

**Pennsylvania's
Retirement Security
Crisis**

Stephen Herzenberg
Keystone Research Center
March 17, 2010

Public Hearing on Public Pension Issues
Wednesday, March 17, 2010
Room 8-EA, Capitol East Wing

Good morning, Chairman Browne, Chairman Ferlo, and members of the Senate Finance Committee. My name is Stephen Herzenberg. I am the Executive Director of the Keystone Research Center (www.keystoneresearch.org). I am also an economist by training—but please don't hold that against me.

I appreciate very much the opportunity to testify before you on the issue of retirement security. In my remarks today, I want to offer a perspective and some suggestions that you may be less likely to get from other voices. My remarks draw on and update the perspective in a report on retirement security that Keystone Research Center released back in 2006 with the Center for American Progress.¹

My starting point is the observation that the real crisis, when it comes to the issue of pensions, is retirement security for middle-class families. As a county and a state, we have become substantially more affluent over the past several decades—indeed, GDP per capita is now slightly more than twice what it was in 1970 (<http://www.measuringworth.org/usgdp/>). Yet retirement security has eroded over this period. The share of workers with guaranteed (defined benefit) pensions has fallen sharply. Nearly half of all Pennsylvania workers (and a slightly higher share nationally) have no pension at all. As retirement security has eroded, the share of workers has grown that are expected to experience a 50% or larger decline in their income when they retire. Approaching half—44.1 percent—of families in America nearing retirement (between 56 and 64) could not replace 75 percent of their pre-retirement income in retirement. More than one-fifth of families nearing retirement, 21.1 percent, could expect retirement income below half of their pre-retirement income. Projected shortfalls in retirement income were larger for minorities, single women, and renters (table 5 in *Rewarding Hard Work*).

¹ Christian E. Weller, Mark A. Price, and David M. Margolis (2006). *Rewarding Hard Work: Give Pennsylvania Families a Shot at Middle Class Retirement Benefits*. Center for American Progress and Keystone Research Center: Washington, DC and Harrisburg, PA, October 4; online at www.keystoneresearch.org/sites/keystoneresearch.org/files/pa_pensions_report.pdf.

In sum, the fundamental issue is not the cost of pensions. The fundamental issue is that a country as affluent as the United States can't afford *not to* provide retirement security for the middle class.

Broadly speaking, the way to ensure retirement security for the middle class is two-fold: we need to develop savings vehicles for the half of workers who have no pension at all; we also need to maintain the stability of defined benefit pensions where they exist, including in the public sector.

Strengthening Retirement Security, Part 1: Expanding Access to Savings Accounts and Low-Cost Annuity Conversion

With regard to enhancing retirement security for the half of workers who have no pension, a first step is to facilitate the creation of some kind of worker and/or employer funded savings vehicle linked with employment. An idea that has gathering momentum nationally is to create “Universal Savings Accounts”—modest 401(k)-type savings plans to which employees and, where they choose to, employers, would contribute. Keystone Research Center, in partnership with state legislators, has been seeking to advance this idea since 2002, well before concern emerged about underfunding of public sector pensions. I point this out to underscore that our advocacy for USAs emerged, from the beginning the way I have presented it today—out of recognition of the torn fabric of retirement security.

Pennsylvania House Bill 1669 of 2007 was the last state bill introduced that would have created “Pennsylvania Voluntary Accounts” managed by the Department of the Treasury. We are looking forward in the near future at working with legislators and the Department of Treasury at advancing an updated state UVA proposal designed to mesh with anticipated reintroduction at the federal level of an “auto-IRA proposal.”²

² An auto-IRA provides for money to be automatically deducted from employee pay checks and contributed to an Individual Retirement Account (IRA) *unless* the employee takes the pro-active step of opting not to contribute. Making the default option for workers to contribute as opposed to the default being that workers do not contribute substantially raises participation rates. As of this juncture, federal proposals to establish mandated auto-IRAs are expected to have a small-employer exemption and also to have no provision for employer matching. Thus, there would still be room for the state to advance a complementary proposal that provides a *voluntary* opportunity for very-small businesses to enable their employees to participate in a USA. The state proposal could also complement a national auto-IRA bill if the state proposal provided an option for employers to match their employees' contributions.

Establishing this type of plan, which could be done at low or no cost to the state, is a missing part of Pennsylvania's retirement security debate.

In conjunction with more widespread savings accounts, another component of a long-term retirement security plan must be to expand options for low-cost conversion of DC savings plans into lifetime annuities that reduce the chance of retirees depleting their savings before they die. The pooling of savings into Universal Savings Accounts managed or contracted by the Department of Treasury would facilitate broad access to low-cost annuity conversion for Pennsylvania retirees.

