WashACE
COMPETITIVENESS BRIEF
Washington Alliance for a Competitive Economy
CB 06-03 July 3, 2006

THE BOTTOM LINE

While continuing to provide public employees with generous retirement benefits, Washington's state and local governments have failed to properly fund and account for obligations. The resulting liabilities threaten to squeeze public budgets for years to come.

To read the executive summary of this report see:

http://researchcouncil.blogs.com/weblog/files/public_retirement_benefits_es_03_2006.pdf

Can We Afford Their Retirement?

Washington workers are aging. Many will soon retire. And when they do, they will live longer and require more expensive services than their predecessors.

Private employers have adapted to these changing circumstances by reducing and replacing retirement benefits with less costly alternatives. However, most public employers continue to provide generous lifetime benefits to retirees.

While continuing to guarantee benefits, public employers have failed to fully fund obligations. As a result, the state-administered retirement systems face $4.9 billion in unfunded pension liabilities. And since retirement health care is funded on a pay-as-you-go basis, very little funding has been set aside for these future costs.

Given demographic and fiscal pressures, continuing to provide public employees with the current level of retirement benefits will place added pressure on an already strained budget.

OVERVIEW OF PERS, TRS AND SERS

The Washington State Department of Retirement Systems (DRS) manages eight retirement systems, serving more than 436,000 current and former government employees. The three largest systems are the Public Employees' Retirement System (PERS), the Teachers' Retirement System (TRS), and the School Employees' Retirement System (SERS). See Figure 1.

Each system comprises several generations of plans (1, 2 and 3), reflecting reforms made to the retirement systems by lawmakers over time. Plans 2 were created to improve the retirement funding structure and Plans 3 were created to provide members with more choice, flexibility, portability, and responsibility.

Plans 1. PERS 1 and TRS 1 were closed to new enrollments on October 1, 1977. They are both defined benefit (DB) plans, meaning employees receive a guaranteed retirement benefit based on their average final compensation (AFC) and years of employment. The number of years used to calculate the pension is capped at 30.

Regardless of salary, all PERS 1 and TRS 1 retirees are guaranteed a minimum monthly benefit, currently set at $35.51 a month per year of service.

In addition, under SHB 2538, Plan 1 members with 25 or more years of service who have been retired for at least 20 years are guaranteed a minimum of $1,000 per month, prior to adjustments made for optional payment reductions. In 2006, SB 6453 extended the alternative minimum benefit to members with 20 or more years of service who have been retired for at least 25 years.

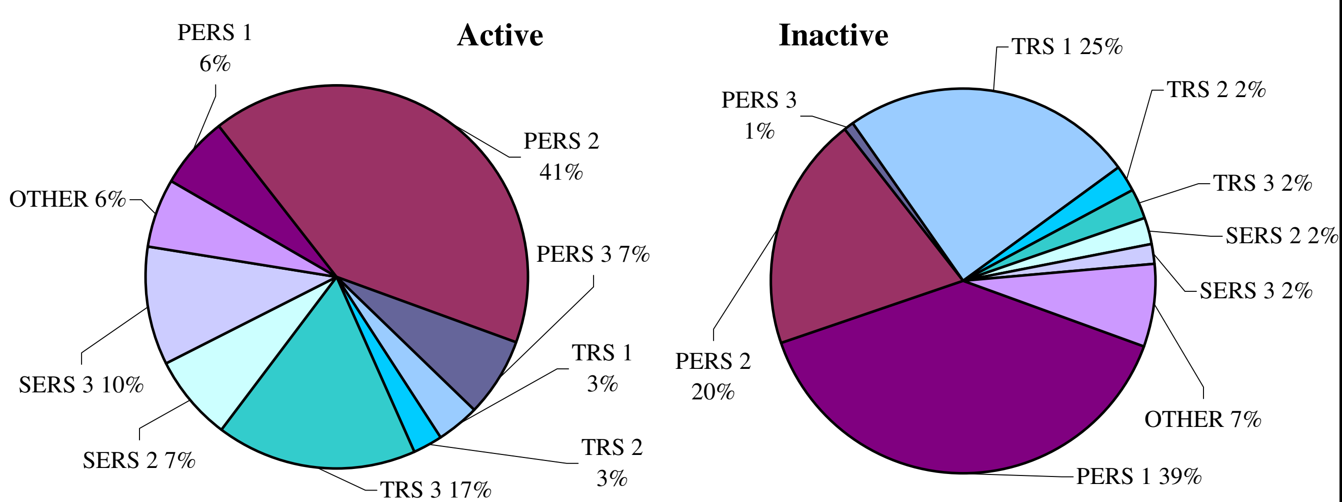
When the $1,000 minimum was first introduced, no annual adjustments were included, essentially making it void once the original benefit calculation plus the annual cost of living adjustment surpassed it in value. However, SB 6453 established a 3 percent annual benefit increase. After remaining fixed for two years, the minimum benefit was raised to $1,030 on July 1.

