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PA

THE KEYSTONE PENSION REPORT

A DISCUSSION OF STRUCTURAL REFORM AND RELIEF TO PENNSYLVANIA'S RETIREMENT SYSTEM FOR LONG TERM SUSTAINABILITY

OFFICE OF THE BUDGET

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INTRODUCTION

Like the stone that locks an arch into place, Pennsylvania seeks a keystone—that integral lock that can both secure the delivery of essential programs and services to our more than 12 million residents and make good on the state's pension obligations to public employees. This keystone, in the shape of pension reform and relief, is essential to addressing the public funding crisis we now confront, which is being driven by rapidly rising pension costs. Reform must pave the way to a future that enables us to provide sustainable support for the core functions of state government and fulfill our consitutional mandates, while meeting our pension obligations to Pennsylvania's state government and public school employees.

Pension reform has become a key topic of discussion, news reports, and debate in nearly every corner of the commonwealth. It is a question on the minds of many, from members of the General Assembly, public and school employees, school district directors and administrators, to retirees, business leaders, and even state and municipal finance rating agencies. As well, it is a question increasingly on the minds of Pennsylvania taxpayers who ultimately bear the cost of the system through their tax dollars. All of these stakeholders, while representing diverse interests, recognize the crisis facing our state: that the commonwealth's growing pension obligations are crowding out funding for their children's basic and higher education, public safety, health, human services, the maintenance and repair of roads and bridges, environmental protection, and other core governmental programs.

Governor Tom Corbett has vividly described this dynamic as a "tapeworm" or "Pac-Man" eating away at the state's budget, an acknowledgment that growing pension costs are severely undercutting the commonwealth's ability to fund essential programs and services. Though no cure-all to Pennsylvania's budget challenges, the fiscal reality is that absent meaningful structural pension reform, the state's General Fund budget is on a very predictable path that will force a choice between either fully funding pension obligations or making cuts to the core functions of government on which our citizens rely.

The primary objective of this Keystone Pension Report is to provide Pennsylvanians a fact-based discussion of the funding crisis we now confront, describe the challenge the state faces in meeting its obligations to both our taxpayers and pension systems, and highlight the likely outcome for state programs and services absent meaningful pension reform. The Report is intended to provide financial facts, highlight key issues, and advance the dialogue on meaningful pension reform and relief, with a goal of creating a common framework around which solutions can be structured.

This report is organized around the answers to the following questions:

- What are Pennsylvania's statewide pension systems?
- What created Pennsylvania's pension problem?
- What is the pension challenge in Pennsylvania?
- What happens if we do nothing?
- How can we create a framework for solutions?

Pennsylvania Faces a Pension Crisis

Currently, the commonwealth faces a $41 billion unfunded pension liability. This depletes money from education, public safety, health and human services and critical infrastructure.

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WHAT ARE PENNSYLVANIA'S STATEWIDE PENSION SYSTEMS?

The commonwealth administers two separate pension systems. The State Employees' Retirement System (SERS) manages the retirement system for most public employees in the executive, legislative and judicial branches, authorities like the Pennsylvania Turnpike Commission, the Pennsylvania Game Commission, and the Pennsylvania Housing Finance Authority, as well as some of the employees in Pennsylvania's higher education systems, including the State System of Higher Education and state-related universities. The Public School Employees' Retirement System (PSERS) manages the retirement system for all public school teachers, administrators, and other public school employees.

Together, these two systems comprise more than 815,000 total members and pay out nearly $8 billion annually in retirement benefits to more than 300,000 retirees and beneficiaries (Exhibit 1). The pension systems are funded through a combination of: 1) employer contributions, 2) employee contributions and 3) investment earnings. Of these three components, SERS and PSERS rely overwhelmingly on investment returns as their primary source of funding, with nearly 71 cents of every dollar derived from investment earnings (Exhibit 2).

Pennsylvania's Public Pension Systems[1]

	SERS	PSERS
Current Total Members	**228,000**	**589,000**
Active	107,000	279,000
Retirees/Beneficiaries	115,000	195,000
Vested, but Inactive	6,000	115,000
Annual Benefit Payments	**$2.7B**	**$5.3B**

EXHIBIT 1

For SERS, the commonwealth and independent entities pay all of the employer contributions for public employees. Department and agency budgets must include sufficient funds to cover all salary and employee benefit costs, including the employer contribution to SERS calculated based on a percentage of payroll. For PSERS, the commonwealth and local school districts together share the employer contribution costs. As a general rule, the commonwealth pays a minimum of 50 percent of the employer contribution cost and that amount increases based on the relative wealth of the district, such that in the state's poorest school districts the state pays more than 75 percent of the cost. In the current fiscal year, 2012-13, the commonwealth's employer contribution costs for both systems are projected to total more than $1.5 billion, $677.4 million for SERS and $856.1 million for PSERS.

The amount of employer contributions are determined each year through a process that establishes an employer contribution rate that is, ideally, based on the amount required to fund the cost of the pension benefits earned that year by the active members in the plans plus any unfunded liability. Actuaries refer to this rate as the "normal cost." Reflected in the normal cost calculation is an assumed discount rate or investment rate of return. At present, the normal cost reflects an assumption of investment returns at 7.5 percent per year.

Employees also contribute to the respective systems. Employee contributions are a percentage of pay as fixed by statute, based on an employee's hire date and the multiplier selection. As such, employee contributions under both plans vary. SERS contribution rates range from 5 to 10 percent of pay, with most employees contributing 6.25 percent. PSERS contribution rates range from 5.25 to 10.3 percent, with most employees contributing 7.5 percent. Last year, employees contributed nearly $1.4 billion.

PSERS and SERS Funding Sources 2002-2011[1]

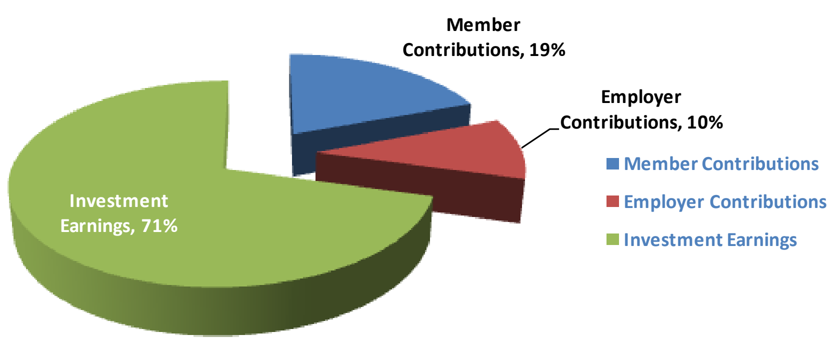

EXHIBIT 2

[1] SERS as of 12/31/11, PSERS as of 6/30/11

Both SERS and PSERS provide employees with what are known as defined benefit, or DB, plans. In a DB plan, the final retirement benefit paid to an employee is a fixed amount determined by a formula that includes years of service, final average salary and a multiplier (Exhibit 3). An important characteristic of DB plans is that the commonwealth, and ultimately the taxpayer, bears the entire investment risk of the plan, which is reflected in the annual employer contribution rate that the commonwealth must contribute. Active members of both pension plans accrue retirement benefits each year. In a DB structure, when investment returns go up, the commonwealth's employer contribution rate is reduced. When investment returns fall short of expected results, the commonwealth's employer contribution rate increases to cover the entire shortfall.

Pennsylvania's Basic Pension Formula

MULTIPLIER 2.5% or 2.0% X YEARS OF SERVICE X FINAL AVERAGE SALARY = RETIREMENT BENEFIT

EXHIBIT 3

WHAT CREATED PENNSYLVANIA'S PENSION CRISIS?

