WHAT TO DO ABOUT PUBLIC PENSIONS?
OPTIONS FOR FUNDING AND REFORM
Report of the Public Pension Working Group

FOREWORD

Temple’s Center on Regional Politics (CORP) thanks the elected officials, representatives of business, labor, and the civic sector, and legal and financial advisors who over an eight-month period volunteered their time, judgment, and expertise as members of our public pension working group. These individuals -- who are listed herein -- demonstrated commendable cooperation across party, jurisdictional, and economic sector lines.

While individual members of the group don’t necessarily agree with every option identified herein, all agreed that the information assembled and the ideas discussed should be made available to policy makers in our state and region as they address pension funding and reform challenges. As noted in the report’s concluding comments, because this document is the product of an informal study group, not an advocacy organization, the group’s work has come to an end. If policy makers wish to pursue any of the options discussed herein, CORP is willing to support such efforts as a neutral convener and advisor, should it be requested to do so. Many group members will no doubt continue working as individual policy makers on the challenge of funding public pensions, a problem about which they obviously care a great deal.

We also thank the William Penn Foundation and Temple University for their support of this project and of the center’s mission of fostering dialogue and consensus on important issues in Southeastern Pennsylvania. As director of the center, I also want to acknowledge and thank the CORP staff for their fine work and continuing efforts toward this end.

Joseph P. McLaughlin, Jr., Director
Temple University Center on Regional Politics
This report discusses options about which some members of the working group have reservations and which, in some cases, they might oppose. Nevertheless, in the spirit of its discussions, the group felt that its work should be made available to other policy makers and to the public to inform debate on ways to address pension reform and funding issues.

**PA State Representative Chris Ross**, Chair, House Commerce Committee (R), and Co-Chair, Act 47 Municipal Distress Task Force, Local Government Commission, PA General Assembly

**PA State Representative John J. Taylor**, Chair, PA House Subcommittee on First Class Cities and Counties (R)

**Anna Wallace Adams**, Office of Finance, City of Philadelphia

**Marc D. Collazzo**, Office of PA State Representative John Taylor

**Rob Dubow**, Director of Finance, City of Philadelphia

**Christine Goldbeck**, Executive Director, PA House Urban Affairs Committee (R)

**Ronald Jumper**, Esq., Office of PA Senator Jay Costa, Democratic Leader

**Timothy J. Klarich**, Finance Director, Tredyffrin Township

**Richard J. Manfredi**, Township Manager, Warminster Township

**Antoinette Marchowsky**, Office of PA Representative Cherelle Parker, Chair, Philadelphia House Delegation

**James McAneny**, Executive Director, Public Employee Retirement Commission

**Pam McCormick**, Greater Philadelphia Chamber of Commerce

**Elizabeth McElroy**, Secretary-Treasurer, Philadelphia AFL-CIO

**Uri Monson**, Chief Financial Officer, Montgomery County

**Folasade A. Olanipekun-Lewis**, Chief Financial Officer, Philadelphia City Council President Darrell Clarke

**John Raymond**, Office of PA Senator State Vincent Hughes, and also representing PA Senator Shirley M. Kitchen, Chair, Philadelphia Senate Delegation

**Shannon Sargent, Esq.**, Office of PA State Senator Anthony H. Williams, Democratic Whip

**Joan Stern, Esq.**, Partner, Blank Rome, LLP

**David B. Thornburgh**, Fels Institute of Government, University of Pennsylvania

**Paul J. Wescler, III**, Commissioner, Springfield Township (Delaware County)

**Steven T. Wray**, Executive Director, Economy League of Greater Philadelphia

**Bobby Yerkov**, Office of Philadelphia City Councilman Brian O’Neill

**Meeting Dates**

|-------------------|------------------|------------------|--------------|

**Guests and Presenters**

**PA State Representative James R. Roebuck**, Chair, House Education Committee (D)

**Randy Albright**, Executive Director, PA Senate Appropriations Committee (D)

**James B. Allen**, Secretary, Pennsylvania Municipal Retirement System

**Jeff Clay**, Executive Director, Public School Employees’ Retirement System

**Daniel Connelly**, Director, Fairmount Capital Advisors, Inc.

**David Donley**, Executive Director, PA House Appropriations Committee (R)

**Vijay Kapoor**, Director, Public Financial Management

**Sandra Kurtz Baxter**, Managing Director, Fairmount Capital Advisors, Inc.

**Don Mooney**, Executive Director of Operations, Springfield School District (Delaware County)

**Steve Nickol**, Assistant Director, Retirement Programs, Pennsylvania State Education Association

At its initial meeting in May 2012, the Executive Committee of Temple University’s Center on Regional Politics (CORP) directed the center’s staff to identify options to address public pension funding challenges that were threatening the ability of the Commonwealth, municipalities, and school districts to maintain vital services and/or avoid significant tax increases. The center responded with two initiatives: (1) efforts to increase understanding of pension problems through publications and the sponsoring of a public symposium and (2) efforts to build consensus on potential options for addressing funding challenges by convening a cross-section of regional public and private sector leaders for informal but focused discussions supported by research. This report is the product of the second initiative.

During the summer of 2012, the center organized a working group that included public finance officers from Philadelphia and suburban jurisdictions, bipartisan members and staff of the General Assembly and Philadelphia City Council, representatives of the Greater Philadelphia Chamber of Commerce and the Philadelphia AFL-CIO, and legal and public finance experts. The membership of the working group is listed nearby. The co-chairs of CORP committees—Fiscal Policy and Governance, Economic Development, and Urban Affairs—were consulted in assembling the group, as were other members of the Board of Fellows.

Between September 2012, and April 2013, the working group met seven times at Temple’s Center City Campus and heard presentations from a wide range of public and private sector officials with public finance and pension expertise, many of whom are also listed in this report. In addition, CORP’s staff had dozens of individual meetings with state legislators and legislative staff analysts, public finance consultants, officials and advisors to public employee unions, and with executives and board members of the State Employees’ Retirement System (SERS), Public School Employees’ Retirement System (PSERS), and Public Employee Retirement Commission (PERC).

In addition to the input gathered from these meetings, the center’s staff reviewed dozens of national, state, and local studies of public pension funding problems and remedies proposed or undertaken in Pennsylvania and in other states, cities, and counties. Many of these studies are listed in the bibliography of this report. The staff also identified and reviewed all legislation attacking the pension funding problem introduced in the Pennsylvania General Assembly during the last session and in the current session. The options identified by the working group are summarized on page 4 and more fully discussed herein.

The staff interviews and research led to the publication in the fall of 2012 CORP’s Issue Memo, entitled The Problem of Funding Pensions. The Issue Memo, which is available on the center’s website (www.temple.edu/corp) outlined the pension funding problems facing the Commonwealth and its municipalities and school districts, with particular focus on the three largest systems: SERS, PSERS, and the City of Phila-
Philadelphia. In the aggregate as of fall 2012, these three systems accounted for almost $46 billion of the total $48 billion in unfunded liability facing Pennsylvania public employees and taxpayers. Table 1 in Appendix 1 updates the status of the three largest public funds. Table 2 updates the status of Southeast Pennsylvania’s municipal pension systems by level of distress. Table 3 compares the actuarial assumptions and earnings history of the three largest systems.

The Issue Memo also identified logical ways in which the Commonwealth and its jurisdictions could address underfunding problems. This report explores the logical options with more specificity and depth. As an example, the Issue Memo identified as options dedicating new or existing revenue sources to reducing unfunded pension liabilities. This report suggests that the City of Philadelphia’s one-percent sales tax due to expire on June 30, 2014, be extended and dedicated by law to reducing the unfunded liabilities of the City’s pension systems, accompanied by plan changes in statutes and labor contracts that make the system sustainable going forward.

Finally, the center sponsored a public symposium on January 18, 2013, in which top national, state, and regional experts and stakeholders participated. More than 100 public and private sector leaders, many of them members of CORP’s Board of Fellows, attended the symposium, the purpose of which was to enhance public understanding of pension funding problems, especially among leaders. The center’s Winter Bulletin summarized the presentations and discussions that took place at the symposium and is available on the center’s website.

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**Options for Funding and Reforming Public Pensions**

**Obtain New Resources**

-- Redirect existing state revenue streams to pay for pensions.
-- Obtain resources by restructuring other, non-constitutionally protected public employee benefits, primarily health care, and use the savings to help fund pensions.
-- Extend the one-percent City of Philadelphia sales tax due to expire June 30, 2014, and require by state law that revenues collected after that date be used to reduce the unfunded liability of the City’s pension system accompanied by changes needed to put the system on a sustainable path for plan members and taxpayers going forward.
-- Sell or lease resources (assets or revenue streams) to reduce unfunded pension liabilities.