Strengthening Retirement Security, Part 2: Shoring Up Public Sector Defined Benefit Plans

The second part of our prescription for strengthening retirement security is shoring up—fully funding—public sector pension plans. As others have testified before, those plans currently are underfunded (e.g., PSERS is at 79.2%) in large part because of inadequate employer contributions and because of fluctuations and declines in the value of the stock market. A third contributing factor, as you have also heard, was the retroactive increase of the pensions to 2.5% of salary times years of service (from 2%) for employees who didn't pay for it.

Before we get to how to find money to shore up PSERS and SERS financially, let me add some additional perspective on the proposal that some have advanced to shift new public-sector workers to defined contribution (DC) plans.

First and foremost, almost any proposal to switch to defined contribution plans would erode retirement security—as the PSBA proposal, for example, illustrates. Once you recognize that the real issue is retirement security, eroding such security isn't a step forward.

One of the reasons that defined contribution plans undercut retirement security is the fact that individual accounts are more costly to administer—put slightly differently, defined contribution plans transfer money from public sector retirees to account managers on Wall Street. The idea that we need to transfer more money to Wall Street at this point in U.S. history is certainly an interesting perspective.

If you drill down and look more closely at the workers that now depend on public sector pensions, it is possible to get an even sharper idea of the Pennsylvanians who would transfer the most to Wall Street with a switch to defined contribution plans for new public sector workers. Stay with me on this, because there are a couple of steps in the argument.

In the Pennsylvania public sector, as KRC documented in our report with CAP, college-educated professionals, from teachers to legislators, earn an average of 15% less than their college-educated counterparts in the private sector. (The gap would be even larger if we deducted from wages the higher contributions that public sector college-educated workers make to their own pensions.) The idea that folks at the high end make more money in the private sector is actually well understood—this becomes apparent when you think of the absurdity of the phrase “I’m leaving the private sector to go make more money.” In the real world, people leave the public sector to go make more money because, at the higher end of the scale, salaries are much higher in the private sector.

The private-public pay gap reveals that high-quality pensions compensate public sector college-educated workers, including teachers, for having low pay. In light of this, if pensions are eroded by a transition to DC plans, salaries would have to increase to attract and retain high-quality workers. If salaries don’t increase, the public sector would have an even harder time attracting and retaining high-quality teachers and professionals. Since market forces would drive up salaries to offset a reduction in the value of pensions, the state and school districts won’t end up saving the money that some observers seem to think they would. (And that’s even before we take into account the issue of the waste and inefficiency associated with individual accounts.)

Now there is one group of workers for whom average wages in the public sector are slightly higher than for the similarly-educated group in the private sector, along with the public sector workers having higher-quality pensions—non-college workers.³ For non-college workers, pensions could probably be eroded without a compensating increasing in wages, and without a dramatic rise in turnover.

³ For most non-college workers (i.e., those with “some college” but no degree and those with a high-school education), pay in the public sector is only slightly higher, on average, than in the private sector. The public sector only has a substantial wage advantage over the private sector for the 3.5% of the public sector workforce that does not have a high-school degree. See *Rewarding Hard Work*, Table 2, p. 9.

“Best case” (from a state cost savings perspective) with a transition to defined-contribution plans, therefore, we might be able erode pensions and total compensation for non-college educated workers, and use the resulting savings to roughly offset the inefficiency and administrative costs of individual accounts. If you break this down, it amounts to a transfer to Wall Street from secretaries, teacher assistants, janitors, and bus drivers.⁴ Now I’m a professional economist and only an amateur political analyst so I’ll defer to your judgment: but is this really something you want to try to sell to hard-working, non-college families in Pennsylvania—a policy that transfers money from them to Wall Street?

Fully funding Pennsylvania’s public sector defined benefit plans would also enable these plans to retain their valuable role in the economy. Well-funded pension plans are a particularly important source of financing for venture capital firms that finance small privately held startup companies in exchange for an equity stake in the companies. Pennsylvania venture capital firms in 2005, for example, received 20 percent of their resources from the DB pension plans for state government employees.

A Federal Retirement Security Proposal

A major challenge Pennsylvania faces is finding the resources to shore up public sector defined benefit plans and, also, ideally finding some resources to provide incentives and subsidies for employer and worker contributions to savings vehicles for the half of workers who currently have no pension of any kind.

One logical place to find money would be a small financial transactions tax. Wall Street’s bubble, and transformation into a gambling casino, is part of what contributed to the current underfunding of many defined benefit pension plans across the country. Imposing a small transactions tax that falls disproportionately on those with greater financial wealth would provide resources to strengthen retirement security and also discourage speculation and volatility on Wall Street. Resources from such a tax could be provided in the form of post-ARRA revenue sharing with the states—call it a “stimulus

⁴ The four occupations listed in the text are the four largest public sector occupations in Pennsylvania which do not require a college education. See Weller et al., *Rewarding Hard Work*, p. 8.

transition plan.” Stabilizing public sector pension plans and incentivizing additional retirement savings plans could simply be specified as among the legitimate uses by states of this additional revenue sharing money.