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Reforming Public Pensions

Briefly

Washington's public pension system is healthy compared to other states. Certain aspects of the system, however, would benefit from reform. Additionally, the discount rates that are used by states understate the magnitude of public pension underfunding.

Nationally, public employee pensions are a source of concern, as most states have significant unfunded liabilities. Happily, Washington's situation is much more favorable—as measured by current valuation rules, only two of Washington's funds have any unfunded liability, and altogether Washington has one of the most fully-funded pension systems in the country. That said, many economists are ringing the alarm about the discount rates used in estimating pension liabilities, arguing that the problem is even worse than reported by the states.

As part of her "Transforming Washington's Government" effort, and to help reduce the state budget shortfall, Governor Gregoire proposed making several changes to public employee pensions, including eliminating certain cost-of-living adjustments. This proposal has been included in the 2011-13 budgets passed by both the House of Representatives and the Senate. Additionally, the state treasurer has requested a constitutional amendment that would require the legislature to ensure that closed plans are fully funded and that unfunded liabilities do not occur in open plans.

Table 1: Unfunded Liability, 2009
(dollars in millions)

PERS Plan 1	$4,169
PERS Plan 2/3	($2,560)
TRS Plan 1	$2,692
TRS Plan 2/3	($947)
SERS Plan 2/3	($340)
PSERS Plan 2	($15)
LEOFF Plan 1	($1,135)
LEOFF Plan 2	($1,215)
WSPRS	($142)
Total	**$507**

The Pension Situation in Washington

Washington's public employee pension system is in better shape than most because of reforms implemented in 1977. Indeed, as the governor's policy brief on pensions says, Washington is now "in an enviable position in some respects." As part of the 1977 reforms, the Public Employees' Retirement System Plan 1 (PERS 1) and the Teachers' Retirement System Plan 1 (TRS 1) were closed to new members. These two plans are the only ones in Washington that currently have any unfunded liability. In 2009, the state's total unfunded liability was $507 million (PERS 1 and TRS 1 had a combined unfunded liability of $6.9 billion; the other plans are over 100 percent funded).

A fact sheet from the Department of Retirement Services explains the problem this way:

> TRS 1 and PERS 1 were both closed to new members three decades ago. Part of the current unfunded liability is related to Cost of Living Adjustments (COLAs) and other benefit increases that were applied retroactively without a corresponding increase in contribution rates. Another part is related to contributions. Over the years, when faced with economic downturns and revenue shortfalls, there were times when the full recommended contribution amount for Plan 1 was not made.

The legislature has not made the full recommended contributions to the plans since 2000. The full contributions would be made in 2011-13 under the House- and Senate-passed budgets.

