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Pension Reform Handbook: A Starter Guide for Reformers

by Lance Christensen and Adrian Moore



Reason Foundation



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Reason Foundation's nonpartisan public policy research promotes choice, competition and a dynamic market economy as the foundation for human dignity and progress. Reason produces rigorous, peer-reviewed research and directly engages the policy process, seeking strategies that emphasize cooperation, flexibility, local knowledge and results. Through practical and innovative approaches to complex problems, Reason seeks to change the way people think about issues, and promote policies that allow and encourage individuals and voluntary institutions to flourish.

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By Lance Christensen and Adrian Moore

Preface

Reason Foundation, a nonprofit 501(c)(3) policy research organization, created the Pension Reform Project to both advocate for reform and assist policymakers in implementing necessary changes in state and local public pension systems. Our goal is to end the practice of passing unfunded liabilities on to future generations through introducing fiscally sustainable retirement plans that are fair to both government employees and the taxpayers who fund them. In defining success, we urge jurisdictions to:

- Commit to making full pension payments and paying down pension debt as soon as possible.
- Stop deferring payments or using unrealistic investment return assumptions to artificially lower payments into the pension system.
- Adopt a sustainable system with smooth accrual of pension benefits in line with the private labor market, allowing workers to accrue benefits throughout their career that are portable and devoid of perverse incentives, which protects taxpayers from unnecessary cost risks.
- If necessary, change contracts over time with existing employees to bring benefits in line with the labor market, increase employee contributions, set more realistic retirement ages, and adopt formulas that

avoid abuses such as pension spiking (gaming the system to increase the final salary used to calculate pension benefits), pickups (where the government pays the employee's share of contributions to the pension system), etc.

- Depoliticize management of pension funds and increase their transparency and accountability.

Policymakers are responding to the need for change, and Reason is here with turnkey solutions that make it easy for interested parties and stakeholders to advance reform. Our goal with the Pension Reform Project is to create real-world models of successful reform that others can easily replicate elsewhere.

Assistance for Reform Efforts

Reason Foundation has recruited a number of current and former public officials who have successfully navigated pension reform and can provide direct peer-to-peer assistance. With these mentors, we are currently working in several jurisdictions across the country sharing best practices and effective strategies, offering interested policymakers a tailored package of implementation activities and consultation services depending on the needs and scope of reform in each jurisdiction.

Our public policy research, polling and journalism put us in the perfect position to communicate the problems to broad audiences across the nation, in all types of jurisdictions. While there are various methods and avenues to reform, we are willing to provide the following services to policymakers at no charge:

- Policy education for key staff;
- Access to proven policymaker reformers;
- Pension reform policy design;
- Independent actuarial analysis;
- Consultation on collective bargaining negotiations;
- Messaging for reform issues;
- Strategy advice;
- Outreach to local media;
- Outreach to community groups and stakeholders with public events;

- Outreach to elected officials;
- Opinion editorials, policy analysis and summary materials.

Our comprehensive, step-by-step plan offers policymakers, in any jurisdiction, practical reforms that can be implemented locally with our consistent and committed assistance.

Access the Pension Reform Help Desk

With more than a decade of experience in public pension reform issues behind us, our team has a depth and breadth of knowledge and expertise with decades of combined experience on government reform. Much of our work on this issue is discussed at <http://reason.org/pensionreform>.

Should you want to discuss a potential partnership further, please do not hesitate to contact Reason Foundation's Director of Pension Reform, Lance Christensen at (916) 220-2728 or lance.christensen@reason.org.

We look forward to the opportunity to work with you in the near future.

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Pension Reform

Introduction

Depending on what assumptions you use, current state and local government workers will earn between \$4 trillion and \$8 trillion in retirement benefits by the time they retire.