Helpful to addressing Pennsylvania's pension crisis is to understand its more recent history and what brought us to this crisis stage in the first place. Like other states, Pennsylvania's crisis was not caused by any single driver, but rather is the product of actions by previous administrations coupled with economic forces outside the commonwealth's control. In Pennsylvania's case, the primary drivers of the current pension crisis were generous improvements to member and retiree benefits that did not require a proportional employee match, nearly a decade of underfunding by state government and local school districts,[2] and investment returns that failed to meet expectations.

Historic Economic Expansion

Our starting point is in late 2000 into 2001, a time when the nation and states were coming off one of the greatest economic expansions in U.S. history. The stock market had expanded nearly four-fold. More than 20 million jobs were added. The Gross Domestic Product (GDP) had grown by about 3.4 percent annually. The commonwealth, along with the rest of the country, was experiencing wealth. Flush with investment returns, the funded ratios of SERS and PSERS were in well in excess of 100 percent (at their height, SERS was 132 percent funded and PSERS was 124 percent funded). That is to say, on paper at least, the actuarial values of the assets of the pension systems were significantly greater than the actuarial values of their accrued liabilities.

Generous Benefit Enhancements

It was in this financial environment, that **Act 9 of 2001 was passed**. Act 9 substantially increased pension benefits for public employees and public school employees. The pension benefit accrual factor (multiplier) was increased from 2 to 2.5 percent (an increase of 25 percent) without an adequate corresponding increase in employee contributions. The higher benefit formula applied to both new and current pension plan members and for current members was made retroactive back to the start of their commonwealth or school service, sometimes as much as thirty or forty years. Act 9 also lowered the vesting threshold from 10 years to 5 years, expanding the base of eligible beneficiaries.

Decisions

Decisions that were overly optimistic and short sighted, based upon the hope that the plans could earn their way out of deficit, led to annual decreased employer contributions and underfunding of the systems.

[2] We recognize that some school districts put funds into pension reserve accounts and may be faring better than other districts.

Economic Downturn and Uncertainty

Act 9 became law on May 17, 2001. Not long after came September 11, 2001, rocking the U.S. economy to the core. As a result of 9/11, the stock market, already down about 10 percent from its peak in 2000, lost more than 14 percent in the five days after it reopened on September 17th. It would take months for the market to recover these losses.

The investment returns of Pennsylvania's pension plans were not immune from the 2001 downturn. SERS experienced a more than 10 percent decrease, while PSERS saw growth of less than 3 percent in the value of its investments. A decline in investment returns meant an increase in employer contribution rates, which were set to go from near zero percent in Fiscal Year 2001-02 to greater than 5 percent in Fiscal Year 2002-03.

Early Legislative Approaches to Reform

Seeking to avoid this steep increase, **Act 38 of 2002** was enacted artifically capping employer contributions at 1.15 percent, in effect, arbitrarily underfunding the pension systems for one year and limiting the growth in the future employer contributions below actuarially recommended rates. For example, the PSERS employer contribution rate was set to increase to over 9 percent in Fiscal Year 2003-04, but these changes resulted in the rate being reduced to 3.77 percent.

Act 38 also established a cost of living adjustment (COLA) without identifying a funding source for it. The actuarial cost of this ad hoc COLA was $1.75 billion for both systems**.** Underlying Act 38 seems to have been a hope that the economic downturn would be short lived and the commonwealth could then backfill any gap through increased market performance.

SERS and PSERS Annually Required Contributions and Actual Contributions

Dollars in Thousands

Fiscal Year	SERS Annual Required Contribution	Actual State Contribution	Funding Shortfall $	Funding Shortfall %	PSERS Annual Required Contribution	Actual State Appropriation	Funding Shortfall $	Funding Shortfall %
2004-05	$105.20	$128.70	$23.50	22.34%	$409.30	$228.80	$(180.50)	-44.10%
2005-06	$319.20	$172.60	$(146.60)	-45.93%	$655.20	$254.50	$(400.70)	-61.20%
2006-07	$548.70	$224.00	$(324.70)	-59.18%	$861.10	$382.80	$(478.30)	-55.60%
2007-08	$617.30	$242.90	$(374.40)	-60.65%	$989.90	$451.10	$(538.80)	-54.40%
2008-09	$584.20	$244.70	$(339.50)	-58.11%	$983.70	$360.60	$(623.10)	-63.30%
2009-10	$643.90	$249.90	$(400.00)	-61.55%	$1,033.00	$342.60	$(690.40)	-66.80%
2010-11	$866.80	$300.40	$(566.40)	-65.34%	$1,256.30	$408.60	$(847.70)	-67.50%
TOTAL	$3,685.30	$1,434.50	$(2,151.60)	-60.00%	$6,188.50	$2,429.00	$(3,759.50)	-60.80%

EXHIBIT 4

When economic performance fell short of expectations, **Act 40 of 2003** was adopted to ease the impending fiscal shock of rising employer contribution rates. The main thrust of Act 40 was to artificially suppress employer contribution rates to both SERS and PSERS to the current fiscal year, through an actuarial manipulation that required the pension plans to recognize gains more quickly and losses more slowly. Act 40 resulted in the state's underfunding of both SERS and PSERS by more than $5.9 billion when comparing what should have been contributed--the annual required contribution (ARC) -- with actual state appropriations (Exhibit 4).

The impact of Act 40, however, did not stop there. In the context of the state budget, Act 40's underfunding of the pension systems had the effect of freeing up General Fund dollars that then became available to spend elsewhere. And spent they were. A beneficiary of this "robbing Peter to pay Paul" budget maneuvering was basic education, which over the succeeding years saw exceptionally high funding increases. The bulk of these new dollars found their way into school district budgets not only to support new programs, but also to pay higher employee salaries, which only further exacerbated future pension obligations given the role of salary in benefit calculations.

This same dynamic often repeated itself at a school district level, further contributing to the problem. Lower state contributions meant lower district contributions and, like the state, had the effect of freeing up dollars in local district budgets that could be and were spent elsewhere. Though some districts acted responsibly in putting funds into reserve accounts knowing a pension tsunami would eventually hit, many more regarded the lower contributions as new found money that made its way into new programs, more personnel, and higher salaries. No matter the final destination, the result was the same: an underfunding of pension systems while at the same time exacerbating future obligations (Exhibit 5).

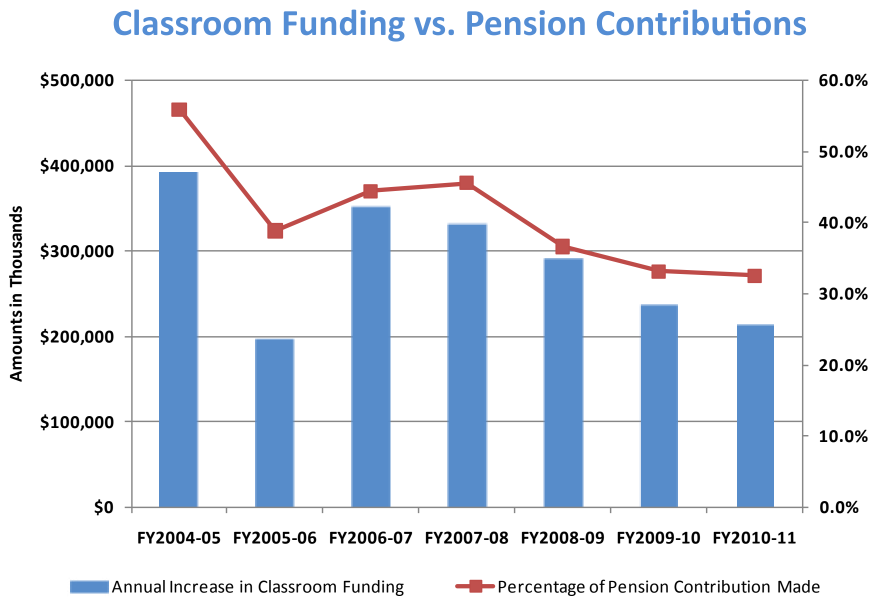

EXHIBIT 5

Assumptions about Investment Returns

Underlying each of the preceding legislative enactments were economic assumptions about the pension systems' financial health, as well as expectations as to future economic prospects. It seems particularly the case that past decisions to expand benefits or arbitrarily reduce contributions were predicated on the belief that the pension systems could earn their way out of any deficit, thereby satisfying any shortfalls. With this in mind, we take a brief pause to consider the role investment return assumptions play in the pension systems.

