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Employee Contributions to the Public Employees Retirement System

This budget information brief reviews the employee contribution portion of the Public Employees Retirement System (PERS) and the Individual Account Program (IAP), including the history, statutory changes and legislative reform, court decisions, collective bargaining agreements, and financial data.

PERS is a state-wide retirement system covering approximately 900 employers comprising state agencies, school districts, universities, statutory judges, participating cities, counties, special districts, and other entities. Oregon's PERS system is classified as a mature system, with 168,177 active members supporting about 136,298 retirees and beneficiaries (1.2 active member per retiree/beneficiary), as of December 31, 2015.

Mandatory Employee Contribution

Since the inception of PERS in 1946, and by statute, a mandatory employee contribution has been required to fund a portion of a member's retirement plan. The other portion of the benefit is funded by an employer contribution and investment earnings on both employee and employer contributions. The premise behind an employee contribution is that benefit plan risks are to be shared between the employer and the employee. Major risks to benefit system funding are: investment, inflation, and employee longevity.

Employees become members of PERS after serving a six-month waiting period. Employers collect and remit the employee's contribution to PERS each pay period as a percentage of an employee's PERS-covered salary. PERS-covered salary is defined by law generally as taxable salary and wages, which includes overtime and any stipends or differentials (e.g., shift times, second language, or training certification). Employee contributions are based on gross salary, with limitation, and on a pre-tax basis (ORS 238A.370).

The employee contribution is required for state agencies, judges, public universities, community colleges, school districts, local government employees, and other entities that participate in PERS. Examples of other entities include: Oregon Lottery, State Accident Insurance Fund, Oregon State Bar, and semi-independent agencies comprised of smaller boards and commissions. There are few statutory exceptions to an employee's mandatory contribution. The primary exception is for legislators that opt out of PERS membership or choose to participate in the state's deferred compensation plan. When legislators participate in the deferred compensation plan they receive an equivalent of an employee contribution.

For the period 1946 to 1967, an employee's mandatory contribution was no less than 5%. In 1967, the employee annuity portion of the retirement benefit was based on mandatory employee contributions of 4% of the first \$500 in salary; 5% for \$500 to \$1,000; 6% for \$1,000 to less than \$1,500; and 7% in excess of \$1,500. The Legislative Assembly in 1981 lowered the employee contribution rate from a high

of 7% to a uniform 6%, and the contribution has remained at that level (ORS 238A.330). The only exception is for the 194 statutory judges, which is set at 7% (ORS 238.500).

Employer Payment of Employee Contribution (“Pick-up”)

Prior to 1979, an employee’s mandatory contribution was paid by the employee on an after tax basis (i.e., deducted from their taxable income). Two events laid the groundwork for change: (1) federal tax law was amended to allow for pre-tax contributions; and (2) the recessionary period of 1979-1982 reduced state revenues and budgets. As a result of both of these conditions, the Legislative Assembly in 1979 provided that a participating public employer may agree, by a written employment policy or by a collective bargaining agreement, to pay the employee contribution (ORS 238A.335). Such an agreement is commonly referred to as the “pick-up.” By statute, employers may only choose between picking up all of the 6% contribution or none of the contribution. The pick-up of statutory judges’ employee mandatory contribution of 7% is directed by statute rather than agreement and is a contribution toward their defined benefit plan.

After the Legislature’s action in 1979, collective bargaining agreements were reached which included the pick-up of the employee contribution for state government employees. This was negotiated in lieu of a 6% general wage increase for state government employees due to the state’s budget situation at that time. By management action, the employee contribution for state management service and unrepresented employees was also picked-up by employers. Since then, some other PERS employers have adopted the practice. System-wide, approximately 65% of all employers have agreed to pick-up the employee contribution for more than 50% of their employees, according to PERS. This totals approximately 72% of all PERS-eligible employees.

For state employees, the pickup of the employee contribution has remained in place for the last 37 years. A recently negotiated collective bargaining agreement for the 2015-17 biennium will have some state employees beginning to pay the 6% mandatory contribution in exchange for a comparatively-valued increase in compensation, which is discussed in more detail below.

An employer pick-up is viewed as having advantages for both the employee and the employer. For the employee, the pick-up portion is considered salary for computing the final average salary for some PERS benefit plans, and since the employer pick-up is not paid as wages is not subject to federal income tax. The benefit to the employer is not having to pay the Social Security payroll tax. Since the 6% pick-up is based on gross pay and free from payroll taxes, an employer pick-up of an employee contribution is a less expensive mechanism for compensating employees than a comparatively-valued 6% salary increase, which would be subject to payroll taxes and provide less net pay to an employee. Again, this action was put into place in 1979 to save money and balance the state budget.

