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Best Practices in Pension Reform

Lessons Learned from Successful Reformers

by Lance Christensen and Adrian Moore

Reason Foundation



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Executive Summary

Ideally, state and local governments set aside a realistic amount of money every year to prefund their employees' pensions using a range of assumptions about their labor costs and terms of service. But if these assumptions are off, even by a little, governments both small and large can find themselves mired in unfunded liabilities and debt obligations that consume an increasing amount of the annual budget. Many local and state governments are overwhelmed by unfunded liabilities right now, and looking for a way to bring pensions back into balance through reform. This document comprises the best practices and lessons learned in pension reform and is largely an excerpt from our *Pension Reform Handbook: A Starter Guide for Reformers*, published in July 2014. It also captures the experience of several jurisdictions that have successfully navigated reform, as spotlighted in our series of case studies, which can be found at Reason.org.

As illustrated by the experience of all of our reformers, the case for pension reform in most jurisdictions is grounded in applying a realistic assessment of the state's unfunded liabilities and reversing a culture of underfunding the pension system. Simply blaming a jurisdiction's public employee pension problem on a downturn in the stock market or a period of economic recession prevents an honest assessment of its long-term causes, which may be numerous and go far beyond the typical fluctuations of a dynamic economy. To lay the groundwork for reform, it is important to first identify a pension problem and then research it in a detailed, specific and deliberate way, realistically assessing liabilities and actuarial assumptions in a jurisdiction's pension system. Actuarial assumptions

should align with real performance. Would-be reformers should also examine the financial volatility of “other post-employment benefits” (OPEB), which often contributes to the problem. Most jurisdictions do not address OPEB unfunded liabilities, and, as a result, shortfalls in retiree health care funding likely outweigh those of the pension systems.

There are several pathways toward reform that may be worth considering before full-scale, comprehensive reform efforts are launched. An initial step is to professionalize the governance of the pension system. This will address conflict-of-interest issues, provide transparency and improve oversight over benefit and investment decisions. A pension board should consist of professional finance and investment experts, and most members should be independent of the pension system.

One way to bring down the costs of pensions—without relying entirely on a political/legislative process—is to secure preliminary concessions in union labor contracts through the collective bargaining process. It is also important to understand that pension reform is more than just defined benefit reform. There are several options, including total defined contribution conversions, hybrid reforms or other plans—it all depends on the culture of the jurisdiction and appetite for reform.

If pension system stakeholders are hesitant or resistant to reform, even when the problem is clearly demonstrated, reformers should seek outside and independent legal counsel. Attorneys who have a personal interest in an existing pension system—no matter how defunct it may be—are less likely to form an objective opinion that would support reform efforts.

In order for any effort to be successful, there must be local and broad support. Forming coalitions to support and push for reform is essential. This may (and should) include elected officials, but it could well be led by concerned and engaged citizens. Coalitions can reduce the complexity of the legislative debate and create buy-in from various stakeholders in the jurisdiction.

It is likely that reform coalition partners have spent years creating reports and studies that could be very useful in building the case for reform, supplying evidence-based arguments backed up by statistics from reputable sources regarding the actual costs of pensions. Any competent pension system should be regularly reporting on its fund’s assets and liabilities. If that is not being done, reformers should agitate for more transparency and oversight with the legislative sponsor or pension board. It may require an independent entity to conduct audits

or perform actuarial analysis by requesting annual financial reports through open records requests. Other applicable information can be found in public documents, reports, audits and actuarial reviews.

While the case for reform may be obvious to those advocating it, a well-organized coalition is essential to educate the public and help them understand the changes that need to be made. A coalition should present a straightforward case to the general public, emphasizing the fiscal impact on the budget and government services if the pension system is not reformed. This can be done by holding informational town halls to answer questions from the public. Active engagement with the community can sway even the most ardent union-dominated jurisdictions like Rhode Island or San Jose. A competent coalition will be prepared and vigilant in combatting the common, but false, arguments opponents will make about the system's health and fiscal impacts if reformed.

If lawmakers are not willing to make the requisite changes, reform may—in some jurisdictions—be taken directly to the voters through a ballot initiative. In this case, reform advocates should utilize competent political consultants, use polling to test ideas and arguments, and ensure that ballot language is vetted by knowledgeable attorneys. They should use the reform coalition strategically to line up funding and to counter labor union opposition tactics.

While it may be desirable to implement one broad and comprehensive reform measure, it is not reasonable to assume that such changes will be politically feasible until there is a felt need for change among both a majority of citizens and at least some elected officials. Attempting to pursue that one comprehensive set of reforms may be overly complex and, ultimately, counterproductive. It may require numerous narrow pension reform measures over the course of years to lay the groundwork for substantive reform. It takes some time to educate the public on the issues, thereby enabling reform proponents to overcome opponents' negative messages and misrepresentations of the effects of the reforms.

Even if reform does happen, the work is not over. Implementation requires constant vigilance to maintain and sustain the reforms so that the retirement system is affordable, sustainable and secure for the employee and taxpayers. Defined benefit plans must continue to be fully funded as they close, based upon an amortization schedule that makes fiscal and budgetary sense.

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Part 1

Introduction

Depending on what assumptions are used, current state and local government workers will earn between \$4 trillion and \$8 trillion in retirement benefits by the time they retire. Ideally, state and local governments set aside a realistic amount of money to prefund their employees' pensions using a range of assumptions about employees' labor costs and terms of service. However, if those assumptions are off by even a little bit—especially considering compound interest, inflation and other factors—or a jurisdiction did not make its full and required payments into the system, unfunded liabilities and debt obligations are likely to increase and impinge on future budgets.

This is a very real problem for small special districts up to large state governments across the nation alike, as the pension plans for their government workers are now in crisis. In some cases, pension systems have only a fraction of the assets needed to meet obligations, creating unfunded liabilities and undermining the soundness of the pension plan.

Pension costs have more than doubled in a decade, yet workforce and revenues have remained stable, leaving less money available for other services. In San Diego, before its reforms, pension payments were over 50% of total payroll costs. In Florida pension costs for state employees rose from 18% of payroll for general employees in 2004 to 25% in 2010, and for public safety employees rose from 28% to 41% during the same time period.¹ It is also possible that benefits are dramatically out of proportion with labor markets and/or relative to plan funding levels. Some unfortunate places have more than one of these fiscal problems.

In most every case, dealing with the serious problems of government pension systems is guaranteed to be a fairly complex and politically contentious process. But the good news is that a number of jurisdictions have paved the way for substantive reform, and several state and local governments now stand as models from which others can learn.

This document comprises the best practices and lessons learned in pension reform and is largely an excerpt from our *Pension Reform Handbook: A Starter Guide for Reformers*, published July 2014. It also captures the experience of several jurisdictions that have successfully navigated reform, which we have spotlighted in our series of case studies found at Reason.org.

Part 2

Pension Problems and Principles of Reform

This section briefly describes the causes of pension problems and outlines some principles that should guide reform.

A. Causes of Pension Problems

Pension problems are nearly always caused by some combination of the following challenges and concerns:

1. Intentional Underfunding

Too many governments have made bad financial decisions by choosing not to make the necessary annual payments into pension systems to fund the benefits they have promised workers. This potentially threatens worker benefits and creates (or increases) unfunded liabilities, or debt. These shortfalls, along with interest payments, must be made up by subsequent administrations that were not responsible for underfunding. Without reforms, pension plan costs are very unlikely to decrease and payments are no easier to make in subsequent years. Making higher payments to make up for past shortfalls is unlikely to reduce the unfunded liabilities. Indeed, underfunding pension plans tends to compound the ever-growing problem.

2. Poor Management and Bad Decisions

Poor management decisions about pension systems can cause serious problems, as well. One of the most severe problems comes from making poor assumptions about market returns earned by funds in the pension plan. Too many governments repeatedly assume higher rates of return on their pension investments than are realized and fail to increase payments into the system to make up the difference, leading to an underfunded pension system. Other governance problems include politicized pension boards, investments driven by

politics rather than sound financial practices, and failures to be transparent and accountable. Poor governance or ignoring the problems allows them to fester, whereas they should have been dealt with early while still relatively manageable.

3. Overgenerous Benefits

A few states and other jurisdictions have driven pension costs out of control by promising or allowing relatively higher benefits than other comparable jobs in the labor market. Excessive benefits can easily increase to levels that governments—and thus, taxpayers—cannot afford.

4. The Great Recession

Periods of economic recession can affect investment outcomes considerably, yielding lower than expected returns on pension system investments. To balance the investment losses, policymakers who overestimate return rates must then increase funding into the pension system during hard economic times. Often, due to tight budgets, they fail to do so, leading to even greater shortfalls. In this way, lower yields exacerbate funding disparities and can compound problems, especially when pension funds are poorly managed to begin with.

Jurisdictions that have enacted serious pension reform have addressed each of these areas of concern. These challenges can be overcome if reformers have the will and demonstrate leadership to seek the necessary reforms. Reformers are likely to be successful if they make the effort to learn what has worked from those who have already been down that road.

B. Principles of Pension Reform

Leaders have succeeded in reforming pension systems in many jurisdictions throughout the country, and reforms have been studied by academics, taxpayer groups and labor organizations, providing several principles to guide reforms. These principles can guide decisions about which reforms to use, how to implement them, and how to talk about them in making the case for reform.

1. Reforms should reduce, and then eliminate unfunded liabilities.

Passing liabilities on to future generations is reprehensible, but all too common. Reforming the structure, the costs and the payments into pension plans to

provide fully funded obligations—while at the same time committing funds to pay down existing debts and liabilities—is crucial. There should be a fixed timeline for paying off the liabilities. Some systems amortize their debts over 30 years. However, some experts caution against using such a lengthy debt repayment timeline and suggest shorter repayment schedules of 10–15 years to prevent “negative amortization.” Just like making the minimum payment on a credit card may not ever pay off the balance, underfunded pension systems need to move aggressively to full funding to avoid future problems with pension debt. The sooner that debt is paid off, the sooner costs go down.

