Washington Research Council

POLICY brief

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Misguided Pension Benefit May Cost Billions

BRIEFLY

Gain-sharing was passed as a short-term benefit, not a long-term obligation. Now that the true cost of this program has been brought to light, lawmakers can no longer afford to ignore this liability. Delaying payments only increases costs and replacing gain-sharing with a less expensive alternative will not sufficiently address pension shortfalls.

Government pension systems throughout the country are experiencing large budget shortfalls. In Washington, lawmakers are faced with a $4 billion unfunded pension liability.

Fiscal experts link Washington's pension deficit to a number of factors, including poor returns on investments during the recent economic downturn, historic underfunding of programs, recent suspension of catch-up payments, and continued benefit expansions.

This report focuses on the impact of "gain-sharing" on Washington's pension system. While the program was originally assumed to provide additional retirement money to public employees at no direct cost to taxpayers, gain-sharing is now recognized as a material liability to state and local governments.

GAIN-SHARING ENACTED

During the 1990s investment boom, many states chose to use higher than anticipated returns to expand public employee retirement plans. In Washington, these benefit enhancements were tied directly to the future investment performance of the plan's assets – through what is referred to as gain-sharing.

Gain-sharing, established in 1998, provides benefits for current and future Public Employees' Retirement System Plan 1 (PERS 1) and Teachers' Retirement System Plan 1 (TRS 1) retirees as well as term-vested, active, and retired members of PERS 3, TRS 3, and School Employees' Retirement System Plan 3 (SERS 3). For employees that qualify, gain-sharing distributions are triggered when the compounded annual rate of return on investments is 10 percent or more for four years in a row. When this happens, half of the returns over 10 percent are used to increase Plan 1 members' post retirement Uniform cost-of-living adjustment (COLA) and Plan 3 members' defined contribution accounts.

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

GAIN-SHARING COST TO DATE

For Plan 1 members, there was a 10-cent Uniform COLA increase in 1998 and a 28-cent increase in 2000. These benefit enhancements, combined with annual adjustments for cost-of-living, resulted in the Uniform

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Gain-sharing funding and membership

Washington administers eight different state and local government pension systems. Three of these plans — PERS, TRS, and SERS — offer gain-sharing benefits to many of its members, depending largely on their date of hire.

PERS covers state employees, employees of all counties and most cities, non-teaching employees of institutions of higher learning, judges first elected or appointed after June 30 1998, and employees of ports, service districts, Energy Northwest, and public utility districts. SERS covers classified school district employees and TRS covers certified teachers, administrators, and educational staff associates.

TRS 1 and PERS 1 are defined benefit plans, meaning members pay six percent of their salary towards the cost of their benefit. Employer contribution rates vary and are set at the level necessary to pay off total costs by 2024.

Plan 3 member contributions are chosen by the member upon joining and are deposited directly into individual contribution accounts. Plan 3 employer contributions vary.

Because of the Plan 1 and Plan 3 funding structures, any benefit increases, including gain-sharing, are paid entirely by employer contributions (SCPP, 2005, p. 1-2).

Figure 1. Example of Benefit Increase for a Plan 1 Member with 30 Years of Service and a $1,200 Monthly Benefit on July 1, 1997

Date	COLA Increase	Gain-sharing[1]	Uniform COLA	Increase Amount	Monthly Benefit	Benefit if no Gain-sharing[2]
7/1/1997	$0.02		$0.63	$18.90	$1,200.00	$1,200.00
7/1/1998	$0.01	$0.10	$0.74	$22.20	$1,222.20	$1,219.20
7/1/1999	$0.03		$0.77	$23.10	$1,245.30	$1,239.30
1/1/2000		$0.28		$8.40	$1,253.70	$1,239.30
7/1/2000	$0.03		$1.08	$32.40	$1,286.10	$1,260.30
7/1/2001	$0.03		$1.11	$33.30	$1,319.40	$1,282.20
7/12002	$0.03		$1.14	$34.20	$1,353.60	$1,305.00
7/1/2003	$0.04		$1.18	$35.40	$1,389.00	$1,329.00
7/1/2004	$0.03		$1.21	$36.30	$1,425.30	$1,353.90
7/1/2005	$0.04		$1.25	$37.50	$1,462.80	$1,380.00

Source: SCPP, 2005, p. 14 and WRC calculations

[1] Uniform COLA increases occurred in July of each year; 1998 gain-sharing took place in July while 2000 gain sharing took place in January.

