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

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Introduction

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

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

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

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

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

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

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

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

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

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

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

**National Trends**

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

The national-level analysis also examined the relationship between income inequality and economic growth. The analysis shows that this correlation was $-0.553$. This simply means that the higher the income inequality, the lower is the economic growth. Other factors considered in the analysis included rate of investment in public education and multifactor productivity. Multifactor productivity refers to economic inputs including labor, capital, and raw materials.

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

**State Trends**

The analysis found that the higher the number of negative pension changes made by a state government, the higher is the increase in income inequality in that state. Again, by negative changes we mean cuts in benefits, increases in employee contributions, and conversion of DB plans into DC or hybrid plans. The data show that the correlation between negative pension changes and income inequality during 2000–2010 was $-0.378$. This correlation means that the more negative changes a state makes to its pension plan, the higher is the income inequality in that state. The state-level data allowed us to do advance multivariate analysis to examine the relationship between pension changes and income inequality and between income inequality and economic growth.

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

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

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

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

Conclusion

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

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