2. Pension plans should be affordable, sustainable and secure.

The security of a pension plan flows from it being affordable and sustainable so that workers do not have to fear that future financial crises will undermine their benefit security. Pension plans should be sustainable at reasonable budget levels and not consume too much of a jurisdiction's budget. San Diego saw pension costs rise from less than 20% of personnel costs to over 50% of personnel costs in just 10 years, a red flag indicating unsustainable costs. Pension costs should never threaten a jurisdiction's ability to provide essential services or require taxation levels that reduce economic growth, but some pension perks undermine sustainability. For example, the “13th check”—a bonus check sent to retirees when markets outperform expectations—gives pensioners a windfall during high markets, but when the market contracts, pensioners don't have to pay the shortfall in pension obligations: governments, a.k.a. taxpayers, do. Perks like this make the current public pension paradigm unsustainable. Unaffordable pension plans are typically seen along with other bad financial management decisions, but because pension costs are opaque and often deferred, typically they are not addressed seriously until there is a fiscal crisis with the threats of reduced services, cuts to education and public safety, default on loans, etc. Responsible pension management should protect against a financial crisis. Sustainability demands that governments use realistic assumptions and make contributions to the plan that will continuously provide promised benefits. If these conditions are met, then pensioners will be secure in their benefits and governments will have predictable and defined costs that make it easier for them to meet their obligations.

3. Reforms should manage and mitigate risk—for both workers and taxpayers.

As pension liabilities have grown relative to government budgets, the consequences of investment losses have grown as well. At the same time, the

market for equities is clearly trending toward more volatility, which increases the risks of those investments for institutional investors. Many government pension systems are structured so risk is completely borne by taxpayers. If the pension system fails to perform to expectations, taxpayers are on the hook for financing any debt created by poor financial decisions.

Whether governments or employees shoulder these risks distinguishes the two main types of pension systems: “defined benefit” and “defined contribution.” A defined benefit (DB) pension system puts investment risk on the employer to ensure the necessary funds are available to pay promised annual benefits to retirees. A portion of each employee’s compensation is paid into a pooled fund that is invested on behalf of all employees. In exchange, the employee is promised a pension upon retirement of an amount defined by the rules of the system (usually some proportion of the former employee’s salary). If the fund does not grow at a rate large enough to pay out the promised amounts to retirees, then the employer (i.e., the taxpayer) is obligated to make up the difference required to pay those pension benefits. The Brookings Institution points out that:

The sustainability of a pension system relies on two mechanisms: government accountability and the balance of taxpayer costs and benefits. ...Defined-benefit pension systems have inherent characteristics that make them difficult to fiscally sustain. First, the time lag between pension plan promises and pay outs gives the pension plan provider a lot of room to “pass the buck.” Second, pension plan providers must unwaveringly pay out pension promises, regardless of market variability, placing a great deal of risk on taxpayers to fill any funding gaps. Third, pension plan providers have a lot of freedom to regulate themselves, sometimes making unreasonable projections about future funding and liabilities and potentially leaving the public with uncertainty around the true cost. In thinking about how to rebuild pension systems, it is important to think long-term about how taxpayers will evaluate benefits and costs in order to continuously support a retirement system.²

As local and state governments find themselves increasingly unable to provide these pension guarantees against the market fluctuation and still provide basic government services, many have looked to the private sector for a pension structure that balances the risk between government (i.e., taxpayers) and retirees, called a defined contribution pension system. A defined contribution (DC) pension system puts the investment risk on the employee and limits the risk to the employer. A portion of a worker’s compensation is paid into a personal fund

that workers manage based on their risk tolerance and retirement goals. In exchange, the employee usually receives slightly higher wages, some of which can be set aside for retirement at the employee's discretion. Since the employee is responsible for managing his or her own retirement finances, the employer has no further obligations. Since this type of pension system enables government to predict its contribution to pensions, it does not create unfunded liability.

Taxpayers should bear risks appropriate to government employers and, conversely, workers should bear the risks appropriate for them and their retirement.

There are various sources of pension risks:³

- **Employer survivor risk:** the risk that the employer fails to adequately fund a defined benefit plan and enters bankruptcy without a means to make good on its promises.
- **Inflation risk:** the risk that the value of the accrued benefits will be eroded by inflation.
- **Investment risk:** the risk that the investments chosen by the employee or plan administrator will not produce the money required to fund an individual's retirement needs (defined contribution) or the obligations of the plan to a group of retirees (defined benefit). This risk within defined contributions can be reduced through limiting the options an employer chooses to give to an employee.
- **Funding risk:** the risk that the individual (defined contribution) or the employer (defined benefit) does not put away enough money to adequately fund the needs of an individual or a group.
 - **Long-term funding risk:** the risk that contribution rates will have to rise to an unacceptable rate over a long period of time to meet projected goals.
 - **Short-term funding risk:** the risk that contribution rates will have to rise to an unacceptable rate over a short period of time to meet projected goals.

Neither governments/taxpayers nor government workers should bear all of these risks. The benefits of good economic times and the costs of realized risks need to be sensibly divided between the two.

4. Reforms should ensure a productive and stable workforce for government.

Most pension reforms enacted over the last decade focused on cutting benefits or increasing costs for new employees. Those are the easiest reforms to implement, but in isolation that creates an unfair system and undermines the quality of the workforce. Since 2009, 48 of 50 states cut benefits for new workers, 33 raised the retirement age, 30 raised employee payments for pension benefits, and 29 reduced or eliminated COLAs.⁴ In some cases such cuts might be needed to bring benefits in line with labor markets, but it will not reduce the unfunded liability already incurred. Just like switching from a heavily indebted credit card to a new one for new purchases, the old debt is still there and must be addressed. Thus paying debts incurred by defined benefit plans only through curtailing benefits for new hires too often is a means of passing the costs of current workers on to future workers.

The goal should be to provide a reasonable and stable retirement benefit for all workers that is fair to workers of different ages, tenure and skills. Government workers already enjoy high levels of job security and parity of pay so it seems unlikely that benefits have much influence on productivity by comparison.

5. Pensions should provide fair benefits for government workers and fair controls for taxpayers.

Benefits and health care costs are increasing, people are living longer, and yet government policy encourages them to retire sooner. The fact that people are living longer, healthier lives, however, means that they are able to contribute to the workforce—with greater wisdom and patience—later in life. With this in mind, it is hard to understand why a standard government employee should be allowed to retire at age 50 or 55 and collect substantial benefits while others cannot begin collecting Social Security benefits until age 62.

A logical reform would be to synchronize government retirement ages, to the greatest extent possible, with Social Security for all those enrolled in defined benefit plans. (Those controlling their own retirement benefits through defined contribution plans should be free to select their own retirement ages since they are the ones bearing the risk of their investments.) To prevent hypothetical cases such as a well-past-his-prime, 61-year-old state trooper still on the job (and, thus, chasing criminals), governments could easily carve out rational, tightly defined exemptions for true “public-safety” officials like firefighters and law enforcement personnel to permit earlier retirements or facilitate transfers to

other office duties. For standard government employees, however, retiring at 62 should be the norm, not the exception. Enacting this reform would be a much more effective tool to retain seasoned workers than, for example, instituting “double-dipping” programs like Deferred Retirement Option Plans (DROP), in which government pays a retirement-qualified employee who continues to work a pension and a paycheck at the same time for the same work.⁵

Common sense pension reform should bring government labor practices closer to what the labor market offers. Perks such as allowing workers a (one-time) purchase of years of service to enhance their pensions (in perpetuity) results in a loss of experienced labor at a net fiscal loss for government. Known as “air time,” this practice of compensating workers for time during which no work was done is completely out of line with what the private sector offers, which is patently unfair to taxpayers who have to foot the bill.

Pension obligations should be accountable to taxpayers who have to pay for them. Government worker benefits should be in line with comparable labor markets and consistent with what a jurisdiction can afford. By benchmarking salary and benefits to the local labor market, government can effectively and efficiently compete for quality workers. At the same time, providing benefits that are portable and desirable is crucial to jurisdictions competing for workers in the labor market.

Every time a labor contract is up for negotiation, pension benefits are on the table. However, there is a notion or unclear legal requirement that once pension benefits are promised for government workers, they can never be reduced. This has a one-way ratcheting effect. Negotiations can include increases in benefits, but never reductions. If it is fair for public employee labor to have that kind of security, it is fair for taxpayers to have security as to the total costs of labor and the like. Governments must meet all their obligations to *both* workers and taxpayers.

6. Pension reform should strive for simplicity, clarity and transparency.

Pension decisions are political in nature. Labor negotiations are much the same as lobbying—a special interest is trying to persuade elected officials to pursue a policy or course of action that will benefit the members of that group. In this case, the special interest group is government workers in a particular jurisdiction. Reforms should seek to depoliticize benefit decisions as much as possible by making pension plans simple, clear and transparent. When the system is so complex that only a handful of people understand it, and/or so

opaque that few learn the details, outcomes are not likely to be fair or widely accepted once they are known.

All pension plans should be subject to examination and potentially to reform. Exempting some employees will defer problems to the future and create an unfair imbalance in the overall workforce of a jurisdiction.

Pension system management should be apolitical, transparent and consistently track performance of its invested funds. Pension board members must have a fiduciary duty to preserve the plans' long-term sustainability, utilize an independent board of investment experts, and openly share data about the plan, its participants and its fiscal condition.

7. Policymakers must be sensible about projections and risks.

One driver of current unfunded liabilities has been unrealistic assumptions about investment gains and risks, driven in part by optimistic and opaque actuarial assumptions. Investment return assumptions should not be based on past performance, but rather linked to the risk profile of the investment portfolio of the system, the risks of projected pension payments in the future, and discount rates in the current market.

Equally problematic is the commonly held notion that funding a pension plan at 80% of needed levels is good enough. Plans should be at least 100% funded to avoid risks to taxpayers and to workers of higher future costs or failure to pay benefits.