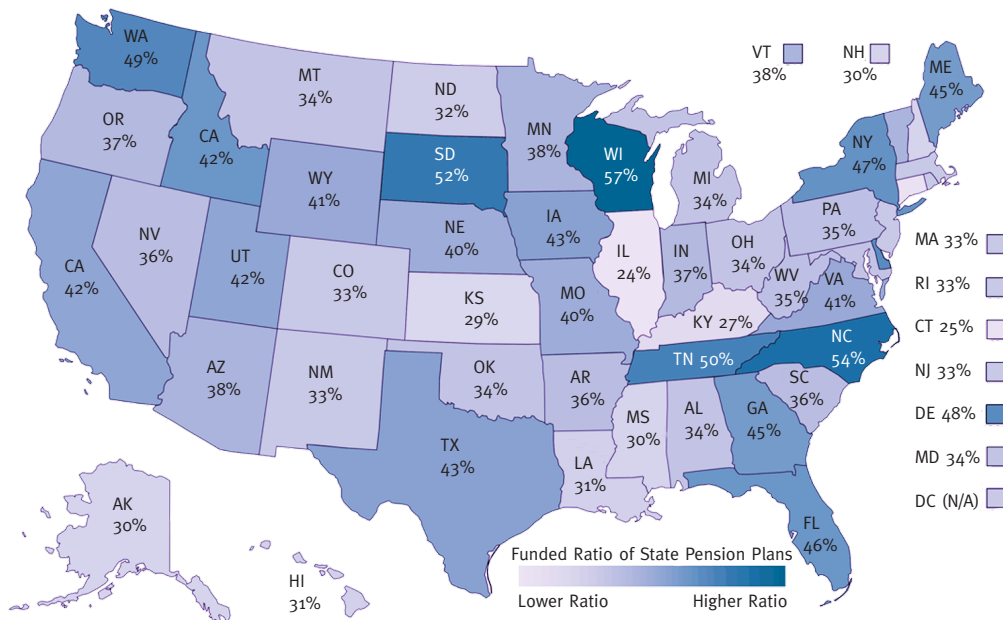
It is important to understand how pension systems are funded. There are two main components to pension funding: the annual cost to prefund pension liabilities, known as “normal cost,” and the cost to pay off unfunded pension debt. Every year, actuaries determine how much a government should save to fully prefund accrued pension benefits. They estimate how much they will earn investing assets before paying out pension benefits, and estimate how long retirees will live. The result is the normal cost needed today to grow over time and payout benefits in the future.

When actuarial calculations for normal cost are inaccurate, or a jurisdiction fails to make the annual required contribution (ARC) to meet normal costs, a pension fund will accrue unfunded liabilities, that is, pension debt. This is measured as the value of a pension fund’s assets relative to the promised benefits. Pension funds project costs out over a fixed period of time, usually 15 to 30 years. Actuaries calculate how much a government should pay each year over that time frame to completely pay off the pension debt. This constitutes an amortized debt payment.

Employees typically contribute a fixed percentage of their pay toward normal cost. The government, considered the “employer,” contributes the rest of normal cost. These are usually calculated as a percent of the salaries for public sector employees.

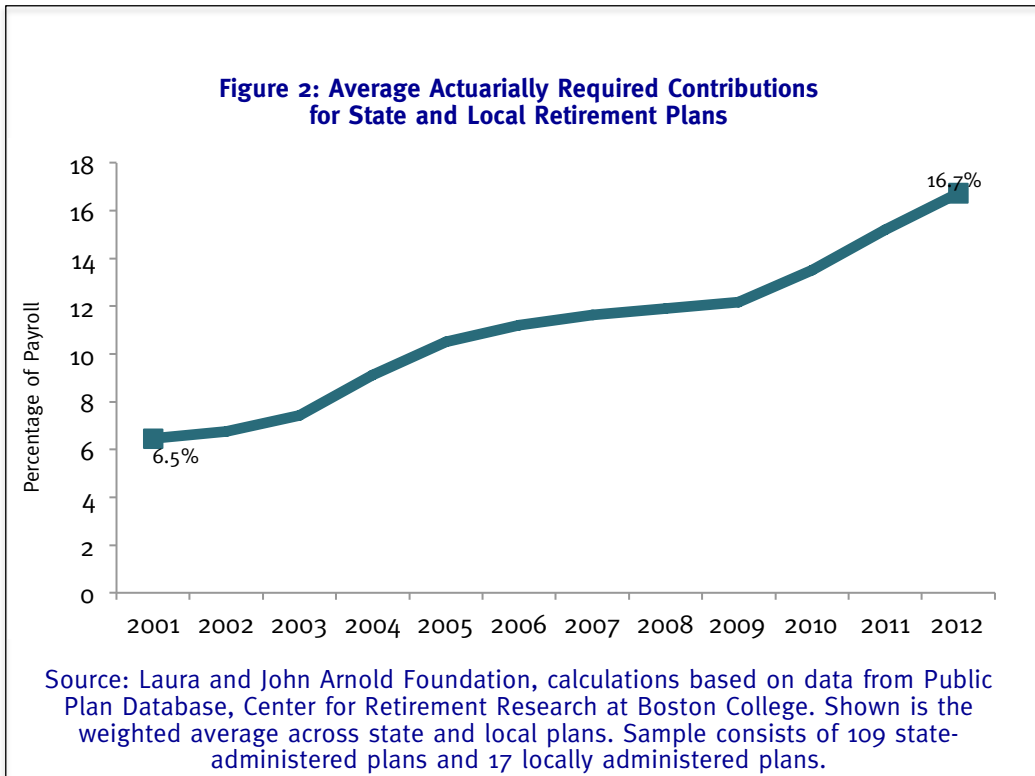
Jurisdictions across the nation—from small special districts up to large state governments—are experiencing crisis in the pension plans for their government workers. In some cases, pension systems have a fraction of the assets needed to meet obligations (see map), creating unfunded liabilities and undermining the soundness of the pension plan.

