Cascade Policy Institute

Pension liberation for Oregon

A proposal to reform PERS

By Peter J. Ferrara J.D.

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About the author

Peter J. Ferrara, J.D., is a contributing scholar to Cascade Policy Institute and Associate Professor of Law and Director of the Juris Master Program at George Mason University. A graduate of Harvard College and Harvard Law School, Ferrara has a broad background in public policy. Under President Reagan, he served in the White House Office of Policy Development. Under President George Bush, he served as Associate Deputy Attorney General of the United States. He has also worked at the U.S. Department of Housing and Urban Development and the Legal Services Corporation.

Ferrara has written numerous books, articles and studies on health, welfare, and federal tax and budget policies. Considered one of the foremost experts on Social Security privatization, he completed the first full-length book published by the Cato Institute in 1980: *Social Security: The Inherent Contradiction.*

The Oregon Better Government Competition

This report is a product of Cascade's Oregon *Better Government Competition*. From its inception in 1994, the *Competition* has focused on ways to improve service quality and reduce the cost of government in Oregon. This report addresses a major fiscal challenge facing our state and local governments: the costly Public Employees Retirement System.

About Cascade Policy Institute

Founded in 1991, Cascade Policy Institute is Oregon's premier policy research center. Cascade's mission is to explore and advance public policy alternatives that foster individual liberty, personal responsibility and economic opportunity. To that end the Institute publishes policy studies, provides public speakers, organizes community forums and sponsors educational programs. Focusing on state and local issues, Cascade offers practical, innovative solutions for policy makers, the media and concerned citizens.

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Contents

About the author ii

The Oregon Better Government Competition ii

About Cascade Policy Institute ii

Contents iii

Foreword v

Executive summary 1

The Oregon Public Employees Retirement System 4

A proposal for reform 8

Advantages of PERS reform for workers 11

Advantages for taxpayers 16

Defined contribution plan concerns 19

Pension liberation across America 21

Conclusion 23

Notes 24

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Foreword

Having read Peter J. Ferrara's "Pension liberation for Oregon" proposal, we want to offer our full endorsement and support for moving this concept forward.

The potential unfunded liability of the Oregon Public Employees Retirement System is a far greater looming crisis to the taxpayers of this state than most people realize. Unless we take significant action soon to restructure the retirement options for all future public employees, the problem will continue to worsen.

Mr. Ferrara has done an outstanding job identifying not only the weaknesses of our current system, but has proposed a reasonable and responsible alternative as well. His proposal works because it honors obligations made to employees already in the system, establishes an alternative for future employees that they will value, and protects the taxpayers from future hidden costs. To do anything less would be irresponsible.

We owe it to our citizens and our public employees to advance this concept.

Robert Johnstone
Yamhill County Commissioner

Patti Milne
Marion County Commissioner

Executive summary

The Oregon Public Employees Retirement System (PERS) is badly in need of reform. After years of probably the most incredible investment boom in history, the system could now face an unfunded liability of billions of dollars over the next 40 years. In fact, the very structure of the system makes a financial crash likely in the future. PERS must wait until each public employee's retirement before determining whether to calculate that worker's benefits under a defined contribution plan, where benefits depend on investment performance, or a defined benefit plan, which promises fixed benefits regardless of performance.

This structure suffers from a severe adverse selection problem because at retirement, workers are given whichever benefit is higher for them, and costs most for taxpayers. When all of the costs to state and local employers are counted, Oregon PERS is one of the most expensive public employee retirement plans in the country, as well as probably the most complex.

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Apparently, little can be done about those already in the work force. The courts have held that they have an established contractual right to the system in place when they were first hired. But a sound, rational system can be designed for all new employees.

The best system for both workers and taxpayers is a simple, defined contribution plan. Under the reform proposed in this study, workers and employers would each pay five percent of wages, for a total of ten percent, into a personal account for each worker. Workers would each choose a mutual fund or a money manager from a list approved and regulated by the state, for investment of the account funds. Retirement benefits would then be financed by the accumulated account funds at retirement.

The state would continue to pay survivors, disability, and health benefits for retirees under the current system. The reforms would not apply to policemen, firefighters, and judges, who would continue with the specialized retirement systems that currently apply to them. However, all other current workers would be free to join the new system if they desire. This reform could be enacted by the legislature or through a citizen initiative.

At just standard, long-term market investment returns, workers would receive substantially higher benefits through this system than promised to them under the current defined benefit alterna-

The best system for both workers and taxpayers is a simple, defined contribution plan.

tive of the Oregon plan. Yet, they would pay about 1 percent less into the new system than required under the current system. The new system would also be at least competitive with the defined contribution plan of the current system. The personal account funds would be completely portable; workers would be able to take all the funds paid into their accounts, plus all investment returns, with them wherever they go. Shorter-term workers would retain control over all the contributions paid into their accounts as well, with no vesting requirements to take away their benefits.

For taxpayers, the new system would reduce employer costs by about 35 percent. These funds can then be devoted to reducing the unfunded liabilities of the current system, lowering that long-term taxpayer burden. Over time, as the workers covered by the new system become a larger portion of the work force, unfunded liabilities of the current system would be further reduced, and ultimately eliminated altogether. Taxpayers would then enjoy the lower costs for the system.

There would, in fact, never be a danger again of an unfunded liability arising under the new system. The government employer under that system is responsible only for paying a specified amount each month into the worker's account, and so there cannot be any financing shortfalls. Under the new system, indeed, the government no longer maintains a huge investment pool to finance future benefits. Those funds are invested instead through the decentralized personal accounts owned by each worker and managed by private investment firms.

