OREGON PERS: BURDENED BY THE PAST, POISED FOR THE FUTURE

City Club of Portland
Good citizens are the riches of a city

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City Club members will vote on this report on Friday, June 3, 2011. Until the membership votes, City Club of Portland does not have an official position on this report. The outcome of the vote will be reported in the City Club of Portland Bulletin dated June 17, 2011 and online at www.pdxcityclub.org.

The mission of City Club is to inform its members and the community in public matters and to arouse in them a realization of the obligations of citizenship.

This report is part of a coordinated series of 2011 City Club program offerings: "From Crisis to Opportunity: Exploring Solutions to Oregon's Fiscal Challenges."

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Copies of this report are available online at www.pdxcityclub.org.

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EXECUTIVE SUMMARY

The Oregon Public Employees Retirement System (PERS) is said to be a principal contributor to Oregon's "decade of deficits," burdening current and future taxpayers with unsustainable retiree benefits. The stock market crash of 2008 and ensuing recession battered public pension systems across the country, and PERS was no exception. As a result, PERS is very much on the minds of policy-makers and concerned Oregonians.

Many see PERS as an albatross around the neck of state and local governments, weighing down budgets, forcing deep cuts in services, and leaving no option but to lay off police, teachers, and fire fighters. A clutch of pending bills in the 2011 legislative session seek to "fix" PERS and plug gaping holes in the budgets of cities, counties, and school districts.

PERS today is heavily burdened by the past. Before earlier legislative reforms, members received a generous guaranteed annual return on their burgeoning retirement accounts. Members dominated the PERS governing board, frequently crediting accounts with more than double the generous guaranteed rate, sometimes as high as 20% in a single year. Many public employees retired with PERS pension payments equaling or even exceeding their salaries at retirement, with Social Security benefits as icing on the cake.

Legislative reforms in 1995 and 2003 provided at least partial fixes to these problems. Employees hired in 1996 or later no longer receive a guaranteed rate of return. Members no longer dominate the PERS governing board. Employees hired in 2003 or later receive a less generous traditional pension benefit, while a new "defined contribution" element places investment risk on the employee. Final average salaries, upon which monthly pension payments are based, no longer include unused sick leave and vacation time for new employees.

The Oregon Supreme Court, however, declared unconstitutional several would-be reforms. The Court held that PERS is a contract with public employees that becomes irrevocable on the date of hire, preventing future legislatures from reducing promised benefits. While not out of step with courts around the country, this "contract" view of PERS effectively blocks many possible benefit reduction reforms.

The City Club of Portland chartered your committee to determine if perception is reality: does PERS represent a significant challenge for Oregon? If so, what policy changes are needed to meet the challenge?

"This report makes recommendations that will reduce PERS costs by over $2 billion, help preserve public services and jobs, and provide adequate retirement benefits that become more sustainable with the passage of time."

Your committee examined studies by think tanks, economists, and politicians; interviewed multiple stakeholders and analysts; and performed independent research. A consensus emerged that PERS does indeed represent a significant challenge for Oregon.

Your committee concluded:

- The Legislature's 2003 reforms addressed many pressing problems, placing Oregon in a better financial position than many other states and on course to a future where public employee retirement benefits are both adequate and affordable. Yet the generous, often excessive, benefits promised to the 250,000 public employees who joined the system before 2003 continue to burden PERS, and there are inadequate measures in place to protect PERS from the inevitable variability in investment returns.
- PERS retirees enjoy generous benefits relative to an objective "adequate retirement benchmark" of 75% to 80% replacement of final pay, including Social Security.
- Court decisions significantly limit options to repair past mistakes.
- PERS has multiple inequities among employers, employees, and generations of workers and taxpayers.
- Public employees and retirees believe that they have earned the benefits coming to them. Any attempts to reduce benefits will be fought in the courts and in the political arena.

This report makes recommendations that will reduce PERS costs by over $2 billion, help preserve public services and jobs, and provide adequate retirement benefits that become more sustainable with the passage of time. Key recommendations include the following:

- The PERS governing board should change the "money match" benefit calculation by using a "risk-free rate of return" that better matches the nature of the benefit. This recommendation, which would reduce the PERS unfunded liability by $1.7 billion, is not ruled out by prior court decisions, and it could be implemented immediately. Some members will receive slightly lower benefits that still exceed the adequate retirement benchmark.

- The Legislature should eliminate prospectively the "Individual Account Program" for members hired before 2003, instead directing their annual contributions of $300 million to reducing the PERS unfunded actuarial liability and funding a reserve to reduce volatility in employer rates. This would allow public employees and retirees who receive the most generous retirement benefits to share in the costs of maintaining the solvency of the system.

- Other recommendations include establishing an "employer rate stabilization reserve" to increase the stability and predictability of employer contribution rates; reducing pension costs for workers hired in 2003 or later by lowering the pension multiplier and raising the normal retirement age by two years across-the-board; and eliminating the gratuitous tax remedy benefit for out-of-state PERS retirees who do not pay Oregon income taxes, saving $72 million per biennium and reducing PERS liabilities by $450 million.

Also important to note is what your committee does *not* recommend. Your committee does not recommend a widely discussed proposal to eliminate or reduce the 6% "pick-up," a practice in which employers pay the employees' required annual contribution to PERS. Your committee views the pick-up as a compensation and budgeting issue that has no impact on PERS itself and is best left to the realm of collective bargaining. Nor does your committee recommend a pure "defined contribution" plan, eliminating defined pension benefits altogether for new employees. Your committee sees this as unnecessary given the Legislature's 2003 reforms.

Oregon PERS is better managed and better funded than public employee retirement plans in many other states. The Legislature made substantive reforms in 2003, and your committee's recommendations build on the strong foundation of the 2003 legislation. There is no doubt that the recommended benefit reductions will be challenged. Your committee believes that these recommendations should withstand the political challenges, will be found legal if adopted, and will provide public employees adequate retirement benefits at a cost that Oregonians can afford.

INTRODUCTION

Oregon faces unprecedented fiscal challenges. In the words of former Governor Ted Kulongoski, Oregon faces a "decade of deficits."[1] Oregon emerges from the Great Recession with high unemployment and inadequate tax revenue to fund state services at a time of surging demand. Oregon's new Governor, John Kitzhaber, and the 2011 Oregon Legislature must grapple with an expected $3.5 billion shortfall in the 2011–2013 biennium.

"The stock market crash of 2008 took a toll on PERS, leaving the system with a significant "unfunded actuarial liability," meaning the liabilities of the PERS system, including benefits promised to current retirees, active public employees, and former employees not yet at retirement age, exceed the available funds to pay for those liabilities, even assuming improved future investment earnings."

The Oregon Public Employees Retirement System (PERS) is the retirement benefits program for employees of most of Oregon's state, county, city, school, and special-purpose governmental organizations. The stock market crash of 2008 took a toll on PERS, leaving the system with a significant "unfunded actuarial liability," meaning the liabilities of the PERS system, including benefits promised to current retirees, active public employees, and former employees not yet at retirement age, exceed the available funds to pay for those liabilities, even assuming improved future investment earnings. This "unfunded actuarial liability," or UAL, is the primary driver of a $400 million increase in costs for state employees[2] in the 2011–2013 biennium, with additional increases slated for local governments of all types.[3]

City Club tasked your committee to study the history, structure, governance, and financial status of PERS. The committee's primary objective was to determine whether or not PERS, in its current form, presents a serious problem for Oregon, and if so, what policy responses should be enacted to address the problem.

STUDY PROCESS

Your committee interviewed witnesses from all sides of the PERS question. These included current representatives of PERS, the PERS Board, the PERS actuary (Mercer, LLC), the Oregon Investment Council, and Oregon Treasurer Ted Wheeler; representatives from PERS employers and employee unions; former and current members of the Oregon Legislature; a member of former Governor Kulongoski's reset committee; state budget officials; professionals historically involved in PERS such as attorneys and a financial consultant; pundits who have studied and commented on PERS; and representatives of Oregon business groups. Your committee amassed an enormous amount of information on PERS and its possible reforms. While your committee was at work, several groups released their own opinion papers on possible reforms, analyzed by PERS in a paper entitled "Analysis of PERS Cost Allocation, Benefit Modification, and System Financing Concepts."[4]

Your committee also studied the impact of PERS on services provided by four diverse local governmental entities. Using defined criteria, including size (in number of employees), location, breadth of services provided, type of entity (municipality, school district, special purpose district), and PERS contribution rates, your committee chose to study the City of Eugene, the City of Pendleton, the Salem-Keizer School District, and the Owyhee Irrigation District, a small (29 employees) special-purpose district in Eastern Oregon.[*] Committee members asked the entities to respond to an extensive survey, conducted site visits, and prepared a written "employer profile" for each organization. This report includes examples of the financial impact of PERS on these entities.

* Your committee opted not to study the State of Oregon, the City of Portland, and the Portland Public Schools. Your committee concluded that the State of Oregon would be implicitly considered in any PERS report based on its size in number of employees. Additionally, the State of Oregon is the subject of study by other groups, most notably former Governor Kulongoski's Reset Committee. Your committee chose not to study the City of Portland because it has features that do not apply to other Oregon governments, such as a separate retirement system for police and firefighters. Your committee chose not to study Portland Public Schools (PPS) because the school district had been unusually fortunate, in the opinion of the committee, in its use of pension obligation bonds and side accounts. This made PERS costs less of a challenge relatively speaking for PPS than for other school districts. Finally, City Club charged the committee with finding geographic diversity in selection of entities, pushing the committee to expand its horizons beyond the Portland metropolitan area.

Finally, your committee studied the impact of PERS on inter-generational equity. Pension plan liabilities accrue with each day worked by public employees, but the benefits are paid out over decades, potentially pushing the cost of those benefits out to future generations of taxpayers. In addition to inter-generational equity impacts, your committee also considered inequities in the PERS system itself, including differences in benefit levels among employees and cost burdens among employers.

BACKGROUND

PUBLIC EMPLOYEE PENSION PLANS IN CRISIS

The stock market crash of 2008 resulted in significant losses to public employee pension funds in the United States. In February 2010, the Pew Center on the States released a study entitled "The Trillion Dollar Gap: Underfunded State Retirement Systems and the Roads to Reform."[5] That study identified a $1 trillion gap between the $2.35 trillion managed in public pension funds and the $3.35 trillion promised in benefits to retirees and employees. The $1 trillion gap was labeled "conservative," because it reflected the status of pension funds as of June 30, 2008, just prior to the devastating downturn of the stock market in the latter half of 2008.

"With sweeping political change in many state governments, 2011 brought proposals to reduce or even eliminate public employee pensions, often made in conjunction with other cuts in public employee compensation and proposals on curbing public employee collective bargaining rights."

Public pension reform became an issue in many 2010 election campaigns. The enormous challenges faced in states such as Illinois and California grabbed headlines.[6] With sweeping political change in many state governments, 2011 brought proposals to reduce or even eliminate public employee pensions, often made in conjunction with other cuts in public employee compensation and proposals on curbing public employee collective bargaining rights.

PERS MULTI-BILLON DOLLAR FUNDING SHORTFALL

Studies Show Oregon PERS Faces Financial Challenges

The Pew Center ranked the states into three categories based on the management of their pension systems. Pew identified 16 states as "solid performers"; 15 states, including Oregon, as "needs improvement"; and 19 states bringing up the rear in the "serious concerns" category. The report stated that Oregon at the end of 2008 had funds to cover 80% of its accrued liabilities, a mark better than many other states.* This 20% unfunded liability represented a $10 billion difference between the benefits Oregon had promised its public employees and the money available to pay those benefits.

In 2007, the Chalkboard Project and the Oregon Business Council commissioned ECONorthwest, an economic consulting firm headquartered in Eugene, to study PERS as it existed four years after the Oregon Legislature's passage of a major reform package. ECONorthwest's 2007 study, entitled "Public Employee Retirement in Oregon: Where does the system stand and where could Oregon go from here?", and its 2009 follow-up report after the sharp recession-driven investment losses, identified problems in the system and recommended solutions.[7] Additionally, a May 2009 paper[8] authored by former Oregon Secretary of State Phil Keisling and articles[9] written by reporter Ted Sickinger of *The Oregonian* identified problems and potential solutions for PERS.

PERS Has a Significant Unfunded Actuarial Liability

The funding status of a pension system is determined through actuarial analysis, projecting both assets and liabilities over a multi-decade time horizon. The analysis uses a series of assumptions, including returns on invested assets, life expectancy of retirees, and expected retirement dates of active employees. When the liabilities accrued exceed the assets available, the system has an "Unfunded Actuarial Liability," or UAL.

PERS contracts with Mercer LLC for actuarial services. Mercer produces reports on the funding status of PERS at the end of each calendar year, with the report on calendar year 2009 being the most recent available at the time of this writing. The Mercer reports for odd-numbered years

* The Pew study noted that for most states, the 2008 funding status was reported at the end of fiscal year 2008, or June 30, 2008. Thus the study concluded that the $1 trillion gap is conservative, because those results don't reflect the stock market declines in the second half of the year. Oregon, however, is different, as it always reports PERS funding status as of the end of the calendar year. Therefore the Oregon number included the stock market declines of late 2008.

are used to determine the PERS funding needed from public employers in the following biennium. For example, the 2009 report was used to set employer contribution rates for the 2011–2013 biennium.

As noted previously, at the end of 2008, PERS reported an unfunded liability of $10 billion. PERS assets enjoyed a strong 19% return on investment in 2009, helping to lower that unfunded liability. At the end of 2009, PERS reported assets of $48.7 billion and accrued liabilities of $56.8 billion. The gap of approximately $8 billion is the UAL. In percentage terms, the system is 86% funded, an improvement from 80% funded with a $10 billion UAL at the end of 2008. PERS earned more than 12% in 2010, which should result in a further decrease in the UAL when Mercer reports the final numbers for 2010. PERS preliminary estimates for December 31, 2010, show the system 88% funded, with a UAL of approximately $7.2 billion.[10]

Your committee, however, believes that these numbers are misleading and understate the financial problems facing PERS. When Mercer calculates the official UAL for PERS, it includes, as an asset, the $5.5 billion deposited in employer "side accounts." These side accounts contain money that employers borrow from the financial markets using pension obligation bonds. The employers borrow money and use it to pre-pay part of their future pension costs. The cost of debt service on the bonds is borne by the employers outside of PERS. In essence, PERS considers the side accounts to be assets of the system, while the employers hold the bond liabilities outside of the system. Additionally, PERS cannot tap the side account balances for current benefit payments because the employer "pre-payments" accrue to PERS year-by-year according to a pre-defined formula. Your committee therefore believes that the UAL should be stated without the side accounts, or $13.6 billion versus the officially reported figure of $8 billion. In percentage terms, your committee views the system as 76% funded with a UAL of 24%. If PERS preliminary 2010 estimates prove accurate, the system is now 79% funded, excluding $5.6 billion in employer side accounts.

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Your committee concluded that this multi-billion dollar shortfall represents a significant financial problem for PERS. This report examines the causes of this shortfall and its expected impacts on government services.

ADEQUATE RETIREMENT BENCHMARK

The liabilities of PERS represent the benefits promised to Oregon public employees and retirees. Your committee needed a way to evaluate those promised benefits against a benchmark for an "adequate" retirement benefit.