Figure 1: Funded Ratio of State Public Pension Plans

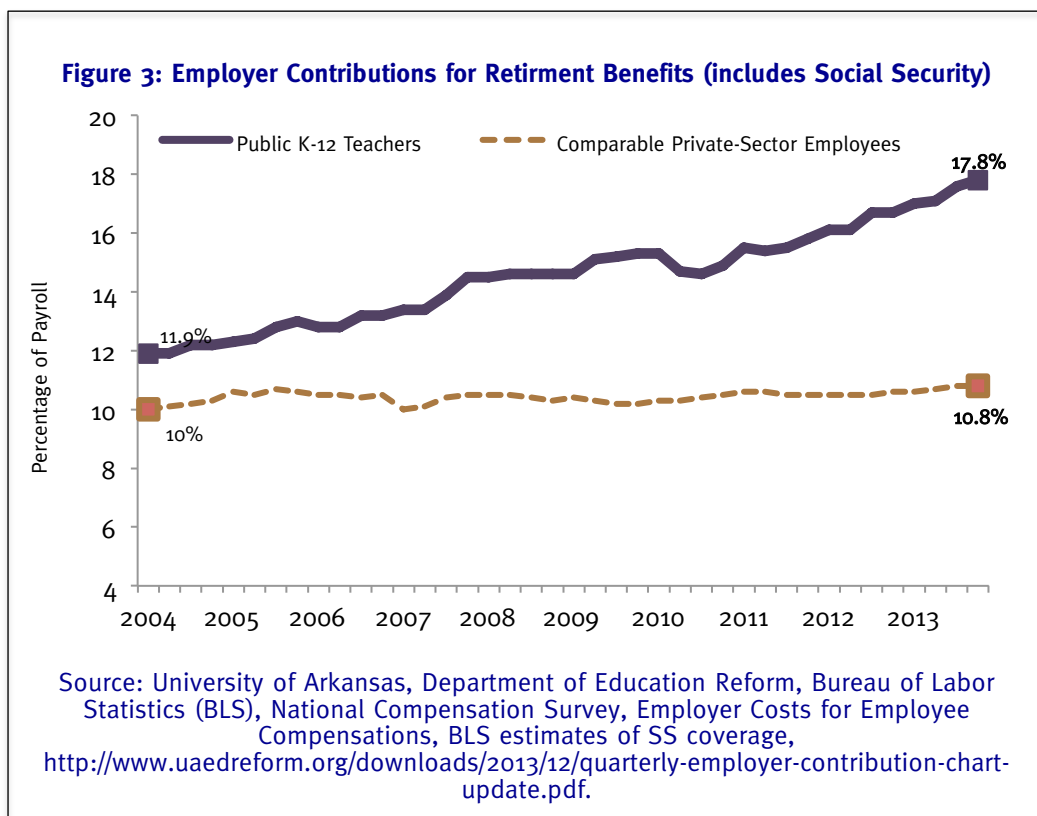


Source: Tax Foundation, <http://taxfoundation.org/blog/monday-map-funded-ratio-state-public-pension-plans>

