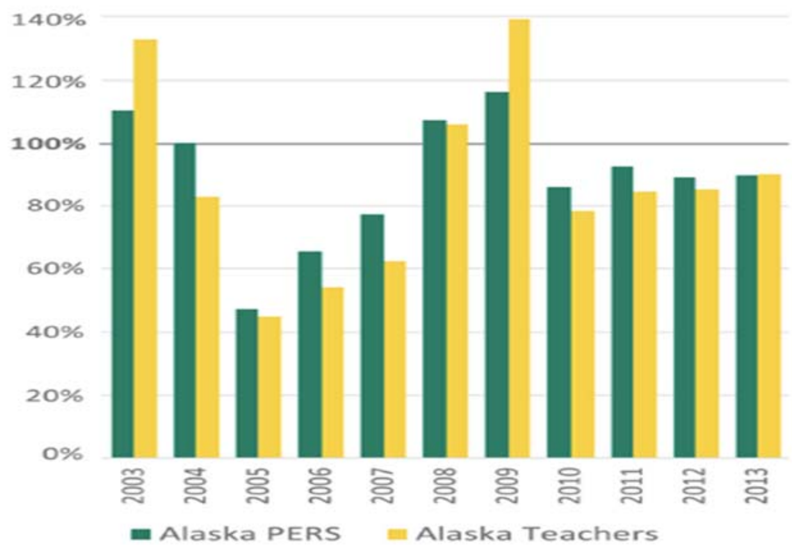
- In **West Virginia**, the state closed the teacher retirement system in 1991 to new employees in the hopes it would address underfunding caused by the failure of the state and school boards to make adequate contributions to the pension. As the pension's funded status continued to deteriorate, retirement insecurity increased for teachers with the new DC accounts. Legislation was enacted to move back to the DB plan after a study found that providing equivalent benefits would be less expensive in the DB than in the DC plan. By 2008, new teachers were again covered by the pension, and most teachers who were moved to the DC plan opted to return to the pension. After reopening the DB pension, the state was disciplined about catching up on past contributions, and the plan funding level has increased by more than 100 percent since 2005. The teacher pension plan is expected to achieve full funding by 2034.



- In **Alaska**, legislation was enacted in 2005 that moved all employees hired after July 1, 2006 into DC accounts. Like

Pennsylvania, the state faced an unfunded liability – to the tune of $5.7 billion for its two pension plans and retiree health care trust. The unfunded liability was the result of the state's failure to adequately fund pensions over time, stock market declines and actuarial errors. The DC switch was sold as a way to slow down the increasing unfunded liability, but the total unfunded liability more than doubled, ballooning to $12.4 billion by 2014. In 2014, the state made a $3 billion contribution to reduce the underfunding. Legislation has been introduced to move back to a DB pension plan.

Table 1. Percentage of ARC Made to Alaska PERS and Teachers, 2003-2013



- In **Michigan**, the pension plan was overfunded at 109% in 1997. The state closed the pension plan to new state employees who were offered DC accounts. The state thought it would save money with the switch, but the pension plan amassed a significant unfunded liability following the closure of the pension plan. By 2012, the funded status dropped to about 60% with $6.2 billion in unfunded liabilities. In recent years, the state has been more disciplined about funding the pension plan, making nearly 80% of the ARC from 2008-2013.

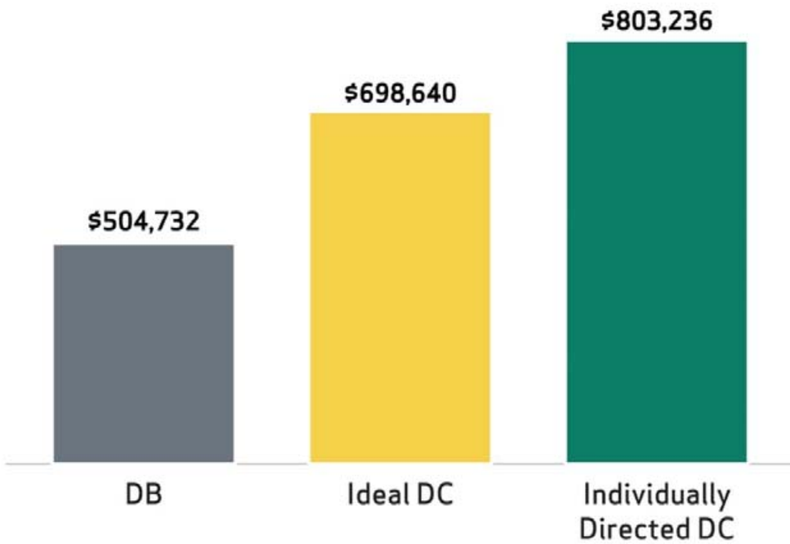
DB Pensions are HALF the Cost of Individual Accounts

The second study, *Still a Better Bang for the Buck: Update on the Economic Efficiencies of Pension Plans,* calculates that the economic efficiencies embedded in pensions enable these defined benefit retirement plans to deliver the same retirement income at a 48% lower cost than 401(k)-type DC accounts.

We partnered with a highly respected actuary who spent his career working in the retirement industry to outline the economics of retirement plans. The study looks at three retirement plans a traditional DB plan, a so called "ideal" DC plan and an typical DC plan

The analysis finds that pension plans are a far more cost-efficient means of providing retirement income as compared to individual DC accounts because of the unique economic efficiencies embedded in pensions. A pensions plan can deliver the same retirement benefit as an individual account at half the cost for three simple reasons:

Figure 7:
Per Employee Amount Required at Age 62
DB Plan vs. DC Plan



1. **Pensions pool the longevity risks of large numbers of individuals**. Said another way, pensions only have to save for the average life expectancy of a group of individuals. Absent a group retirement plan, individuals must save enough on their own should they be among the half of retirees who will live longer than the average life expectancy. This DB pension longevity risk pooling feature generates a **10% cost savings**.

2. **Pensions are "ageless" and therefore can perpetually maintain an optimally balanced investment portfolio**. In contrast, a typical individual investor must down shift investments over time to a lower risk portfolio of cash and bonds, sacrificing higher investment returns generated from stocks. This DB pension balanced portfolio feature generates an **11% cost savings**.

3. **Pensions achieve higher investment returns** as compared to individual investors because they have lower fees and are managed by investment professionals. This lower fees and higher returns DB pension feature generates **a 27% cost savings**.

In recent years, 401(k) plans have been modified with target date funds and annuities. But even with these changes, DC plans cannot replicate the economic efficiencies of a well-managed pension plan.

Lastly, it is important to remember that the state offers a pension plan to help manage its workforce – to attract, retain and transition employees into retirement. The retirement plan is an extremely or very important job feature to nearly 9 out of 10 public employees while salary is extremely or very important job feature to less than 6 our of 10 public employee. This preference contrasts with workers in the private sector where salary is more important. Changes to retirement benefit will likely result in greater demands for higher earnings so that employees can achieve a secure future.

Figure 24: **Retirement Benefits are Significantly More Important to Public Workers as Compared to Private Sector Workers**

When making job decisions, how important are the following job features to you?

Conclusion

The state of Pennsylvania adopted a plan and stepped up to the significant challenges to meet its retirement commitments to its employees in 2010. Those plans take time as you can see from West Virginia's experience to reach their goals.

Our research finds that the best path forward for states in situations similar to Pennsylvania has been to implement and stick to a disciplined funding plan to close the unfunded liability. The experience in other states clearly shows that switching from a pension to individual accounts doesn't just magically close funding shortfalls. In fact, the switch opens a new funding hole causing shortfalls even worse by starving the pension of future contributions.

Our research also shows that pensions are the most economically efficient means of providing retirement benefits – half the cost of individual accounts.

We hope that this research is helpful as you examine policy options to protect both taxpayers and the state's public workforce.

I would be happy to answer your questions.

Written Testimony Expressing Concern with Pension Changes Proposed in PA Senate Bill 1

by Hank Kim, Esq.
Executive Director and Counsel
National Conference on Public Employee Retirement Systems (NCPERS)
Before the PA House State Government Committee

Submitted June 4, 2015

Introduction

Chairman Metcalfe, thank you for allowing my organization, the National Conference on Public Employee Retirement Systems (NCPERS), to submit this on-the-record testimony.

NCPERS is the largest trade association for public sector pension funds, representing more than 500 funds throughout the United States and Canada. It is a unique non-profit network of public trustees, administrators, public officials, and investment, actuarial and legal professionals who collectively manage more than $3.7 trillion in pension assets. Founded in 1941, NCPERS is the principal trade association working to promote and protect pensions by focusing on advocacy, research and education for the benefit of public sector pension stakeholders. Further, NCPERS promotes retirement security for *all* workers through access to defined benefit pension plans.

In addition to serving as Executive Director and Counsel for NCPERS, I currently serve as Vice-Chair of the Fairfax County Uniform Retirement System, $1.5 billion public employee retirement system providing pension coverage for the Fire & Rescue Department, Sheriff's Department, and certain other sworn employees of Fairfax, Virginia.

I am also on the board of the *Benefits Law Journal,* a quarterly law journal that for over 20 years has featured the most respected and accomplished employee benefits professionals who have shared their expertise. Each quarterly issue offers in-depth analysis of new legislation, regulations, case law, and current trends governing employee benefits: pension plans, welfare benefits, executive compensation, and tax and ERISA issues. Previously, I've served on the Morningstar Pension Endowments and Foundations Steering Committee and the City of Virginia Beach Mayor's Committee on Employee Pensions.

The Negative Economic Impact of Income Inequality

NCPERS • 444 North Capitol Street NW, Suite 630, Washington, DC 20001 • 202.624.1456 • fax 202.624.1439 • info@NCPERS.org • www.ncpers.org

NCPERS has recently released a research paper entitled "Income Inequality: Hidden Economic Cost of Prevailing Approaches to Pension Reforms" that examines the relationship between pension reforms and the economy. Based on the analysis of empirical data on pension reforms over the past 30 years, the NCPERS study suggests that the kind of reforms proposed in SB 1 in Pennsylvania, will be harmful to the Pennsylvania Economy. In the end everyone in Pennsylvania will suffer, not just public employees.

A good economy means three things: job growth, income growth, and reduction in income inequality. The relationship between pensions, jobs, and income is well documented. However, little is known about the relationship between pension reforms and rising income inequality.

Some might argue that there is nothing wrong with rising income inequality in a "free market" economy (free market is in quotes because how can a transaction be free when one party has more information than the other?). However, there is mounting evidence from studies done by researchers at organizations such a Standard and Poor's, International Monetary Fund, Organization for Economic Cooperation and Development (OECD) that show that rising income inequality puts a drag on the economy.

Regardless of one's personal views on income inequality, the NCPERS study uses empirical data to examine the following two questions:

1. Do pension reforms of the past three decades exacerbate income inequality?
2. Does rising income inequality in turn dampen the economy?

The study reviewed changes in pensions resulting from pension reforms at national and state levels. At the national level, the key change has been a trend of conversion of defined-benefit (DB) pension plans into defined-contribution (DC) plans. At the state and local levels pension changes consisted of cuts in benefits, increased employee contributions, and conversion of DB plans into DC plans. These changes have a negative impact on plan participants and beneficiaries as well as on local economies. Therefore, we refer to these changes as negative pension changes.

The study analyzed the relationship between pension changes and income inequality at national and state levels. At the national level, the data allowed us to examine trends in pension changes, income inequality, and economic growth during the 1980s, 1990s, and 2000s. At the state level, these trends could be examined only during 2000–2010.

National Trends

The analysis found that income inequality was highly co-related with the trend toward conversion of DB into DC plans. The correlation between income inequality and percentage of workforce (public and private) covered by DB plans was –.894. This correlation is robust and means that the lower the percentage in the workforce with DB plans, the higher the income inequality. Other factors that had a robust inverse relationship with income inequality included changes in the percentage of the workforce in unions, marginal (top income) tax rates, and the rate of investment in public education. Inverse relations mean that higher income inequality is the result when the percentage of the workforce in unions; marginal tax rates; and the rate of investment in public education are all lower.

The national-level analysis also examined the relationship between income inequality and economic growth. The analysis shows that this correlation was –.553. This simply means that the higher the income inequality, the lower is the economic growth. Other factors considered in the analysis included rate of investment in public education and multifactor productivity. Multifactor productivity refers to economic inputs including labor, capital, and raw materials.

Higher-level analysis of the national data using advanced multivariate techniques was not viable due to limitations of the available data. Yet it is clear from the empirical data from 1980s, 1990s, and 2000s that when DB plans are changed into DC plans, income inequality rises and economic growth dampens.

State Trends

The analysis found that the higher the number of negative pension changes made by a state government, the higher is the increase in income inequality in that state. Again, by negative changes we mean cuts in benefits, increases in employee contributions, and conversion of DB plans into DC or hybrid plans. The data show that the correlation between negative pension changes and income inequality during 2000–2010 was –.378. This correlation means that the more negative changes a state makes to its pension plan, the higher is the income inequality in that state. The state-level data allowed us to do advance multivariate analysis to examine the relationship between pension changes and income inequality and between income inequality and economic growth.

The analysis shows that with a single negative change in pensions in a state, income inequality increases by 15 percent in that state. This relationship holds true even when other factors contributing to income inequality, such as lack of investment in education, are taken into account.

Next, the analysis examined the relationship between income inequality and economic growth in each of the 50 states during 2000–2010. The analysis shows that states with rising income inequality had slower economic growth. The analysis found that for each one-unit increase in income inequality in a state, the rate of economic growth in that state was reduced by about 18 percent. By one unit we mean the ratio of incomes of top and bottom quintiles changes by one. Again, this relationship holds true even when other factors affecting economic growth, such as productivity, are taken into account.

Pennsylvania

While our model is based on the analysis of data from 50 states, the results for Pennsylvania seem to be consistent with what the model would have predicted. For example, during 2000-2010, Pennsylvania passed pension reform legislation four times that had adverse consequences for Pennsylvania economy. The reforms mainly consisted of changes in benefits without adequate funding mechanisms. In fact, the recent Keystone Pension Report by Office of Budget shows that actual employer contributions were about 60% less than what was required. The relationship between these changes and economy is evident from the fact that during the same period income inequality increased by about 12.5 %.

SB 1 proposes to reform pensions further in several adverse ways, including proposing to convert DB pensions into DC plans, in the hope of saving money. If we apply the model developed in the NCPERS study (based on the experience of 50 states), our preliminary estimate is that the proposed changes are likely to result in a loss of about $110 billion to Pennsylvania economy during the same period. We urge Pennsylvania to investigate this matter thoroughly and conduct a study on the likely economic impact of the pension changes proposed in SB 1.

Conclusion

Policymakers should pay serious attention to income inequality and its hidden economic cost to taxpayers before they make the changes that diminish pensions. Rather than making such changes, they should close tax loopholes. A recent study of a number of states by Good Jobs First shows that on average states gave away twice as much in economic development subsidies and loopholes as they were required to pay into annual pension contributions. Whereas taxpayer money given through loopholes and subsidies often ends up in overseas tax havens, pension checks are spent locally and stimulate local economies. Pennsylvania legislature might want to consider a study that examines how much is given away in tax subsidies and through loopholes and whether closing these loopholes will result in closing the pension funding gap.