**Reduce Pension Costs and Liabilities**

-- Restrict Act 205 state subsidies to paying for municipal pension benefits as opposed to administrative costs, creating incentives for increased efficiency and plan consolidation.
-- Reduce benefits for new hires and/or for current workers prospectively, including moving new hires to defined-contribution (DC) systems or hybrid systems (cash balance) systems.
-- Fully fund Commonwealth and school district pension obligations through higher appropriations and give reforms enacted in 2010 time to work.
-- Establish “stacked hybrid” pensions that provide a traditional defined-benefit (DB) plan for all public employees up to a predetermined salary level and a mandatory defined-contribution (DC) plan for all employees based on their salaries above the threshold.
-- Undertake long term borrowing and use the proceeds to buy out the remaining obligations to one or more groups of fund participants.
-- Address underlying causes of fiscal pressures affecting distressed municipalities.
-- Taking advantage of low interest rates, issue pension obligation bonds to reduce unfunded liabilities.

**Explore Innovative Paths to Meet Pension Funding and Reform Challenges**

-- Establish a task force of political, labor, and business leaders to forge consensus on legislation and labor contract changes needed to meet pension funding challenges.
-- Negotiate labor contracts and devise legislative solutions to funding challenges that are mutually contingent.
Members of the working group were guided by two rules of thumb designed to engender trust, candor, and openness to the widest possible range of ideas: First, no options were off the table, and second, all discussions were off the record. Members also agreed that while it was important to understand the genesis of public pension funding challenges if for no other reason than to guard against their recurrence, the focus of their efforts should be on finding solutions and not on assessing blame.

The group honored these guidelines, and consequently, both the discussions and this report deal with options about which some members have reservations and which in some cases they might oppose. Nevertheless, following through on the spirit of the discussions, the group felt that its work should be made available to other policy makers and to the public to inform debate on ways to address pending funding and reform challenges.

**Findings and Principles**

The group largely agreed with these facts and principles:

1. Benefits earned by retirees and by current workers are obligations that governments must pay. Any efforts to abridge those benefits would be unfair to workers and retirees and risk being struck down by the courts.

2. Benefits for future workers can be changed by legislation or through union contracts; in some cases, both would be required. Some group members also believe that some kinds of benefits for current workers can be changed prospectively, that is, after a date certain. Other group members believe the benefits promised workers on their first day on the job cannot be changed during their careers or after their retirement.

3. Even if future workers were denied pensions altogether, which no member of the group believed was either feasible or a good idea, the Commonwealth’s three largest pension funds would have unfunded liabilities. That is, their assets would not be sufficient to cover the present value of benefits already earned by retirees or current workers.

4. Changes from defined-benefit (DB) to defined-contribution (DC) systems for future hires will have higher costs for public employers in the short run but eventually lower costs and little or no employer risk in the long run. The duration of the “short term” -- and hence the tradeoff between “short” and “long” run employer costs and savings -- will vary depending on the plan.

5. Public pension policy should be designed to achieve the goals of affordable costs for taxpayers and adequate benefits for retirees, so plan members can reasonably expect to meet financial industry standards for replacement income, when Social Security and personal savings are taken into account.

6. Labor’s concerns should be addressed in pension legislation, and labor leaders should be at the table when pension policies are under discussion.

7. Given concerns about large and in some cases rapidly rising burdens that many pension systems are imposing on taxpayers, new resources should be linked to pension plan modifications -- including collective bargaining agreements -- that are necessary to assure the funds are on a sustainable path for both plan members and for taxpayers going forward.

8. The General Assembly should address pension funding challenges for municipalities as well as for PSERS and SERS in the current session rather than defer action on municipal funding challenges to an indefinite date in the future, as has been proposed by the Corbett administration and some legislative leaders.

9. The adequacy of public pension funds is coming under increasing scrutiny from public and private agencies, with the result that many governments will have to report much larger unfunded pension liabilities than they are currently projecting. (See the summary in the box on the following page.)

This report divides approaches to addressing pension funding challenges into three broad categories: Obtaining New Resources, Reducing Pension Costs and Liabilities, and Exploring Innovative Paths to Meet Pension Funding and Reform Challenges.
The Governmental Accounting Standards Board (GASB) rules requiring state and local governments by 2015 to report unfunded pension liabilities on their financial statements will show for many governments much larger pension debts than their official plan statements. Although the new rules will not automatically require governments to increase pension contributions, they may lead to credit rating downgrades and higher borrowing costs for some governments. Similarly, Moody’s Investors Service on April 17, 2013, announced adjustments it will make to official pension fund data for purposes of rating the credit of sponsoring governments, with the expected result that for many governments, the Moody’s calculation of net plan liabilities will be larger than the unfunded pension liabilities reflected in their actuarial valuations. Moody’s will adjust pension obligations using a 20-year amortization period discounted by a high-grade, long-term, taxable bonds index as opposed to the plans’ assumed rates of return. Citing pension concerns among other factors, Moody’s downgraded the Commonwealth from Aa1 to Aa2 with a negative outlook last year. Further, the federal Securities and Exchange Commission (SEC) and the State of Illinois have reached agreement on stiffer public disclosure requirements about the funding status of public pension plans in the wake of an SEC investigation of whether the state had misled bond buyers. The SEC also has charged the City of Harrisburg with securities fraud for misleading statements about its financial condition. These developments may cause other state and local governments to adopt more conservative standards for reporting pension liabilities and other forms of debt that affect their financial condition.

New Standards Will Require Many Governments to Report Higher Unfunded Liabilities

Obtaining New Resources

Redirect existing state revenue streams to pay for pensions.

As indicated in the CORP Issue Memo on pensions, dedicating existing revenue streams to pay down unfunded pension liabilities may be a more efficient use of those resources, but it does require cutting programs or finding new funding for functions previously supported by the revenue streams. It therefore involves policy tradeoffs and almost certainly formidable political opposition.

PERC has identified as an option redirecting state revenues now dedicated to helping support municipal pensions to reducing the unfunded liabilities of SERS and PSERS until these funds attain a certain funding threshold. These revenues from a tax on foreign fire insurance premiums total about $230 million a year. Rededicating these revenues would shift the burden of funding municipal pensions entirely to local taxpayers, although presumably the pension burden for school district taxpayers would be reduced. As discussed elsewhere in this report, the tax supports a municipal pension system widely regarded as inefficient. Recognizing the shift would impose additional costs on municipal taxpayers, PERC has identified as an option phasing in the shift over five years. Such a change would create severe hardships for many municipalities. An alternative approach discussed in this report would be to retain the subsidy but restrict its use to paying for benefits as opposed to administrative costs, thus incentivizing efficiencies and plan consolidations.

Another option discussed briefly by the CORP working group would be to redirect the 34 percent state tax imposed on slot machine revenues to paying down the unfunded liability of school districts. The slot machine tax now produces more than $800 million that is dedicated to tax relief. Some of that relief is distributed through the state’s Property Tax and Rent Rebate program, which sends payments directly to low-income senior citizens. The bulk -- more than $600 million -- is distributed through local tax reductions. School districts outside Philadelphia will receive over $508.8 million for property tax relief in FY 2013-14. In Philadelphia, $86.3 million of the gaming revenues will support wage tax reductions for city residents and suburban commuters, and $16.6 million will be used to compensate municipalities outside Philadelphia for their inability to collect their own wage taxes from residents who paid the Philadelphia wage tax.  

1. At the time the gaming tax was enacted, the City of Philadelphia asked that its share of the revenues be dedicated to wage tax relief for residents and commuters rather than school property tax relief. Municipalities outside Philadelphia are prevented by state law from collecting their own wage tax from their residents who are subject to the Philadelphia wage tax.
The $500 million from slot machine tax revenues distributed to school districts outside Philadelphia takes the form of credits on school property tax bills of owner-occupied housing. The credits average about $200 per homestead and range from roughly $50 in very wealthy school districts to more than $600 in very poor districts. Some group members felt that because the credits are reflected on school tax bills that often are rising by more than the amount of the credit -- perhaps partly due to rising pension burdens -- the credits are not necessarily accorded much significance by taxpayers.

According to a very preliminary analysis requested by CORP, the $600 million revenue stream could eliminate the school districts’ 44 percent share of the PSERS unfunded liability (approximately $13 billion) within 20 years. School district pension burdens would thus fall over time, until only the normal costs of the school districts’ share of the retirement system remained. Reduced pension burdens would benefit businesses as well as residents, but school districts could make up for the lost revenues from the slot machine tax by raising levies on businesses and residential owners alike.

Pursuing this option would engender significant opposition from Philadelphia and its business community unless the City either retained its gaming-financed wage tax relief or were provided with a compensatory revenue stream to support wage tax reductions. One possibility is that such revenues could be directed to the City from a larger share of revenues from a newly licensed gaming facility, should that occur.

The working group recognized this option would face significant political and technical hurdles. Assuming that Philadelphia’s wage tax relief could be preserved, the group felt that the option would be worth exploring as an alternative use of this revenue stream for school districts and property taxpayers across the state.

Another idea involves raising new gaming revenues as proposed in legislation introduced by Representative Paul I. Clymer (R-Bucks). According to a Pennsylvania Legislatives Services summary, HB 527 would require each slot machine licensee to collect a $2 per patron admission fee which would be transmitted by the licensee weekly to the state treasurer for deposit into the licensee’s account. The bill would require the state treasurer to transfer 50 percent of the moneys to SERS and 50 percent to PSERS.

