A Recommended Framework for PERS Reform

Executive Summary

Rather than pursuing reforms of the Public Employee Retirement System on a piecemeal basis, selecting isolated cost-reduction reforms from a menu of options, we recommend creating a framework for a package of reforms intended to:

- Establish an adequate and affordable retirement plan for public employees in the future;
- Achieve significant savings for public employers and taxpayers;
- Ensure that employees are contributing to the mitigation of future PERS costs in proportion to their share of the system's liability for benefits earned throughout their careers;
- Correct the inequities that would otherwise persist between older and younger workers (regarding benefits) and higher- and lower-paid workers (regarding future cost-sharing); and
- Pass constitutional muster in light of the Oregon Supreme Court's *Moro* decision.

Our recommended framework offers two levers to achieve these goals.

1. *Equalize pension benefits for current workers so that those in Tier 1 and Tier 2 (hired before August 28, 2003) accrue benefits hereafter that are as close as possible in cost to those now being earned by employees in Tier 3 (OPSRP); and,*
2. *Establish an employee contribution toward the accrual of future pension benefits that is differentiated for Tier 1/2 and Tier 3 employees, is calibrated to minimize the contributions required of lower-paid employees and is structured to allow the redirection of payments to the system's supplemental retirement savings plan (known as the Individual Account Program or IAP) to cover the employees' contribution to the pension plan.*

Within this framework, we offer the following legislative concept to illustrate a package that could be designed to implement these recommendations. We also encourage policymakers to explore other legislative and administrative policy changes that could achieve similar results.

- Freeze current employer contribution rates through 12/31/17;
- Establish the following new provisions effective 1/1/18:
    - Create a new tier of benefits for Tier 1/2 employees that is as close as possible in design and cost to OPSRP; alternatively, authorize and direct the PERS board to design and establish the new tier of benefits for Tier 1 and 2 to be as close as possible to OPSRP in its "normal cost;"
    - Reduce the annuitization rate for Money Match to reflect current market rates;
    - Establish an employee contribution for pension benefits (distinct from IAP) at all tiers of coverage, differentiated by tiers (not to exceed 6% for Tier 1/2 and 3% for Tier 3 employees) and by salary level (e.g. no contribution required on the first $30,000 of salary);
    - Direct the PERS board to reset the employee contribution rates up or down every biennium thereafter (within the 3% and 6% maximums) so as to provide for proportionate increases or decreases in the employee rate when the UAL attributable to current employees rises above or falls below the levels identified in the actuarial report used for 2017-19 rate setting;
    - Provide that employees may opt to direct some or all of their IAP contributions to cover their contributions to the pension plan, thereby allowing an individualized redirection of the IAP on an employee choice basis.

Background

The following proposals take a forward-looking approach to mitigating the impacts of rising PERS pension costs that will otherwise claim ever-larger shares of public budgets in Oregon over the next 20 years. If unaddressed, these costs will divert funds from services and shift costs to taxpayers, fee payers and tuition payers, even as the economy continues to deliver revenue gains in excess of inflation and population growth.

From a backward-looking perspective, what is done is done and cannot be changed. The underfunding and overpromising of benefits in prior years have created a $21.8 billion liability for PERS employers and their taxpayers. This is a bill that must be paid. In its origins, it is a legacy cost. In its effects, it looms as decades-long opportunity cost, diverting resources that would otherwise go to sustain and improve our public schools, public safety, health and social service systems and to maintain and expand our public infrastructure. This is because the Oregon Supreme Court has ruled that it is unconstitutional to recover any of the PERS unfunded liability from those already retired or by reducing benefits earned to date by those in the current workforce. Benefits earned to date are promises that must be kept. But, because of these promises, yesterday's bills must be paid by tomorrow's taxpayers or borne, in some fashion, by today's and tomorrow's citizens (in the form of service reductions) and public employees (in the form of lower compensation and higher workloads).

Our choice then is to accept these costs, do nothing to mitigate them and suffer a cascade of negative effects on public services for decades to come – or to manage these costs and mitigate their impacts in a manner that is fair to taxpayers, protects public services and sustains adequate retirement benefits for public employees. We support the latter approach.

Summary of Our Approach

In this endeavor, we began with a forward-looking question:

What would constitute an adequate and affordable retirement plan for public employees in the future?

From there, we quantified the savings to be achieved for employers from establishing such a system of retirement benefits – more affordable but still adequate -- compared to the trajectory of cost increases projected under the current system.