Using realistic estimates of investment returns and discounting future liabilities typically means higher costs in the present budget year, so politicians are too often willing to go with optimism over prudence. Yet projections are really just educated guesses about the future, so it makes sense to be very open and transparent about what assumptions are used and to disclose the consequences of errors in either direction.

Keeping projections up to date on how long people live (mortality tables), how long new employees stay in one jurisdiction, how the workforce will grow, etc. are crucial, but often neglected.

8. Pension benefits should be portable and secure.

Today's young people who pursue government jobs are far less likely to want lifetime employment by the same employer than even a decade or two ago. As the Brookings Institution put it, "Current pension systems remove many risks from long-career individuals by transferring these risks to the pension plan provider; however, these plans do not provide nearly the same protection to individuals who change jobs before retirement eligibility."⁶

The structure of many currently used government pension systems discourages young employees. Since it often takes many years to vest a new employee's pension, the public sector becomes less attractive to new hires, and not even considered by the many and talented private sector workers who wish to work in the public sector for only a few years. Pensions that vest sooner and offer portability make the public sector more attractive to a larger pool of potential employees. Thus, pension plans should create benefits that belong to employees and can go with them throughout their careers without losing value, while still providing options with adequate security and risk pooling to meet all workers' risk tolerance.

9. Reform should reflect rethinking unfunded liabilities and pension obligation bonds.

Policymakers should fully fund pension obligations as they are created and not allow debts to accumulate. Existing debts should be paid off as soon as possible, on a committed schedule, while avoiding negative amortization.

Some jurisdictions encounter costs to their pension systems that they don't have liquid assets to cover, or they expect to leverage other bonded debt against the costs of their pension funds, so they may purchase pension obligation bonds. However, pension obligation bonds are a particularly odious form of debt:

While the idea of issuing pension obligation bonds to "lock in" low interest rates may be appealing to policymakers, it is a risky game of arbitrage and something that should be avoided—particularly when these debt instruments are used to cover current-year expenditures. In addition to the fact that issuing one debt to cover another is not a sound financial strategy, many state and local governments have been burned when pension investment returns dropped and they were forced to incur additional expenses to cover the debt service. At the very least, such actions should only be taken with a vote of the public and repayment of the obligation must be given the very highest priority—the quicker the

repayment, the lower the investment risk and the lower the overall interest payment. In such instances, states and municipalities should consider imposing (subject to collective bargaining) additional assessments on government employees that would be dedicated to bond repayment. Since these employees will benefit from the debt, they should be required to help finance it.⁷

Part 3

Pension Reform Case Studies

Massive unfunded liabilities in public sector pension systems have threatened the fiscal stability of state and local governments nationwide and have put the future retirement benefits of public sector workers at risk. Political and legal factors have impeded pension reform efforts over the years, but there are a number of states that have succeeded in enacting varying degrees of reforms to their systems. Some states like Rhode Island, Michigan and Alaska have been able to pass significant structural changes to their pension systems, while other states like California have only been able to make minor tweaks to the system.

In this section we will examine pension reform measures passed in several states and highlight the lessons for policymakers that can be drawn from reform measures.

A. Michigan Reforms

The first state to pass and implement significant pension reform was Michigan, which did so in 1996 when the state legislature passed a bill freezing the state employees' defined benefit (DB) pension fund for new members. Members already in the DB system were allowed to remain in the system. Michigan's state employees' DB fund had a relatively healthy funding ratio at the time, which made the move unusual. But in retrospect, the decision was clearly a good move.

When the Michigan legislature did not vote to reform the public school employees' pension fund, exempting this fund alone, they inadvertently created a natural experiment to determine which system would be more sustainable in the long run. Over the past 15 years, the public school employees' plan accrued unfunded liabilities that would have likely been mirrored by the state employees' fund in the absence of a defined contribution (DC) option. This would have increased fiscal pressure on current state leaders and made Michigan worse off on the whole.⁸

1. What Michigan Did

(1) Froze the Defined Benefit System. The Michigan State Employees' Retirement System (MSERS) was closed to new workers hired after March 30, 1997. Employees currently in the system were allowed to remain and the system was put on a path to shut down once all eligible members had their benefits paid out, recently estimated to be by 2037. No changes were made to cost-of-living adjustments, the retirement age or accounting practices.

(2) Implemented a Defined Contribution System for New Employees. All employees hired on or after March 31, 1997 were automatically enrolled in a DC fund in which the state contributes 4% of each employee's salary into the DC fund. The state also matches additional contributions made voluntarily by employees up to another 3% of salary. Contributions from the state in the DC system vest faster than they do in the old DB system: employees attain ownership of 50% of their accumulated benefits from state contributions to their DC fund after two years of service, 75% after three years of service, and 100% after four years. Any contributions from the state employee to the DC fund vest immediately.

(3) Offered Current State Employees the Opportunity to Switch to the DC System. The pension reform legislation offered current Michigan state employees the option to leave the DB system and have the actuarial present value of their accrued benefits transferred into the new DC system. This amounted to a buyout because the state was giving the workers the pension benefits they had earned ahead of time. Approximately 5.5% of state employees, or about 5,100 employees, took this buyout.

Michigan's 1996 reforms have been considered successful because they have saved the Michigan taxpayers money (by reducing the annual pension contributions required) and because the state has seen a sharp increase in the number of state employees with control over their vested pensions since reform. An analysis conducted in 2011 by Richard C. Dreyfuss, an actuary and adjunct scholar with the Mackinac Center for Public Policy, concluded that Michigan had saved at least \$2.4 billion over the first 13 years of the plan's existence.

However despite reform efforts, the state employee DB plan's unfunded liability has grown from \$0.5 billion in 1996 to \$5.4 billion as the state has not fully paid its annual required contributions. During this period the number of employees in the DB system declined, and so there were fewer employee contributions to mask past years of underfunding by the state. While some point to Michigan as an example of reform not working, the problem in Michigan is despite the

reform, not because of it. Further, massive unfunded liabilities in retiree health care—or other post-employment benefits (OPEB)—were not adequately addressed in the reform process. The assumed return on assets was also unchanged, and is too optimistic, understating Michigan’s unfunded liability.

2. Lessons from Michigan

(1) Do not underfund a closed DB system. Missing or insufficient annual required contributions (ARC) payments may expose unfunded liabilities previously covered by a larger pool of active contributors. Since a closed system naturally has fewer employee contributions as the system draws down, it is much harder to catch up on underfunding than in an open DB system.

(2) Review actuarial assumptions. Actual rates of return even one percentage point less than the assumed rate of return mean billions of dollars in additional contributions needed for the state to pay off its pension debt.

(3) Do not ignore other post-employment benefits (OPEB) risks. Michigan did not adequately address the risks of OPEB unfunded liabilities during the reform process. Today, the MSERS health care fund is facing a shortfall of \$14.3 billion.

Politically speaking, several of the lessons learned in Michigan are similar to the lessons highlighted in other states. That is, determined policymakers can drive reform with good preparation, by avoiding direct conflict, and by emphasizing the taxpayer risk inherent in DB pension plans.

B. Alaska Reforms

In 2005, the Alaska State Legislature passed Senate Bill 141, which closed the state employees’ and teachers’ DB pension plan to new members. Members already in the existing DB plans were allowed to remain in them, and their benefits continued to accrue as originally promised. New workers hired after June 2006 were switched to DC plans, with their pension contributions going into personal accounts that they can manage on their own and take with them if they decide to no longer work for the state. Since the reforms passed, Alaska’s pension system has continued to struggle with high unfunded liabilities, a low funding ratio, and missed ARC payments due to poor policy choices by elected officials not interested in keeping the promises of a previous elected body. But

the situation in Alaska would likely be much worse had pension reform not been passed back in 2005.⁹

1. What Alaska Did

(1) Ushered in a Defined Contribution Plan. The 2005 reforms created a DC pension plan for all new state public employees and teachers. The new 401(k)-style savings accounts, to which employees and employers both make contributions, would replace the existing DB plans for new employees and employees choosing to switch over. The new plan would allow employees to contribute amounts up to the federal limit and direct how money is allocated and invested.

(2) Protected Existing Employee Benefits. SB 141 made no changes affecting existing teacher or public employee pensions and medical benefits.

(3) Created the Alaska Retirement Management Board (ARMB). SB 141 dissolved the Public Employees Retirement Board and Teachers Retirement Board, streamlining administration of the retirement systems into one board (the ARMB). The new board requires more experience with financial and pension matters than the previous boards required in order to serve.

(4) Eliminated Cost of Living Adjustments (COLAs). Before SB 141, all public employees and teachers in the state received an annual COLA. Changes to both of Alaska's pension systems in 1986 and 1990 made COLAs available only to employees 65 or older, but the 10% COLA was still among the highest in the country. SB 141 removes COLAs for all employees hired after 2006. The new DC plans do offer a voluntary long-term care coverage plan that provides a range of health and social services for people who, because of chronic conditions, need help with basic activities. This plan, within the framework of the new DC plans, does have 5% COLAs.

(5) Changed Employee Contributions. Employee contributions have changed from 6.5% for public employees and 8.65% for teachers, to 8% for all public employees and teachers.

2. Lessons from Alaska

(1) Expect strong and organized pushback. The labor unions were not supportive of the switch to a defined contribution system and almost immediately after the bill was passed, they joined forces with one another to try and reinstitute a defined benefit system.

(2) Every ARC payment must be realistic and fully funded. In the years after Alaska's reform, ARC payments to the old defined benefits system fell dramatically. The state's unfunded liability grew. As long as defined benefit plans still exist in large numbers, they are going to present a financial problem to the state and can't be ignored or left unfunded.

(3) Audit records and actuary reports regularly. Actuaries can make mistakes. Alaska's former actuary, Mercer, Inc., did a poor job measuring the soundness and performance of the state's pension system. Alaska was able to settle out of court with Mercer for \$500 million.