While employee contributions are fixed at 6 percent of salary, employer contributions vary and are set at the rate needed to fully amortize liabilities by 2024.

Plans 2. PERS 2, SERS 2, and TRS 2 are defined benefit plans with no restrictions on the number of years of employment used in calculating retirement benefits. While normal retirement is set at age 65 with five years of service, members can retire at age 55 with 20 years of service in return for reduced benefits. Plans 2 do not have a minimum benefit provision. Both employee and employer contribution rates vary, depending on the

Figure 1. DRS Membership as of September 30, 2004

Plan	Active	Inactive	Total	Plan	Active	Inactive	Total
PERS 1	17,829	57,561	75,390	SERS 3	29,430	2,516	31,946
PERS 2	118,572	28,860	147,432	LEOFF 1	848	8,117	8,965
PERS 3	19,855	1,506	21,361	LEOFF 2	14,754	953	15,707
TRS 1	9,862	36,099	45,961	WSPRS 1	997	862	1,859
TRS 2	7,470	3,637	11,107	WSPRS 2	60	0	60
TRS 3	49,302	3,302	52,604	JUDGES/JRS	19	145	164
SERS 2	20,424	3,525	23,949	TOTAL	289,422	147,083	436,505



Note: Does not include PSERS, which opened to enrollment on July 1 2006
Source: DRS, 2005

Pension Benefits

Public employee pension benefits are based off of employees' average final compensation. The AFC is calculated using either the 12 or 60 consecutive months of highest earnings, depending on the plan. As a comparison, Social Security benefits are calculated using employees' 35 years of highest earnings.

To keep pace with inflation, retirees receive an annual pension increase, known as a Cost of Living Adjustment (COLA). The TRS 1 and PERS 1 adjustment is currently set at $1.29 per month per year of service. For all other retirees, the adjustment is based off of the percent change in the Seattle Consumer Price Index.

projected benefit cost.

TRS 2 closed in 1996 and SERS 2 closed in 2000, but PERS 2 remains open to new members.

Plans 3. PERS 3, TRS 3, and SERS 3 are dual benefit plans, meaning they have both a defined contribution (DC) and defined benefit component. The DC component is member financed and allows employees to put a portion of their salary into tax-deferred investments. The DB component is employer financed and provides a lifetime monthly benefit to retirees, based off of their average final compensation and years of employment.

Normal retirement is set at age 65 with ten years of service or at age 65 with five years of service if at least one year of service was performed after attaining age 44. Members can retire at age 55 with 10 years of service in return for reduced benefits.

Retired employees with at least 20 years of service credit can delay benefits in return for a 0.25 percent per month increase in the defined benefit portion of their pension.

Plans 3 do not have a minimum benefit provision. All three plans remain open.

Additional retirement systems. The Department of Retirement Systems also administers plans for the Law Enforcement Officers' and Fire Fighters Retirement System (LEOFF), the Washington State Patrol Retirement System (WSPRS), the Judges' Retirement Fund (JRF), and the Judicial Retirement System (JRS), as well as Deferred Compensation and Dependent Care Assistance programs.

PSERS. On July 1 an additional retirement plan became available to public employees. The Public Safety Employees' Retirement System (PSERS) Plan 2 will cover employees in public safety positions. Certain PERS 2 and PERS 3 members are allowed to join. Employees hired into eligible positions are automatically enrolled.

See Figure 2 for an overview of plan membership.

PENSION FUNDING

Pensions are funded through employer and employee contributions, as well as returns on investments. As of November 2004, the market value of Washington's DRS-administered pension assets reached $41.25 billion (OSA, 2005c p. 4). But while assets are accumulating, the cost of providing pensions is also increasing. Under the current funding structure, pension spending is projected to take up more than 3 percent of Washington's 2007-2009 GF-S operating budget, rising to over 5 percent by 2021-2023.

Liabilities. Poor returns on investments, underfunding of programs, and suspension of catch-up payments have led to a recent decline in the ratio of assets to liabilities. On September 30, 2004, Washington pension plans had an overall funding ratio of 91 percent, compared to 93 percent the previous year (DRS, 2005).