Pension costs have more than doubled in a decade (see graph below), yet workforce and revenues have remained stable, leaving less money available for other services. In San Diego before reforms were enacted pension payments were over 50 percent of total payroll costs. In Florida pension costs for state employees rose from 18 percent of payroll for general employees in 2004 to 25 percent in 2010, and for public safety employees rose from 28 to 41 percent during the same time period.¹



Or benefits are dramatically out of proportion with labor markets and/or relative to plan funding levels. The graph below shows how much pension benefit costs for teachers have increased compared to private sector workers.



Some unfortunate places have more than one of these fiscal problems. Total pension debt has increased dramatically in total and as a share of GDP (see graphs below).

Figure 4: State and Local Pension Debt (adjusted for inflation)

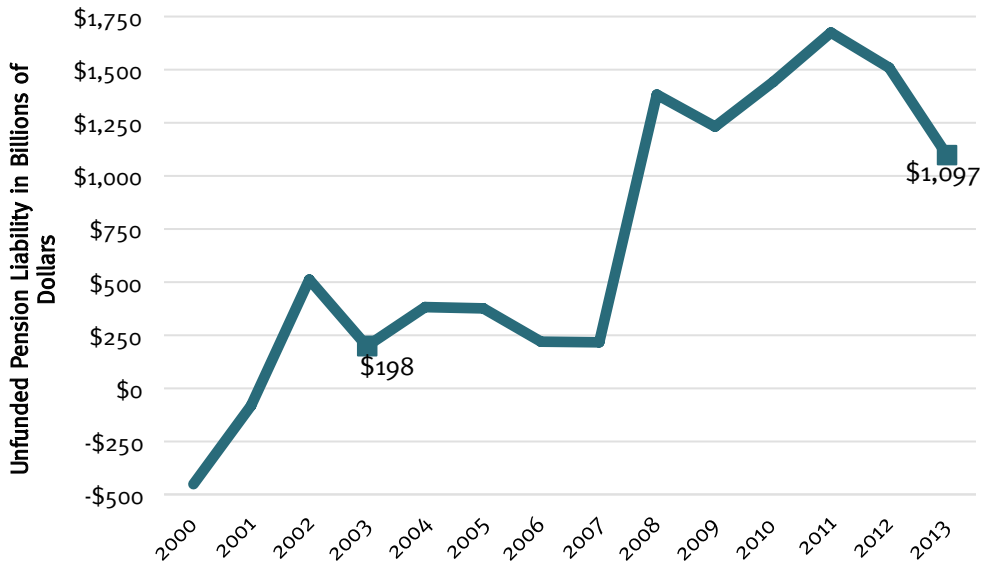
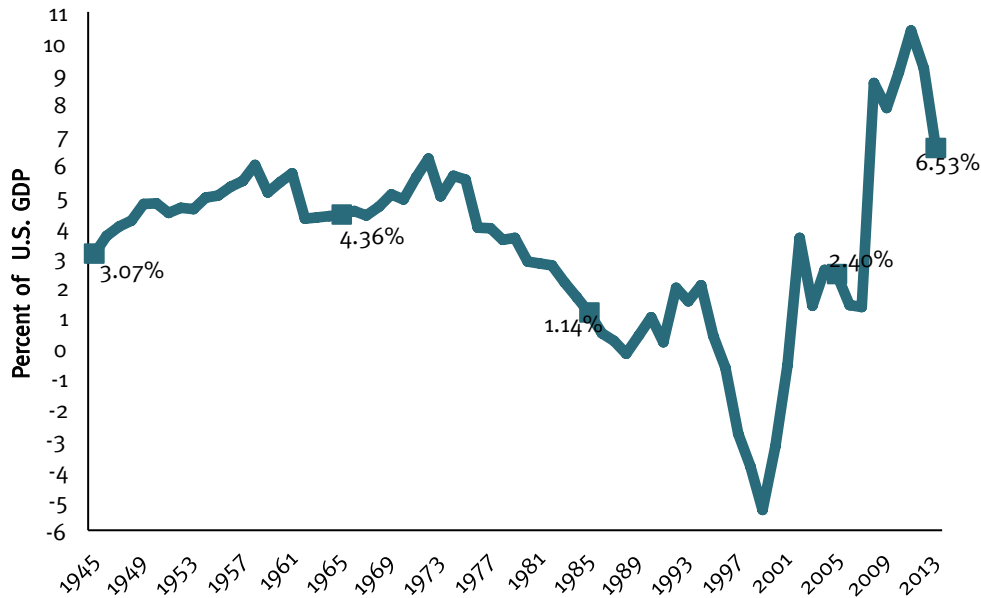