Consequently, the new system eliminates investment risk for taxpayers. It also shields them from the political risk of politicians promising a giveaway of higher future benefits, or increasing benefits during financially flush times that will have to be paid permanently in the future. Taxpayers are shielded as well from various adverse economic and demographic developments that would otherwise raise costs under the current system.

The new defined contribution system would follow a trend in both the private and public sectors. The number of private sector employers in defined contribution plans has increased by three times or more over the last 25 years, while the number in defined benefit plans has stagnated. As a result, more private sector workers are now in defined contribution plans than in defined benefit plans.

A trend is now developing among the states to move in this direction as well. Michigan adopted a comprehensive defined contribution system for its workers in 1996. Montana did the same in 1999, as did Florida last year. Altogether, 20 states now have defined contribution options serving as an alternative to traditional defined benefit plans for some or all of their workers, and legislation providing for further reform is now under consideration in seven states.

Oregon was originally a forerunner in this trend; PERS began as a defined contribution plan in 1945. The state should now return to its roots.

Basically, defined contribution reform plans privatize the investment function of public employee pension systems, producing the above-described benefits for both workers and taxpayers. Because of these wide-ranging benefits, the movement towards defined contribution reforms in public employment pensions is called pension liberation.

This study will present the case in more detail for adopting a pension liberation plan in Oregon. It will first describe the Oregon Public Employees Retirement System, and outline a specific defined contribution reform plan for Oregon. Next the study will discuss in more detail the advantages of such a defined contribution option for both workers and taxpayers, and then respond to related concerns. Finally, the study will summarize the reforms adopted in other states.

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In 1979, the state and most local government employers agreed to pay the six percent employee's contribution to PERS. When a 1994 ballot initiative challenged this arrangement, employers granted the workers a six percent pay increase, and workers began paying the six percent PERS contribution again.

The Oregon Public Employees Retirement System[1]

The Oregon Public Employees Retirement System (PERS) may be the most complex in the country. It covers all state government workers and all school district and community college employers. Local government employers can sign up their workers as well, and almost all in the state have done so.

Overall, the system covers about 151,000 workers employed by 816 state and local employers, including 115 state agencies, 458 local government political subdivisions, 17 community colleges, and 215 school districts. About $1.4 billion in benefits is paid each year to about 83,000 retirees and other beneficiaries.

More generous provisions apply under PERS to policemen, firefighters, and judges. The discussion below focuses on the standard, general provisions only.

In an effort to control the costs of the system, the legislature provided for somewhat less generous benefits for workers who started public employment on or after Jan.1, 1996. These are called Tier 2 workers. Those who began employment before Jan. 1, 1996 are called Tier 1 workers.

Generous to a fault

The employee contribution to PERS has long been six percent of wages. But in 1979, the state agreed to pay the employee's contribution for its workers, and most local government employers agreed to do so as well. When a 1994 ballot initiative challenged this arrangement, the state and most local government employers granted the workers a six percent pay increase, and workers began paying the six percent PERS contribution again.

The employer contribution to PERS is set at the rate needed to fund promised benefits as determined by an actuarial formula and investment performance. Effective July 1, 2001, state agencies and community colleges will pay 9.49 percent of wages for PERS. Local schools will pay 12.73 percent of wages, while the payment for other local government employees will average 9.77 percent. When the six percent employee contribution is counted as a cost to the employer, because the employer has picked up that contribution one way or another for years, Oregon PERS is one of the most expensive public employee retirement systems in the country. Remember, in this context, "employer" means the taxpayers.

Heads I win, tails you lose

The funds paid into PERS are invested by the Oregon Investment Council (OIC), a public body governed by a six member board including the State Treasurer and others appointed by the governor. The OIC contracts with private money managers to invest most of the funds, and invests some contributions directly in investment vehicles it chooses.

Workers can exercise some control over how their retirement funds are invested, directing their annual contributions, within proscribed limits, between a Regular Account (currently invested approximately 65 percent in equities[2]), and a Variable Account (always invested 100 percent in U.S. equities). Workers can choose to invest up to 75 percent of their annual contributions in the Variable Account. Tier 1 workers are guaranteed a minimum return on their Regular Account assets, but not on their Variable Account assets. The minimum investment return is equal to the actuarially assumed interest rate for each year. Since 1990 that has been eight percent.

As a result, Tier 1 workers can maximize their investments in stocks, which generally provide the highest return over the long run, but entail greater risk. Relatively few workers have chosen to put a high percentage of their contributions in the Variable Account. Approximately 16 percent of member reserves are currently in the Variable Account.[3] Therefore, the minimum investment return currently applies to about 84 percent of total Tier 1 worker member reserves. Because such a high percentage of Tier 1 worker PERS assets are guaranteed a minimum return, taxpayers might view these workers as having a "heads I win, tails you lose" benefit structure, at the expense of the taxpayers.

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The short-term employee short change

Workers become vested for their benefits after contributing to the system for five years, though the first and last year is counted as complete if the worker contributed for any part of those years. Workers can also become vested by working for a covered employer after turning 50.

If a worker leaves public employment under PERS before vesting, the worker receives back only his own employee contributions plus investment returns. The departing worker loses all contributions paid by the employer plus associated investment returns.

After vesting, a worker who leaves can wait for the retirement benefits to be paid as described below. If, however, the departing,

vested worker wishes to withdraw his retirement funds from the system and take them elsewhere, the worker can still only withdraw his own contributions plus investment returns. The worker still loses all employer contributions and associated investment returns.