Publicly available financial studies provided guidance.[11] Financial analysts use a measure called the "replacement ratio," or the income expected from a retiree's assets, including Social Security and pensions, divided by the retiree's income in the last year worked. For example, if an employee has income of $50,000 in the last year of employment, and retires with assets providing $30,000 in annual income, the replacement ratio for that employee is 60%. Financial analysts assume that retirees need less income in retirement to maintain their standard of living, because work-related expenses such as commuting come to an end, and retirement income is free from payroll taxes and sometimes enjoys favorable income tax treatment. The studies examined suggest that a replacement ratio of 75-80% is "adequate" to maintain a retiree's standard of living.[12]

Your committee found historical support for the idea that PERS should provide a benefit sufficient to maintain a retiree's standard of living. The governing body for PERS, the PERS Board, first made such a statement in 1979, then adopted it as official policy in 1986 and 1992.[13] The PERS Board described a "target" replacement of 75-85% of income,* assuming that 20-40% of income would be replaced by Social Security and the balance replaced by PERS. In 1997, the PERS Board called 75-85% replacement a "minimum." In 2001, the PERS Board stopped taking a position on income replacement. There is evidence that the 2003 Oregon Legislature discussed a 75-80% replacement ratio, but opted not to include it in legislation.

* Use of words such as "income," or "final salary," or even "final pay" are problematic when discussing PERS, because retirement benefits are calculated on the statutory Final Average Salary (FAS). For some PERS members, FAS includes components that are not typically thought of as part of annual pay, such as unused sick leave and unused vacation. This report uses "pay" or "income" to refer to what an employee receives through salary and a reasonable amount of overtime, and your committee's adequate retirement benchmark is based on that idea. When PERS discusses replacement ratios it refers to a percentage replacement of FAS, which means that PERS benefits are even more generous than they may seem.

"[I]t is good policy to structure a public employee retirement plan that will allow the retiree to replace 75-80% of final income, and that about 30% of that final income will be replaced by Social Security."

Inherent in all of these calculations of replacement ratio is an assumption about Social Security benefits. These benefits, by design, replace a higher percentage of income for lower-income individuals than for higher-income individuals. According to the Social Security Board of Trustees[14], a worker who earns average U.S. wages throughout his or her working life and who begins collecting benefits at the normal retirement age would receive benefits equal to about 40% of prior earnings. For workers consistently earning below-average wages, the replacement ratio would be about 55%, while for workers consistently earning above-average wages, the replacement ratio would be just under 34%. Using these figures as guideposts, your committee decided to err on the side of caution and to assume that Social Security benefits will replace 30% of retirees' incomes.

Based on these studies and assumptions, your committee concluded that it is good policy to structure a public employee retirement plan that will allow the retiree to replace 75-80% of final income, and that about 30% of that final income will be replaced by Social Security. Your committee found no evidence that a more generous retirement program would be required to attract potential workers to the public sector. Therefore, your committee concluded that PERS should provide a targeted benefit of 45-50% of final income, well below the PERS Board minimums throughout the 1980s and 1990s. Your committee used this "adequate retirement benchmark" in its evaluation of current PERS benefits and in fashioning its recommendations for future PERS benefits.

PERS LIABILITIES: BENEFITS PROMISED

The nearly $57 billion in PERS accrued liabilities represent benefits promised to PERS members, whether retirees, current employees, or former employees who have not yet retired. In order to understand the key drivers of those liabilities, one must understand who receives benefits from PERS, how those benefits are calculated, and how the benefits compare to the adequate retirement benchmark.

Nothing about PERS is simple. PERS benefits are no exception.

Nearly All Oregon Public Employees Are in PERS

Since 1946, PERS has functioned as a statewide retirement system for nearly all public employees in Oregon.[15] All types of state and local government entities, including the state of Oregon, county governments, municipal governments, school districts, universities, community colleges, and special purpose districts, are PERS employers, with obligations to fund the PERS system. Once an employer decides to join PERS, it cannot later opt out. All PERS members receive retirement benefits from the same fund.*

PERS Offers Generous, even Excessive, Benefits

"When Social Security is added in, the average PERS retiree with 30 years of service has more income in retirement than while working. [T]hese excessive benefits are not available to employees who joined the system in 2003 or later, but … even those employees will enjoy a benefit more generous than that considered to be adequate."

Using the adequate retirement benchmark, your committee concluded that PERS offers generous retirement benefits, and for some Tier 1 and Tier 2 PERS members, the benefits can only be described as excessive. As Table 1 demonstrates, many PERS members retire with benefits far greater than the replacement target of 45-50% of final income, and some retire with replacement of over 100% of final income. In its February 2011 "PERS: By The Numbers" report, PERS stated that for retirees in 2009, the average replacement ratio for an employee retiring with 30 years of service was 77%, not counting Social Security.† When Social Security is added in, the average PERS retiree with 30 years of service has more income in retirement than while working. To be clear, your committee notes that these excessive benefits are not available to employees who joined the system in 2003 or later, but as will be discussed, even those employees will enjoy a benefit more generous than that considered to be adequate.

* Oregon is different from other states where cities often have their own pension plans or teachers have a plan separate from other government employees.

† Some studies reference lower average replacement rates for PERS retirees, but those studies take into account all PERS retirees, including those who were members for only the minimum five-year vesting period. This report focuses on the benefits of employees with 30 years of service.

Table 1: Average salary replacement ratio based on final average salary (FAS)

	Retirees with 30 Years of Service		All Retirees in Study		
Calendar Year	# of Retirees in Study*	Average Replacement Ratio Based on FAS	# of Retirees in Study*	Average Replacement Ratio Based on FAS	% of Retirees Receiving >100% of FAS
1990	146	61%	1,866	44%	0.0%
1995	304	66%	2,827	47%	1.0%
2000	273	100%	2,112	63%	15.8%
2005	393	84%	2,548	51%	4.4%
2009	432	77%	3,881	53%	6.2%
Total/Avg.	**7,760**	**80%**	**67,179**	**55%**	**7.9%**

* Includes monthly benefit payments for members retiring from active service within the preceding 12 months. Benefits related to inactive, lump sum, judge, and legislator retirements are excluded.

Source: Adapted from PERS, "PERS: By the Numbers," (February 2011), p. 5, http://www.oregon.gov/PERS/docs/general_information/pers_by_the_numbers_2_2011.pdf?ga=t.

PERS Members Are Divided into Three Tiers

PERS members are divided into three benefit categories, depending upon date of hire. Each category differs in how benefits are calculated and the age at which an employee can retire with full benefits. (See Table 2). The categories stem from historical events, which will be discussed below.

The first category, known as "Tier 1," consists of employees hired before January 1, 1996. The second, known as "Tier 2," consists of employees hired between January 1, 1996 and August 28, 2003. The third, which functions like a "Tier 3," is for employees hired on or after August 28, 2003. This third category is commonly referred to as "OPSRP," which stands for the Oregon Public Service Retirement Plan.

Employees are eligible for pension benefits at retirement once they are "vested" in the pension plan. For Tier 1 and Tier 2, an employee vests in the plan at five years of service or when reaching age 50. For OPSRP, an employee vests at five years of service or upon reaching the "normal" retirement age, which is age 65 for general service employees and age 53 for police and fire employees.

The "normal" retirement age varies from tier to tier. PERS defines the "normal" age as the age at which an employee is eligible to retire with full benefits. Employees who reach a minimum "early" retirement age may retire prior to reaching the normal retirement age, but their benefits will be reduced.

The normal retirement age for Tier 1 general service members is age 58 or any age with 30 years of service. Tier 1 police and fire fighters may retire with full benefits at age 55 or as early as age 50 with 25 years of service. The normal retirement age for Tier 2 general service members is age 60 or any age with 30 years of service, and Tier 2 police and firefighters enjoy the same retirement ages as for Tier 1. The normal retirement age for OPSRP general service members is age 65, although an employee can retire with full benefits at ages 58 to 65 with 30 years of service. OPSRP police and fire fighters may retire with full benefits at ages 53 to 60 with 30 years of service. In contrast, full federal Social Security benefits are available at a minimum of age 65, with age 67 required for employees born in 1960 or later.

Table 2: PERS benefit component comparisons

	Tier 1	Tier 2	OPSRP Pension	IAP
Normal retirement age	58 (or 30 yrs); P&F = age 55 or 50 w/25 yrs service	60 (or 30 yrs); P&F = age 55 or 50 w/25 yrs service	65 (or 58 w/30 yrs); P&F = age 60 or 53 w/25 yrs service	55
Early Retirement	55 (50 for P&F)	55 (50 for P&F)	55, if vested	55
Regular account earnings	Guaranteed assumed rate annually (currently 8%)	No guarantee; market returns	N/A; no member account	No guarantee; market returns
Variable account earnings	Market returns on 100% global equity portfolio	Market returns on 100% global equity portfolio	N/A; no member account	N/A
Retirement calculation methods	Money Match, Full Formula, or Formula + Annuity	Money Match or Full Formula	Formula	Six account distribution options
Full Formula benefit factor	1.67% general; 2.00% P&F	1.67% general; 2.00% P&F	1.50% general; 1.80% P&F	N/A
Formula + Annuity benefit factor	1.00% general; 1.50% P&F	N/A	N/A	N/A
Lump-sum vacation payout				
Included in covered salary (6%)	Yes	Yes	No	Yes for Tier 1 and Tier 2; no for OPSRP
Included in FAS	Yes	No	No	N/A
Unused sick leave included in FAS	Yes	Yes	No	N/A
Vesting	Contributions in each of 5 years or active member at age 50	Contributions in each of 5 years or active member at age 50	5 yrs qualifying services or normal retirement age	Immediate
2% maximum annual COLA after retirement	Can retire through July 1 and receive maximum COLA for the year	Can retire through July 1 and receive maximum COLA for the year	COLA prorated in year of retirement based on retirement date	N/A

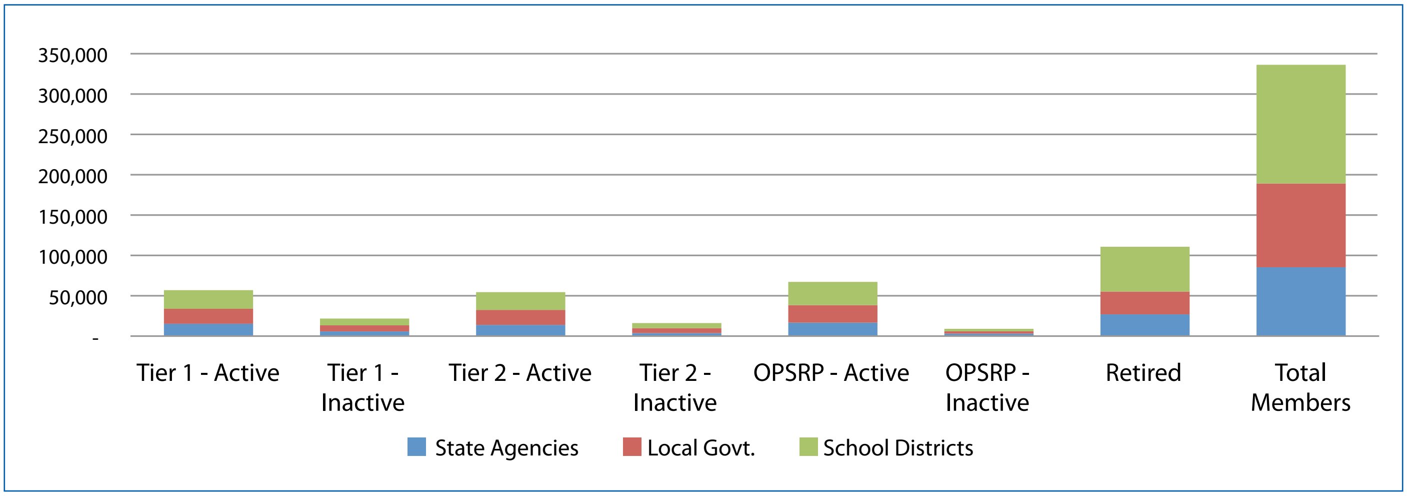
P&F = police and firefighters; FAS = final average salary; COLA = cost-of-living adjustment; N/A = not applicable; IAP = defined benefit portion of PERS plans.

Note: PERS uses three methods to calculate Tier 1 and Tier 2 retirement benefits: Full Formula, Formula + Annuity (for members who made contributions before August 21, 1981), and Money Match. PERS uses the method (for which a member is eligible) that produces the highest benefit amount. OPSRP Pension benefits are based only on a formula method.

Source: "PERS: By the Numbers," (February 2011), p. 3, http://www.oregon.gov/PERS/docs/general_information/pers_by_the_numbers_2_2011.pdf?ga=t.

As of September 30, 2010, there were approximately 328,000 vested PERS members. Of those, 110,000 are retired and collecting benefits. Essentially all current retirees are Tier 1 members. Another 40,000 are vested in PERS but are no longer public employees and have not yet started receiving their PERS benefits. Of the active public employees, 55,000 are Tier 1, while 55,000 are Tier 2 and 67,000 are OPSRP, with all new employees becoming members of OPSRP at the time of hire. (See Table 3.)

Table 3: PERS membership by category (as of December 31, 2009)



Source: Adapted from PERS, "Analysis of PERS Cost Allocation, Benefits Modification, and System Financing Concepts," (December 1, 2010), p. A-10, http://www.oregon.gov/PERS/docs/cost_allocation_12-1-10.pdf.

PERS Individual Account Program / Defined Contribution Plan

Since 2003, each PERS category has offered both a pension, which is a defined benefit plan, and an Individual Account Program (IAP), which is a defined contribution plan. Employees, at least in theory, are required to contribute 6% of salary to their IAPs.* The IAP proceeds are invested in the same manner as other PERS funds, with the employee's balance growing at the PERS actual rate of return until retirement. The IAP is similar to 401(k)-style plans common in the private sector in that taxes on the contributions and earnings are deferred until retirement and the employee bears the risk of whether the benefit at retirement will be adequate. The IAP, however, varies significantly from most 401(k)-style plans in that the employee's contribution is mandatory and financial experts make all of the investment decisions.

* The majority of PERS employers pay the employee's contribution, a benefit known as the "pick-up," which will be discussed later.

Defined Benefit Plan = retiree receives an annual benefit based on a formula, typically using final pay, years of service, and a pension factor. The employer guarantees the benefit; the employee bears no investment risk.

Defined Contribution Plan = the employee and/or employer makes contributions to the employee retirement account. The funds are invested, with the employee bearing the investment risk. Most plans allow for contributions and earnings to grow tax-free until retirement.

PERS Pension / Defined Benefit Plan

The PERS pension for all tiers is essentially a defined benefit plan, under which the retiree receives a guaranteed benefit with the employer bearing all investment risk. PERS uses two primary benefit calculation methods: "full formula," available to all members, and "money match," an option available only to Tiers 1 and 2.

Most pension plans calculate retiree benefits using a formula based on years of service, final salary, and a "pension factor." These three values are multiplied together to determine the annual benefit amount at retirement. For example, using a 1% pension factor, a person retiring at a final salary of $50,000 with 30 years of service would receive $50,000 x 30 x 1%, or $15,000 per year in benefits, replacing 30% of final salary. The same person with a 1.5% pension factor would receive $22,500 per year in benefits, replacing 45% of final salary.

PERS uses a formula-based method to calculate benefits, known as the "full formula" method. The pension factor for Tiers 1 and 2 is 1.67% and for OPSRP is 1.5%. A Tier 1 or Tier 2 employee retiring with 30 years of service will therefore receive a pension of approximately 50% income replacement, while an OPSRP employee will replace about 45% of income. In contrast, Tier 1 and 2 retirees often receive benefits at a far higher income replacement level due to the use of the money match calculation, discussed below.