Employee Contributions Nationwide

The National Association of State Retirement Administrators (NASRA) has conducted several studies of employee contributions for public pension plans, the most recent being completed in February of 2015. The study concluded:

Employee contributions are a key component of public pension funding policies. The vast majority of employees of state and local government are required to contribute to the cost of their pension benefit, and this number has grown in recent years as most states that previously administered non-contributory plans now require worker contributions. Many employees also are being required to contribute more toward the cost of their retirement benefit. In some cases, this requirement applies to both current and new workers; in other cases, only to new hires. A growing number of states are exposing employee contributions to risk – either by tying the rate directly to the plan’s investment return, or by requiring hybrid or 401k-type plans as a

larger component of the cost of the employee's benefit. Some of these changes to contribution requirements affecting existing plan participants are currently under legal review. The outcome of these legal challenges is likely to affect additional future reforms in this area.

Employee contributions in other states vary widely, by benefit plan selection, hire date, plan funded status, compensation level, and the type of position (e.g., general service, police officer and firefighter, teacher, etc.), according to the report. Nevada Police Officers and Firefighters appear to pay the most at 20.43% with the low being a non-contributory option in a few states.

Employee Contribution and PERS Reform in 2003

The Legislative Assembly in 2003 enacted reforms to limit the increase in the size of member accounts that was driving larger retirement benefits and higher employer contributions. One of the principal goals of the reform legislation was to limit the impact of the "money match" calculation for the service retirement allowances of Tier 1 PERS members.

For the defined benefit plan ("pension"), active PERS members participate in one of three benefit programs, depending on when they were hired: Tier 1, for members hired before January 1, 1996 (50,695); Tier 2, for members hired on or after January 1, 1996 but before August 28, 2003 (58,104); OPSRP, for members hired after August 28, 2003 (98,623); and a separate statutory judgeship plan. Benefits in these plans are now funded entirely by employer contributions and credited with investment earnings since legislative reforms in 2003 diverted all employee contributions to an account-based plan, discussed below.

Pension benefits, with the exception of benefits under the Oregon Public Service Retirement Plan (OPRSR), are the greater of either a formula based on the retiree's years of service and final average salary (or formula plus annuity for members who were contributing before August 21, 1981) or money match. The money match benefit is based on the value of the retiree's account balance rather than being a formula-driven benefit. A Tier 1 or Tier 2 retiree is entitled to the higher of the formula or money match benefit. An OPRS member's pension benefit is exclusively formula-driven. One particularly important benefit reform in 2003 was the move to hybrid plans that combined an existing, as well as a newly created, defined pension benefit plan, with a newly created account plan.

For the account-based plan, which is nearly identical to a defined contribution plan, almost all members, regardless of their starting date or defined benefit plan, contribute 6% of PERS eligible salary into the Individual Account Program, beginning on January 1, 2004. The IAP includes new accounts for existing Tier 1 and Tier 2 members and an account for any newly hired employee under the OPSRP. Statutory judges, and legislators opting out of PERS, do not participate in the IAP program.

The reform legislation also redirected subsequent Tier 1 and Tier 2 employee contributions into IAP accounts. Prior to these reforms, member contributions for Tier 1 and Tier 2 members were credited, or commingled, with employer contributions into a member's regular and variable accounts.

The introduction of the IAP produced three types of cost savings: (1) reduced the amount of contributions into regular member accounts for Tier 1 and Tier 2 members, which meant fewer active employees qualified at retirement for the money match benefit; (2) members that continued to qualify received a lower money match benefit due to a lower regular and variable member account balance; and (3) Tier 1 member contributions into the IAP were no longer subject to a guaranteed rate of return.

As an aside, when the Legislative Assembly met in 2013 for its regular session and an October special session, it passed additional PERS reforms; however, no further changes were made to the employee contribution statute or the IAP. The changes that did become law that session included modifications to the annual cost-of-living adjustment and the elimination of the tax remedy for out-of-state retirees.

Employee Contribution and Court Decisions

Oregon Supreme Court decisions around the employee contribution and pick-up have evolved over time. Ballot Measure 8, approved by the people at the 1994 general election, amended the Oregon Constitution. The measure prohibited an employer pick-up, requiring every PERS employee to make a personal contribution to the system, among other reforms. Ballot Measure 8 was later challenged in court. The Oregon Supreme Court decision (1996) in *Oregon State Police Officers Association (OSPOA) v. State of Oregon* ruled that “The six percent pick-up is an integral part of the underlying PERS pension contract.” The Court held that all the provisions of Ballot Measure 8 were “void” by reason of violating the Contracts Clause of the United States Constitution.