NCPERS wishes to thank the Committee for this opportunity to share our findings from our research and express our concern regarding SB 1. NCPERS stands ready to assist state policymakers with facts, research, and expertise as they delve into policy discussions on retirement security. We invite this committee to contact us should you need additional information.

INCOME INEQUALITY

Hidden Economic Cost of Prevailing Approaches to Pension Reforms

National Conference on Public Employee Retirement Systems

The Voice for Public Pensions

The National Conference on Public Employee Retirement Systems (NCPERS) is grateful for the contribution of NCPERS director of research Michael Kahn, Ph.D., in bringing this seminal work to light.

INCOME INEQUALITY

Hidden Economic Cost of Prevailing Approaches to Pension Reforms

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Executive Summary

The struggle for social and economic justice in the United States cannot be won unless we address the issue of rising income inequality. Income inequality is related to many challenges we face in America today, including retirement security. Do pension reforms of the past three decades exacerbate income inequality? Does rising income inequality in turn dampen the economy? The purpose of this study is to address these questions.

The study reviewed changes in pensions resulting from pension reforms at national and state levels. At the national level, the key change has been a trend of conversion of defined-benefit (DB) pension plans into defined-contribution (DC) plans.[1] At the state and local levels pension changes consisted of cuts in benefits, increased employee contributions, and conversion of DB plans into DC plans. These changes have a negative impact on plan participants and beneficiaries as well as on local economies. Therefore, we refer to these changes as negative pension changes.

The study analyzed the relationship between pension changes and income inequality at national and state levels. At the national level, the data allowed us to examine trends in pension changes, income inequality, and economic growth during the 1980s, 1990s, and 2000s. At the state level, these trends could be examined only during 2000–2010.

National Trends – The analysis found that income inequality was highly co-related with the trend toward conversion of DB into DC plans. The correlation between income inequality and percentage of workforce (public and private) covered by DB plans was –.894. This correlation is robust and means that the lower the percentage in the workforce with DB plans, the higher the income inequality. Other factors that had a robust inverse relationship with income inequality included changes in the percentage of the workforce in unions, marginal (top income) tax rates, and the rate of investment in public education. Inverse relations mean that higher income inequality is the result when the percentage of the workforce in unions; marginal tax rates; and the rate of investment in public education are all lower.

The national-level analysis also examined the relationship between income inequality and economic growth. The analysis shows that this correlation was –.553. This simply means that the higher the income inequality, the lower is the economic growth. Other factors considered in the analysis included rate of investment in public education and multifactor productivity. Multifactor productivity refers to economic inputs including labor, capital, and raw materials.

Higher-level analysis of the national data using advanced multivariate techniques was not viable due to limitations of the available data. Yet it is clear from the empirical data from 1980s, 1990s, and

[1]A defined-benefit pension plan refers to a lifetime guarantee of a pension based on years of service and salary. The employer bears all the risk. A defined-contribution plan, on the other hand, refers to a do-it-yourself pension. In a defined-contribution plan an employee and employer contribute into a tax-deferred 401(k)-type plan, but there is no guarantee that the employee will have adequate or any retirement income. The employee bears all the risk.

2000s that when DB plans are changed into DC plans, income inequality rises and economic growth dampens. Also, just by looking at the raw data one can conclude that if the trend toward conversion of DB into DC plans during the past 30 years did not exist, 15 million more US workers would be covered by a lifetime guarantee of a DB plan.

State Trends – The analysis found that the higher the number of negative pension changes made by a state government, the higher is the increase in income inequality in that state. Again, by negative changes we mean cuts in benefits, increases in employee contributions, and conversion of DB plans into DC or hybrid plans. The data show that the correlation between negative pension changes and income inequality during 2000–2010 was –.378. This correlation means that the more negative changes a state makes to its pension plan, the higher is the income inequality in that state. The state-level data allowed us to do advance multivariate analysis to examine the relationship between pension changes and income inequality and between income inequality and economic growth.

The analysis shows that with a single negative change in pensions in a state, income inequality increases by 15 percent in that state. This relationship holds true even when other factors contributing to income inequality, such as lack of investment in education, are taken into account.

Next, the analysis examined the relationship between income inequality and economic growth in each of the 50 states during 2000–2010. The analysis shows that states with rising income inequality had slower economic growth. The analysis found that for each one-unit increase in income inequality in a state, the rate of economic growth in that state was reduced by about 18 percent. By one unit we mean the ratio of incomes of top and bottom quintiles changes by one. Again, this relationship holds true even when other factors affecting economic growth, such as productivity, are taken into account.

Implication – Policymakers should pay serious attention to income inequality and its hidden economic cost to taxpayers before they make the changes that diminish DB pensions. Rather than making changes such as increasing employee contributions, cutting benefits, converting DB plans into DC or hybrid plans, and so forth, policymakers should close tax loopholes. A recent study of a number of states by Good Jobs First shows that on average states gave away twice as much in economic development subsidies and loopholes as they were required to pay into annual pension contributions (see state data[2]). Whereas taxpayer money given through loopholes and subsidies often ends up in overseas tax havens, pension checks are spent locally and stimulate local economies.

[2] See www.goodjobsfirst.org/statepensions.

Annual Employer Normal Pension Costs Compared with Annual Cost of Taxpayer Money Given Away in Corporate Subsidies and Tax Loopholes in Selected States.

State	Annual Employer Normal Pension Costs (in Billions of Dollars)	Annual Cost of Corporate Subsidies (in Billions of Dollars)	Annual Pension Costs as a Percentage of Corporate Subsidies
Arizona	0.47	0.55	86
California	6.82	9.7	70
Colorado	0.18	0.59	30
Florida	0.91	3.81	24
Illinois	1.85	2.40	77
Louisiana	0.35	1.81	19
Michigan	0.59	1.86	32
Missouri	0.43	0.84	51

Introduction

The struggle for social and economic justice in the United State cannot be won unless we address the issue of rising income inequality. The prevailing struggle between Republicans and Democrats in Congress, and between Congress and the White House, is nothing compared to the economic consequences of rising income inequality for ordinary Americans. Income inequality is related to many challenges we face in America today, including retirement security. Do pension reforms of the 1980s, 1990s, and 2000s exacerbate income inequality? Does rising income inequality in turn dampen the economy? Using empirical data, the purpose of this study is to address these questions.

It is true that there are many factors that contribute to income inequality. However, it is common sense to conclude that when incomes of some people are reduced through cuts in pensions and compensation, and incomes of others are increased through cuts in marginal (top) tax rates, income inequality is bound to increase. Yet consideration of negative consequences of pension reforms for income inequality and dampening of economic growth is missing in policy circles.

The purpose of this study is to shed some light on the hidden economic cost of prevailing approaches to pension reforms. The findings and conclusions, it is hoped, would cause policymakers to reconsider and reverse the rush to dismantle pensions. When income inequality rises and economic growth dampens, everyone suffers, not just public employees or all those workers in the private sector who still have defined-benefit (DB) pension plans.

The study reviewed changes in pensions resulting from pension reforms at national and state levels. At the national level, the key change has been conversion of DB pension plans into defined-contribution (DC) plans. At the state and local levels pension changes consisted of cuts in benefits, increased employee contributions, conversion of DB plans into DC or hybrid plans, and so forth. These changes have a negative impact on plan participants and beneficiaries as well as on local economies. Therefore, we refer to these changes as negative pension changes.

According to the latest Gallup Poll, two out of three Americans are concerned that the rich are getting richer and the poor are getting poorer.[3] In other words, people have a gut feeling that rising income inequality is limiting opportunities for them to advance, no matter how hard they work. But neither policymakers nor the general public has made the connection between the prevailing changes in pensions and rising income inequality. In a way we are shooting ourselves in the foot, economically, by overlooking this important connection. A recent study by Standard and Poor's (S&P) that focuses on income inequality and economic growth in the United States has an interesting quote that is worth repeating:

> *"A rising tide lifts all boats … but a lifeboat carrying a few, surrounded by many treading water, risks capsizing."*

[3] See Gallup Poll: www.gallup.com/poll/166904/dissatisfied-income-wealth-distribution.aspx.

Later in the study we'll discuss details of S&P and other studies, including studies conducted by researchers at the International Monetary Fund (IMF) and Organisation for Economic Co-operation and Development (OECD). At this point, suffice it to say that analysis of empirical data in the United States shows that making changes to pensions that diminish them exacerbate income inequality and rising income inequality in turn dampen economic growth.

We are stuck in a debate over DB versus DC plans that overlooks the hidden societal costs of the prevailing trends in pension reforms. One side argues, Why should public employees have DB pensions when most employees in the private sector don't have them? They use the pension-funding gap as a starting point and argue that public pensions are unsustainable; taxpayers can't afford to pay for these pensions, and therefore they must be changed or dismantled.

The other side argues that pensions contribute to the economy and that everyone should have a DB pension. Taxpayers are not paying for these pensions. It's the money that participants have earned as "deferred compensation." Not making a contribution to the pension plan, according to David Cay Johnson, is in fact "a wage theft."[4] It's unfair and not the American way. Since when in America do we tell workers that we are not going to pay them when they have done the work? This side also argues that DB pensions are more efficient than DC plans. Therefore, they should be preserved and expanded to cover all workers.

Yet the trend toward making negative changes to pensions continues. For example, in the private sector, the number of DB plans has declined by 57 percent, and the number of workers covered by DB plans declined by 10 percent during 1975–2011. In the public sector, the number of plans as well as coverage has remained relatively stable, but the recent changes in the public pensions are troubling in the context of income inequality and dampening of state economies. The National Conference of State Legislatures reports that 48 states made changes to their pension plans – some more than once.[5] The main approaches consisted of the following changes:

- 34 states increased employee contributions
- 38 states instituted higher age and service requirements for retirement
- 30 states reduced cost-of-living adjustments
- 18 states instituted steps to convert DB plans into DC or hybrid plans (mandatory hybrid – 6 states, mandatory cash balance – 3 states, mandatory DC – 2 states, and choice of plan – 7 states)

There may have been additional changes this year, but the push is likely to be in the same direction as was observed at the NCPERS Public Pension Funding Forum in 2014.

Overall, the percentage of the workforce (public and private) covered by DB pension plans continues to decline. Empirical data show that if such a decline did not take place, more than 15 million more workers would have had a lifetime guarantee of a DB pension today.

The present study will present more details in later sections about the trends in pensions in the context of income inequality and economic growth. Our analysis is based on data at both the national and state levels. At the state level, the analysis is limited to public plans. At the national level, the analysis includes both public and private plans. The study is divided into the following four sections. The first section consists of a review of literature on pensions and income inequality and economic growth. The second and third sections will address

[4] David Cay Johnson spoke at the National Institute on Retirement Security conference in March 2015. Also, see his article at http://america.aljazeera.com/opinions/2015/3/dont-be-duped-by-misleading-economic-terms.html.px.

[5] Luke Martel, National Conference of State Legislatures, Presentation at the National Conference on Public Employee Retirement Systems Public Pension Funding Forum, April 2014: http://www.ncpers.org/ppff_archives.

the following two questions:

- What do the national trends in public and private pensions, income inequality, and economic growth reveal?
- What do the state trends in public pensions, income inequality, and economic growth reveal?
- The fourth section will discuss the conclusions of this study.

We must acknowledge that the present study is a work in progress. There has been little research on pensions and income inequality and dampening of economic growth. Most of the research in the area of pensions and economy has focused on the role of pensions in stimulating local economies, especially in terms of jobs and level of spending of pension checks in local economies. This type of research is important on its own and must be continued.

But it seems that despite this compelling research on the positive impact of pensions on local economies, policymakers continue to make harmful changes to pensions, and the general public feels they don't have "a skin in the game." If this new research focused on pensions and income inequality can make policymakers and the general public become aware that the prevailing approach to pension reforms is harmful to everyone, not just those in DB plans, then we would consider this study a success.

Section I: Review of Literature on Pensions and Income Inequality and Economic Growth

Income Inequality in the United States – A strong economy produces three outcomes: job growth, income growth, and shared prosperity through a reduction in income inequality. Lower inflation is also an important component of a strong economy, but management of inflation is often left at the discretion of the monetary policy of the Federal Reserve Bank. The discussion about economy in policy circles is usually focused on jobs and income. Too often, the subject of income inequality is overlooked.

The most recent research, including Stiglitz[6] and Piketty,[7] shows that income inequality has reached the levels of the years prior to the 1930's Great Depression. The Robert Reich documentary – *Inequality for All* – depicts that income inequality reached its peak in 1928 and 2007. Using a graphic that looks like a suspension bridge, the documentary underscores that each time income inequality reached such high levels, an economic disaster followed.

In Figure 1, we have updated the graphic shown in the documentary using the latest data from the World Top Incomes Database established by Alvaredo, Atkinson, Piketty, and Saez.[8] Data show that we are not out of the woods yet as the rise in income inequality continues beyond 2007.

Others go beyond what the documentary shows. They say that high levels of concentration of wealth and income led to the fall of the Roman Empire and other empires.[9]

Income inequality limits opportunities for advancement. Above all, rising income inequality polarizes our society and causes gridlock in the policymaking arena. In the end, everyone suffers. For example, Nolan McCarty, Keith Poole, and Howard Rosenthal, in their study *Polarized America: the Dance of Ideology and Unequal Riches,*[10] found a direct relationship between economic inequality and polarization. Nobel Laureate Joseph Stiglitz, in his book *The Price of Inequality* (see note vi), argues that rising inequality in the United States has created a division that puts our democracy in peril.

Despite the evidence to the contrary, some conservatives believe that income inequality is not a problem. For example, in a speech in Detroit during the 2012 presidential primary elections, presidential hopeful Rick Santorum said, "There is income inequality in America, there always has been, and hopefully, and I do say that, there always will be." Of course, some income inequality is inevitable, but colleagues on the conservative side argue that income inequality is good for economic growth because it provides an incentive for people to work harder to get ahead.

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[6] Joseph Stiglitz, *The Price of Inequality* (New York: Norton, 2013).

[7] Thomas Piketty, *Capital in the 21st Century* (Cambridge, MA: President and Fellows of Harvard College, 2014).

[8] See http://topincomes.parisschoolofeconomics.eu/#Home:.

[9] See United Nations Research Institute, referenced in Flemming Funch http://ming.tv/flemming2.php/__show_article/_a000010-001114.htm.