(4) Amortization schedules matter. Alaska has gone back and forth on which amortization schedule to use, but has settled on level percent of payroll. Since reform, Alaska's pension debt has continued to grow and it is possible that a consistent use of level dollar amortization, which doesn't add interest to the debt, could have prevented the growth of the state's unfunded liability.

In the nine years since Alaska passed its pension reform bill, the state's unfunded pension liability has doubled from roughly \$6 billion to \$12 billion. Critics of Alaska's pension reform, and of pension reform elsewhere, claim this decline in funding level is *because* of SB 141. The actual problem is that Alaska did not change its debt payment schedule to accelerate debt payments. Further, the SB 141 bill did not correct for systematic errors in actuarial assumptions. The state's assumed rate of return on investments was not changed in the 2005 reform bill, and remained at 8.25% until 2011 when it was lowered to 8%. In the years after reform, PERS has averaged an actual rate of return much lower than its assumed rate. Rosy projections on the books keep the current pension crisis from appearing as bad as it really is. A higher assumed rate of return means lower mandatory contributions from the state budget, but it masks the severity of the debt problem.

The move to a defined contribution system for new employees was a bold but necessary step for Alaska, given the growing unfunded pension liabilities in the state. But state officials turned a blind eye to the existing debt left behind from the previously unsustainable system. As a result, Alaska's pension system

continues to struggle with high unfunded liabilities and a low funding ratio. In response to the state's growing pension woes, in 2014 the Alaska legislature passed Governor Sean Parnell's plan to use \$3 billion from the state's Constitutional Budget Reserve Fund (essentially a state savings account) to pay down the unfunded pension liability in the public employees' and teachers' retirement systems. Under the plan, \$1 billion will go to PERS and \$2 billion will go to TRS. It is a big step in the right direction for the state.

C. Utah Reforms

After the 2008 stock market meltdown, Utah's pension system faced serious financial trouble. Having lost 22% of its assets, Utah's retirement system faced a \$6.5 billion gap and dropped from being 100% funded in 2007 to 70% funded in 2009.¹⁰ In the wake of these losses, in March 2010 Utah became one of the first states to enact major pension reform. Interestingly, unlike other states, Utah's pension problems were not a result of financial mismanagement. The state had never borrowed from its pension fund and always made 100% of its annual actuarially required contributions. So how was Utah's pension system underfunded?

Because of compounding, problems are actually larger than they appear. It is not unusual for investments to underperform their targets in a year, or even lose money. But investment math, particularly compounding, means that problems are more serious than they first appear. Utah's pension fund lost 22% of its value in 2008. It made a 13% return in 2009. Public employee unions cited the 2009 returns as evidence that the state was more than halfway out of its trouble. After all, 13 is more than half of 22. But the 22% loss actually led to a 30% gap between where the fund should have been and where it was. It was expected to have earned 7.75% in 2008. Instead, it ended 2008 far behind where its managers had called for: 29.75% down, to be precise. To make up for the loss, the pension fund would have had to generate a 68% return in 2009. Reformers had to explain to legislators over and over that of the 13% return in 2009, 7.75% was already assumed, and the remaining 5.25% barely covered the interest the state expected to earn on the money that was not there because of the 2008 losses. In effect, the state treaded water in 2009.¹¹

State Senator Dan Liljenquist spearheaded Utah's pension reform bills—Senate Bills 63 and 43—and became known across the nation as the architect of Utah's pension reform efforts detailed below.

1. What Utah Did

(1) Implemented a DC Plan or Hybrid DB/DC Plan for New Employees. New employees of Utah can choose between a DC plan or a DB/DC hybrid plan. Employers contribute 10% of a worker's pay, which employees are free to supplement (for public safety employees, the contribution is 12%). Employee contributions vest immediately in the DC plan, while employer contributions have a four-year vesting requirement. The hybrid plan features a defined benefit determined by 1.5% multiplied by years of service credit and the salary average of the five highest-paid years of employment.¹²

(2) Ended the Practice of "Double Dipping." Utah's reforms prohibit public employees who retire, but are rehired after July 1, 2010, from collecting a pension and salary at the same time.¹³

(3) Limited Cost of Living Adjustments. COLAs were limited to 2.5%.¹⁴

(4) Protected Taxpayers. Taxpayers are protected against having to make extra contributions to the DB plan. If in any given year the plan requires additional funding, employees—not taxpayers—must make up the gap. The law also allows future legislatures to make adjustments should the ARC increase year after year. In that case, they are free to reduce the benefits for all retirees and employees.¹⁵

2. Lessons from Utah

(1) Model alternative pension scenarios and assumptions. Senator Liljenquist's first step was to request a comprehensive, long-term model from actuaries that was used to make the case for reform. The models allowed legislators and the general public to look further into the future and see just how bad the situation was, based on different assumptions regarding future investment returns and the like. Good data are necessary when making the case for reform.

(2) Apply strong leadership. Senator Liljenquist spearheaded the reforms and saw them through till the very end. Not only did he guide the legislation through the process, he communicated the need for reforms directly to the people. For example, Senator Liljenquist responded to every single email he received on this issue, winning many supporters in the end.

(3) Understand that pension reform has many components. In addition to creating a new DC and a hybrid DB/DC plan, Utah also implemented COLA limits and ended “double dipping.”

Utah’s reforms have eliminated the need for tax increases or spending cuts for schools, parks and roads in order for the state to make its legally required payments to retired state workers.¹⁶ A 2012 analysis performed by two Brigham Young University economists estimated that the state’s pension fund had a 50% chance of becoming insolvent by 2028 in the absence of the 2010 pension reforms, but that with the reforms there is now just a 10% chance of insolvency over the next decade or so.¹⁷

D. Rhode Island Reforms

Rhode Island has had a history of systemically underfunding its pension systems dating back to the early 1990s. Eventually the mismanagement of the Ocean State’s pension systems—which included failing to make annual required contributions to the system and borrowing state pension funds to address other fiscal concerns—caught up to the state. By 2011, the need for reform was evident. State Treasurer Gina Raimondo commissioned an independent actuarial assessment of the pension system because of the threat it posed to the state’s finances. This assessment showed the system was less than 50% funded and had an unfunded pension liability of \$6.8 billion. That same year, the Rhode Island General Assembly passed a major pension reform bill that suspended cost-of-living adjustments (COLA) for retirees, increased the retirement age, and introduced a hybrid defined benefit/defined contribution funding system to the state. The state’s reforms are detailed below.¹⁸

1. What Rhode Island Did

(1) Suspended Cost-of-Living Adjustments (COLAs). COLAs for all state workers—including general state employees, teachers, state police and judges—were suspended until the funding ratio for the whole pension system improves to 80% funded. The legislation allows for the General Assembly to consider a COLA adjustment every five years while this suspension is in place. Also, once the pension system reaches a healthy funding level, COLAs will be calculated between zero and 4% and will only apply to the first \$25,000 of an individual’s annual pension, rather than the first \$35,000. The legislation also directs municipal pensions to suspend COLAs if they are not above an 80% funding level.

(2) Created a Hybrid Defined Benefit (DB) and Defined Contribution (DC) Plan. The Rhode Island Retirement Security Act (RIRSA) created a defined contribution plan to operate in tandem with the present defined benefit system. The hybrid DB/DC plan aims to reduce DB liabilities with a DC fund while also maintaining support from union groups who desire the security of a DB system. Workers will receive a DB out of one fund, which the state will have to ensure is properly funded with a healthy ratio of assets to liabilities. But the exact amount of a pension will depend in part on the asset growth of a worker's DC fund.

(3) Increased Retirement Age. The RIRSA increased the retirement age for receiving a full pension so that it matched Social Security's age thresholds.

(4) Extended Amortization Rate of Liabilities. The RIRSA reduced pressure on unfunded accrued liabilities by extending the amortization rate from 19 years to 25 years. This re-amortization makes it easier for the state budget to handle pension debt payments.

(5) Encouraged Municipal Pension Reform. The RIRSA did not provide wholesale changes to the municipal pension system in Rhode Island. However, Governor Chafee, Treasurer Raimondo and state lawmakers recognized that a string of municipal bankruptcies would have a negative effect on the state's budget and on the state's pension system. To that end, the RIRSA established a local pension commission to study ways local governments could improve the solvency of their pensions. The law also set deadlines for cities whose pensions have funding ratios of 60% or less to enact substantive reform.

2. Lessons from Rhode Island

(1) Be determined to drive reform. Rhode Island Treasurer Gina Raimondo was a driving force in the development and implementation of the most sweeping changes in the state's pension system.

(2) Realistically assess liabilities. Actuarial assumptions should align with real performance. The case for pension reform in Rhode Island was grounded on a realistic assessment of the state's unfunded liabilities and a culture of underfunding the pension system.

(3) Form coalitions. Coalitions can reduce the complexity of the legislative debate. Rhode Island's coalition included the governor, state treasurer, house speaker and senate president.

(4) Educate the public. In a state with strong support for public sector unions, Rhode Island’s Pension Advisory Group held informational town halls all over the state to answer questions from the public.

(5) Understand that pension reform is more than defined benefit reform. Rhode Island switched to a DB/DC hybrid, but also wisely froze COLAs in the face of high unfunded liabilities.

The RIRSA reforms will reduce the state’s unfunded pension liability by \$3 billion (from \$7.3 billion to \$4.3 billion), and the annual state and local pension payment by \$275 million (from \$690 million to \$415 million). The Pew Center for the States called the Rhode Island reforms “the most extensive public pension reform in U.S. history,” while Fitch Ratings stated that “The reform is unusually expansive [and] the sweeping nature of the reform may inspire similar efforts in other states.”

However, cost savings may not be as high as expected as the state must contribute another 1% of its payroll to the new DC plan, and the pension debt re-amortization increased the state’s existing overall pension debt. The reform also lacks a solution for the problems of municipal pension systems, many of which turn out to have large unfunded liabilities, which collectively are threatening to add to the state government’s debts.

