

## PERS Reform Initiative for 2013

### Why this is important

The rates that taxpayer funded entities (school districts, local governments, state agencies) will pay to cover exploding public employee retirement costs will increase by 45 percent, or \$ 2 billion next year. That means that Oregon, in order to pay for the retirements of existing and soon-to-be retirees, will have to forgo hiring – and actually cut – hundreds of teachers, police, firefighters and other public employees next year. This is unacceptable.

### Background

Oregon’s ongoing problems with its pension system are rooted in complex, poorly understood plan designs, successive increases in benefits beyond what was originally intended or needed for adequate retirement, and inherently volatile capital markets. Problems and the range of possible solutions are well documented and will not be repeated here<sup>1</sup>. The system’s actuaries predict that unsustainably high taxpayer contribution rates will persist for the foreseeable future ([Milliman 2012, page 11](#)) unless the system is reformed.

*Growing PERS retirement costs are unfunded and unsustainable, and they threaten to swamp public service budgets, requiring school districts and localities to forgo hiring – and actually cut – hundreds of teachers, police, firefighters, and other public employees.*

### The Oregon Business Plan Strategy

Public employers, pension experts and business leaders have convened to assess problems associated with growing PERS liabilities to state and local governments and to advance recommendations for system reform. The need for change is indisputable. Failure to address rising pension costs now undermines efforts to improve education, health, and public safety.

The policy changes outlined here are fair to public employees and taxpayers and are consistent with long-established PERS mandates. Enactment would meaningfully reduce the system’s long-term unfunded liability, translate into lower costs to public employers in the near-term, and free up resources for important public sector investments in education, health and public safety.

The PERS Board and Oregon Legislature should pursue these initiatives immediately. Together, these reforms will reduce system liabilities, provide much needed relief to government employers, and preserve the adequacy of affected retirees’ pensions.

Reform options are numerous. In choosing between them, the following principles were applied:

1. **Adequacy and Fairness to Public Employees.** Affected beneficiaries should have an adequate retirement income for a given level of public service. Experts generally agree that an “adequate retirement benchmark” is 75 to 80 percent of final average salary (Oregon PERS: Burdened by the Past, Poised for the Future. City Club of Portland. 2011. Pg 4), including Social Security income. For many years (until the benefits produced by the “Money Match” formula grew way beyond intentions) the stated policy goal of PERS was to replace 50 percent of final salary that, combined with Social Security, would hit the 75 to 80 percent mark. Today PERS members with 30 years of service retire, on average, [with an 80% salary replacement ratio just from the base retirement plan](#) (Oregon PERS. *PERS by the Numbers*. December 2012). When you add in the supplemental

<sup>1</sup> See, for example, Milliman (2012), City Club of Portland (2011), Pew Center on the States (2012), ECONorthwest (2007)

“Individual Account Program” (IAP) which functions like a 401K plan and social security income, this average is above 100%.

2. **Legality.** The reform must stand a high likelihood of withstanding legal challenge.
3. **Actuarial Soundness.** The reform should reflect best actuarial practices and ensure that the system is well-funded over the long-term.
4. **Fiscal Impact.** The collection of reforms should provide fiscal relief in the 2013-2015 biennium.

## Recommendations

### **1. Use Market Rate Factors to Annuitize the Money Match Benefit.**

#### **Concept**

The money match option, which is unique to Oregon’s pension plan, has generated excessively high benefits for some retirees and has been a key driver of PERS’s unfunded liabilities. Under the option, a member’s individual account balance is matched dollar for dollar, and the resulting balance is annuitized at an 8 percent rate. The Board’s use of the 8 percent rate is wholly inconsistent with the nature of the benefit. Rather, the PERS Board should use a rate that is available in the commercial annuity market – currently about 3.25 percent. The Board would apply the change prospectively. Pre-reform retirees would be unaffected. Portland’s City Club advanced a similar concept in its May 2011 report.

The change would reduce the value of the money match option for future retirees. All affected retirees would be eligible for a benefit under the existing full formula or full formula plus annuity calculations. Those alternatives would effectively provide an adequate safety net.

#### **Evaluation**

**Adequacy.** All affected retirees would retire with no less than is provided through the full formula or full formula plus annuity. PERS’s Tier I and II full formula generates a 50 percent wage replacement for a 30-year employee. Retirees are additionally eligible for Social Security, and the benefit produced by contributions to their IAP Account. For most PERS retirees this will produce a monthly benefit at Social Security retirement age of close to or even in excess of 100 percent of final average salary.

**Legality.** The PERS contract does not specify an exact formula to calculate the money match annuity. Moreover, no contractual commitment exists to maximize the money match benefit. However, there may be a question whether a change to the annuity factors can be applied to existing account balances or whether the benefit a PERS member anticipated using current annuity factors is a protected accrued benefit that cannot be reduced.

**Actuarial Soundness.** Using rates available in the commercial marketplace is a sound, defensible policy.

**Fiscal impact.** PERS estimated that a two-percentage point reduction in the annuity rate (from 8 to 6 percent) would reduce the system’s unfunded liability by \$1.7 billion. Using commercial rates (approximately 3.25 percent) should create an even larger reduction in the liability. This reduction in long-term liability would translate to significant savings in the rates taxpayer funded school districts, local governments, and state agencies will pay each year.