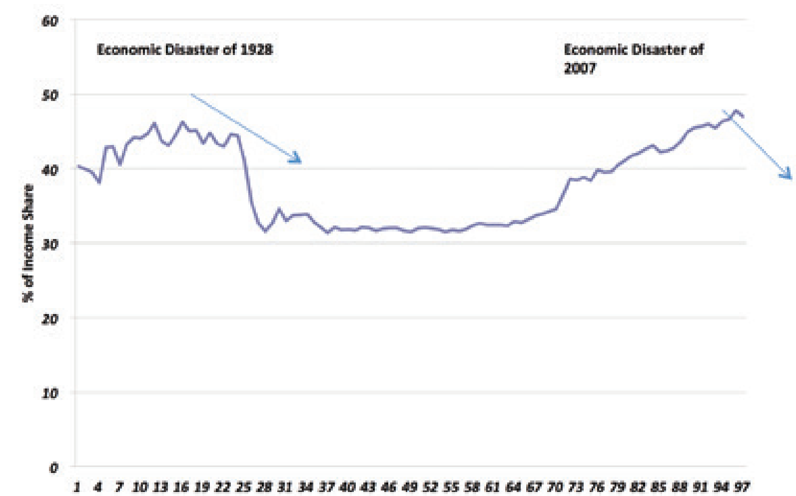
[10] McCarthy, N., Poole, K., and Rosenthal, H. Polarized America, Cambridge, MA: MIT Press, 2006

Other conservatives argue that income inequality is the result of an increasing number of newcomers (immigrants) into the United States at the lower end of the income scale. The data from the decennial census, however, show that the percentage of foreign born in 1860 was about 13 percent. The latest data show that today that number is about 12 percent. For more information about conservative views, those interested might want to watch the video or review the content of a debate between American Enterprise Institute visiting scholar Edward Conard and Vice President Biden's former chief economist Jared Bernstein.[11]

Regardless of what conservatives or liberals say, the present study focuses on what empirical data demonstrate. As mentioned earlier, our main purpose is to examine the relationship between income inequality, pension reforms, and economic growth. Before we examine the literature on the relationship between pensions, income inequality, and economic growth, it is important to underscore the positive role pensions play in the economy.

Pensions and Economy – Pensions play an important role in the US economy. For example, spending by retirees stimulates local economies; pension assets are an important source of capital for businesses and stimulus for economic growth. A recent study by Public Finance Management suggests that spending by retirees accounts for 5.3 percent of our gross national product.[12] Retirees spend about $838 billion annually. This spending employs millions of Americans directly and tens of millions indirectly. Should such spending decline in the future, especially through changes that are being made to pension plans, there will be broad economic consequences in terms of negative impact on jobs and income.

Figure 1. Income share of the top 10% in the United States., 1917-2013



The Public Finance Management report further suggests that annuitants hold invested capital totaling $20.8 trillion either directly, through pension funds, or in 401(k)-type self-directed investments. If this capital is not replaced as it is drawn down, new sources will have to be found to support the capital needed for economic renewal and expansion. America's mortgage market, its private equity and high-tech industries, and many of its start-ups rely on pension funding as a source of capital.

Similarly, other studies such as *Pensionomics 2012: Measuring the Economic Impact of DB Pension Expenditures* [13] found that DB pension benefits have significant positive impact on the economy. This study, conducted by the National Institute on Retirement Security, shows that DB plans support 6.5 million jobs and $1 trillion in economic output. The study also shows that every dollar paid in pension benefits supports $2.37 in economic output.[14]

[14] See www.nirsonline.org/index.php?option=com_content&task=view&id=684&Itemid=48.

[11] See www.aei.org/publication/bernstein-vs-conard-on-income-inequality/.

[12] Public Financial Management, *Addressing the National Pension Crisis: It's Not a Math Problem* (Philadelphia: Public Financial Management, 2013).

[13] National Institute on Retirement Security, *Pensionomics 2012*, Washington, D.C., 2012

On the contrary, when strategies such as raising employee contributions are employed to address the funding gap issue, the effect on local economies is negative. For example, in a typical state like North Carolina, if the state were to increase employee contributions to pension funds by 1 percent in 2013, the job loss in 2014 would have been about 2,500 jobs, personal income loss would have been $458 million, and gross state product (a measure of state economy) would have declined by $155 million. These negative economic consequences have a ripple effect that continues well into the future. For example, in North Carolina, by 2020, the job loss would reach 3,100, loss in personal income would be $723 million, and gross state product would shrink by $209 million. These losses result in revenue loss, which in turn results in additional job losses. This cycle of negative consequences, in an example like this, continues well into the future.[15]

Prevailing pension reforms, such as cuts in pension benefits, increases in employee contributions, and conversions of DB pensions into DC plans, affect the economy in another way. They increase income inequality, which in turn dampens the economy. Next, we'll examine literature on this subject.

Pensions and Income Inequality – Literature on pension reforms and income inequality is somewhat limited. However, there are several studies that indicate that pension reforms focusing on privatization (converting DB plans into DC plans) and reduction of benefits increase income inequality as well as poverty among the elderly. For example, Robert Brown and Steven Prus in their *Social Transfer and Income Inequality in Old Age* [16]show that the lower the percentage of seniors receiving income from a public pension, the higher is the income inequality among them. Similarly, Kees Goudswaard and Koen Caminada in their 2010 article in *International Social Security Review* (Vol. 63) and Camila Arza in *Pension Reforms in Europe* [17]conclude that shifting from public to private pensions generally results in poverty and higher income inequality among retirees. A recent report by the National Institute on Retirement Security[18] finds that poverty rates among senior citizen households without pensions were about nine times higher than those with such pensions.

Income Inequality and Economic Growth – There is mounting empirical evidence that rising income inequality dampens economic growth. We will discuss three key studies that were published in 2014 by researchers at IMF,[19] S&P,[20] and OECD.[21] We'll briefly describe these studies.

The IMF study takes advantage of a recently compiled cross-country data set that distinguishes before taxes and transfers inequality and net (after tax) inequality and allows the researchers

[15] This analysis was done using Regional Economic Model, Inc., by Richard Sims, Sierra Institute on Applied Economics.

[16]R. Brown and S. Prus, *Social Transfer and Income Inequality in Old Age: A Multinational Perspective*, SEDAP Research Paper No. 109, McMaster University, Ontario, Canada.

[17]K. Goudswaard and K. Caminada, *The Redistributive Effect of Public and Private Social Programs: A Cross CountryEmpirical Analysis*, International Social Security Review, Vol. 63:1, 2010

[18]F. Porell and Diane Oakley, *The Pension Factor*, Washington, DC: National Institute on Retirement Security, 2012.

[19]Jonathan Ostry, Andrew Berg, and Charalambos Tsangaridesl, *Redistribution, Inequality, and Growth* (Washington, DC: International Monetary Fund, 2014).

[20] Beth Ann Bovino and Gabriel Petek, *How Increasing Income Inequality Is Dampening U.S. Economic Growth, and Possible Ways to Change the Tide* (New York: Standard and Poor's, 2014).

[21] F. Cingano, *Trends in Income Inequality and Its Impact on Economic Growth*, OECD Social, Employment and Migration Working Papers No. 163 (Paris: Organisation for Economic Co-operation and Development, 2014).

to calculate redistributive transfers for a large number of countries over a number of years. The study found that more unequal societies tend to redistribute more, but redistribution appears generally benign in terms of its impact on growth. Lower net inequality, on the other hand, is robustly correlated with faster and more durable economic growth, for a given level of redistribution.

The S&P study is based mainly on secondary research but presents a wealth of data and insights. It concludes that the current level of income inequality in the United States is dampening gross domestic product (GDP) growth at a time when the world's biggest economy is struggling to recover from the Great Recession and the government is in need of funds to support an aging population. The S&P researchers underscore that the United States is reaching extreme levels of income inequality, which can harm sustained economic growth over the long haul. Therefore, according to the study, the S&P has revised its 10-year forecast of US economic growth from 2.8 percent to 2.5 percent.

The OECD study draws on data covering the OECD countries during the past 30 years. The analysis suggests that income inequality has a negative impact on subsequent growth. Like the IMF study, the OECD study argues that redistribution policies (taxes and transfers) are a key tool to ensure that the benefits of growth are more broadly distributed. The results of the study suggest that redistributive policies do not undermine growth.

One of the unique features of the OECD study is that it measures how much economic growth is reduced by inequality in different OECD countries. The study estimates that rising inequality has knocked more than 10 percentage points off growth in Mexico and New Zealand. In the United States, the United Kingdom, Sweden, Finland, and Norway, the growth rate would have been more than one-fifth higher had income disparities not widened. On the other hand, greater equality helped increase GDP per capita in Spain, France, and Ireland during the study period.

Section II: What Do the National Trends in Public and Private Pensions, Income Inequality, and Economic Growth Reveal?

The present study examined national trends using data from various sources, including the Census of Governments, the Bureau of Labor Statistics, and the Bureau of Economic Analysis. We looked at several variables, including income inequality, workforce covered by DB pensions, unionization, marginal tax rates, and economic growth. The historical depth of the data varied. Some data (e.g., unionization, workforce, marginal tax rates) are available as far back as the 1960s. Other data, such as statistics capturing workforce covered by a DB plan, median income, income inequality, and multifactor productivity (MFP), are available only since the early 1980s (MFP data are available starting only in 1988). So that we can study the trends and relationships among these variables, the analysis had to be limited to the decades of the 1980s, 1990s, and 2000s.

The national trends in income inequality and economic growth were examined by looking at the correlations between these variables and the variables that might affect them. Let's focus first on the relationship between income inequality and pension reforms and the variables that might affect income inequality. We'll then examine the relationship between income inequality and economic growth.

Table 1. Correlation between Income Inequality and Other Variables, 1982–2011

Variable	Correlation Coefficient
Income inequality and percentage of workforce in defined-benefit plans	–.894
Income inequality and percentage of workforce in unions	–.972
Income inequality and marginal tax rate	–.789
Income inequality and investment in education	–.675

Income Inequality and Pension Reforms – In the absence of detailed data on the changes in pensions in private-sector plans during the 1980s, 1990s, and 2000s, we have measured pension reforms by the percentage of the workforce (public and private) covered by DB plans. Other variables included in the study of correlations were measured as follows. Income inequality is measured by the ratio between incomes of the top and bottom quintiles. In some graphics, we have used the ratio of incomes of the top 5 percent to the bottom quintile. Unionization is measured by the percentage of the workforce in unions. Marginal tax rate is the rate that top-income individuals pay. Investment in education is measured by the annual rate of change in investment in education.

Table 1 shows the correlation between income inequality and pension reforms as well as other variables that might be related to income inequality. The correlations shown in Table 1 suggest that when the percentage of the workforce covered by DB pension plans declines, income inequality rises. This is depicted in Figure 2. The two trend lines in Figure 2 clearly show that when the percentage of workforce in DB pensions goes down, the income inequality goes up.

The correlations in Table 1 also suggest that when unionization, marginal tax rates, and investment in education decline, income inequality rises. These are robust relationships in terms of magnitude and are consistent with the literature. The data and trend lines for these variables are shown in Appendix A.

The graphic presentation of these trends in Appendix A shows that the income inequality line is the only line that is trending upward. All other trend lines are trending downward. These trend lines support the general contentions that as marginal tax rates, unionization, and investment in education decline, income inequality rises.

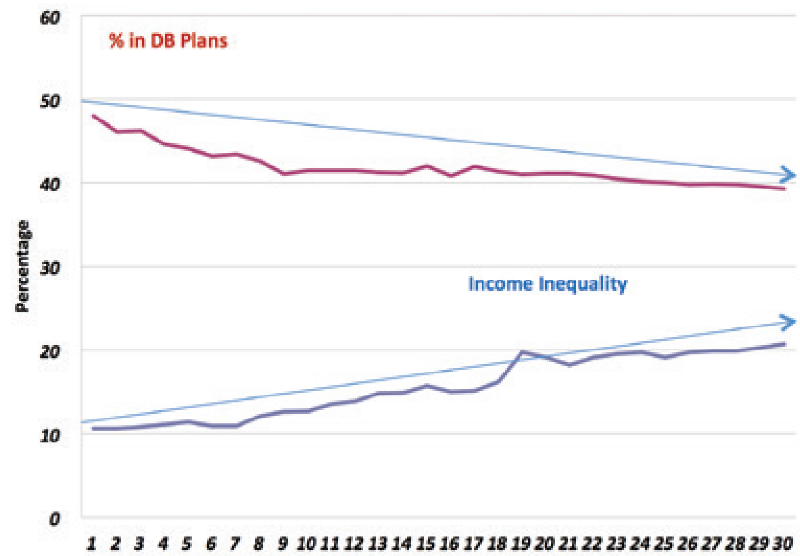
Next we'll examine whether rising income inequality slows down the economy.

Income Inequality and Economic Growth – Economic growth is often measured by GDP growth. However, GDP growth hides the very essence of the subject matter we are trying to examine – income inequality. For example, if the majority of the economic growth goes to the top 1 percent, the GDP will still grow. However, the economic circumstances of the majority of Americans will change little, if at all. Therefore, we use median income growth as a measure of economic growth in our analysis. The other variables that are related to economic growth are investment in education and MFP. MFP refers to all the inputs that go into economic growth, including labor, capital, and raw materials.

The analysis found that the correlation between economic growth and income inequality in the United States is –.553. This relationship means that higher the income inequality, the lower is the economic growth (see Figure 3).

We also looked at other variables that affect economic growth such as investment in education and MFP. The results in Table 2 show that the correlation between economic growth and investment in education and MFP is positive, which means that the higher the investment in education and MFP, the higher is the economic growth.

Figure 2. Trends in Pension Reforms and Income Inequality, 1982-2011



Note: DB = defined-benefit.

Figure 3. Economic Growth and Income Inequality – 1984-2011

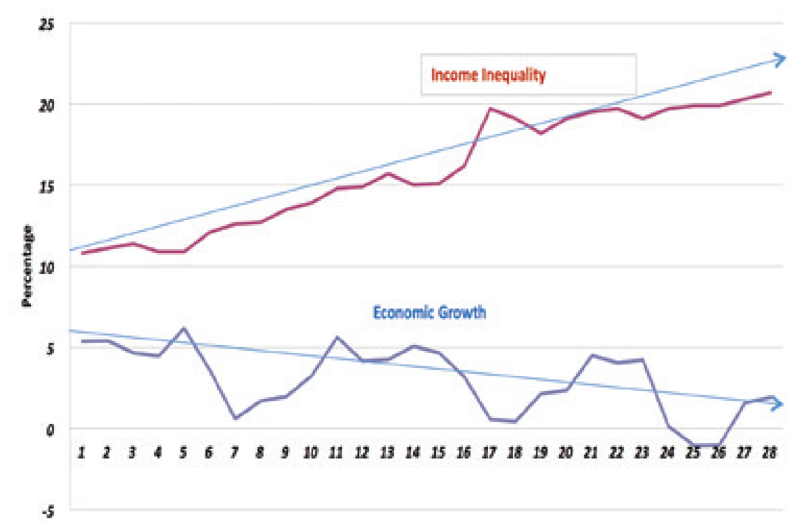


Table 2. Correlation between Economic Growth and Income Inequality and Other Variables, 1984–2011

Variable	Correlation Coefficient
Economic growth and income inequality	–.553
Economic growth and investment in education	.410
Economic growth and MFP (MFP data are limited to 1988–2011)	.666

Note: MFP = multifactor productivity.

The results in Table 2 are consistent with the literature that shows that rising income inequality slows down economic growth. This analysis is limited to 1984–2011 because of the lack of data on MFP.

Since our focus is on assessing whether income inequality dampens economic growth, the relationship between these two variables is elaborated on in Figure 3. This figure shows that the trend lines for these two variables move in the opposite direction. The basic data used in the graphics and analysis are shown in Appendix B.

The limitations of the data do not allow further analysis such as multivariate analysis. Yet it is clear from the empirical data from the 1980s, 1990s, and 2000s that when DB plans are changed into DC plans, income inequality rises. It follows that when income inequality rises it dampens economic growth.