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Figure 1: PERS Funded Ratio

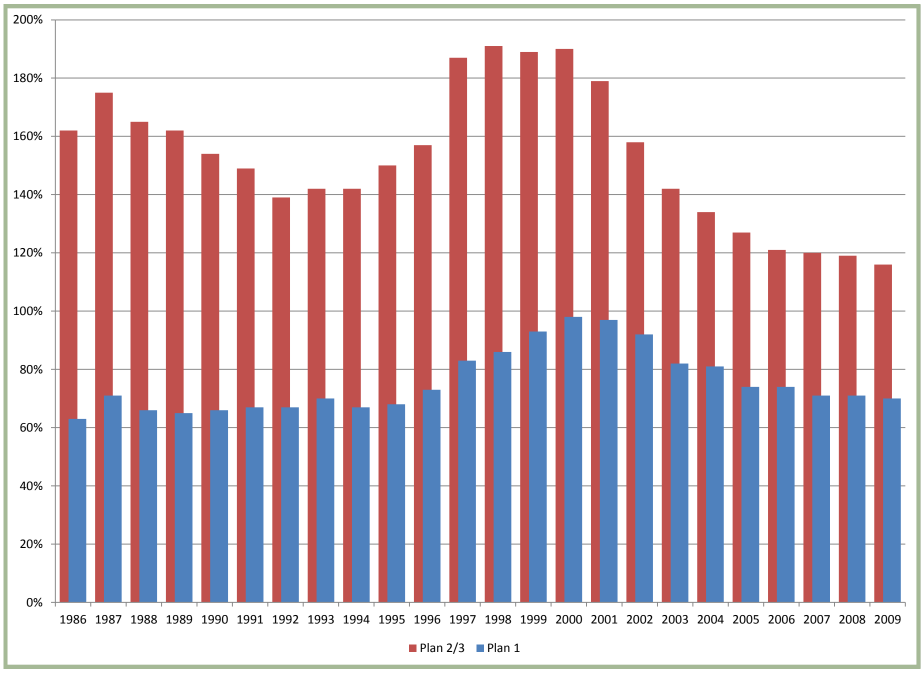
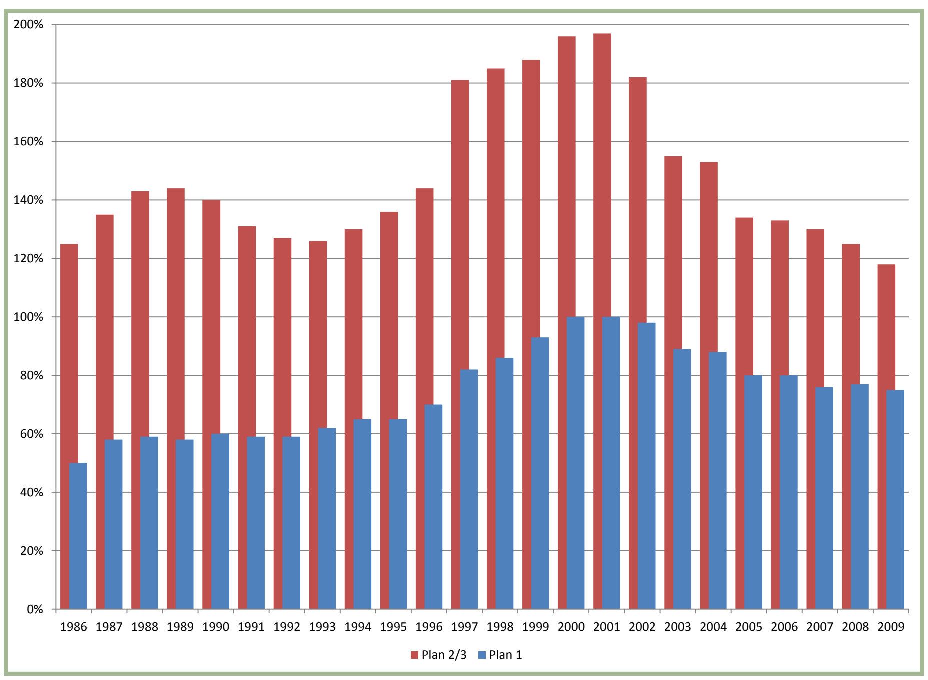


Figure 2: TRS Funded Ratio



In addition, the state Treasurer requested a constitutional amendment (SJR 8214, HJR 4219) that would require contributions to state-administered open pension plans to be "in amounts sufficient to fund at least eighty percent of the expected long-term annual cost of benefits under the plan." Minimum contributions would also be in place for the closed plans until they are 100 percent funded. These rate floors are currently set in statute. Both resolutions have received public hearings, but no other action has been taken.

Ending Automatic COLAs

In 1995, the legislature passed a bill providing retirees in PERS 1 and TRS 1 an automatic COLA. The COLA was not linked to inflation—retirees would receive it no matter the economic conditions. Recognizing that it would be expensive, the legislature reserved "the right to amend or repeal this section in the future and no member or beneficiary has a contractual right to receive this postretirement adjustment not granted prior to that time" (RCW 41.32.489 and 41.40.197).

Under the House- and Senate-passed budgets, these automatic COLAs would be eliminated (HB 2021, SB 5920). The governor's policy brief notes that this action would "eliminate more than half of the unfunded liability in the closed plans." In the fiscal note, the state actuary estimates that eliminating the COLAs would reduce total public employer spending by $7.9 billion over 25 years, including $2.1 billion over the 2011-13 and 2013-15 biennia. HB 2021 was passed by the House Ways and Means Committee on April 14, 2011. SB 5920 was adopted by the Senate Ways and Means Committee on April 15, 2011.