Figure 5: State and Local Pension Debt as a Percentage of U.S. GDP



Source: Laura and John Arnold Foundation, calculations based on Financial Accounts of the United States (Z.1) release, Federal Reserve Board of Governors, U.S. Department of Commerce: The Bureau of Economic Analysis (BEA).

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 handbook captures their experience, comprising the best practices and lessons learned. Combined with tools that work on reforming public policy in general, this handbook is a starter guide to provide you with simple steps and information that will give you what you need to know to start reforming pensions in your jurisdiction.

The first few chapters address problems that troubled pension systems typically experience and then delve into the principles for reform. They also provide a number of case studies of reform for reference.

The later chapters focus on how to build a pension reform effort from the ground up based on lessons learned from jurisdictions that have successfully navigated reform and the leaders who made it happen. They start by analyzing the problem, and then examine possible reforms for those problems. They provide all the elements—technical, political and otherwise—for successful reform.

Chapter 1: Causes of Pension System Problems and Principles for Reform

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

Causes of Pension Problems

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

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.

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 have repeatedly assumed higher rates of return on their pension investments than were realized and failed to increase payments into the system to make up the difference, leading to an underfunded pension system. Other governance problems included 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.

Overgenerous benefit

A few states and other jurisdictions have driven pension costs out of control by promising or allowing relatively higher benefits than the labor market can bear as a whole. Excessive benefits can easily increase to levels that governments cannot afford.

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.

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 your decisions about which reforms to use, how to implement them, and how to talk about them as you make the case for reform.

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.

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 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 percent of personnel costs to over 50 percent 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. 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 avoid being any part of a financial crisis. 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

Sustainability demands that governments use realistic assumptions and make contributions to the plan that will continually provide promised benefits. Indeed, "a formal legal commitment to funding required contributions backed with a potential remedy, as New Jersey has adopted and Illinois has proposed, and dedicated revenue sources as several states have provided for local government contributions, hold promise at least to create political pressure for payment of contributions."³

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.

Credit Rating Agencies and Pensions

Credit rating agencies have a role in the municipal bond market, as they offer analysis and opinion on the ability of an issuer to meet its debt obligations in a full and timely manner.

The three main credit rating agencies in the United States—Moody’s Investor Service, Standard and Poors and Fitch Ratings—have their own methods of analyzing the credit risk of different investment and debt instruments. For instance, Standard and Poor’s “valuates available current and historical information and assesses the potential impact of foreseeable future events, or the probability of default.”⁴ The ratings and opinions offered by credit agencies provide investors with an independent assessment of risks associated with particular debt instruments, and in turn have the potential to affect the demand for a given municipality’s debt, and/or the interest rates investors demand.

The credit rating agencies consider a variety of issues to assess whether the costs of government services threaten their ability to repay debt obligations. For example, Moody’s has a methodology that:

...covers debt backed by the [general obligation] pledge of a local government to pay its debt service....Despite its fundamental strength, the GO [general obligation] pledge has practical and legal limits. From a practical perspective, there is an economic limit on the level of taxation that a municipality’s tax base can bear. From a legal perspective, the local government’s mandate to provide essential public services and pay retiree pensions may also have strong claims on a government’s revenue and taxing power, depending on the particular state’s laws.” Moody’s analysis “seeks to measure a local government’s overall means and wherewithal to meet financial obligations from all of the resources at its disposal.”⁵

Credit rating agencies will likely continue to examine municipal pension obligations very closely, as Moody’s announced a series of new pension measures in 2013.