The salary used in the full formula calculation is not simply the employee's final salary at retirement, but is instead a "final average salary" (FAS) defined by statute. For Tiers 1 and 2, FAS includes any unused sick leave the employee has at retirement. PERS estimates that inclusion of unused sick leave increases an employee's final salary for pension calculations purposes by roughly 6%. For Tier 1, FAS also includes any unused vacation time at retirement. PERS estimates that inclusion of unused vacation time increases an employee's final salary for pension purposes by roughly 2%. The practice of including unused sick leave and vacation time in FAS is prohibited for OPSRP. Additionally, FAS includes some level of overtime pay, although the amount of overtime for benefit calculation purposes is capped in OPSRP. The practice of working lots of overtime to drive up an employee's FAS is often called "spiking."

For example, a Tier 1 employee with a final salary of $50,000 may have unused sick leave, unused vacation time, and overtime earnings that result in a FAS of $55,000. With 30 years of service, that employee would receive a benefit of 1.67% x 30 x $55,000, or $27,555, representing replacement of 55% of final salary. With Social Security replacing 30% of final salary and the IAP providing additional funds for retirement, that Tier 1 employee could receive retirement benefits that replace 90% or more of final pay.

PERS also offers the "money match" benefit calculation technique for Tiers 1 and 2. PERS calculates benefits using both the full formula and money match techniques and grants the retiree whichever benefit is higher. Money match works like this. Tier 1 and Tier 2 members contribute 6% of their salary to the IAP, the defined contribution portion of PERS, although in the majority of cases the employer actually "picks up" this contribution. Prior to 2003, that contribution did not go to an IAP, but rather into a "regular account" for each employee. While member contributions no longer go into the regular account, PERS continues to credit each member's regular account with annual earnings. When a member retires, the amount in the regular account is "matched" by the employer, and then that double balance is converted into an annuity for the lifetime of the employee. The annuity is calculated using actuarial assumptions for both rate of return and life expectancy.

"PERS also offers the "money match" benefit calculation technique for Tiers 1 and 2. PERS calculates benefits using both the full formula and money match techniques and grants the retiree whichever benefit is higher."

For example, an employee with $200,000 in the regular account at retirement receives a match of $200,000. The resulting $400,000 is converted into an annuity using the PERS assumed annual earnings rate of 8% and a life expectancy as determined by actuarial tables.

Each year the PERS Board decides what level of earnings to "credit" to members' regular accounts. Tier 1 members are guaranteed to earn 8% on their regular accounts, regardless of actual investment results, providing them protection from market downturns. Tier 2 member regular accounts are credited with the actual earnings of the fund, thus reflecting market ups and downs. Prior to 2003, the PERS board frequently credited Tier 1 member regular accounts with actual earnings when those earnings exceeded 8%. Tier 1 members received all of the up-side benefit when times were good, but when investment returns fell below 8%, the fund had no reserves to pay the 8% guarantee for Tier 1. This practice was known as "over-crediting" of Tier 1 accounts.

The guaranteed rate of return coupled with over-crediting produces money match benefits that your committee concludes are excessive. These excessive benefits are driving PERS liabilities. Unfortunately, previous attempts at reform have been thwarted by decisions of the Oregon Supreme Court, which held that prior promises to PERS members are constitutionally protected and cannot be changed. The history of PERS is critical to understanding why these burdens of the past are essentially inescapable.

HISTORY OF EXCESS AND THWARTED REFORMS

The three-tier PERS benefit structure is an artifact of history. That history includes irresponsible benefit decisions, attempts to roll back those decisions, and court challenges.

The Legislature's Irresponsible Decisions on Money Match and Guaranteed Returns

Back in the 1950s, money match was the only method for calculating pension benefits. In the 1960s, the Legislature abandoned money match in favor of a formula-based approach. However, in a move that haunts PERS today, the 1969 Oregon Legislature determined that "a few" employees would be disadvantaged by the loss of the money match option and reinstated it. Some sources say that rather than a few employees, it was only one, but your committee could not confirm the story. Whatever motivated the Legislature, reinstating money match in 1969 was a fateful mistake that burdens PERS today.

"Whatever motivated the Legislature, reinstating money match in 1969 was a fateful mistake that burdens PERS today."

The Legislature in 1975 decided to ensure that PERS members, all of whom were contributing a percentage of their income to the regular account, would enjoy favorable investment returns by granting a guaranteed rate of return. The balance of the regular account would grow each year based on investment earnings, never falling below the assumed earning rate in any given year. In 1975, the assumed earnings rate was 5.5%; over the years the rate was increased and is now 8%.

Legislature Permits the 6% Pick-Up

In 1979, the Oregon Legislature passed an amendment that allowed public employers to "pick up" the 6% employee contribution to the PERS fund as a bargained-for benefit in lieu of a wage increase. During collective bargaining, many, but not all, PERS employers agreed to pick up the employee contribution to PERS, and today approximately 70% of employees receive the pick-up.

PERS Board Over-Credits Regular Accounts

In the 1980s, the majority of PERS employees had a consistent 6% contribution to the regular account paid by the employers and a guaranteed rate of return of at least 8%, a generous arrangement. But further mischief was in the offing. The booming stock market of the 1980s resulted in PERS investment returns of greater than 8%. The PERS Board, populated at that time mostly by PERS members, credited member regular accounts with the actual returns on investment. The PERS board granted credits above the assumed rate in 19 separate years, sometimes crediting member regular accounts with as much as 20% in a single year. PERS employees retiring on money match could retire and earn more in annual benefits than their final salary, with payments guaranteed for life and an annual cost of living adjustment (COLA) to boot. The generous PERS benefits had become excessive.

Ballot Measure 8

In 1994, Oregon voters passed a ballot initiative known as "Measure 8." The measure had several goals. First, it proposed elimination of the guaranteed rate of return for PERS accounts in order to return at least some PERS investment risk to the employees. Second, the measure prohibited the employer "pick-up," requiring every PERS employee to make a personal contribution to the system. Finally, the measure prohibited the inclusion of unused sick leave in the Final Average Salary calculation.

Oregon Supreme Court Overturns Measure 8

Measure 8 led to court challenges, including a case brought by the Oregon State Police Officers Association (OSPOA), which eventually reached the Oregon Supreme Court. In its 1996 "OSPOA decision,"[16] the court held that Measure 8 violated the Contracts Clause of the United States Constitution, which prohibits the government from interfering in contracts. The court reasoned that PERS is a "unilateral" contract between the government and the employee. This means that an employee, on the date of hire, receives a contractual right to whatever retirement program is promised at that time. In other words, when an individual accepts an offer of public employment, a unilateral contract is formed and the retirement terms are the statutory promises in place at that time.

The court decided that the U.S. Constitution prohibited future legislatures from reducing benefits promised under the PERS unilateral "contract." The court decided that the guaranteed rate of return, the employee pick-up, and the inclusion of sick leave in final average salary were all parts of the PERS "contract" and could not be changed. The Legislature could pass new statutory promises that would become part of a new employee's unilateral contract, but the Legislature is constitutionally prohibited from making changes to existing PERS contracts.

"The court [in its 1996 OSPOA decision] decided that the guaranteed rate of return, the employee pick-up, and the inclusion of sick leave in final average salary were all parts of the PERS 'contract' and could not be changed."

The OSPOA decision also stands for the proposition that, even if employees have not yet earned their PERS benefits by working, any benefits that they may receive from future years of service cannot be reduced. The Legislature thus cannot "cap" or "freeze" the pension benefits of current members, a technique used widely in the private sector.

Note that because Tier 2 had not yet been created at the time of the OSPOA lawsuit, and thus all PERS members were part of what became Tier 1, the court in the *OSPOA* ruling effectively held that Tier 1 benefits included in the statutory promises at that time are constitutionally protected.

Oregon Legislature Creates Tier 2

In 1995, the Oregon Legislature eliminated the guaranteed rate of return on regular accounts for new members, effective January 1, 1996. This action created a new category of employees, known as Tier 2. All active employees, vested former employees, and retirees as of December 31, 1995 were then known as Tier 1.

Elimination of the guaranteed rate of return for Tier 2 employees means that most Tier 2 employees retire using the full formula method rather than money match. The Legislature made other modest changes for Tier 2 employees, such as prohibiting the inclusion of unused vacation time in final average salary under the full formula method.

PERS Board Over-Credits Regular Accounts Yet Again

The concerns of the public and the Legislature over PERS costs went by the wayside with the internet-driven stock market bubble of the late 1990s. Excellent investment returns filled the PERS coffers and invited even more over-crediting of regular accounts by the PERS board. All appeared well; members enjoyed better than expected benefits and the roaring stock market kept the PERS system fully funded.

Dot-Com Bust Exposes PERS Problems; Legislature Passes Reforms

The free-wheeling days of regular account over-crediting and Tier 1 members retiring in their 50s with pensions larger than their final salaries became unsustainable with the stock market crash of 2001. Then-Governor Kulongoski asked the 2003 Legislature to take on the problems of PERS. Greg Macpherson, a freshman Democratic legislator and employee benefits attorney at a prominent Portland law firm, led the effort in the House. On the Senate side, Democrat Anthony (Tony) Corcoran from Cottage Grove, a labor leader, led the charge. Your committee interviewed both of these leaders.

"The 2003 Legislature passed much-needed changes in PERS governance."

The 2003 Legislature passed much-needed changes in PERS governance. The Legislature reduced the number of members of the PERS Board and made it impossible for PERS members to have a majority of positions on the PERS Board. The Legislature also made changes to actuarial tables. PERS had been using out-of-date actuarial tables with life expectancies several years shorter than what retirees could expect in 2003. This had the effect of producing higher annual Tier 1 money match benefits, which PERS would then pay out over more years than expected. Additionally, the PERS Board had used a 30-year time horizon to calculate investment gains in the system, resulting in smaller employer contributions than necessary to support the burgeoning benefits. These legislative changes reduced benefits for employees retiring under money match and imposed greater fiscal discipline on employers by forcing them to pay down liabilities over shorter time periods.

The 2003 Legislature also created OPSRP, essentially a "Tier 3" benefit program, for all new employees beginning work after August 28, 2003. OPSRP retained the idea of a defined benefit pension plan for employees, but reduced the potential pay-outs under that system by eliminating the money match option and reducing the full formula "pension factor" from 1.67% to 1.5%. Additionally, OPSRP ended the practice of including unused sick time and accrued vacation in the Final Average Salary used to calculate benefits. The Legislature, in response to the Supreme Court's *OSPOA* decision, also included a provision that OPSRP benefits could be changed by future legislatures.

The 2003 reforms also introduced the Individual Account Program (IAP) for all PERS members, thus injecting a defined contribution element into PERS. Most significantly, the Legislature redirected Tier 1 and Tier 2 annual employee contributions from employee regular accounts to the new IAP. This had the effect of reducing the annual growth of regular accounts that would be eligible for money match.

"The lasting impression is that PERS is the 'third rail' of Oregon politics and that would-be reformers must be mindful of a possible political backlash."

The Legislature made several other changes targeted at reducing Tier 1 money match benefits. The Legislature redefined the guaranteed rate of return for Tier 1 members from an annual guarantee to a lifetime guarantee, thereby attempting to blunt the run-away regular account crediting of the late 1990s. The Legislature placed restrictions on PERS Board over-crediting, forcing the PERS Board to stop over-crediting until a reserve is accumulated, which has had the practical effect of eliminating the practice.

The Legislature implemented a court order issued by Marion County Circuit Court Judge Paul Lipscomb in the *City of Eugene v. PERS* case.[17] Judge Lipscomb overturned decisions made by the PERS Board in 1998 and 2000, including over-crediting of member regular accounts. The Legislature temporarily suspended annual COLAs for retirees until PERS recovered the amounts over-credited in order to meet the requirements of Judge Lipscomb's decision.

Oregon Supreme Court Strikes Down Some Reforms and Allows Others

Once again, court challenges followed the reforms. The 2003 Legislature allowed challenges to be brought directly to the Oregon Supreme Court. In *Strunk v. Public Employees Retirement Board*, decided in 2005, the Court upheld some of the 2003 PERS reforms and struck down others. The Court found that annual crediting of Tier 1 member regular accounts was part of the PERS contract and could not be changed to "lifetime" crediting. The Court also found that the temporary suspension of the annual COLA was a violation of the PERS contract. However, the court upheld the rest of the 2003 reforms that reduced benefits, including the redirection of the 6% annual employee contribution to the IAP and the use of up-to-date actuarial tables.

Political Implications of PERS Reforms

Both Mr. Macpherson and Mr. Corcoran paid high political prices for backing PERS reform. Neither are members of the Legislature today. Most notably, Mr. Macpherson, in 2007, lost a fierce primary campaign for Attorney General to John Kroger, a law professor and former Federal prosecutor. Public employee unions provided strong financial support to Kroger, interpreted by at least some political observers and members of the media as a backlash to Macpherson's PERS reform efforts.[18] The lasting impression is that PERS is the "third rail" of Oregon politics and that would-be reformers must be mindful of a possible political backlash.

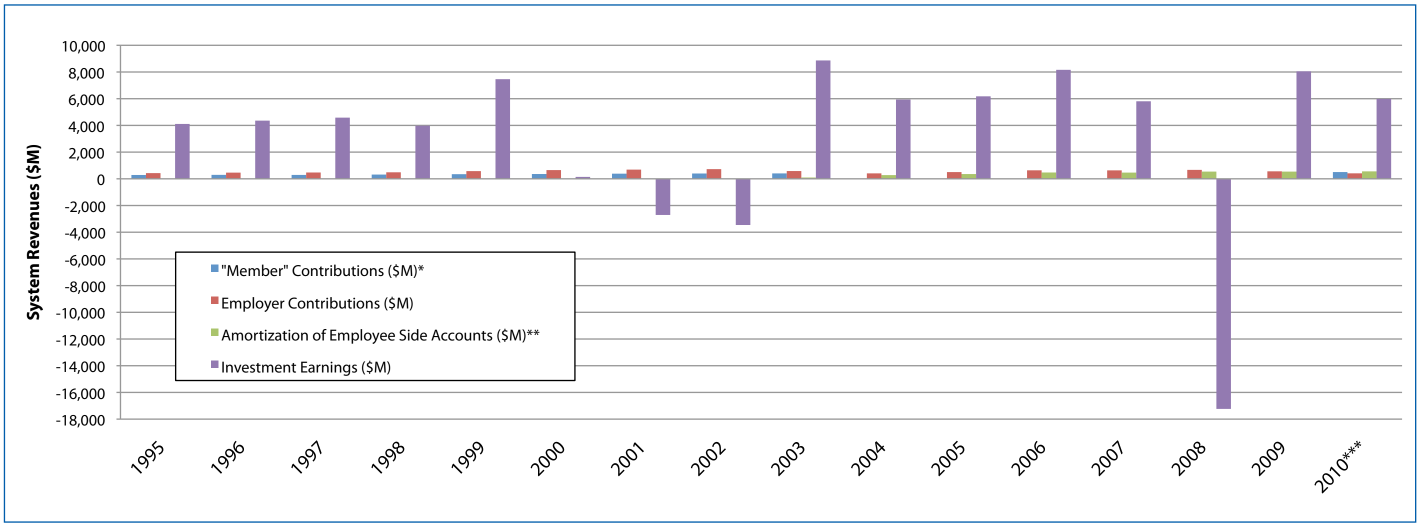
PERS ASSETS: WHO CONTRIBUTES AND HOW MUCH?