The many, many possibilities

At retirement, workers receive benefits calculated under the defined contribution money match method, or benefits calculated under the defined benefit full formula method, whichever amount is higher. Under the defined contribution money match, the total of the worker's contributions over the years plus investment returns is matched by the employer out of the general retirement fund, to which the employer contributes each year for all workers. The monthly retirement benefit is then equal to the amount this total sum can pay over the rest of the worker's expected life, calculated on an actuarial basis.

Under the defined benefit full formula method, benefits are equal to the worker's final average salary, which is the average of the worker's three highest earning years, times years of service, times 1.67 percent. So, for example, take a worker retiring at age 55 with 30 years of service and an average annual salary over the three highest earning years of $50,000. Multiplying this average by 30 years times 1.67 percent produces annual benefits of $25,000.

After periods when investments have done quite well, workers receive the defined contribution benefits, which should be higher as a result, leaving nothing for the taxpayers. After periods when investments have done poorly, workers receive the defined benefit alternative, leaving taxpayers to make up any shortfall. No wonder the system now projects such deep long-term deficits.

Workers employed prior to August 21, 1981 have yet a third PERS plan, combining the defined benefit *plus* the defined contribution methods. An actuarially determined defined contribution benefit is calculated based on the total sum of the worker's contributions plus investment returns over the years. Then a defined benefit is calculated based on the employer's contributions, equal to average final salary times years of service times one percent. The worker's retirement benefit is then equal to both of these benefits combined.

Workers employed prior to August 21, 1981 have yet a third PERS plan, combining the defined benefit *plus* the defined contribution methods.

Full retirement benefits are available to Tier 1 workers at age 58, to Tier 2 workers at age 60, and to workers at any age with 30 years of service. Early retirement for workers who have not achieved 30

years of service is available at age 55. Under the defined benefit calculation, the retirement benefit is reduced by eight percent per year of early retirement. So benefits would be reduced 24 percent for a Tier 1 worker retiring early at 55, rather than the normal retirement age of 58, while a Tier 2 worker, with a normal retirement age of 60, would see a reduction of 40 percent. Under the defined contribution alternative, benefits are actuarially reduced to reflect the spreading of the accumulated investment sum over a longer period of retirement years.

Survivor, disability and health benefits

Workers can choose among a dozen different payment options, including benefits for a surviving spouse or other beneficiary, and various lump sum payments of accumulated funds before or after death. Retirement benefits for the worker are actuarially reduced as necessary to finance these additional options.

Primarily because of its extreme overgenerosity, PERS is expected to face a sizeable unfunded liability in the coming years.

Retirement benefits under the various payment options are increased each year by a cost of living adjustment, up to two percent per year.

Survivor benefits are also available for workers who die before retirement. If the worker was still employed in PERS covered employment at death, the worker's survivor can choose to receive the total accumulated worker contributions plus investment returns in a lump sum, plus a matching amount from the employer. Or the survivor can choose an actuarially calculated monthly benefit for life based on the accumulated employee contributions, plus again a matching monthly benefit from the employer. Or the survivor can choose a lump sum payment from the worker's contributions and a monthly benefit for life from the employer's contributions.

If the worker was not still in PERS covered employment at death, then the survivor receives benefits based only on the worker's contributions plus investment returns.

PERS also pays disability benefits. Workers are eligible for these benefits regardless of length of service if the disability resulted from their employment. For non-service related disability, workers must have a minimum of ten years service to qualify for benefits. Benefits are equal to the retirement benefits the worker would have received if he had worked to age 58.

PERS pays an additional $60 per month towards Medicare supplemental health insurance for retired workers with at least 8 years of service. This benefit is also available to surviving elderly spouses or

dependents of such workers. Certain state retirees not eligible for Medicare can receive a subsidy to help them buy the same health coverage as those continuing to work. The subsidy is equal to half the difference between the average cost of such coverage for retirees and the cost for workers.

The looming financial crisis

Primarily because of its extreme over-generosity, PERS is expected to face a sizeable unfunded liability in the coming years. Though the exact amount of this system deficit is in dispute, it could amount to billions of dollars over the next 40 years.

PERS has initiated a detailed analysis of what could happen as the Tier 1 workers reach retirement. Its report is a work in progress and limited in scope; further analysis that includes Tier 2 workers could alter the results, for better or worse. Its preliminary findings, however, indicate concern is justified. According to *The Oregonian*, "In one computer model, using reasonable assumptions about the long-term performance of the market, the study found that the Tier 1 program could be $7.3 billion in the hole at the end of 40 years."[4] It is estimated that eliminating a $7 billion deficit would cost each taxpayer in the state over $400 per year for each of the next 40 years.[5]

Oregon PERS needs to be greatly simplified and rationalized so that the system is not so detrimental to the taxpayers. Reform in Oregon should focus on designing a new defined contribution system for newly hired workers.

A proposal for reform

Oregon PERS needs to be greatly simplified and rationalized so that the system is not so detrimental to the taxpayers. Well-structured reforms can provide generous benefits to workers while actually reducing costs for both workers and taxpayers.

Promised retirement benefits cannot be taken away from those already working in the system, however. The courts have uniformly held across the country and in Oregon that workers have a contractual right to the benefits they were promised to induce them to accept employment in the first place.

Pension liberation reforms in other states avoid this problem because they are based on allowing workers the freedom to choose to switch to a defined contribution plan in place of their current defined benefit plan. But this wouldn't work in the Oregon system, because workers can already receive benefits based on a defined contribution plan if the returns exceed the defined benefit guarantee.