The working group recognized that raising taxes to fund pensions is a logical option but one that does not appear to have sufficient support to be considered feasible in the current environment. PERC’s review of pension funding options summarizes yields from increases in the state sales and income taxes (2013b: 9). Labor leaders, some economists, and some Democratic legislators have argued that new revenues to fund pensions could be found by slowing corporate tax cuts, closing corporate tax loopholes, taxing high-end pensions (also suggested by one member of the working group), and by imposing severance taxes (as opposed to impact fees) on the extraction of Marcellus Shale gas (Finucane 2013; Keystone Research Center 2012). Act 205, governing municipal pensions, already allows municipalities to increase local taxes above current statutory limits if the purpose is to fund pensions, yet few if any municipalities have exercised this option, which could be considered further evidence of its perceived infeasibility. As reported by PA TownshipNews, “the last thing supervisors want to do is raise taxes for a controversial line item like employee retirements” (Ercolino 2012).

2. One potential source of new revenues that could be available to support pensions is a full extension of the sales tax to Internet purchases. The US Senate has passed and sent to the House legislation allowing states to tax goods purchased through the Internet even if the producers do not have operations within their borders. If enacted at the federal level and then adopted in Pennsylvania, this tax would probably produce several hundred million dollars in new revenues, although it appears unlikely it could be implemented in the FY 2013-14 Fiscal Year. Governor Corbett has supported the federal legislation.

3. According to the National Conference of State Legislatures, Pennsylvania’s exclusion of all retirement income, including private pensions, from taxation is broader than in any of the 41 states that levy income taxes. Only nine other states exclude federal, state, and local pension income from taxes (Snell 2011). One recent study concludes that state exemptions of pension income evolved in the 1970s as a tool to recruit high-spending but low-service-demanding (e.g., for schools and prisons) senior citizens. The authors conclude, however, that Pennsylvania’s exemption resulted from efforts to satisfy the state constitution’s uniformity clause because the legislature was determined to exclude Social Security payments. They further conclude that there is little evidence that seniors move primarily to take advantage of lower taxes (Conway and Rork 2012). A recent article in Governing suggests that given the growing costs of serving aging populations, states may start reexamining tax breaks for seniors (Lemov 2013).
--Obtain resources by restructuring other, non-constitutionally protected public employee benefits, primarily health care, and use the savings to help fund pensions.

In its review of options for funding pensions, PERC has noted that health care benefits for employees and retirees have generally not been accorded the constitutionally protected status that govern pensions, although health care benefit changes might have to be submitted to collective bargaining. PERC notes that the Commonwealth could modify health care coverage for employees and retirees (or even eliminate it for retirees) and direct the savings to the retirement funds (2013b: 11). Unions in other states have agreed to health care changes to protect pensions or have agreed to pension changes to protect health care benefits. Broader health care coverage as a result of the Affordable Care Act may lead to a reassessment of the degree to which health care benefits are a concern for current and retired public sector workers.4

Steve Nickol, assistant director of retirement programs for the Pennsylvania State Education Association and a former member of the Pennsylvania House of Representatives, and State Representative James Roebuck, (D-Philadelphia) Democratic chair of the House Education Committee, met with the group to discuss a proposal to consolidate health care plans for school employees into a single statewide system or a small number of regional systems. A 2004 study overseen by the Legislative Budget and Finance Committee (LBFC) and conducted by Hay Group, Inc., estimated that $585 million could be saved by establishing a statewide system to provide health care benefits for teachers and other public education employees. The study assumed that the new system’s benefits would be similar to those now provided to Commonwealth employees.5

Legislation to move public education employees toward statewide or regional health care plans has been introduced in subsequent sessions and won approval of the House Education Committee in 2008, when Roebuck was the majority chair. Although introduced for the last several sessions by State Representative Bernie O’Neill (R-Bucks), it has never been brought to a floor vote in either chamber. Consolidation has at times attracted the interest of PSEA but has been consistently opposed by many individual school districts, insurance companies that cover health care for individual districts, and the American Federation of Teachers of Pennsylvania (AFT Pennsylvania), whose members work for the state’s largest urban districts where benefits tend to be more generous and expensive than in many suburban or rural districts.

Matthew Stanski, chief financial officer of the School District of Philadelphia, and Don Mooney, chief operations officer of the Springfield School District, participated in the discussion and affirmed that health care costs were putting severe pressures on their budgets, although school districts in Delaware County are purchasing health care as a consortium and have realized savings as a result. Philadelphia school teachers currently make no contributions to their health care plans under their existing labor contract. The district’s unions are represented on the board that oversees its health care plans.

The consolidation proposal would effectively remove health care benefits from collective bargaining, which is the case with school pensions in Pennsylvania and with teacher health care in other states. The Pennsylvania School Boards Association (PSBA) contends that many of the savings projected by the 2004 study have been achieved by cooperative arrangements among school districts to purchase health insurance where economies of scale make sense. If achievable, health savings could be available to help support pension burdens at the discretion of the Commonwealth and individual school districts or could be directed through legislation to that use. It should be noted that in 2007 former State Senator Jane Orie and 20 colleagues introduced a resolution calling for a LBFC study of the benefits of consolidating municipal health care plans among districts.

4. According to the Pew Center on the States, Pennsylvania’s retiree health care program has a liability of $17.5 billion, over and above the SERS and PSERS combined unfunded pension liabilities of $41 billion. Like many states, Pennsylvania funds health care for retirees on a pay-as-you-go basis (The Pew Charitable Trusts 2012c).

5. The Hay Group maintained that savings would accrue more from economies of scale in plan management rather than from higher contributions or lower benefits on the part of employees. It also assumed that the savings would be split as follows: 5 percent to plan members and the balance divided between the Commonwealth and school districts in rough proportion to their overall share of school finance, or 40-60 respectively.
The City’s most recent valuation report projects the MMO from all funds for FY 2014 at $523.4 million while the funding policy calls for $769.2 million, a gap of $245.8 million (City of Philadelphia Municipal Retirement System 2013). See notes to Table 1.

A number of studies have suggested pension changes to put the system on a more sustainable path, including, as noted above, the Pennsylvania Intergovernmental Cooperation Authority (2005) and The Pew Charitable Trusts (2009).

The working group concluded that consolidation of health care benefits for school employees and retirees into a statewide plan or regional plans might make sense but that a new study of potential savings would be needed to support such a move.

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This sales tax was requested by the mayor, authorized by the Pennsylvania General Assembly, and enacted by City Council as a temporary measure to help Philadelphia weather the 2008 recession.

The authorization was accomplished through an amendment to Act 205 of 1984, which governs municipal pensions in Pennsylvania, so a bill extending the tax for pension relief would be germane under the Constitution and House and Senate rules. Although the existing authorization requires the City to use revenues from the tax to fund pensions, it does not require that that they be used strictly to raise contributions above the minimum levels required by state law. In fact, it was understood by the mayor, City Council, and the sponsoring legislators that the authorization allowed the City to substitute these new sales tax revenues for pension fund contributions that otherwise would have been made from its traditional general fund revenue sources. As explained by Mayor Nutter in a September 14, 2009 letter to legislators, the legislation expressly allowed the City to defer pension payments and to extend the amortization of its plans as a way of avoiding severe budget cuts and massive layoffs.

As discussed by the working group, any extension of the sales tax should require by statute that the new revenues be used to reduce the system’s unfunded liability by amounts over and above the City’s Minimum Municipal Obligation (MMO) as defined by state law and projected in the City’s FY 2013-14 budget and subsequent Five Year Plans. Increasing contributions above the MMO was recommended by the Pennsylvania Intergovernmental Cooperation Authority (PICA) in a 2005 report on the City’s pension system and repeated again last fall in testimony before PERC by its executive director, Fran Burns (Burns 2012). The 2005 report, which also recommended cost-saving steps, noted that the City started making the MMO in FY 2004 as opposed to the actuarially determined contribution using a 30-year amortization period. The City has never failed to make its MMO payment, but the gap between the system’s MMO and the required contributions under the pension system’s 30-year funding policy has continued to grow. Thus if the City were meeting the required contributions of the retirement system’s funding policy, pension payments – which already exceed the budgets of any City department, including police – would consume an even larger share of City resources.

Also as discussed by the group, continuation of the sales tax would be contingent upon the City’s pension systems as defined in law and union contracts meeting a standard of sustainability for taxpayers and beneficiaries that would have to be worked out in conjunction with the implementation of this option. Some members of the group, concerned about the City’s economic competitiveness, emphasized that rather than fund new services or activities, the tax extension would have to be connected by state law to reducing

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6. The City’s most recent valuation report projects the MMO from all funds for FY 2014 at $523.4 million while the funding policy calls for $769.2 million, a gap of $245.8 million (City of Philadelphia Municipal Retirement System 2013). See notes to Table 1.

