Washington Research Council

Policy Brief

May 11, 2012 PB 12-10

A Small Step for Public Pension Reform

Briefly

At the end of the first special session, the legislature enacted some reforms to public employee pensions. 2ESB 6378 reduces subsidized early retirement benefits for new employees and lowers the assumed rate of return of pension investments.

New public employees will still have access to a subsidized early retirement option.

The Senate coalition's 2012 supplemental budget proposal included public employee pension reforms. As originally passed by the Senate, the coalition proposal would have closed the Public Employees' Retirement System (PERS), Teachers' Retirement System (TRS), and School Employees' Retirement System (SERS) Plans 2 to new entrants and make new entrants ineligible for subsidized early retirement. (The coalition also proposed to suspend Plan 1 unfunded actuarial accrued liability payments for PERS, TRS, SERS and Public Safety Employees' Retirement System (PSERS) for fiscal year 2013.)

The pension issue was one of the sticking points in the final budget negotiations. Ultimately, a pared down version of public pension reform was enacted by the legislature at the end of the first special session and signed by the governor on May 2. 2ESB 6378 reduces subsidized early retirement benefits for new employees and lowers the assumed rate of return of pension investments.

Table 1: Pension Reductions under Early Retirement Options for Public Employees

Retirement Age	Early Retirement	2000 Alternate Early Retirement	2007 Alternate Early Retirement	2012 Alternate Early Retirement
55	64%	30%	20%	50%
56	61%	27%	17%	45%
57	57%	24%	14%	40%
58	52%	21%	11%	35%
59	47%	18%	8%	30%
60	41%	15%	5%	25%
61	35%	12%	2%	20%
62	28%	9%	0%	15%
63	20%	6%	0%	10%
64	10%	3%	0%	5%

Early Retirement

Normally, members of the PERS, TRS, and SERS Plans 2 with at least five years of service may retire with a pension at age 65. Members of the PERS, TRS, and SERS Plans 3 may retire at 65 with 10 years of service or with five years of service if one of those years is after age 44.

Plan 2 members with at least 20 years of service may retire as early as age 55, but their pension amount will be actuarially reduced to offset the greater number of years over which they will receive the money. (Plan 3 members must have 10 years of service to retire at 55.) With an actuarial reduction, a 55-year-old's pension is reduced by 64 percent, while a 64-year-old's pension is reduced by 10 percent.

In 2000, the legislature added an alternate (subsidized) early retirement option allowing Plans 2 and 3 members with at least 30 years of service to retire at 55 and have their pension benefit reduced by only 3 percent per year. For example, if they retire at 55, the benefit is reduced by 30 percent; if they retire at age 64, the benefit is reduced by 3 percent.

In 2007, the legislature further sweetened alternate early retirement for members of Plans 2 and 3 with at least 30 years of service retiring on or after September 1, 2008. The benefit is reduced by only 20 percent for those who retire at 55, and there is no reduction at all for those who retire at 62.

Under 2ESB 6378, Plans 2 and 3 members who are first employed on or after May 1, 2013 are not eligible for the 2000 or 2007 alternate early retirement options. Instead, they have a third alternate early retirement option. When they reach 30 years of service, they may retire at 55, but their retirement allowances will be reduced by 5 percent each year should they decide to retire early. A member who retires at 55 would receive a benefit that is reduced by 50 percent. Table 1

	2013-15	25-Year
Total State	(5.5)	(208.7)
Local Government	(4.1)	(173.8)
Total Employer	**(9.6)**	**(382.5)**
Total Employee	**(4.5)**	**(272.0)**

Table 2: Spending under 2ESB 6378 (Dollars in Millions)

compares the reductions of retirement allowances by year in each early retirement scenario.

The legislation also requires the Select Committee on Pension Policy to study the appropriateness of providing new early retirement options specifically for employees in positions that have "unusually high physical requirements that result in elevated risks of injury or disablement for older employees." The committee must also study "existing early retirement factors and job requirements that may limit the effectiveness of the older classroom employee" and whether to create additional early retirement options in TRS.

Rate of Return on Investment

The state actuary is charged with setting contribution rate requirements for the state retirement systems. The law specifies certain long-term economic assumptions that the actuary uses, including an investment rate of return assumption. Previously, this was set at 8 percent.

We discussed the rate of return issue in detail in an April 2011 policy brief, *Reforming Public Pensions*. As we noted then, "using their assumed interest rates, states discount future benefit costs. In short, states are expecting that investment returns will lessen the need for contributions to cover benefits. This assumption downplays the risk that returns will be down in a particular year." Professors of Finance Robert Novy-Marx of the University of Chicago and Joshua Rauh of Northwestern "argue that, commensurate with the level of risk involved, public pensions should use the interest rate on Treasury securities to discount future payments." Currently, those rates are less than 5 percent.

The Pension Funding Council adopted new assumptions in October 2011, including reducing the rate of return assumption to 7.9 percent for 2013–15.

2ESB 6378 reduces the assumed rate of return for PERS, TRS, SERS, PSERS, Law Enforcement Officers' and Firefighters' Retirement System Plan 1, and Washington State Patrol Retirement System. The assumed rate of return will be reduced to 7.9 percent beginning July 1, 2013; to 7.8 percent on July 1, 2015; and to 7.7 percent on July 1, 2017. These reductions are consistent with August 2011 recommendations by the state actuary.

Budget Impacts

The state actuary produced a fiscal note for 2ESB 6378. The bill's changes to early retirement options are estimated to reduce spending. Meanwhile, the new assumed rate of return is estimated to increase contribution requirements (and spending) over 25 years, but yield employer savings over 50 years. The estimated net impact of the two provisions is to reduce total employer spending by $9.6 million over the 2013–15 biennium and by $382.5 million over 25 years.

Discussion

According to the state actuary, under 2ESB 6378, long-term affordability improves (from both the alternate early retirement changes and the new rate of return assumptions) and "Plan 2 member contribution rates are expected to decrease in the long-term." Reducing the rate of return assumption is a good step toward measuring pension obligations more accurately.

As enacted, the legislation continues to provide new employees hired beginning a year from now with a subsidized early retirement option. Though not as generous as the 2000 and 2007 versions, it is still considerably sweeter than basic early retirement. The normal retirement age for Social Security is increasing—it will be 67 for people born after 1959. This change reflects increased labor force participation rates for ages 65 to 69 (from 20 percent to 32 percent over the last 30 years). Continuing to offer state employees subsidized early retirement is inconsistent with these broader demographic changes.

In all, the reforms enacted this year move public employee pensions in the right direction, but they do not go far enough.

WASHINGTON RESEARCH COUNCIL
16300 Christensen Road, Ste. 207
Tukwila, Washington 98188
206-467-7088
fax: 206-467-6957
www.researchcouncil.org