#### **The Rate Game: Three Rates, Three Purposes**

**Assumed Earnings Rate (AER).** The annual rate or return that the PERS Board assumes will be earned by the funds’ investments. It is currently 8 percent. Over the past 5 years, the actual earnings rate was 4.43 percent.

**Guaranteed Rate of Return (GRR).** The annual rate of return that PERS members are guaranteed to receive (while working) on their accounts, regardless of actual market returns. Under law, the GRR must match the AER.

**Annuity Rate.** When Money Match members retire the balance in their account is doubled and converted to an annuity. The annual interest rate on the annuity is currently 8 percent, but not law requires that it match the AER or GRR. The market rate for a private annuity is currently 3.25 percent.

## **2. Sunset the Member Contribution Requirement.**

### **Concept**

State law requires PERS and OPSRP members to contribute 6 percent of their salary to retirement. Many public employers negotiated to “pick up” the employee’s contribution. Before the 2003 legislative changes, the members’ contributions were deposited into regular accounts that were eligible for money match. Post 2003, member contributions build an Individual Account Program, which functions like a traditional defined-contribution plan.

The provision of state law requiring employees to contribute 6 percent to their retirement should be eliminated. This would indirectly eliminate the employer pickup of employee’s contributions. Whether and how employees and/or employers make supplemental contributions to retirement or otherwise adjust total compensation would be left to their contractual negotiations.

### **Evaluation**

*Adequacy.* Experts suggest that an adequate retirement benchmark is between 70 to 80 percent of final working salary, inclusive of Social Security and other retirement savings. Tier 1, Tier 2 and OPSRP employees who have worked a full career in government will be well above that benchmark even with the elimination of the 6 percent contribution. Moreover, employees could voluntarily make individual retirement contributions under an alternative program (Section 457), or negotiate new agreements under collective bargaining, if they were concerned about the adequacy of their pension.

*Legality.* The Oregon Legislature has the authority to eliminate the 6 percent requirement.

*Actuarial Soundness.* To employers the pick up is a 6 percent increase in the total cost of compensation, and, because it’s factored into final average salary calculations, it contributes to PERS’s long-term unfunded liability as well. Meanwhile public employees see the pick up as a tradeoff for accepting lower salaries. Eliminating the member contribution would end the confusion and, through collective bargaining, produce total compensation that is more transparent and commonly understood.

*Fiscal Impact.* About 70 percent of employers pick up the 6 percent contribution. If all of this employer expense were eliminated, biennial savings for those employers would total about \$750 million. The savings is likely less because employers and employees would renegotiate contracts to take elimination of the 6 percent contribution requirement into account in determining total compensation. Additionally, employer contribution rates would decrease approximately .67 percent, saving approximately \$124 million per biennium, due to a reduction in the final average salary (FAS) for those Tier One/Tier Two members whose IAP contributions are picked up and who retire under the Full Formula or Formula Plus Annuity benefit calculation method.

## **3. Eliminate State Tax Adjustment for Non-Oregon Residents.**

### **Concept**

Until the late 1980s, PERS pensions were exempt from state taxation; however, federal pensions were taxed. In 1989, the U.S. Supreme Court ruled that state pensions could not receive more favorable tax treatment than federal pensions. In 1991, the Legislature imposed a tax on PERS pensions, but the Oregon Supreme Court later ruled the tax effectively reduced the value of the benefit and, therefore, violated the PERS contract. In 1995, the Legislature enacted HB 3349, which increased PERS benefits to offset the effect of the state taxation. Only PERS members who established membership prior to July 14, 1995 are eligible for the benefit increase.

PERS makes the so-called state tax adjustment to the pension whether or not the retiree lives or pays taxes in Oregon. Under this recommended policy, PERS would not include the benefit increase for retirees who declare residency (for tax purposes) outside of Oregon.

## **Evaluation**

*Adequacy.* PERS staff estimates the policy would reduce annual benefits of current out-of-state retirees by about 6 percent annually. The policy would affect about 15 percent, or 16,000, retirees. The change would still leave retirees above adequate wage replacement levels. The only effect is that out of state beneficiaries would not be “reimbursed” for Oregon taxes that they are not paying anyway.

*Legality.* It is highly likely that the change would survive a legal challenge.

*Actuarial Soundness.* The policy simply eliminates an unintended benefit.

*Fiscal impact.* Uncollared employer contribution rates would fall by .4 percent of payroll. The unfunded liability would decline by \$450 million.

### **4. Change the Definition of Final Average Salary to Reduce Instances of Pension Spiking and Padding.**

#### **Concept**

Statutes allow employees to apply overtime, vacation pay, unused sick pay, and other adjustments to boost the level of final average salary (FAS) (used in pension formulas) of near-term retirees. Moreover, pre-retirement raises or promotions have generated some pensions that are inconsistent with an employee’s broader compensation profile. The recommended policy change would tighten the definition of FAS to mitigate so-called pension spiking. This could include limiting the final average salary to base pay and limiting the growth of base pay for late career employees (at least for the purposes of pension formulas).