The PERS reforms in 2003 that redirected the mandatory employee contributions for Tier 1 and Tier 2 members from the members’ regular accounts and into an IAP were also challenged in court. In the *Strunk v. Public Employees Retirement Board* decision (2005), the Supreme Court upheld the redirection of the employee contribution to the IAP.

In both *OSPOA* and *Strunk*, the court held that the Legislature could not change terms of the PERS contract for both accrued benefits and benefits that had yet to be accrued; however, the court’s most recent decision in *Moro v. State* (2015) disavowed the reasoning in *OSPOA* and gave a new framework for analyzing contract rights issues: “Although the participating employers can change the COLA offer as to benefits that might accrue in the future, they cannot change the COLA contract as to benefits that have already accrued.”

Remaining Statutory Reform Options

Oregon Supreme Court decisions around the employee contribution and the IAP limit further possible reform options for the Legislative Assembly to consider. The Court’s new analysis under the *Moro* decision provides that the Legislature may change the terms of the PERS contract prospectively, as long as accrued benefits are protected. Under the *Moro* decision, it seems likely that the Legislature could constitutionally eliminate or reduce the pick-up going forward. Eliminating the 6% member IAP contribution requirement for OPSRP members, which has no contractual guarantee by statute, or a statutory change to allow only a partial employer pick-up of the member IAP contribution are options, but would likely trigger collective bargaining for a comparatively-valued increase in compensation. Collective bargaining agreements, with the exception of the Service Employees International Union agreement discussed below, contain the following clause:

In the event that the State’s payment of a six percent (6%) employee contribution under Section 1 or under Section 2, as applicable, must be discontinued due to a change in law, valid ballot measure, constitutional amendment, or a final, non-appealable judgment from a court of competent jurisdiction (other than in the PERS Litigation), the State shall increase by six percent (6%) the base salary rates for each classification in the salary schedules in lieu of the six percent (6%) pick-up. This transition shall be done in a manner to assure continuous payment of either the six percent (6%) contribution or a six percent (6%) salary increase.

Redirecting future 6% member contributions from the IAP to instead offset the costs for the member’s pension benefits also remains a potential option, but likely subject to legal challenge. Redirecting such funds would eventually reduce the level of unfunded liability, if and when such a liability exists.

Individual Account Program

The IAP was originally estimated to pay approximately 15% to 20% of a retiree’s final average salary (FAS) (for a 30-year career) based upon the assumed earnings rate at the time the program was created (8%). One of the three defined contribution plans make-up an approximately 54% of an employee’s FAS, based on a 2015 actuarial retirement study.

An employee's contribution is included in the FAS calculation for Tier 1, Tier 2, and statutory judge members regardless of whether the employee or employer pays the cost. An employee's contribution is excluded from the FAS calculation for OPSRP members, if the contribution is picked-up by the employer, otherwise such contributions are included in this calculation.

IAP contributions are generally pre-tax. Employer-paid contributions are pre-tax. Member-paid contributions can be pre- or post-tax. Only in very limited circumstances are some member-paid IAP contributions paid post-tax. Taxes, or tax withholdings, are paid at the time of the IAP distribution for pre-tax contributions.

Employee mandatory contributions to the IAP are generally not "matched" by employers like a private sector 401K, and contributions are limited to 6%; however, according to PERS, some employers can and do make supplemental IAP contributions on behalf of their employees. The IAP has no unfunded liability and is not included in actuarial valuations because IAP assets are not available to pay a defined pension benefit (see *Projected Increase in PERS Unfunded Accrued Liability*, LFO Budget Information Brief 2016-5). The contribution also is not included as part of the rate collar calculation (an administrative method to smooth fluctuations in employer contributions between biennia; see *2013-15 PERS Rate Collar*, LFO Budget Information Brief 2014-2). The employee contribution is not funded with pension obligation bond proceeds or other side account proceeds (see *State Pension Obligation Bonding*, LFO Budget Information Brief 2016-6).

At retirement, IAP dollars are paid in either a lump-sum payment or in installments over 5, 10, 15, or 20 years, or over the member's expected lifetime. For installment, future payments are adjusted as the balance that remains is subject to potential investment earnings and losses. The majority of retiree payments made by PERS are net payments after taxes have been withheld unless transferred or rolled over into a qualified tax-exempt plan, as discussed below.