7. A number of studies have suggested pension changes to put the system on a more sustainable path, including, as noted above, the Pennsylvania Intergovernmental Cooperation Authority (2005) and The Pew Charitable Trusts (2009).
the ongoing cost of City government, including pensions. If municipal employee unions were to support this plan, they almost certainly would want to see requirements that the new revenues not be diverted to purposes other than protecting their members’ pensions under whatever contract changes they and the City administration have agreed to, so that under-funding of the system doesn’t occur and the system’s future benefits, as well as costs, are sustainable.

The working group recognized that this option would extend for an indefinite period the sales tax collected in Philadelphia at 8 percent, composed of the state sales levy of 6 percent, the 1 percent City sales tax authorized in the 1991 PICA legislation, and the 1 percent temporary tax authorized in 2009. Although Philadelphia consistently ranks among the two or three most highly taxed big cities in the US, an 8 percent sales tax would not make it an outlier on this levy, although it would make the extra one percent a continuing factor in overall tax burden calculations. As can be seen in the table nearby, Philadelphia and San Diego are tied for the lowest sales tax rates of the 10 largest cities.

**SALES TAXES IN THE 10 LARGEST US CITIES**

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<tr>
<th>CITY</th>
<th>SALES TAX RATE (%)</th>
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<tbody>
<tr>
<td>New York</td>
<td>8.875</td>
</tr>
<tr>
<td>Los Angeles</td>
<td>9.0</td>
</tr>
<tr>
<td>Chicago</td>
<td>9.25</td>
</tr>
<tr>
<td>Houston</td>
<td>8.25</td>
</tr>
<tr>
<td>Philadelphia*</td>
<td>8.0</td>
</tr>
<tr>
<td>Phoenix</td>
<td>9.3</td>
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<tr>
<td>San Antonio</td>
<td>8.25</td>
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<tr>
<td>San Diego</td>
<td>8.0</td>
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<tr>
<td>Dallas</td>
<td>8.25</td>
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<tr>
<td>San Jose</td>
<td>8.75</td>
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*Philadelphia’s 2 percent local sales tax will return to 1 percent, and its total sales tax to 7 percent, on July 1, 2014.

None of the largest cities dedicate their sales tax revenues to paying for pensions. Springfield, Missouri did dedicate a 0.75 percent sales tax to paying for its police and fire pensions, with reportedly good results for the plans. According to news reports, three California cities – Sacramento, San Diego, and Santa Barbara – have considered measures to link sales tax increases to pension reform but did not follow through, at least partly because of the failure of pension reform efforts.

Tax economists consulted informally by the center’s staff generally felt that the economic effects of the one percent of the sales tax enacted in 2009 had already been absorbed and that its extension was unlikely to have significant adverse marginal impacts. To the extent that the one percent sales tax revenues were dedicated to diminishing the system’s unfunded liability in amounts above projected MMOs, they would eventually free up City resources for other uses. Each one percent of the City sales tax raises about $130 million.

Although the group included several City of Philadelphia officials, they have not endorsed this option, but the City Finance Department indicated there were roughly three ways the revenues could be used to reduce the system’s unfunded liability.

First, the revenues could be dedicated to annual contributions to the City’s pension system, gradually reducing the unfunded liability, until some predetermined funding ratio had been achieved. This use would be analogous to a homeowner reducing his or her long-term interest payments by pre-paying principal. Second, the revenue stream could be used to support pension obligation bonds. If bond proceeds backed by the one percent sales tax were issued at today’s rates and deposited in the City’s pension plans, the funded ratio of the system could almost immediately reach 80 percent or higher, the level considered sound by many municipal finance experts. Pension obligation bonds entail risk, however, as is discussed elsewhere in this report and as the recent history of such bonds in Philadelphia and other jurisdictions shows. Third, some combination of annual contributions and pension obligation bonds could be pursued.

The group also heard a presentation during its deliberations that perhaps could be a model for pursuing sales tax extension and sustainable pension changes in Philadelphia. Vijay Kapoor of Public Financial Management (PFM), who was involved in an innovative process in Lexington, Kentucky, described for the group how a task force of city officials, legislators, union
representatives, and local business interests achieved consensus on how to restructure the 40-year old police and fire pension system. Some variation of this process, which is described elsewhere in this report, may be worth pursuing in Philadelphia, and it also may be applicable to other jurisdictions facing pension funding challenges.

--Sell or lease resources (assets or revenue streams) to reduce unfunded pension liabilities.

The sale or long-term lease of public resources to private sector companies, referred to as the monetization of assets, can provide governments with a source of capital for reducing unfunded pension liabilities. Generally speaking, such transactions may be worth considering if there is reason to believe that private operators can more efficiently deliver services or build or maintain physical assets than the government, if the services being privatized have market characteristics (e.g., user fees such as utility bills, highway tolls, etc.) rather than social missions, and if there are safeguards against governments using the proceeds of the transaction for recurring operational expenses rather than non-recurring costs such as pension liabilities or capital projects (Lanctot 2012; Levenson 2011). Critics argue that privatization is often a short-term solution that ignores the loss of long-term revenues and public employee contributions into a pension system and also overlooks the potentially higher unemployment and social program costs of displaced public employees.

Large scale monetization efforts in Pennsylvania have proven politically difficult to achieve, as is evident from so far unsuccessful attempts to sell the state store system, turn the state lottery over to a private operator, or lease turnpike maintenance responsibilities and tolls. Public employee unions fear their members will lose jobs or have their pay and benefits diminished under private operators and typically oppose monetization efforts, but so do business interests that benefit from current arrangements. Although citizens sometimes support privatization, they also sometimes reflect concerns about the loss of public control over important services and about “excessive” profitmaking by the private operators who typically have the right to raise fees. Nevertheless, some municipal governments are undertaking such efforts. The City of Allentown is attempting to lease its water utility and use proceeds to shore up its pension funds. According to news reports, pension obligations are otherwise projected to consume 30 percent of the city’s general fund revenues within a few years. The Lehigh County Authority, which provides water service to outlying municipalities, submitted the highest bid for the 50-year lease, $220 million, well above the $200 million the mayor was hoping for and above bids submitted by four private sector companies. Philadelphia has proposed selling the Philadelphia Gas Works and the Love Park garage to help cope with unfunded pension liabilities or to fund capital projects.

Among resources that have attracted the attention of private companies and city officials elsewhere are revenues from parking garages and meters. Morgan Stanley and LAZ Parking in 2006 paid Chicago $563 million for the right to operate four downtown garages for 99 years and in 2009 paid just over $1 billion for the right to operate the city’s meter parking system for 75 years.

A brief review of the history of monetization projects in Pittsburgh and Chicago suggests that local politics can frustrate efforts to realize benefits for pension purposes. Faced with the potential state takeover of its woefully underfunded pension system, Pittsburgh’s City Council nevertheless rejected a $453 million bid by J.P. Morgan for a 50-year lease on its on-street and off-street parking revenues that would have been more than adequate to fully fund its pension system. Instead, the city transferred the parking revenues directly to the pension system. The city then successfully argued that counting the net present value of the revenue stream as assets raised the funded ratio above the 50 percent threshold necessary to avoid the takeover. This step was not accompanied by changes in the cost of the pension system, and the funded ratio has again begun to slip downward toward the 50 percent level.

Although Chicago secured just over $1 billion from the monetization of its on-street parking revenues with the announced purpose of using the proceeds to

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8. The discussion of monetization projects in other cities that follows is based largely on a presentation by Thomas E. Lanctot, partner, William H. Blair and Company, to the Central Philadelphia Development Corporation, on September 11, 2012. See also McLaughlin 2011.
reduce its unfunded pension liability, it did not follow through with that intention. In the end, the City used most of the proceeds to help overcome an operating deficit in its budget. Chicago’s six pension plans currently have a funded ratio of about 50 percent and an unfunded liability of about $26 billion.

Because Chicago city government owned the garages and operated on-street parking, it did not require state approvals to complete these transactions. Furthermore, Chicago had previously privatized parking enforcement, meaning that difficult issues involving public unions had already been faced.9

In Philadelphia, on-street parking enforcement and the operation of many garages are controlled by the Philadelphia Parking Authority, a state-established entity. Many of the authority’s employees, however, are members of a municipal union and all are members of the City’s underfunded pension system. The authority and the City should explore the potential value of allowing a private company to operate on-street parking under the supervision of the Parking Authority, with the proceeds dedicated to the pension system. Any such transaction would have to take into account the short-term, as well as the long-term, impact on the authority’s employees. Because state law requires the Parking Authority to transfer a portion of its proceeds to the City and to the School District of Philadelphia, provision also would have to be made to insure the transaction did not have a negative effect on their budgets.

One professional with experience in such transactions estimates that a long-term lease of on and off-street Parking Authority revenues in Philadelphia might attract offers from a private firm of as much as $1 billion, roughly equivalent to about 20 percent of the City’s unfunded pension liability. Such a transaction would probably require state legislation and therefore would be more complex and would require bipartisan cooperation to accomplish. On the other hand, state legislation also could include requirements that the proceeds be used to reduce the City’s pension liabilities, insulating the transaction from the City’s operating budget pressures and assuring members of the retirement system that the proceeds would not be diverted to other uses.