Moody’s focus is the evaluation of credit risk of rated debt obligations. Because pensions represent material financial commitments that affect a government’s financial risk profile, we have always incorporated pensions into our credit analysis where we have been aware of significant unfunded liabilities. As pension stress began to be a driving factor in a number of government rating downgrades over the past few years, we recognized a need to bring greater transparency and comparability to the pension measures used in our analysis. After two years of study, supplemented with an extensive centralized database collection and analysis effort, we believe the adjustments we are adopting provide us with improved pension measures that will be important and consistent inputs to our government credit analysis.⁶

It is important to engage in the right pension reforms that will shore up state and local budgets. As unfunded pension obligations rise, the potential for the deterioration of credit ratings of states and local governments increases. Because investors will insist on higher interest costs to compensate for higher risks driven by unfunded pension liabilities, this in turn threatens these governments’ affordable access to the capital markets.

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. 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 from poor financial decisions. 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:⁷

- 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. Shifting from a "defined benefit" pension system, in which employees are promised a fixed payment for life upon retirement, to a "defined contribution" system, in which employer and employee contribute fixed amounts into a 401(k)-style account, is one way to better share these risks.

1. 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.⁸ In some cases such cuts might be needed to bring benefits in line with labor markets, but too often it is a means of passing the costs of current workers on to future workers.

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 instituting programs like DROP.⁹

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. At the same time, “a defined-benefit retirement system only truly rewards individuals who intend to have long careers, potentially discouraging workers from exploring public-sector work.”¹⁰

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

Pension obligations should be transparent and 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. Balance is essential.

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.

3. 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.

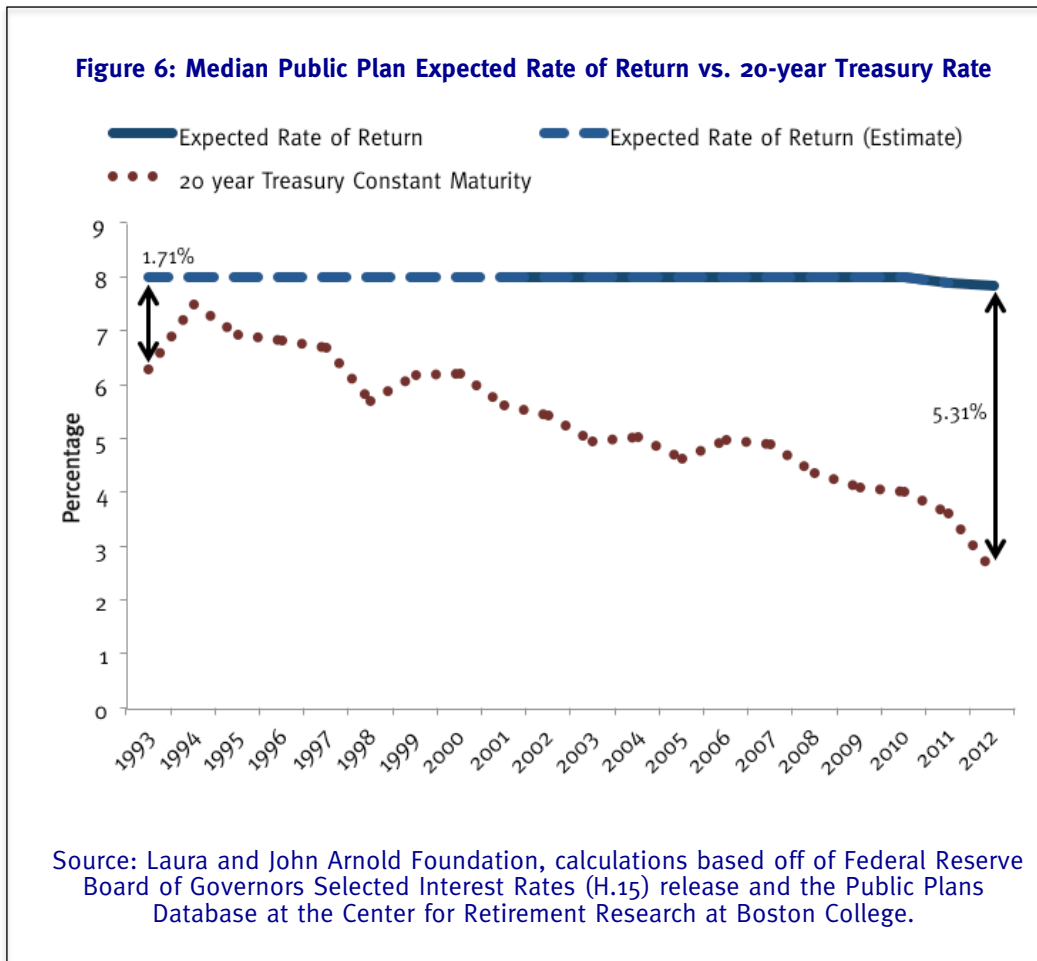
All pension plans should be subject to examination and potentially to reform. Exempting some employees will defer problems to the future and create an unfair imbalance in the overall workforce of a jurisdiction.