We then looked at what current employees would give up or "contribute" in the mitigation of future costs compared to their share of the unfunded liability attributable to them and their co-workers for the benefits they have earned to date.

Finally, we structured our solutions to address the inequities that would otherwise persist between older and younger workers (in regard to benefits) and the differential burdens that would accrue to higher-paid and lower-paid workers (in regard to future cost-sharing).

This approach led us to two recommendations:

1. *Equalize pension benefits for current workers so that those in Tier 1 and Tier 2 (hired before August 2003) accrue benefits hereafter that are as close as possible in cost to those now being earned by employees in Tier 3 (OPSRP); and,*

2. *Establish an employee contribution toward the accrual of future pension benefits that is differentiated for Tier 1/2 and Tier 3 employees, is calibrated to minimize the contributions required of lower-paid employees and is structured to allow the redirection of payments to the system's supplemental retirement savings plan (known as the Individual Account Program or IAP) to cover the employees' contribution to the pension plan.*

We found that the savings to be achieved from these two recommendations can be significant – potentially as large as the savings projected for the 2013 "grand bargain" legislation. Further, these savings would align with the share of the unfunded liability that is attributable to current employees, thereby assuring that their "contribution" to mitigation would not exceed their share of the system's liabilities.

Finally, these recommendations need not force a reduction in pay, nor in net take-home pay, for any employee, unless an employee chooses to maintain the existing level of contributions to the IAP in addition to his or her pension plan.

Establishing an Adequate and Affordable Retirement Plan for the Future

Debates over the adequacy of a retirement plan can be difficult to resolve. But they tend to involve formulas that approximate a targeted percentage of one's final years of salary at a specified retirement age or comparisons to the retirement benefits that similar employees are able to accrue in another workforce.

Using a target of 80% of pre-retirement salary from a combination of pension benefit, retirement savings (the IAP) and Social Security, the current Tier 3 or OPSRP program appears to easily meet this target for a 30-year career employee at the average salary of $56,000 a year.

Also, in comparison to the Washington state plan for teachers, OPSRP shapes up very well:

	% Salary per Year of Service	Final Average Salary	EE Contribution to Supplemental Savings
Oregon PERS OPSRP	1.5%	3 years	6.0% fixed
WA State Teachers	1.0%	5 years	5.0% minimum

By these measures, then, it appears that the PERS OPSRP plan is an adequate and competitive retirement plan.

Further, an examination of the differences between Tier 1/2 and Tier 3 (OPSRP) reveals a large inequity in benefits and compensation within the current workforce.

OPSRP covers employees hired since August 2003, who now comprise 56% of the workforce and approximately half of the payroll of all public employers covered by PERS in Oregon. The remaining employees are covered by Tiers 1 and 2, which provide richer and more costly benefits and are the source of almost all of the unfunded actuarial liability (UAL) attributable to the current workforce. Here is how ongoing benefit costs and unfunded liabilities compare for Tier 1 and 2 employees and those now covered by OPSRP.

Plan	Benefits*	Normal Cost**	Share of UAL
PERS Tier 1/2	1.67%/yr of service Money Match Unused sick leave option COLA Other provisions*	15.07% of payroll	25% Will require additional 16.02% of payroll to be paid by employers.
PERS OPSRP	1.5%/yr of service COLA	8.56% of payroll	5% Will require additional 1.27% of payroll to be paid by employers.

*For general employees; police and fire = 2.0% in Tier1/2 and 1.8% in OPSRP.
Also, Tier 1 employees are covered by special provisions related to a guaranteed rate of return, an earlier retirement age, no maximum salary for benefits and a state income tax remedy.
**Ongoing cost, net of any unfunded liabilities, as a percentage of payroll. <u>These rates do not include the 6% IAP</u>.

It is evident that the difference in ongoing costs and costs attributable to prior underfunding for Tier 1/2 employees and OPSRP employees are considerable. Although these costs are borne directly by employers, they affect the calculation of total compensation for the entire workforce, whether expressed in one number (such as the 20.85% of payroll projected for 2017-19) or differentiated by tiers. But, regardless of how they are classified, these costs reduce funds available for other forms of compensation and staffing levels. And, they do so in a way that creates grossly unequal burdens between employees hired before August 2003 and those who entered public employment after them and now constitute a majority of the workforce.

Since, as we have shown, the OPSRP benefit plan is adequate, competitive and obviously more affordable than the Tier 1/2 benefit plans, the equalization of benefits going forward, keyed to the existing OPSRP plan, appears to be the most fair and effective first step to the goal of establishing a system of benefits that is adequate for public employees and affordable for taxpayers in the future.