Given Pennsylvania’s history of failing to consummate large-scale asset-monetization transactions, it seems likely that private firms would want to see consensus among the City, Parking Authority, and state political leaders that fair and serious consideration would be given to bids they might submit.

Officials from suburban municipalities in the working group generally believed that there were fewer asset-monetization opportunities in the region’s smaller municipalities, but that many of these jurisdictions were taking advantage of privatizing services as a way of reducing operating budget pressures, indirectly freeing up resources for pension payments as well as other uses.

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Reducing Pension Costs and Liabilities

--Restrict Act 205 state subsidies to paying for municipal pension benefits as opposed to administrative costs, creating incentives for increased efficiency and plan consolidation.

Alone among the states, Pennsylvania subsidizes its municipal pension systems with the distribution of a dedicated tax, a 2 percent levy on premiums by out-of-state fire and casualty insurance companies. As expanded in 1984 along with system reforms, the tax helped stabilize municipal pensions at a time when they were woefully underfunded and sinking fast. An unintended consequence of the legislation, however, may be that the subsidy contributes to plan proliferation, excessive administrative costs, and lost opportunities to improve investment performance. Pennsylvania has more than 3,000 public pension plans covering employees in more than 400 authorities and 2,500 municipalities, almost 80 percent of which have populations below 5,000. Most municipal pension plans

9. The Chicago transaction has proven extremely controversial over the last few years. Critics (including some City Council members) have argued that the City was undercompensated for its revenue stream at the time of the deal, failed to anticipate public outrage over steep increases in rates that required parkers to feed meters with large quantities of quarters, and should not have to reimburse the private company for persons fraudulently using disability placards to avoid paying for metered parking.
have fewer than 10 members, both active and retired. According to a 2009 study from the University of Pittsburgh Institute of Politics (IOP), Pennsylvania thus has about 25 percent of the roughly 12,000 public employee pension plans in the US.

The 2 percent tax produces about $230 million a year, which is then distributed by formula to the municipal plans. Distributions to Philadelphia are artificially capped. For an estimated 40 percent of the plans, the state subsidy has at times covered all employer costs, including retiree benefits, required employer contributions, and plan administration. It stands to reason that when a third party pays costs, employers will be less likely to attempt to control those costs.

Roughly 900 of the plans with a combined $1.6 billion in assets and 14,000 members have voluntarily joined the Pennsylvania Municipal Retirement System, or PMRS. Municipal plans administered by PMRS vary widely in size, funding status, and benefit design but take advantage of the system’s centralized plan administration and investment functions. PMRS pays member plans a guaranteed 6 percent interest rate on their assets and as a result has a conservative approach to investments. It also uses an assumed actuarial rate of investment return of 5.5 percent, lower than the SERS and PSERS assumed rates of 7.5 percent and the City of Philadelphia’s assumed rate of 7.95 percent. Members who switch from one PMRS employer to another are guaranteed portability, which means they can take their pensions with them to their new job. Portability is lacking for municipal employees outside the PMRS system. This option is also lacking for state workers and for teachers who leave public schools in Pennsylvania.

As compared to SERS and PSERS, PMRS claims its per-member administrative costs are about 20 percent lower. PERC analyses have found that the state’s smallest plans (10 or fewer members) had per-member administrative costs almost five times larger than the state’s largest plans (500 or more members). Comparing the administrative costs of public authorities, which are unsubsidized, to the administrative costs of subsidized municipalities, PERC has estimated that as much as $50 million of the state subsidy may be paying for administrative costs, such as for lawyers, financial consultants, and support staff. Restricting the state subsidy to paying for retiree benefits would require municipalities to shift the cost of plan administration either to other assets of the fund or, as recommended by one working group member, to the general fund of the government, thus increasing transparency and accountability to taxpayers. Either approach would provide incentives for plans to join the PMRS system if its fees for administration were lower. It also is reasonable to assume that the investment performance of the centralized PMRS portfolio would over the long run exceed the average returns of hundreds of very small municipal funds.

Other approaches to achieving greater efficiency in municipal pensions would be to require all plans to pay a minimum percentage of their annual outlays from their own-source revenues and/or to freeze state-reimbursable per-member administrative costs. These steps were recommended in a 2009 study by the University of Pittsburgh’s IOP. The IOP study also called for increasing education training for investment officers and prohibiting benefit increases for underfunded plans.

A step that would not require legislation would be for the Auditor General or PERC to rank municipal pension funds from highest to lowest administrative costs per plan member or per municipal resident and to publicize the rankings. Plans with high administrative

| Per-Member Administrative Cost for Selected Municipal Pension Plans Based on Pension Plan Size |
|-----------------|-----------------|-----------------|
| 10 or fewer Active Members | $1,567.84 | $1,440.62 |
| 11 to 100 Active Members | $1,063.78 | $1,008.63 |
| More than 100 Active Members | $382.86 | $445.38 |
| More than 500 Active Members | $333.55 | $403.73 |

Source: Public Employee Retirement Commission 2013a
costs would presumably have to justify their ranking to taxpayers.

--Reduce benefits for new hires and/or for current workers prospectively, including moving new hires to defined-contribution (DC) systems or hybrid systems (cash balance) systems.

Governor Corbett and Senators Patrick Browne (R-Lehigh), and Dominic Pileggi (R-Chester and Delaware), among others have proposed that Commonwealth and school employees hired after a date certain be provided with a mandatory DC system to stabilize and, over the long run, reduce employer contributions. Some legislators have advocated “hybrid” plans that combine DB and DC features. Cash-balance hybrids provide retirees with the cash balance in their accounts that can be paid in a lump sum or converted to an annuity.

Philadelphia Mayor Michael Nutter has proposed hybrid plans for newly hired City workers, although legislation to implement his proposal has not yet been introduced in City Council (Ransom 2013).

As noted earlier in this report, closing DB plans and switching to DC plans for future hires increases employer costs in the near term, largely because contributions by new workers accrue to their own benefit and are not available to help finance the legacy costs of the closed plan (CalPERS 2011; Keystone Research Center 2013). The Corbett administration’s proposal would further suppress the required employer contributions over the next several years as a bridge to the projected savings of the new system. In FY 2014, the administration proposes holding increases to 2.25 percent as opposed to the 4.45 percent provided for in current law, thus saving $175 million. Subsequent to the administration’s proposal, PSERS projected that because of falling payrolls, required contributions by the Commonwealth and schools would be $69 million less than anticipated for the current year and again for next year (Chute 2013).

Although there is little doubt that changing pension benefits for new hires does not entail the legal risks of attempting to make such changes for current workers, public employee unions have generally resisted changes for new hires, even on an optional basis. The binding arbitration award for Philadelphia police officers does include the establishment of a voluntary DC system, but reportedly at the urging of union leaders, no officers have yet volunteered to enter the system. Although the City is appealing a binding arbitration award for its firefighters, it is not appealing a similar provision for a voluntary DC option. Philadelphia prison guards lost an arbitration award that includes a mandatory hybrid DB/DC plan for new hires, but the union is appealing that award to the courts.

The governor also has proposed changing benefits for current workers after a date certain, specifically by requiring higher employee contributions and by reducing the multiplier used to calculate pension benefits from 2.5 to 2 percent. Current employees would have the option of increasing their contributions to obtain the higher multiplier. Some legal experts and members of the General Assembly are skeptical that such a change would be upheld by the courts. State Representative Chris Ross (R-Chester), and State Senator Mike Brubaker (R-Lancaster) introduced legislation to implement the Corbett administration’s plan on May 7, 2013, and the Senate Finance Committee held a public hearing on the Senate legislation on May 29.

In testimony before the House State Government Committee, the PSBA supported the move to a lower multiplier for current employees and advanced an argument that such a change could be found constitutional. Citing a court decision that has been considered as applying to elected officials beginning new terms of office, PSBA argued that acceptance by current public school employees of promotions, changes in job classifications, or even pay raises could be defined in legislation as a “triggering event” that would place them in a new retirement plan (PSBA 2013) with different benefits and rules. PSBA does not support moving future employees to a DC system, however.

10. The duration of higher “near term” employer costs -- and hence the tradeoff between projected “near term” costs and “long-term” savings -- will vary from plan to plan. Higher near term costs could last for a few years or for a decade or more. The Nutter administration has proposed hybrid plans to avoid the higher costs associated with closing existing DB plans.
--Fully fund Commonwealth and school district pension obligations through higher appropriations and give reforms enacted in 2010 time to work.

Under Act 120 of 2010, Commonwealth and school employees hired after December 31, 2010, are subject to higher employee contributions, a lower multiplier, later retirement ages, and a 10-year vesting period. The act also provides for employees to share with employers the burden of replenishing funds due to investment losses by requiring increased contributions of up to 2 percent. Some Democratic legislators have argued that the Commonwealth and school districts (with the help of additional state aid) should simply step up to the funding requirements of Act 120 and give the reforms it embodies a chance to work. Public employee unions (AFSCME, PSEA, and PFT) have echoed that position and threatened legal challenges if the governor’s plan is enacted.

