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THE PENNSYLVANIA MUNICIPAL PENSION CRISIS: A TIME FOR HARD DECISIONS

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At least a “One Trillion Dollar Gap”! That is how a recent Pew Foundation study described the unfunded liability that states face to pay for pension and other post retirement employment benefits (OPEB), mainly

healthcare benefits, that states have promised to employees. The truly

frightening aspect of the Pew study is that it is based on an analysis

completed at the end of fiscal year 2008, which for most states ended on

June 30, 2008, *before* the stock market crash of the second half of 2008 and the first half of 2009 that caused many of those funds to suffer significant losses. As a result, “The Trillion Dollar Gap” is potentially much larger.

Notwithstanding the fact that the Pew Study only examined the unfunded liability facing states, its analysis and findings and recommendations apply

equally to Pennsylvania’s local municipalities. Many municipalities have unwittingly followed the footsteps of state governments and face substantial unfunded pension and OPEB liability as well. Local taxpayers thus are potentially facing a double-barreled tax increase to fund the unfunded liability gap on the state and local levels.

While tax increases, wage and hiring freezes, benefit cuts for current employees and even furloughs and layoffs are the possible avenues to cut costs, local elected officials must also begin to take other necessary steps to address the structural and systemic problems that have caused this liability.

In a nutshell, “unfunded liability” with respect to pension and other post employment benefits (OPEB’s) is the difference between what a municipality should have saved to pay for such



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benefits, as they become payable and what it has actually saved. This unfunded liability is the result of several factors. The most common and often discussed factor is declines in the stock market that municipalities experienced in 2001-2002 and 2008-2009. However, unfunded liability is also caused by a combination of the following: overly generous benefits; interest rate assumptions that are unmet over time and for years have simply been too high; early disability retirements at benefit levels that are higher than the plan's normal retirement benefit; the spiking of final pension benefit calculations; and smoothing techniques that do not enable the pension fund to recover before the next market decline.

This past summer, the Pennsylvania legislature attempted pension reform through Act 44. As we all know now, Act 44 is a far cry from pension reform. Although Act 44 recognized the pension crisis facing the Commonwealth's local cities and municipalities, it merely enabled local governments to defer, defer and defer some more the unfunded pension liability.

Act 44 did nothing to even open the door for, let alone provide, real pension reform. In fact, in authorizing Deferred Retirement Option Plans ("DROP"), the legislature added a brand new pension enhancement. While the cost of DROPs is often minimized by DROP proponents, all can agree that Act 44, a bill that purported to be a pension reform bill to address a pension crisis on the local level is no place to be providing new pension benefits. With respect to true pension reform, Act 44 and the legislature have failed to assist local governments in truly fixing the pension and OPEB crisis.

Since there is no silver bullet to slaying this fiscal crisis and there has been no direct legislative assistance or even guidance from the legislature on this issue, the way out of this problem will not be easy. Although the ability of municipalities to impose real pension reform on the local level is hindered by the existence of legislatively mandated defined benefit plans, such as that required by Act 600 or the Third Class City Code, there are steps local elected officials and managers can take to begin to address their pension liability. At the very least, such steps will "draw a line in the sand" to stop the liability from increasing. Even if a municipality is fortunate enough to not currently suffer from an unfunded pension liability that will fiscally handicap the municipality for years to come, such municipalities should take heed of the problems and take steps to not fall into the same unfunded pension and OPEB liability hole.

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In addressing this issue, it is helpful for municipalities to separately address unfunded accrued pension liability and unfunded accrued OPEB liability. With respect to the unfunded pension liability, as opposed to unfunded liability for OPEB's, the solution is complicated by the fact that in many cases constitutional protections protect the reduction of benefits for current employees. In such cases, the key is often to stop digging by adding more pension benefits that cannot be taken away or reduced. Under the current state of the law in Pennsylvania, employers have a greater ability to change and even eliminate OPEB's, particularly post retirement health care, as long as the employee has not yet retired with a guaranteed benefit.

There are, however, several key steps that municipalities should take to begin to address this issue as soon as possible:

- *Pension and OPEB Audit.* The first step is to carefully review your pension plan and ordinances as well as all OPEB plan documents with your actuary, labor counsel and insurance broker. First, you should follow the proper and legally required avenues to eliminate any unlawful benefits. Second, carefully look for ways to alter benefits for current and future employees through benefit and plan design changes that will reduce current and future funding costs.
- *Stop Digging Now:* Remember, you may not get what you want in bargaining but if you do not ask, you definitely will not get what you want or need. All new benefit enhancements, including DROPs, for current employees should be resisted based on the current cost of the existing benefits.
- Regardless of whether you want to address pension benefit costs or OPEB costs, it is imperative that you first highlight the current cost of providing such benefits and create reasonable projections based on current fund performance and the fund (or GASB 45 Study) assumptions. This is also a helpful tool in projecting future municipal expenses overall.
 - As noted above, with respect to pensions, it is difficult to reduce future pension benefits for current employees; however, certain pension benefit should be examined, particularly the disability pension percentage if it is higher than the normal retirement benefit, to determine whether any avenue exists to reduce the benefit.
 - Likewise, consider the adoption of a new benefit structure for newly hired employees that provide the minimum defined benefit.
 - If law does not mandate a defined benefit pension, consider providing a defined contribution plan for newly hired employees (with or without and employer match). Although the adoption of newer, less costly plans will not eliminate your unfunded liability for your current employees, it will "draw a line in the sand" and begin to get your pension plan costs under control.

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- Any optional benefits that are not mandated by law should not be adopted. For example, cost of living increases, service increments, increased percentage calculations should be resisted.
- Although DROPs (or “double dipping” as the PEW Study characterized such programs) are now authorized, municipalities should resist the adoption of such plans after Act 44. Act 44 significantly reduced a municipality’s ability to negotiate a DROP under favorable terms. Municipalities also should carefully consider what benefit it will obtain by the existence of a DROP.
- Employee contributions to any defined benefit plan should be maximized to the fullest extent permitted by law.
- Any contract language relating to pension contributions should be carefully examined to determine if any change is necessary.
- With respect to OPEB’s, take the necessary legal steps, such as collective bargaining, seek to change the post retirement benefit structure for current employees to reduce the municipality’s future exposure. There are a variety of options ranging from increased cost sharing, plan design or the outright elimination of the benefits for current employees or new hires.
 - Plan redesign should also be explored to determine whether any cost savings could be realized through increased deductibles or other benefit alterations.
 - In addition, any OPEB benefit should be designed to change to match the same benefits that are provided to current employees. This will avoid being contractually required to have a menu of benefit plans for retirees, which often must be grandfathered by the insurance provider and become more costly over time.

Of course, all of the foregoing changes will require collective bargaining if the relevant work force is unionized. This has often provided a convenient excuse for some public employers to not seek change. Such employers often argue that the cost of drawn out negotiations, or Act 111 interest arbitration for uniformed employees, is not worth the time, energy or money. Such arguments have always been shortsighted, but are even more so today. The cost of interest arbitration, particularly when spread out over the term of the contract, is well worth the annual savings that can be obtained by changes to benefit and compensation structures. In fact, never have municipalities have more rational and persuasive arguments to justify the need for such change.