Making the switch

Reform in Oregon should focus on designing a new defined contribution system for newly hired workers. Slowly over time, as the newly hired workers become a larger and larger component of the work force, the problems of the current system would be eliminated by the new system. The reforms would not apply to policemen, firefighters or judges, as new and current workers in those areas would continue with their current specialized retirement programs without change.

Current workers can be allowed to opt into the new defined contribution system. In fact, many may find the freedom, personal control, cost savings and benefits of that system desirable. This may be particularly true for the many shorter-term workers who plan to leave state public employment after less than ten years of service. Because making the switch would be at the worker's choice, there is no doubt that the courts would uphold it.

Current workers can be allowed to opt into the new defined contribution system. In fact, many may find the freedom, personal control, cost savings and benefits of that system desirable.

Simplify, simplify, simplify

Under the reform plan all new workers, other than policemen, firefighters, and judges, would be automatically enrolled in the new system from the start of their employment. Workers and employers in the new system would each pay five percent of wages, for a total of ten percent, into a personal account for each worker. The employer would continue to pay the 0.65 percent contribution for retirement health coverage, as under the current system, and another 0.55 percent for survivor and disability benefits, which should be sufficient to finance the continued payment of these benefits under the current system as well.

The employer would consequently pay 6.2 percent of wages into the new system. This is 3.3 percentage points less than state agencies are paying today for their general service workers, 3.5 percentage points less than local government employers are paying, and 6.5 percentage points less than local schools are paying for teachers. Employers would then pay these saved amounts towards covering the unfunded liabilities of the current system for current workers, reducing the burden on taxpayers to close those funding gaps. After all funding gaps are eliminated, these savings would remain with the employer, resulting in a continuing net reduction in the burden on taxpayers.

Workers under the new system would pay one percentage point less than under the current system, producing an immediate net gain for them. School employers could grant part of their net

savings to teachers in a pay increase, because their cost reduction is so large, providing further immediate gains for them as well. If they granted a two percent pay increase, they would still save 4.5 percentage points.

Investment freedom

Each worker with a personal account would then choose investments for that account from a list approved by the OIC. The list would include a diversified mix of mutual funds offering stocks and/or bonds and a range of fixed investments. The list may also include approved money managers who would pick the particular direct investments for workers. Workers would exercise their choice of these investment alternatives through a Third Party Administrator for the program hired by the OIC, leaving the worker with one single point of contact. This is similar to the Oregon Savings Growth Plan, the supplemental Section 457 personal accounts to which some Oregon public employees can contribute today on top of the public pension system.

The new system would not be subject to any vesting requirement and the funds in the account would become the immediate personal property of the worker. But as long as the worker continued to work for an Oregon public employer covered by the system, the worker would not be allowed to withdraw funds from the account before retirement. Workers who left such employment would take their personal accounts with them as an IRA or 401(k) for their future retirement. The funds and investment returns would accumulate in the accounts tax free until withdrawn at retirement.

The first immediate advantage of the new plan is that it reduces costs to workers by almost 20 percent.

At retirement, worker benefits would equal what the accumulated funds could pay. As discussed below, at just standard market investment returns, workers generally would receive substantially better benefits than promised by the current defined benefit system. The standard retirement age would be 60, but workers could choose to retire as early as 55 as under the current system. However, the amount of their benefits would be actuarially reduced to reflect their earlier retirement age. Workers also do not have to retire at 60, but can wait and get actuarially increased benefits for a later retirement age.

Like the current system, PERS would continue to pay all disability benefits, pre-retirement survivor benefits, and retiree health benefits.

Advantages of PERS reform for workers

The proposed reform plan would produce several advantages for Oregon's government workers.

Lower costs

The first immediate advantage of the new plan is that it reduces costs to workers by almost 20 percent compared to the current system, because the employee contribution is reduced to 5 percent from the current 6 percent.

Vesting

The defined contribution reform plan eliminates any vesting requirement, because both employer and employee contributions are immediately paid into the personal account for each worker and become the personal property of that worker. This is a great advantage for shorter-term workers who may remain in state and local employment less than the current vesting period of three to five years. These workers would lose all employer contributions plus associated investment returns under the current system when they left, but under the new system these funds plus their own contributions and returns would remain in their personal accounts and go with them to their new jobs.

Portability

The defined contribution reform plan would provide workers with complete portability. Workers who leave government employment in the state for another job would take their entire individual account with them, including all past employer and employee contributions plus full market investment returns

The current PERS plan, by contrast, has only limited portability. Workers who leave can only take their past employee contributions plus investment returns. They then lose all past employer contributions plus associated investment returns. If their benefits are vested, they can leave all of their money in the system and receive in the future the benefits for which they are eligible based on their limited period of service. But in that case they are still not taking their money with them. They must leave behind in the system all past contributions and returns.

Fair and attractive benefits

Finally, the defined contribution plan would provide workers with completely fair and highly attractive benefits. They would be completely fair because all workers would get the same market returns,

The new system would not be subject to any vesting requirement and the funds in the account would become the immediate personal property of the worker.

Proposed defined contribution plan versus current defined benefit plan

All figures are in constant 2001 dollars and assume a 5.5 percent real rate of return on investment. The worker is assumed to enter public employment at 22 and retire at age 60. The defined benefit plan column states the cash benefits that would be paid by the defined benefit option of Oregon PERS, as calculated under current law.