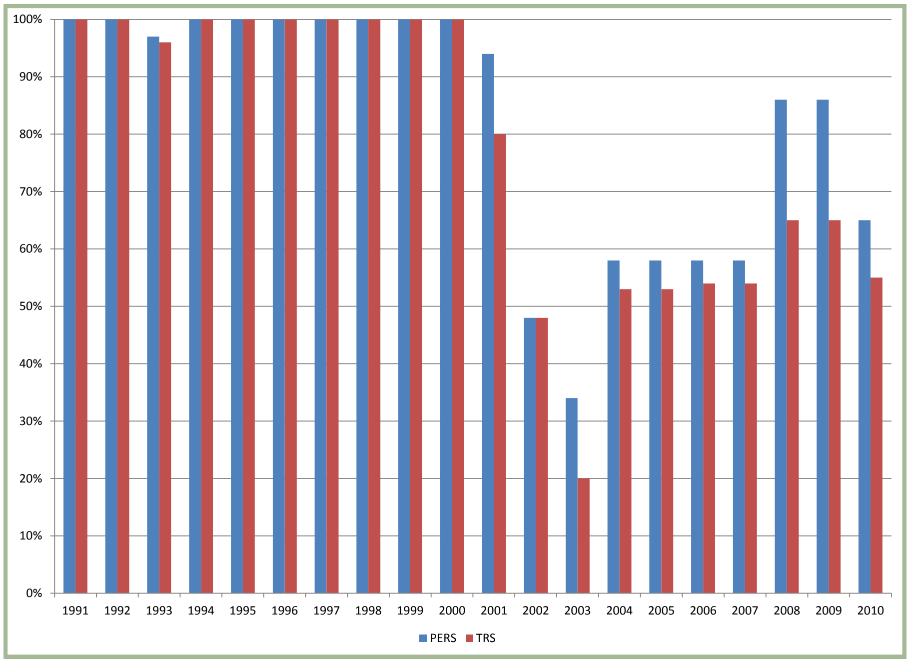
Unfunded Liabilities and Discounting

Another pension issue that has received a high level of commentary of late is the method of discounting. The Center for Retirement Research at Boston University estimates that state and local public pensions were underfunded by about $700 billion in 2009, but some economists estimate the underfunding is really upwards of $3 trillion.

The discrepancy occurs because states, including Washington, use the actuarial method of accounting in valuing assets and liabilities. Accordingly, Washington smooths gains and losses over an eight-year period and assumes a return on investment of 8 percent (it was increased from 7.5 percent in 2001). Eight percent is the average among the states (the lowest is 7 percent and the highest 8.5

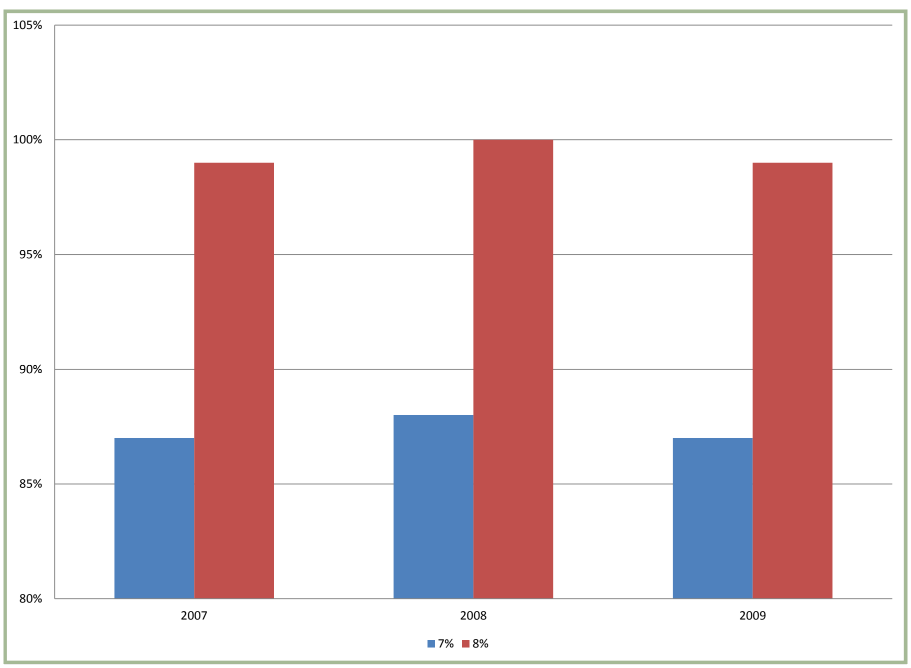
percent). Using their assumed interest rates, states discount future benefit costs.