How PERS Is Funded

PERS funding comes from three sources: employee contributions, employer contributions, and investment returns. (See Table 4.) Employees are required by statute to contribute 6% of their annual salaries to PERS, but as a result of collective bargaining, the employers "pick up" contributions for 70% of employees. This means that the employers pay 6% of employee salaries directly into PERS. It may appear that those employees contribute nothing to their retirement plans, but as their union representatives are quick to point out, the 6% pick-up was bargained for in lieu of a salary increase, albeit 30 years ago.* Employers were originally attracted to the pick-up because it provided a way to increase employee compensation without additional payroll taxes. Employees liked the pick-up because

* Note that the 6% paid by the employer is free from payroll taxes; thus the employees gave up a smaller percentage increase in salary for the 6% pick-up.

Table 4: System revenue from "member" and employer contributions and investment earnings



*Oregon statute requires that employees contribute 6% of compensation to their retirement accounts. Approximately 70% of Oregon's public employees do not make this contribution and it is "picked-up" by the employer. Beginning with 2004, member contributions are placed in the Individual Account Program, instead of the legacy Tier 1/Tier 2 member accounts subject to money match.

**PERS' methodology for tracking amortization of side accounts began in 2002. Side accounts represent deposits from pension obligation bond (POB) proceeds and other lump-sum payments. The liabilities associated with the POB's are not reflected by PERS but are considered liabilities of the respective jurisdictions.

***2010 data is preliminary.

Source: Adapted from PERS, "PERS: By the Numbers," (February 2011), p.13, http://www.oregon.gov/PERS/docs/general_information/pers_by_the_numbers_2_2011.pdf?ga=t.

it provided them with what is in effect a pay increase, larger than they would have received otherwise, free from payroll taxes as well as federal and state income taxes until retirement. The state of Oregon is one of the PERS employers that pays the pick-up today, at an estimated cost of $360 million per biennium.[19]

Each participating employer must contribute to the system, with the rate of contribution determined by the PERS Board. Employer contribution rates are typically expressed in a percentage of overall payroll expense, with and without side account balances. (See Table 5.) For example, an employer may have a contribution rate of 5% of total payroll. If that rate increases to 7.5% of payroll, the employer must pay 50% more in terms of dollars, and even more if the overall payroll increases. PERS employer contribution rates quoted in the media are average rates. The actual contribution rates vary considerably among employers based on factors such as differences in workforce composition.

One significant factor driving the variation in employer contribution rates is whether or not the employer issued "pension obligation bonds" to invest in a PERS "side

Table 5: Systemwide average employer contribution rate history (not including employer contributions to health care nor the employer pick-up of the 6% "employee contribution")

Valuation Year	Rate Effective Dates	Average Rate With Side Accounts (%)	Average Rate Without Side Accounts (%)	Annualized Salary ($M)
1975	Various	11.21	11.21	1,014.5
1977	Various	11.87	11.87	1,226.8
1979	Various	10.97	10.97	1,488.0
1982	Various	10.13	10.13	2,062.1
1985	Various	10.87	10.87	2,428.3
1987	Various	11.3	11.3	2,764.7
1989	Various	9.74	9.74	3,199.4
1991	Various	9.19	9.19	3,887.5
1993	Various	9.15	9.15	4,466.8
1995	Various	9.42	9.42	4,848.1
1997	Various	11.4	11.4	5,161.6
1999	7/1/2001 - 6/30/2003	10.74	10.74	5,676.6
2001	7/1/2003 - 6/30/2005	10.64	10.64	6,256.5
2003*	7/1/2005 - 6/30/2007	14.47*	18.89*	6,248.5
2005**	7/1/2007 - 6/30/2009	8.22	15.01	6,792.0
2007	7/1/2009 - 6/30/2011	4.73	12.42	7,721.8
2009	7/1/2011 - 6/30/2013	10.8	16.3	8,512.0
2011 (EST)	7/1/2013 - 6/30/2015	15.6	20.9	TBD

*December 31, 2003 rates were phased-in. Actual rate paid averaged 15.10% without employer side accounts and 10.58% with employer side accounts.

**Includes weighted average rate for Tier 1/Tier 2 and OPSRP beginning in 2005.

Source: Adapted from "PERS: By the Numbers," (February 2011), p. 17, http://www.oregon.gov/PERS/docs/general_information/pers_by_the_numbers_2_2011.pdf?ga=t.

account," and, if so, how successful the employer was with its investment. A Pension Obligation Bond (POB) is a debt of the state or a local government entity. Employers sell these bonds to the public and then invest the proceeds in a PERS side account. The goal is to borrow money at one rate, invest it in PERS at a higher rate, and use the spread to fund at least part of the employer's PERS contribution. This technique has worked brilliantly for some employers. (See Table 6 on page 10.) For example, the Salem-Keizer school district's contribution rate for Tiers 1 and 2 is 11.75% of payroll, down from the 19.48% of payroll it would have paid without the side account returns. This technique has worked poorly for other entities, with negative side account returns further increasing their PERS financial burden. For example, the David Douglas School District issued bonds and invested the proceeds in a PERS side account, which has lost nearly $12 million in value. This means that David Douglas School District will pay 2% of payroll more that it otherwise would have been required to contribute to PERS. The district estimates its payroll at $60 million, meaning that its bad bet on the side account will cost it an additional $1.2 million per year.

There is a PERS-adopted limit on changing employer contribution rates from one biennium to another, known as the "rate collar." This technique is designed to stabilize the required contributions, thus insulating employer rates from market volatility. The increase in employer rates from year to year is capped. For a given year, the employer may be paying less than is needed to return the fund to fully funded status and is instead pushing the liability out into the future. PERS employer rate increases are capped at 3% of payroll when PERS has an unfunded liability of 20% or less (calculated optimistically with side accounts included), and at 6% when the unfunded liability is greater than 20%. In January 2010, it appeared that the unfunded liability to use in setting employers rates for 2011–2013 would exceed 20%, resulting in an employer contribution rate increase of 6% of payroll. Rather than imposing the rate-capped increase of 6%, the PERS board further capped employer contribution increases by adopting a "sliding scale" rate collar when the unfunded liability exceeds 20%. This allowed the PERS Board to mandate a lower employer contribution rate increase than otherwise required but at the expense of delaying repayment of the UAL.

"If PERS does not meet the assumed 8% earnings rate over the long term, then employer rates will increase even more than currently estimated in order to make up the gap."

The third source of funds for PERS, investment returns, varies with the overall health of investment markets. In calendar year 2008, PERS suffered a 28% drop in value. PERS bounced back with a 19% gain for 2009 and nearly 13% for 2010. As will be discussed further below, one cannot simply add and subtract these numbers to determine the funded status for PERS. This is due to several factors, one of the largest of which is that the UAL calculation already bakes in an assumption that PERS investments will return 8% per year. This tends to amplify the effect of investment losses and blunt the effect of investment gains.

The employer contribution rates are based on actuarial assumptions about PERS liabilities and assets. The liabilities change over time based on several factors, including the number of PERS members by tier and how many actually take retirement and under what benefit calculation. The assets change based on investment returns. When investment returns exceed expectations, employer rates are reduced. Your committee observes that robust investment returns through the end of 2007 resulted in low employer rates for the 2009–2011 biennium.

The sharp losses in 2008 created a deep hole that even a 19% return in 2009 could not eradicate, forcing a jump in employer rates for 2011–2013. The rate collar is designed to limit the volatility in employer rates, but your committee concludes that volatility remains a problem and recommends a rate-stabilization reserve, discussed below.

The performance of PERS investments relative to the assumed long-term earnings rate of 8% is a critical driver of the employer contribution rate and thus of taxpayer costs for PERS. With the significant losses in 2008, the three-year average return for PERS for 2008-2010 was 0.6% and the five-year return for 2006-2010 was 4.43%. If PERS does not meet the assumed 8% earnings rate over the long term, then employer rates will increase even more than currently estimated in order to make up the gap.

PERS GOVERNANCE STRUCTURE

There are several organizations responsible for PERS governance, and your committee spoke to representatives from each group.

PERS management and staff are led by Paul Cleary, Executive Director. PERS is responsible for collecting money from employers and employees, tracking employer and employee account balances, calculating and paying out benefits, and making recommendations to legislators and other groups on changes to help in the administration of PERS.

PERS management reports to a Board of Trustees, known as the PERS Board, led by James Dalton. The PERS Board sets the direction for PERS and oversees the program. The board has five members, who are appointed by the Governor. Three members must be non-PERS members who have expertise in business, pensions, or other financial matters. One member must represent a PERS employer and the final member must represent PERS members.

The PERS Board employs an actuarial firm, Mercer LLC, to report on the myriad of financial metrics required to run the system, including expected investment returns, expected cash flow required to pay benefits as employees retire, the growth in PERS liabilities for active employees, and the required employer contributions to make up for any unfunded actuarial liability.

PERS management does not invest the money that flows into PERS. Oregon is unusual in that it uses a bifurcated model, with the administration of its pensions separated from management of its pension investments. The Oregon Treasurer, currently Ted Wheeler, is responsible for day-to-day investment decisions for the $48 billion PERS fund. The Treasurer has a trained internal staff and also employs external investment firms.

The goals and policies that determine the asset mix for PERS investments are set by another organization, the Oregon Investment Council (OIC), appointed by the Governor. Your committee spoke with the current chair and immediate past chair of the OIC. Your committee was struck by the difference of opinion on whether investment returns will be robust enough in the coming years to return PERS to fully funded status without undue impact on public services. The current chair said "yes" with considerable confidence, while the immediate past chair said "no" with apparently equal confidence.[20] However, both agreed that reducing the current annual assumed earnings rate from 8% to, say, 7.5%, would not affect investment decisions. Regardless of what eventually happens, your committee concluded that it is not prudent to rely on investment returns alone.

"Your committee was struck by the difference of opinion on whether investment returns will be robust enough in the coming years to return PERS to fully funded status without undue impact on public services. The current chair said 'yes' with considerable confidence, while the immediate past chair said 'no' with apparently equal confidence."

Conflicts of Interest: Legislators and Judges

The final two organizations responsible for PERS governance are the Oregon Legislature and the Oregon Supreme Court. Most Oregon legislators and all Oregon Supreme Court judges are themselves members of PERS, giving at least the appearance of a conflict of interest. Members of the Legislature may opt out of PERS, and a few have done so, most notably several new members of the 2011 Legislature.[21] Judges in Oregon enjoy a special PERS benefit program tailored just for them.[22] The justices of the Supreme Court recognized in the Strunk decision that there is at least an appearance of a conflict of interest, but the "doctrine of necessity" required the court to decide on PERS issues. Because the Oregon Supreme Court is the ultimate judicial body that interprets Oregon state law, and PERS is state law, by "necessity" the Supreme Court must make decisions on PERS despite the appearance of a conflict of interest.

PERS matters, including proposed legislation, are overseen in the House by the House Business and Labor Committee. In the current 2011 legislative session, Rep. Mike Schaufler, a Democrat from Happy Valley, and Rep. Bill Kennemer, a Republican from Oregon City, co-chair the House Business and Labor Committee. Your committee interviewed Rep. Schaufler, who described himself as a strong advocate for public employees. While numerous pieces of proposed legislation have been submitted to the Business and Labor Committee, at the time of this writing, the fate of any particular reform idea is unknown.

STRONG EMPLOYEE UNIONS, LESS VISIBLE EMPLOYER GROUPS

Who Represents Employers and Employees?

Your committee looked for employer and employee organizations that have taken public positions on PERS reform. On the employer side, your committee contacted the Oregon School Boards Association, the Oregon League of Cities, and the Association of Oregon Counties. Your committee found that these organizations either had no official position on PERS reform or supported reforms posed by others. For example, the Oregon League of Cities supports ending the tax remedy benefit for out-of-state PERS recipients, an idea with wide support across employer and employee groups.

PERS employers, of course, are funded by Oregon revenues, primarily income taxes and property taxes. Your committee tried to identify groups who claim to represent taxpayers and determine if those groups had taken a public stand on PERS, but this proved difficult. Your committee did find a paper[23] published jointly in October 2010 by The Cascade Policy Institute and the Americans for Prosperity Foundation that contained a small section on PERS reform, but found it to be duplicative of ideas put forth by former Governor Kulongoski's reset committee.[24]

In contrast, PERS employees are represented by strong and vocal unions. These include the American Federation of State, County and Municipal Employees (AFSCME); the Service Employees International Union (SEIU); the American

Federation of Teachers (AFT); and the Oregon Education Association (OEA). Your committee interviewed several representatives from these unions. The unions presented a consistent message that employees have earned their benefits and that any state budget problems should not be solved on the backs of public employees. One union representative, in a moment of candor, suggested that perhaps public employee unions had done too good of a job in negotiating Tier 1 benefits. Your committee agrees.

"One union representative, in a moment of candor, suggested that perhaps public employee unions had done too good of a job in negotiating Tier 1 benefits."

DISCUSSION

PERS: PROBLEMS REMAIN

Your committee's first task was to determine if PERS, as currently structured and administered, represents a "problem" for Oregon. Your committee had to consider several categories of possible problems, including financial, political, equity, and governance.

From a financial perspective, your committee determined that the PERS unfunded actuarial liability (UAL) represents a significant financial problem for Oregon. It is impossible to ignore a UAL, optimistically calculated at $8 billion, and over $400 million in increased employer contributions over the next biennium. Your committee believes that when the effect of pension obligations bonds and side accounts is considered, the UAL is actually $13.6 billion and the already steep increases in employer contributions should be even higher.

The PERS financial problems in turn create a political problem that is expected to grow over time, as the cost of PERS either crowds out funds for government services or requires tax increases to pay for public sector employee benefits. Your committee assumes that the political climate in Oregon, as in many other states, will not support increased income taxes to pay for public employee benefits. Your committee further assumes that significant tax reform in Oregon is unlikely. With few opportunities to increase revenues, state and local governments must either cut services or struggle to deliver them more effectively.

"The PERS financial problems in turn create a political problem that is expected to grow over time, as the cost of PERS either crowds out funds for government services or requires tax increases to pay for public sector employee benefits."

The committee also found PERS to be riddled with inequities among employees, employers, and generations. Benefits differ widely among employees, with Tier 1 members receiving far more generous benefits than OPSRP members. Some employers have enjoyed great returns from PERS side accounts funded by Pension Obligation Bonds, thus reducing their employer contributions. Other employers were not so fortunate, facing even larger increases in contribution levels and looming bond payments. Finally, future generations will be paying for the retirement of the Tier 1 baby-boomers for decades to come, facing contribution rates higher than those paid by the baby-boomers during their working years, putting future generations at a disadvantage in the availability of public services.

Each of these problems is explored in greater detail below, with recommendations designed to make at least modest improvements to the system within the constraints defined by the Oregon Supreme Court.

Tier 1 and Tier 2 Liabilities Drive the Unfunded Actuarial Liability

PERS estimates the unfunded actuarial liability at the end of 2009 to be $8 billion. In its simplest form, the UAL is equal to the liabilities of the system minus the assets of the system. The liabilities, of course, are the benefits promised to retirees and employees, and those vary by tier. Therefore, in order to understand the UAL for PERS, one must analyze the liabilities of the system by PERS member tier and compare them to the assets available.