	Defined contribution plan			Defined benefit plan	
Annual salary	Total investment fund accumulated by retirement	Annual annuity benefit	Replacement rate	Annual cash benefit	Replacement rate
30 years of work					
$25,000	$253,017	$22,152	88.60%	$12,525	50.10%
$30,000	$303,620	$26,582	88.60%	$15,030	50.10%
$40,000	$404,827	$35,443	88.60%	$20,040	50.10%
$50,000	$506,033	$44,307	88.60%	$25,050	50.10%
20 years of work					
$25,000	$241,086	$21,107	84.4 %	$8,350	33.4 %
$30,000	$289,303	$25,328	84.4 %	$10,020	33.4 %
$40,000	$385,738	$33,771	84.4 %	$13,360	33.4 %
10 years of work					
$25,000	$152,062	$13,313	53.3 %	$4,175	16.7 %
$30,000	$182,475	$15,976	53.3 %	$5,010	16.7 %
$40,000	$243,299	$21,301	53.3 %	$6,680	16.7 %

without any bias for any politically favored group of workers. The benefits would be highly attractive because they would likely beat the defined benefit promises of the current system and would at least be competitive with the current defined contribution plan. This is shown in the accompanying Table (see next page).

The new defined contribution plan would provide workers with completely fair and highly attractive benefits.

The Table assumes that 10 percent of salary is paid into the defined contribution account each year for each worker, half by the worker and half by the employer. The contributions are assumed to be invested and to earn a 5.5 percent real rate of return over the long run. In fact, over the last 75 years, going back before the Great Depression, the composite real rate of return on all stocks in the Standard and Poors 500 was 8.0 percent.[6] The composite real rate of return on smaller company stocks on the New York Stock Exchange over this period was even higher, at 9.2 percent.[7] Over the long-term, the real return paid by investment quality corporate bonds has been three to four percent.[8] So a 5.5 percent real return is a quite fair assumption allowing for some diversification of stocks and bonds, and quite ordinary investment performance.

After 10 years of employment. Take a worker who enters government employment at 22, works for ten years, and then leaves for the private sector. Assume he earns $25,000 per year after inflation during his period of government employment. Payments totaling ten percent of salary are paid into his retirement account each year during his government employment, but all further contributions stop after that. However, the funds continue to be invested and earn returns over the years after government employment.

By age 60, the worker would retire with a fund of $152,062 in today's 2001 dollars, after inflation. That fund would finance an annuity of $13,313 per year for the rest of the worker's life. The Oregon PERS defined benefit plan, by contrast, would pay only $4,175 per year. In other words, the benefits paid by the defined contribution personal account would be more than three times as large as the defined benefits that would be paid by the current system. The relative results are the same for workers at $30,000 and $40,000 per year.

After 20 years of employment. A large advantage for the defined contribution system is similarly maintained if the worker remains in government employment for 20 years, again beginning at age 22. A worker earning $30,000 each year after inflation would retire at 60 with $289,303 in today's dollars. That fund would

finance an annuity of $25,328 each year for the rest of the worker's life, compared to $10,020 per year that would be paid by the current PERS defined benefit plan. In other words, the benefits paid by the defined contribution personal account plan would be about 2 ½ times the benefits paid by the current PERS defined benefit plan. The relative results are the same for a worker earning $25,000 or $40,000 per year.

The new defined contribution plan beats the current system's defined benefit promises so decisively for the short- and medium-term workers, up to 20 years, because the defined benefit plan is typically skewed toward the older and longer term workers.

After 30 years of employment. A major advantage remains as well for the defined contribution plan for a worker who continues government employment for 30 years. A worker earning $40,000 per year, which is the current average salary per worker, would reach retirement at 60 with just over $400,000 in today's 2001 dollars. Such a fund would finance an annuity of $35,443 per year for the rest of the worker's life, compared to $20,040 paid by the current PERS defined benefit plan. In other words, the personal account defined contribution plan would pay about 75 percent more than the current PERS defined benefit. The benefits of the new defined contribution plan alone would equal 88.6 percent of the workers pre-retirement income. Social Security would add at least 28 percent more, leaving the worker with more income after retirement than before.

Eliminates current system bias. The new defined contribution plan beats the current system's defined benefit promises so decisively for the short- and medium-term workers, up to 20 years, because the defined benefit plan is typically skewed toward the older and longer-term workers. That bias results from several factors.

First, the benefits are a percentage of average salary, which tends to be much higher for those who have worked the longest, and for older workers. Secondly, granting the same percentage of final salary for each year worked does not give the full value to younger workers of the contributions made for them. The contributions for younger workers earn investment returns for many more years than for older workers. Yet, the younger workers get no credit for these additional years of returns.

Inflation makes the problem even worse. Salary increases over the years incorporate compensation for inflation. When benefits are calculated based on salary, they incorporate the compensation for inflation included in the salary increases over the worker's career. But for younger, shorter-term workers, this inflation compensation stops when they leave government employment, as the salary

used for their benefit calculations is fixed at that age.

None of these distortions occur in the defined contribution plan. The same full market investment returns are available to each worker on the contributions into their accounts every year throughout their careers. Moreover, the investment returns over the years would also include an inflation compensation component that workers would continue to earn on their accounts throughout their careers regardless of where they work.

The defined contribution benefits decisively beat the promised defined benefits even for the longer-term 30-year workers, at just standard long-term investment returns. This common result reflects the fact that workers just do not get the most for their money through defined benefit plans. Investment managers for such plans seem to invest only to meet the defined benefit targets, not to get the most they can for workers, who are not supposed to get the benefit of any higher investment returns in such a plan anyway.