As noted above, the amount of employer contributions is determined each year through a process that establishes an employer contribution rate based on the amount required to fund the cost of the pension benefits earned that year by the active members in the plans, a rate known as the normal cost. Reflected in the employer normal cost calculation is an assumed discount rate or investment rate of return. SERS and PSERS both currently use an assumed rate of return of 7.5 percent. This rate though was only recently lowered, having previously been set as high as 8.5 percent.[3]

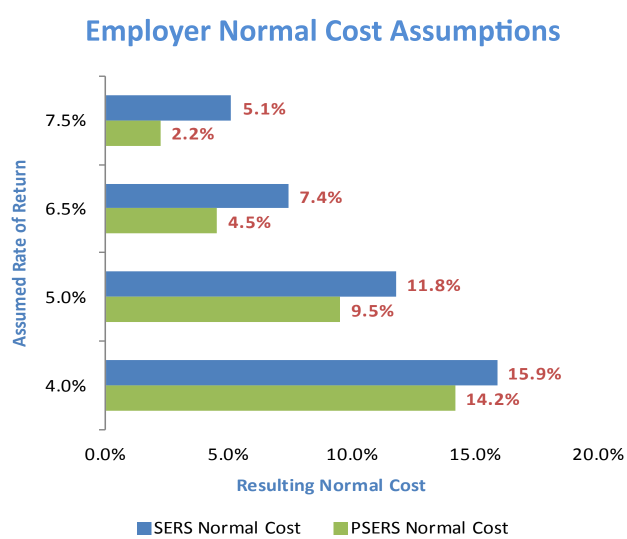

EXHIBIT 6

The higher the assumed rate of return, the lower the normal cost and conversely, the lower the rate of return, the higher the normal cost. This can be seen in Exhibit 6, which shows the current (2012) normal cost of 5.1 percent for SERS and 2.2 percent for PSERS, and how that cost increases as the rate of return declines.

For a time, SERS and PSERS outperformed their respective assumed rates of return. For much of the past decade, however, the actual investment performance of the pension funds' assets has not kept pace with the assumed rate of return, further contributing to the systems' unfunded liabilities and the difficulty of meeting current and future pension obligations.

[3] Note that since 2008, both SERS and PSERS have reduced their assumed rates of return.

The 2000s are generally known in the investment and finance worlds as the “Lost Decade.” During that time, the stock market went through one of the most volatile periods in recorded history. The S&P 500, which many consider as best reflecting the overall performance of the stock market, started the decade higher than it ended it, meaning no gains were achieved over the 10-year period, hence the lost decade. Over that time, the S&P registered two major plunges of over 50 percent and several declines of at least 10 percent. Pension plans, as a whole, lost much of the gains they realized during the 1990s and, in fact, went from surpluses to double-digit declines in asset value.

The Great Recession of 2008 was the knockout punch delivered to national pension plan earnings. The ripple effects of the lending market crisis and the subsequent credit crunch drove investors from the market and sent stock prices plummeting. Returns on investment holdings suffered some of the largest losses since the 1930s, and have yet to fully recover. The investments of our retirement systems were similarly affected (Exhibit 7).

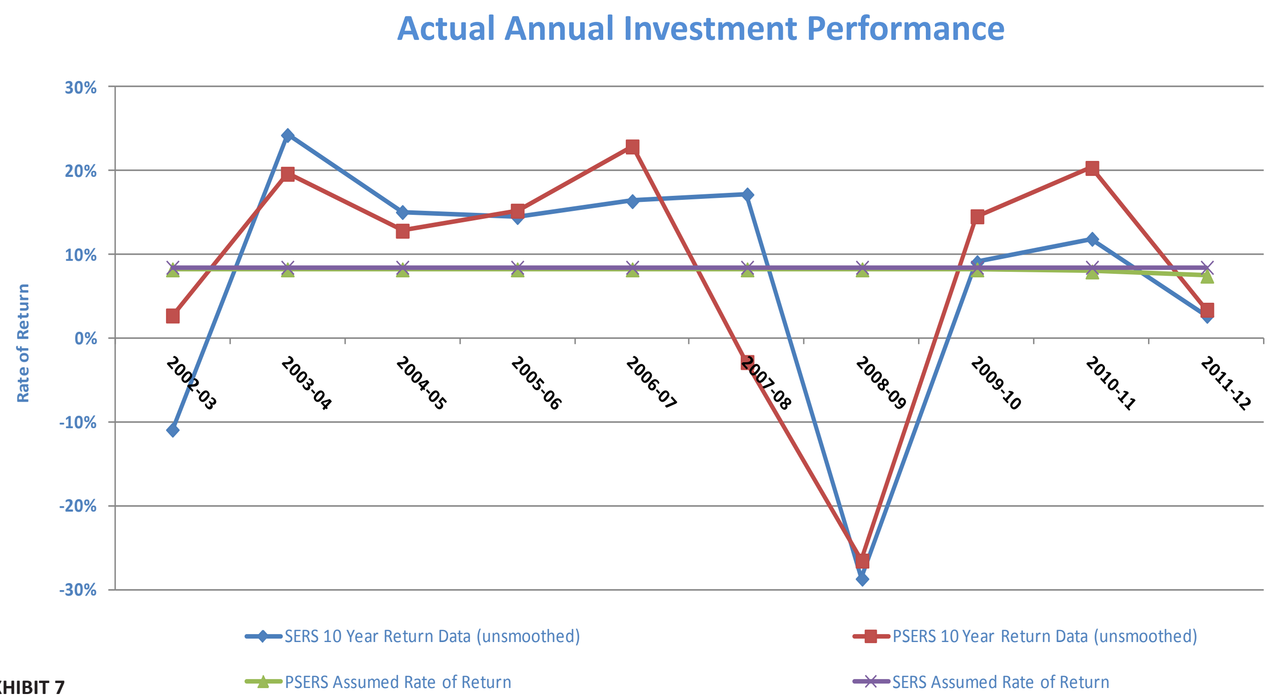

EXHIBIT 7

Turning A Corner

Breaking from previous legislative enactments, **Act 120 of 2010** was the first successful effort at curbing rising pension costs, containing savings offsets that previous legislation did not contain. A key milestone in reform, Act 120 began to “stop the bleeding” caused by previous Acts and instituted a number of important changes to reduce the costs of Pennsylvania’s public pension systems. The critical reforms implemented by Act 120 included:

- Creating short-term funding relief through a series of annual rate collars that artificially limited the amount the employer contribution rate could increase over the prior year’s rate to not more than 3 percent for FY 2011-12, not more than 3.5 percent for FY 2012-13, and not more than 4.5 percent for FY 2013-14. Especially noteworthy is that the short-term budget relief provided by Act 120 was “paid for” by long-term reforms that produced an overall savings to the pension systems;
- Reducing pension benefits for new employees by lowering the multiplier used to calculate retirement benefits from 2.5 percent to 2 percent, returning it to pre-2001 levels (Exhibit 8);
- Increasing the retirement age to 65 for new employees, extended the period for employees to vest from 5 to 10 years, and eliminated the lump sum withdrawal of their contributions at retirement; and
- Implementing an innovative “shared risk” provision for new employees that allowed for increased employee contributions if the actual investment returns fell below assumed returns.