At the end of 2009, the PERS liability for Tier 1 and Tier 2 employees was $56 billion, while the liability for OPSRP employees was only $500 million. This is an enormous difference, and it reflects several factors, including the number of people in each system (250,000 for Tiers 1 and 2 versus 67,000 for OPSRP) and the length of service of the members (OPSRP employees by definition have served only since 2003).

Without side accounts, at the end of 2009, PERS had assets of approximately $43 billion for Tier 1 and Tier 2, versus the liability of $56 billion, leaving an unfunded liability of $13 billion. For OPSRP, PERS had $445 million in assets versus the liability of $535 million, leaving an unfunded liability of $90 million. Thus, over 99% of the UAL for PERS is due to Tier 1 and Tier 2 liability for which the PERS system has insufficient assets. Given this result, your committee focused on finding ways to reduce the liability and increase the assets for Tier 1 and Tier 2. This approach led to two recommendations discussed below concerning the money match calculation and the redirection of Tier 1 and Tier 2 employee contributions.

Investment Returns Alone Not Sufficient

The union leaders that appeared before your committee uniformly stated that there is no need for further PERS reform and that robust investment returns would, in time, eliminate the unfunded liability. Harry Demorest, chair of the Oregon Investment Council, also spoke with confidence of the potential for investment returns to eliminate the PERS unfunded liability. PERS enjoyed a 19% return in 2009 and nearly a 13% return in 2010, well above the 8% assumed earnings rate. Is it possible, then, that investment returns alone will return PERS to fully funded status without further reforms?

Your committee concluded that yes, it is possible: investment returns could exceed the 8% assumed earnings rate and return PERS to fully funded status without further reform. Your committee also concluded that it is possible that investment returns will not exceed 8% over the long run and plunge the fund into deeper financial difficulty. After all, the PERS return over the 2006-2010 five-year period was 4.43%, far less than the 8% assumed earnings rate.

Your committee concludes that, while it is *possible* that robust investment returns will eliminate the unfunded liability, it is not *prudent* to rely on returns that could just as easily fall below the 8% assumed earnings rate. Your committee recommends that steps be taken to further insulate PERS, and thus the employer rates, from the volatility in investment returns and the possibility that long-term returns will not meet the 8% assumed earnings rate.

"…while it is *possible* that robust investment returns will eliminate the unfunded liability, it is not *prudent* to rely on returns that could just as easily fall below the 8% assumed earnings rate."

Impact of PERS on Government Services

It is difficult to understand the impact of a multi-billion dollar UAL without understanding what it means to individual employers and the public services offered by those employers. Your committee looked at four employers and their strategies for dealing with increased PERS costs. All of these employers are experiencing limited revenue growth. The experiences of these four employers highlight the complex nature of PERS and why it is so difficult to make sweeping generalizations on the impact of increasing PERS costs. (See Table 6., p. 20)

City of Eugene: Restructuring Services

Incorporated in 1862, Eugene is the second largest city in Oregon, with a population of 157,100. It is a home rule charter city governed by an elected mayor and eight city council members who set policy and hire the city manager.

Between 2007 and 2011, city government employment decreased 5% to 1467, driven by escalating personnel costs. Expenses associated with personnel account for 74% of the general fund budget. The city pays 100% of PERS costs, including the pick-up, and 92-95% of the employee share of health insurance premiums. Eugene eliminated 80 positions last year.

Facing increased PERS costs and property tax revenues limited by declining property values, Eugene focuses on restructuring city services. In effect, the city views PERS costs as just another expense to plan for, like electricity or fuel for city vehicles. The chief financial officer stated that Eugene has been preparing for PERS increases for at least a couple years, simply factoring it in to the forecasting and budgeting process. The city has restructured some aspects of service delivery, such as extending the life of fleet vehicles and creating new models for delivery of information technology services.

Eugene has in the past offered early retirement incentives to reduce employment without resorting to lay-offs, but city staff showed little enthusiasm for more broad-based incentives to encourage early retirement.

Eugene is better prepared than many public employers to deal with the realities of high and growing PERS costs. The city has a comprehensive budget process that looks back two years and forward six, enabling city finance staff to identify and plan for developing cost trends. Eugene currently projects an increase of 6% of payroll for PERS beginning in FY2013, which would bring its total employer contribution rate (including the pick-up and debt service on pension bonds) to 31.53% of payroll.

The City Manager's 2011 Proposed Budget Message stated that roughly 70% of general fund costs were associated with personnel, and that Eugene "cannot make strides in bringing our revenues and expenditures in line without addressing rising employee costs." He went on to say that

Table 6: Contribution rates by selected jurisdiction

Employer	Employer Pick Up	Tiers 1 & 2 Employer Rates		OPSRP Employer Rates GS*	
		With Side Account	Without Side Account	With Side Account	Without Side Account
Salem-Keizer School District					
Normal Cost		7.64%	7.64%	6.13%	6.13%
UAL (combined)***		11.84%	11.84%	11.84%	11.84%
Side Account Offset		-7.73%	0.00%	-7.73%	0.00%
Total Rate	**6.00%**	**11.75%**	**19.48%**	**10.24%**	**17.97%**
City of Pendleton					
Normal Cost		11.35%	11.35%	6.13%	6.13%
UAL (combined)***		4.98%	4.98%	4.98%	4.98%
Side Account Offset		-3.54%	0.00%	-3.54%	0.00%
Total Rate	**6.00%**	**12.79%**	**16.33%**	**7.57%**	**11.11%**
Owyhee Irrigation District					
Normal Cost			5.95%		6.13%
UAL (combined)***			20.76%		20.76%
Side Account Offset			0.00%		0.00%
Total Rate	**6.00%**	**N/A****	**26.71%**	**N/A****	**26.89%**
City of Eugene					
Normal Cost			9.98%		6.13%
UAL (combined)***			4.05%		4.05%
Side Account Offset			0.00%		0.00%
Total Rate	**6.00%**	**N/A****	**14.03%**	**N/A****	**10.18%**

* General Service (excludes Police and Fire rate).

** Employer does not have a side account.

*** Combined Tiers 1 & 2 and OPSRP UAL employer rates (OPSRP UAL rate: .08%).

Note: Cities of Eugene and Pendleton Tiers 1 & 2 normal cost rate includes both general service and police and fire.

Source: Table provided via email by Donna Allen, PERS, February 18, 2011.

the "lower impact fixes have been exhausted . . . [and] the only remaining choices are to significantly reduce certain services."[25] In effect, the City Manager's report indicates that while Eugene has so far been successful in restructuring services and reducing employment through attrition, continuing cost increases in a capped revenue environment will invariably lead to service reductions.

City of Pendleton: Hope Is Not Enough

The City of Pendleton is located in northeastern Oregon on Interstate 84 and is best known outside the region for the famous Pendleton Roundup, which attracts thousands of tourists each year. The surrounding area is predominantly rural and agricultural, but the town itself has been successful in attracting manufacturing and light industry. A mayor and eight city council members govern the city, but much of the decision-making rests with the city manager. Pendleton has a population of 17,535, covers an area of 10.5 square miles, and provides services that include a convention center, an airport, a cemetery, water services, sewer services, roads, parks, recreation, police, fire, ambulance and a municipal court.

The city employs 130 full-time employees but during the summer that number increases to approximately 200. The seasonal employees account for a very small part of the annual payroll costs and are not generally PERS members. The current operating budget is $22.5 million with a general fund of $10.5 million. Employee compensation as a share of the total operating budget is 53% and consumes 65% of the general fund.

The city's revenue comes from property taxes, franchise fees (e.g., rights-of-way), ambulance fees, fines, and money received from the state. By far the greatest expense is salaries for public safety employees. The City provides employee health insurance coverage and additionally covers 80% of employee dependent health coverage.

In recent years the city has reduced employment by three positions in the fire department, one position in street maintenance, and one position in engineering. These reductions are due largely to increased compensation costs. The city manager anticipates that these reduced levels of employment will continue.

For PERS specifically, the city picks up the 6% mandated employee contribution for a cost of $63,678. The city has a side account balance of $3,124,842 against a pension bond obligation of $6,895,000. The number of employees currently eligible to retire is ten. The City does not expect to reduce services in 2011–2013, but does not yet have a plan for later years.

Rather than plan for further PERS increases now, which could change based on better-than-expected investment returns, Pendleton is taking a wait-and-see attitude. City representatives stated that they have little or no bargaining power when dealing with the unions regarding PERS, particularly the police and fire unions. Your committee believes the strategy of hoping for improved investment returns is not enough, and that service cuts are highly probable for the city of Pendleton.

Salem-Keizer School District: Cutting Teachers

The Salem-Keizer School District is the second-largest school district in Oregon, serving just over 40,000 students. The district employs nearly 5000 people. A school board sets policy and adopts budgets for the district and a superintendent leads the management team.

The general fund provides for ongoing operations, with 87% of the fund going to personnel costs. The district faced a budget shortfall of $9 million in the current fiscal year, which it was addressing by cutting school days and reducing expenditures in technology, transportation, and supplies.

Looking to the 2011–2013 biennium, the district faces a PERS increase from 3.16% of payroll for Tier 1 and Tier 2 to 11.75%, and from 3.68% of payroll for OPSRP to 10.24%. Salem-Keizer issued pension obligation bonds and has enjoyed good returns on its side account, resulting in a benefit to the PERS contributions rates of 7.73% of payroll. In other words, without the side account, Salem-Keizer would be looking at PERS contribution rates of at least 18% of payroll. Salem-Keizer also picks up the employees' required 6% contribution, effectively spending another 6% of payroll on PERS.

"[W]ithout the side account, Salem-Keizer would be looking at PERS contribution rates of at least 18% of payroll. Salem-Keizer also picks up the employees' required 6% contribution, effectively spending another 6% of payroll on PERS."

PERS cost increases are especially difficult for school districts because education is inherently labor-intensive, and the majority of school funding comes from the financially strapped State of Oregon. Other revenue sources, such as property taxes, are primarily flat. Salem-Keizer has little choice but to schedule lay-offs. At the end of April 2011, Salem-Keizer Superintendent Sandy Husk's budget message included a "substantial increase in the PERS rate" as one of the factors in the current budget reality. In 2011-12, with $313 million in anticipated revenue and $379 million needed to operate without cuts, the superintendent recommended spending a $12 million projected fund balance, $5 million in PERS reserves and $1.6 million in capital maintenance reserves to begin closing the $66 million gap. She recommended closing three schools and eliminating 400 staff positions: 331 instructional positions (teachers, librarians, etc.) and 69 central services, administration and support positions. Class sizes would increase and selected programs would be reduced or eliminated. Dr. Husk also said, "We need our employee groups to help solve the shortfall." If negotiations with the district's employee groups do not yield $13 million in furlough days and reduced compensation then additional cuts will be made.[26]

Owyhee Irrigation District: Struggles of a Small Employer

Owyhee Irrigation District, headquartered in the Eastern Oregon city of Nyssa, provides water for 67,171 acres of cultivated farmland. A board of five elected representatives governs the district, with day-to-day operations run by a manager and one administrative person. The organization currently employs 29 workers, a reduction from 40 just a few years ago. Owyhee is an example of a "special purpose governmental entity" within the PERS system.

Owyhee was formed after the federal government constructed the Owyhee Dam, and it continues to receive federal funding. In recent years, however, the district has relied primarily on assessments on its farmer members for funding. Personnel costs make up over 51% of its annual operating budget of over $3.6 million. Over 25% of those personnel costs are PERS contributions, which are expected to rise.

The rising cost of PERS, over which the district exercises no control, places a squeeze on its finances. Further increases in assessments on farmers in the community are not tenable. Owyhee has reduced the number of employees, sometimes by electing not to replace employees who have retired. Today, approximately 45% of the Owyhee PERS members are retired. This means that Owyhee's total payroll costs have declined, driving up its PERS contribution rate when expressed as a percentage of payroll costs. This trend is expected to continue, as in 2010 five employees were over the age of 60 and four were age 55-59 with over 15 years of service. Owyhee cannot exit the PERS system without legislative action, leaving the district no choice but to fund PERS before other obligations.

At the same time the district is faced with PERS increases, operations have become more difficult. The district provides irrigation water during the growing season through over 500 miles of waterways, mainly from three reservoirs. In addition, three hydro generators produce 14 megawatts of electricity. The reservoirs, tunnels, steel and concrete pipes, ditches and concrete lined waterways are for the most part 80 years old. Proper maintenance has become more difficult due to:

1. Infrastructure age and continuous exposure to a harsh environment.
2. Higher cost of supplies and equipment.
3. Increasing burden of environmental regulation, invasive plants, and aquatic life.
4. Changing technology and crops that demand more staff time to micro-manage water delivery.

Increased costs with little ability to raise revenue will lead to further staff cutbacks and more deferred maintenance, ultimately threatening the viability of the irrigation system. The district staff is committed to doing its best to continue to deliver the necessary water. This PERS employer may eventually face costs that cripple its ability to deliver on its mission.

As a special purpose entity, Owyhee could, under current law, declare bankruptcy. Your committee emphasizes that the district is not contemplating this catastrophic move, but rather uses this as an illustration of what could happen to small employers who face rapidly rising PERS costs and an inability to increase revenue.

"As a special purpose entity, Owyhee [Irrigation District] could, under current law, declare bankruptcy. Your committee emphasizes that the district is not contemplating this catastrophic move, but rather uses this as an illustration of what could happen to small employers who face rapidly rising PERS costs and an inability to increase revenue."

Multiple Dimensions of Inequity

In addition to the impact of increasing PERS costs on government services, there are equity questions among generations, employees, and employers.

Your committee examined the extent to which taxpayers of future generations must bear the costs of benefits provided to prior generations. While it is common to pay for public infrastructure such as schools, parks, and roads over several decades, multiple generations of citizens will benefit from the infrastructure. It is also common to fund benefits for current retirees from the contributions of current workers, with Social Security serving as a familiar example. Your committee, however, believes that if the burden of retirement benefits for prior generations is so heavy on future generations that the future generations suffer from restricted governmental services, a generational inequity exists. Stated another way, a system is equitable if the burden of retiree benefits remains relatively consistent across generations, allowing all generations to enjoy adequate public services. Additionally, a system is equitable if each generation of retirees enjoys a similar level of retirement benefits.

The unfunded benefits for Tier 1 and Tier 2 employees, mostly members of the baby-boom generation, make up 99% of the PERS UAL. Unless that UAL is reduced in the years that baby-boomers continue to work, that burden will be passed on to future generations. Your committee believes that the UAL for the baby-boomer generation will force future generations either to make larger contributions to public services than prior generations or to live with lower levels of public services, including education, parks, public safety, and transportation. Your committee recommends reductions in Tier 1 and Tier 2 benefits in order to reduce the UAL that is passed on to the next generation. Your committee also decided to avoid recommendations that would extend payment for Tier 1 and Tier 2 benefits further into the future, such as moving from a 20-year to a 30-year time horizon for returning PERS to fully funded status.

"…the UAL for the baby-boomer generation will force future generations either to make larger contributions to public services than prior generations or to live with lower levels of public services, including education, parks, public safety, and transportation. Your committee recommends reductions in Tier 1 and Tier 2 benefits in order to reduce the UAL that is passed on to the next generation."

In addition to inequity among generations, there is enormous inequity among employee groups, with Tier 1 and Tier 2 enjoying better benefits than employees in OPSRP. Your committee recommends changes to require Tier 1 and Tier 2 members to contribute to the financial maintenance of the system and to make a modest reduction in Tier 1 money match benefits, recommendations that do not affect OPSRP members. Unfortunately, decisions of the Oregon Supreme Court limit the ability of PERS reformers to do more. Your committee also recommends reducing OPSRP benefits, but only to a level that would still remain within the adequate retirement benchmark.

