Oregon PERS Must Be Protected

By Tyler Bond        September 2018

National Public Pension Coalition
Executive Summary

- The median annual benefit for a PERS member is $24,062.
- Oregon made major structural changes to PERS in 2003 that have already reduced costs for employers.
- The current rising costs for PERS employers are the result of decisions made decades ago and are paying for benefits for employees who have already retired.
- Switching new hires to a defined contribution-only plan, like a 401(k), would do nothing to reduce the unfunded liability and would actually increase costs for taxpayers.
- Defined benefit pensions help recruit and retain public employees. Eliminating the pension component of PERS would make public employers less competitive.
- Few other states offer 401(k)-style plans to their public employees. The vast majority of states continue to offer defined benefit pensions.
History of the Public Employees Retirement System

Oregon has historically demonstrated a strong commitment to the retirement security of its public employees. This continues to be the case today. The Oregon Public Employees Retirement System (PERS) covers more than 168,000 active public employees across the state. It also provides benefits to more than 136,000 retirees and other beneficiaries. The average annual benefit for a PERS member is $30,363 and the median annual benefit is $24,062. These are modest amounts earned by public employees throughout a career in public service.

PERS was founded in direct response to the crisis of the Great Depression and the reality of elderly poverty. After a decade of debate, on March 26, 1945, Governor Earl Snell signed House Bill 344 establishing PERS. The legislation became effective more than a year later on July 1, 1946. PERS has not been frozen in time since 1946 though.

PERS currently follows the “three-legged stool” model of retirement: Social Security; an employer-provided defined benefit pension; and a defined contribution plan - similar to a 401(k) - funded by employee contributions. Oregon adopted this model following major legislation passed in 2003. As a result, pension benefits were reduced for Tier One and Tier Two employees and a third tier of benefits – the Oregon Public Service Retirement Plan – was created. The 2003 legislation fundamentally changed the design of the plan to reduce costs for taxpayers while continuing to provide retirement security for public employees. Today, more than half of the public workforce earns this reduced benefit.

Pension funding, the current liability, and employer costs

From 1970 - 2015, Oregon PERS benefits were funded 73.4 percent by investment earnings, 21.1 percent by employer contributions, and 5.5 percent by employee contributions. Following the 2003 plan changes, Oregon PERS reached a height of 111 percent of reserves needed to pay future pension liabilities in 2007, including employer side accounts. After the recession hit, that number dropped to 80 percent in 2008. This drop occurred because PERS earns such a high percentage of its revenues from investment earnings. PERS was more strongly impacted by the financial crisis as a result.

Today, Oregon has an unfunded pension liability of $22 billion. It’s important to note that Oregon does not allow employers to take “pension holidays” to stop payments, which has prevented some of the problems in other states. If investment assumptions are met, employer contribution rates to pay for the unfunded liability will rise over the next two biennia (two year budget cycles) then level out and start to decrease as more lower cost OPSRP members make up the retiree population.

There has been a very public debate in Oregon about the unfunded liability. Many of the proposals look to active public employees and future hires to pay the state’s debt. For example, in 2013, the state reduced cost of living increases for future retirees. However, the majority of the unfunded liability - more than 70 percent - is to cover the cost of pensions for people already retired or who have left state service for other reasons. The Oregon Supreme Court has been clear - those benefits cannot be reduced. Therefore, many of the proposals are centered on further reducing retirement benefits for today’s workforce.
These proposals will not reduce the unfunded liability to any significant degree, will reduce the retirement security of current public employees, and will have unintended consequences, based on math and the experiences of other states.

**Switching to 401(k)s for new hires is not the answer**

Anti-pension ideologues have argued that more major changes are needed for PERS. Specifically, they have argued for switching to a defined contribution-only, 401(k)-style plan. This would be a mistake. Making additional significant changes is both unnecessary and potentially harmful. The changes made in 2003 are working and have reduced costs for the plan while still ensuring retirement security for public employees. One way to measure the cost of a public pension plan is by looking at the “normal cost”, which is the cost to fund benefits earned in a single year by active employees. The normal cost for employees in OPSRP for the current biennium is only 8.56 percent of payroll and for the next biennium is only estimated to increase to 8.92 percent of payroll.8

Pension critics have pointed to increased costs for employers in PERS, but those costs need to be put in context. Current employees and future hires are not driving the cost increases for employers. The legacy debt from decisions made decades ago are a major driver of the current unfunded liability in PERS. Changes included in the 2003 legislation have been reducing costs for PERS employers.