UAAL. Of particular concern is the underfunding of the teachers' and pub-

<table>
<tr><th colspan="7">Figure 2. Overview of Washington's Five Largest State Administered Retirement Systems</th></tr>
<tr><th></th><th>Date Closed</th><th>Employee Contribution Rate</th><th>Employer Contribution Rate</th><th>Normal Retirement Eligibility</th><th>Benefit Calculation</th><th>COLA</th></tr>
<tr><td>PERS 1</td><td rowspan="3">9/30/ 1977</td><td rowspan="2">6% of salary</td><td rowspan="2">Balance of cost of benefits, equal to payment to amortize Plan 1 UAAL by 6/30/24 plus estimated annual cost of Plan 2 benefits</td><td rowspan="2">At age 60 with 5 years of service (YOS), at age 55 with 25 YOS, or at any age with 30 YOS</td><td rowspan="2">2% of AFC for each YOS, maximum 60% of AFC</td><td rowspan="2">$1.29 per month per YOS</td></tr>
<tr><td>TRS 1</td></tr>
<tr><td>LEOFF 1</td><td>6% of salary. No contribution required when plan fully funded.</td><td>6% of salary. No contribution required when plan fully funded. State pays remaining cost.</td><td>At age 50 with 5 YOS</td><td>Accrual % times YOS times FAS, regardless of the number of years worked (cap removed in 2006)</td><td>Full CPI</td></tr>
<tr><td>WSPRS 1</td><td>12/31/ 2002</td><td>50% of the annual cost of projected benefits but no less than 2% of salary</td><td>Balance of the cost of benefits</td><td>At age 55, at any age with 25 YOS, mandatory at age 60</td><td>2% of AFC for each YOS, maximum 75% of AFC</td><td rowspan="9">Lesser of CPI or 3%</td></tr>
<tr><td>PERS 2</td><td>Open</td><td rowspan="3">50% of the annual cost of projected benefits, less Plan 3 gain-sharing costs</td><td rowspan="3">Balance of the cost of benefits plus additional payments to amortize Plan 1 UAAL by 6/30/24</td><td rowspan="3">At age 65 with 5 YOS but can retire early in return for reduced benefits</td><td rowspan="3">2% of AFC times YOS, regardless of the number of years worked</td></tr>
<tr><td>TRS 2</td><td>6/30/ 1996</td></tr>
<tr><td>SERS 2</td><td>9/1/ 2000</td></tr>
<tr><td>LEOFF 2</td><td rowspan="5">Open</td><td>50% of the annual cost of projected benefits</td><td>Set at 30% of annual benefit costs. State rate set at 20% of annual benefit costs.</td><td>At age 53 with 5 YOS but can retire early in return for reduced benefits</td><td>2% of AFC times YOS, regardless of the number of years worked. 0.25% per month pre-retirement COLA with 20 YOS.</td></tr>
<tr><td>WSPRS 2</td><td colspan="4">Same as WSPRS 1</td></tr>
<tr><td>PERS 3</td><td rowspan="2">Do not contribute to the defined benefit portion</td><td rowspan="3">Same as Plan 2 employer rates</td><td rowspan="3">At age 65 with 5 or 10 YOS but can retire early in return for reduced benefits</td><td rowspan="3">1% of AFC times YOS, regardless of the number of years worked. 0.25% per month pre-retirement COLA with 20 YOS.</td></tr>
<tr><td>TRS 3</td></tr>
<tr><td>SERS 3</td><td>Required to contribute at least 5% of salary to their defined contribution benefit</td></tr>
<tr><td colspan="7">Source: OSA 2006e and OSA 2005c</td></tr>
</table>

lic employees' Plan 1 retirement programs. According to the Office of the State Actuary (OSA), the Plan 1 Unfunded Actuarial Accrued Liability (UAAL) reached $4 billion in 2004. By law, the UAAL must be fully amortized by June 30, 2024. In order to do this, the cost has been spread to all PERS, TRS, SERS, and PSERS employers.

Underfunding. Back-loading unfunded liability payments will require future contribution rates to increase, yet lawmakers have repeatedly voted to delay funding. In 2003, EHB 2254 suspended UAAL contributions for the 2003-2005 biennium. In 2005, ESHB 1044 suspended contributions for the 2005-2007 biennium.

Employer contributions to the Plan 1 unfunded liability were reinstated during the 2006 legislative session under ESSB 6896, using a three-year phase-in approach. Starting September 1, 2006, TRS employers will contribute an additional 1.29 percent of employee salaries to fund the UAAL and SERS employers an additional 0.87 percent. Beginning January 1, 2007, PERS and PSERS employers will contribute an additional 1.77 percent of salaries.

