Fear and Loathing at the Site of the Head On Collision

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We live in a universe full of motion—asteroids whiz through space, airliners soar across the sky, locomotives hurdle down narrow tracks and cars zip along even narrower asphalt ribbons. Inevitably, some objects in motion collide head on – and the results are usually catastrophic. The evidence of these head on collisions bears witness to their ferocity – scarred planets, disintegrated aircraft and twisted metal hulks.

We also live—and the people in this room work in—the world of political economy, a world where equally catastrophic collisions are possible between human desires for financial security on one hand and the hard economic reality of satisfying those desires on other. These collisions are taking place with increasing frequency in every area where government is offering guarantees of financial security whether it is the security of knowing you will get a specific price for your crop or knowing you will have your medical care paid for by someone other than yourself.

As we sit here today, we are witnessing a particularly bone-wrenching, head on collision between the desire for financial security in our older years versus the hard, hard reality of paying for it. In programmatic terms, it is the collision between defined benefit pension plans and financial reality of funding them. Debris from this collision is falling in the Congress, many corporate boardrooms, the Pension Benefit Guarantee Corporation and most state legislatures and city councils across our country, indeed across most of the industrialized world.

You, in your involvement with Social Security, and we here in Oregon, in our involvement with the Public Employees Retirement System, are eyewitnesses to two exceptionally clear examples of this type of collision. In both cases, the strong and completely understandable desire for guaranteed financial security after retirement is colliding head on with the economic reality of paying for it.

In the case of Social Security, the April 9, 2003 report of the SSA's Chief Actuary to the Senate Committee on Finance is sobering, and given the scale involved, that is certainly an understatement. The Actuary's report concludes that Social Security program cost-- that is benefit payments-- will exceed revenue from payroll tax deductions in 2018, just 15 years from now. In "pension time", something akin to "geologic time", 15 years is a mere heartbeat from now. From then on, according to the Actuary's report, it only gets worse as he predicts the Social Security Trust Fund will be "exhausted" in 2042. The report concludes that maintaining Social Security's current benefit structure indefinitely, even under the current pay-as-you-go paradigm, would require that Americans immediately and permanently give up an additional 3.8% of their income to new payroll taxes. If there were a Richter scale of sorts for collisions, this collision between the financial security offered by Social Security and the cost—and consequences-- of funding it would register triple digits.

In the case of Oregon PERS, our Legislature and newly elected Governor faced an unfunded actuarial liability of more than $15 billion at the beginning of this year. This is a large obligation in a state with roughly 3.5 million people and far fewer taxpayers. We forecast that payroll rates to fund our pension plan would need t rise from roughly 10% of pay to more than 24% for most of our

public employers. The first jump—scheduled for July 2003—would have taken rates to nearly 17%.

In an unfortunate confluence of ill winds, our state and local governments simultaneously faced a sharp decline in state income tax revenue, but constant, and in many cases rising, demands for expenditures on public safety, education, parks, transportation and other public services. Further complicating matters here in Oregon was the belief that our Supreme Court would find that any reduction in current or future pension benefits violated the state's constitution. As we are a small state in a big nation, our collision between the financial security offered to public employees in OPERS and the cost—and consequences—of funding it may be rounding error in Social Security's books. However, since approximately 95% of all public employees in our state are PERS members and since one in nine adult Oregonians has a financial relationship with PERS, the collision has been remarkably intense indeed.

I don't pretend to be an expert on Social Security and our own state's pension system is so extraordinarily complex itself, I am even reluctant to claim expert status here as well, even though I am the system's chief executive officer. Our two systems, in a sense, represent the terrain or playing field on which the collision I described above is taking place. And, as every sporting type knows, the field of play profoundly affects the game itself whether it's the Green Monster in Fenway Park, the "short porch" in Yankee Stadium or the thin air in Denver.

The differences in our respective playing fields may be affecting our options and choices for untangling the collision and trying to restore some harmony. At the national level, Social Security, save for reforms that are structurally minor, largely has marched on unchanged. The system remains on an actuarially unfunded, pay-as-you-go basis with an extraordinarily constrained investment

program. Here in Oregon, the force and consequences of our head on collision have caused our state to do major surgery on benefit methodologies, dramatically change the governance of the pension system, curtail benefits to active members and even to current retirees via the suspension of their COLA payments.

Why the difference? The only structural reason I can think of is that our statutory requirement to set contribution rates that are actuarially sound and lead to full benefit funding has prevented us from assigning the costs of delivering the financial security we desire to the next generation, as does Social Security. Here in Oregon, at least a healthy portion of the cost of supplying financial security began showing up now, competing with our citizens other desires for schools, public safety, parks and so on. And thus, we were stirred to action.

Our tale is not yet finished. Some critics of the many significant and complex reforms that have been recently enacted in Oregon say that they will not withstand judicial review. If they are right, it is not difficult to see more collisions ahead.

But let me conclude with one profound similarity I see between the way our national leadership is addressing the Social Security dilemma and the final reform underway here in Oregon. Our state legislature and governor are close to passing legislation that would terminate new entry into our existing pension, a system which, by offering significant life annuity benefits, excels in providing financial security, but does so by making employer costs extremely unpredictable. In its place, our House of Representatives has passed a pure defined contribution plan while our Senate has approved a hybrid, that is a two part pension plan, which builds a retirement income stream simultaneously through a separate defined benefit structure paired with a separate defined contribution structure. Most parties with opinions on the matter

suggest the hybrid structure will be Oregon's public sector pension plan for the 21st century.

What is notable about the hybrid structure is that the cost and consequences of creating a measure of financial security in retirement are shared between the recipients of that security and Oregon's taxpayers who are the beneficiaries of the public service provided by those recipients. In this respect, Oregon's path to reconciling our public servants' desire for financial security after retirement and the cost, and consequences, of providing it, is structurally quite similar to the sum of pension policy changes emerging from Washington over the past decade.

The view from our far off corner of the country suggests that when one adds Social Security's defined benefit structure with the defined contribution basis for such things as Individual Retirement Accounts, Medical Savings Accounts, Retirement Savings Accounts, 401-K's and 457 deferred compensation plans, the aggregate of these programs adds up to … a hybrid structure where the cost and consequences of providing a measure of financial security after retirement is shared between the recipients of that security and taxpayers.

Backing into a hybrid structure nationally does not mean that the collision between inflexible defined benefit obligations in the Social Security system and the cost and consequences of funding them will disappear. Far from it. If anyone thinks that, I urge them to review once again the report by the system's actuary discussed earlier. What it might mean, is that as real alternatives or supplements to Social Security become reality, the playing field may be transformed enough to make real Social Security reforms increasingly possible. If so, our country might avoid an exceptionally large and painful head on collision.

Thank you