<table>
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<th>Changes included in the 2003 PERS legislation:9</th>
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<td>• Increasing the retirement age</td>
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<td>• Decreasing the retirement formula</td>
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<td>• Eliminating Money Match</td>
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<td>• Eliminating guaranteed rate of return on all employee contributions made after January 1, 2004</td>
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<td>• Eliminating inclusion of sick leave or vacation in Final Average Salary (FAS) calculation</td>
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<td>• Capping salary at $200,000 with adjustments at the level set by the IRS</td>
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Switching to a 401(k)-style plan would not eliminate the costs PERS has already accrued. Closing a pension plan does not magically get rid of existing unfunded liability. Just like any other type of debt - a credit card, a mortgage, student loans - the debt already accrued by PERS in the form of unfunded liability must be paid. Switching to a 401(k)-style plan will just make it more difficult to do this.

**Experience of other states on switching to a 401(k)-style plan**

States that have moved public employees to a 401(k)-style, defined contribution plan have experienced harmful consequences, which is why so few states have done it. Only three states currently offer a defined contribution-only plan exclusively to their public employees. At least eight other states offer public employees some choice among defined benefit pension plans,
defined contribution plans, or hybrid retirement plans. In these states, public employees overwhelmingly choose the pension plan.\textsuperscript{10} For the states that only offer a defined contribution plan, these plans end up costing taxpayers more and leave public employees without retirement security.

West Virginia was the first state to make the switch - and the first to switch back. In 1991, West Virginia closed its defined benefit pension plan for teachers and placed all new teachers in a 401(k)-style plan. Over the course of the next fifteen years, teachers in the 401(k)-style plan failed to save enough to retire securely. As of April 30, 2005, the average account balance was just $41,478, and only 105 of the 1,767 teachers over age 60 had balances over $100,000.\textsuperscript{11} This was largely because teachers saving in the defined contribution plan earned lower investment returns than those earned by the pension plan. Studies have shown that defined benefit pension plans consistently earn higher investment returns than 401(k) plans.\textsuperscript{12}

In the early 2000s, West Virginia began to study a return to a defined benefit pension plan. These studies showed the state could provide equivalent benefits at half the cost under a pension plan, due to the inherent efficiencies of pensions, such as longevity risk pooling, a balanced investment portfolio, and lower fees.\textsuperscript{13} The state reopened the closed teacher pension plan to new teachers beginning in 2006. Two years later, the state gave teachers in the 401(k)-style plan the option to switch to the reopened pension plan and more than 78 percent did.\textsuperscript{14}

In the years since, the funding level for the teacher pension plan has steadily risen with new members paying into the fund and more consistent contributions from the state. The funded level has increased from just 25 percent in 2005 to 58 percent as of July 31, 2013.\textsuperscript{15} Reopening the pension plan has also saved money for taxpayers. West Virginia is expected to save $22 million because so many younger participants in the 401(k)-style plan switched to the reopened pension plan.\textsuperscript{16}

In 1997, Michigan closed its defined benefit pension plan for state employees. For the past two decades, all new state employees have participated in a 401(k)-style defined contribution plan. This has had at least two very serious consequences. First, it has failed to create retirement security for state employees. The state Office of Retirement Services reported in January 2017 that among state employees older than age 60 and with at least fifteen years of service, the median savings in the defined contribution plan is only $36,000.\textsuperscript{17}

