



CASCADE POLICY INSTITUTE

CASCADE COMMENTARY

February 2003 No. 2003-05

Summary

Governor Kulongoski is to be commended for pursuing major PERS reform, not band-aid solutions. However, his proposal to replace PERS with a defined benefit pension would expose the state to substantial risk in the years ahead. Oregon needs to replace PERS with a straight defined contribution plan, along the lines of a 401(k).

Word count: 641

“The governor’s proposal to replace PERS with a defined benefit pension plan will set Oregon up for future crises...”

Fix PERS to fix future budget problems

By William B. Conerly, Ph.D.

The defeat of Measure 28 is not Oregon’s greatest fiscal problem. PERS is.

Unfortunately, Governor Kulongoski’s key proposal to fix PERS is wrong. The governor is very, very right that a major fix is needed, and he shows courage in not trying band-aid solutions. He’s also right to keep the legislature focused on fixing PERS, a necessary step toward putting future state and local government and school budgets on firmer ground.

However, the governor’s proposal to replace PERS with a defined benefit pension plan will set Oregon up for future crises, albeit not of the magnitude we are now experiencing.

The greatest problem with PERS is the dual-option that all members have, whether they are Tier I or Tier II. At retirement, they get the better of two different calculations. The first is a defined benefit formula based on years of service and final salary. (This is called “Full Formula” in PERS lingo.) Benefits are also calculated under a defined contribution method, in which investment returns are compounded over time (“Money Match” in the language of PERS). Then the employee gets whichever formula has worked out better, after the fact.

When investment returns have been high, PERS must match the high returns in employees’ accounts. But when investment returns are low, PERS has to pay the guaranteed benefit under Full Formula. This, more than any other problem, has caused the crisis in PERS. Governor Kulongoski recognizes that this double option has to end, and he is to be commended for saying so.

The governor’s proposal, however, exposes the state to substantial risk in the years ahead. His idea is to replace PERS with a pure defined benefit plan. This approach is being abandoned by corporations and should be shunned even more by state governments.

In well-administered plans, years of high investment returns make up for years of poor investment returns. In the time of Joseph, the seven fat years were fol-

lowed by seven lean years. The pattern continues to this day, though not necessarily in seven-year stretches.

What would the state legislature do with a defined benefit plan after seven fat years of investment performance, such as we had from 1992 through 1999? Someone from the public employee unions will suggest raising benefits. After all, after the fat years, the money is already in the trust fund. We can improve benefits and it won't cost a thing! As sure as lobbyists look out for their clients, as sure as politicians look for votes, the legislature will vote to spend the surplus in the new retirement trust fund.

Then the lean years will come. There will be no excess to draw upon. Taxpayers will have to cough up more money or accept cuts in government services to pay the generous benefits. The crisis will emerge anew.

Defined benefit plans also produce serious inequities. The formulas favor long-term employees over shorter-tenured workers. This is exactly backwards from what an employee incentive system should do. The employee with 25 years of service is unlikely to be looking around for another job. The two-year employee, however, is going to look at other possibilities. In short, the defined benefit plan does little for those who need encouragement to stay in government service, and does a lot for people who would not consider changing jobs anyway.

Oregon needs to replace PERS with a straight defined contribution plan, along the lines of a 401(k). Every employee will be vested from day one.

Political risk? The only way to provide more benefits in a defined contribution plan is to put more money in. Legislators can do that in the future, but they won't be misled by a few years of strong investment returns into thinking that extra benefits are free.

The governor's defined benefit plan subjects the state to substantial political risk, which will cause repeats of today's fiscal crisis.

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