Although simply funding rising pension costs without further changes to the system is a logical option for the two state systems, it almost certainly would require either higher taxes (discussed above) or cuts in other programs and functions of the state government and school districts. Even with Act 120 reforms, the Commonwealth’s annual employer contributions are projected to increase by 43, 33, 26, and 13 percent over the four years beginning July 1, 2013, according to projections by the governor’s budget office (Zogby 2012). School districts would face similar increases.

For some members of the working group, providing these additional resources would violate the principle cited earlier in this report that new resources should be contingent upon system reforms. Other group members would contend that Act 120 did just that, mandating reforms and introducing new resources through higher contributions by employees.

Although the views of individual members of the working group varied on the Corbett and Nutter administrations’ proposals, there was general agreement that changing benefits for current workers, unless negotiated in labor contracts, entailed legal risks and that switching to DC plans raised employer costs in the near term.

--Establish “stacked hybrid” pensions that provide a traditional defined-benefit (DB) plan for all public employees up to a predetermined salary level and a mandatory defined-contribution (DC) plan for all employees based on their salaries above the threshold.

As conceived by PERC and discussed with the working group, the stacked hybrid concept could be adopted as the template for a statewide pension policy. PSERS, SERS, and municipal systems could adjust its features to best fit the circumstances of their active members and retirees. Because the plans would be similar in structure, they would be easier for the public to understand. When combined with Social Security benefits, the stacked hybrid plan could be designed to provide retirees with an estimated 70 to 75 percent of their final income as a retirement benefit, reducing the likelihood that they will need other forms of government assistance in their old age. At the same time, the stacked hybrid option would avoid the costs of closing current DB plans and would reduce the risk that taxes might have to be increased in the future to support public pension systems.

What follows is an example of how it might work:

--All employees would belong to a traditional DB plan up to a salary threshold determined legislatively unless modified by collective bargaining, e.g., $50,000. Employee contributions would be 6.25 percent and vesting would be after 10 years.

--Above the threshold, all employees would belong to a mandatory defined-contribution plan with a maximum 5 percent employer match. Employees could contribute up to the IRS maximum.

--The DB plan would be the default pension, but new hires could select the DC plan for all income. For the elective DC plan, the employee would be required to contribute 5 percent of income and would be vested after 3 years.

--The annual DB would be limited to 50 percent of the final average salary, or $25,000 for the current example. (The average SERS pension is now about $24,000.) Members could retire after 25 years but
would have to wait until 65 for full retirement benefit or accept an actuarial reduction in benefits if selecting to receive benefits before 65.

--Employees who do not participate in Social Security would also participate in a mandatory supplemental DC plan, in conjunction with the DB plan for the first $50,000. Above $50,000 the employee/employer match will be a total of 10 percent for the DC plan.

--Liability for work-related disabilities would be shifted to the worker's compensation system.

--The lump sum contribution distribution option for the DB would be abolished.

The working group believes policy makers should request actuarial analyses of how such a plan might affect state and local public employees and employers under various scenarios.

--Undertake long term borrowing and use the proceeds to buy out the remaining obligations to one or more groups of fund participants.

Sandra Kurtz Baxter and Daniel Connelly from Fairmount Capital Advisors, Inc. told the working group about a pension related funding concept that they are currently working on with a national nonprofit organization. The objective of the strategy is to reduce those unfunded pension liabilities most susceptible to market volatility. The concept involves offering lump sum buyouts, based on the present value of individual obligations, to certain pension plan participants whose obligations represent longer term liabilities in the entity’s pension plan. The payment of lump sum offers accepted is funded through the issuance of debt by way of long-term fixed rate bonds or a privately placed loan. While a number of variables such as demographics, outreach methods, and number of participants included are important to the level of success achieved, this model might provide a number of benefits that make it worth considering for public-sector entities.

The funding strategy reduces the plan’s unfunded liability, but does not affect the fund’s assets as the funding is provided to directly pay off participants who accept the lump sum offer. This approach helps to reduce the market risk exposure associated with longer-term obligations and reduces the investment risk burden the plan faces in trying to achieve targeted rates of return, which is especially beneficial in low interest return environments. The strategy also reduces the exposure of discounting the future payment obligations at low discount rates, which in turn increases the reported value of the liability on an entity’s financial statement. The concept takes advantage of low borrowing rates by locking in funding costs instead of being subjected to the risk that low rates will increase the unfunded portion of the plan due to discounting. To the extent borrowing costs are below the entity’s discount rate used for calculating future pension liabilities, cash flow savings are achieved.

To illustrate the financial benefit of this funding strategy, Fairmount asked the working group to consider a hypothetical beneficiary who is owed $500 per month from retirement (assumed at age 65) through death (assumed at age 85). These monthly $500 payments represent a series of cash flows that can be present valued assuming a discount rate. The discounted cash flows can be thought of as principal and interest payments on a 20-year loan (age 65 to age 85), with the conceptual “interest” portion of the loan based on the discount rate. If the entity can replace the “loan” with a buyout financing at a lower interest rate, the cash flow benefit is secured. Essentially, the organization is able to lock in lower monthly payments compared to pension amortization, while also creating a defined period in which payments may be made (20 years), eliminating longevity risk.

As with all proposals, there are potential risks to consider, including how the buyout of one or more groups converts a “soft” pension liability to a “hard” debt liability. Though the entity’s combined pension and debt liability will remain the same, the strategy will increase the total balance sheet debt, which may have negative credit ratio implications. Other considerations include tax implications for those who participate, what requirements may exist for non-ERISA plans, as well as what the tax status may be for borrowing.
WHEREAS the issuance of traditional pension obligation bonds involves issuing debt and depositing the proceeds in with other pension fund assets, making the success of the borrowing dependent on future investment returns, that risk is eliminated with this new approach. The discount rate used for future benefits can be thought of as the equivalent of an investment return and is fixed. The upside potential of a strong market is foregone but the downside risk of market declines is also avoided. With most or all fund assets subject to return risk, diversifying a portion of the fund’s strategies seems prudent.

The buyout option may be especially attractive to inactive members of public sector plans; that is, those who have left public employment, are employed elsewhere, and are several years away from beginning to draw pension benefits. (Note that these plan beneficiaries would therefore be able to accept the buyout outside the constraints of public employee union contracts.) These members may not be planning to return to active status and would therefore be willing to forgo future benefits for a present payout. PSERS has approximately 122,000 inactive but not retired members, although the liability associated with such members does not represent a large percentage of the plan’s total liability. Jeff Clay, executive director of PSERS, was present for the presentation and found this concept interesting. He discussed it briefly at subsequent House Appropriations Committee budget hearings in Harrisburg.

--Address underlying causes of fiscal pressures affecting distressed municipalities.

The working group learned of two differing efforts related to pension funding challenges and other fiscal pressures on distressed municipalities that are under discussion in the Pennsylvania Capitol: The Coalition for Sustainable Communities, which is an outside organization lobbying the General Assembly for new legislation, and the Act 47 Municipal Distress Task Force, a group largely internal to the legislature but that also includes representatives of municipal unions and local government associations. Both efforts were represented by members of the CORP working group. Steven Wray, director of the Economy League of Greater Philadelphia and a member of the working group, outlined the goals of The Coalition for Sustainable Communities, which is staffed by the Economy League of Greater Pittsburgh. In addition to the Pennsylvania Economy League, the coalition is comprised of business, industry, and professional associations, including the Pennsylvania Manufacturers’ Association, dozens of county and local chambers of commerce, and local government associations and elected leaders of many individual counties and municipalities.

Concerned with municipal financial pressures exacerbated by distressed pension systems, the coalition favors amending state laws pertaining to binding arbitration and municipal pensions, creating cash balance plans for many Pennsylvania police officers and firefighters, and requiring distressed municipal pension plans to be administered by PMRS, a concept discussed in greater detail elsewhere in this report.

Embedded in state law via Act 111, municipal binding arbitration requirements were enacted in 1968 to provide a neutral process to adjudicate labor disputes between municipalities and their police officers and firefighters, who unlike most public employees in the Commonwealth are prohibited from striking. The coalition contends that binding arbitration is one of the primary causes for escalating costs and has contributed to 41 percent of Pennsylvania citizens living in financially stressed municipalities. The coalition’s amendments to Act 111 would require arbiters to consider a municipality’s ability to pay for awards, prohibit post-retirement health care and pension benefits not required by statute from being the subject
of collective bargaining, require arbitration costs to be shared equally between employer and employees, mandate that arbitration sessions be made public, and allow a broader appeal process for municipal relief when the Auditor General identifies an illegal pension benefit. Philadelphia binding arbitration awards for Act 111 employees already include an ability-to-pay provision enacted in legislation creating PICA, its state oversight board (Coalition for Sustainable Communities 2013).