Also, just by looking at raw data – if the trend toward conversion of DB into DC plans during the past 30 years did not exist, we would have 15 million more workers with DB plans.[22]

[22] In 2011 there were about 150 million people in the workforce. The percentage of the workforce in defined-benefit plans has declined by about 10 percent during 1982–2011. In other words, if there were no such decline, about 15 million more people would have had a lifetime guarantee of a defined-benefit pension.

Section III: What Do the State Trends in Public Pensions, Income Inequality, and Economic Growth Reveal?

To examine the relationship between current pension reforms and income inequality, we reviewed the legislation passed and enacted during 2000–2010 in each of the 50 states.[23] We counted the negative pension changes, such as increased employee contributions, cuts in benefits, conversion of DB plans into DC plans, and so forth and analyzed the correlation between such changes and income inequality. Income inequality was measured by the change in the ratio of income of the top quintile to the bottom quintile for each of the 50 states during 2000–2010.

Correlation between Income Inequality and Pension Changes in the States – The analysis found that the correlation coefficient between the number of negative pension changes and income inequality was .379 (see Appendix C). This correlation suggests that the higher the number of negative changes a state makes, the higher is the increase in income inequality in that state.

While income inequality is caused by various factors – including lack of investment in people and lack of policies that level the playing field – the current "pension reform" efforts in the states seem to exacerbate income inequality. The results of multivariate analysis are shown in Table 3.

Table 3. Impact of Negative Pension Changes on Income Inequality (Including Other Variables), 2000–2010

Variable	Regression Coefficient
Intercept	–.537
Number of negative pension changes	.147
Lack of investment in public education	.322
Lack of progressivity of state and local taxes	.0175
Public employees as a percentage of total workforce	.278

Results show that the relationship between negative pension changes and income inequality holds even when other factors are taken into account. Although various other regression runs are not shown here, we found that when the percentage of public employees in each state's workforce is taken into account, the relationship between negative pension changes and income inequality becomes even more pronounced. The analysis also suggests that a single negative change in public pensions increases income inequality by about 15 percent.

Correlation between Income Inequality and Economic Growth – To examine the relationship between income inequality and economic growth, we examined the correlation between income inequality, economic growth, and investment (or

[23] See www.ncsl.org/research/fiscal-policy/pension-and-retirement-legislative-summaries-and-r.aspx.

Table 4. Impact of Income Inequality on Economic Growth, 2000–2010

Variable	Regression Coefficient
Intercept	–.248
Income inequality	–.180
Lack of investment in public education	–.030

lack thereof) in education. Again income inequality was measured by the ratio between top and bottom income quintiles. Economic growth was measured by change in median income. Investment in education was measured by education spending as a percentage of state and local budgets.

We found that the correlation between income inequality and economic growth was –.184. It simply means that the higher the income inequality in a state, the lower is the economic growth in that state. Table 4 further analyzes this relationship using multivariate analysis.

The results show that when inequality – the ratio of the top and bottom quintiles – increases by one in a state, it decreases that state's economic growth by 18 percent. These results hold even when we control for other factors such as investment in education.

Section IV: Conclusions

Chuck Collins, cofounder of United for a Fair Economy and author of *Economic Apartheid in America,* argues that as inequality rises, power concentrates in the hands of a few wealthy people and big corporations. Wealthy citizens and corporations begin to influence policies in their own favor, resulting in voter disengagement, polarization, and a dysfunctional government. He calls this phenomenon the "Wheel of Misfortune." The current pension reform movement might be a pathway to economic misfortune for all of us.

While there are many factors that are related to income inequality, and we have considered them in our analysis, it is just common sense that when incomes of some people are reduced through cuts in pensions and wages of working people and incomes of others such as the top 1 percent are increased through cuts in marginal tax rates, income inequality is bound to increase. Yet consideration of negative consequences of pension reforms for income inequality and dampening of economic growth is missing in policy circles. The present study has shed some light on the hidden economic cost of prevailing approaches to pension reforms in the hope that we can reverse the rush to dismantle DB pensions.

This study examined national- and state-level trends in pension changes and their implications for income inequality. It then examined the relationship between rising income inequality and economic growth at each level. The period that the analysis covers is limited by the availability of data. The national-level analysis covers the period of the 1980s, 1990s, and 2000s and includes public- and private-sector workers. The state-level analysis is limited to 2000–2010 and covers only public-sector workers.

The national data show that the main trend was conversion of DB into DC plans. We found that this conversion exacerbated income inequality. The analysis shows that there is a robust inverse relationship between the percentage of the workforce covered by a DB plan and income inequality. Other factors that were correlated with rising income inequality included declining membership in unions, marginal tax rates, and rate of investment in education. The national data also show that rising income inequality slowed down economic growth during 1980s, 1990s, and 2000s. The national data are limited and do not allow us to do multivariate analysis. Yet it is clear from the empirical data that when DB plans are changed into DC plans, income inequality rises and economic growth dampens. Also, just by looking at the raw data one can conclude that if the trend toward conversion of DB into DC plans during the past 30 years did not exist, we would have 15 million more workers with DB plans.

The state-level data focus mainly on recent changes in public pensions during 2000–2010. The main trend at the state and local levels was one of negative changes, such as reductions in benefits, increases in employee contributions, and conversion of DB into DC or hybrid plans.

The analysis found that there was a positive relationship between the number of negative pension changes and income inequality. This relationship suggests that the higher the number of negative changes a state makes, the higher is the increase in income inequality in that state. This relationship holds even when we control for other factors that contribute to income inequality, including lack of investment in people and lack of policies that level the playing field through progressive taxation. The state-level data allow us to conduct multivariate analysis. The analysis suggests that a single negative change in public pensions in a state increases income inequality in that state by about 15 percent.

Next, we examined the relationship between income inequality and economic growth in the states. The results show that when inequality increases by one in a state, it decreases the state's economic growth by 18 percent.

According to the latest Gallup Poll, two out of three Americans are concerned that the rich are getting richer and the poor are getting poorer.[24] In other words, people have a gut feeling that rising income inequality is limiting opportunities for them to advance, no matter how hard they work. But neither policymakers nor the general public has made the connection between the diminishing of pensions and rising income inequality. In a way we are shooting ourselves in the foot, economically, by overlooking this important connection.

Policymakers should pay serious attention to income inequality and its hidden economic cost to taxpayers before they make the changes that diminish pensions. Instead of making negative changes such as increasing employee contributions, cutting benefits, converting DB plans into DC or hybrid plans, and so forth, state and local governments should close tax loopholes. A recent study of a number states by Good Jobs First shows that on average states gave away twice as much in economic development subsidies and loopholes as they were required to pay into pension contributions.[25] Whereas taxpayer money given through loopholes and subsidies often ends up in overseas tax havens, pension checks are spent locally and stimulate local economies.

[24] See Gallup Poll: www.gallup.com/poll/166904/dissatisfied-income-wealth-distribution.aspx.

[25] See www.goodjobsfirst.org/statepensions

APPENDIX A

Data Used in Analysis of Correlations and Figure 2					
Year	Income Inequality	Percentage in Defined-benefit Plans	Marginal Tax Rate	Percentage in Unions	Investment in Public Education
1982	10.6	47.98918	50	16.33335	2.078017
1983	10.6	46.07351	50	15.88256	5.416667
1984	10.8	46.2138	50	15.27161	7.012987
1985	11.1	44.61853	50	14.72012	8.975306
1986	11.4	44.04162	50	14.40586	8.826805
1987	10.9	43.20194	38.5	14.11004	6.531411
1988	10.9	43.38903	28	13.97398	7.129135
1989	12.1	42.56997	28	13.69269	9.937234
1990	12.6	41.05531	28	13.30261	8.120567
1991	12.7	41.43305	31	13.1132	7.851755
1992	13.5	41.4535	31	12.79419	7.581195
1993	13.9	41.43885	39.6	12.84675	6.066088
1994	14.8	41.22131	39.6	12.77317	1.375157
1995	14.9	41.17109	39.6	12.36546	8.501801
1996	15.7	42.00817	39.6	12.14621	4.472658
1997	15	40.783	39.6	11.81978	4.923584
1998	15.1	41.91526	39.6	11.775	7.318421
1999	16.2	41.34522	39.6	11.82266	6.652524
2000	19.7	40.99156	39.6	11.45578	7.554603
2001	19.1	41.08631	39.1	11.35083	7.176587
2002	18.2	41.10366	39.6	11.17124	7.572204
2003	19.1	40.83612	35	10.76787	5.620445
2004	19.5	40.43188	35	10.49654	5.027941
2005	19.7	40.16542	35	10.50429	5.515857
2006	19.1	40.03883	35	10.14277	8.078765
2007	19.7	39.7854	35	10.23354	2.364832
2008	19.9	39.85819	35	10.4338	6.319676
2009	19.9	39.77761	35	9.943429	0.006787
2010	20.3	39.57528	35	9.562087	4.018594
2011	20.7	39.27235	35	9.610915	–1.7789

APPENDIX A

Trends in Income Inequality, Marginal Tax Rate, Percentage of Workforce in Defined-benefit Plans and Unions, and Investment in Education, 1982–2011

Note: DB = defined-benefit

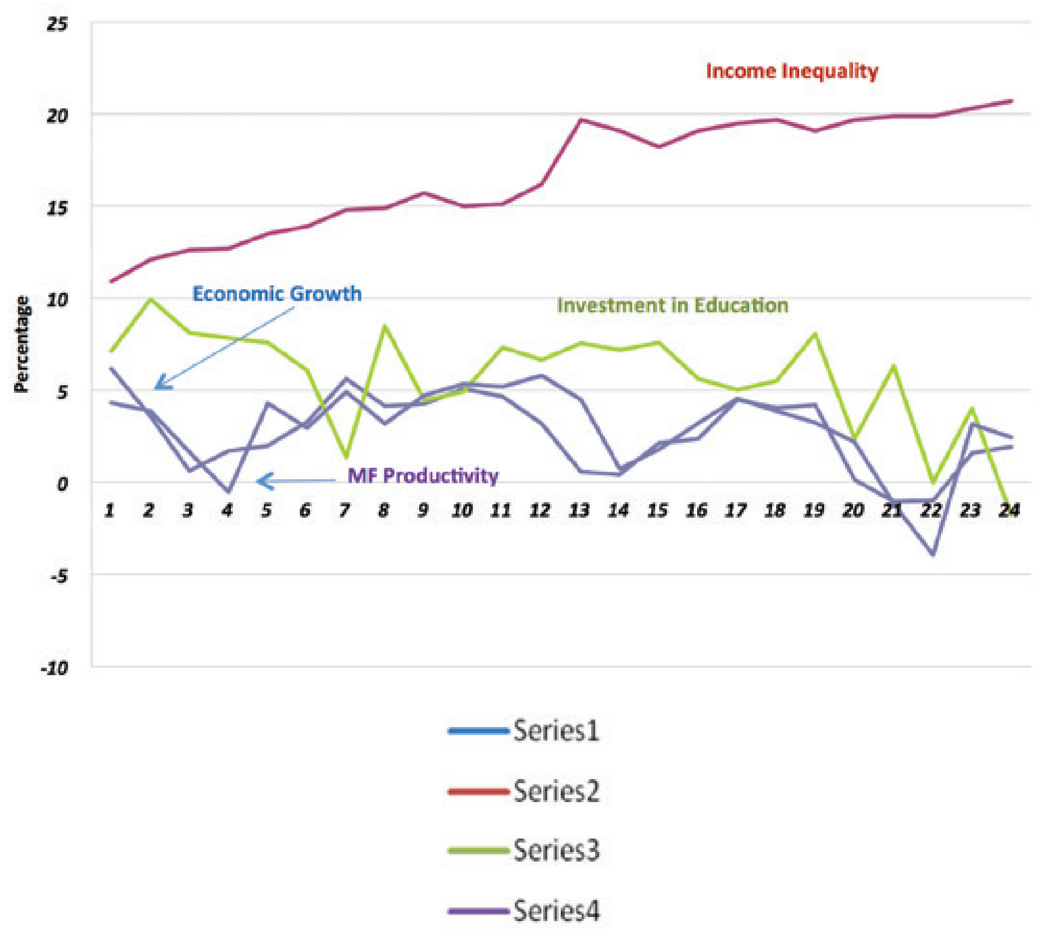
APPENDIX B

Data Used in Analysis of Correlations and Figure 3				
Year	**Economic Growth**	**Income Inequality**	**Investment in Education**	**Multifactor Productivity**
1984	5.0	10.8	7.012987	NA
1985	5.0	11.1	8.975306	NA
1986	5.0	11.4	8.826805	NA
1987	4.0	10.9	6.531411	NA
1988	6.0	10.9	7.129135	4.317381
1989	4.0	12.1	9.937234	3.859869
1990	1.0	12.6	8.120567	1.638726
1991	2.0	12.7	7.851755	–0.52926
1992	2.0	13.5	7.581195	4.281567
1993	3.0	13.9	6.066088	2.954151
1994	6.0	14.8	1.375157	4.901366
1995	4.0	14.9	8.501801	3.190408
1996	4.0	15.7	4.472658	4.70324
1997	5.0	15	4.923584	5.343416
1998	5.0	15.1	7.318421	5.197003
1999	3.0	16.2	6.652524	5.802716
2000	1.0	19.7	7.554603	4.489204
2001	0.0	19.1	7.176587	0.748099
2002	2.0	18.2	7.572204	1.792063
2003	2.0	19.1	5.620445	3.213242
2004	4.0	19.5	5.027941	4.551037
2005	4.0	19.7	5.515857	3.853788
2006	4.0	19.1	8.078765	3.243689
2007	0.0	19.7	2.364832	2.195678
2008	–1.0	19.9	6.319676	–1.17698
2009	–1.0	19.9	0.006787	–3.93853
2010	2.0	20.3	4.018594	3.164905
2011	2	20.7	–1.7789	2.437388

Note: NA = Data Not Available.

APPENDIX B

Trends in Income Inequality, Economic Growth, Investment in Education, and Multifactor Productivity, 1988–2011



Note: MF = multifactor

APPENDIX C

Data Used in Correlation between Negative Pension Changes and Income Inequality, 2000–2010				
State	**Pension Changes 2000–2010**	**Top/Bottom Income Quintile 2000**	**Top/Bottom Income Quintile 2010**	**Change 2000–2010**
Alabama	1	7.0	7.8	0.8
Alaska	3	6.2	6.8	0.6
Arizona	3	7.3	9.8	2.5
Arkansas	1	6.5	6.6	0.1
California	5	8.2	9.5	1.3
Colorado	5	6.6	8.2	1.6
Connecticut	2	7.4	8.2	0.8
Delaware	0	6.4	6.9	0.5
Florida	4	7.3	8.3	1.0
Georgia	3	7.3	9.3	2.0
Hawaii	1	6.2	6.7	0.5
Idaho	1	6.7	6.4	–0.3
Illinois	4	6.9	8.3	1.4
Indiana	1	5.8	7.4	1.6
Iowa	2	5.7	5.6	–0.1
Kansas	3	6.6	7.2	0.6
Kentucky	3	7.4	7.6	0.2
Louisiana	4	7.3	8.8	1.5
Maine	1	5.9	6.6	0.7
Maryland	1	7.1	7.5	0.4
Massachusetts	2	7.6	8.3	0.7
Michigan	2	6.9	7.5	0.6
Minnesota	4	6.1	6.9	0.8
Mississippi	3	6.8	8.3	1.5
Missouri	2	6.5	7.3	0.8
Montana	1	6.1	6.7	0.6
Nebraska	4	6.2	6.3	0.1
Nevada	1	6.4	7.6	1.2

Note: Correlation between the number of negative pension changes and income inequality = .379.