A simple calculation suggests that moving all Tier 1/2 employees into OPSRP going forward would yield an initial savings of approximately 3.2% of payroll. However, there are two reasons for caution in such an estimate.

First, as more Tier 1/2 employees retire, savings from their reduction in benefits would diminish as a portion of the PERS payroll over time. However, starting with savings in the range of 3% of payroll equates to roughly $300 million per year for PERS employers.

Second, it will be difficult to reconcile all of the provisions of OPSRP with all of the provisions of the Tier 1 and 2 plans for current employees. The earlier retirement ages applicable to Tier 1 and 2 are one example – those features are not easily integrated or prorated between tiers. Therefore, <u>we recommend the construction of a Tier 3.1 or OPSRP Plus plan for Tier 1 and 2 employees.</u>

This can be done by legislatively "adjusting the dials" on the pension dashboard, including:

- the pension accrual formula (percent of pay for each year of service);
- the years of service used to determine final average salary;
- the guaranteed rate of return and "Formula + Annuity" benefit for Tier 1 employees;
- the Money Match option for Tier 1 and 2 employees;
- a potential salary cap (now $270,000 a year for Tier 2 and OPSRP employees, but unlimited for Tier 1 employees);
- an adjustment of the annuitization rate to align with market rates;
- the inclusion of the 6% IAP in covered salary for Tier 1/2 employees (but not OPSRP);
- the inclusion of vacation payouts in covered salary for Tier 1/2 employees (but not OPSRP);
- the option to use unused sick leave in final average salary for Tier1/2 employees and their employers (not available in OPSRP);
- possible further limits on COLAs; and,
- incentives for delaying retirement or penalties for early retirement.

Each of these components could become part of a Tier 3.1 or OPSRP Plus plan. What that plan would look like in final form would be a product of actuarial engineering and legal analysis. That work could be done by the legislature, by a designated task force or by the PERS Board itself. In any case, the final product would significantly reduce the costs of the PERS system in the future and mitigate a serious inequity in compensation within the current workforce.

A Modified Approach to Employee Cost-Sharing

In addition to benefit reductions, employee contributions can also be used to shore up the PERS pension plan and moderate future employer rate increases. Such contributions are the norm in most public employee pension systems and are sometimes adjusted upward or downward to reflect the funding level for promised benefits.

In 2003, Oregon switched from a pension-only system which included a 6% employee contribution (in most cases paid or "picked up" by employers) to a hybrid system in which the pension plan became fully supported by employer contributions and an individualized, supplemental retirement savings plan (the IAP) was established with a 6% employee contribution (also, in most cases, picked up by employers). However, contributions to the IAP are segregated from and do not in any way support the pension plan. Now faced with severe underfunding of the pension plan, however, the question arises:

Can a system that offers an underfunded pension plan, now paid in full by employers, afford to offer a second retirement savings plan (the IAP) in which employee contributions do not support the pension plan?

The answer to that question is "no, but" – there are different ways to establish and calibrate employee support for the pension plan from funds that would otherwise flow to the IAP in the future. These include:

- Redirecting all future IAP contributions to support the pension plan, as recommended by the Portland City Club in 2011;
- Redirecting some portion of future IAP contributions to support the pension plan;
- Establishing employee contribution rates for the pension plan and allowing employees the option to redirect some or all of their IAP payments to cover their contributions to their pension plan.

None of these approaches would force a reduction in any employee's gross salary or take-home pay, unless, in the last example, an employee chose to maintain future contributions to the IAP in full and pay the pension contribution from salary.

In examining these approaches, we concluded that "contribution rate + IAP option" offers greater flexibility to tailor employee contribution rates to benefit levels and pay levels, thereby mitigating an element of potential inequity in the new system, and honors employee choice when it comes to balancing pay and supplemental retirement savings during the course of a career.

Our recommendation in regard to employee cost sharing is as follows:

- Establish employee contribution rates to the pension plan that are calibrated to reflect benefit costs going forward (presuming a residual difference in cost between a Tier 3.1 benefit level and the current OPSRP benefit level) and salary (lower-paid employees would contribute less or there would be a salary threshold above which the contribution rate would apply.)
- Allow employees the option to redirect future contributions to the IAP to cover their pension contributions, perhaps as frequently as annually, biennially or keyed to the durations of collective bargaining agreements.

For illustration purposes, here is one example of what could be established under this framework.

