PROPOSAL FOR ADDRESSING THE PERS FUNDING CHALLENGE

Leadership Summit Discussion Draft, December 5, 2016

State government, schools, cities, and counties in Oregon face extraordinary payroll cost increases driven by the need to finance unfunded pension liabilities that have accumulated in the Public Employees Retirement System (PERS) since the Great Recession of 2008. These costs will take up an ever larger share of public budgets, robbing funds for services, even as the economy continues to deliver revenue gains in excess of inflation and population growth.

A Multi-Billion Dollar Unfunded Liability

The PERS system's unfunded liability now totals $21.8 billion, an amount that is likely to increase if investment returns fail to meet expectations. Under the current system, these costs will have to be borne in full by public jurisdictions and their taxpayers. As a result, nearly $6 billion in additional pension payments will to be carved out of public budgets to shore up the PERS pension system over the next six years. This will decimate funding for public services at all levels of government, diverting revenues from services to an investment fund which may continue to chase a growing pension deficit.

The Oregon Business Plan addressed this problem in the "Headway and Headwinds" Policy Playbook last year. It proposed reforms to the PERS system in the context of establishing an overall cap on the growth of the total compensation of state, school, and local government employees.

Since then, PERS administrators have developed estimates of savings from a variety of reforms to PERS benefits and financing, and the Legislature's counsel has issued guidance on the likely constitutionality of changes following the Supreme Court's *Moro* decision. With this information and guidance, we can identify reforms that appear to be legally viable and sufficient to avert a significant portion of payroll cost increases that would otherwise be borne by public jurisdictions and their taxpayers.

Views of the Problem

There are two ways to view the PERS problem. But they are not mutually exclusive.

One view is that the $21.8 billion unfunded liability is a bill to be paid for benefits already earned and therefore a legacy cost that has become the obligation of public jurisdictions. Applying these legacy costs to current payrolls is simply a payment mechanism that should not be seen as a component of compensation for current and future employees. By this view, governments should look for ways to reduce and amortize their unfunded obligation separate from managing their payroll costs, e.g. by issuing pension obligation bonds. However, some 30 percent of PERS' unfunded liability, or $6.5 billion, is attributable to current employees – an amount which could rise if investment returns continue to undershoot the system's assumed rate of return for benefits yet to be earned. Further, current employees, especially those in the richer Tier 1 and Tier 2 benefit groups, are continuing to be held harmless from the system's liabilities while they accrue additional benefits which remain underfunded. The Oregon Supreme Court in *Moro* ruled that costs attributable to those already retired are beyond the reach of cost recovery. But recovering a portion of the unfunded liability from current employees can be accomplished on a prospective basis.

The other view focuses on managing payroll costs. The cost of PERS benefits has never exceeded 18 percent of payroll system-wide. It is now projected to reach 30 percent or more over the next six years. To avoid such increases, the Legislature could make prospective reductions in benefits and/or require employee contributions to offset employer costs, both of which have been done in public employee retirement systems in other states. Either or both could be used to moderate employer rate increases. Options for moderating or averting employer costs that have been reviewed by legislative counsel and the PERS actuary include the following benefit reductions.

Change	Leg Counsel Legal Analysis	Effect on ER Rate
Discontinue the pension program prospectively	Significant risk of invalidation	Depends on terms of successor plan
Disallow future use of unused vacation & sick leave as part of final average salary (FAS)	Likely permissible if limited to prospective benefits	Reduces ER rate by 0.6% of payroll
Reduce the annuitization rate for Money Match from 7.5% to 3.5%	Likely permissible	Reduces ER rate by 0.8% of payroll
Cap the calculation of FAS at $100,000/year	Likely permissible if applied prospectively	Reduces ER rate by 2.85% of payroll
Calculate FAS at five years instead of three	Permissible if changes protect accrued benefits	Reduces ER rate by 0.7% of payroll
Reduce the factor for calculation of pension benefit	Significant risk of invalidation	Reduces ER rate by 2.6% of payroll if reduced to 1.0/1.2% per year of service
Raise retirement age	High risk of invalidation	Not evaluated

In addition to benefit reductions, employee contributions can also be used to shore up the pension plan and moderate future employer rate increases. In fact, the structure of the Oregon PERS system offers a unique opportunity for doing so. In 2003, PERS became a hybrid retirement system, with a defined contribution retirement savings plan (known as the Individual Account Program or IAP) in addition to the larger, and now underfunded, pension plan. Employees are required to contribute six percent of salary to the IAP (although these contributions are sometimes "picked up" by employers). Regardless, contributions to the IAP are segregated from the pension plan. This raises the question of whether a system that offers an underfunded pension plan, for which employers are responsible in full, can afford to offer a second retirement savings plan in which employee contributions do nothing to support the pension plan.

To this end, our major recommendation in 2016 reflected that proposed by the Portland City Club in 2011 – to redirect future employee contributions from the IAP to the pension plan to help offset the costs of financing its promised benefits. Since the City Club report, we have seen more examples of other states boosting both employer and employee contribution rates to shore up their pension plans. Treating the IAP as a source of employee support for the pension plan and as a way to mitigate increases for employers is, to our thinking, the most feasible way to do this, especially since it can be done without reducing take-home pay for employees and without touching IAP balances accrued to date. Repurposing the IAP in this fashion will facilitate a phase-in of employee contributions to the PERS pension plan that can offset half of the rate increases that will otherwise be borne by employers over the next six years.

Change	Leg Counsel Legal Analysis	Effect on ER Rate
Redirect future employee IAP contributions to the pension plan	Likely permissible; safer if used to fund future benefits	Could reduce ER rate by as much as 6.0% of payroll

Recapitalizing the PERS fund and establishing a mechanism for employees to share responsibility for financing promised pension benefits will not answer the question about the best design for an adequate and affordable retirement system for public employees in the future. That question remains to be answered. But reforms of the kind outlined here will enable us to manage the unavoidable costs of an unaffordable pension system in ways that better balance the needs and interests of taxpayers and citizens and of our public and private sector enterprises.