Effects of Act 120 Changes on Retirement Calculations

Example 1 (Pre-Act 120 Hire Date)

Multiplier	Years of Service	Final Average Salary	Yearly Retirement Benefit	Monthly Retirement Benefit
2.50%	35	$ 50,767	$ 44,421	$ 3,702

Example 2 (Post-Act 120 Hire Date)

Multiplier	Years of Service	Final Average Salary	Yearly Retirement Benefit	Monthly Retirement Benefit
2.00%	35	$ 50,767	$ 35,537	$ 2,961

EXHIBIT 8

WHAT IS PENNSYLVANIA'S PENSION CHALLENGE?

Pennsylvania's pension challenge is multi-faceted. Past legislative actions expanded member and retiree benefits, oftentimes without funding support to sustain them. In addition, nearly a decade of underfunding by state government and local school districts, combined with investment returns that failed to exceed expectations, have left the state with massive unfunded liabilities and created growing employer contributions needed to fund past obligations. These costs are taking a greater and greater share of available revenues, threatening to crowd out funding for core governmental programs and services. We now look at each aspect of Pennsylvania's pension challenge.

Unfunded Pension Liability

Pennsylvania's two public pensions systems have a combined unfunded liability of over $41 billion.[4] In other words, the total liabilities (future retirement benefits to be paid) exceed the total assets of the combined plans by $41 billion in 2012. It is important to note that this unfunded liability is essentially a state debt owed to state workers and public school employees.

The latest actuarial valuations show that SERS is 65.3 percent funded, while PSERS is 69.1 percent funded. When the valuations of the two systems are combined, as Exhibit 9 shows, they are just under 68 percent funded.[4] A healthy funding ratio is considered 80 percent. The funded ratios of the two systems are expected to continue to decline in the next several years, hitting a low of 55.2 percent for SERS and 59.4 percent for PSERS before they begin to slightly rebound (Exhibit 10).

Pennsylvania's Pension Problem

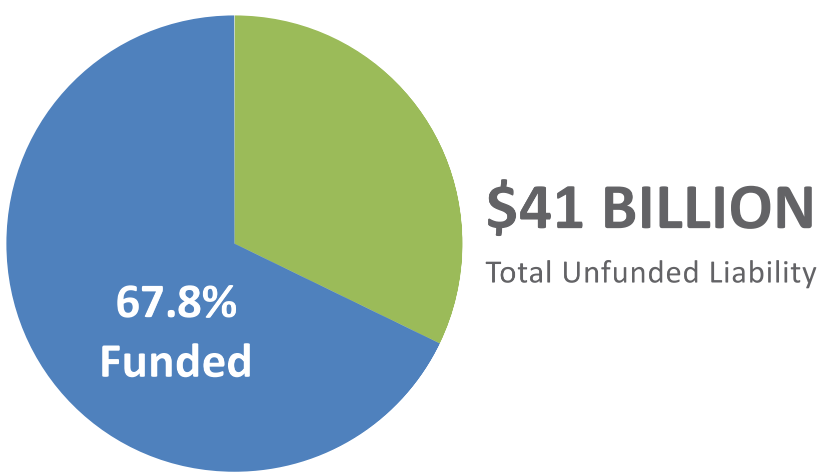

EXHIBIT 9

[4] SERS as of 12/31/11, PSERS as of 6/30/11

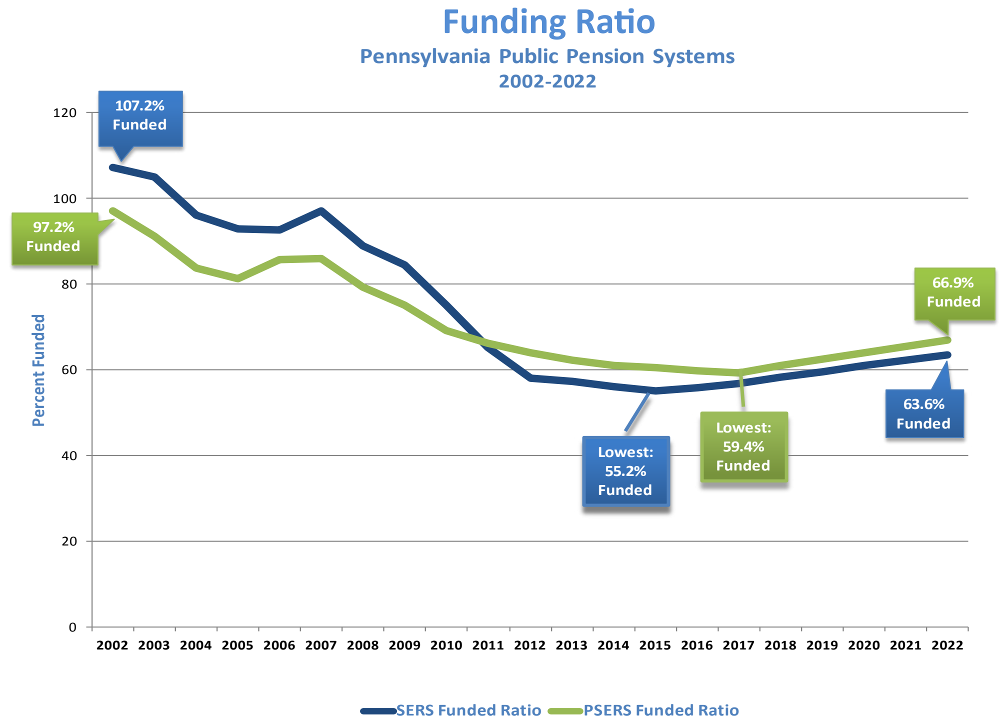

EXHIBIT 10

Growing Total Commonwealth Employer Contributions

To fund the current cost of pension benefits as well as the unfunded liability, Pennsylvania's total required employer contribution rates and total employer contributions will rise quickly. The employer contribution rate for SERS rate, which was just 5 percent in FY 2009-10, is now 11.5 percent, and will grow every year until it tops out at 32.5 percent in FY 2016-17. Likewise, the PSERS rate, which stood at 5.64 percent of payroll in FY 2010-11 is at 12.36 percent for the current fiscal year and expected to increase every year until it peaks at 28.04 percent in FY 2019-20. Both rates will plateau at these high levels for several years before retreating.

As the employer contribution rates for both systems grow, so do the total dollar amounts of required employer contributions, more than doubling every two years. Like a runaway freight train, contributions will rise over 625 percent in total funding in the coming decade.

These numbers are staggering but the pain they impose on the state budget comes in the year-over-year cost growth as pension contributions claim a growing share of the General Fund and of available new revenues (detailed in the next section). Costs have more than doubled in just the past two years, with net growth of $825 million. Looking ahead to FY 2013-14, total contributions are expected to increase by $697 million, just the start of the significant increases over the next five years. It is not until FY 2018-19, that the cost growth begins to taper down and level off, though at very high levels of overall commonwealth funding (Exhibit 11).