DEFINED CONTRIBUTION ONLY: NOT THE SOLUTION FOR PERS

Differences Between Plans

No discussion of a public employee retirement system is complete without a comparison of defined benefit and defined contribution plans. In the most general sense, a defined benefit plan is one that guarantees the retiree a monthly benefit for life, with the responsibility and investment risk of providing that benefit placed on the employer, or in the case of public employees, the taxpayer. The amount of the monthly benefit is typically determined by a formula that multiples final pay times years of service times a "pension factor," such as 1.5%. An annual cost-of-living adjustment (COLA) may provide increases in the benefit over time.

In contrast, a defined contribution is one that accumulates contributions from the employer and/or employee, without any benefit guarantees. The employee bears the entire investment risk (whether or not responsible for investment decisions) and an annuity or other beneficial use of the assets is provided at retirement.

PERS does not fit neatly under either the defined benefit or defined contribution definition. The 2003 reforms introduced OPSRP and the IAP, which essentially turned PERS into a "hybrid" system for all employees. Each group—Tier 1, Tier 2, and OPSRP—have a defined benefit pension component, and each has the IAP, which functions like a defined contribution plan.

Private Sector Moves to Defined Contribution Plans

Historically, workers in both the public and private sectors enjoyed defined benefit pension plans. In the last several decades, private sector employers have transitioned their employees to defined contribution plans. In 1975, 87% of active participants in private sector retirement plans had primary coverage via defined benefit plans, dropping steadily over time to below 50% by the 1990s.[27] By 2008, only 22% of private sector employees had defined benefit plans versus 84% of state and local government employees.[28]

Does Oregon Need a Pure Defined Contribution ("Tier 4") Plan?

Your committee debated the question of whether to recommend that the Legislature follow the private sector and create a "Tier 4" that consists only of a defined contribution plan. Your committee ultimately concluded that Oregon should continue to offer new public employees the hybrid model in OPSRP, and here's why.

First, many people have the impression that defined contribution plans always provide cost savings for employers. That is not necessarily the case. For example, it is possible to develop an inexpensive defined benefit plan by simply reducing the "pension factor" used in the formula. A defined benefit plan with a factor of 1.5% is 50% more expensive than a plan with a factor of 1%. A modest defined benefit plan, based on reasonable expectations for long-term investment returns, may actually cost less than a defined contribution plan, which typically features an "employer match" of the employee's contribution.

> **"A modest defined benefit plan, based on reasonable expectations for long-term investment returns, may actually cost less than a defined contribution plan, which typically features an 'employer match' of the employee's contribution."**

If lower cost is not a guarantee, why is the private sector switching to defined contribution plans? One factor is the stability of retirement plan costs from the employer's perspective. If the employer commits to match the employee's contribution, for example, up to perhaps 5% of salary, then the employer's contribution of 5% of salary can be planned for in advance and will be a relatively stable cost. In contrast, because the employer bears the investment risk in a defined benefit plan, its required contributions will vary as investment returns vary. Employers may try various methods to stabilize the contribution rates, such as the PERS "rate collar," but ultimately the required contributions will vary more than in a defined contribution plan. In addition, organizations typically adjust contributions on a time lag. Today's increase in contribution may have been caused by a prior period's poor returns in the market. In the private sector, this causes fluctuations in earnings not related to current performance, masking the operating performance of the company and depressing stock prices. In the public sector, this causes fluctuations in costs to taxpayers, and may result in increased costs of services during difficult times, such as for the 2011–2013 biennium in Oregon.

A defined contribution plan provides the employer another benefit. The employer can negotiate with employee representatives to increase contributions in good times and scale them back in bad times. There is no hangover from prior promises; the amount to contribute relates only to the current period, not an unfunded liability from the past. In the public sector, a defined contribution plan prevents a current legislature from making exorbitant promises that bind future legislatures.

The IAP Is a Defined Contribution Plan

Your committee noted that the Oregon Legislature had already introduced a defined contribution plan into PERS with establishment of the Individual Account Plan (IAP). The IAP is a great model for employers, as the employer makes no required contribution to the plan* and assumes no risk, giving PERS employers all of the advantages of a defined contribution plan without the cost of an employer match.

The Defined Benefit Plan in OPSRP Is Affordable and Flexible

Given that PERS already has at least a defined contribution element, your committee turned its focus to whether the defined benefit element in OPSRP is affordable for employers, has the flexibility to adapt to changing economic realities, and can be structured in a way to improve stability and predictability of employer contribution rates.

Your committee concluded that by creating OPSRP in 2003, the Oregon Legislature enacted needed reforms well ahead of other states and put Oregon in a position well poised for the future. Your committee decided to recommend building on the strengths of OPSRP rather than moving to a purely defined contribution "Tier 4."

Employers pay a "normal cost" for the OPSRP pension component. This normal cost reflects the cost of pension liabilities for active employees as they accrue, and is expressed as a payroll percentage for OPSRP employees. The normal cost is the contribution required today to allow PERS to provide an OPSRP employee the promised pension benefit tomorrow. The normal cost determination

* If the employer pays the "pick up," then the employer has chosen to pay the employee's contribution.

uses a set of assumptions, including the assumed earnings rate for invested assets, the expected retirement dates and life expectancies for OPSRP employees, and the OPSRP pension formula (1.5% times years of service times final average salary). For the four entities studied in detail by your committee, the normal cost for OPSRP is 6.13% of payroll.

Unfortunately the actual employer contribution to OPSRP is not just the normal cost. The PERS UAL, over 99% of which represents unfunded liability for Tier 1 and Tier 2 employees, is spread across all employees in the system, regardless of tier. Employers are paying more for OPSRP employees than the actual costs of their pensions, and less for Tier 1 and Tier 2. Your committee concluded that this did not represent a problem with OPSRP itself, but rather another burden placed on the system by Tier 1 and Tier 2 benefit promises.

Given normal costs in the 6% range and the lack of an unfunded liability associated with the OPSRP pension, your committee determined that the OPSRP pension did not present a financial problem, at least today. It is true that any defined benefit plan relying on investment returns could eventually end up with an unfunded liability. OPSRP, however, differs from Tier 1 and Tier 2 in an important way: the benefits promised to employees can be adjusted downward by future legislatures, if necessary. Your committee decided to use this feature to recommend a reduction in OPSRP pension benefits, thus improving the sustainability of a defined benefit pension element that is already well positioned financially.

"Tier 4" Not Needed and Not Recommended

Defined contribution plans are not a panacea for what ails public pension plans, particularly with regard to employer costs. Your committee determined that the hybrid model of OPSRP offers the advantages of both defined contribution and defined benefit plans. OPSRP does not currently represent an employer cost problem and the Legislature designed in the flexibility to reduce costs if needed. Additionally, as recommended below, there are techniques available to reduce the volatility of employer contribution rates for the PERS defined benefit plans. In short, your committee concludes that there is no compelling need to move to a "Tier 4" and instead recommends changes to the OPSRP hybrid model to reduce costs and improve rate stability and predictability.

RECOMMENDED REDUCTIONS IN TIER 1 AND TIER 2 BENEFITS

The PERS funding problems are real, and investment returns alone cannot be relied on to return PERS to fully funded status and keep it there over the coming decades. To avoid unacceptable cuts in public services driven by the PERS UAL, and to avoid passing the UAL on to future generations, your committee concluded that Tier 1 and Tier 2 benefits must be reduced.

PERS employees and retirees fervently believe that they have earned their benefits, even if those benefits are far more generous than the adequate retirement benchmark. Any benefit decrease will be fought in Oregon courts and in the court of public opinion. Your committee agrees with an Oregon state official who states that the benefits promised are out of touch with the reality of paying for them and laments the fact that this discussion did not occur when the benefits were promised 30 years ago. Rank and file public employees should not be blamed for the current status of PERS, but there is no choice but to reduce benefits to match financial reality and to improve intergenerational equity.

"The 1996 *OSPOA* and 2005 *Strunk* decisions of the Oregon Supreme Court limit the ability of would-be reformers to reduce excessive Tier 1 and Tier 2 benefits, yet your committee believes it has found two ways to make at least modest reductions … [that] will be challenged in the courts but will ultimately be upheld …."

Your committee concluded that Tier 1 and Tier 2 benefits are very generous, and Tier 1 benefits from money match are excessive. This is certainly not the first time a group has studied PERS and drawn the same conclusion. The Legislature created Tier 2 back in 1996 in part to reduce money match benefits. The 2003 reforms redirected the employee contribution for Tier 1 and Tier 2 members from the regular account to the IAP in order to slow the growth of regular account balances subject to money match.

The 1996 *OSPOA* and 2005 *Strunk* decisions of the Oregon Supreme Court limit the ability of would-be reformers to reduce excessive Tier 1 and Tier 2 benefits, yet your committee believes it has found two ways to make at least modest reductions. Your committee believes that these adjustments will be challenged in the courts but will ultimately be upheld by the Oregon Supreme Court.

Redirect Tier 1 and Tier 2 Employee Contributions

The 2003 PERS reforms redirected the mandatory employee contributions for Tier 1 and Tier 2 members, currently set at 6% of salary, away from the members' regular accounts and into IAPs. This reform slowed the growth of member regular accounts, resulting in two sources of cost reduction: fewer active employees for whom money match would provide the highest benefit at retirement, and a lower money match benefit for those who qualified. The employee unions challenged this reform in court. In Strunk, the Supreme Court held that the PERS contract requires that money match be available as a possible higher-paying alternative to the full formula, but that the contract does not guarantee that the money match benefit will be maximized. In other words, the Court found that the Legislature intended the full formula to be the primary method for benefit calculation at retirement, serving as the "floor" benefit amount, with money match available in those cases where it happens to offer a better benefit.

"By redirecting the Tier 1 and Tier 2 mandatory employee contribution from the IAP to the general PERS fund, the money can be used to reduce the UAL while Tier 1 and Tier 2 employees continue to work, returning the fund to fully funded status faster and lowering the burden passed on to future generations."

Given the court's logic, your committee decided to explore the possibility that the Tier 1 and Tier 2 employee contributions could be redirected again, this time away from the IAP and into the general PERS fund. Tier 1 and Tier 2 pension benefits, even calculated on full formula, provide pension benefits at the high end of the adequate retirement benchmark. The 1.67% pension factor in Tier 1 and Tier 2 produces a 50% income replacement after 30 years of service. Tier 1 money match retirees, by definition, receive even higher benefits. Your committee concluded that adding the IAP benefit on top of these already generous pensions benefits is not needed and only further exacerbates benefit inequity among Tier 1, Tier 2, and OPSRP.

Your committee recommends that the Legislature amend the PERS statutes to redirect the 6% mandatory employee contribution for Tier 1 and Tier 2 employees from the IAP to the PERS general fund. Tier 1 and Tier 2 members will be entitled to their IAP balances and any earnings on those balances, but their IAPs will no longer grow with the 6% annual contribution.

Tier 1 and Tier 2 employees by definition joined PERS prior to August 28, 2003, and are therefore typically closer to retirement than OPSRP employees. Because the IAP did not come into existence until 2003, employees have only contributed to their IAPs for eight years. For Tier 1 and Tier 2 employees retiring in the next few years, the IAP will represent a small percentage of their overall PERS retirement benefit.

By redirecting the Tier 1 and Tier 2 mandatory employee contribution from the IAP to the general PERS fund, the money can be used to reduce the UAL while Tier 1 and Tier 2 employees continue to work, returning the fund to fully funded status faster and lowering the burden passed on to future generations. The mandatory employee contributions for all employees generate roughly $500 million for PERS annually.[29] If 62% of current employees are Tier 1 and Tier 2, then around $312 million would be available for reducing the UAL.[30] This represents a 32% increase in the money available for reducing the UAL, and increases the Tier 1 and Tier 2 employee funding of their pensions from zero percent (because the entire contribution goes to the IAP today) to around 24%.

Your committee anticipates that employee unions will challenge this change in court. Your committee believes that this $300 million redirection will withstand legal review because the PERS contract guarantees a pension for Tier 1 and Tier 2 employees, but not the IAP. The statute that created the IAP allows it to be changed in the future.

Reduce Tier 1 Money Match Benefits

This report repeatedly points to Tier 1 money match benefits as excessive benefits and a key driver of the PERS UAL. Your committee believes that one of the current methods of calculating those benefits is flawed and recommends that the PERS Board change it to better reflect the actual nature of the benefit. Your committee believes that a change in the money match calculation is allowable under

Strunk, as the PERS contract does not specify the exact formula and there is no contractual commitment to maximize the money match benefit.

As discussed above, PERS calculates a member's money match benefit by taking the balance in the regular account, doubling it, and then calculating an annuity based on the employee's life expectancy (determined from actuarial tables) and a rate of return over the period of life expectancy. That rate of return is important in the calculation of an annuity, and must be understood.

It may be helpful to some readers to discuss the basics of an annuity. Rather than buying an annuity for retirement, an investor could simply invest money over time and withdraw a fixed amount every year for his expected life span until the money is gone. In order to figure out how much to withdraw, the investor must assume that the money invested will earn a rate of return. If the investor lives longer than expected, he will be out of money. If he dies sooner than expected, there will be money to pass on to his heirs. An annuity is similar in that the investor starts with a certain amount of money, but transfers the risk that he will live longer than expected to the annuity provider. The annuity provider determines the maximum annual withdrawal amount based on age when withdrawal begins, life expectancy, a rate of return on investment, and coverage of administrative costs and profit margin expectations. The annuity purchaser gets a guaranteed lifetime annual pay out and death benefit, and the provider makes a profit based on investment earnings and administrative fees.

The same principles apply when calculating the PERS money match annuity. The PERS money match retiree currently pays nothing for administrative fees. Those are all borne by the employers—a good deal for retirees. But the PERS board offers an even better deal in the rate of return used in the money match calculation. The PERS Board currently uses the 8% assumed earnings rate for the PERS fund overall, a rate that reflects a portfolio having a certain amount of investment risk. The PERS money match retiree, however, assumes no risk in his money match benefit. If a PERS retiree tried to buy a commercial annuity using the same matched funds, he would receive a lower benefit because the annuity provider would use a lower, "risk-free" rate of return.

Your committee therefore recommends that the PERS Board change the money match calculation to use the "risk-free" rate of return, which better reflects the true nature of the money match benefit. Not only is it risk free to the retiree, but it is also subject to yearly COLA increases, all at the expense of taxpayers. If the PERS Board dropped the rate to only 6%, still higher than today's true risk-free rate, PERS estimates a $1.7 billion savings over the decades in which the money match benefits will be received, translating into a $1.7 billion reduction in the PERS UAL.[31]

Your committee recognizes that this recommendation, if adopted, will be challenged in the courts. While this represents a potential obstacle, your committee believes that prior decisions of the Supreme Court allow for legislative and administrative changes in the money match calculation. This recommendation will have an impact only on Tier 1 money match beneficiaries, who your committee believes receive excessive benefits. It is an effective way to require those Tier 1 employees to contribute to fixing the PERS financial problems. Your committee recommends that the PERS Board make this change immediately.