ESSB 6896 also created a Pension Funding Stabilization Fund and appro-

Figure 3. Projected FY 2005-2011 Pension Contribution Rates

		2005[1]		2006[1]		2007[1]		2008[1]		2009-2011[1]	
		Plan 1	Plan 2/3	Plan 1	Plan 2/3	Plan 1	Plan 2/3	Plan 1	Plan 2/3	Plan 1	Plan 2/3
Employer[2]	PERS	2.44%	2.44%	5.46%[3]	5.46%[3]	6.71%	6.71%	8.27%	8.27%	8.23%	8.23%
	PSERS	NA	NA	NA	8.53%[3]	NA	8.97%	NA	9.85%	NA	10.35%
	SERS	NA	2.94%	NA	4.85%	NA	8.81%	NA	10.11%	NA	10.47%
	TRS	2.92%	2.92%	4.74%	4.74%	8.22%	8.22%	9.99%	9.99%	12.24%	12.24%
	LEOFF[4]	0.19%	4.39%	0.18%	4.90%[5]	0.18%	5.35%	0.18%	5.46%	0.18%	5.39%
	WSPRS	4.70%	4.70%	4.69%	4.69%	7.83%	7.83%	7.83%	7.83%	9.02%	9.02%
Member[6]	PERS	6.00%	2.25%	6.00%	3.50%	6.00%	4.06%	6.00%	4.74%	6.00%	4.20%
	PSERS	NA	NA	NA	6.57%	NA	6.57%	NA	6.57%	NA	6.57%
	SERS	NA	2.75%	NA	3.79%	NA	4.32%	NA	4.74%	NA	4.60%
	TRS	6.00%	2.48%	6.00%	3.01%	6.00%	3.05%	6.00%	3.54%	6.00%	4.41%
	LEOFF[4]	0.00%	6.99%	0.00%	7.85%[5]	0.00%	8.60%	0.00%	8.79%	0.00%	8.68%
	WSPRS	4.51%	4.51%	4.51%	4.51%	6.60%	6.60%	6.60%	6.60%	7.79%	7.79%

Note: Rates based on legislation enacted during the 2006 legislative session. 2007-2011 rates are preliminary estimates based on current plan provisions and funding policy, the 2003 actuarial valuation report, and an 8 percent return on investments.

1. PERS, PSERS, LEOFF and WSPRS rates become effective July 1 while TRS and SERS rates become effective September 1.
2. Employer rates include a 0.19% administrative expense rate.
3. PERS UAAL 0.01% supplemental rate increase for SB 6453 effective 9/1/06; PERS UAAL 1.77% rate phase-in for ESSB 6896 effective 1/1/07; PERS Total Employer Rate from 7/1 to 8/31 is 3.69% (5.47% - 1.77% - 0.01%). PERS Total Employer Rate from 9/1 to 12/31 is 3.69% (5.46% - 1.77%). PSERS Total Employer Rate similarly reduced from 7/1 to 12/31.
4. In addition to the member and local employer, the state contributes to LEOFF Plan 2. To date, no LEOFF Plan 3 exists.
5. 2006 LEOFF 2 rate includes a supplemental rate that becomes effective 9/1/06.
6. Plan 3 members do not contribute to the defined benefit portion of their retirement benefit.

Source: OSA, 2006d

Benefit Creep

Rather than focus on cost containment, some lawmakers appear intent on expanding retirement benefits. The prevailing logic seems to be that if a benefit is offered to a few, it is only fair that it be offered to all. However, attempts to promote "equality" are often misguided and one-sided. Other times, insufficient attention is given to the actual impact of benefit expansions. As a result, benefits that were supposed to be temporary remain in place and benefits that were supposed to be revenue-neutral turn costly.

The June 2006 meeting of the Select Committee on Pension Policy illustrates the problem. "Consistency between the plans" was the phrase of the day: If law enforcement officers and fire fighters are eligible for a death benefit for a death resulting from a duty-related illness, why not others? If most dual members get to include all of their years of service when calculating their retirement benefits, why should Plan 1 dual members be restricted by their 30 year cap? If certain public employees are allowed to purchase 24 months of service credit due to injury, why are others limited to shorter periods? Maybe these are good questions. But a true attempt to create plan equality would involve a comparison of the various benefits and costs of each plan, not cherry picking select issues.

The "Rule of 90" provides another example. While originally presented as an alternative to gain-sharing, it was introduced separately during the 2006 legislative session. The bill proposed providing full retirement benefits to members whose age and number of service years totaled 90 or more, essentially providing a benefit improvement to anyone hired before age 40. Had it passed, the Rule of 90 would have led more people to retire, increased the number of retirees eligible for subsidized medical benefits, and cost employers an estimated $3.2 billion over the next 25 years. While the bill failed to make it to the floor for a vote, it will likely reappear during the 2007 legislative session.

priated $350 million of the 2006 supplemental budget to the account. About $49 million will be spent during the 2005-2007 biennium.

In addition, the legislature passed HB 2681. Beginning in 2009, the bill establishes minimum state and employer contribution rates in order to amortize the Plan 1 unfunded liability. The bill also establishes a process for determining minimum employer and employee contribution rates for the normal cost of Plans 2 and 3. See Figure 3.

While the pension stabilization account and increased contribution rates help put pension funding back on track, plans remain underfunded.

Pension Alternatives. Across the nation, state and local governments are considering making changes to current and future pension plans. Strategies being considered include: making additional up-front payments, stretching out payments over a longer period of time, issuing pension obligation bonds, trimming benefits, consolidating programs, aiming for low but guaranteed investment income, using unorthodox investments, changing the calculation method of benefits, raising employee contribution rates, switching to 401(k)-style defined contribution plans, attaching sunset provisions to any new pension benefit, requiring the identification of new funding sources if benefits are to be expanded, and changing the benefit package for new employees.