Fiscal Year	Total Commonwealth Contributions*	Dollar Increase*	Percent Increase
2010-11	$709		
2011-12	$1,064	$355	50%
2012-13	$1,534	$470	44%
2013-14	$2,231	$697	45%
2014-15	$2,971	$740	33%
2015-16	$3,752	$781	26%
2016-17	$4,346	$594	16%
2017-18	$4,765	$419	10%
2018-19	$4,968	$203	4%
2019-20	$5,164	$196	4%

*Dollars in Millions

EXHIBIT 11

Employer Contributions

Unfunded liability (future retirement benefits to be paid) requires the commonwealth to pay more in employer contributions to the pension systems. Employer contributions are the fastest growing line item in future budgets.

This fiscal year, increases in SERS and PSERS required employer contributions will be 43% and 46%, respectively.

Commonwealth Employer Contributions as a Share of Available Revenue

If the sheer size and growth in the state's total pension contributions over the next several years were not enough of a challenge, the effort to meet these obligations is made more difficult by the fact that pension costs are claiming a significantly larger share of all available new revenues in every budget cycle going forward for the foreseeable future. Like an oncoming tidal wave, pension costs threaten to overwhelm the General Fund budget and the vital programs and services that it funds.

Consider, for example, the impact of rising pension costs on the coming (FY 2013-14) General Fund Budget absent any reform. We know that total contributions will rise to $2.2 billion from $1.5 billion, aproximately a $700 million increase. Of this increase, $403.1 million is for PSERS and $293.9 million is for SERS. Of the SERS increase, about 37 percent is paid for out of the General Fund, which translates into a net impact to the General Fund of $511.3 million.

Next, consider the pension cost increase in the broader budget context. General Fund revenues, assuming a 3 percent growth rate, are expected to increase by $818.7 million this year. At $511.3 million, pension cost growth alone will claim 62 percent of all new revenues. If pensions alone were the only area of state government growing, the challenge posed here might be less acute. But, of course, pensions are not the only area of state government seeing substantial cost growth (Exhibit 12).

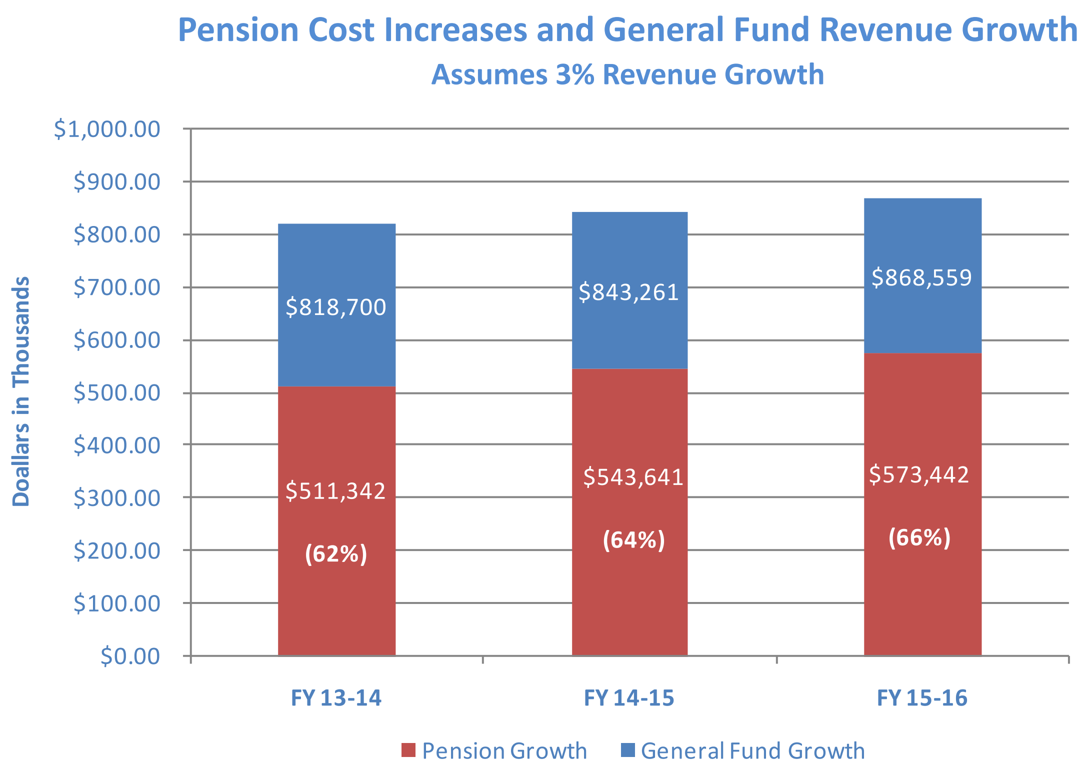

EXHIBIT 12

Along with pensions, the state is expected to see substantial cost increases in medical assistance programs, debt service, and prisons, which together total over $1.31 billion and outstrip projected revenue growth by nearly $500 million (Exhibit 13). Closing this gap to balance the budget, a constitutional requirement, requires cuts in spending elsewhere in the General Fund. Having already reduced over 260 distinct budget line-item appropriations in the past two years totaling over $1.25 billion, additional spending reductions, particularly of the magnitude necessary to close the gap, will almost certainly require cutting into core programs and services, absent a tax increase or revenue uptick. It is one thing to have accomplished line item reductions in 2003, when program spending levels were more robust, it is quite another, given today's leaner budget.

Cost Drivers in the 2013-14 Budget[5]
(in Thousands)

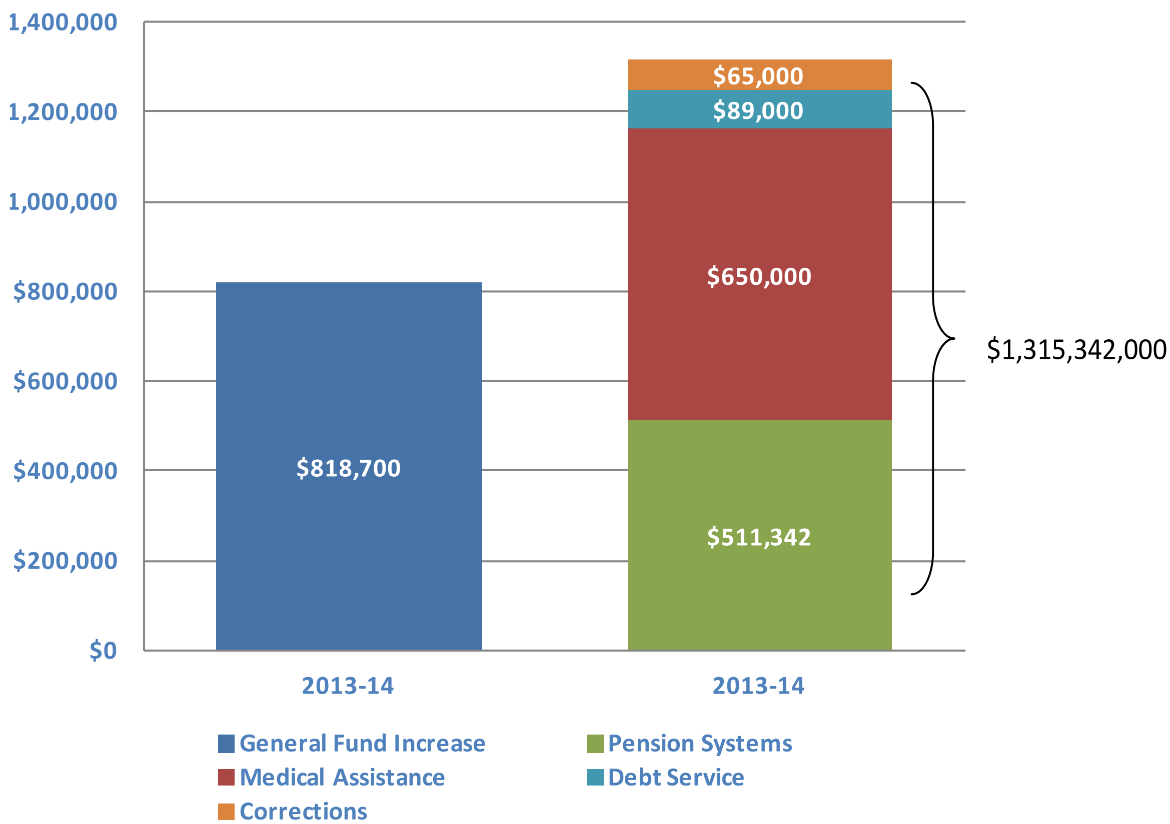

EXHIBIT 13

This dynamic of pension and other mandated cost growth exceeding new revenues that force reductions elsewhere in the budget in order to achieve balance is not a new phenomenon, nor is it one that will end with the coming fiscal year. The spending cuts of the past two fiscal years were due, in part, to this same dynamic. Going forward, as pension costs grow significantly year- over- year for the next several years, the future is likely to include similar reductions as more and more pressure is put on the General Fund (Exhibit 14).