Entering public employment later in life. Workers who start public employment in the state later than in these examples—where workers started at age 22—would not earn as much in the defined contribution plan, because their contributions would have fewer years to earn investment returns. But these workers would have had previous employment enabling them to generate retirement funds or at least savings from their earnings during those years. With the additional funds or savings from those years, workers would have even higher benefits overall through the new defined contribution system relative to the defined benefit promises. It is not fair to expect Oregon taxpayers to pay more for a failure of workers to provide for retirement savings during earlier employment years before they were publicly employed in Oregon. Moreover, even without such previous savings, most workers would probably still beat the defined benefits through the new defined contribution system.

The defined contribution benefits decisively beat the promised defined benefits even for the longer-term 30-year workers, at just standard long-term investment returns.

Compared to the current defined contribution plan. The new defined contribution plan should also earn returns at least as good as those earned in the current defined contribution alternative for workers, if not better. But workers pay six percent into the current system, typically with an even larger employer contribution. Under the new system, workers and employers would each contribute only five percent of wages, which should mean lower defined contribution benefits at the end. However, in this new system workers may be able to earn higher returns by investing the full ten

percent of wages in a broader array of investment alternatives. Currently, there are limitations on the types of investments the employer contribution can be invested in.

Additionally, workers can be allowed to pay the full six percent that they are paying into the current system into their new defined contribution accounts if they desire.[9]

Because workers in the new system would end up with higher retirement incomes than pre-retirement incomes at just standard market investment returns, there is no justification for asking taxpayers to pay more into the new system than the specified five percent of wages.

Advantages for taxpayers

The proposed reform plan would also produce enormous advantages for Oregon taxpayers.

Eliminate potential unfunded liability

The reform plan would reduce and ultimately eliminate the projected unfunded liabilities in the current PERS system in a painless manner.

The reform plan would reduce and ultimately eliminate the projected unfunded liabilities in the current PERS system in a painless manner. New workers covered by the new defined contribution system would not have any unfunded liability associated with them because their future benefits would be fully funded through their personal accounts. As they would come to represent more and more of the work force the unfunded liabilities of the current system would decline because the number of workers producing those liabilities would be smaller. As this process continues admittedly over several decades, eventually all workers and then all retirees would be covered by the new system, and the current unfunded liabilities would be eliminated.

The reform would also produce additional funds to help reduce the unfunded liabilities faster in the short-term. The state would save 3.3 percent of wages for each general service worker, local governments would save 3.5 percent, and schools would save 6.5 percent, though they may share some of that with the teachers. These saved funds would then be devoted to closing projected unfunded liability gaps. Only a relatively small amount of new funds would be generated in this way in the first few years. However, over the longer run, these saved funds would add up to larger amounts, making a much bigger dent in projected unfunded liabilities.

Reduced costs

After the projected unfunded liability is eliminated, taxpayers would continue to benefit from reduced costs. For each new worker hired under the new system, employers would save roughly 3.5 percentage points of wages and even more in the case of teachers, as compared to the current system.

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Always fully funded

The defined contribution plan also eliminates the danger of any future unfunded liability, from any source, that must be covered by taxpayers. Under a defined benefit plan like the one included in Oregon PERS, any shortfall in the common investment pool that leaves the pool unable to pay the promised benefits, creating an unfunded liability, must be covered by the taxpayers, regardless of the cause of the shortfall. Indeed, because of the adverse selection in the PERS hybrid defined benefit/defined contribution plan, as described above, the current system is almost guaranteed to fall into steep unfunded liabilities over and over again.

In the defined contribution plan, where the government does not maintain a common investment pool but only pays a specified amount to each worker's individual account each month, there is no possibility of an unfunded liability that taxpayers would have to cover. Retirement benefits equal what the account funds can finance, so, in fact, the system is always fully funded.

No investment risk

Another clear advantage for taxpayers of the defined contribution plan is that it eliminates investment risk for them. With the government managing a common pool of investment funds as under Oregon PERS, the taxpayers bear the complete risk of poor investment performance. If such poor performance leaves the pool unable to pay the promised defined benefits, then taxpayers have to make up the difference.

Indeed, because of the opportunity for adverse selection under the Oregon system, taxpayers in the state bear unique, in fact, intractable, investment risks. If PERS were simply a defined benefit system, the OIC could at least target the return it needs to meet the specified benefits. However if they were to do that now by choosing safe, fixed income investments sufficient to finance the defined benefits—a traditional approach used by other states—they would be stuck when stock market returns are strong. Workers would then receive the defined contribution alternative when they reach retirement, requiring the state to match the employee share ac-

With the government specifying benefits far in the future, as under a defined benefit plan, there is always a strong danger of political giveaways by shortsighted politicians. Under a defined contribution plan these risks are eliminated.

counts that they have heavily invested in stocks. Because the state invested in fixed income investments, however, it would not have enough funds to match worker accounts.

On the other hand, suppose the OIC were to heavily invest in stocks, and the market returns are poor or the market declines for a period. Workers would receive the defined benefit option, but the system would then not have sufficient funds to pay those benefits.

The new defined contribution plan, however, completely eliminates these problems. The taxpayers (through the government) simply make a specific contribution to the accounts of the workers each month. The taxpayers are then not liable for the investment performance.

Reduced political risk

Defined contribution plans greatly reduce another set of risks that are usually overlooked—political risks. With the government specifying benefits far in the future, as under a defined benefit plan like the one included in PERS, there is always a strong danger of political giveaways by shortsighted politicians. These politicians can promise higher retirement benefits, while leaving future officials and taxpayers to pay for them. Politicians can also give away benefit increases when investment performance is going well, leaving taxpayers holding the bag when performance inevitably turns down. The Oregon Legislature has been known to do this in the past. Under a defined contribution plan, where the government does not specify future benefits but only makes regular investment contributions, these risks are eliminated.