Oregon Savings Growth Plan

The IAP or an employee's contribution should not be confused with the 457b Oregon Savings Growth Plan (OSGP) or other federally authorized employee deferred compensation plans, which are optional, supplemental retirement plans voluntarily initiated at the employee's discretion and are separate from the PERS system benefit plans (albeit PERS administers the OSGP and funds are invested by the State Treasurer under the direction of the Oregon Investment Council [OIC]). At retirement, however, IAP payouts can be transferred into the OSGP accounts as a qualified plan. The OSGP currently has approximately 26,600 participants (16,404 active contributing participants) whose accounts are valued at \$1.6 billion in voluntary employee contributions and investment earnings, as of December 31, 2015. The average balance is \$60,000, based on these figures.

Individual Account Program Financials

The IAP Account is a fiduciary fund held in trust for the "exclusive benefit of the participants and beneficiaries," as funds in the trust cannot be reappropriated for any other general governmental use. PERS reports that out of the \$1.1 billion in IAP contributions system-wide for the prior 2013-15 biennium, employers paid \$827 million (78%) and employees paid \$238 million (22%). Of the \$1.1 billion, all but \$1.7 million of employee contributions were pre-tax contributions (both member-paid and employer-paid contributions).

The IAP's growth represents a large share of the PERS portfolio and is a key benefit for OPSRP members.

As of December 31, 2015, IAP assets are equal to \$7 billion, or 11% of the \$61.8 billion portfolio. There were 255,896 active IAP accounts, with an average IAP account balance of \$26,988. The IAP payout for the 2015-17 biennium equals an estimated \$869 million.

Graph A: IAP Net Asset Growth

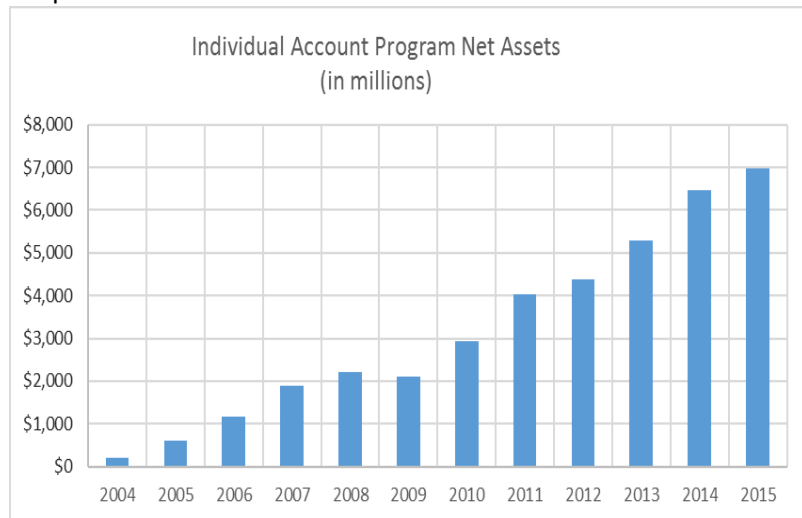


Table A is a 12-year history of IAP investment returns that have averaged 7.88%, with the highest return being 18.47% (2009) and the lowest being -26.75% (2008). An IAP account has no guaranteed return and members have no control over the underlying investment decisions.

Returns are based on market returns produced by the State Treasurer under the direction of the Oregon Investment Council. The IAP's administrative costs are funded from gross investment earnings (\$7.6 million for calendar year 2015).

Table A: Historic IAP Investment Returns

# Years	Valuation Year	IAP Return
1	2004	12.77%
2	2005	12.80%
3	2006	14.98%
4	2007	9.46%
5	2008	-26.75%
6	2009	18.47%
7	2010	12.13%
8	2011	2.15%
9	2012	14.09%
10	2013	15.59%
11	2014	7.05%
12	2015	1.87%
	Average	7.88%

Proposed De-Risking of the Individual Account Program

Beginning around 2011, concern was raised about the risk the IAP potentially places on PERS members at retirement. The City Club of Portland formally raised the issue in its bulletin on recommended PERS reforms (Vol. 93, No. 49). Given that IAP accounts are invested long-term in the same manner as the rest of the PERS portfolio, a market downturn at an inopportune time could jeopardize a portion of a PERS member's retirement. A somewhat similar experience occurred with the Oregon 529 College Savings Network plan after the 2008-09 market downturn and the 2007-09 economic recession. The 529 College Savings account balances plummeted just as some participants sought to withdraw funds to pay for college.

The State Treasurer, the OIC, and the PERS Board, are evaluating options for reducing IAP investment risk; however, the de-risking of the IAP portion of the PERS portfolio could impact the OIC's ability to meet the assumed earnings rate, which the PERS Board has set administratively at 7.5%.