Second, closing the pension plan caused the unfunded liability in the plan to skyrocket. When the plan was closed, it was overfunded at 109 percent; fifteen years later, it was only 60 percent funded.\textsuperscript{18} Without future contributions for new participants in the plan, it is difficult to maintain strong funding levels. Public pension plans can invest on an infinite time horizon because new members are joining and contributing to the plan as older members are retiring and collecting their benefits. This allows the plan managers to maintain an optimal investment portfolio that balances high- and low-risk investments. When a plan is closed and contributions from new members stop, the plan managers must shift to more conservative, low-risk and low-return investments. This lowers the overall returns for the pension fund. On average, pension plans earn anywhere from two-thirds to three-fourths of their revenue from investment earnings.
Were Oregon to follow a similar path as West Virginia and Michigan, it would experience similar negative consequences. Oregon PERS has historically received a significant percentage of its revenue from investment earnings (73.4 percent). This is a testament to the good work of the Oregon Investment Council (OIC) and the leaders of the plan. However, if new hires were switched to a defined contribution-only plan, that would cut off new revenue for the plan and would force the OIC to switch to more conservative, lower return investments. This would be the case even if current active employees were forced to contribute to the pension plan because eventually all of those employees would retire and the plan would lose that source of revenue while still paying out benefits to retired employees and other beneficiaries.

**401(k)-style plans cause recruitment and retention problems**

Closing a defined benefit pension plan doesn’t only cause problems for retirement security and funding status. It also makes it more difficult for cities and states to recruit and retain public employees. Public pensions have long been an effective workforce management tool for public employers from school districts to fire departments to state governments. They are an attractive benefit for employees who are willing to commit to a career serving their communities. When public pensions are eliminated as a workplace benefit, it makes public employers less competitive and, therefore, less able to recruit and retain the most qualified employees.

Retaining public employees throughout their careers benefits taxpayers. Teachers, for example, dramatically increase their effectiveness during the first several years of teaching. Studies have shown that most teachers do not reach their peak effectiveness until five years of teaching. Teachers then maintain this effectiveness throughout their careers, so having more experienced teachers in the classroom raises the overall quality of teaching at a school.

When it comes to public safety professions such as policing and firefighting, there are large sunk costs that go into training new employees in these professions. One estimate suggested it costs a quarter million dollars to train a new police officer. Taxpayers want to be sure they are getting a good return on their investment for paying for this training. Offering a defined benefit pension to career police officers and firefighters guarantees that the public will receive a return on investment for the money paid to train these professionals. It also means the public will be protected by experienced public safety officers who know how to handle dangerous situations.

Some states have learned these lessons the hard way. Oregon experienced more than 12,000 retirements in 2003, the year major pension changes took effect. That was more than twice the number of retirements than the year before or the year after. Utah closed its pension plan in 2011 and placed new hires in a hybrid defined benefit-defined contribution plan. The state has struggled to hire new police officers and firefighters since the plan changed with hundreds of vacant positions statewide.

A similar situation occurred in Palm Beach, Florida, when it moved from a pension plan to a hybrid plan. That change affected not just future hires, but current employees. Since Palm Beach already had so many police officers eligible to retire, many of them left as soon as the changes passed since they would no longer be able to earn their full pension benefit. Many police officers also received their training in Palm Beach, but then transferred to other departments where they could still receive a full pension. After four years of the hybrid plan,
the Palm Beach City Council went back to a defined benefit pension for public safety officers to address the severe shortage. Despite this reversal, the damaging effects of the hybrid plan still linger. Palm Beach continues to experience high levels of attrition among its police officers and many point to the pension plan changes of the past decade as the cause.28

A harmful proposal: taking the current employee contribution to their individual account to fund the pension

Six percent of Oregon public employees’ salaries go into their defined contribution account, also known as their Individual Account Program. Whether the 6 percent contribution is paid by the employee or the employer is part of the collective bargaining negotiations for unionized public employees. Most members of the state government workforce pay the 6 percent themselves, for example.

One of the most draconian proposals on the table takes away the 6 percent contribution from the employee’s defined contribution account and moves it into the pension plan with no corresponding increase in pension benefits. Here’s what that would mean:

- **Drastically reduced retirement benefits:**
  The effect of this proposal on the future retirement security of public employees would be devastating. It would, in effect, freeze the defined contribution accounts at their current level of funding to be only interest earning accounts. This would have the most devastating effect on employees with 10 or fewer years of service because there has not been enough time for them to significantly save in those accounts to generate adequate interest returns. During the 2017 legislative session, there was testimony from younger workers that showed their retirement accounts would be cut between 40 and 75 percent.

