POLICY
brief

Washington Research Council

PB 07-04 February 22, 2007

GAIN-SHARING PAIN SHARING

BRIEFLY

The gain-sharing program was intended to be a cost-free way to enhance retirement benefits for state employees. But the economists' truism *there is no free lunch* has never been more true. The state pension system-cannot afford this program.

As we explained in our 2006 brief titled, "Misguided Pension Benefit May Cost Billions," Washington's pension deficit can be attributed to a number of factors, including poor returns on investments during the recent economic slowdown, historic under-funding of programs, and continued benefit expansion, of which "gain-sharing" is the most prominent example.

Under gain-sharing, instituted in the late 90s, any extraordinary returns on pension reserve investments are used to boost state pension benefits. So far there have been two gain-sharing events, with another expected in 2008. This program was intended to be a cost-free way to enhance retirement benefits for state employees. But the economists' truism *there is no free lunch* has never been more true. The state pension system cannot afford this program.

The 2006 legislature grappled with the issue of gain-sharing and the increasing pension deficit but was unable to reach a solution. Now, in the 2007 session, legislators have taken up the issue once again, this time with the governor supporting the termination of the gain-sharing program after the 2008 event.

GAIN-SHARING

Gain-sharing was established in 1998 after the investment boom of the mid 90s. It provides benefit enhancements for current and future Public Employees' Retirement System Plan 1 (PERS 1) and Teachers' Retirement System Plan 1 (TERS 1) retirees as well as term-vested, active and retired members of PERS 3, TERS 3, and School Employees' Retirement System Plan 3 (SERS 3).

Under the current system, those who qualify receive gain-sharing distributions when the compounded annual rate of return on investments is 10 percent or more over four years in a row. When this occurs, half of the returns over 10 percent are used to increase Plan 1 members' post retirement uniform cost-of-living-adjustments (COLA) and Plan 3 members' defined contribution accounts.

Gain-sharing distributions potentially take place in January of even numbered years.

GAIN-SHARING TO DATE

There have so far been two gain-sharing events. In 1998 Plan 1 members received a 10-cent Uniform COLA increase, while eligible TRS 3 mem-

Washington Research Council
108 S Washington St., Suite 406
Seattle WA 98104-3408
voice: 206-467-7088
fax: 206-467-6957
www.researchcouncil.org

bers were allocated $134.43 per year of service for the 1998 gain-sharing distribution.

In 2000, Plan 1 members received a 28-cent uniform COLA increase per month per year of service. Plan 3 members had $254.23 per year of service credited to their accounts.

In total, over $2 billion has been allocated either to pay down the Plan 1 unfunded accrued actuarial liabilities (UAAL) or to increase members' benefits.

Problems with Gain Sharing

Gain-sharing was intended to augment state employee benefits by using extraordinary stock market returns at essentially no cost to taxpayers. Gain-sharing was supposed to pay for itself. But periods of high growth are eventually balanced with periods of low growth.

As we pointed out in last year's brief, gain-sharing taps money that would otherwise cover future retirement cost obligations. Giving away returns in peak years essentially lowers the average rate-of return on pension fund investments. Contribution rates will have to be raised in the future to compensate.

With the recent recession, investment returns have declined but members continue to receive increased benefits. Because of the way the law was written, the excess investment returns become part of the base pension rather than a one-time distribution.

The Actuarial Valuation Report (AVR) in 2003 estimated that gain sharing will add $622 million to the present value of the fully projected benefits liability in Plans 2/3 and increase the UAAL of Plan 1 by $930 million (SCPP 2005, p. 1). If it is continued, gain-sharing is projected to cost state and local governments $7.8 billion over the next 25 years.

It is very likely that the next gain sharing event will occur in 2008, with the amount to be distributed based on investment returns from 7/1/2003 to 6/30/2007. The 2008 gain sharing increase is projected to result in an annual COLA increase of 26-cents per month per year of service. Estimates for the Plan 1 cost of the 2008 gain-sharing event are between $351 million and $650 million (depending on investment returns between now and 6/30/2008) and estimates for the Plan 3 cost are $136 million to $252 million. The total will likely be around $760 million distributed to the two plans.

Sharing the Pain

Several bills have been introduced this session to reform the gain-sharing system.

The governor's plan to reform gain-sharing is laid out in SB 5779 and its companion House Bill 1771. Under this proposal Plan 1 and Plan 3 gain sharing would be discontinued after the 2008 gain-sharing event. If the 2008 distribution results in less than a 23-cent adjustment to the annual increase amount there could be up to a 5-cent additional increase in 2009. Actuaries evaluate this promise as equivalent to a 2-cent uniform COLA increase for Plans 1, which would cost the state nearly $90 million over the next 25 years.

Also in this bill, new TRS and SERS members, who now all go into Plan 2, would be given a choice between Plans 2 and 3. Plan 2 costs the state slightly more than Plan 3. In addition, Plan 3 members hired before July 1, 2007 would have the option of joining the Assured Benefit Program (APB). This program allows retirees to receive a 1 percent annuity even if the funds in their ABP account are insufficient to cover the 1 percent.

In total this bill is expected to save state and local governments $5.4 billion over twenty-five years. The Plan 2/3 choice is predicted to cost $302 million, and the Assured Benefit Program is expected to cost $944 million. This is offset, however, by the elimination of gain-sharing, which would save $6.7 billion.

Several other bills are currently in front of the legislature.

HB 2116 would increase the investment return threshold that triggers gain-sharing distributions to 14 percent over the previous four years. The savings from this increase are projected to be $2.25 billion over twenty-five years. This bill also limits gain-sharing benefits to Plans 1 and 2 and Plan 3 members hired before July 2007, which would save $3.2 billion. In order to amortize the UAAL in PERS 1 and TERS 1 this bill establishes additional employer contribution rates for PERS, TRS, SERS, and PSERS, which saves $4.54 million. An additional employer contribution rate increase to pre-fund the 2008 gain-sharing event would save $117 million. The bill would also allow TRS and SERS members to decide between Plans 2 and 3.

SB 5668 limits gain-sharing benefit distributions to employees hired before July 2007 but it keeps the 10 percent trigger saving $3.2 billion. It also gives newly hired SERS and TRS members a choice between Plans 2 and 3.

References

Washington Research Council (WRC). 2006 “Misguided Pension Benefit May Cost Billions.” Policy Brief 06-05. January 27. http://www.researchcouncil.org/publications_container/gainsharing_report_jan_26_2006.pdf

Text of bills and fiscal analyses (fiscal notes) can be found on the web at http://apps.leg.wa.gov/billinfo/