Recent Collective Bargaining Agreements

A recently concluded Service Employees International Union (SEIU) collective bargaining agreement with the Department of Administrative Services (DAS) for state agencies has their represented employee's paying the 6% mandatory employee contribution. SEIU represents approximately 21,000 employees, which is about 51% of the approximately 41,000-person state agency workforce.

DAS reports that no other state employee union, besides SEIU, has expressed an interest in bargaining to move the IAP contribution from employer to employee paid. The American Federation of State, County and Municipal Employees (AFSCME) collective bargaining agreement continues the employer pick-up of the IAP contribution. The mostly non-unionized Judicial and Legislative Branch agencies also have continued with the employer pick-up.

Financial Impact of the SEIU Collective Bargaining Agreement

There is a financial impact of shifting from an employer to an employee pick-up for both the employee and the employer. The fiscal impact of the SEIU change to employees paying their PERS employee contribution was premised on leaving net employee pay unchanged and leaving the net cost to the state unchanged, according to the DAS Chief Human Resource Office.

For the employee, the SEIU contract provides for a comparatively-valued increase in compensation of 6.95% of salary. 6% of the increase is for the employee-paid IAP contribution and 0.95% is for the associated payroll taxes (e.g., Social Security/Medicare and Mass Transit tax). The effective date of the SEIU change is November 1, 2016. Employees will still be responsible for the payment of personal income taxes.

For the state, the SEIU contract provides for a 1.48% cost-of-living adjustment (COLA) on December 1, 2015, which is below the 2.25% increase negotiated for subject employers by other unions. The 0.77% difference in the COLA, along with the difference in the effective dates of the implementation of the change in the pick-up and the COLA, is meant to offset the 0.95% cost of transferring the PERS pick-up from the employer to the employee. In future biennia, the initial lower 1.48% COLA adjustment will continue to produce offsetting savings as the basis of employee pay is 0.77% lower than in other collective bargaining agreements, even after comparatively-valued increases in compensation.

The fiscal impact of the SEIU collective bargaining agreement change for eight months of the 2015-17 biennium is \$15.2 million total funds, of which \$4.9 million is General Fund. As noted previously, this cost was largely offset by a lower December 1, 2015 COLA (1.48% vs. 2.25%).

For SEIU employees, the comparatively-valued increase in compensation will increase the employee's IAP contribution. 6% of all future COLA or other salary and wage increases will also go into the IAP account rather than provide an increase to an employee's take-home pay. If applicable, the salary increase will result in higher overtime, work-out-of-class, and vacation payout amounts as well as a higher COLA for employees since their base hourly rate will increase by 6.95%.

The SEIU agreement will have no appreciable impact to Tier 1 and Tier 2 member benefits, including money match, as the 6% IAP contribution is already included in final average salary calculations; however, OPSRP member defined benefits would increase due to the comparatively-valued increase in compensation, which is estimated to increase employer contribution levels into the future by as much as 1% to cover an increased benefit.

There would be an indirect, albeit likely nominal, decrease to employer contribution rates due to an increase in payroll growth (6.95%) above what is currently assumed in actuarial assumptions (3.50%), as well as a nominal decrease to the pension obligation bond rate change as fixed debt service costs would

be allocated across higher payroll costs; however, such a change would not be expected to occur until the 2019-21 biennium.

Apart from the state budget, SEIU the organization also benefits since the amount of union dues collected will increase, as they are calculated as a percentage of salary and wages.

Conclusion

An employee mandatory contribution has been a feature of PERS benefit plans since its inception, though the actual payment of the employee contribution for the majority of employees has shifted from the employee to the employer through federal and state law changes and the collective bargaining process. An employer pick-up has financial advantages to both the employer and the employee.

A return to the employee paying the employee contribution in exchange for a comparatively-valued increase in compensation was recently negotiated by one major union. This has increased employee costs due to payroll taxes. To date, other unions and managements have chosen to remain with the employer-paid employee contribution.

Legislative changes in 2003 that created the IAP have been a successful cost-saving reform. The IAP now represents a significant source of retirement income for PERS members, especially OPSRP members. As the IAP has grown in value, both as a portion of an employee's retirement assets and as a portion of the PERS portfolio, an evaluation of the underlying investment risk is being undertaken.

There are a few legally viable options for further reform of the employee contribution and the IAP based on the most recent Oregon Supreme Court decision on *Moro*; however, any statutory change to the employee contribution will likely trigger changes to current collective bargaining agreements.