Because of the different availability of overtime and other adjustments, only certain types of public employees (e.g., police and fire) can take significant advantage of spiking and other public employees with more fixed compensation (e.g., teachers and general service) cannot inflate their final average salary as significantly. Eliminating the opportunity to spike FAS provides greater fairness as among public employees, as well as to taxpayers.

#### **Evaluation**

*Adequacy.* Concentrated back-end use of overtime, vacation, and unused sick time distorts the final wage and distorts the pension. The adjustment would bring the pension into line with base pay that was more typical over the employee’s public service tenure and to which the standard of 70 to 80 percent replacement rate applies.

*Legality.* In recent years, states and localities across the U.S. have used a variety of approaches to limit spiking. Nothing in Oregon law gives employees a contract right to inflate their “final average salary” with one-time adders above base compensation.

*Actuarial Soundness.* Spiking is an abusive practice that undermines predictability and confidence in the system.

*Fiscal Impact.* According to PERS, uncollared employer contribution rates would decrease by about 1.35 percent of payroll if the policy eliminated lump sum vacation and unused sick leave as factors for PERS Tier I and II. OPSRP already excludes vacation and unused sick time.

### **5. Create a Dedicated Portfolio of Conservative Investments to Back the Tier 1 GRR.**

#### **Concept**

Tier I members are guaranteed a rate of investment return on their member account. By statute that guaranteed rate is the Assumed Earnings Rate, currently 8 percent. However, to achieve an 8 percent return, PERS invests in assets such as stocks which are highly volatile from year to year, and inconsistent with the idea of a guaranteed return. (Would any prudent investor guarantee an 8 percent annual rate of return every year with stocks and other investments volatile investments? To do so would violate

every prudent investment principle imaginable.) The proposal is that that PERS trustees should bifurcate the PERS investment fund such that there is one pool of relatively safe, stable investment used to provide the Tier 1 guarantee. All other investment would be a general pool. Together the two pools would be expected to produce an overall rate of return of 8 percent or whatever rate is recommended by the actuary and accepted by the Board, but the Assumed Earnings Rate of the guarantee pool would be whatever can be reasonably expected to be produced by that pool. In today's interest rate environment, that would likely be something in the 3 to 4 percent range.

### ***Evaluation***

If the PERS investment fund were to be bifurcated into two distinct, identifiable investment pools, each could and should be assigned a separate Assumed Earnings Rate based on what advisors expect each pool to earn. Currently the advisors believe a combined rate of 8 percent is reasonable, although they have suggested a slightly lower rate would be more prudent.

*Adequacy.* Lowering the guaranteed Assumed Earnings Rate for Tier 1 members would reduce expected money match benefit for that group, and only that group. Since membership in Tier 1 is limited to members who joined before 1996, this change has no impact on the majority of PERS members, but impacts those whose benefits are otherwise most likely to exceed 100 percent of pay.

*Legality.* There is nothing in the Oregon Revised Statutes that requires there be only one Assumed Earnings Rate.

*Actuarial Soundness.* The existing 8 percent guarantee is not actuarially sound. Every year the fund earns less than 8 percent, yet PERS must still credit Tier 1 members with an 8 percent return. By bifurcating the fund into two distinct investment pools, PERS can create a sustainable interest crediting policy without driving up employer contribution rates which would occur if there remains a single Assumed Earnings Rate and that rate is lowered.

*Fiscal Impact:* This change would save \$320 million annually if 3.25 percent Assumed Earnings Rate is used for "safe" fund.

### ***6. Apply COLA Only to First \$24,000 of a Member's Retirement Benefits.***

#### ***Concept***

The average PERS retiree benefit is about \$24,000 per year. Approximately 58 percent of all current retired members receive a benefit of \$24,000 per year or less and would not be impacted until their annual benefit after COLAs grew to greater than \$24,000. Benefits above the specified level would diminish further in purchasing power over time due to the impact of inflation on the portion of the annual benefit that exceeds \$24,000.

*Fiscal impact.* Uncollared employer contribution rates would decrease by about 3.2 percent of payroll or save approximately \$576 million per biennium. This change would reduce system liabilities by approximately \$3 billion.

#### ***Resources***

City Club of Portland. May 2011. [\*Oregon PERS: Burdened by the Past, Poised for the Future.\*](#)

ECONorthwest. August 2007. [\*Public Employee Retirement in Oregon: Where does the system stand and where could Oregon go from here?\*](#)

Milliman. August 2012. [\*December 31, 2011 Actuarial Valuation: Oregon Public Employees Retirement System.\*](#)

Oregon PERS. December 2010. [\*Analysis of PERS Cost Allocation, Benefit Modification, and System Financing Concepts.\*](#)

Oregon PERS. December 2012. [\*PERS by the Numbers\*](#)

The Pew Center on the States. June 2012. [\*The Widening Gap Update\*](#)