APPENDIX C

Data Used in Correlation between Negative Pension Changes and Income Inequality, 2000–2010				
State	**Pension Changes 2000–2010**	**Top/Bottom Income Quintile 2000**	**Top/Bottom Income Quintile 2010**	**Change 2000–2010**
New Hampshire	1	6.0	6.1	0.1
New Jersey	5	7.5	8.3	0.8
New Mexico	3	7.7	9.9	2.2
New York	3	8.7	9.2	0.5
North Carolina	0	7.4	7.9	0.5
North Dakota	1	6.0	7.0	1.0
Ohio	2	6.8	6.9	0.1
Oklahoma	3	7.3	8	0.7
Oregon	1	7.3	6.9	–0.4
Pennsylvania	4	6.4	7.2	0.8
Rhode Island	4	7.0	7.5	0.5
South Carolina	2	6.6	7.4	0.8
South Dakota	1	5.5	6.8	1.3
Tennessee	0	7.6	7.8	0.2
Texas	3	8.1	8.6	0.5
Utah	2	5.3	5.6	0.3
Vermont	2	6.0	6.0	0.0
Virginia	3	7.3	8.1	0.8
Washington	2	6.6	7.1	0.5
West Virginia	2	6.8	6.9	0.1
Wisconsin	2	6.1	6.1	0.0
Wyoming	1	5.9	5.9	0.0

Note: Correlation between the number of negative pension changes and income inequality = .379.

National Conference on Public Employee Retirement Systems

The Voice for Public Pensions

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Testimony on Pennsylvania Senate Bill 1



Issues to consider in transitioning from a traditional DB plan to a DC hybrid plan

Cathie Eitelberg
Senior Vice President and Public Sector Market Director
Washington, DC

Segal Consulting

Notes on Senate Bill 1

- The proposed bill changes the retirement program from a traditional defined benefit (DB) plan to defined contribution (DC) plan with a cash balance overlay.
- Based on information supplied by Xerox Consulting, the proposed plan reduces expected retirement benefits for future employees by 70%.
- Furthermore page 22 of the actuarial note includes these observations:
  - The proposed bill may be found to impair the rights of affected members.
  - The proposed plans will provide less secure, more volatile and less valuable benefits for employees. Policymakers should consider the appropriateness of such a significant change.
  - The proposed plans do not provide meaningful death and disability benefits. Particularly for public safety employees this is a major departure from past practice.

In making such a monumental change one should establish the goals for the change

Following is the goal stated in Article I, Section 101 (1) of Senate Bill 1:

- It is the intent of the General Assembly to ensure the financial health of the Commonwealth and its school districts by adopting reforms to provide for the sustainability of our public retirement system.

Since this is such a dramatic change, great care should be taken to assure that the proposed change will indeed attain the stated goal.

Multiple Issues must be considered in evaluating whether the proposed bill will meet the intended goals. These issues include:

- Initial Transition Costs
- Future Plan Costs
- Risk Sharing
- Value for your Benefit Dollars
- Other Cost Impacts
- Human Capital Issues

Initial Transition Costs

At transition there will be increased costs. These fall in three categories as follows.

- Set up costs, these include
  - Communication requirements
  - Structural modifications
- Behavior impacts
  - Potential short-term increase in retirements

Initial Transition Costs

Other transition items are shown below.

- Possible shorter amortization period
  - Without new entrants, a plan will gradually lose its active employees
  - To avoid shifting current liability to future generations of taxpayers the amortization period should be shortened
- Long-term investment return
  - Upon transition the plan is no longer perpetually middle-aged
  - Therefore the investment return assumption should be modified to reflect the shorter investment horizon

Risk Sharing Issues – Investment Return

The distinct nature of the two types of systems results in significantly different investment outcomes.

- DB plans pool investment return over generations of taxpayers and plan participants
  - As such an ongoing DB plan can be thought of as being perpetually middle-aged
  - This provides the ability for the plan to diversify investments over a long period of time

Risk Sharing Issues - Investment Return

DC plans on the other hand by nature have a limited investment horizon.

- This limited investment horizon is because a DC plan is essentially for an individual.
  - Individuals age, they are not perpetually middle-age
  - Most financial planners encourage DC plan investors to gradually move their allocation to less volatile securities as they age.
  - This is because they do not have time to recover from a market correction

Risk Sharing Issues - Investment Return

Recent estimates indicate that switching from a DB to a DC plan will reduce investment returns from 1% to 2% per year. As DC plans mature, this difference may grow, placing additional burdens on plan participants.

Risk Sharing Issues - Plan Expenses

Expense ratios vary greatly between DB and DC plans.

- Recent studies have shown that DB plan expenses run from 28 to 60 basis points depending on a variety of factors
  - A basis point is 1/100 of 1%
- A Boston College paper indicated that average DB plan expenses were 43 basis points while DC plans were 95 basis points (Other studies have confirmed these findings)

Risk Sharing Issues - Pooled Mortality

A major strength of DB plans is their ability to pool mortality experience.

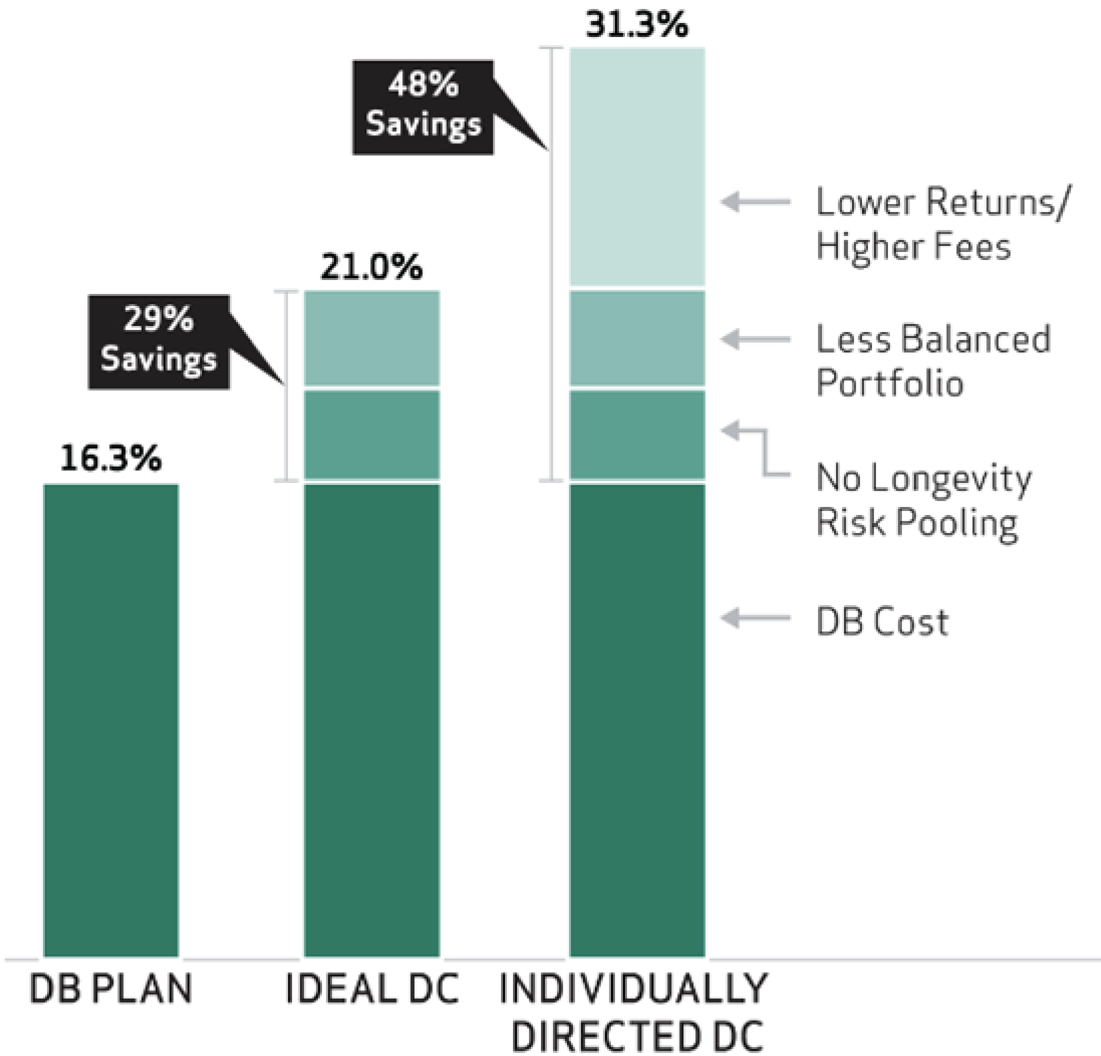
- In a DB plan, each participant will receive roughly the same number of monthly retirement payments
  - From the plan's perspective this results in predictable and manageable payment pattern
- DC plan participants on the other hand must
  - Predict their own life expectancy and hope they do not live too long
  - Or purchase an annuity from a private party but that annuity will be priced to protect the private party and further erode purchasing power in retirement

Mortality pooling allows DB plans to share the risk of retirement longevity over all participants.

Value for Your Benefit Dollars

- In December of 2014, the NIRS released a paper, “Still A Better Bang for the Buck”.
  - The new paper included a comparison of a DB plan, a traditional DC plan and an “ideal DC plan”
  - The “ideal DC plan” is one that uses a pooled investment portfolio with mandatory annuitization at retirement
  - The results are shown on the next page.

Value for Your Benefit Dollars



Value for Your Benefit Dollars

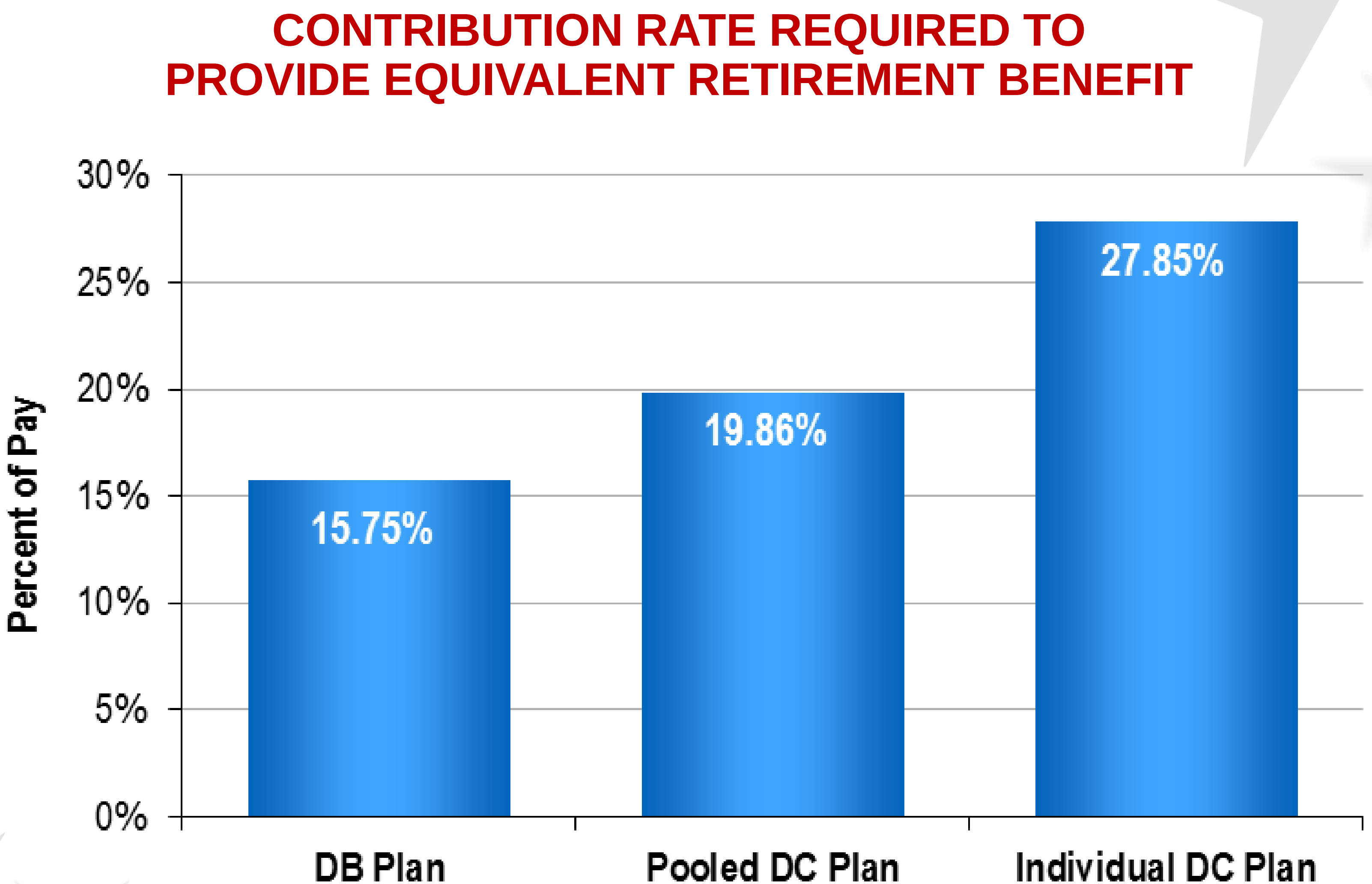
- The chart on the preceding page from “Still a Better Bang for the Buck” illustrates the impact of the structural efficiencies inherent in DB plans.
- For an individually managed DC plan, a DB plan is 48% more cost effective in delivering benefits.
- As noted on the prior page, the efficiency is 29% better than an “ideal” DC plan