Figure 3: Percent of Recommended Employer Contribution Rate



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. Private sector plans are required to discount future costs using interest rates consistent with risk. In the Spring 2011 issue of *National Affairs*, Josh Barro of the Manhattan Institute writes that this market-value approach means that private-sector plans use a discount rate of 5 to 6 percent. According to Professors of Finance Robert Novy-Marx of the University of Chicago and Joshua Rauh of Northwestern, "The use of 8 percent appears to be a rule of thumb, but it does not have a valid economic motivation." Instead, Novy-Marx and Rauh argue that, commensurate with the level of risk involved, public pensions should use the interest rate on Treasury securities to discount future payments. Currently, the rate is 0.25 percent to 4.75 percent, depending upon how far into the future the payments will occur.

Figure 4: Total Funded Status of Plans in Washington, Using Different Interest Rates



The unfunded liability of a plan is sensitive to the discount rate used. Alicia Munnell, Jean-Pierre Aubry and Laura Quinby of the Center for Retirement Research studied public pension plans in 2010. Using an 8 percent discount rate, the unfunded liability was $0.7 trillion. Using a 5 percent discount rate (1 percent above the 30-year Treasury bond yield), the unfunded liability was $2.7 trillion.

The Washington Office of the State Actuary's 2010 Risk Assessment also touched on this issue:

> Private sector plans calculate their funded status based on market value measures of both assets and liabilities. We use the actuarial value with longer asset smoothing and a long-term interest rate assumption. If we were to calculate the funded status for our public plans the same way that private plans do, our current funded status would be much lower.

In fact, Washington's actuary, in the 2009 Actuarial Valuation Report, calculated state plan funding status using different interest rates (see Figure 4). The 8 percent figure is the one that is reported; clearly, the unfunded liability gets larger the lower the interest rate.

Public employee retirement plans in Washington include (as described by the Department of Retirement Services):

- PERS Plan 1 and TRS Plan 1 are defined benefit plans that provide full pension benefits based on years of service – members are eligible after 30 years of employment.
- PERS Plan 2, School Employees' Retirement System (SERS) Plan 2, TRS Plan 2, and Public Safety Employees' Retirement System (PSERS) Plan 2 are defined benefit plans that provide full pension benefits after the member reaches age 65.
- Law Enforcement Officers' and Fire Fighters' Retirement System (LEOFF) Plans 1 and 2 and Washington State Patrol Retirement System (WSPRS) Plans 1 and 2 are defined benefit plans that provide full pension benefits based on the member's age at retirement.
- PERS Plan 3, SERS Plan 3 and TRS Plan 3 are defined benefit plans that include a member-funded defined contribution component. Full pension benefits are provided after the member reaches age 65.

Discussion

Suspending COLAs that are distributed without regard to current legislative goals or the inflation rate, particularly in retirement funds with significant unfunded liability, makes sound fiscal policy sense. Instead, let future legislatures decide, based on current economic decisions, whether to provide these COLAs from one biennium to the next. At the time the PERS 1 and TRS 1 plans were closed to new entrants, participants had no expectation that COLAs would be made available.

The legislature should also be making the recommended contributions each biennium to ensure that Washington's pensions remain well-funded.

Finally, policymakers should be aware of alternate measures of the pensions' funding status. Relying on rosy investment assumptions to keep current costs down may be setting us up for problems down the road.

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