The pension changes also prompted public employees' unions to sue on the grounds their retirement benefits were contractual relationships that were allegedly violated by reforms. Ongoing litigation continues to delay implementation of the reforms.¹⁹

E. San Diego Reforms

In less than a decade, San Diego’s pension system’s funding ratio had gone from fully funded to only 67% funded in 2003. San Diego’s Pension Reform Committee reported in 2004 that the city’s pension crisis was a “perfect storm” of financial mismanagement that included substantial increases in pension benefits for city employees, intentional underfunding of the system, alleged conflict of interests, corruption, excessive influence by city employee labor unions, financial reporting irregularities, and a pension board that operated secretly behind closed doors. Something had to be done.²⁰

1. What San Diego Did

(1) Enacted Reforms to Ensure Adequate Pension Funding. Passed in 2004, Proposition G amended the city charter in order to prevent the city and the retirement board from entering into any future multi-year agreements that delayed full actuarial funding of city pension contributions to the retirement system. In addition, the measure specified that new retirement benefits would be amortized over a period of no longer than five years, and net accumulated actuarial losses would be amortized over a period no longer than 15 years.

(2) Enacted Pension Board Governance Reforms. A lesson learned from the underfunding scandal was that there was too much labor union influence on the pension board, resulting in conflicts of interest. Passed in 2004, Proposition H changed the composition of the retirement board from one dominated by union representatives and city administrators and appointees to one with a majority of financial experts.

(3) Closed the Deferred Retirement Option Plan (DROP). DROP allows senior city employees to draw retirement pay, deposited into special accounts, in addition to their regular salaries if they agree to work an additional length of time. Considered “double dipping” by critics, since DROP allows city employees to earn both a paycheck and a pension at the same time—a net drain on the city’s finances—the program was ripe for reform in the late 2000s, but it was unclear whether the city could legally effect change to the plan.

In 2009 and 2011 the courts affirmed that DROP benefits were not vested, and that the city could thus modify or eliminate them. It was a major win for pension reformers.

(4) Required Voter Approval of Future Pension Benefit Increases. Proposition B in 2006 (different from Proposition B in 2012) asked voters in San Diego if the city charter should be amended to require voter approval of all future increases in retirement system benefits, not including COLA adjustments. Proposition B passed overwhelmingly, garnering 70% of the vote. Many other local governments in California have since followed suit.

(5) Created a New Defined-Contribution Retirement Plan for New Hires. San Diego’s pension reform efforts culminated with Proposition B in June of 2012, which switched new employees (other than police officers) into DC plans. It also called for restrictions on pensionable pay, loss of pension if a city employee or officer is convicted of a felony related to his or her employment, and increased transparency, among other things.

San Diego's independent budget analyst estimated that the reforms in Proposition B (2012) alone would result in net savings to the city of approximately \$950 million over 30 years. The reform experience in San Diego can provide several valuable lessons to pension reformers elsewhere.

2. Lessons from San Diego

(1) Reform requires constant education and may require sustained action.

While it may be desirable to implement one broad and comprehensive reform measure, it is not reasonable to assume that such changes will be politically feasible until there is a felt need for change among both a majority of citizens and at least some elected officials. Attempting to pursue that one comprehensive set of reforms may be overly complex and, ultimately, counterproductive. San Diego passed numerous narrow pension reform measures over the course of nearly a decade that laid the groundwork for Proposition B in 2012. This allowed the public to become better educated on the issues, enabling reform proponents to overcome opponents' negative messages and misrepresentations of the effects of the reforms.

(2) Professionalize the governance of the pension system. This is a necessary and effective way to address conflict-of-interest issues, provide transparency and improve oversight over benefit and investment decisions. The board should consist of professional finance and investment experts, most of whom are independent of the pension system (i.e., they are not representatives of either city management or city labor unions).

(3) Conduct audits of additional retirement benefits, such as deferred retirement option programs and "air time" purchases quantify the problem for all concerned. If these benefits cost more than expected or create unfunded liabilities, they should be scaled back or eliminated.

(4) Seek outside legal counsel for questions on pension reform. In-house attorneys who have a stake in the current pension system—no matter how defunct it may be—are less likely to form an objective opinion that would support reform efforts.

(5) Get concessions in union labor contracts through the collective bargaining process. It must be remembered that these concessions do not constitute reform in and of themselves, but this is nevertheless an option for bringing down the costs of pensions while not relying wholly on a political process.

(6) *Take reform directly to the voters* through a ballot initiative, where possible.

(7) *Make a straightforward case to the general public* emphasizing the fiscal impact to the budget and government services if the pension system is not reformed.

(8) *Take extra care to verify that signatures collected during efforts to get a pension reform measure on the ballot are legitimate* and budget for the campaign accordingly.

(9) *Build a smart campaign.* Utilize competent political consultants, use polling to test ideas and arguments, ensure that ballot language is vetted by knowledgeable attorneys, build strong and strategic coalitions, line up funding, and prepare to counter labor union opposition tactics.

(10) *Focus on the structural problems and risks.* Simply blaming a jurisdiction's public employee pension problem on a downturn in the stock market or a period of economic recession prevents an honest assessment of its causes, which may be numerous and go far beyond the typical fluctuations of a dynamic economy.

F. San Jose Reforms

Despite increasing its annual pension contribution from \$73 million in 2001 to \$245 million in 2012, San Jose's unfunded liability for post-employment benefits grew from \$300 million in 2003 to over \$4 billion in 2014. Of that, approximately \$2.3 billion is for pensions and \$1.8 billion is for retiree health care. The primary cause of these huge liabilities is a massive increase in both salaries and benefits of public employees. Between 1991 and 2009, after adjusting for inflation, the average annual benefit for police and fire retirees increased 75%, and by 54% for other retired city workers.

In the face of these rising costs, San Jose tried to save money by cutting employee salaries and government services. But these cuts were not enough, so starting in 2010, the city embarked on a series of pension reforms.²¹

1. *What San Jose Did*

(1) Revised Unrealistic Actuarial Assumptions. City pension plan administrators realized that their actuarial assumptions were overly optimistic, painting an unrealistic picture of the plans' financial health, so they revised some assumptions to reflect a more conservative outlook. For the Federated Plan (covering miscellaneous city employees), administrators reduced the investment return assumptions from 8.25% in 2007 to 7.5% in 2011, reduced payroll growth assumptions from 4.0% to 3.25%, and adjusted the discount rate for other post-employment benefits from 6.6% to 6.1%. Similar adjustments were made to the Police and Fire Plan.

(2) Restructured the Pension Boards. In 2010, San Jose restructured its pension boards so that a majority of board members would be independent members with financial and investment expertise, as opposed to union and city representatives who have conflicts of interest when determining pension benefits.

(3) Changed the Arbitration Process. Measure V changed the arbitration process used for disputes between the city and police and fire department employees. Measure V prohibited the arbitration board from:

- Issuing awards that would increase compensation faster than the five-year average of certain city revenues,
- Retroactively altering compensation for past service,
- Creating new unfunded liabilities that the city would have to pay.

(4) Modified the Existing Pension System. Measure W, which passed with 72% of votes, allowed the city to shift new employees into new pension plans with benefits less than levels specified in San Jose's charter. It also required that all new pension plans be actuarially sound.

(5) Created a New Retirement System for Future Workers and Other Reforms. In spite of the earlier reforms, the city's finances remained perilous, and in 2011 the city council declared a fiscal emergency. In June of 2012, Measure B passed. It raised current employee contributions, created a new plan for new employees, stopped the issuance of so-called "13th checks" (bonus pension payments), reduced COLAs for new employees and some current employees, and required voter ratification of all future pension benefit or OPEB increases.

While all of San Jose’s pension reform measures passed with significant margins of victory, they were not easy battles. Opponents tried to paint these measures as “risky,” “reckless,” and harmful to city workers. Measure B also faced legal challenges after being passed. On December 20, 2013, Judge Patricia Lucas of the Santa Clara County Superior Court issued a tentative decision that overturned several key pieces of Measure B, while simultaneously upholding a majority of the initiative and sustaining substantial savings anticipated in the passage of the measure.

With many other cities and states in a similar predicament, San Jose offers one possible model for reform. Among the key lessons from its reforms are the following:

2. Lessons from San Jose

(1) Prepare the ground by ensuring, if possible, that the pension review board is independent, in order to reduce internal opposition to reform.

(2) Use evidence-based arguments backed up by statistics and reports from reputable sources regarding the actual costs of city workers and the true scope of liabilities from post-employment benefits. Communicate these findings to voters and public employees.

(3) Emphasize the trade-offs. Ensure that voters recognize the alternatives to reform (e.g., in San Jose’s case, fewer services and fewer government jobs).

(4) Specify the consequences of inaction. In the proposed reforms, include explicit and painful default alternatives, such as cuts in pay for government workers if pension reforms are overturned, as a disincentive to lawsuits.

These lessons are of particular use in areas where ballot measures are possible. But even in states that do not allow such measures, it is important to develop a winnable strategy, prepare the ground and stick with a clear message. San Jose still faces legal battles with its employee unions over its constitutional authority to deal with pension benefits, but the city has nevertheless identified a path toward reform that other financially distressed municipalities around California and across the nation may use to address their mounting pension liabilities before it is too late to avoid fiscal ruin.

Part 4

Addressing Common Objections to Shifting from Defined Benefit Pensions to Defined Contribution Pensions

Converting from a defined benefit system to a defined contribution or hybrid or other plan will meet resistance. Some of the same objections show up over and over again. Acknowledging that all reforms have challenges and are only as good as their implementation, here are some of the most common arguments against reform and their rebuttals.

Argument 1: Switching to DC plans would be more expensive for up to several decades. Moving new employees into 401(k) plans would endanger existing pensions, increase costs to taxpayers, and increase the cost of paying pension obligations to current employees and retirees. A switch to 401(k) plans would destabilize the pension system financially, potentially saddling taxpayers with additional debt.