[2] The monthly benefit will be even less if the maximum annual COLA increase was three percent, rounded to the nearest cent.

COLA reaching $1.25 (per month per year of service) in 2005. This means that, for a Plan 1 retiree with 30 years of service, there was a $37.50 monthly benefit increase in 2005 (SCPP 2005, p. 14). To date, $924 million has been distributed to members in the form of permanent increases to the Uniform COLA and an additional $924 million to accelerate the amortization of Plan 1 (p. 15).

For TRS 3 members, the 1998 gain-sharing distribution allotted $134.43 per year of service to eligible members and the 2000 distribution gave an additional $254.23 per year of service (SCPP, 2005, p. 15). Although SERS 3 and PERS 3 were established after the gain-sharing distribution, legislation has allowed many of these members to receive this benefit as well.

In total, over $2 billion has been allocated to pay down the Plan 1 unfunded accrued actuarial liabilities (UAAL) and to members in the form of increased benefits (SCPP, 2005, p. 15).

FACING FACTS

Washington lawmakers originally assumed that gain-sharing would pay for itself. But periods of high returns are eventually balanced with periods of low returns.

With the recent recession and dot-com bust, investment returns have declined below the 10 percent gain-sharing threshold. Still, because of the way the law was written, members continue to receive increased benefits. This is because, instead of making the excess investment returns a one-time distribution, lawmakers allowed it to become part of the base pension for eligible public employees. See Figure 1.

Even when gain-sharing appeared "cost free," it directed money away from future retirement cost obligations. By using temporary investment gains to raise benefit levels, legislators essentially lowered the average rate-of-return on investments (SCPP, 2005, p. 12). To compensate, contribution rates will have to be raised in the future.

Figure 2. Projected Cost of Gain-sharing (in millions)

		Plan 1 Members	Plan 3 Current Members	Plan 3 Future Members	Total
2007-2009	State	$104.8	$90.6	$33.0	$228.4
	Local	$74.9	$69.4	$30.3	$174.6
	Total Employer	***$179.7***	***$160.0***	***$63.3***	***$403.0***
2006-2031	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, 2005, p. 11

FUTURE COST

According to the Office of the State Actuary (OSA), the Plan 1 UAAL has reached $4 billion — $1.416 billion for TRS and $2.620 billion for PERS. A large portion of this liability is attributable to the post-funding of gain-sharing benefits.

The 2003 Actuarial Valuation Report (AVR) found that future gain sharing will add an estimated $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).

Despite future costs, gain-sharing liabilities are still not adequately funded or recognized (SCPP, 2005 p. 11). And while the 2003 AVR included gain-sharing costs in its projections, the OSA was instructed by lawmakers to exclude future benefits from the 2004 AVR (OSA, 2005b, p. 8).

If left intact, gain-sharing is projected to cost state and local governments an estimated $7.8 billion over the next 25 years. See Figure 2.

FUNDING SHORTFALLS

Lawmakers have repeatedly voted to underfund the pension system by delaying cost recognition and payments. In 2003, EHB 2254 suspended employer contributions towards PERS 1 and TRS 1 unfunded liabilities for the 2003-2005 biennium. Funding was again suspended in 2005.

For the 2005-2007 biennium pension contribution rate recommendations, the OSA included pre-funding for gain-sharing and money to pay down the Plan 1 unfunded liabilities (Washington State Legislature, 2005b). However, pension funding legislation was adopted in 2005 that removed these costs from the contribution rates.

ESHB 1044 delayed recognizing the cost of future gain-sharing benefits and suspended UAAL contributions until after the 2005-2007 biennium. The bill also changed the employer and Plan 2 member contribution rates over the next four years in order to phase–in projected future contribution rate increases (Washington State Legislature, 2005a). See Figure 3.

While delaying payments may temporarily "save" $147 million in gain-sharing and $176 million in UAAL payments, the lag in contribution increases will cost taxpayers an additional $552 million over the next 25

Figure 3. 2005-2007 Contribution Rate Comparison				
		OSA Rates	Rates Under ESHB 1044	
		2005-2007 Biennium	FY 2006	FY 2007
Employer Rates	PERS	5.73%	2.25%	3.50%
	TRS	6.74%	2.73%	3.25%
	SERS	7.56%	2.75%	3.75%
Plan 2 Member Rates	PERS	3.38%	2.25%	3.50%
	TRS	2.48%	2.48%	3.00%
	SERS	3.51%	2.75%	3.75%
Source: Final Bill Report ESHB 1044				

years and will require increased contribution rates in the future.