PSERS and SERS Employer Contribution Projections
Dollars in Millions

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
PSERS Rate (%)	8.65%	12.36%	16.75%	21.25%	25.56%	26.26%
PSERS State Share ($)	$600.2	$856.1	$1,259.2	$1,688.4	$2,140.7	$2,385.8
SERS General Fund Rate (%)	8.00%	11.50%	16.00%	20.50%	25.00%	29.50%
SERS General Fund Share ($)	$172.3	$249.3	$357.4	$471.9	$593.1	$721.2
Total GF Contributions ($)	**$772.5**	**$1,105.4**	**$1616.6**	**$2,160.3**	**$2,733.8**	**$3107.0**
Year over Year Increase ($)		**$332.9**	**$511.2**	**$543.7**	**$573.5**	**$373.2**
Year over Year Increase (%)		**43.1%**	**46.2%**	**33.6%**	**26.5%**	**13.7%**

EXHIBIT 14

[5] Assumes a 3% revenue growth.

Crowding Out of Funds for Core Programs and Services

As the previous discussion shows, growing pension contributions are taking a greater share of available revenues. Pension costs added together with cost increases in other mandated expenditure areas are significantly outpacing all available new revenues. Closing the gap between these cost increases and available new revenues produces what is best described as a crowding-out effect on the rest of the General Fund Budget. That is to say, with mandated spending growing faster than available revenues, balancing the budget for the foreseeable future requires deep spending cuts in other areas of the General Fund, thus crowding out funding for core programs and services.

The areas at greatest risk of being cut are not "nice to have" government services and programs, but rather the core constitutional responsibilities of state government the commonwealth provides for through the annual budget process. These constitutional responsibilities include public safety and police services, health and human services, public education, and roads and bridges. These programs and services are all in jeopardy.

The impact of increasing pension costs along with other mandated cost areas in the General Fund directly correlates to not only less funding being available for other programs and services, but real cuts in these areas as they all compete for limited tax dollars. The commonwealth must first pay capital debt service obligations. Second comes pension obligations. Third, the commonwealth must pay any federally mandated match for entitlement programs. Only after these obligations have been met, can the commonwealth begin to pay for other programs and services.

As it stands, once debt service, pensions, and federal entitlement obligations are paid, there are too few dollars left to fully fund the remaining General Fund programs and services in this or succeeding fiscal years, therefore budget cuts must occur. As noted above, for 2013-14, this means having to cut as much as $500 million to balance the budget.

WHAT HAPPENS IF WE DO NOTHING?

Although some have given voice to the view that Pennsylvania does not have a pension crisis in light of the fact that our unfunded liabilities will be paid off and eliminated in 40 years, this rather narrow view fails to consider the commonwealth as a whole, beyond pensions, and the almost certain financial pain to core programs and services that will result from ever increasing employer contributions.

Absent structural redesign and reform of the pension systems, the commonwealth and the General Fund budget are on a very predictable path. With $41 billion in unfunded pension liability already incurred, we know that annual pension costs are growing significantly; that they are claiming a greater share of available new revenues; and that together with the cost growth in mandated expenditure areas, our liabilities will outstrip revenues each year. We know too that accommodating this mandated spending growth will force spending cuts in the rest of the General Fund budget - cuts that will impact directly core programs and services.

Just as it impacts at a state level, this same dynamic will play out in nearly every school district across the commonwealth. Increasing pension contributions obligations will claim a greater and greater share of school district budgets, crowding out funding for education, whether it is direct classroom instruction, sports, facilities and maintenance, and ultimately put pressure on districts to increase property taxes.

Increasing Cost to Taxpayers

Unfunded liability results if established employer contribution rates fall short of covering the assumed annual cost of the retirement systems. Currently, the combined unfunded liability for both systems is $41 billion. The legislatively created caps, which artificially restrain annual growth in the employer contribution rate, will still increase employer contributions from the

Cost to Taxpayers

Currently, the combined unfunded liability for both state pension systems is $41 billion. Each Pennsylvania household's share of unfunded liability is more than $8,000.

current 12.36 percent for PSERS to 28.04 percent in fiscal year 2019-20. Respectively, the SERS rate will increase from the current 11.50 percent to 32.50 percent in 2017-18. These rates will remain in place until the plans reach sufficiently funded status, which is not expected to occur for several years, assuming, of course that investment returns meet expected rates of return.

Over the next 30 years, the employer contributions required to fund this liability will reach $4.3 billion and $2.7 billion at their peak (Exhibit 15). If nothing is done, each Pennsylvania household's share of this unfunded liability would be $8,000.

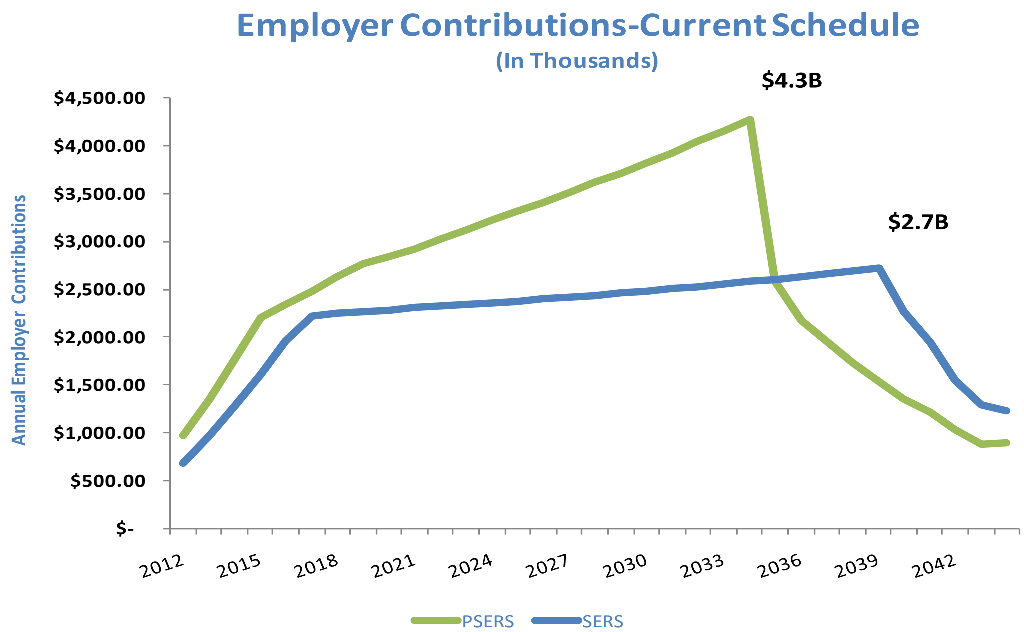

EXHIBIT 15

Negative Impact on the Commonwealth's New Business Growth

A growing number of leaders in the business community are concerned about the potential negative impact on employers and taxpayers, such as higher taxes and/or reduced services, should the pension crisis not be sufficiently addressed and the commonwealth is not able to meet all of its competing funding obligations. Among the major factors that go into a decision-making process for choosing a business location are regulation, geography, climate, employment laws, property values, business tax incentives, level of workforce skills, crime rates, and costs and standards of living. When evaluating a state's regulatory climate, as well as its tax system, businesses look for consistency and predictability. Job creators need to have confidence that the marketplace will remain consistent and stable and the commonwealth will be able to continue to provide core services to businesses and their employees.