A second significant reform advocated by the coalition would change the types of pension plans available to municipal police officers and firefighters. State Representative Seth Grove (R-York) introduced legislation in early April 2013 that would place new hires for these two public safety departments under a cash balance pension plan in Pennsylvania municipalities with the exception of Philadelphia. This plan would have a formula based on a percentage of pay that provides less of a pension benefit than under a traditional DB plan Grove’s legislation, which is supported by the coalition, would also allow police officers and firefighters to retain their current benefits. However, the proposed legislation would effectively freeze these benefits at present rates.

In a statement strongly opposing the legislation, the Fraternal Order of Police (FOP) contended, among other things, that it would virtually double the number of police and fire pension plans by requiring cash balance plans in addition to the DB plans that must be continued. The FOP favors a statewide DB plan similar to that enjoyed by members of PSERS, which would provide portability to its members (Neri 2013).

The working group included members of suburban jurisdictions who generally support the legislative goals of the coalition with respect to Act 111 and municipal pensions.

Act 47, the Distressed Communities Act, was enacted in 1987 to provide the Commonwealth with tools to help municipalities with finances that have deteriorated to the point that basic services are threatened. The Act 47 Municipal Distress Task Force is an informal group of legislators, legislative staffers, administration officials, and representatives of county and municipal government associations and of municipal employee unions organized by the Local Government Commission, a legislative service agency. The task force will review the need for changes to further address causes of municipal distress. The task force, whose work in the current session is just getting underway, is co-chaired by State Senator John Eichelberger (R-Blair, Cumberland, Franklin, Fulton, and Huntingdon), and State Representative Chris Ross (R-Chester), both of whom are members of the commission’s board. Senator Eichelberger is chair of the Local Government Commission. Representative Ross is also co-chair of the CORP Urban Affairs Committee and a member of its public pension working group. In the 2011-12 session, a similarly organized task force successfully amended Act 47 to some degree to restore the ability of state-approved financial recovery plans to constrain binding arbitration awards after a Pennsylvania Supreme Court decision ruled that an award in the City of Scranton trumped the city’s approved financial plan. Representative Ross told the group that he agreed to co-chair the effort on the condition that public employee unions were included in the discussions, and he has since become the chair of the task force’s labor subcommittee on which the unions are represented. The CORP staff had an informational meeting with legislative staff members of the group.

--Taking advantage of low interest rates, issue pension obligation bonds to reduce unfunded liabilities.

Pension obligations bonds (POBs) are an option when they function as designed: governments issue bonds, in so many words borrowing against future tax revenue, invest the proceeds, and use the returns to pay down pension debt. Bond issuance doesn’t always work out as planned, however. The earnings on the bonds are fully taxable, unlike state and local bonds for capital improvements. Sometimes the taxable interest rate due on the bonds is higher than the returns earned on the proceeds, effectively raising the costs of pension obligations. In addition, bonds have to be supported by current revenue, requiring offsetting cuts in public services, or new revenues. Finally, several members of the group emphasized that POBs should be conditioned upon a prohibition against expanding benefits during the life of the bonds.
Act 120 of 2010 prohibits the issuance of POBs for SERS and PSERS funds. In testimony before the House Appropriations Committee earlier this year, officials representing the two state funds indicated that they believe POBs should be allowed to benefit the state systems but used with caution. The working group also believes the use of such bonds should be an option to benefit the two funds. Elsewhere in this report, POBs backed by an extension of the one percent sales tax that would otherwise lapse in 2014 are identified as one option for reducing Philadelphia’s large unfunded pension liability.

In use is such states as California, Connecticut, Illinois, New Jersey, and Oregon, POBs are popular tools to deal with pension debt. Still, POBs issued before 2008 were partially to blame for the bankruptcies in Stockton and San Bernardino, California. In short, timing is key, as POBs issued before a market downturn are deadly for government budgets. For example, according to a study by Alicia Munnell, after 2008 all POBs were in negative territory, that is, all except those issued at the nadir of the crash (Schulzke 2013).

According to a December 2012 Moody’s Investors Service report, POBs rarely improve the credit quality of the state or local government that issues them. When the debt is transferred from an unfunded pension liability to a POB, the impact is neutral. Risks arise when the expected return is high, and with the chance of a declining economy, when any gains realized are eliminated. The bond is rated according to the revenue stream, an appropriation obligation perhaps, or a dedicated sales tax, so that the bond itself could be rated positive, while the overall issuer’s rating is downgraded. The best outcome for POBs is usually neutral for the government issuing them, and they are often interpreted often as an indication of the inability to deal with structural debt and therefore an effort to move costs into the future. But Moody’s suggests they might be viewed differently if accompanied by a plan to make sustained improvement in net pension fund status and to restore budget stability over the medium term (Moody’s Investors Service 2012).

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Exploring Innovative Paths to Meet Pension Funding and Reform Challenges

--Establish a task force of political, labor, and business leaders to forge consensus on legislation and labor contract changes needed to meet pension funding challenges.

The working group heard a presentation by Vijay Kapoor, director of Public Financial Management’s workforce consulting practice, about a process that he mediated to address funding challenges in Lexington, Kentucky. The Lexington story was described by the January 31 issue of Bond Buyer as “a new path” to pension reform and by the April issue of Governing magazine as a model for how to achieve success in solving unfunded pension liabilities. The CORP working group believes the Lexington story might hold lessons for municipalities facing a need for a comprehensive approach to address pension funding challenges, including revised labor contracts and city and state legislation.

As reported by Bond Buyer, Lexington officials were grappling with ways to mitigate public employee pension costs, which went from 7 to 22 percent of the general fund over a 12 year period (Sigo 2013). The city of 300,000 residents under the leadership of Mayor Jim Gray made contributions of about $11 million a year into the pension plans for retired police officers and firefighters. Concern over the solvency of the system escalated when officials determined that their costs were escalating to the point where the City needed to contribute $29 million a year to address a looming $296 million unfunded liability.

Mayor Gray convened a task force comprised of business leaders, union leaders, city officials, council members, and legislators who began deliberating in 2011, establishing what Bond Buyer called “a new level of dialogue” about pension funding remedies. The task force’s meetings were open to the public and were recorded and broadcast on local access television with supporting documentation posted on the official city webpage. After reaching a stalemate, the city and representatives from the public worker unions formed a selection committee to hire Public Financial Management, Inc. (PFM) in November 2012 to
provide technical assistance to the task force toward reaching consensus (Kapoor 2013). PFM helped the stakeholders achieve a common understanding of the system’s finances (both the city and the unions were misinformed to a degree) and initiated three months of face-to-face negotiations among a discrete, smaller team that brokered agreements and built consensus. Ultimately, the group’s reform proposal was endorsed by the task force and won the support of 76 percent of current and retired members of the police and firefighter unions.

The agreement, which needed city council support to increase funding to $20 million a year, preserved the basic, traditional DB plan framework but required police officers and firefighters to contribute a larger portion of their salaries to the pension system, reduced COLAs for retirees, and revised benefit formulas for new workers (Cheves 2013). The Lexington Herald-Leader reported that the changes agreed to by the task force would immediately diminish the pensions’ unfunded liability by nearly half, to $161 million. Governor Steve Beshear signed House Bill 430 on March 14, 2013, allowing for the implementation of Lexington’s pension reform package after the legislation won unanimous support in the Kentucky House and was carried by a 36 to 1 vote in the Senate.

Kapoor told the working group that while the task force approach might not fit the circumstances of other cities, key factors in its success in Lexington might be transferrable. They include giving representation to a diverse array of political and policy interests; developing agreement on a common understanding of the system’s finances; educating the public as well as stakeholders about the issues; allowing a smaller group to break off and negotiate with the goal of presenting a consensus plan to the entire task force; clearly explaining that the consequences of failing to reach a consensus would be worse than the alternative; setting and keeping deadlines; avoiding impractical proposals; and presenting a united front to the legislature.

Bankruptcy Rejected as an Option

Although municipal bankruptcy was discussed as a possible outcome of pension funding crises, the working group did not believe that bankruptcy was a good option for dealing with municipal distress. Further, to the group’s knowledge, no municipality in the five county CORP region is in danger of filing for bankruptcy. Bankruptcy entails prolonged, expensive, and divisive litigation and can impose substantial economic costs not only on the government and its workers but on businesses and residents of the affected community and possibly of surrounding communities. Nevertheless, bankruptcy has been discussed as an option in Pennsylvania municipalities outside the region, and it is a remedy for severe fiscal distress that is being pursued in other states. It is included in this report to take note of this national context and to document possible consequences of failure to take more constructive steps to deal with unfunded pension liabilities.

Federal law precludes states from declaring bankruptcy, though it is possible for Pennsylvania’s municipalities to exercise this option. The prohibition on Third-Class cities declaring bankruptcy, specifically designed to prevent Harrisburg from filing, expired in November 2012. School districts can declare bankruptcy with the approval of the Department of Education, leaving the possibility that the court could then force creditors and unions to accept payments below the original contracts. Since the bankruptcy courts are federal, they employ the federal constitutional
contract clause, allowing judges to vacate arguments regarding abrogation of contracts when pensions are lowered through legislative channels (Public Employee Retirement Commission 2013). This issue is being litigated in Rhode Island and California and is expected to make its way to the US Supreme Court.