	Pension Contribution	IAP
Tier 1/2 or Tier 3.1/OPSRP Plus	6% > $30K salary	6% < $30K salary Option to have 6% > $30K salary go to cover pension contribution or go to IAP
OPSRP	3% > $30K salary	6% < $30K salary Option to have 3% > $30K salary to go to cover pension contribution or have full 6% go to IAP

We note that there is much confusion – unnecessary and unfounded, we believe – regarding the effect of employer pickup provisions of the IAP that are contained in various collective bargaining agreements. Arguably, in some cases, those provisions would trigger an employer buyout by which the employer's pre-tax payment of the 6% employee contribution to the IAP would be converted to a post-tax payment of 6% in salary. In some cases, bargaining agreements call for a replacement of 6.95% to make up for employee-paid payroll taxes that would apply to a post-tax 6%. However, none of these provisions would negate the savings of 6% or whatever employee contribution rate (e.g. 3% to 6%) would apply under our model above in the form of reduced employer payments for the pension plan. The only offsetting cost to employers would come from having to pay additional payroll costs for the 6% paid in salary and, in cases where higher conversion rates are specified, from that fractional increase in salary.

Thus, in a worst case scenario, an employer might gain a 6% savings on pension costs from a full redirect of the IAP and have to pay an additional 2% or so in additional salary and attendant payroll costs. Still, this is not a pension issue; it is a salary issue, as we are often reminded by employees and their unions in defense of the pickup. Employers and unions would remain free to negotiate salary and pickups of the IAP as they do now. Meanwhile, the pension plan would receive a new infusion of contributions that would help to keep it affordable in the future.

Legislative Concept

We offer the following legislative concept to illustrate a package that could be designed within the framework described above. In addition to these noted concepts, we include a deferral of the scheduled increase in contribution rates for 2017-19 by six months, so as to provide time for implementation of new rates in 2018.

- Freeze current employer contribution rates through 12/31/17;

- Establish the following new provisions effective 1/1/18:

    - Create a new tier of benefits for Tier 1 and 2 employees that is as close as possible in design and cost to OPSRP; alternatively, authorize and direct the PERS board to design and establish the new tier of benefits for Tier 1 and 2 to be as close as possible to OPSRP in its "normal cost" (measured in payroll contribution rate);

    - Clarify how the proration of prior and future service would be calculated for Tier 1 and 2 employees;

    - Reduce the annuitization rate for Money Match to reflect current market rates;

    - Establish an employee contribution for pension benefits (distinct from IAP) at all tiers of coverage, differentiated by tiers (not to exceed 6% for Tier 1 and 2 and 3% for Tier 3 employees) and by salary level (e.g. no contribution required on the first $30,000 of salary),

- Direct the PERS board to reset the employee contribution rates up or down every biennium thereafter so as to provide for proportionate increases or decreases in the employee rate when the UAL attributable to current employees rises or falls above or below the levels specified in the actuarial report used for 2017-19 rate setting;
- Provide that employees may periodically opt to direct some or all of their IAP contributions to cover their contributions to the pension plan, thereby allowing an individualized redirection of the IAP on an employee choice basis.

Conclusions

Reforms are feasible and can achieve significant savings with equity for the affected employees.

A package like that outlined above should be able to achieve reductions in employer costs for the PERS pension plan that approximate the savings achieved by the 2013 provisions overturned by the Oregon Supreme Court in the *Moro* decision, representing about 4% to 5% of payroll and contributing to a reduction in the unfunded liability of the pension plan by $5 billion or more over 20 years.

For public employees, our recommendations would establish a more solid financial foundation for their future pension benefits, assure an adequate and competitive pension plan and equalize benefits and burdens for categories of employees now treated unequally. Further, the employee choice provision would enable all employees to avoid any reductions in their take-home pay. Finally, these changes would relieve some of the pressures on public payrolls and budgets that would otherwise make it difficult to maintain competitive salaries, sustain health benefits and meet the staffing needs of current programs.

For public employees and employers, the ability to adjust rates upward and downward in the future would create a new mechanism to adjust to better-than-expected investment earnings, which could occasion a reduction in rates for both employers and employees. Alternatively, in the case of worsening earnings and an increase in liabilities, this provision would ensure an orderly way to share the burden of unexpected cost increases in the future.

For employers and taxpayers, our recommendations would produce significant savings and free up resources for public services.

For all concerned, however, the remaining unfunded liability would still represent a major claim on budgets and services in the future. It will remain a challenge to manage the amortization of this liability over time. However, we can envision options for removing this liability from public payrolls in the future and would recommend considering new options for treating the recapitalization of the PERS pension fund going forward.

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