GAIN-SHARING

The enactment of "gain-sharing" has further strained Washington's pension funding. Established in 1998, gain-sharing provides benefits for current and future PERS 1 and TRS 1 retirees as well as term-vested, active, and retired members of PERS 3, TRS 3, and SERS 3. For employees that qualify, distributions are triggered when the four-year compound average rate of investment returns exceed 10 percent. When this happens, half of the Plan 3 returns over 10 percent are distributed to members' DC accounts and half of the Plan 1 returns over 10 percent are used to increase members' Uniform COLA (a monthly benefit increase designed to keep pensions inline with inflation).

Gain-sharing distributions potentially take place in January of even-numbered years. Since its introduction, there have been two gain-sharing events.

Cost to Date. In 1998 gain-sharing increased the Plan 1 Uniform COLA by 10 cents, meaning retirees received 74 cents per month per year of service instead of 64 cents. Gain-sharing increased the Uniform COLA by an additional 28 cents in 2000.

For TRS 3 members, the 1998 gain-sharing distribution gave eligible members $134.43 per year of service and the 2000 distribution gave members an additional $254.23 per year of service. Although PERS 3 and

Figure 4. Projected Cost of Future Gain-sharing Events (in millions, 2006-2031)

	Plan 1 Members	Plan 3 Current Members	Plan 3 Future Members	Total
State	$1,390.4	$763.6	$2,183.0	$4,337.0
Local	$998.7	$552.7	$1,951.3	$3,502.7
Total Employer	***$2,389.1***	***$1,316.3***	***$4,134.3***	***$7,839.7***

Source: SCPP, 2005b p. 11

SERS 3 were opened to enrollment after gain-sharing was first established, legislation has allowed many members to receive this benefit as well.

The remaining extraordinary returns on investments were used to lower the Plan 1 unfunded liability.

In total, over $2 billion has been allocated to temporarily pay down the Plan 1 unfunded liability and to members in the form of increased benefits.

What Comes Up Must Come Down. Lawmakers originally assumed that gain-sharing would pay for itself. But with the recent recession, investment returns declined below the 10 percent gain-sharing threshold. Still, because gain-sharing events permanently increase the Uniform COLA, Plan 1 members continue to receive higher benefits.

Even when gain-sharing appeared "cost free," it directed money away from future retirement obligations and lowered the average rate-of-return on investments. With lower investment returns, future government contributions must increase.

The 2003 Actuarial Valuation Report (AVR) found that gain-sharing adds an estimated $622 million to the present value of the fully projected benefits liability in Plans 2/3 and increases the unfunded liability of Plan 1 by $930 million.

If left intact, gain-sharing will cost an additional $7.8 billion over the next 25 years as a result of future gain-sharing events and new member enrollments. Because of the Plan 1 and Plan 3 funding structure, the cost will be born entirely by employers. See Figure 4.

The next gain-sharing event could take place as early as January 2008. The 2004 and 2005 returns on investment were 16.06 and 13.34 percent, respectively and, so far, 2006 investment returns appear strong (OSA, 2006a).

Despite costs, gain-sharing is still not adequately funded or recognized. And while the 2003 AVR included gain-sharing costs in its projections, the OSA was instructed by lawmakers to exclude costs from the 2004 AVR. Likewise, in 2005, lawmakers delayed recognizing the cost of gain-sharing until after the 2007-2009 biennium.

Reform. In lieu of contribution rate increases, the 2005 legislature directed the Select Committee on Pension Policy (SCPP) to review gain-sharing policy options. The committee released their findings in December 2005.

The SCPP originally recommended replacing gain-sharing with a less costly and more certain alternative. However, upon receiving information regarding potential conflicts with Internal Revenue Service retirement plan regulations, the committee recommended continued study in the 2006 interim instead.

A number of gain-sharing related bills were introduced during the 2006 legislative session. None passed.

Summary of Adopted 2006 Pension Legislation and the 2006-2031 Fiscal Impact for Employers

ESHB 2680: Allows TRS 2 and TRS 3 members to purchase service credit for education experience outside the state of Washington. No fiscal impact.

HB 2681: Established minimum contribution rates. No fiscal impact.

SHB 2684: Reduced the vesting period for Plan 3 members from ten to five years. $142.8 million.

ESHB 2685: Made eligibility changes to the newly established PSERS system. No fiscal impact.

SHB 2688: Removed the LEOFF 1 benefit cap. No fiscal impact if the plan remains in a surplus.

HB 2690: Allows members to purchase additional service credit. No fiscal impact.

SHB 2691: Created optional public retirement benefits for justices and judges. No fiscal impact.

HB 2932: Established a catastrophic disability retirement allowance for LEOFF 2 members. $18.4 million.

SHB 2933: Provides a $150,000 death benefit to survivors of a LEOFF 2 member who dies as a result of a disease arising from employment. $6.7 million.

SHB 3137: Clarified the benefit for surviving spouses of disabled WSPRS members. $14.4 million.