This argument, often misconstrued as “transition costs,” has been debunked by several pension scholars, including Josh McGee, Andrew Biggs and Michael Podgursky.²² There are two main claims upon which the transition cost argument relies.

The first claim is that, according to the accounting rules set by the Government Accounting Standards Board (GASB), shifting new hires to a new plan would oblige the sponsor of the closed DB plan to pay down, or “amortize,” its unfunded liabilities more quickly, which would result in higher amortization costs. This claim has two problems:

- First, given the fact that moving to a new plan does not change the amount of unfunded liabilities, paying off the pension debt faster would increase short-term payments but produce even larger savings in the long term.

- Second, the GASB standards are for disclosure purposes only and never dictate funding policy. If states and municipalities wish to follow their current amortization schemes, there is nothing preventing them from doing so. More importantly, the language regarding amortization schedules has been removed from GASB's recent update, making the claim entirely moot.²³

Breaking that first point down further, let's look at different ways of scheduling, or amortizing, debt payments. Figure 1 shows how payments change over time depending on the payment schedule chosen. Level dollar is the most sensible, as it makes steady payments over all years. But most plans choose to use a level percent schedule which lowers payments in the early years but increases them in later years—an all too typical play-now-pay-later approach.

Just as important, Figure 1 also shows that for the schedules based on level percent of payroll, the payments rise much more steeply for a closed plan than for an open one, per GASB recommendations. That is a function of officials *choosing* to incur the debt, *choosing* not to pay it off with a level dollar schedule and *choosing* the more rapid repayment schedule.

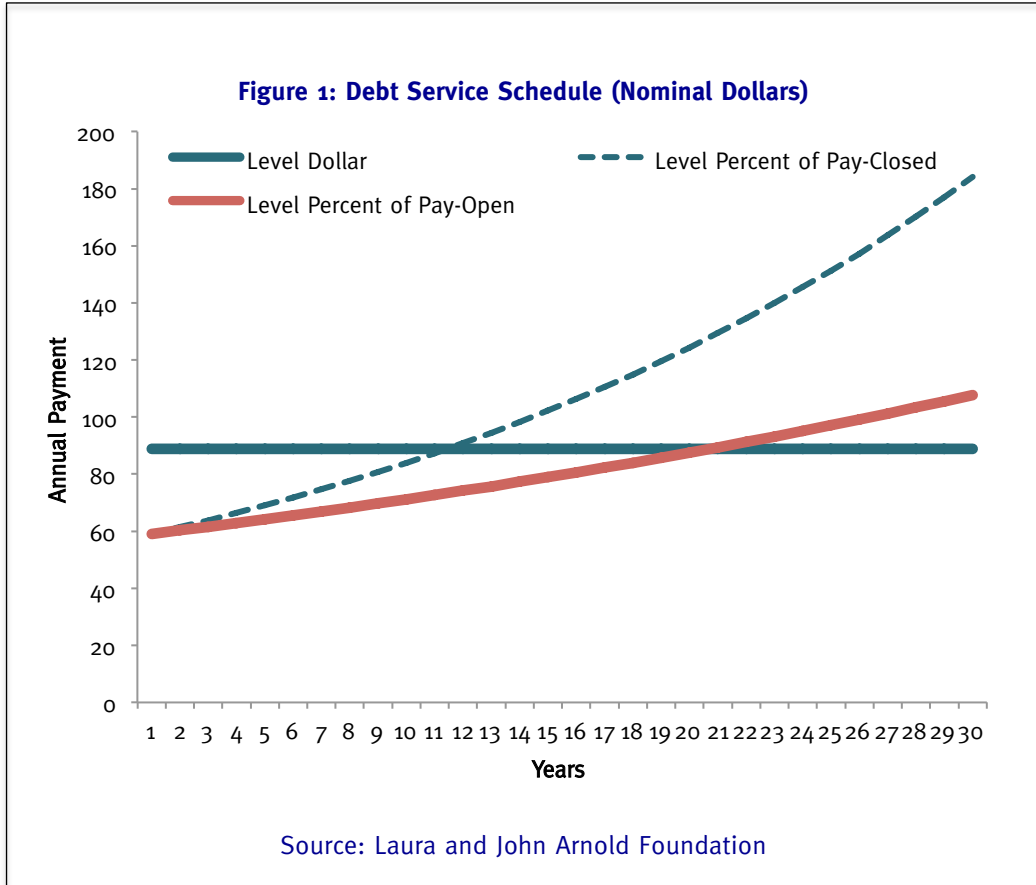
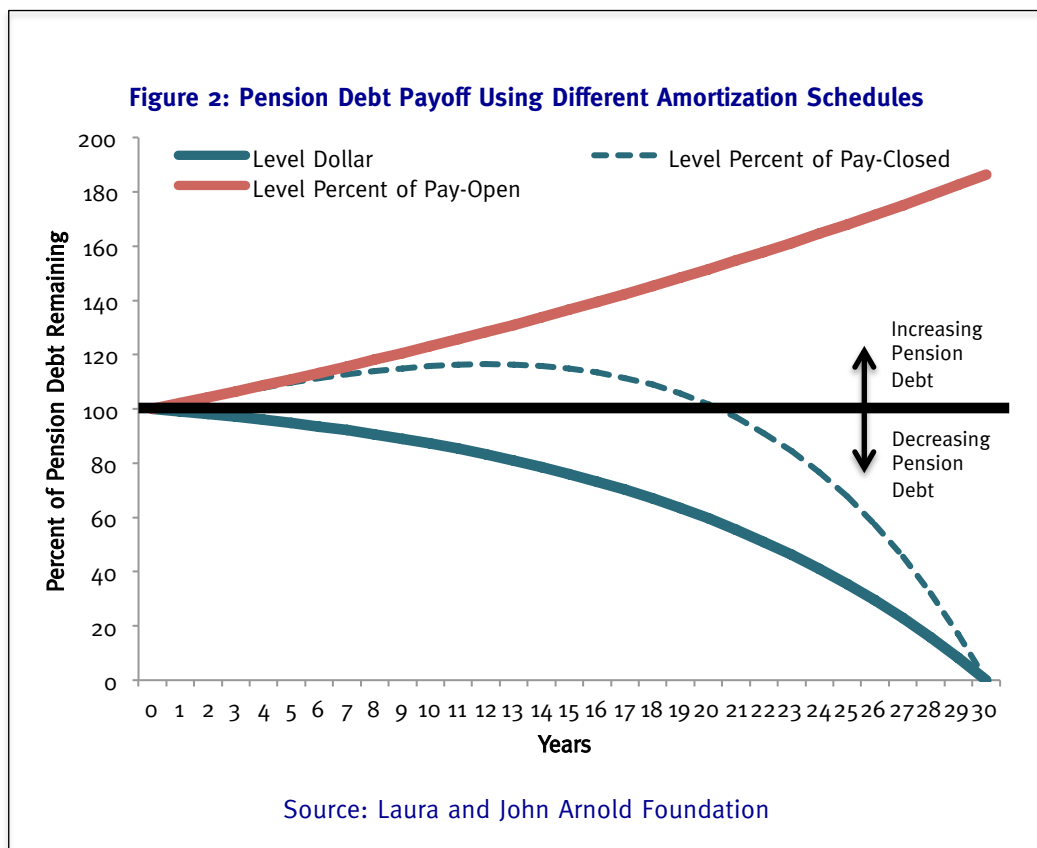


Figure 2 shows that using a level dollar payment schedule never incurs any additional debt. Level percent schedules do involve debt, and level percent of pay schedules don't ever reduce the total amount of debt when a fund is still open to new members. However, the level percent of pay-closed curve shows that the debt does get paid off when the fund is closed to new members.

The key point here is that any increases in payments due to closing a plan are strictly a matter of paying off the debt that was incurred by earlier choices.



The second claim is that when a DB plan is closed, the fund must invest more conservatively and in more liquid assets as it gets closer to closure. Since more conservative and liquid investments have lower expected returns, the plan would require higher contributions, hence higher costs. However, this claim is based on the myth of time diversification, which has been debunked by Nobel laureate Paul Samuelson and other economists.²⁴ Basically, the extra earnings from riskier investments are offset by the larger contingent liabilities on future taxpayers. A closed pension plan that takes less investment risk imposes smaller contingent liabilities on future generations, and so the total cost of the plan remains unchanged. As to liquidity, the shift to more liquid investments need not happen until the last few years of a plan's existence when the remaining asset base is small, and therefore the reduced returns are trivial.

All the focus on transition costs misses an important point, however, which is the long-term savings from the new DC plan that replaces the old plan. With more predictability, and much less risk imposed on the employer, a DC plan is less costly and less volatile than a DB plan, as demonstrated in the private sector.²⁵ This means more fiscal sustainability in the long run.

If a government decided to transition toward a DC system, it could simply declare its DB plans closed to new members. Current members would continue accruing benefits and the government would continue its annual contributions, but each year normal cost for the DB system would decline. By the time the last member of the DB system retired, there would be no more normal cost payments required to fund the system. Any difference between the amount of promised benefits and assets available to pay those benefits would be debt, that is, an unfunded liability. The amortized debt payment is a separate part of pension funding, meaning employee contributions *never* subsidize debt payments.²⁶

It is possible that the transitioning government might want to increase its debt payments as a part of a pension reform—a wise choice to reduce long-term costs. This would be a separate policy choice from transitioning to a DC system, though, and not a transition cost.

Argument 2: Defined contribution plans are more expensive to operate with higher administrative costs due to higher financial management and trading fees.

It is true that a traditional DC plan incurs higher administrative costs than a DB plan. However, the net costs to taxpayers from DC plans are much lower than DB plans because there are no unfunded liabilities that occur that need to be paid down.