Value for Your Benefit Dollars

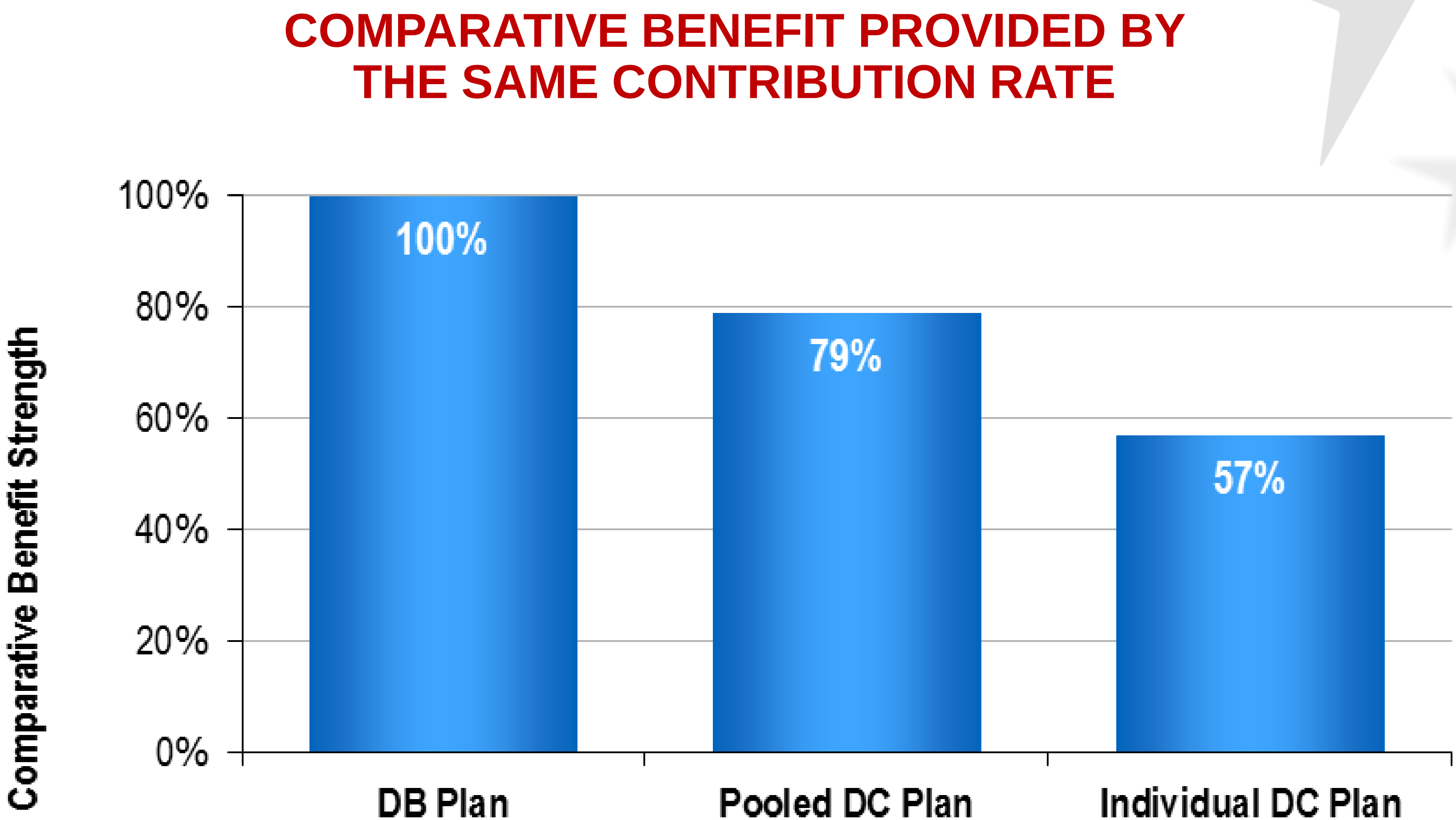
- Since 2008, improvements have been made in benefit delivery for some DC plans.
  - The Better Bang paper refers to these as “ideal DC” plans, also known as pooled DC plans.
- These plans remove asset allocation and selection from the individual to a professional manager.
- Even with this improvement DB plans are 29% more efficient than an “ideal” DC plan

The following pages illustrate the impact of providing the contribution rate necessary to provide an equivalent benefit and the benefit provided by an equivalent contribution.

Value for Your Benefit Dollars



Value for Your Benefit Dollars



Value for Your Benefit Dollars

These efficiencies in delivering benefits are due to three structural advantages of DB plans.

1. Longevity risk pooling
2. Asset allocation
3. Low fees and professional management

Any savings as a result of shifting from a DB plan to a DC plan is due to decreased retirement income.

Other Cost Impacts

Legacy DB plan as noted earlier

- Without new entrants, a plan will gradually lose its active employees
- This will increase the cash-flow requirements for the investments of the plan
- Without new entrants, any fluctuations in liability will be more acutely felt on a diminishing population

Other DC plan issues

- DC plans do not provide meaningful death and disability benefits during a working career
- To provide these benefits an employer will have to secure life insurance and long-term disability from another source

Human Capital Issues

DB plans are designed to encourage certain career behaviors. Without this potential changes in employment behavior could impact an entity's ability to provide constituent services. Examples are:

- As shown earlier, DC plans are not expected to provide the same level of benefit as a DB plan thus encouraging employees to work beyond normal retirement
- The portability of DC plans may also result in shorter service employees leaving sooner than desired by the entity.

Each of the above possibilities may increase the cost of supplying community services.

Why Switch?

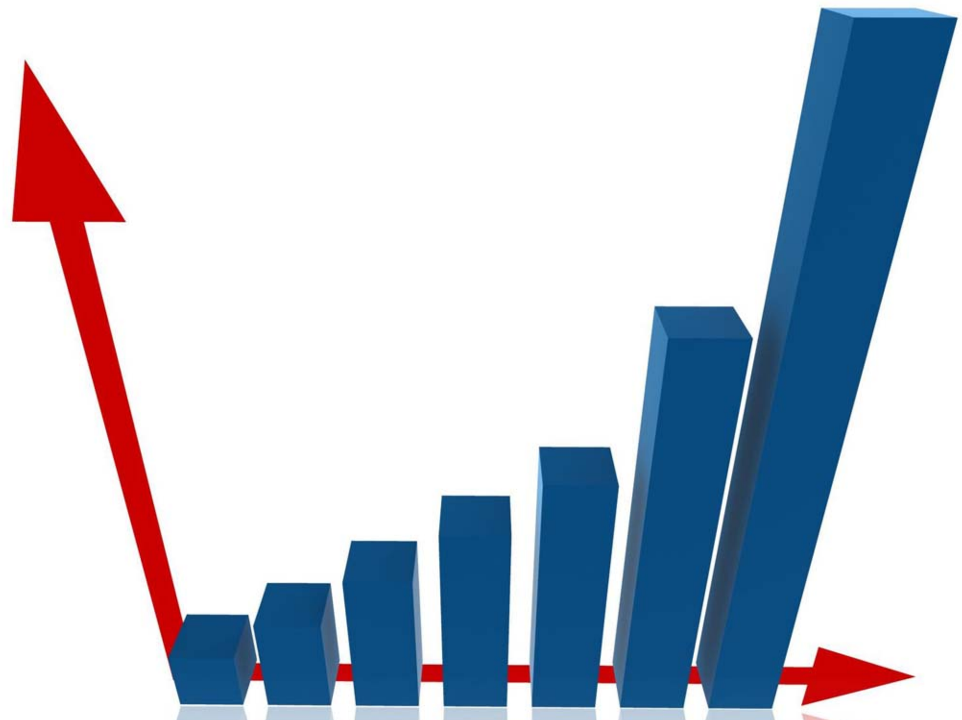
If DB plans are so clearly more efficient in providing benefit dollars, why would an entity consider a change?

- DB plan contributions are subject to market fluctuations. The contribution rate is not set in stone.
- If markets go down, the DB contribution will go up resulting in a higher cost for the employer.
- In a DC plan, if the market goes down, employee benefits are decreased but the employer contribution rate remains the same.

Why Switch?

Alternatively,

- If markets go up, the DB contribution will go down resulting in a lower cost for the employer.
- In a DC plan, if the market goes up, employee benefits are increased but the employer contribution rate remains the same.



The nature of the promise has changed in shifting from a DB to a DC plan, resulting in tremendous differences in where plan risks lie.

Guidelines in Making a Decision

The American Academy of Actuaries established a set of principles to guide plan sponsors and participants in understanding the retirement promise and to assist in setting priorities. These principles are on the following page.

The principles are referred to as Retirement for the AGES and can help in addressing which party can best handle which type of retirement risk.

Guidelines in Making a Decision

Alignment: A retirement system should align stakeholder roles with their skills.

Governance: Good governance provides a balanced framework for making and implementing good decisions.

Efficiency: Systems should maximize retirement income while avoiding excessive risk.

Sustainability: The system should be designed to support retirement income over all generations of participants while being able to withstand financial shocks, such as recession or prolonged inflation.

Summary

- DC plans provide less benefits per dollar of contribution.
- Employer cost reduction in changing from a DB to a DC plan results from lowered retirement benefits, not from any intrinsic design unique to a DC plan.
- DC plan contributions are by design insulated from market fluctuations shifting that risk for adequate retirement income to the plan participant.
- A DB to DC transition may also impact other aspects of an entity's ability to serve its constituency.

Transitioning to a DC plan is not the panacea some tout them to be. Care must be taken to assure that all aspects have been considered.

Summary

At the beginning, the stated goal of Senate Bill 1 was stated as:

- It is the intent of the General Assembly to ensure the financial health of the Commonwealth and its school districts by adopting reforms to provide for the sustainability of our public retirement system.

Is the Bill projected to do so?

Based on the reports of three different actuarial firms, all of which indicate concern that they have not had sufficient time to thoroughly study the proposed changes, it does not appear that sufficient information is available to support the premise that the proposed bill will accomplish its stated aims.

Summary

"If the motivation for a conversion to DC is to reduce costs, then it should be noted that shifting to DC actually increases the cost of delivering a comparable retirement benefit."

"If the motivation for a conversion to DC is to reduce government's exposure to the financial risks associated with sponsorship of the pension plan, then it should be noted that other plan design options are available for reducing or transferring risk that do not require sacrificing the plan's investment efficiency."

"If the motivation for a conversion to DC is to address an existing unfunded liability, then it should be noted that converting to DC does nothing to address past-service unfunded liability that a plan may have accumulated."


Questions

Cathie G. Eitelberg

Senior Vice President, National Director, Public Sector Market, Washington, DC

Expertise

Ms. Eitelberg is a Senior Vice President in Segal's Washington, DC office. She has over 30 years of public policy experience with a focus on employee benefits and public finance. Ms. Eitelberg is the firm's National Director of the Public Sector market and a member of its Senior Management Team.

Ms. Eitelberg's specialized expertise includes:

- Public pension policy, design and governance,
- Public finance and plan administration, and
- Total rewards strategies.

Ms. Eitelberg's past and current clients include: the State of Nevada Public Employees' Retirement System, the State of North Dakota Public Employees' Retirement System, the Maryland Supplemental Retirement Plan, National Conference of Public Employer Retirement Systems (NCPERS), Ohio Public Employees Retirement System, the City of Duluth Teachers' Retirement Fund, the Indiana Public Employees' Retirement Fund and Indiana Teachers' Retirement Fund, the American Federation of Teachers, the New Jersey Education Association and the Nebraska Public Employees Retirement System.

Professional Background

Ms. Eitelberg serves on the advisory committee to the Board of the National Association of State Retirement Administrators (NASRA), the Industry and Legislative Committee of the National Association of Government Defined Contribution Administrators (NAGDCA) and as an advisor to the Committee on Pension and Benefits Administration of the Government Finance Officers Association (GFOA). She has also served on several committees of the International Foundation of Employee Benefit Plans (IFEBP) and is a founding member of the Arthur N. Caple Foundation managed by NAGDCA. Ms. Eitelberg received the 1995 Private Sector Financial Excellence Award from the Association of Government Accountants.

Publications/Speeches

Ms. Eitelberg lectures and writes on public retirement and health topics. She is frequently quoted in the press and is an accomplished speaker.

Recent articles by Ms. Eitelberg include:

- "Taking Control: How Effective Communications Can Help Public Employers Navigate Change" by Cathie Eitelberg and Tupper Hillard, IPMA HR News, November 2014
- "Actuarial Funding Policy Guidance: Comparison of Recommendations Reveals Considerable Consensus — and a Few Notable Differences," Public Sector Letter, October 2014
- "GASB Exposure Drafts Propose New Disclosures for Other Postemployment Benefits (OPEB)," Bulletin, September 2014
- "GASB's Second Implementation Guide on Pension Plan Financial Reporting Provides Guidance for Employers," Compliance Alert, June 10, 2014
- "Moody's Revised New Approach to Adjusting Reported State and Local Government Pension Data," Segal Bulletin, April 2013
- "Competing for Talent as the Economy Improves," by Cathie G. Eitelberg and Elliot R. Susseles, IPMA HR News, March 2013
- "Gearing Up to Comply with GASB's New Accounting Standards for Public Sector Pension Plans and Sponsoring Employers," co-author, Segal Public Sector Letter, November 2012

Ms. Eitelberg frequently leads webinars and speaks at conferences that educate clients about important developments affecting retirement and health benefit plans. Some of the issues she has addressed include:

- "The Future of Public Employers in Health Benefits," Washington, DC, NCPERS 2015 Healthcare Symposium, January 2015
- "The Future of Retirement in America," Public Pension Forum, October 2014
- "Building on the Past to Prepare for the Future," Segal's 16th Annual Fund Administrator's Seminar, May 2014
- "How to Think About the Future of Health Care," National Conference on Public Employee Retirement System, January 2014
- "Five Steps to Saving Pensions," CoRPaTH Winter Think Tank, December 2013
- "What They Don't Know Might Hurt You: Trustee and Fiduciary Education," 107th Government Finance Officers Association Annual Conference, June 2013
- "Claims and Insurance Coverage Issues," Public Sector Fiduciary Liability Insurance Webinar, April 2013
- "The Appian Way to Plan Reform," 15th Annual Klausner, Kaufman, Jensen; Levinsen Client Conference, March 2013
- "Blue Cross Blue Shield Labor: A Working Advantage," National Labor/Management Healthcare Strategies Conference, March 2013
- "Planning a Successful Funding Policy," Segal Webinar, January 2013
- "Public/Private Retirement Security: The New Dating Game," National Conference on Public Employee Retirement Systems 2012 Public Safety Conference, October 2012 and NASRA Directors and Affiliate Directors Workshop, August 2012

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Thank You!

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Supporting Retirement Security for America's Teachers

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June 1, 2015

House Democratic Policy Committee
Commonwealth of Pennsylvania
414 Main Capitol Building
Harrisburg, Pennsylvania 17120

Members of the House Democratic Policy Committee:

I am writing to you on behalf of the National Council on Teacher Retirement (NCTR) in connection with your June 4, 2015, hearing on retirement security from a national perspective.

NCTR, founded in 1924, is an independent 501(c)(6) association dedicated to safeguarding the integrity of public retirement systems in the United States and its territories to which teachers belong, and to promoting the rights and benefits of all present and future members of these systems. NCTR membership includes 68 state, territorial, and local pension systems—including the Pennsylvania Public School Employees' Retirement System (PSERS)—which serve more than 19 million active and retired teachers, non-teaching personnel, and other public employees, with combined assets of over $2 trillion in their trust funds.

NCTR believes that all Americans should have access to a pension plan that will provide adequate and reliable retirement security, and therefore appreciates this opportunity to address retirement security from a national perspective.