Under state law, Philadelphia is not permitted to declare bankruptcy as long as PICA bonds are outstanding. If PICA bonds are not outstanding, the written permission of the governor is required for the City to declare bankruptcy. The Philadelphia School Reform Commission also would need permission of the governor to declare bankruptcy.

Last year, Stockton, California, a city of nearly 300,000 in an agricultural region east of the San Francisco Bay area, became the biggest US city to file for bankruptcy. Chief Bankruptcy Judge Christopher Klein said the federal Chapter 9 municipal bankruptcy code does not allow courts to tell cities seeking protection from their creditors how to use their property and revenues. To get to the bankruptcy point, Stockton slashed city jobs and wages. It continues to pay into the California pension fund (CalPERS) and stopped payments to some bondholders. Needless to say, the creditors besides CalPERS are not pleased with this position, stating that federal law should trump state law (The New York Times 2013). San Bernardino, California, declared bankruptcy in August 2012, but has not paid its full dues into the state pension system. Jefferson County, Alabama, home to Birmingham, declared bankruptcy in 2011, the largest local government bankruptcy to date. After going into bankruptcy in 2011, Central Falls, Rhode Island cut pensions for retirees, some by as much as 55 percent--this after more than a decade of perpetual underfunding of the pension system (Bidgood 2013).

Bankruptcy has huge drawbacks. In the case of once bankrupt Vallejo, California, the city’s bond rating plummeted, nearly eliminating borrowing ability. The police force was decimated and crime escalated. Other department budgets had to be cut and residents’ morale suffered as taxes went up while the perceived value of city services went down. Still, there is a growing trend of municipalities using bankruptcy to restructure debt, renegotiate labor contracts and reform pensions (Farmer 2013). In Central Falls, Rhode Island, bankruptcy provided the city with the leverage necessary to get the unions to the negotiating table. However, engaging the public is another option, as citizens who are not considered debt holders don’t get a seat at negotiations while in bankruptcy. If mismanagement is the issue, bankruptcy won’t solve that problem, either.

Concluding Comments

Because this report is the product of an informal study group, not an advocacy organization, its work ends with the publication of options. It will be up to state and local elected officials and other stakeholders, such as leaders of business, labor, and civic organizations, to continue working on options and ideas they believe have merit. CORP’s staff is available as a neutral resource for subsequent efforts to build consensus and help further refine options into agreements and even legislation, should lawmakers or other policymakers request it to do so.
Table 1. Key Data for PA’s Largest Public Pension Systems

<table>
<thead>
<tr>
<th>Membership</th>
<th>PSERS</th>
<th>SERS</th>
<th>Philadelphia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Active Members</td>
<td>273,504</td>
<td>106,048</td>
<td>26,306</td>
</tr>
<tr>
<td>Inactive Members</td>
<td>122,286</td>
<td>6,189</td>
<td></td>
</tr>
<tr>
<td>Retired Members</td>
<td>202,015</td>
<td>117,061</td>
<td>38,179</td>
</tr>
</tbody>
</table>

| Actuarial Value of Liabilities  | $87.85 billion | $43.06 billion | $9.80 billion |
| Actuarial Value of Assets       | $58.32 billion | $25.30 billion | $4.72 billion |
| Market Value of Assets          | $48.6 billion  | $25.39 billion | $4.15 billion |

| Trends in Key Financial Data   |             |             |              |
| Current Unfunded Actuarial Liability | $29.53 billion | $17.75 billion | $5.08 billion |
| Projected Unfunded Liability in FY 2018 | $45.6 billion | $20.87 billion | $5.55 billion |
| Current Funded Ratio           | 66.4%       | 58.8%       | 48.1%        |
| Projected Funded Ratio in FY 2018 | 56.6%     | 55.7%       | 45%          |
| Current Employer Contributions (FY 2013) | $1.77 billion | $677 million | $491.2 million* |
| Projected Employer Contributions in FY 2018 | $4.5 billion  | $2.22 billion | $602.8 million |
| Projected Five Year Increase in Contribution | 154%     | 228%        | 22.5%        |

Notes: Actuarial data for PSERS is FY 2012, for SERS is CY 2012, and for Philadelphia is FY 2012.

For the Commonwealth retirement systems, employer contributions are from all sources, not just the state’s general fund. Approximately 56 percent of the PSERS employer contribution comes directly from the state’s general fund. The balance comes from 773 educational employers, of which 500 are school districts that represent by far the largest share of the non-state-government contributions. Approximately 80 percent of the SERS employer contributions come from agencies under the governor’s jurisdiction, and about 20 percent comes from the legislature, judiciary, Penn State and state system universities, and other independent agencies. About 45 percent of the contribution from the governor’s agencies comes from the general fund, with the balance coming from special funds, federal funds, and other sources. For both PSERS and SERS, in addition to this direct general fund impact, the required increases in employer contributions by school districts and independent agencies may indirectly put pressure on the state’s general fund to offset these higher costs, resulting in a greater burden than is now projected.

* For Philadelphia, the employer contributions for FY 2013 and FY 2018 are the amounts projected to meet the Minimum Municipal Obligation (MMO) as defined in state law rather than the higher amounts that would be required to meet the City pension system’s funding policy as recommended by its actuaries. For FY 2013, the amount shown is the MMO before an adjustment to add in required repayments with interest of contributions deferred to help meet pension costs in the wake of the recession. See Table 1-1, page 8, City of Philadelphia Municipal Retirement System, 2013.

The City began paying the MMO, rather than the amount required under the pension system’s funding policy in FY 2004 (Burns 2012). Although the City has never failed to make the MMO, the gap between the MMO and the pension system’s funding policy has continued to grow. For FY 2014, the City of Philadelphia Municipal Retirement System’s latest Actuarial Valuation Report as of July 1, 2012 (March 2013) projected the MMO without adjustment at $523.4 million and projected the amount due under the funding policy at $769.2 million. Again, see Table 1-1, page 8, City of Philadelphia Municipal Retirement System, 2013.
Table 2. Southeast PA Pension Systems by Level of Distress as of December 12, 2012

<table>
<thead>
<tr>
<th></th>
<th>Severe (&lt;50% funded)</th>
<th>Moderate (50-69% funded)</th>
<th>Minimal (70-89% funded)</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bucks</td>
<td>0</td>
<td>7</td>
<td>20</td>
<td>27</td>
</tr>
<tr>
<td>Chester</td>
<td>1</td>
<td>6</td>
<td>20</td>
<td>27</td>
</tr>
<tr>
<td>Delaware</td>
<td>0</td>
<td>12</td>
<td>24</td>
<td>36</td>
</tr>
<tr>
<td>Montgomery</td>
<td>0</td>
<td>4</td>
<td>32</td>
<td>36</td>
</tr>
<tr>
<td>Philadelphia</td>
<td>0</td>
<td>1*</td>
<td>1**</td>
<td>2</td>
</tr>
<tr>
<td>Total for Region</td>
<td>1</td>
<td>30</td>
<td>97</td>
<td>128</td>
</tr>
</tbody>
</table>

* City of Philadelphia Public Employees Retirement System. As of the report to PERC, the Philadelphia system was 50 percent funded and therefore classified as moderately distressed in Table 2. According to the Board of Pension’s latest valuation report (March 2013) cited in Table 1 above, its funded ratio has fallen to 48.1 percent, and it would be classified as severely distressed.
** Philadelphia City Redevelopment Authority

Source: PERC

Table 3. PA’s Largest Public Pension Systems: Actuarial Assumptions and Earnings History

<table>
<thead>
<tr>
<th>Actuarial Assumption Rate of Returns</th>
<th>PSERS</th>
<th>SERS</th>
<th>Philadelphia</th>
</tr>
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<tbody>
<tr>
<td>7.50%</td>
<td>7.50%</td>
<td>7.95%</td>
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</table>

<table>
<thead>
<tr>
<th>Actual Investment Returns Net of Fees*</th>
<th>PSERS</th>
<th>SERS</th>
<th>Philadelphia</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Year</td>
<td>3.43%</td>
<td>2.70%</td>
<td>0.50%</td>
</tr>
<tr>
<td>3 Years</td>
<td>12.57%</td>
<td>7.80%</td>
<td>11.15%</td>
</tr>
<tr>
<td>10 Years</td>
<td>7.19%</td>
<td>6.00%</td>
<td>6.26%</td>
</tr>
<tr>
<td>25 Years</td>
<td>8.42%</td>
<td>8.80%</td>
<td>7.51%**</td>
</tr>
</tbody>
</table>

* The Actual Investment Returns are as of the date of CORP’s Issue Memo on Public Pensions published in September 2012.
** Philadelphia’s investment earnings were averaged from July 1, 1988.


Burns, Fran. 2012. Testimony of Fran Burns, Executive Director, Pennsylvania Intergovernmental Cooperation Authority, before the Public Employees Retirement Commission, October 3.


CalPERS. 2011. The Impact of Closing the Defined Benefit Plan at CalPERS.


Public Employee Retirement Commission.