The primary reason that DC plans can have higher administrative costs than DB plans is because of the personalized nature of individual accounts as opposed to managing a large pool of funds (as in a DB). According to a report by the Center for Retirement Research at Boston College, the average administrative and investment costs for DB plans (public plans) and DC plans (public and private plans) were 0.43% and 0.95% of assets, respectively.²⁷ From an accounting perspective this is a worthwhile trade-off to millions or billions of dollars in unfunded liabilities.

That said, a DC plan can be modified in several ways to achieve low administrative costs without becoming a DB plan. One solution is pooling all individual accounts together and having them managed collectively by

professional money managers instead of letting workers control their accounts. This model, called “collective defined contribution pension plan,” would reduce administrative costs the same way a DB plan does without imposing any risk on the employer/taxpayer.²⁸ Another way to reduce the costs is to offer only index funds to employees. Index funds are passive investments—basically run by computer models designed to reflect whatever market index/sector they are trying to capture—that track the components of market indices such as S&P 500. A passive investment approach focuses on achieving long-term gains through a pre-determined strategy (usually based on computer models) that does not rely on forecasting or day-to-day management of the portfolio itself. These funds are very low-cost due to their “passive” nature. Combining the collective defined contribution pension structure and the use of index funds would further reduce the costs of managing the pension plan. Choosing a collective or passive investment strategy, however, may limit the individual workers’ ability to choose an individual investment strategy and get personalized service for their accounts outside of a pooled system.

Argument 3: Defined contribution pensions deliver lower investment returns, partly because individuals making investment choices do not match the returns of investment experts who manage defined benefit pooled funds and partly because individuals need to invest more conservatively as they approach retirement. By contrast, pension plans that retain a mix of young, mid-career, and older workers and retirees can maintain a diversified portfolio and invest for the long term. It is irresponsible to move new workers into 401(k)-style retirement savings plans at precisely the time when a chorus of observers have recognized that these plans have failed to deliver retirement security in the private sector.

Employees who are offered traditional DC plans may not attain optimal retirement security for several reasons. First, because of procrastination and shortsightedness, many workers fail to save enough early in their careers—missing the advantage of compound interest over decades—despite being given the opportunity to participate in a DC plan. Second, due to lack of financial knowledge (sophistication risk), many employees invest too conservatively to earn adequate returns in order to achieve their savings goals, and/or do not adequately diversify their pension investments and adjust their portfolios over time when they approach retirement to hedge against market risk.

These factors, along with high administrative costs that can chip away at assets, can put employees’ retirement security at risk. DB plans require employees to participate in the pension system (thereby eliminating the risk of procrastination)

and have the pension funds managed by financial professionals who usually make better educated investment decisions with the potential to earn higher returns. Besides, by combining the accounts of older workers with those of younger workers, DB plans can create something called “intergenerational risk sharing,” allowing different age groups of employees to share risk and returns over time, which traditional DC plans do not offer.

However, with DB plans, pension boards can easily direct investment strategies to political goals (or “socially responsible investments”) and put those considerations ahead of the primary responsibility of maximizing investment returns for their pensioners. And depending on which politically desirable investments replace the undesirable investments, there could be more exposure and risk, as CalPERS discovered in 2011.²⁹ Unless an individual feels compelled to invest or not invest in a particular portfolio for any number of social, moral or political reasons, DC plans do not have this problem.

Again, the supposed advantages of DB plans over DC plans do not come from any unique feature of DB plans. A few changes to DC plans can bring about the same benefits without adopting the DB plan core structure. Procrastination of saving can be easily dealt with by automatic enrollment; workers would, by default, be enrolled in the pension plan and have the option to opt out if they wish to. The use of index funds and the collective contribution pension plan (which employs professional money managers) can effectively deal with sophistication risk and bring about the same (if not better) level of investment returns provided by DB plans. It should be noted that most professional investors (even “superstar” investors) and mutual funds do not beat the market.³⁰ This means that non-expert individuals could outperform most active fund managers by simply putting their pensions in low-cost passive index funds. DB plans, therefore, do not have any advantage regarding investment returns if DC plans offer only index funds and/or adopt the collective structure, which also creates the same “intergenerational risk sharing” feature that DB plans have. Employees with even traditional 401(k) plans can do pretty well over the long term if they are disciplined about saving for retirement and make moderate investments with those savings.³¹

It is important to remember that retirement security should not be treated separately from fiscal sustainability. While DB plans may be able to generate reasonable returns from their investments, their built-in structure contains perverse incentives that breed financial distress to governments. By shifting risk from employees to employers—ultimately taxpayers—and by creating a lag between pension promises and payouts that encourages and facilitates

underfunding, DB plans pose a substantial threat to the long-term fiscal health of state and local governments. The Brookings Institution argues that DB plans ensure retirement security at the expense of fiscal sustainability.³² In the long run, however, the seeming trade-off between fiscal sustainability and retirement security will likely vanish, since financially troubled states and cities will not be able to deliver the promised pension payments.

In other words, the DB structure risks *both* financial distress and retirement instability when a longer time horizon is considered. This is not pure speculation but a real possibility, as state public pensions are just 39% funded, with the total unfunded liability being \$4.1 trillion based on a fair-market valuation.³³ The danger is compounded by the fact that most DB plan managers assume overly optimistic rates of return, which pressures them to invest in riskier assets, exposing government budgets to 10 times more risk than in 1975.³⁴ A recent report by the influential hedge fund Bridgewater Associates predicts that 85% of public pension funds could go bankrupt in three decades.³⁵ Indeed, municipalities across the nation are looking for opportunities to significantly reduce their pension liabilities before—or even as—bankruptcy becomes an option.³⁶

By contrast, DC plans are not only fiscally sustainable for states and municipalities *by definition*, but also capable of delivering adequate retirement security when structured in the right way, as acknowledged by the Center for American Progress.³⁷

Argument 4: Defined benefit plans promote recruitment and retention of qualified employees. DC plans increase employee turnover and the associated costs have a negative impact on public service quality.

There certainly are individuals who find the idea of a lifetime pension attractive and may be more likely to take a civil service or police department job because of the idea of retirement security. However, this is not always the case with every public sector worker. And as labor mobility increases into the 21st century, and fewer individuals in the labor market stay at the same job or with the same employer all of their lives (as was more likely in previous generations), the attractiveness of a portable pension for recruitment will increasingly be a local hiring factor.

Nationally, there is no clear evidence supporting the claim that it would be harder to recruit employees to the public sector without a DB pension plan. A recent paper by the Brookings Institution examines how DC plans and DB plans can improve public sector workforce productivity and concludes that neither of

the two pension types is superior in this respect.³⁸ Theoretically, DB plans can improve the retention of high-quality workers by a “pull and push” mechanism. By guaranteeing future benefits that increase over time, DB plans “pull” experienced mid-career employees to stay with their current jobs and make them work hard to avoid getting fired. By withholding pension benefits from employees who are eligible for retirement—but continue working—DB plans “push” overpaid workers to give way to younger and lower-cost ones. But at the same time, many government employees are unwilling to leave a job they dislike if it will threaten their benefits. Keeping unmotivated employees who are marking time to accrue benefits is not a path to a more productive workforce.

However, the mechanism in reality does not work as well as what the theory predicts for several reasons. First, the layoff rate for the public sector is considerably lower than that of the private sector, so public employees are not as concerned about job security. Second, there is no clear evidence that older employees who are eligible for retirement are overpaid. Some may be overpaid, but some are not. “Pushing” all these workers therefore is not necessarily desirable. Third, only individuals who are interested and willing to have long careers would be influenced by these pension incentives. A 15- to 20-year career is not long enough to reap the full benefit of a DB plan.

While the DC plans offered at The State University of New York (SUNY) differ in some respect from private DC plans by offering annuitized income, when given the choice, a report from the Empire Center showed that many of the CUNY and SUNY employees choose DC plans.³⁹ It does not appear that offering a DC plan has made it harder for the universities to hire. The fact that many choose DC plans over DB plans shows that these personalized and portable pensions are attractive.

Traditional DC plans may have higher employee turnover rates due to their mobility feature: the pension account belongs to the individual, who can usually roll the money into a new employer's pension plan if he or she changes jobs. This feature reduces the penalty associated with changing jobs, and hence increases job turnover. But it also means that workers who value mobility of benefits will find this feature attractive. Since people today change jobs often and few stay with an employer for decades, DC plans are more suited for the modern workforce. Further, public employers should ask themselves: “In terms of turnover, would it not be better to have the best talent work for you for a few years, than to permanently have workers whose only incentive is to maximize their pension payouts?”

Argument 5: Lower income workers retain lower returns on a DC plan when compared to a DB plan. DC plans favor higher income workers at the expense of lower income workers.

This claim rests on two arguments. The first argument is that in DC plans, lower income employees have lower participation and contributions rates, thereby earning fewer pension benefits compared to higher income employees. This is probably because lower income workers have to spend a larger part of their incomes on essential living expenses, leaving them less money for retirement saving. While this may be true, it does not lead to the conclusion that DB plans, which typically force employees to contribute to the pensions at fixed rates, are superior. Low income workers have low participation and contribution rates precisely because their earnings are low and they need to keep more cash on hand to deal with unexpected events (e.g. unemployment, emergency health care, etc.). Forcing them to contribute a fixed portion of their incomes, as in the case of DB plans, leaves them less room to cope with such contingencies. Traditional DC plans give workers more choice over what to do with their money.

One can argue that low income workers tend to lack foresight and financial sophistication compared to high income workers, and hence tend to make bad decisions about their saving plans. But DC plans can solve this problem by making pension enrollment automatic and setting a default contribution rate. Considering the fact that DC plans can be customized to address sophistication risk without changing their core structure, DB plans have no inherent advantage in improving low income workers' pension choice.

