REFORMING PENSIONS TO HOLD DOWN COSTS

Five months ago, Governor Gregoire asked a group of business, nonprofit and government leaders to help her transform Washington government. She posed eight questions to guide the committee's deliberations. With its advice and input from citizens across the state, the Governor recommends the following actions to reform the state pension system to hold down costs so we can invest those savings in essential services. Her proposals address the question "Are there more cost-effective, efficient ways to do the activity?"

Washington has been a national leader in designing and maintaining sustainable public pension plans. Current open retirement plans have had reasonable benefit levels and are fully funded. The older, more generous retirement plans were closed to new members in 1977, when the current plans were created. As many states struggle to address staggering pension liabilities, they are doing what Washington did in 1977: raising the retirement age, requiring more cost-sharing between members and employers, and limiting opportunities to inflate pensions with late career salary increases. Money spent on state pensions means less funding available for essential services such as education and public safety.

We continue to innovate. We were the first state to use hybrid defined contribution/defined benefit plans. Our State Investment Board has followed progressive investment policies, which has led to an 8 percent return for the past 20 years — among the top 10 percent of public pension plans over this time period.

While Washington is in an enviable position in some respects, we recognize that significant challenges lie ahead. The older closed plans are underfunded, and will fall further behind. Unless action is taken, underfunding will cause employer pension contribution rates to double in the 2011–13 biennium and remain high for the next 20 years. This will make it difficult to maintain the healthy funded status of the open plans.

Just like Washington did 33 years ago, when we closed the older plans and moved to less-generous, more-modern benefit plans, we must again make hard decisions. Governor Gregoire proposes the following actions to reduce future costs to employers and taxpayers while maintaining reasonable benefits for valued public employees and retirees.

Eliminate automatic benefit increases

In 1995, the Legislature passed an annual benefit increase for members and beneficiaries in public pension plans closed to new members since 1977. While intended to protect against inflation, the increase itself was not linked to inflation, which has been low. The Legislature anticipated the benefit could have a high cost, so it reserved the right to amend or repeal the benefit in the future.

The closed plans for teachers (TRS 1) and public employees (PERS 1) were identified by the State Actuary last year as the state's only unhealthy pension plans, with funded ratios between 70 and 75 percent, or an unfunded liability approaching $7 billion as of June 30, 2009. (The remaining plans had funding ratios that exceeded 116 percent.)

The Governor proposes to end future automatic benefit increases from the 1995 legislation, which would eliminate more than one-half of the unfunded liability in the closed plans. The Legislature, as was the case prior to 1995, could award cost-of-living increases at its discretion. The repeal will also reduce public employer payments by an estimated $9 billion over the next 25 years, with $2 billion of that reduction expected to be realized over the next two biennia. The Office of the State Actuary estimates that $4 billion of the $9 billion savings will be realized by local governments over this period. For the next two years, local governments will save $353 million and the state will save $368 million.

The Governor's proposal removes the annual increase amount only for members and beneficiaries whose monthly pensions exceed the minimum benefits provided in the plans. Retirees receiving the minimum benefit amounts won't be affected — their benefits will continue to be adjusted annually.

Modernize the public pensions

In 1977, state policymakers created new retirement benefits for public employees. While policymakers balanced the provision of benefits with affordability for employers and reasonableness for taxpayers, times and circumstances have changed. Since then, we have seen significant changes to retirement patterns and personal longevity, not to mention retirement options available to the public. At the same time, costs to provide public employees with no-risk pensions at ages far earlier than offered by Social Security are rising.

The Governor proposes to discontinue incentives to retire earlier than age 65 for new hires in Plans 2 and 3 for PERS, TRS and SERS. This modernization of the state's primary pension systems will slash the long-term cost of public pensions by an estimated $2.2 billion over 25 years for state and local governments, freeing scarce resources for other essential functions. (See chart on next page).

Reform higher education pensions

» Close the retire-rehire exception

In 2001, lawmakers expanded the opportunity for retirees from state-administered retirement systems to return to work while still receiving their monthly pension. This change allowed employers to use experienced retirees as a short-term solution to bridge a recruitment gap for long-term personnel, especially in the education field. In 2003, lawmakers added safeguards and limits on the number of hours retirees could work while still receiving their pension.

Still, an exception occurs when a retired public employee returns to work for an institution of higher education and participates in a separate retirement plan offered by the institution. Participation in the other retirement plan exempts the retiree from limits in the state-administered retirement plan. In this situation, the retiree can work and draw full retirement and salary.