First, NCTR firmly believes that there is a retirement crisis facing our country. Consider the following:

- Americans themselves think so! According to the National Institute on Retirement Security (NIRS), 86 percent of Americans believe that the nation faces a retirement crisis; a recent PBS survey put the number at 92 percent.
- A survey done by Alliance Life Insurance Company showed that substantially more Americans feared a retirement shortfall than feared death. (Jean Chatzky, Financial Editor, *NBC Today*)
- In 2013, the typical working household approaching retirement with a 401(k) plan had only $111,000 in combined 401(k) and IRA balances. This amount translates into less than $400 per month, adjusted for inflation. (Alicia Munnell, Director, Center for Retirement Research at Boston College)

- When all households are included—not just households nearing retirement with retirement accounts—the median retirement account balance is $2,500, which is $500 less than the comparable number from 2013, and nearly 40 million working-age households (45 percent) have nothing at all set aside for retirement. (NIRS)
- White families have more than $100,000 more in average liquid retirement savings than African American and Hispanic families, and this gap has quadrupled in the last 25 years. (The Urban Institute)
- Federal tax subsidies for employer-based retirement savings plans total $714 billion for FY2013-17, according to the Congressional Budget Office (CBO). Yet, in 2013, the lowest income quartile got only 0.7 percent of this subsidy, while the top quintile got 68.4 percent. (Michael Grinstein-Weiss, Associate Professor, Washington University, St. Louis, MO)
- Social Security replacement rates for the average worker retiring at 65 will be just 31 percent by 2030, when Medicare Part B premiums alone are estimated to consume 10.4 percent of the average Social Security benefit. (Munnell)
- Social Security and Supplemental Security Income account for more than 90 percent of income for retirees in the bottom 25 percent of income distribution, and 70 percent of annual income of retirees in the middle 50 percent. (Grinstein-Weiss)
- According to the Pew Charitable Trusts, 48 percent of parents are providing financial support for kids over age 18, 21 percent are providing support to parents over age 65, and 15 percent are doing both.
- From 1992 to 2010, the percentage of consumers age 65 to 74 with mortgage debt doubled from 17 percent to 35 percent. Among those aged 75 and up, it more than doubled from roughly 8 percent to nearly 22 percent. (Chatzky)
- 72 percent of Americans plan to stay in their current job as long as possible (NIRS), but each person who delays retirement can block 5 or more jobs; if 4 percent of employees are retirement eligible and half of them choose to delay retirement, 10 percent of employees would experience promotion blockage. (Arthur L. Noonan, Senior Partner, Mercer)

NCTR is therefore very concerned that, overall, Americans are woefully unprepared for retirement, and that the consequences of this lack of preparedness will place a significant strain on families, communities, and the nation's social safety net.

Furthermore, when workers have not saved enough to meet their retirement needs, many will simply have to continue at their current jobs. This can have a serious impact on employers, who will be paying higher salaries to these longer-tenured workers. Also, as some experts have warned, continuing to work primarily because they can't afford to retire can seriously impact these workers' morale and productivity. Finally, other employees' career advancement can be blocked, as Mercer notes, with serious ramifications for an employer's overall workforce talent.

In short, America's economic future will pay the price of a failed retirement policy.

That is why, in the public sector, state and local governments have worked diligently for over a century to build and maintain retirement systems that offer real protection from financial risk and provide a guaranteed stream of income for life that is adequate and affordable. They have done so by providing public pension plans that are designed to:

- Assure self-sufficiency for retirees by providing a predictable benefit that is guaranteed for life, including cost-effective disability and survivor benefits.
- Create a high performance workforce by providing a benefit that will attract and retain quality and highly trained public employees.
- Lower overall benefit costs by pooling the risk of outliving retirement benefits and of investment losses over the total number of participants.
- Invest plan assets at a low cost in order to produce (1) predictable cash flow for payment of recipient benefits that contribute to state and local economies; (2) earnings that reduce future employer and employee contributions; and (3) a large pool of capital that provides entrepreneurial funding that would not otherwise be available to strengthen the economy.
- Provide flexibility that helps state and local governments maintain an effective workforce.

Consequently, despite frequent media reports to the contrary that point to the exception and not the general rule, the state of America's public pensions is sound. Consider, for example, the following:

- The "Wilshire 2015 Report on State Retirement Systems: Funding Levels and Asset Allocation" found that the funding ratio for the 131 state defined benefit retirement systems covered in its study was 80 percent in 2014, up from 74 percent in 2013.
- Despite the fact that the 2008-09 market decline reduced public pension asset values by 25 percent, they were once again above their 2007 peak by 2013, according to the National Association of State Retirement Administrators (NASRA), and as of 9/30/2014, state and local retirement trusts held $3.7 trillion in assets, according to the Federal Reserve.
- This remarkable comeback has been accomplished at the same time that public plans distributed more than $1 trillion in benefits to more than eight million retirees and their survivors, and required, on a nationwide basis, only 3.9 percent of all state and local direct general spending in order to do so. (U.S. Bureau of the Census)
- Despite sharp declines in capital markets in 2000-02 and again in 2008-09—with accompanying economic recessions that caused required pension contributions to rise significantly at the same time that the ability of states and local governments to respond was severely challenged—public plans received an average of 89 percent of their annual required contributions (ARCs) during the FY 2001-2013 period. Only six states averaged less than 75 percent, while half the plans got 95 percent of their ARCs. (NASRA)

- More than one half of the 126 plans in the Public Fund Survey have reduced their investment return assumption since FY2008; the median is now 7.75 percent. (NASRA)
- Since 2009, 36 states have increased required employee contribution rates. (NASRA)
- In September, 2014, Moody's claimed that the 25 largest U.S. public pensions face about $2 trillion in unfunded liabilities. However, over the next 30 years, total US economic activity will be more than $750 trillion, assuming 2.5 percent average annual growth in real GDP. "Split it up over 30 years and the alleged pension shortfall comes to $67 billion a year or about 0.26 percent of GDP." (Ryan Chittum, former *Wall Street Journal* reporter and deputy editor of the Columbia Journalism Review's business section.)
- In April, 2014, the Pew Charitable Trusts reported that state pensions had incurred unfunded liabilities of $915 billion based on 2012 data. But looked at another way, this shortfall is equal to approximately 0.2 percent of projected GDP over the next thirty years, the period over which the shortfall would have to be filled; alternatively, it is equal to about 2.0 percent of projected state and local tax revenues over this same period. (Dean Baker, co-founder of the Center for Economic and Policy Research)

NCTR is therefore hopeful that, as the Pennsylvania legislature considers possible changes to the existing retirement security model for Pennsylvania's public employees, it will "do no harm" in its work on pensions, particularly with regard to the important need to provide Pennsylvania's children with the best quality education by continuing to attract and retain the best possible teachers. In this regard, we believe that the important role of the retirement security model currently in use in Pennsylvania in meeting this need should be carefully, completely and independently documented by those who do not have potential conflicts of interest with regard to the outcome of such analyses. Also, the impact on employee turnover of recent changes in other states similar to those under consideration in Pennsylvania should be fully examined before any major modifications are considered.

NCTR would also encourage the Pennsylvania legislature to closely examine the work of NIRS in assessing the most cost-effective manner in which to provide whatever level of retirement benefits the legislature deems appropriate for Pennsylvania's public employees. NIRS' work has consistently shown that pension plan designs similar to that currently in use in Pennsylvania are a far more cost-efficient means of providing retirement income as compared to individual defined contribution accounts. Without clear and convincing evidence to the contrary, we would urge policymakers to be very cautious in abandoning a tried and tested model, when properly implemented, in favor of a new design that may promise to cap costs, but in practice will only cut benefits and, in doing so, ultimately diminish the overall quality of public services.

In summary, NCTR believes that while the public sector, overall, is doing an admirable job in providing its employees with retirement plans that offer them the ability to earn a safe, sustainable, affordable and secure lifetime income benefit, the nation as a whole faces a serious retirement security crisis. I would also like to reiterate that in the governmental sector, public pension plans are designed to provide a core retirement benefit that will help assure vital taxpayer services by providing cost-effective retirement benefits that attract and retain qualified employees. Public pension systems such as PSERS help ensure a stable retirement income for those who dedicate their career to serving the public, and I would again caution the Pennsylvania legislature to be very careful in making fundamental changes in the successful model currently in use in the Commonwealth.

Thank you for this opportunity to comment.

Sincerely,

Meredith Williams
Executive Director

June 4, 2015

WILL PROPOSED CHANGES TO PENNSYLVANIA PENSIONS SAVE TAXPAYERS MONEY?

House Democratic Policy Committee Hearing
Harrisburg, PA

Monique Morrissey
Economist, Economic Policy Institute
mmorrissey@epi.org

Economic Policy Institute
Research and Ideas for Shared Prosperity

Economic Policy Institute

- Nonprofit, nonpartisan think tank created in 1986 to include needs of low- and middle-income workers in policy discussions.
- Presentation based on:

  Will Switching Government Workers to Account-type Plans Save Taxpayers Money?

- www.epi.org

SB1 Overview

- Reduces value of DB pension benefits for **current employees**
  - Workers choose between lower multiplier or higher employee contribution
  - Higher discount rate for lump sum distributions
  - Anti-spiking provision

SB1 Overview

- For **new hires**
  - Reduces employer contributions
  - Replaces traditional DB pension with hybrid DC–cash balance plan (mostly DC)

SB1 Overview

- Delays paying down **legacy costs**
  - Extends amortization period
  - SERS employer contributions based on cost of new hybrid plan, not cost of benefits for all employees

SB1 Overview

- Reduces value of DB benefits for **current employees**
  - Court challenge
- Slashes retirement benefits for **new hires** and switches to account-type plan (mostly DC)
  - Account-type plan *less* cost-effective (lower returns, loss of risk pooling, higher administrative costs)
- Delays paying down **legacy costs**
  - Is this the goal?!

Will SB1 save taxpayers money?

- Cuts for current employees challenged in court
- Can we keep putting off legacy costs (they're not going away)?
- **Is it realistic to think you can slash pensions without higher pay?**

Will SB1 save taxpayers money?

- Economists generally assume benefits come out of wages, and any cuts must be offset by higher pay
- Taxpayers may save money if...
  - Labor markets aren't competitive
  - Workers value retirement benefits less than other compensation (shortsighted... or newly distrustful?)
  - Account-type plans are more popular with workers

Will SB1 save taxpayers money?

- Josh McGee of Arnold Foundation concedes that DC and cash balance plans don't save taxpayers money (but claims they're fairer)
- Other questions:
  - Why did private sector switch to DC plans?
  - Do account-type plans reduce taxpayer risk?
  - Do DB pensions help recruit and retain good workers?
  - How do account-type plans affect retirement decisions?

Will SB1 save taxpayers money?

- Labor market isn't competitive?
  - Arguably true for some privileged insiders (beware of anecdotal evidence!)
- Workers value DB pensions less?
  - Public sector workers consistently choose DB pensions and are willing to pay for them

Public vs. Private Sector

- Public sector workers are paid less than private sector counterparts but get better benefits
- Total compensation is lower in public sector
  - Except for least skilled workers ("high road" employer)
  - Taxpayers get a bargain due to job satisfaction from public service (and more efficient benefits?)
  - Research consensus, unless you use a *very* low rate to discount future pension obligations (AEI)

Public vs. Private Sector

- Public sector workers better educated/trained and informed about retirement
- DB pensions recruit career-minded workers
  - – Long learning curve for teachers
  - – Significant training costs (and short careers) for public safety workers
- Public sector workers contribute to DB pensions
  - – Private sector workers don't (but do bear 2/3 DC cost)
  - – Public sector workers now shoulder half DB normal cost

Public vs. Private Sector

- Why did private sector switch to DC plans?
  - – Stock market optimism (long gone!)
  - – In private sector, only DC plans permit cost sharing
  - – Risk shifting
  - – "Ownership Society"

Public vs. Private Sector

- 401(k) inventor says experiment failed
  - Median retirement account balance for households approaching retirement is $14,500 ($2,500 for all working-age households)
- Why don’t private sector employers switch back?
  - DB plans are long-term commitment
  - Accounting liability
  - Rules exacerbate funding volatility
- **Private sector not good model for public sector**

What about risk?

- DB pensions pool risk across workers, generations
  – Insure individuals against longer-than-average lifespans
  – Insure individuals against worse-than-average returns
  – Employers bear cohort longevity risk and long-term market risk (but contributions adjusted gradually)
- Account-type plans shift risks to workers
  – Inefficient loss of risk pooling: Employers shed some risk, but workers shoulder much more

What about underfunding?

- Pew/Arnold suggest account-type plans will eliminate funding risk and improve transparency
  - *Why?*
- Severe pension underfunding in PA and other states almost always due to failure to pay ARC, not lack of transparency
- No reason to believe cash balance plans will discourage underfunding (and little to prevent DC cuts)

Distribution of benefits

- Account-type plans turn retirement into a gamble
- ...increase turnover
- ...introduce perverse retirement incentives (workers delay retirement during recessions)
- Nothing inherently fair about cash balance plans (depends on interest credit)

Young and mobile workers

- Critics say DB pensions unfair to young and mobile workers
- DB pensions easier for workers to understand
  – Recruitment tool
  – Retirement planning
- Unlikely that DC plans appeal to the kinds of workers public employers are trying to recruit
- Mobile workers usually cash out DC accumulations

Conclusion

- Public sector workers value secure pensions
- Cuts will lead to offsetting pay increases, not cost savings

Conclusion

- Pension changes proposed in SB1 appear designed to repel prospective workers and degrade quality of public services

Pennsylvania House State Government Committee
Senate Bill 1
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Testimony of

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Chairman Metcalfe, Democratic Chair Cohen, and Members of the Committee - thank you for allowing me to submit written testimony on this important matter regarding retirement benefits for Pennsylvania state and school employees.

NASRA is an association whose members are the directors of the largest state, statewide, and territorial public employee retirement systems in the United States. Collectively NASRA members are responsible for the management of nearly 2/3 of the nearly $3.8 trillion held in trust to provide retirement benefits for 14 million working and 9 million retired employees of state and local governments.

The purpose of an employer sponsored retirement benefit is to meet the unique objectives of plan stakeholders, chiefly public employers, employees, and taxpayers. Generally, public employers want to be able to attract, retain, and provide for the orderly turnover of a skilled professional workforce while maintaining budget stability and predictability. Public employees want a competitive compensation package that includes secure, reliable retirement income. Taxpayers want public services delivered in a professional and cost-efficient manner.

These objectives can both conflict with and complement one another. A retirement plan design focused on one of these objectives, to the exclusion of others, is likely to produce unintended negative outcomes.

It is, however, possible to design a retirement plan that meets all desired objectives. While there have been an unprecedented number of changes to public retirement plans in recent years, nearly all state and local governments have retained key elements of plan design known to promote retirement security, assist in workforce management, and meet the unique objectives of their stakeholders. These key principles include:

- **Mandatory participation:** Most state and local employees are required, as a condition of their employment, to participate in their statewide retirement system.

- **Shared financing:** Nearly all public employee retirement systems require periodic contributions from both employees and participating employers. Public employees typically are required to contribute 5 to 10 percent of their wages on a tax-deferred basis to their state or local pension.

- **Assets that are pooled and professionally invested:** Employee and employer contributions are pooled and invested by professional staff to take advantage of lower fees, greater portfolio diversity and economies of scale to grow the fund from which benefits are distributed.

- **Targeted income replacement in retirement:** Retirement policies aim to replace a certain percentage of pre-retirement wages to better assure financial independence in retirement.

- **Mandatory annuitization:** Benefits are required to be distributed in installments over a member's retired lifetime, which ensures the benefit cannot be exhausted or outlived. Age and service requirements that must be met to begin distributions promote an orderly turnover of personnel.