RECOMMENDED REDUCTIONS IN OPSRP BENEFITS

OPSRP includes a defined benefit pension with a multiplier of 1.5% for general service employees and 1.8% for police and fire employees. Your committee examined this defined benefit pension from two perspectives: the benefits provided relative to the adequate retirement benchmark, and the affordability for employers. Your committee concluded that OPSRP currently has a small UAL, only $90 million, and that the normal cost of the OPSRP pension, in the 6% range, is not outrageous. Your committee, however, believes that OPSRP offers a benefit too rich when compared to the adequate retirement benchmark, and reducing it will lower the normal cost for employers. In effect, your committee likes the hybrid nature of OPSRP, but believes that the benefit and corresponding cost of the defined benefit pension element should be reduced.

"Your committee … believes that OPSRP offers a benefit too rich when compared to the adequate retirement benchmark, and reducing it will lower the normal cost for employers."

PERS estimates that the IAP will provide OPSRP retirees with 15-20% income replacement. Coupled with 30% income replacement from Social Security, an OPSRP employee thus needs a pension benefit that replaces 30% of income in order to meet the adequate retirement benchmark. With the current 1.5% pension factor for general service employees, retirees after 30 years of service will receive 45% income replacement from their pension alone. Police and fire employees, with a 1.8% pension factor, will receive an even more generous benefit of 54% income replacement after 30 years of service. Your committee recommends reducing the pension factor for OPSRP general service employees by one-third to 1.0%, providing 30% income replacement at retirement. With 30% from a defined benefit pension, 30% from Social Security, and 15-20% from the IAP, an OPSRP employee can expect to retire with 75-80% income replacement, matching exactly the adequate retirement benchmark. Your committee similarly recommends reducing the pension factor for police and fire employees by one-third from 1.8% to 1.2%, providing 81-86% income replacement.

RECOMMENDED IMPROVEMENTS IN THE IAP

OPSRP also includes the IAP, a defined contribution plan. As discussed above, OPSRP employees have many years to contribute to their IAPs and experience investment growth. The IAP, therefore, will represent a significant component of income replacement for OPSRP retirees, estimated by PERS at 15-20%.

Some features of the IAP are superior to common 401(k) plans offered by private sector employers. For example, employees are required to make a 6% contribution to their IAP each year. Private sector 401(k) plans are widely criticized for allowing employees to forego retirement contributions, especially early in their careers when they can experience decades of growth.

Professional investors, under the oversight of the Oregon Treasurer and the Oregon Investment Council, invest IAP funds using the same investment strategy as other PERS assets. While some employees may have the time and skills required to effectively invest their IAP balances, your committee assumes that, on average, employees will earn better returns with professionals managing their money.

This strength of OPSRP, however, will be problematic as OPSRP employees approach retirement. The current PERS portfolio is invested to achieve an assumed earnings rate of 8%, with a portfolio of investments having a commensurate level of risk. This level of risk may be too high for employees approaching retirement, exposing those employees to unwanted volatility. Imagine an OPSRP employee who planned to retire in early 2009 but then experienced a 28% IAP loss in late 2008.

Your committee concludes that OPSRP employees need lower-risk investment strategies as they near retirement. Younger OPSRP employees may also want strategies with higher risks but higher rewards, given that they are decades from retirement and have many years to recoup losses.

Your committee therefore recommends that the Legislature change the IAP to provide multiple investment strategy options designed to reflect the life cycle of OPSRP employees. For example, the Legislature could define IAPs based on the employee's expected retirement year—perhaps 2020, 2030, and 2040. The PERS Board, the OIC, and the Treasurer would be required to take steps to ensure that the funds in those IAPs are invested to achieve a targeted return consistent with the OPSRP employee's life stage.

"Imagine an OPSRP employee who planned to retire in early 2009 but then experienced a 28% IAP loss in late 2008. … OPSRP employees need lower-risk investment strategies as they near retirement. Younger OPSRP employees may also want strategies with higher risks but higher rewards, given that they are decades from retirement and have many years to recoup losses."

Your committee recognizes that this recommendation will have little or no impact on current PERS funding issues. Your committee makes this recommendation for the long-term benefit of PERS and its growing number of OPSRP members. This recommendation builds on strengths of OPSRP, providing a better retirement benefit for OPSRP members with minimal additional cost.

RECOMMENDED IMPROVEMENTS IN GOVERNANCE

Any time there is a large amount of money that must be managed, there is a potential for mismanagement and inefficiency. Your committee examined the effectiveness of the various entities involved with governance of PERS. The committee found that while PERS governance had been weak in the past, the 2003 reforms made useful changes. There are troubling conflicts of interest within the system, but your committee concluded that there is little, if anything, that can or should be done about the conflicts of interest.

First, the committee considered PERS itself. Your committee found PERS management to be experienced, active, and engaged. The administration of PERS is reasonably efficient. In short, your committee believes that Oregon has no reason to be concerned about the integrity and efficiency of PERS management.

Next, your committee considered the PERS Board, which sets the direction for PERS and determines the average employer contribution rates for each biennium. The PERS Board in the past had been dominated by PERS members, setting up an obvious conflict of interest. The 2003 reforms solved that problem. The PERS Board today has five members, only one of whom represents PERS members.

Your committee considered the actuarial firm, Mercer LLC, that produces the data relied upon by PERS and the PERS Board, particularly the assumed earnings rate and the calculation of the unfunded liability. Your committee, which includes several people with financial expertise, found no reason to question Mercer's competence or independence and does not see Mercer as part of the problem with PERS.

Next, your committee considered the Oregon Investment Council, which sets the investment strategies to be followed by members of the Oregon Treasurer's office. Your committee interviewed the current and immediate past chairs of the OIC, finding that they disagree on whether PERS can be returned to fully funded status by relying on investment returns alone. While this gave your committee cause for concern, we concluded that the OIC as it is structured does not present a considerable problem. Some members of your committee were troubled by the OIC's suggested asset class mix, particularly the heavy reliance on private equity and real estate investments that are difficult to value. Ultimately, however, the committee found that the strategies followed by the OIC had produced better returns over the decades than those of other states. Your committee did, however, conclude that it agrees with the immediate past chair that Oregon cannot rely on future investment returns to save PERS.

Next, the committee considered the day-to-day investment decisions made by members of the Treasurer's office. The Treasurer of the State of Oregon, Ted Wheeler, met with your committee. Mr. Wheeler stated that he believes the investment side of PERS has strong checks and balances and is managed by people with the right level of investment experience.[32] Your committee found no reason to disagree.

There is, however, one troubling exception to the PERS governance structure, the apparent conflict of interest that exists with the members of the Legislature and the judiciary, most of whom are also PERS members. Your committee debated this point and agreed that the system would indeed be better if members of the Legislature and the judiciary were not members of PERS, but that the conflict is more appearance than substance. Therefore, while it may be wise to eliminate the appearance of a conflict of interest, your committee decided not to recommend changes in this area and instead leave this to the political process.

RECOMMENDED RATE STABILIZATION RESERVE

The employer representatives who appeared before the committee expressed the need for more stability and predictability in contribution rates. PERS can achieve stability and predictability for employers with a "rate stabilization reserve," or in other words, a reserve fund specifically dedicated to holding employer contribution rates steady over time.

"PERS can achieve stability and predictability for employers with a 'rate stabilization reserve,' or in other words, a reserve fund specifically dedicated to holding employer contribution rates steady over time."

Contribution rate volatility is particularly problematic for public employers because it is difficult for the employers to accumulate reserves. Consider, for example, the Salem-Keizer School District. The district faces tremendous pressure to utilize every available dollar on services for students. When PERS employer rates are low, the district is forced to spend the extra money on services rather than establishing a reserve. When PERS rates increase quickly, the district has little choice but to cut services. To avoid this "binge and purge" cycle, the district would prefer stable rates, even if the rates must be higher on average in order to achieve the stability.

PERS today has a "rate guarantee reserve," but that reserve is used only to help the system meet the 8% guarantee on Tier 1 regular accounts when actual investment returns fall short. That reserve is currently running a negative $400 million balance and provides no help to employers struggling with volatile contribution rates.

Your committee recommends that the Legislature require the PERS Board to establish a reserve fund for the purpose of stabilizing employer rates. The PERS Board would fund the reserve when actual investment returns exceed the 8% assumed earnings rate, and draw from the reserve when the investment returns fall short. The crucial point here is that the PERS Board would fund the reserve with surplus returns before allowing those surplus returns to be used to reduce employer rates. Conversely, the PERS Board would pull from the reserve when returns are deficient rather than increasing employer rates.

Your committee believes that a rate-stabilization reserve will provide more stability and predictability in rates than the current PERS rate collar. Your committee debated the possible size of such a reserve, ultimately deciding to leave that to the discretion of the PERS board.

It is important to note that the requirement for a rate-stabilization reserve will mean that employer rates will not fall in the next few biennia even if PERS enjoys returns greater than 8%. A rate-stabilization reserve also means that PERS could achieve greater than 100% funded status and maintain that status during periods of robust returns. Your committee believes that PERS employers would rather pay high but predictable rates. Rate stability facilitates planning and budgeting for future years. It also forces the baby-boom generation to pay now for benefits to be received later, rather than pushing the costs down the road to future generations.

> **"…retirement ages for OPSRP employees, both general service and police and fire, [should] rise by two years across-the-board, matching the retirement age under Social Security for general services members, and rising the same number of years for police and fire members. These adjustments would reduce the cost of OPSRP and reduce the inequity that exists between the public and private sectors."**

ADDITIONAL RECOMMENDATONS

Change Retirement Ages to Correspond to Social Security

PERS members may retire and receive full retirement benefits much earlier in life than workers in the private sector. The majority of private sector employees do not have a defined pension benefit plan. For those that do, the employee must typically wait until age 65 to collect a full pension benefit. For Social Security, older workers must wait until age 65 to receive full benefits, while younger workers, born in 1960 or later must wait until age 67. For private sector workers with 401(k) plans, a worker cannot withdraw benefits without a penalty before age 59½, and a worker is not required to take 401(k) benefits until age 69½.

In contrast, the retirement age for PERS members is much younger and varies by tier. Tier 1 general service members may retire at age 58 or 30 years of service, and Tier 1 police and fire employees may retire as young as age 50 with 25 years of service. Tier 2 general service members may retire at age 60 or 30 years of service, with Tier 2 police and fire employees also eligible to retire with full benefits at age 50 with only 25 years of service. OPSRP benefits are more in line with private sector norms, with full benefits available only at age 65 or 30 years of service, and police and fire at age 53 with 25 years of service.

Your committee believes that retirement ages under Tier 1 and Tier 2 are part of the PERS contract and thus cannot be changed under the Strunk and OSPOA decisions of the Supreme Court. Because of forward thinking by the 2003 Legislature, OPSRP retirement ages can be adjusted. Your committee recommends that retirement ages for OPSRP employees, both general service and police and fire, rise by two years across-the-board, matching the retirement age under Social Security for general services members, and rising the same number of years for police and fire members.* These adjustments would reduce the cost of OPSRP and reduce the inequity that exists between the public and private sectors.

Eliminate the Tax Remedy Benefit for Out-of-State PERS Recipients

As your committee interviewed the various stakeholders in PERS, it became clear that one potential reform had near-unanimous support: ending the tax remedy benefit for out-of-state PERS recipients. Like many aspects of PERS, this benefit is an historical artifact. The Oregon Legislature

* This recommendation includes a two-year increase in the retirement age for police and fire fighters. The committee concluded that this modest increase in retirement age would reduce costs without imperiling either the delivery of services or the health of employees in these physically demanding jobs.

originally made PERS pension benefits free of Oregon personal income taxes. In the early 1990s, a group of federal retirees, whose federal pension benefits were subject to Oregon income taxes, sued the state of Oregon arguing unequal treatment under the law. The federal employees won their lawsuit, forcing the Oregon Legislature either to eliminate taxes on federal pensions or to impose taxes on PERS benefits. The Legislature opted to impose taxes on PERS benefits, but elected to increase PERS benefits with a supplemental "tax remedy benefit" such that PERS retirees, even after paying taxes, would realize the same effective benefit.

"Today there are 14,000 to 16,000 PERS retirees living in other states, and thus not subject to Oregon income taxes, yet receiving a 'tax remedy benefit.'"

Today there are 14,000 to 16,000 PERS retirees living in other states, and thus not subject to Oregon income taxes, yet receiving a "tax remedy benefit." Your committee joins the popular call to eliminate this benefit for out-of-state retirees. The size of the tax remedy benefit varies by retiree, based on years of service before and after 1991, the year the Legislature imposed taxes on PERS benefits. PERS estimates that out of state recipients of the tax remedy benefit would see a pension reduction of approximately 6% on average.[33] PERS estimates that employer contributions would decrease by about $72 million per biennium and system liabilities would decrease by $450 million. These financial benefits are modest yet worth pursuing in order to eliminate a glaring inconsistency in the system.

RECOMMENDATIONS CONSIDERED BUT REJECTED

Eliminating the 6% Pick-Up and/or Eliminating the 6% Employee Contribution

Those suggesting PERS reform often focus on the employee's mandatory contribution to PERS and the employer "pick-up." Measure 8 in the mid-1990s attempted to prohibit employers from picking up the employee contribution, but was struck down by the Supreme Court in the OSPOA decision. The 2003 reforms re-directed the employee contributions for Tier 1 and Tier 2 employees into an IAP rather than the normal account, an approach challenged but upheld by the Supreme Court in the Strunk decision.

More recent suggested reforms fall into one of two categories: reducing or eliminating the pick-up for particular employers, and doing away entirely with the idea of a mandatory employee contribution. Your committee chose not to recommend either of these approaches, for the following reasons.

First, the Legislature cannot prohibit employers from picking up the employees' mandatory contribution, as indicated by the OSPOA decision. Discussions about the pick-up thus inevitably devolve into discussions of what a particular employer should do. Should the employer pick up the employees' contribution? If so, to what extent? These decisions are made at the bargaining table. Employers pick up the contribution for roughly 70% of PERS members today. For example, the state of Oregon picks up the entire 6% employee contribution for all of its employees.

The 6% pick-up offers advantages for both employers and employees. Employees receive that 6% of pay without FICA taxes and with federal and state income taxes deferred until retirement. For Tier 1 and Tier 2, that 6% is also included in final average salary for the purposes of the full formula calculation. Employers also like the pick-up because they are not assessed payroll taxes on the contributions. To put it another way, if employers offered a 6% increase in salary instead of the pick-up, that 6% would cost them more than 6% of payroll because of payroll taxes. From the employee perspective, accepting a 6% increase in salary would result in less than 6% because of taxes.

Your committee took a hard look at the pick-up and decided that it has little to do with PERS itself and a lot to do with the budgets of individual entities. It is really a decision made outside the PERS system. PERS receives 6% of employee pay, no matter who pays it. Those who are looking at the state of Oregon's budget have suggested reducing or eliminating the pick-up, which may help the state with a short-term budget problem, but doesn't change the fact that 6% of employee pay still goes to PERS. Additionally, your committee learned that many entities have collective bargaining agreements specifying that any reductions in the pick-up must be replaced with comparable additions in salary, resulting in increased costs for both employers and employees. Therefore your committee chose not to make a recommendation to reduce or eliminate the pick-up, but instead views it as an employer budget issue that is best sorted out employer-by-employer at the bargaining table.

