

## PERS IN CRISIS: THE SEQUEL

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PHIL KEISLING

Public employers in Oregon, such as state and local governments, support employee retirement benefits via contributions to the state's Public Employee Retirement System (PERS). Historically, these contributions have averaged 12 percent to 15 percent of public payrolls. However, a combination of factors—especially the recent recession which has impaired PERS' investment returns—mean public employers are facing steep increases in payroll costs over the next decade. These increases will likely exacerbate future state and local budget problems.

On May 29, 2009, the five member board that oversees the Oregon Public Employee Retirement System (PERS) convened for one of its regular, bi-monthly meetings.

No journalists apparently attended this meeting, nor did any legislator. At the time, Oregon's 90 lawmakers were holed up in the Capitol building in Salem, trying to grapple with a \$4.5 billion projected budget deficit—a deficit that was driven by Oregon's worst economic crisis in a half century.

In a lengthy presentation the actuary hired by PERS, Mercer Consulting, outlined the recession's severe impact on PERS' financial fortunes. In less than two years, PERS' main account, known by its acronym OPERF, had fallen from a peak of \$63 billion to \$45 billion. The "funded status" of OPERF—the ratio of PERS assets to liabilities—had fallen from almost 100 percent funded to 74 percent funded.

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Mercer's actuaries then described an even more brutal reality. Historically, OPERF earnings have provided 70 percent of what the PERS system needs to meet its actuarial and contractual obligations. The remainder is then largely made up by direct employer contributions, with rates set every two years by the PERS board based on OPERF's past (and projected future) returns, plus a wide range of other assumptions.

As the Mercer report noted, with OPERF so ravaged by the market downturn, there was only one other source for necessary funds: Oregon taxpayers, the ultimate financiers of any public employer's contribution rate. Even with a relatively quick and robust recovery of OPERF earnings back to about 8 percent annual returns Mercer's conclusion was breath-taking. By decade's end, Oregon's public employers would likely need to pony up an additional \$5 billion a biennium (compared to 2009–11 levels) to keep PERS adequately funded.

This is real money. Even half that amount, or \$2.5 billion, would allow the hiring of 20,000 new K–12 school teachers; or could entirely abolish tuition for all of Oregon's university and community college students; or could provide health insurance for 300,000 uninsured Oregonians.

## STATE EMPLOYER CONTRIBUTIONS AND THE EMPLOYEE "BURDEN RATE"

When I first came across the Mercer report, I was a Vice President for Beaverton-based CorSource Technology Group, an IT and software services company that provided contract staffing and project services to many Oregon businesses. So I was familiar with the basic concept of a "burden rate" for calculating total employee costs.

All employers, private and public, are required to pay certain taxes, such as Social Security and Medicare payroll taxes. In addition to other mandatory costs, such as unemployment insurance and workers compensation, most private employers provide employee benefits such as health insurance and retirement contributions. In the private sector, the combined total of all these "burden costs" is typically between 30 percent and 35 percent of payroll. So an employer, hiring an employee at \$50,000 a year, needs to budget an additional \$15,000 to \$17,500 to cover all these obligations.

PERS obligations vary for each of Oregon's 800+ public employers. But for the State of Oregon itself, total PERS related obligations amount to about 15 percent of payroll for 2009–11.

Based on the Mercer report's analysis of the "50 percent probability" scenario for future financial market returns—and assuming the continuation of existing policies and practices—by 2017–19 the burden rate for PERS related obligations alone or a typical public employer would be about 35 percent of payroll. (Further assuming the state also continued to provide current levels of health insurance and other benefits, the total employee burden would also rise, to about 70 percent of payroll or more than double the typical rate in the private sector.)

While Mercer's most recent analysis now projects typical rates peaking at about 30 percent by decade's end, this still represents an historic sea change. Since 1975, the core "employer contribution rate" paid by state and local entities to support their PERS obligations

was fairly stable. Over this period, it stayed within a narrow band of 9 percent to 12 percent of payroll, even during the recession earlier this decade.

### WHAT ABOUT THE PERS REFORMS IN 2003?

The 2001 recession triggered major changes in PERS. In the wake of the recession, OPERF lost about 17 percent of its value in the 2001–02 period. With potential unfunded liabilities projected to soar to \$17 billion, and employer rates projected to hit 25 percent, in 2003 the Legislature enacted major changes in PERS.

These reforms, which are still controversial, were championed by Democratic Governor Ted Kulongoski, most Republican legislators, and a few Democratic legislators like Rep. Greg MacPherson. Even so, many reforms were widely opposed by PERS recipients and public employee unions, who challenged the reforms in court. In the end, the Oregon Supreme Court rejected the most ambitious reforms, but retained others.

From 2003 to 2007, OPERF grew at an annualized rate of 15 percent. The combination of relatively high returns and other changes made by a newly-constituted PERS board allowed PERS rates to remain relatively stable. “Crisis averted” was the dominant emotion and PERS essentially vanished from the public policy radar screen.

In 2008, OPERF plunged an historic 28 percent. Though OPERF has rebounded from its March 2009 low point of \$41 billion, its \$50 billion value (as of December 31, 2009, a key date for rate-setting purposes) is still down about 21 percent from its \$63 billion high point of 2007.

If Oregon’s string of public finance crises were a chain of horror films, the latest predicament might be called *PERS in Crisis: the Sequel*. It even has its own scary plot line: Even if OPERF can consistently earn 8 percent a year, every year for the next decade, employer contribution rates will still soar so that for the state of Oregon (and many other local governments) total PERS obligations will approach approximately 30 percent of payroll.