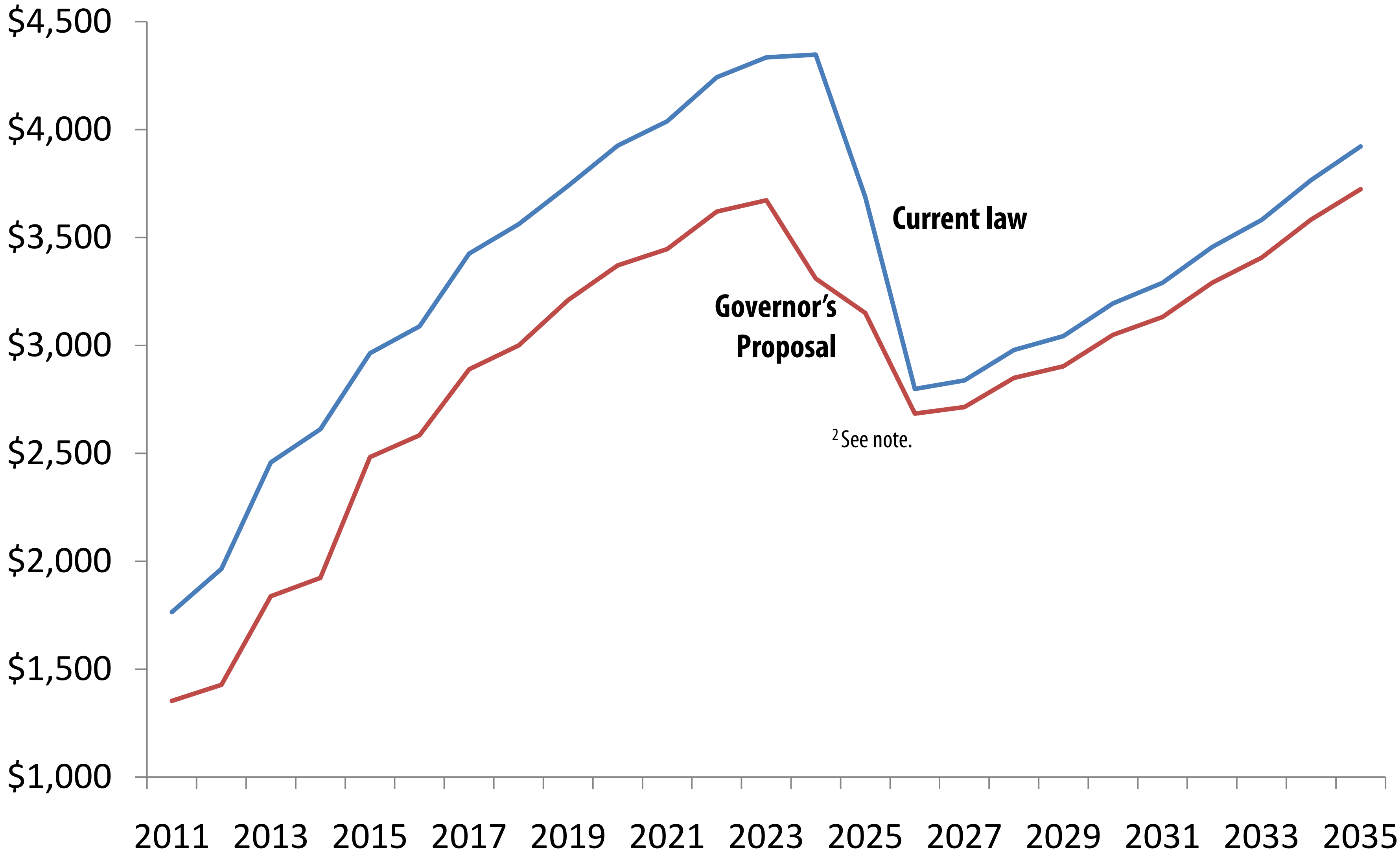
The Governor proposes to close this exception by disallowing retired employees from participating in these separate retirement plans. Restrictions will also be imposed to not allow individuals to draw full-time retirement benefits as well as a salary.

» Align state contributions

The Governor proposes to align state support for higher education retirement plans more closely with that provided for other state employees. These plans now provide both a defined contribution amount and a supplemental guaranteed minimum benefit similar to the formula used in the old state pension systems that closed in 1977. As an alternative, new higher education employees would be given the option to participate in one of the state's hybrid pension plans.

The Governor's proposal will cap the state's contribution to these plans at 6 percent. The higher education institutions could contribute more. For 2011–13, these higher education changes save the state $57 million dollars, and all pensions reform saves $425 million.

Reforming State Contributions to our Pension System: Savings of up to $11.3 billion[1] over 25 years (in millions)



[1] The State Actuary estimates savings of $10 billion to $11.3 billion.
[2] Unfunded liability paid off in 2024.

OFFICE OF THE STATE ACTUARY
DECEMBER 2010