SB 6453: Extended the PERS 1 and TRS 1 alternative minimum benefit to members with at least 20 years of service who have been retired for at least 25 years. Also added a 3 percent annual increase to the $1,000 minimum benefit. $40.8 million.

SB 6723: Reimbursed surviving spouses and dependent children of LEOFF 2 members killed in the course of duty for the cost of PEBB health insurance. $15.9 million.

ESSB 6896: Reinstated employer contribution rates for the unfunded accrued liability in PERS 1 and TRS 1 and created a pension funding stabilization account. -$11.1 million.

Net fiscal impact for employers (not including administrative expenses): $227.9 million.

Legal Concerns. Although gain-sharing laws include a “non-contractual rights” clause that allows the legislature to amend or repeal it, any benefit reduction will likely invite both public employee opposition and lawsuits. Still, Attorney General Rob McKenna has made it clear that the explicit language included in the bills allows for program cancellation at any time.

Legal and political concerns aside, gain-sharing was passed as a low-cost way to increase benefits. Now that the true cost of this program has been brought to light, lawmakers can no longer afford to ignore this liability.

DEMOGRAPHIC CHALLENGES

In addition to fiscal concerns brought about by low investment returns, plan underfunding, and benefit expansions, retirement systems face demographic challenges.

An estimated 11.3 percent of Washingtonians (696,988) were age 65 or older in 2004. By 2030, the number of elderly will have increased to 1,660,075, representing approximately 19.4 percent of the population (OFM, 2005).

The number of public sector workers nearing retirement is even greater. Within the next decade, 64 percent of Washington’s full-time public employees will reach retirement eligibility – the highest rate in the nation (GPP, 2005; OSA, 2005b p. 41). While many will choose to remain in the workforce, the number of retirements is projected to steadily increase.

As a result, state and local governments anticipate a substantial drain on their retirement funds, along with the potential loss of institutional memory and expertise.

Many strategies are being implemented to lessen the impact. In 2000, the Washington State Department of Personnel released a workforce planning guide to assist employers in “providing strategic methods for addressing present and anticipated workforce issues.” More recently, Marty Brown, legislative liaison for Governor Gregoire, encouraged the use of succession planning and mentoring (Honoré, 2005). Another response has been to expand “retire-rehire” opportunities.

RETIRE-REHIRE

While many public employees are nearing retirement eligibility, employers are particularly concerned with the retirement of PERS 1 and TRS 1 employees. Unlike Plans 2 and 3, Plan 1 caps the number of service years used in calculating employees’ pension benefits so many members choose to retire after 30 years, regardless of their age or desire to remain in the workforce. If large numbers of these seasoned workers were to retire, there

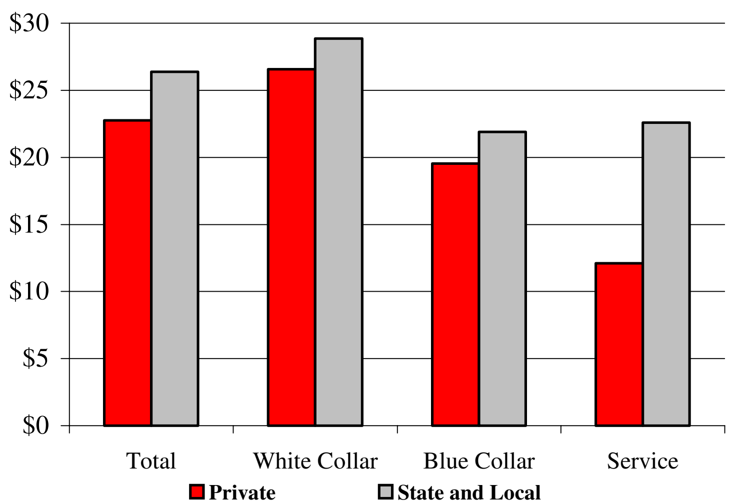
Higher benefits for lower pay?

While nearly all public sector employees participate in pension plans, the Bureau of Labor Statistics reports that an estimated 60 percent of private sector workers have access to retirement plans and only 50 percent participate. Twenty-one percent of workers participate in a defined benefit plan and 42 percent in a defined contribution plan. (Some employees participate in both plan types.) Most public sector workers participate in defined benefit plans, although some of the newer plans – notably Washington's PERS 3, TRS 3 and SERS 3 – include a defined contribution component as well.

Despite mounting liabilities, many public employers resist any changes to benefits, arguing generous retirement plans are needed to attract workers to the public sector. But while lower pay is often cited as a justification for high public employee benefits, New York's Citizens Budget Commission recently found that "Most government workers are paid more than their private sector counterparts." A preliminary look at wages supports this statement.