Some pundits suggested a further step of eliminating the 6% mandatory employee contribution altogether. The theory here is that if the employee contribution is not required, it will be easier for employers to bargain away the pick-up. As discussed above, this may or may not result in reduced costs overall for the employer, because the employee unions will bargain to replace the pick-up with salary. Your committee, however, recommends against this approach because of its potentially devastating long-term impact on OPSRP employees. Because OPSRP is a hybrid program, with both defined benefit and defined contribution elements, an OPSRP employee will receive an adequate retirement benefit only if the defined contribution element is properly funded and invested. If the Legislature eliminates that 6% employee contribution, OPSRP employees would have the option of taking their compensation in salary rather than contributing for retirement. Like many in the private sector who fail to contribute to 401(k) plans, those OPSRP employees may find themselves with inadequate assets for retirement. Your committee believes that for OPSRP, the 6% mandatory contribution represents a program strength and should be retained. Additionally, while the idea of eliminating the employee contribution has been proposed by several people, none of the employee or employer representatives interviewed wanted to see the contribution eliminated, and in some cases forcefully spoke out against the idea.

Keeping the mandatory employee contribution has another beneficial side effect. It supports the committee's recommendation to redirect that contribution for Tier 1 and Tier 2 employees from IAPs to the general fund to reduce the UAL and build a reserve. Unless the contribution is mandatory, this source of funding for Tier 1 and Tier 2 will dry up.

To summarize, your committee characterizes the "pick-up" as a budget issue best resolved outside of PERS through the collective bargaining process, while the mandatory employee contribution helps ensure adequate retirement benefits for OPSRP members and provides an additional potential source of funds to pay for the UAL associated with Tier 1 and Tier 2.

Reducing the 8% Assumed Earnings Rate

It is fair to say that your committee is skeptical whether or not PERS will achieve the 8% assumed earnings rate in the long run. This skepticism derives from published PERS returns, such as a 4.43% return over the last five years, as well as the personal experience of committee members with their own investment accounts.

The PERS Board determines the assumed earnings rate based on data and recommendations made by the PERS actuary. Some pundits have suggested a lower rate should be used, and point to other states such as California, where the assumed earnings rate is 7.75%. Your committee concludes that the assumed earnings rate should not be based on political considerations, but rather on market performance and disciplined actuarial analysis.

PERS uses the assumed earnings rate for several purposes. One is crediting of Tier 1 regular accounts, which receive annual returns at no less than the assumed earnings rate. Reducing the rate would result in slower growth of Tier 1 regular accounts, and would therefore reduce the number of retirees for whom money match produces the highest benefit and decrease the benefits paid under that money match (because the balance to be matched will be smaller). Therefore a reduction in the assumed earning rate would slow the growth in PERS liabilities, making this an interesting option.

"If the PERS fund is assumed to earn a lower rate, then employers will need to make additional contributions, thereby driving up the employer contribution rate."

The assumed earnings rate is also used in the calculation of the money match benefit, as discussed above. If the assumed earnings rate is reduced, a Tier 1 member who retires on money match will receive a reduced pension. This also makes a reduction in the assumed earnings rate an interesting possibility. Your committee believes, as discussed above, that moving to a risk-free earnings rate in the annuity calculation, which better reflects the nature of the money match pension benefit, is a better approach. It achieves greater savings than reducing the assumed earnings rate, and better reflects the nature of the money match pension benefit.

The problem with this popular recommendation to reduce the assumed earnings rate is that it would not result in a savings for taxpayers in the short-run. This is because the assumed earnings rate is used in the calculation of employer rates. The actuary uses the assumed earnings rate to determine to what extent PERS can rely on funding from investment returns. If the PERS fund is assumed to earn a lower rate, then employers will need to make additional contributions, thereby driving up the employer contribution rate.

The assumed earnings rate is thus a two-edged sword for PERS. If reduced, the number and size of money match pensions will be reduced, but employer costs will increase. Without a clear benefit to the system, your committee sees no reason to force a reduction in the rate. Your committee believes that the rate should continue to be based on market returns and actuarial analysis.

Eliminating Side Accounts and Pension Obligation Bonds

As discussed above, entities have raised money through the issuance of pension obligation bonds, investing that money in side accounts in the PERS system. When PERS earns higher returns than the interest promised on the bonds, the entity's employer contributions can be reduced. Of course there is a possibility that returns in the long-run could fall to the point where the returns do not cover the debt service on the bonds, thereby essentially driving up an entity's PERS costs.

Your committee was troubled by this practice of financial arbitrage, which is gambling with borrowed money. The results, however, for the majority of entities who issued the bonds, have been positive. For PERS overall, at the end of 2009, the system was funded at the 76% level with side accounts excluded, but at 86% with side accounts included. The employer rates for school districts that successfully invested bond proceeds are lower, as seen with Salem-Keizer, and the state of Oregon similarly enjoys a significant benefit.

Your committee ultimately decided that this practice should continue to be available to employers, and decisions around whether or not to issue bonds to fund side accounts should be left to financial experts based on market conditions.

Capping Total Compensation

PERS is only one component of public employee compensation, with salary and health benefits being the other two major components. Both PERS employers and the union representatives of employees indicate that collective bargaining uses a "total compensation" approach, implying that even if the dollars available for employee compensation are fixed, the percentage breakdown of the major components – salary, PERS, and medical benefits – are available for negotiations. Your committee is somewhat skeptical of these claims. The reality seems to be that salary never goes down, the PERS Board determines the PERS contribution rate for the employer, and medical benefits continue to rise. It seems that the leverage comes in the number of employees an employer can afford. Given that most collective bargaining agreements specify layoffs based on seniority, the system tends to protect the employees with the longest service, most likely to be Tier 1 PERS members. Therefore while both sides talk about "total compensation," it is not a magic bullet.

It is possible that a cap on total compensation could be implemented, which could conceivably drive down salary costs in order to pay for PERS. This, however, like the 6% pick-up discussed above, is really a budget issue that is separate from PERS and should be handled through the regular collective bargaining process.

"Given the nature of the PERS system as a statewide fund, bankruptcy at the local government level would have no effect on PERS liabilities or assets. The PERS liabilities for a bankrupt entity's employees would simply accrue to the unfunded liabilities of the overall system, and be spread to other employers."

Bankruptcy

Several municipalities around the country have declared bankruptcy, driven in part by rising pension costs. This led your committee to discuss whether or not Oregon governmental entities could, under existing law, declare bankruptcy, and if so, what would happen to the entity's PERS benefits. Your committee learned that current law does not allow the state government to declare bankruptcy. It does, however, provide for bankruptcy of special-purpose districts.

Given the nature of the PERS system as a statewide fund, bankruptcy at the local government level would have no effect on PERS liabilities or assets. The PERS liabilities for a bankrupt entity's employees would simply accrue to the unfunded liabilities of the overall system, and be spread to other employers. It is possible that some local government entities could eventually be pushed to consider bankruptcy, but for the PERS system overall, such a bankruptcy would have a negligible effect.

One-Time Buy Out

Your committee considered offering active Tier 1 and Tier 2 employees a one-time buy out package to encourage early retirement. Such a package could offer cash incentives, or perhaps help with health insurance premiums until the early retiree becomes eligible for Medicare. The theory behind an early buy-out is to essentially cap a member's retirement benefit at a given length of service and final salary, thereby eliminating the growth in future benefit commitments that comes with active Tier 1 and Tier 2 members remaining in the workforce.

There are at least two significant problems with buy-out proposals. First, there is the cost of the incentive itself, which is difficult to calculate. Second, the employees who take early retirement will collect pension benefits over a greater number of years, thereby blunting any savings from reduced monthly pension amounts. In short, while buy-out ideas are intriguing, your committee was unable to determine if indeed there is a buy-out scenario that would reduce PERS costs, and if so, by what amount.

CLOSING REMARKS

Your committee recommends reforms that make modest reductions in Tier 1 and Tier 2 benefits, consistent with Oregon law, helping to reduce the UAL and return PERS to fully funded status while the baby-boomer generation continues to work. Your committee also recommends that the Legislature build on the strong foundation of OPSRP, by further reducing its pension costs and shoring up the IAP with common-sense reforms. Finally, your committee recommends that the PERS Board adopt rate-stabilization and risk management policies that provide employers, and taxpayers, stability and predictability in pension costs. These reforms do not solve the PERS funding problems or its inherent inequities, but your committee believes that these reforms move PERS in the right direction and will be upheld when challenged in the courts.

The 2003 reforms positioned PERS for the future, but the burdens of Tier 1 and Tier 2 remain. Your committee thanks you for the opportunity to review this complex and important issue.

SUMMARY OF CONCLUSIONS

1. Oregon faces a multi-billion dollar fiscal crisis in the next biennium and a "decade of deficits." PERS is part of that crisis. PERS will demand an increasing percentage of state and local government payrolls, having an impact on government services.
2. The Oregon Legislature improved PERS in 2003, putting Oregon in a better financial position than many other states. The Legislature, however, did not adequately insulate PERS from lower-than-expected investment returns and higher-than-expected market volatility.
3. PERS faces a significant unfunded liability and it is not prudent to rely on investment returns and increased employer contributions to return PERS to fully funded status; reductions in benefits are needed.
4. PERS members enjoy benefits that are generous relative to an objective "adequate retirement benchmark" of 75-80% replacement of final pay.
5. Tier 1 members who retire under money match receive benefits that are not only generous, but excessive. The money match calculation does not properly reflect the guaranteed nature of the pension benefit, inflating an already very generous benefit.
6. Public employees and retirees believe that they have earned the benefits coming to them. Any changes to PERS that result in reduced benefits will be fought in the courts and in the political arena.
7. Prior decisions of the Oregon Supreme Court limit options for PERS reform, particularly for Tier 1 and Tier 2. Oregon cannot escape the burden of Tier 1 and Tier 2 benefits; only modest reductions are possible.
8. OPSRP does not currently represent a significant financial problem for Oregon and statutory provisions allow OPSRP benefit commitments to be changed in the future.
9. PERS has inherent equity problems among employees, employers, and generations. Reforms can alleviate but not eliminate these inequities.

SUMMARY OF RECOMMENDATIONS

Lightening the Burdens of the Past:

1. The PERS Board should direct the PERS actuary to use the risk-free rate of return in calculating the Tier 1 money match benefit, better reflecting the guaranteed nature of the benefit and lowering the costs of an already excessive benefit. This will reduce the PERS Unfunded Actuarial Liability by $1.7 billion.

2. The Legislature should eliminate the Individual Account Program for Tier 1 and Tier 2 members and should instead direct the $300 million annual Tier 1 and Tier 2 employee contribution to reducing the Unfunded Actuarial Liability and funding a reserve that can be used to reduce volatility in employer rates.

3. The Legislature should eliminate the tax remedy benefit for out-of-state PERS retirees, thereby saving $72 million per biennium and reducing PERS liabilities by $450 million.

Positioning PERS for the Future:

4. The Legislature should require the PERS Board to establish an "employer rate stabilization reserve" to increase the stability and predictability of employer contribution rates. When PERS investment returns exceed the assumed annual earnings rate, the PERS Board must fund this reserve to a pre-defined level before providing employer rate relief. Conversely, when PERS investment returns fall short of the assumed annual earnings rate, the PERS Board must pull funds from this reserve prior to increasing employer rates.

5. The Legislature should act to bring the OPSRP pension in line with an adequate retirement benchmark of 75-80% income replacement by reducing the years-of-service multiplier by one-third, from 1.5% to 1.0% for general service employees and from 1.8% to 1.2% for police and fire fighters.

6. The Legislature should reduce the cost of the OPSRP pension by aligning OPSRP retirement ages with Social Security, both now and as Social Security evolves in the future. OPSRP retirement ages should immediately increase by two years across-the-board, to match the two-year Social Security age increase from 65 to 67 for general service employees born in 1960 or later and increasing by two years the retirement ages for police and fire employees.

7. The Legislature should improve the Individual Account Program for OPSRP employees by offering more investment options as the employees near retirement. Rather than requiring IAP accounts to be invested to achieve the overall assumed earnings rate, OPSRP employees nearing retirement should be able to choose more risk-averse investment strategies.

Respectfully submitted,

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WITNESSES

Ken Allen, Executive Director, American Federation of State, County and Municipal Employees (AFSCME); representative of PERS employee labor union; interviewed December 1, 2010.

Mary Botkin, Senior Political Coordinator, American Federation of State, County and Municipal Employees (AFSCME); representative of PERS employee labor union; interviewed December 1, 2010.

Linda Burgin, President, Service Employees International Union (SEIU) Oregon; representative of PERS employee labor union; interviewed November 17, 2010.

Lindsey Capps, Director of Public Affairs, Oregon Education Association (OEA); representative of PERS employee labor union; interviewed November 17, 2010.

Paul Cleary, Executive Director, Oregon PERS; interviewed August 18, 2010 and September 1, 2010.

Anthony Corcoran, member, Oregon Employee Appeals Board; Oregon State Senator in 2003 and Senate leader on PERS reform; interviewed July 28, 2010.

Sue Cutsogeorge, Finance Director, City of Eugene; representative of PERS employer; interviewed December 15, 2010.

James Dalton, Chair, PERS Board; interviewed September 1, 2010.

Myrnie Daut, Risk Manager, City of Eugene; representative of PERS employer; interviewed December 15, 2010.

Brian DeForest, Deputy Administrator, Budget and Management Division, State Department of Administrative Services; interviewed February 9, 2011.

Harry Demorest, Chair, Oregon Investment Council; interviewed December 8, 2010.

Katherine Durant, Immediate Past-Chair, Oregon Investment Council; interviewed December 8, 2010.

William H. Gary, Partner, Harrang Long Gary Rudnick P.C., counsel on PERS matters for a coalition of Oregon local governments; interviewed September 8, 2010.

Gregory Hartman, Bennett Hartman Morris & Kaplan LLP, counsel on PERS matters for a coalition of public employee labor unions; interviewed September 22, 2010.

Phil Keisling, former Oregon Secretary of State and author of "PERS in Crisis: the Sequel," (November 9, 2009); interviewed August 11, 2010.

Matt Larrabee, Mercer LLC; Mercer is the actuarial firm retained by the PERS Board; interviewed August 18, 2010 and September 1, 2010.

Larry Lehman, City Manager, City of Pendleton; representative of PERS employer; interviewed December 15, 2010.

Gregory H. Macpherson, Partner, Stoel Rives, LLP; member of the Oregon House of Representatives in 2003 and House leader on PERS reform; interviewed July 14, 2010.

Tim Nesbitt, Chief of Staff to Governor Kulongoski; member of Governor's "reset" committee; interviewed October 13, 2010.

Scott Preppernau, Mercer LLC; Mercer is the actuarial firm retained by the PERS Board; interviewed September 1, 2010.

David Rives, President, American Federation of Teachers, Oregon; representative of PERS employee labor union; interviewed December 1, 2010.

James Sager, Assistance Superintendent, Northwest Regional Education Service District; representative of a PERS employer and knowledgeable about PERS impact on school districts; interviewed October 27, 2010.

Carol Samuels, Senior Vice President, Seattle Northwest Securities Corporation; expert on PERS side accounts and pension obligation bonds; interviewed October 20, 2010.

Mike Schaufler, member, Oregon House of Representatives; chair of House Business and Labor Committee that is responsible for PERS matters; interviewed September 29, 2010.

John Topogna, President, ECONorthwest, co-author of "Public Employee Retirement in Oregon: Where Does the System Stand and Where Could Oregon Go from Here?"; interviewed August 25, 2010.

Ted Wheeler, Treasurer, State of Oregon; interviewed March 16, 2011.

Mike Wolfe, Assistant Superintendent for Business and Support Services, Salem-Keizer School District; representative of PERS employers; interviewed December 15, 2010.

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