Moreover, a large government investment pool, as under Oregon PERS, is always subject to the danger of political interference that could raise costs. Political favoritism may influence investment policy, prohibiting some investments and forcing the fund into others. By taking the focus off of simply maximizing investment returns, such political favoritism would reduce investment returns and increase the cost of funding the specified defined benefits.

Government management of the funds also creates the risk of less than competent handling of the funds by bureaucrats who lack the incentives, competitive pressures, and perhaps expertise of private investment managers. Attempts to insulate the funds from political and bureaucratic control by contracting out to private investment managers may not be entirely successful. The investment managers can still be subject to political pressure, political mandates in their

contracts, or even counterproductive legislative mandates.

Finally, a large government investment pool creates the risk for taxpayers of greater government control of the private economy. Through such a pool, the government may end up owning large shares of private companies. The government would also hold a large share of investment capital that it could use to impose mandates on the private sector.

Even where there has been a good record of avoiding these abuses in the past, as in Oregon, the danger is always present. However, none of these risks arising from a large government investment pool exist in a defined contribution plan, where the government does not maintain such a pool.

The defined contribution plan offers greater certainty and predictability in budgeting. There is no possibility that taxpayers would be surprised with a large, unexpected unfunded liability requiring increased taxes.

Greater control over costs

Finally, the defined contribution reform plan provides the government and taxpayers greater control over costs. Costs under a defined benefit plan, where the government has pledged to provide a certain benefit amount regardless of cost, can vary greatly, depending on a wide range of factors outside of the government's control. Retirees can live longer, greatly increasing costs. More workers may stay with the government employer long-term, increasing costs. Interest rates or the stock market may decline, requiring increased contributions to make up the difference.

With the new defined contribution plan, by contrast, the government is responsible only for a specified contribution each year. This contribution is completely dependent only on what the government agrees with workers or their union to pay. This means greater certainty and predictability in budgeting. There is no possibility that taxpayers would be surprised with a large, unexpected unfunded liability requiring increased taxes.

Defined contribution plan concerns

Unsophisticated investors

One of the major criticisms of defined contribution plans is that most workers are too unsophisticated about investing to handle the responsibility of directing their own retirement investments. This underestimates the capabilities of working people. Nevertheless, the proposed reform plan is carefully structured to avoid this problem in any event. Workers simply pick from a range of sophisticated investment funds designated and approved by the state government. These would include major mutual funds and other

Workers can fully handle the investment risk posed by defined contribution plans. With such a long-term investment horizon, perhaps 60 years or more, workers can weather many ups and downs in investment performance.

highly reliable pooled vehicles.[10] Through these vehicles, highly sophisticated investment managers would then be picking the individual stocks, bonds and other investments, not the workers. This model has worked well for individuals in a broad range of contexts, domestically and internationally.

Investment risk

Probably the main criticism of defined contribution plans is that they shift investment risk from the employer to the worker. In a defined benefit plan, the worker receives the specified benefits regardless of investment performance, so the worker apparently bears no investment risk. In a defined contribution plan, the worker's benefits depend entirely on the investment performance of his retirement account, so the worker bears full investment risk. Poor investment performance leads directly to lower benefits.

Workers can fully handle the investment risk posed by defined contribution plans for several reasons. First, retirement investments are very long-term. The worker is investing not only for his entire career, but, indeed, for his entire adult life, as the remaining retirement fund would continue to be invested to support benefits throughout retirement. With such a long-term investment horizon, perhaps 60 years or more, workers can weather many ups and downs in investment performance, with the average return on a diversified portfolio very likely over the long run to close in on the average long-term market return.

Secondly, workers can easily invest in simple, widely available, highly diversified pools of stocks, bonds and other investments, through mutual funds and other vehicles. Such diversified pools will track the general market investment returns discussed above over the long run. Indeed, with a sufficiently broad-based investment pool, the worker would basically own a piece of the economy as a whole. If the entire economy collapses, state and local governments will not be able to support defined benefit plan promises either.

Thirdly, with professional investment managers handling the specific investments for workers, investment risk can be minimized in a sophisticated and reliable manner through diversification and other market strategies.

Workers, indeed, may be able to handle this investment risk better than state and local governments, for they can do so without all of the political risks previously discussed.

Finally, our discussion above showed that through defined contribution accounts workers were likely to get substantially higher benefits than the defined benefits promised by Oregon PERS, at just standard, long-term market investment performance. This is true of defined benefit plans generally. Workers are quite likely to do much better taking direct responsibility for retirement financing through personal account investments. This provides a cushion against the risk of substandard market performance. Stated another way, there is a substantial risk to workers being stuck in defined benefit plans and not taking advantage of defined contribution opportunities. The risk is they will lose the substantially higher benefits of the defined contribution personal accounts.

Pension liberation across America[11]

States across the country are now starting to move to new defined contribution retirement plans for their public employees, in place of the older defined benefit plans, to obtain the extensive benefits of such reform discussed above. Michigan was at the forefront of this movement, adopting a comprehensive plan in 1996 proposed by Governor John Engler.

States across the country are now starting to move to new defined contribution retirement plans for their public employees, in place of the older defined benefit plans.