Negative Impact on the Commonwealth's Credit Rating

The impending financial decisions demanded by the sizeable unfunded pension liability hinder confidence in Pennsylvania's financial strength, flexibility and structural balance. Underfunded pension systems have a negative impact on a state's credit rating, costing the taxpayer more in increased interest rates for bond issuance because the state's bonds are perceived as riskier investments. In Pennsylvania, the impact of increasing pension contributions has been reflected by a recent downgrade to the Commonwealth's bond rating:

- On April 10, 2012, Fitch Ratings provided, "The negative outlook reflects the commonwealth's limited financial flexibility in the context of revenues underperformance through the third quarter of fiscal 2012 and the challenges presented by significant expected growth in annual pension funding obligations in the next few years."
- On April 13, 2012, Moody's Investors Service noted, "The pension fund ratio has fallen to 75% and will continue to decline until 2017 when the commonwealth will begin to make its full actuarial recommended contribution under current legislation. Annual debt service costs, pension contributions and other post-employment benefit costs will increase substantially through 2012, absorbing an increasing percentage of the budget and challenging the Commonwealth's ability to return to structural balance."

HOW CAN WE PROVIDE A FRAMEWORK FOR SOLUTIONS?

Having a clear understanding of the crisis and the challenges we confront, it is imperative that Pennsylvania find a workable solution.

The rules governing pensions, benefit levels, and contributions are set by law. Structural reform and relief then can only occur through legislative action. Governor Corbett has indicated that he intends to include a pension reform proposal as part of his FY2013-14 budget. As we begin the process of working together towards a solution, there are several considerations that should help guide any framework to achieve a legislative solution.

1) **Put Taxpayers First:** Pennsylvania taxpayers did not create the pension crisis, yet bear the significant portion of cost of our pension systems through their tax dollars. Today, that cost is growing as never before, largely as a result of past decisions by their elected leaders and less-than-expected investment returns. They are contributing large sums to make good on the state's pension obligations to public employees, even as they see an erosion of support for services benefitting the larger public. Governor Corbett took a pledge upon being elected to not raise taxes. Tax increases, particularly in a difficult economy that is already straining many Pennsylvania families and business, should be off the table.

2) **Do No Harm to Retirees:** Former public and school district employees worked throughout their careers to feel secure in the fact that the pension payments they now receive in retirement will not be affected by any reform that the commonwealth undertakes.

3) **Respect Current Employees:** The commonwealth recognizes that any accrued retirement benefits of current employees cannot and will not be touched as a result of pension reform. Like our taxpayers, our employees did not create the pension problem. That being said, components of current employee's prospective benefit can be changed to conform with prior court determinations regarding deferred compensation. Given the current state of both pension systems, it may be necessary to explore changes to prospective benefits for all current public and school district employees.

4) **Achieve Intergenerational Fairness:** Pennsylvania has incurred $41 billion in unfunded liability. This is a debt owed, an obligation on which the state must make good. Any reform should not exacerbate this problem by pushing more of this onus to our children and grandchildren. Similar to the Act 120 reforms, any short-term prospective budget relief should be paid for by long-term reforms that are at a minimum cost neutral or, ideally, generate overall savings to the pension systems. By instituting meaningful cost offsets, the reforms of today will not leave the burden to tomorrow.

5) **Learn from Other States:** Pennsylvania is not alone in its pension challenge. Nearly every state is struggling in their ability to fund both pension obligations and meet the growing needs of core public programs and services. A 2010 report compiled by the Pew Center on the States notes that states collectively confront a $900 billion to $1.38 trillion pension funding gap[6]. The study found that while a majority of states have taken steps to address their pension issues, there was no singular solution or approach taken by states. Despite different approaches, the report is clear to point out that pension plans still face challenges in the long run due to the growing gap between assets and liabilities. The following examples reflect actions taken by other states, which Pennsylvania might consider in implementing long term structural reform to its pension systems:

    Increased Employee Contributions- As part of their pension reform efforts, several states have instituted increased member contributions. Depending upon the state, increases have been instituted for either current or new employees, and in some cases, both.

    Retirement Age- Increasing the retirement age even two to three additional years can yield significant savings. Pension benefits would still remain competitive, while allowing public and school employees to retire with security.

    Accrual Rates- Changes in how the basic pension formula is calculated, particularly the factor by which years of service and salary are multiplied could result in significant long-term stability to the systems.

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[6] Source: Pew Center on the States, 2012

Early-Outs- Providing an incentive to long-term public and school district employees to retire without penalty upon reaching certain milestones would provide the commonwealth with a long-term foundation of pension stability.

Risk Mitigation- There are a number of options that could provide greater risk balance in the systems. Those options could include transitioning from a defined benefit plan to a defined contribution plan, adopting a hybrid defined benefit-defined contribution plan, cash balance plan or modifying the current defined benefit plan to balance evenly the risk between employees and the employer through various investment return and contribution triggers. Increasing the flexibility of the plans to accommodate future economic downturns and stock market declines could also be important factors in structuring the systems for long-term sustainability.

Other Options- Changes in the term over which average salary is calculated, the elimination of overtime pay in salary calculations, or capping the retirement benefit could also yield significant savings and provide for long-term sustainability.

SUMMARY

Pennsylvania is at a crossroads with respect to its public pension systems. A number of factors have contributed to the financial distress and pension crisis that we now face. Some of these were within the control of past legislative leaders and government officials. Some were outside their control, including a global economic downturn and the resulting financial market decline, which continues to challenge us in the form of a substantial unfunded liability in our systems. The goal of pension reform in Pennsylvania is not to place blame, but rather to place the responsibility of building a balanced, solid and sustainable solution on all stakeholders.

Over the next few months, the Corbett Administration will work with General Assembly, stakeholder groups and the pension systems themselves to shape a realistic, strategic approach to building the long term sustainability and affordability of our pensions. This process will allow for the candid discussion of the issues, full and comprehensive examination of the options and the development of a long term solution for overall stability of the systems, as well as address the detrimental effects of spiraling pension costs on the commonwealth's ability to govern and to balance its future budgets.

Pension reform will not be easy, but it is achievable. With a measured and transparent process, the commonwealth can realize tangible, attainable results that will allow for the continuation of vital programs and services for our residents, provide equitable retirement benefits to our public and school district employees, and relieve the burden on taxpayers of paying for our pension systems.

GLOSSARY OF KEY TERMS

Accrued Liability: The difference between (a) the present value of future plan benefits, and (b) the present value of future normal cost. It is the portion of the present value of future plan benefits attributable to service accrued as of the valuation date. Sometimes referred to as "actuarial accrued liability."

Accrued Service: The service credited under the plan that was rendered before the date of the actuarial valuation.