Plans that include these elements provide greater certainty for employees and employers and in doing so promotes key human resources objectives including enhancing the ability of employers to plan for the management of a professional workforce. As such, NASRA has long supported these core, indispensable elements of public plan design as guiding principles to plan sustainability.

Every state is unique with respect to its public sector workforce needs and fiscal situation, but some overarching public pension issues have unfolded among all states in recent years. The effects of the two most recent economic recessions on state and local governments are well documented. Public employee retirement systems, like many large institutional investors, lost more than 20 percent of their value as a result of the sharp decline in the global equity market in 2008. Recent improvements in global equity markets have pushed assets above pre-recession levels, but this recovery is not reflected in aggregate funding levels due to the process of actuarial smoothing, a method that enhances contribution stability by recognizing investment gains and losses over a prescribed period of time.

The investment losses associated with sharp declines in capital markets that occurred in 2000-02 and 2008-09 increased the unfunded portion of pension liabilities in every state and caused pension contributions to rise, exacerbating the strain felt by state and local governments who were pressured to continue normal operations and delivery of core services in an environment of reduced tax revenues.

In Pennsylvania, PSERS and SERS additionally received far less than their required pension contribution for a number of years. The percentage of required contributions received has risen, gradually, for both systems. This represents a positive trend in restoration of full funding with a commitment to continue on this path.

In response to the drop in funding levels, between 2009 and 2014 nearly all states, including Pennsylvania, passed reforms to restore or preserve the sustainability of their public employee retirement plans. The most common changes were increases to required employee contributions, benefit reductions (including both the primary benefit and postemployment benefit increases, or COLAs), and increases in the eligibility requirements which must be met to qualify for normal (unreduced) retirement benefits. A handful of states passed reforms that included a hybrid plan design, which pertained to new hires only, in all but one case. These hybrid designs generally marry a diminished defined benefit with a defined contribution, or individual account component. So far only one state in this most recent period has adopted a defined contribution plan as the primary benefit for a broad employee group, which will apply to those hired after November 1 of this year.

In 2010 the Pennsylvania legislature passed a package of pension reforms. Act 120 of 2010 established a new tier for newly hired teachers and state workers that included the following changes:

- An unchanged employee contribution rate with a reduced retirement multiplier, from 2.5% to 2%;
- An option to retain the 2.5% multiplier with an increased contribution rate;
- Increased eligibility for normal (unreduced) retirement.;
- Increased the vesting period from 5 years to 10 years;
- Eliminated the lump sum withdrawal “option 4”;
- Established a shared-risk provision which automatically increases employee contribution rates if actual investment returns do not meet the assumed rate over a three-year period.

The Pennsylvania reforms were among the most substantial and comprehensive in the nation during this period. Retirement system staff calculate that 18.6 percent of PSERS and 23 percent of SERS membership, respectively, are covered by Act 120.

Research from NASRA and the Center for State and Local Government Excellence measured the degree to which recent pension reforms reduced the initial retirement benefit expected to be received by newly hired workers. Reductions ranged from less than 1 percent to as much as 20 percent and new hires in Pennsylvania were among those whose expected retirement income was reduced by 20 percent relative to the pre-reform benefit terms. Using this same analysis, SB 1, would reduce expected retirement income by an additional 30 percent for SERS and 41 percent for PSERS, respectively, from Act 120 levels. This likely could have an impact on the ability of the pension to serve as a tool for hiring and retention, as well as place pressures on other expenditures, such as other forms of compensation and training costs.

Fully funding the pension system should be a requirement for any sponsoring government. The fact that some systems have accumulated significant unfunded liabilities should not be overlooked or repeated. However, pension benefits are paid out over many years, not all at once, and the restoration of full funding is a path that usually cannot be achieved all at once. For example, closing a defined benefit plan and replacing it with a defined contribution plan as the primary retirement benefit does not resolve the unfunded liabilities of the original plan. Research published by the National Institute on Retirement Security even suggests that an action such as this can sharply increase the associated employer costs, since a closed plan has very different liquidity needs and, as such, utilizes a much more conservative investment strategy, than a plan that is open to new participants. Research published by the Center for Retirement Research at Boston College has identified that plan administrative and investment costs are higher, to produce the same level of benefit, for a DC plan than for a DB plan. Without the ability to take advantage of pooled investment and longevity risks a likely scenario is a rise in employer costs or a significant reduction in benefits for new hires. These are just two of many implications that should all be considered as part of a measured approach to restore the pension funding stream in a manner that takes into consideration the needs of all stakeholders.

Also, retirement benefits should be only one consideration in the overall landscape of public employee compensation, which includes salary and other benefits. In a traditional pension plan, the ability of an employer to provide a secure retirement benefit attainable at a certain level of eligibility provides for the ability of the employer to replace older, more highly paid workers with younger, lower paid workers. This turnover can be anticipated and planned for to retain and transfer the institutional knowledge lost by those who elect to retire.

Crafting a retirement plan involves the consideration of multiple objectives. It is possible to design a plan to meet the objectives of all stakeholder groups. A plan that encompasses key principles of sound retirement plan design, namely mandatory participation, shared financing, pooled and professionally managed investments, targeted income replacement and required annuitization, is one that is likely to produce a more positive outcome for all involved.

As a final note, attached to this testimony please find the following resources:

- NASRA Resolution 2010-01: Guiding Principles for Retirement Security and Plan Sustainability
- NASRA Memo: Pennsylvania Pension Reform Supplemental Analysis

Again, I thank you for inviting me to testify on this important matter. If you are interested, NASRA can provide additional information and facts on strategies that have been utilized by retirement systems around the country. I would be pleased to address any questions.

NASRA

MEMORANDUM

PENNSYLVANIA PENSION REFORM SUPPLEMENTAL ANALYSIS

Since 2009 nearly every state has passed significant reforms to their pension plans for major public employee groups. These actions have generally taken the form of increased contributions, benefit reductions, or both. In a handful of cases states have closed their existing pension plan and replaced it with a different plan design, generally a hybrid plan taking the form of either a cash balance plan or a combination hybrid which marries a diminished defined benefit plan with a defined contribution plan.

In 2010 the Pennsylvania legislature passed a package of pension reforms affecting new participants in the State Employees Retirement System and the Public School Employees Retirement System. These reforms included the following provisions:

- An unchanged employee contribution rate with a reduced retirement multiplier, from 2.5% to 2%.
- An option to retain the 2.5% multiplier with an increased contribution rate.
- Increased eligibility for normal (unreduced) retirement.
- Increased the vesting period from 5 years to 10 years;
- Eliminated the lump sum withdrawal "option 4";
- Established a shared-risk provision which automatically increases employee contribution rates if actual investment returns do not meet the assumed rate over a three-year period.

A 2013 study by NASRA and the Center for State & Local Government Excellence examined the impact of recent state pension reforms on newly hired workers[1]. The study included an analysis which evaluated the benefit produced under post-reform conditions with the original, pre-reform benefit. The study found that, if new state and school employees in Pennsylvania elected to retain the pre-reform contribution rate, they would experience a 20 percent reduction in their benefit vis-à-vis the benefit available to existing workers. This reduction was the most significant of any observed in this analysis. Retirement system staff calculate that 18.6 percent of PSERS and 23 percent of SERS staff, respectively, are covered by Act 120.

The changes for new hires proposed in Senate Bill 1 would make further reductions in benefits for new hires. The aforementioned NASRA/SLGE study included an evaluation of new hybrid plans, with benefit levels determined using a set of reasonable assumptions to project benefits.

The chart below compares the benefit levels produced under the plan provisions pre-Act 120, Act 120, and Senate Bill 1for SERS and PSERS as proposed, as we understand the legislation. For comparison, an "average" hybrid benefit is included, the product of which is the plans included in the NASRA/SLGE study. Solid bars represent guaranteed levels of benefits provided by defined benefit or cash balance plans, and patterned bars represent variable benefit levels provided by defined contribution plans.

[1] See full report on NASRA.org http://www.nasra.org/content.asp?admin=Y&contentid=210

Figure 1. Benefits as a percent of final average salary: Pre-Act 120, Act 120, SB 1

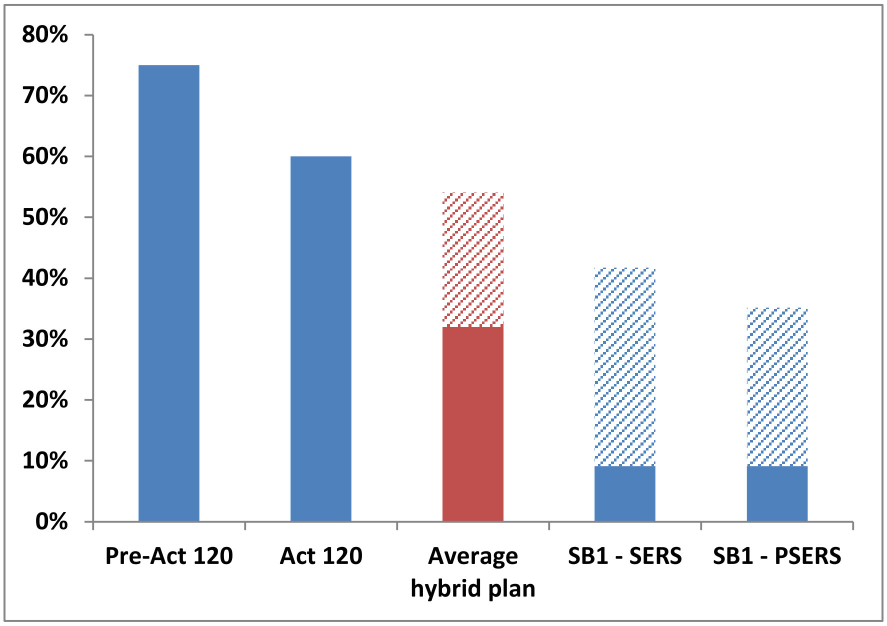

Figure 1. Assumptions

Pre-Act 120: Benefits calculated for state and school employees hired before 7/1/11 are calculated using a 2.5% multiplier.

Act 120: State and school employees hired as of 7/1/11 will elect to retain their contribution rate and accept a reduced multiplier of 2%.

SB 1: Cash balance benefits are projected using employee contributions of 3% and an interest crediting rate of 4%, compounded over 30 years. The benefit is annuitized for a 25-year term. Defined contribution benefits are projected using default contributions (5.59% for PSERS, 7% for SERS) and an annual return of 6.50%, compounded over 30 years. The balance is annuitized for a 25-year term.

Cost-of-living adjustments (COLAs) are not included in this analysis

The benefits produced by the Pennsylvania plans using the NASRA/SLGE model are below those provided by the Act 120 benefit and the average hybrid plan. Specifically, the defined benefit component of the SB 1 plan is much smaller than the average defined benefit plan of the other hybrid plans examined. This is primarily due to a relatively modest cash balance benefit.

As the NASRA/SLGE study found, one of the most important factors in the ability of a cash balance or defined contribution plan to deliver adequate retirement income is the level of contributions made to the plan. The cash balance plan proposed by SB 1 for new SERS and PSERS participants requires employees to contribute 3 percent of pay; there are no employer contributions to this plan. This rate is below that which is required for all other statewide cash balance plans which serve as a primary or supplemental benefit option; total contribution rates in other plans generally range from 4 percent to 10 percent, depending on many factors[2].

The ultimate level of retirement income from a hybrid plan with a diminished defined benefit component relies heavily on the investment performance of assets in members' individual defined contribution accounts. With such a large percentage of the retirement benefit variable, subject to fluctuations in the capital market, replacing a targeted level of income in retirement becomes more difficult. Moreover, the risk of a market downturn shortly before retirement, which could eliminate a significant portion of retirement assets in individual accounts, becomes a major factor in determining the level of retirement income.

Our research shows, and many states exemplify the idea, that any type of retirement plan—defined benefit, defined contribution, or cash balance-- can be crafted to meet the diverse objectives of stakeholders, including recruitment and retention of a qualified public sector workforce, stable and predictable employer costs, and a secure, lifetime income in retirement for public employees. The more important factors in determining the level and reliability of retirement income are the presence or absence of core retirement plan design features known to promote retirement security, including mandatory participation, pooled assets that are invested professionally, employee-employer cost-sharing, targeted income replacement, and required annuitization.

[2] NASRA Issue Brief: State Hybrid Retirement Plans http://www.nasra.org/hybridbrief

RESOLUTION 2010-01 - GUIDING PRINCIPLES FOR RETIREMENT SECURITY AND PLAN SUSTAINABILITY

WHEREAS:

- State and local government employee retirement systems have demonstrated the ability to thrive in highly volatile market environments; and

- The resilience of public plans during periodic market declines is sustained through long-term investment and financing strategies; statutory, contractual, moral, and in some cases constitutional benefit protections; as well as the ability to adjust plan designs, financing structures, and governing statutes to accommodate changing needs and fiscal realities; and

- Needed periodic modifications, which have a history in state and local government retirement plans, require an open public legislative and regulatory process involving all stakeholders - governments, their plans, their employees (who typically share in the financing of their pension), and other taxpayers; and

- This open public process requires honest, unbiased and relevant information on public financing and long-term retirement policy objectives that should not be unduly influenced by projections that include unrelated healthcare liabilities or irrelevant corporate sector metrics, or that exclude relevant data regarding the inefficiencies and steep transition costs of closing, rather than adjusting existing plans; and

- Differing plan designs, financial conditions, and fiscal frameworks across the country do not lend themselves to one-size-fits all solutions, but rather, require a range of tailored approaches, agreed to by the relevant stakeholders, in order to best secure the viability of each state and local retirement system for the very long-term; and

- Core elements of public pension plan design – which include mandatory participation, benefit adequacy, shared financial responsibility, pooled assets invested by professionals over long time frames, and benefits that cannot be outlived – are the most reliable and economical means of providing retirement security, while also assisting in the retention of qualified workers needed to perform essential public services and providing economic stability to local communities; and

- These core components of public pension plan design are indispensable to sound retirement policy and not only should be retained in current and future benefit designs in the public sector, but also should be cultivated in the design of retirement plans for employees outside the public sector; and

- Federal policy should be supportive of these central features of public pension design and the flexibility of state and local governments to meet local needs and concerns, and should also encourage the development of similar design characteristics in retirement plans beyond the public sector;

NOW, THEREFORE, BE IT RESOLVED, that the National Association of State Retirement Administrators:
Supports the following guiding principles to retirement security and public plan sustainability:

- Participation of all relevant stakeholders, including government employers, their plans, their employees, plan beneficiaries and retirees, and other taxpayers in discussions and processes pertaining to the design and financing arrangements of public retirement plans

- Policy-driven decision making based on objective and pertinent information that fairly reflects the long-term time horizon and economic effects of public plan financing, benefit adequacy and benefit distributions

- Tailored solutions, achieved by affected stakeholders working through the state and local legislative and regulatory processes

- Retention of core, indispensable elements of public plan design, namely mandatory participation, shared financing, benefit adequacy, pooled investment and longevity risks, and lifetime benefit payouts

- Removal of federal policy barriers to the preservation of these central retirement plan design features in the public sector and adoption of federal policies that encourage their inclusion in the private sector.

Adopted August 11, 2010