According to the Bureau of Labor Statistics, state and local government workers in Seattle, Tacoma and Bremerton earn higher hourly wages than their private sector counterparts in service, white collar, and blue collar occupations. (The difference in earnings is less significant when sales jobs are excluded.) While average wages are greater, earnings vary by industry, with some public sector classifications earning far less than their nongovernmental counterparts. Nonetheless, the trend is clear. Over time, public sector wages have caught up with, and in many cases, surpassed pay in the private sector.

Public vs. Private Sector Hourly Earnings*



* Mean hourly earnings for full time workers in selected occupations as of January 2005.

Source: BLS, "Seattle-Tacoma-Bremerton, WA, National Compensation Survey, January 2005," September 2005, Bulletin 3130-04.

is some concern that employers will be less able to retain their experience base and address labor shortages. To prevent this, legislation passed in 2001 expanding post-retirement employment opportunities for Plan 1 public employees. (The bill originally contained a sunset clause but the provision was vetoed by Governor Gary Locke.)

Fiscal Impact. According to the OSA, the expansion of the retire-rehire program has encouraged earlier retirement and greater utilization of retire-rehire opportunities. While not a direct benefit enhancement, the expansion imposes large costs on the pension system. Greater than anticipated retirements requires earlier funding of benefits and longer payout times, and the loss in member contributions to the trust fund reduces revenues.

The OSA estimates that the retire-rehire expansions, if left intact, will cost an estimated $101.5 million over the next 25 years. If the same experience of greater than anticipated retirements continues into the future, the cost of the post-retirement employment program will be even higher.

Retire-rehire restrictions were somewhat tightened in 2003, particularly for PERS 1 employees. A number of Plan 1 retire-rehire bills were introduced during the 2004, 2005 and 2006 legislative sessions, but no major changes have been made.

OTHER POSTEMPLOYMENT BENEFITS

In addition to pensions and salaries, many public employers provide "other postemployment benefits" (OPEB) as part of the total compensation offered to attract and retain employees. OPEB includes benefits such as medical, prescription drug, dental, vision, life insurance, disability, and long-term care. Of these benefits, health care is the most common and generally the most costly.

Coverage. The benefit packages offered by governments vary greatly across states and plans. But, according to the SCPP, every state makes health insurance available to retirees up to the age of 65, and 48 states provide coverage for retirees age 65 and older. For retirees under age 65, the benefits are usually similar to the coverage received while working. For retirees age 65 and older, benefits are usually coordinated with Medicare.

Funding. While historically small, the cost of

Private Sector OPEB

Like the public sector, private sector employers are faced with the challenges of rising health care costs and changing accounting standards. In response, many employers have begun "a major overhaul of their retiree health benefit programs" (EBRI, 2005 p. 69).

A common strategy has been to reduce benefits by increasing retiree contributions to premiums, increasing cost-sharing requirements, terminating subsidies for future retirees, shifting to defined contribution plans, and/or imposing new caps.

Many employers have removed benefits entirely. According to Kaiser and Hewitt, the percent of large U.S. firms offering retiree health benefits declined from 66 percent in 1988 to 33 percent in 2004.

providing retiree health care now rivals pensions. With the "baby boomer" generation beginning to retire and with beneficiaries living longer, cost pressures are further exacerbated.

Despite costs, very few governments have kept track of mounting liabilities and most continue to fund benefits in the year that they are used, through what is known as the "pay-as-you-go" approach. However, new accounting rules require states and localities to account for promises.

Accounting Changes. The Governmental Accounting Standards Board (GASB) recently issued two statements regarding OPEB, Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pension*. The new accounting standards are intended to improve information regarding the cost of providing benefits, the commitments that governments have made, and the extent to which commitments have been funded.

Analysts and government agencies are scrambling to comply. Several states have already conducted preliminary actuarial studies and the "numbers are shocking" (O'Connor, 2005 p. 17). According to GASB Project Manager Dean Mead, the financial impact of these benefits will likely amount to hundreds of billions of dollars. Standard & Poor's Ratings Services recently estimated the total liability to be as high as $500 billion (Prah, 2006).

Calculating the Liability. Actuaries and accountants will determine the liability based on certain assumptions regarding factors such as health care costs, retirement rates and ages, retiree mortality, contributions, benefit utilization, Medicare coverage, and the interest rate used to discount future benefit payments to the present. If benefits are pre-funded, the discount rate will likely be between 7 and 8 percent but if employers continue under the pay-as-you-go method the discount rate will likely be between 2 and 5 percent (SCPP, 2005). According to Milligan, a one percent decrease in the discount rate could cause a 15 to 20 percent increase in liabilities (Botsford, 2005).