Actuarial Assumptions: Estimates of future plan experience with respect to rates of mortality, disability, turnover, retirement, rate or rates of investment income and salary increases. Decrement assumptions (rates of mortality, disability, turnover and retirement) are generally based on past experience, often modified for projected changes in conditions. Economic assumptions (salary increases and investment income) consist of an underlying rate in an inflation-free environment plus a provision for a long-term average rate of inflation.

Actuarial Cost Method: A mathematical budgeting procedure for allocating the dollar amount of the "present value of future plan benefits" between the present value of future normal cost and the accrued liability. Sometimes referred to as the "actuarial funding method."

Actuarial Valuation: Pension fund value as determined by computing its normal cost, actuarial accrued liability, actuarial value of its assets, and other relevant costs and values.

Annuity: A specified income payable at regular, stated intervals for a set time period, often for the remainder of a recipient's life. (i.e. Defined Benefit)

Annual required contribution (ARC): The actuarially determined pension fund contribution in a single year. This includes the normal cost of the plan and also may include another amount that may be required to pay for a portion of benefits earned in past years that have not yet been funded.

Amortization/Reamortization: Paying off an interest-bearing liability by means of periodic payments of interest and principal, as opposed to paying it off with a lump sum payment. Reamortization refers to the recalculation of periodic payments of interest and principal.

Cost of Living Adjustment (COLA): Periodic increase in wages or salaries, to compensate for loss in purchasing power of money due to inflation. Rate of COLA is commonly pegged to a general index such as consumer price index (CPI). Also called cost of living allowance.

Discount Rate: The rate used to discount future pension obligations to determine pension benefit obligations.Also known as assumed rate of return.

Employer Normal Cost: The annual cost assumed, under the actuarial funding method, for current and subsequent plan years. Sometimes referred to as "current service cost."

Gain (Loss): A measure of the difference between actual experience and that expected based upon a set of actuarial assumptions during the period between two actuarial valuation dates, in accordance with the actuarial cost method being used.

Governmental Accounting Standards Board (GASB): GASB is the private, nonpartisan, nonprofit organization that works to create and improve the rules U.S. state and local governments follow when accounting for their finances and reporting them to the public.

Multiplier: A fixed percentage that is typically used, in conjunction with an employee's final average salary and years of service, to determine an employee's pension benefits.

Smoothing: The process of amortizing investment gains and losses over a period of time. For example, rather than using the market value of a fund's assets in determining the ARC, actuaries will calculate an actuarial value of assets, by taking, say, a five-year average of assets. This can help to reduce volatility in contribution rates.

Superannuation: Normal retirement age or full retirement status

Unfunded Liability: The difference between the actuarial accrued liability and valuation assets.

Vested/Non-Vested: Vesting occurs when the employee completes the number of years of service required before being entitled to pension benefits under the terms of the plan. A non-vested pension plan is one in which the employee has not completed the required years of creditable service in order to earn the right to receive benefits under the terms of the plan.

APPENDIX A – SURVEY OF NATIONAL PENSION REFORM EFFORTS [7]

PENSION REFORM EFFORTS 2010

STRATEGY	Number of States	Affect New Employees Only	Affect New & Current Employees
Increase Employee Contributions	10	4	6
Higher Age and Service Requirements	11	9	2[8]
Reduce Post-Retirement Benefit Increases	8	4	4[9]
Change Average Final Salary Calculation	8	8	
Reduce Benefit for Early Retirement	9		9
Greater Restrictions on Return to Employment	9		9
Switch from Defined Benefit to Defined Contribution or Hybrid	2	1[10]	1[11]
Vesting Changes	5	5	

PENSION REFORM EFFORTS 2011

STRATEGY	Number of States	Affect New Employees Only	Affect New & Current Employees
Increase Employee Contributions	5		5
Higher Age and Service Requirements	4		4
Reduce or Repeal Post-Retirement Benefit Increases	9	2	7
Change Average Final Salary Calculation	5	5	
Greater Limits for Early Retirement	7		7
Greater Restrictions on Return to Employment	3		3[12]
Switch from Defined Benefit to Defined Contribution or Hybrid	4	1	3

[7] Ronald Snell, State Pension Reform in 2010 and 2011, National Conference of State Legislatures (June 2011)

[8] Vermont will have higher service requirements for teachers who are more than five years from retirement. In Colorado, the higher service requirements affect members with less than five years' service

[9] In Rhode Island, will affect current members with less than 10 years' service. In Colorado, Minnesota and South Dakota, requirement reaches back to current employees and retirees. These are currently facing legal challenges.

[10] Utah will offer new employees choice of two plans-traditional DC plan with 10%/12% employer match depending on employee type. The second option is a DB plan and a 401(k) hybrid. Employees not required to contribute unless employer contribution is inadequate to maintain soundness of plan.

[11] Michigan replaced DB plan for employees hired after July 1, 2012 with hybrid plan. Includes DB component with higher age and service requirements and lower benefits than previous plan. Includes opt-out DC plan with four-year vesting and employer match. No post-retirement benefit increase.

[12] Calculations based upon data assumptions from Ronald Snell, State Pension Reform in 2010 and 2011, National Conference of State Legislatures (June 2011)

PENSION REFORM EFFORTS 2012

So far in 2012, eight states have made major structural changes in state retirement plans. Kansas, Louisiana and Virginia replaced defined benefit plans with cash balance or hybrid plans for new employees. Michigan has added an optional defined contribution plan for public school employees.

Alabama will close its existing retirement plan for most state and local government employees on December 31, 2012, and replace it with a new defined benefit tier that includes higher age and service requirements for retirement, a longer period for calculating final average compensation, a lower multiplier for calculating benefits, and, uniquely in 2012, a reduced mandatory employee contribution.

Kansas concluded a two-year reconsideration of its defined benefit retirement plans for state, school and local public employees with new statutory provisions that include generally higher contributions from current employees (or a reduction in benefits) and a cash balance plan for most new state, school and local public employees hired on or after January 1, 2015.

Louisiana will close its defined benefit plan for most state government employees and employees of higher education on July 1, 2013, and replace it with a cash balance plan.

Michigan will offer new members of the Public School Employees' Retirement System a defined contribution plan option in addition to the hybrid plan that has been mandatory for new members since July 2010. Members of previously-closed defined benefit plans will be required to choose between higher contribution rates or lower future benefit accrual rates, along with an option to move to a defined contribution plan. The state also terminated retiree health insurance coverage for members of the plan, replacing it with employer matches to employee contributions to deferred compensation plans plus a lump-sum termination payment.

New York closed its latest retirement tier for state and local employees, including most New York City employees, on March 31, 2012, and replaced it with a Tier 6 plan that increases the age of retirement, and provides a longer period for calculating final average compensation and a lower multipliers for calculating benefits. The legislation will increase employee contribution requirements with an unusual plan of scaling contributions to the amount of employees' salary.

South Carolina enacted legislation to increase employee contributions for current and new employees, increase age and service requirements for retirement with full benefits, provide a longer period for calculating final average compensation, cap future cost-of-living increases and terminate a deferred retirement option for general employees and teachers.

Virginia enacted legislation to require local government plan members to begin contributing 5 percent of salary to retirement plans, contributions that for many years have been picked up by employers. Local government employers will provide an offsetting salary increase. Separate legislation will close defined benefit plans for most state and local government employees at the end of 2013 and replace them with a hybrid plan with defined benefit and defined contribution components. Legislation also limited future cost-of-living increases.

Wyoming created a new defined benefit plan tier applicable to state and local government employees as of August 31, 2012. The new tier includes higher age and service requirements for retirement, a longer period for calculating final average compensation and a lower multiplier for calculating benefits. Contribution requirements are unchanged. Separate legislation provides that cost-of-living adjustments will be granted in the future only when the retirement system is fully funded.