SCPP RECOMMENDATIONS

In December 2005, the Select Committee on Pension Policy (SCPP) released their gain-sharing findings. As directed by the legislature, the SCPP reviewed a number of policy options including repealing, suspending, or replacing gain-sharing, delaying the inclusion of gain-sharing costs, and changing the timing of gain-sharing funding. See Figure 4.

The SCPP originally recommended replacing the gain-sharing provision with a less costly, more certain, and more inclusive 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 (SCPP, 2005, p. 6 & 35).

ON THE AGENDA

With healthier than anticipated general fund revenues, lawmakers in the 2006 session are faced with an additional $1.45 billion to either spend or put into reserves. Governor Christine Gregoire has proposed using $176 million of this to pay down the pension system budget gap; $127 million would be placed in a new Pension Funding Stabilization Account to fund a portion of upcoming pension obligations and the remaining $49 million would go directly towards current obligations.

Some legislators are advocating for spending as much as $300 million of the supplemental budget on the pension program. Others support either repealing or amending the gain-sharing benefit.

A number of gain-sharing related bills have already been introduced this session, including ones that would adjust gain-sharing increase amounts, replace gain-sharing with changes to other pension benefits, and/or make changes to contribution rates. Additional bill proposals are expected.

LOCAL GOVERNMENTS

Cities and counties employ a large fraction of government workers and the SCPP estimates that local governments are liable for approximately 45 percent of the projected gain-sharing cost over the next 25 years (2005, p. 11). But while the state can take advantage of additional revenues to pay down the unfunded liability and gain-sharing costs, local governments will have difficulty finding additional funding. Therefore, many cities are urging legislators to delay any rate adjustments until 2007 (AWC, 2005).

Figure 4. Gain-Sharing Reform Options Considered by the SCPP

Options	Description	Fiscal Impact	Legal Concerns
Repeal and not Replace	Eliminate gain-sharing liability completely	Will significantly lower future cost of pension system	Allowable under AGO, but likely to result in litigation
Repeal and Replace	A variety of replacements have been proposed, including replacing gain-sharing with a more stable, less costly benefit	Liability depends on the portion of gain-sharing being replaced—could be less or more expensive	Allowable under AGO but, if a court rules contrary to AG's opinion, could make employers liable both for gain-sharing and replacement benefit
Suspend Benefits and Funding	Temporarily suspend the granting and funding of gain-sharing	Would eliminate the liability of an event that occurred during the suspension period	Allowable under AGO, but could result in litigation
Make Discretionary	Legislature would decide whether to grant a distribution	Would eliminate the liability of an event that was triggered but not granted	Allowable under AGO, but could result in litigation
Retain and Pre-fund	Could be achieved by immediately including or phasing-in costs through higher contribution rates	Results in immediate costs but would lower future costs and contribution rate increases	Eliminates any "systemic funding" concerns
Retain and Post-fund	Delay the inclusion of gain-sharing costs in contribution rate calculations	When gain-sharing is funded after the event , as it is now, contribution rates will eventually be greater than had costs been recognized earlier	Possible "systematic funding" concerns

Source: SCPP, 2005, p. 5, 19-32 & Appendix B

LEGAL CONCERNS

Although the gain-sharing laws include a "non-contractual rights" clause that allows the legislature to amend or repeal the benefit at any time, eliminating the benefit is likely to invite both public employee opposition and potential lawsuits. Still, Attorney General Rob McKenna has made it clear that the explicit language included in the bill allows for program cancellation at any time. According to AGO 2005 #16, issued on November 2, 2005, "the provisions [in the legislation …] are sufficient to negate any obligations of the state to provide gain-sharing benefits that have not been provided prior to any subsequent modification or repeal of gain-sharing statute." However, this clause has never been tested in court so legal uncertainties remain. And, even if the courts uphold a gain-sharing repeal, state workers and teacher unions are prepared to defend their benefit.

DISCUSSION

Legal concerns aside, gain-sharing was passed as a short-term benefit, not a long-term obligation. Now that the true cost of this program has been brought to light, lawmakers can no longer afford to ignore this liability. Delaying payment only increases costs and replacing gain-sharing with a less expensive alternative will not sufficiently address budget shortfalls.

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