WASHINGTON OPEB OBLIGATIONS

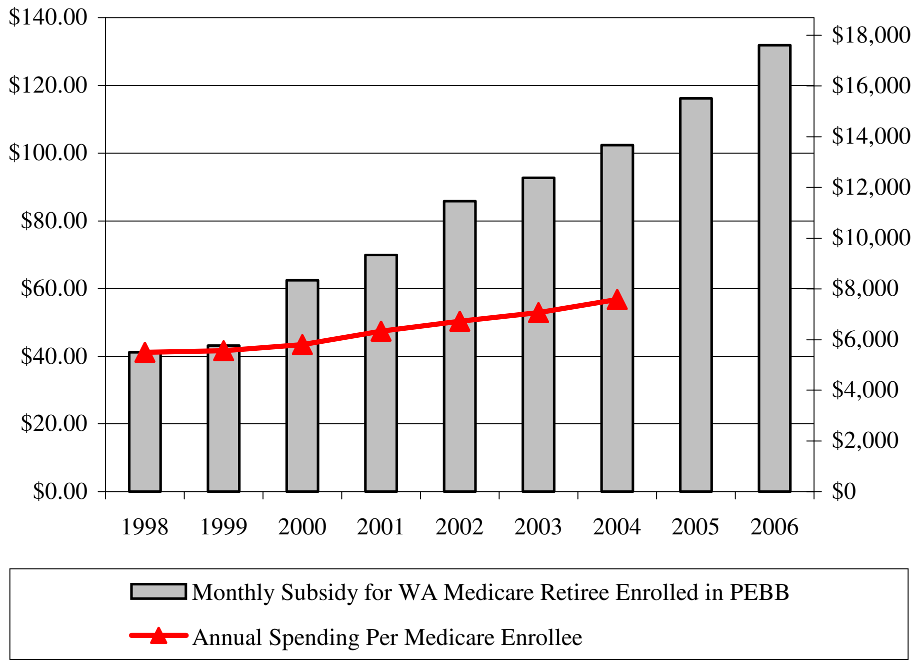
Washington authorities have yet to complete their actuarial valuations but the SCPP released a report last year highlighting the potential implications of GASB 43 and 45 implementation. According to the committee, the new accounting standards will impact the financial statements of public employers who subsidize retiree medical premiums.

PEBB. Retired state, K-12, and higher education employees are eligible to receive government subsidized medical benefits through the Public Employees Benefits Board (PEBB). PEBB also covers certain local governments.

According to the SCPP, pre-Medicare enrolled members currently receive an implicit subsidy of $375 a month. Medicare enrolled members receive an explicit subsidy of $132 per month.

The explicit subsidy increased 220 percent between 1998 and 2004. As a

Figure 5. Washington PEBB Retiree Subsidies for Medicare Eligible Members Compared to National Medicare Spending per Enrollee



Source: http://www.cms.hhs.gov/NationalHealthExpendData/downloads/tables.pdf
http://www.pebb.hca.wa.gov/doc/meetings/071205presentation.ppt

comparison, National Medicare spending per enrollee increased 38 percent over the same period. See Figure 5.

The total Washington state subsidy for retirees participating in PEBB was approximately $223 million for the 2003-2005 biennium. Using the rule of thumb that OPEB expense will be between five and 10 times the pay-as-you-go cost, the SCPP projects that the reported expense for retirees receiving medical benefits through PEBB would have been between $1 and $2 billion for the 2003-2005 biennium alone.

LEOFF 1. LEOFF 1 members receive 100 percent employer funded medical benefits upon retirement. The fiscal liability of providing these benefits was recently estimated at over $1 billion for cities, counties and fire districts (AWC, 2006). Obligations remain almost entirely unfunded.

Attempts to use the LEOFF 1 pension surplus to fund LEOFF 1 retiree health care remains politically unpopular.

Funding Options. To reduce costs, governments may seek concessions from employees by decreasing or capping benefits, closing off existing benefit levels to new employees, converting plans from defined benefit to defined contribution, instituting or increasing member contribution levels, or increasing employee co-pays.

Employers may also begin pre-funding obligations. While funding is not required, GASB 45 does establish a pre-funding framework. If these funds are then invested, investment returns could help reduce long-term costs. And, if the funds are placed in a qualifying trust, employers can take advantage of better discount rates when reporting liabilities. This in turn will help governments maintain their credit level.

Governments can also issue OPEB obligation bonds. If the investment yield from the bond assets exceed the interest paid to bond holders, the proceeds can be used to reduce liabilities. However, issuing bonds is risky as investment returns are not guaranteed.

DISCUSSION

Coupled with changes in accounting standards and workforce demographics, the rising cost of retirement has led many private sector employers to reduce benefits. But public employers have been reluctant to follow suit, despite the diminishing difference between public and private sector salaries. And while continuing to provide these benefits, state and local governments have failed to properly account for and fund obligations. The resulting liabilities threaten to squeeze public budgets for years to come.

Public employees defend their benefits, arguing governments are to blame for their failure to anticipate future costs. But it's not governments that will be held accountable, it's taxpayers – be it through higher taxes, reduced services, or a combination of both.

While public employees provide a valuable service, and while government should strive to maximize the effectiveness of plan provisions, the focus needs to be on cost containment. Past mistakes cannot be allowed to worsen. It is time for lawmakers to balance benefits with budgetary realities.

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