- **No reduction in the unfunded liability:**
  As noted above, the unfunded liability is driven by more than 70 percent from people already retired or no longer in state service. Taking money from today’s workforce to pay the state’s liability does not solve the problem because contributions from current employees cannot be used to pay down the unfunded liability.

Oregon should maintain its commitment to retirement security

The impact of the financial crisis and ensuing Great Recession must be considered in regards to PERS. Before the financial crisis, PERS was more than 100 percent funded. PERS took a major financial hit during the financial crisis as did so many others, both institutional and individual investors. The uneven economic recovery from the recession has made it difficult for PERS to return to its previously high funded status.

According to the most recent reports, PERS today is funded at 80 percent when including employer side accounts. These accounts were created in 2003 to allow employers to set aside money to pay down the unfunded liability in PERS. In 2017, the plan earned a 15.3 percent rate of return on its investments, more than double its expected rate of return.
PERS also delivers a great value for Oregon taxpayers. Historically, almost three-fourths of the revenue in the PERS fund comes from investment earnings. This is a great return on investment. According to the National Institute on Retirement Security, every taxpayer dollar invested in PERS supports $6.11 in total economic activity in Oregon.\(^27\) This adds up to more than $5 billion annually in economic activity that supports more than 36,000 jobs.\(^28\)

The National Conference on Public Employee Retirement Systems recently examined whether public pension plans are net revenue generators for state and local governments. Their analysis concluded that public pensions in Oregon generate significant amounts of tax revenue for state and local governments: more than $2 billion.\(^29\) Public employers in Oregon are not just recouping what they spend on PERS pension benefits, they are receiving billions of dollars beyond what they contribute through tax revenue. This is because the investment returns for the PERS pension fund generate such high returns and fund the majority of the PERS pension benefit. A move to a 401(k)-style plan for public employees would eliminate this additional tax revenue because fewer investment returns would be generated and more money would be lost to fees and other costs of money managers and financial institutions.

**Conclusion**

The best path forward for Oregon is to continue to allow the reforms of 2003 to work. Additional changes and cuts to pension benefits would truly harm the retirement security of public employees. It would also harm local communities throughout the state by undercutting crucial economic activity and denying valuable tax revenue to local governments.

Forcing new public employees into a 401(k)-style defined contribution plan would have unintended consequences that would harm Oregon taxpayers and public employees. As the experiences of other states have shown, closing a pension plan and switching to a 401(k)-style plan increases the unfunded liability in the pension plan. This would actually increase the cost to employers as they would have to contribute more to pay down the unfunded liability. It also poses real challenges for recruiting and retaining qualified public employees.

Oregon’s population keeps growing— it needs good public employees.\(^30\) Public pensions are valuable tools for recruiting and retaining quality public employees. Further unnecessary changes would harm the ability of state and local governments to attract the best and the brightest.
These employees fall into three tiers: Tier 1 (members hired before January 1, 1996); Tier 2 (members hired between January 1, 1996 and August 28, 2003); and OPSRP (members hired on or after August 29, 2003). OPSRP members hired after 2003 now represent the majority (58 percent) of the total active member population in the system.


Ibid., Pg. 21.

Ibid., Pg. 13.

Ibid.

Ibid.

Ibid.

Uncollared System-Wide OPSRP Normal Cost for this biennium is 8.56% and is projected to be 8.92% for the next biennium. PERS Board Packet, 8-3-18, Milliman Presentation p. 35.


Ibid.

Ibid.


K. Ryals, 2017(Feb. 22), “City’s move to 401(k) pensions is big mistake as Palm Beach showed,” Florida Times Union, Jacksonville, FL.


25 This is similar to the situation in Oregon. 70,335 additional PERS active and inactive members are currently eligible to retire by age or service, according to *PERS: By the Numbers* (May 2017), p. 2.

26 I. Cohen, 2018 (September 10), “Palm Beach Police Dept. sees highest turnover in more than a decade,” *Palm Beach Daily News*, Palm Beach, FL.


28 Ibid., Pgs. 18 and 22.