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### THE UPS AND DOWNS OF SIDE ACCOUNTS

The state as well as many K–12 school districts and local governments face another potential PERS problem due to a once-promising “hedge strategy” that could end up adding to their deficit. Over the last decade the state of Oregon and over 100 local government entities sold more than \$6 billion in pension obligation bonds. In so doing, they borrowed money at about 5 percent interest, and then invested the proceeds in OPERF “side accounts.” They did so in the expectation that OPERF returns would be higher than the interest rates they would pay on the bonds. Through this arbitrage strategy they hoped they could “buy down” their employer contribution rate by as much as three percentage points.

The strategy worked brilliantly during the 2003–07 market run-up. Some jurisdictions reduced their entire employer contribution to zero through side account earnings.

But, bonds are debt and debts have to be repaid. What’s more, many jurisdictions decided to repay their bonds on an escalating schedule of about 8 percent more each biennium, on

the assumption that their payrolls would also increase about 8 percent. For example, under this repayment schedule, the Portland public school district will pay about \$61 million in bond repayments during the 2009–11 period. By the 2019–21 biennium, those obligations will rise to about \$106 million. Contrast this with how most homeowners repay their mortgages or home equity loans, with fixed, regular payments until their loan obligations are fully discharged.

Public finance experts will likely debate the wisdom of the pension obligation bond strategy for years to come. But at the risk of some over-simplification, the strategy is similar to a homeowner taking out a \$100,000 second mortgage to invest in the stock market. This homeowner then further assumed his or her salary would steadily increase, so that the increasing repayments would remain constant as a percentage of household income. Needless to say, a wrong bet, either with respect to future investment returns or future household income, can quickly cause real problems.

Of course, unlike most homeowners, public pension funds have a much longer investment horizon, and since 1975 the Oregon Treasury calculates OPERF's annual rate of return at 10 percent. But for the 1999–2009 period, the return rate was just 4.5 percent and now some jurisdictions are losing money on their side account investments.

## THE SIX PERCENT PICKUP

The final major component of PERS obligations involves something known as the “6 percent employee pick up.” By law, a PERS beneficiary must contribute 6 percent of his or her pay to participate in PERS. But over the last 30 years, and often through negotiated contracts, most public employees in Oregon now have their 6 percent share paid, in full, by the public employer. (There are, however, exceptions; in the 1990s, the Portland school board negotiated a contract with its employees that included pay hikes and the abolition of the employer-financed pick up.)

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While the 6 percent pick up issue can legally be re-visited as part of any new contract negotiation, for decades it has been widely treated as a “built in” component. For example, its assumed continuation is part of the state's current projected state general fund deficit of \$2.7 billion. Even so, Governor Kulongoski's recent “Reset Cabinet” report recommended reducing the state's pick-up contribution.

Few issues so raise hackles as much as the 6 percent pick up issue. Proponents of the pick up argue that it is justified because employees in past years agreed to forego what they considered to be deserved pay increases in exchange for this pick up. Critics of the pickup note that most private sector workers (and public workers in other states) must make some contribution from their own pockets to their retirement plans.

A further wrinkle is that, since the 2003 reforms, these employee contributions have gone into separate accounts, which are more like “defined contribution” plans than PERS' core “defined benefit” plans whose value is based on factors such as salary, years worked, and date of original hire. This means a portion of today's public employees' retirement plans are also subject to market uncertainties, though certainly to a lesser extent than for workers solely reliant on their 401(k) plans.

## CONCLUSION

Regardless of the various legal and political debates surround PERS, few would disagree that an adequate, stable retirement plan is an essential ingredient to any well-designed, well run public compensation system. It is the various details of PERS that will be key issues for policy makers, public employees, and courts in coming years, especially as public employers at all levels grapple with unprecedented budget deficits that could well persist long after the economy recovers. With PERS, some of those details have already been resolved by various court decisions. But other details can and likely will be discussed (e.g., the 6 percent pick up) as public officials now confront a “perfect storm” of a lingering economic recession, near double-digit unemployment, and yet another round of massive budget cuts.

Already, that grappling is evident, as PERS costs are beginning to play a much bigger role in state and local budget crises. For example, beginning with the 2011–13 biennium the state and other Oregon public employers will face about a 6 percent hike in their net employer contribution rates. Put another way, they must come up with an additional \$1 billion relative to the 2009–11 biennium just to stay even with their PERS obligations.

And of course, the timing could not be worse. The state currently faces a projected \$2.7 billion deficit for 2011–13 (this is on top of an additional 9 percent in state general fund cuts recently ordered by Governor Kulongoski). Meanwhile, some local governments may be even worse off than the state. Many have already started to lay off employees, due to current revenue shortfalls and partly in anticipation of looming PERS hikes.

Indeed, even though these increased PERS costs have not technically “hit the books” yet, there is no escaping that they will arrive with all the certainty of an Oregon summer eventually turning to a rainy winter. That is all the more reason for policy makers to start discussing PERS now, lest the passage of time (or more bad economic news) make the problems even more difficult to resolve. ■

**Phil Keisling** served as Oregon Secretary of State from 1991 to 1999. Prior to that he was a member of the Oregon House of Representatives, and spent six years as a journalist for *Willamette Week* and *The Washington Monthly* magazine in Washington, D.C.