The Michigan experience

Under Michigan's reform, all newly hired employees enter the defined contribution plan. The state contributes a minimum of four percent of the worker's salary to an individual investment account for each worker. The employer will then match voluntary employee contributions up to an additional three percent of salary, making a total contribution of ten percent. The worker can choose to contribute up to an additional 13 percent of salary without the employer match.

Investment options are structured for workers to make investing easy. First, they can choose from three core investment funds with set percentages of asset allocations in different investment areas, reflecting a range of risk and return variations. Secondly, the worker can choose from among 12 pre-selected mutual funds considered the best in their primary investment areas, whether stocks, or bonds, or other private investments. Finally, the worker can choose a self-directed option, which includes the choice of hundreds of mutual funds determined to be sound and suitable for retirement investment.

Current employees were able to switch to the new defined contribution plan only during an "open season" in the first four months

The Michigan Department of Management and Budget estimated that the state saved almost $100 million in the first year alone because of their new defined contribution plan.

of 1998. There was no change in benefits for employees who chose to stay in the old defined benefit plan, and no change in the benefits of current retirees.

The Michigan Department of Management and Budget estimated that the state saved almost $100 million in the first year alone because of their new defined contribution plan, due to savings on employer contributions and administrative costs. Further, 45 percent of state employees, who effectively received no benefits under the old plan because they left state employment too early, are now able to benefit under the new system after state employment of only two years, with fully vested benefits after only four years.

In addition to the state, four major counties in Michigan have switched to defined contribution plans for their workers. These include Oakland County, Saginaw County, Washtenaw County and Wayne County. The state capital, Lansing, has switched as well, and the City of Kalamazoo has a partial defined contribution plan.

The Florida experience

Just last year, Florida adopted a comprehensive defined contribution plan for its public employees as well. Workers there each have the choice of a defined contribution alternative to the traditional defined benefit plan.

For those who choose that alternative, their government employers pay nine percent of wages into personal accounts for workers to finance their own future retirement benefits. These workers continue to receive disability and health benefits from the old system.

Each worker with a personal account chooses investment funds for that account from a list approved by the state. In retirement, the worker can take the personal account benefits in the form of an annuity paid through a Third Party Administrator for the program, providing a guaranteed monthly income for life. Or the worker can choose various lump sum withdrawal options, with only some or none of the funds devoted to an annuity.

Pension reform elsewhere

In 1996, a defined contribution reform movement in California won an option for employees of the state's colleges and universities. Montana passed a bill providing for a defined contribution option for its workers in 1999.

Other states with defined contribution systems for some of their employees include Ohio, Illinois, Washington, Alabama, West Virginia, Virginia, Utah, South Carolina, Colorado, Missouri, Nebraska, Louisiana, Vermont, Arizona, South Dakota, and North Dakota.

Conclusion

The current Oregon Public Employees Retirement System is an unsustainable defined contribution / defined benefit hybrid badly in need of reform. The Oregon legislature should consider the proposed defined contribution reform plan.

A defined contribution plan would provide important advantages to workers, including reduced costs, complete portability, and fair, highly attractive benefits superior to the defined benefit promises of the current system. The reform would also ensure much needed protection for taxpayers, including the reduction and eventual elimination of the current unfunded liabilities, reduced costs, the end of any potential for future unfunded liaibilities, elimination of investment and political risks, and greater control over long run costs.

The current Oregon Public Employees Retirement System is an unsustainable defined contribution / defined benefit hybrid badly in need of reform. The Oregon legislature should consider adopting the proposed defined contribution reform plan.

Notes

1. The discussion of the Oregon system in this section is based on Oregon Public Employees Retirement System, *Comprehensive Annual Report for the Fiscal Year Ended June 30, 1999* (December 3, 1999); Oregon Public Employees Retirement System, *PERS Member's Handbook 2000*, November, 1999; and Oregon Public Employees Retirement System, *Actuarial Valuation as of December 31, 1999* (Milliman & Robertson, Inc., January 8, 2001).

2. Dale S. Orr, administrator, PERS Fiscal Services Division, personal communication, June 13, 2001.

3. ibid.

4. James Mayer, "Study fuels state pension plan feud," *The Oregonian*, February 26, 2001.

5. This calculation was made as follows. The constant annual payment needed to amortize $1 billion over 40 years at 9 percent (the opportunity cost of the invested funds) is about $93 million. So, at $7 billion the annual payment needed would be $651 million. Assuming there are 1.5 million filing taxpayers (this was the approximate amount in 1998), then retiring the deficit and covering all obligations would cost each taxpayer $434 per year.

6. *Stocks, Bonds, Bills and Inflation, 1999 Yearbook*, (Chicago, Ill., Ibbotson Associates Inc., 1999).

7. Ibid.

8. Calculated from Moody's Investor Services, *Industrial Manual, Bond Survey*.

9. State workers and workers whose local government employers have opted into the PERS managed 457 deferred compensation plan, known as the Oregon Savings Growth Plan, could still invest in that vehicle if they chose to do so. Other PERS workers could still invest in the other plans they are currently allowed to contribute to on top of their regular PERS contributions.

10. Many 401(k) plans are invested in "lifestyle funds," which blend equity and fixed income funds, domestically and even internationally. The blend is tailored to the needs and preferences

of each investor regarding risk, return, income, etc. An investment manager picks the particular portfolio for each investor based on the investor's stated preferences. This would be an attractive option for workers with defined contribution personal accounts.

11. The discussion in this section is based on information obtained from the American Legislative Exchange Council and Americans for Tax Reform, both of whom maintain ongoing projects monitoring developments among the states on this issue.

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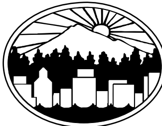

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