The second argument is related to the tax deductibility of pension contributions in DC plans. Economically, the cost of providing pension benefits is borne by the workers in the form of lower wages. Therefore, the value of being paid in the form of tax-deductible contributions instead of higher taxable wages is more valuable to higher income workers, who face higher marginal taxes. This argument, however, relies on the assumption that DC plans do not affect the total compensation that each worker receives, that is, pension contributions are perfectly offset by lower wages for all workers. This is highly unlikely because low income workers are more reluctant than high income workers to accept wage reductions in exchange for retirement contributions. Therefore, DC plan contributions reduce wages only modestly for low income workers, resulting in higher total compensation for these employees.⁴⁰

These arguments also ignore the large inequality of pension benefits between partial-career and full-career workers in DB plans. Due to vesting requirements and the “backloaded” structure of DB plans (benefits are not earned proportionally to the worker’s years of service), public employees who do not remain in government employment for 20 or more years earn fewer retirement benefits than those who do.⁴¹

Pension accounts in DC plans, on the other hand, accumulate value relatively smoothly over time, and thus those plans do not generate this kind of inequality.

Argument 6: Switching to a DC plan would do nothing to solve the problem of unfunded liabilities. In fact, it would make the problem worse as the government would need to continue making payments under the old system even as current employee contributions are taken by the new system.

It is true that changing to a DC plan would, by itself, not eliminate unfunded liabilities. However, it does prevent the accumulation of new unfunded liabilities that would not have otherwise been accrued by the retirement system. And, more critically, the transition to a DC plan would not make taxpayers worse off because pension plans do not rely on current employees to pay the benefits earned by retirees.

A DB plan’s total costs consist of two elements: (1) the *normal* costs of accruing benefits, and (2) the *amortization* costs for unfunded liabilities (akin to debt service). The normal costs paid by government employers are used to prefund the pension system. Amortization costs—the cost component used to pay down pension debts—are separate, and the government will still be responsible for covering amortization costs, regardless of whether normal cost contributions flow to the old DB plan or to a new DC plan.

This is why transitioning from a DB to a DC does not incur extra costs, nor does it undermine the old DB system by removing the contributions of current employees. The benefits of retirees are supposed to be prefunded from the year they were accrued. Any unfunded liabilities—benefits promised to workers that were not properly prefunded—would not be paid for by current employees, but instead through a separate amortization payment that is carried by the taxpayer, until that DB pension system has run its course.

In other words, even without the new plan, the normal costs paid by governments and employees cannot be used to pay for the unfunded liabilities, which must be covered by the government through paying amortization costs. Arguing that moving new employees to the DC plan exacerbates the unfunded

gap betrays a serious misunderstanding about pension funding.⁴² One should remember that shifting from a DB plan to a DC plan does not add any extra cost to the system or create more unfunded liabilities. DB plans dig a financial hole, and switching to DC plans enables governments to stop digging, but the hole dug still has to be filled in.

Argument 7: DC plans do not pool longevity risk. When individuals convert their accumulated savings into an annuity—a fixed payment until they die—their annuity payment is lower because the provider of the annuity knows an individual is more likely to purchase an annuity if he or she is in good health and has a longer-than-average life expectancy. Since defined benefit plans do pool longevity risk across tens of thousands of plan members, they can base annuity payments on the average life expectancy of the population.

It is true that traditional DC plans do not pool longevity risk, and the cost of purchasing an annuity can be expensive for individuals. In reality, pooling penalizes those who could buy lower cost annuities in order to subsidize those for whom annuities would be more expensive. Yet, if pooling were a preferred strategy, there are other ways to pool risk besides DB plans.

Aforementioned collective DC plans can effectively pool longevity risk the same way DB plans do without transferring the market risk to the employer/taxpayers or creating perverse incentives to underfund the system. Building an annuity option into a mass pension plan, even if it is DC plan, has a volume and pooling effect for companies offering annuities.

Argument 8: Our pension system is fairly well funded today. We're not in a crisis now, so why should we reform pensions?

Even though a given government pension system may appear well funded today, pension funding conditions can change quickly. Overly optimistic DB pension actuarial assumptions tend to ignore the prospect for major market volatility, like the 2008–09 recession. This was the case in Utah, according to former State Senator Dan Liljenquist:

We had the best-funded pension system in the country going into the 2008 downturn, but during the downturn we lost about 22 percent of the value of our pension fund almost overnight. [...] [E]ven though we were well-funded, that the 22 percent loss in value actually opened up a 30 percent gap in our pension funding ratio—our funding ratio dropped from about 100 percent in 2007 to a projected 70 percent by 2013—even though we had paid every penny that the actuary had asked us to over the previous several decades.

[...] [W]e realized that if this system was dependent on stock market returns—with the legislature and taxpayers required to come back and cover any funding gaps if the markets do poorly—then we felt like it was a risky proposition and one that we wanted to try and mitigate moving forward.⁴³

It is sensible public policy to lower the financial risks to governments, taxpayers and retirees by shifting away from DB pensions and funding employee retirement benefits at the time they are accrued, as opposed to the common current practice of shifting an uncertain burden to future taxpayers. If DB pension fund returns were to fall short in the future, tax hikes and/or service cuts could inevitably follow, and pension benefits for retirees could be cut in extreme cases. Further, public services could be jeopardized by the “crowding out” effect, where current services are reduced or eliminated to cover higher pension system contributions. Reforming DB pension systems now can also minimize the risk of future policymakers increasing benefit levels in an unsustainable fashion for short-term political gain.

Part 5

Conclusion

As can be seen, several states and municipalities have successfully implemented substantive forms of pension reform in the last 20 years. While the nature of any particular state's or city's pension challenge and political environment for reform can vary, the experiences of these states and cities can serve as a useful guide to policymakers across the country. Most of the examples highlighted in this report illustrate strong pension reform efforts, but lessons can even be gleaned from weak pension reform measures.

First and foremost, pension reform in most states and cities is grounded in realistically assessing the state's unfunded liabilities and reversing a culture of underfunding the pension system. A jurisdiction's public employee pension problem, if well-structured, can withstand a temporary downturn in the stock market or a period of economic recession. Blaming a unfunded pension liability on such temporary events prevents an honest assessment of its structural causes, precluding effective change that would result in financial stability and sustainability.

As San Diego and San Jose found, an important initial reform is to professionalize the governance of the pension system. This will address conflict-of-interest issues, provide transparency and improve oversight over benefit and investment decisions. The board should consist of professional finance and investment experts and ensure that most members of the retirement board are independent of the pension system.

San Diego's experience shows that another productive place to start is with concessions in union labor contracts through the collective bargaining process. While not necessarily reform, it is an option for bringing down the costs of pensions while not relying wholly on a political process. Utah's and Rhode Island's experience shows the importance of understanding that pension reform is more than defined benefit reform. There are several options including total DC conversions, hybrid reforms or other plans depending on the culture of the jurisdiction and appetite for reform.

But as most reformers have learned, lasting and effective change may ultimately involve using the political process through appeals to the public and ballot initiatives. When taking this route, first identify a pension problem and then research it carefully, realistically assessing liabilities and actuarial assumptions, which should align with real performance. Michigan's reforms illustrate the need to adequately address the risks of other post-employment benefits (OPEB) unfunded liabilities during the reform process. Since most jurisdictions all but ignore their impact, shortfalls in retiree health care funding far outweigh those of the pension systems, and threaten the financial ability of governments to provide basic services.

In order for any reform effort to be successful, there must be local and broad support. Following Rhode Island's example, reformers should form coalitions to support and push for reform. This may and should include elected officials, but more than likely will be concerned and engaged citizens. If lawmakers are not willing to make the requisite reforms, take reform directly to the voters through a ballot initiative, where possible. Utilize competent political consultants, use polling to test ideas and arguments and ensure that ballot language is vetted by knowledgeable attorneys. Use the coalition strategically to line up funding and to counter labor union opposition tactics. Coalitions can reduce the complexity of the legislative debate, and will create buy-in from various stakeholders in the jurisdiction. It is likely that reform coalition partners have spent years creating reports and studies that could be very useful in building the case for reform.

While the case for reform may be obvious to the reform coalition, it is essential to educate the public, as all of these reformers did. Change through a political process cannot occur until a majority of citizens and elected officials understand how pensions work. Make a straightforward case to the general public emphasizing the fiscal impact to the budget and government services if the pension system is not reformed. Hold informational town halls in any and all venues to answer questions from the public. As Alaska learned, be prepared to combat the common, but false, arguments opponents will make about the system's health and fiscal impacts if reformed. Active engagement with the community can sway even the most ardent union-dominated jurisdictions like Rhode Island or San Jose.

San Jose's experience shows the importance of using evidence-based arguments backed up by statistics from reputable sources regarding the actual costs of pensions upon the particular jurisdiction if not dealt with soon. Information useful for reform can be found in public documents, reports, audits and actuarial

reviews. Any competent pension system should be regularly reporting on its fund's assets and liabilities. If that is not being done, agitate for more transparency and oversight with the legislative sponsor or pension board. It may require an independent entity to conduct audits or perform actuarial analysis by requesting annual financial reports through open records requests.

If a pension system is hesitant or resistant to reform, even when a problem is clearly demonstrated, seek outside and independent legal counsel, as San Diego did. Attorneys who have a stake in a current pension system—no matter how defunct it may be—are less likely to form an objective opinion that would support reform efforts.

But, as seen in San Diego, fundamental structural reform may ultimately require taking incremental steps. While one broad and comprehensive reform measure may seem like the most direct and simplest route, such reform may overwhelm the public and be counterproductive. Lasting change may require numerous narrow pension reform measures over the course of years to lay the groundwork for substantive reform. It takes some time to educate the public on the issues, enabling reform proponents to overcome opponents' negative messages and misrepresentations of the effects of the reforms.

Provided that reform happens, the work is not over. Implementation requires constant vigilance to maintain and sustain the reforms so that the retirement system is affordable, sustainable and secure for employees and taxpayers. DB plans must continue to be fully funded as they close based upon an amortization schedule that makes fiscal and budgetary sense.

These best practices and lessons learned, in conjunction with the actual steps outlined in our *Pension Reform Handbook: A Starter Guide for Reformers*, will equip the willing and motivated pension reformer to make substantive change.

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