Pension system management should be apolitical, transparent and performance-based. 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.

4. 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. The graph below shows how wide of the mark market pension plan investment return assumptions have become.



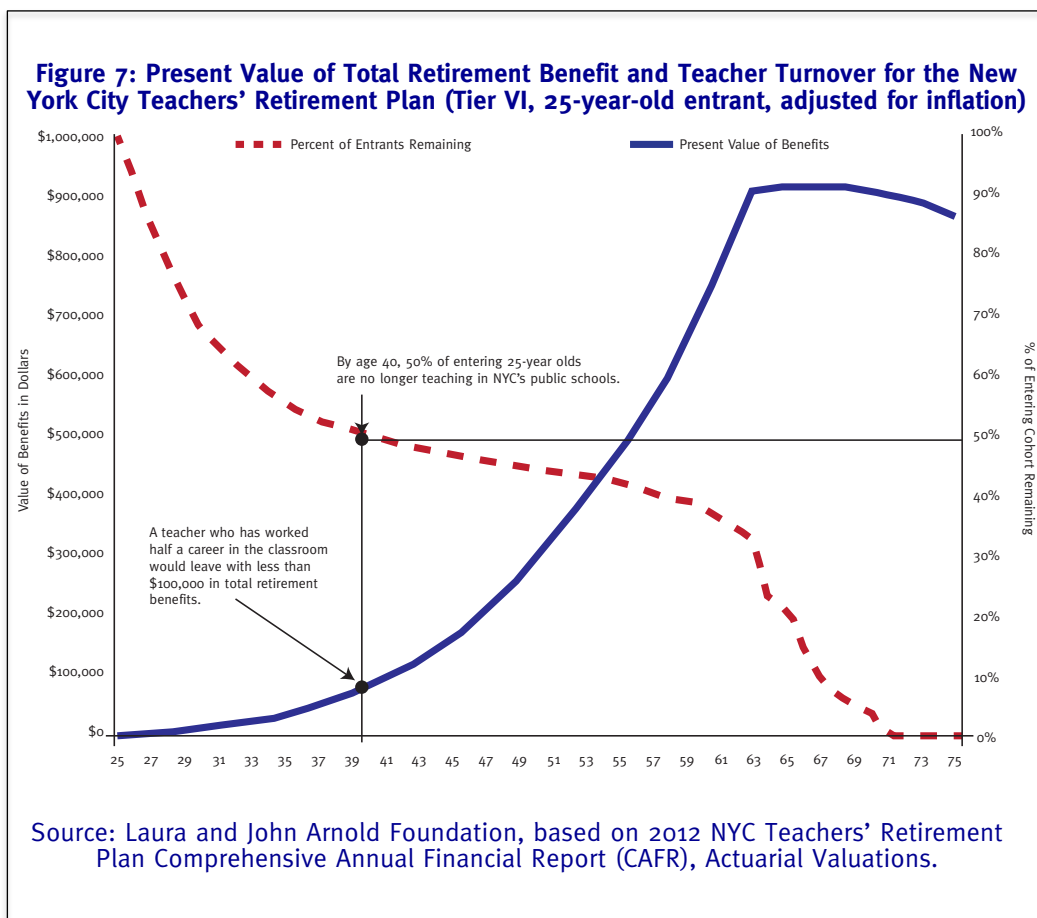
Equally problematic is the notion that funding a pension plan at 80 percent of needed levels is good enough. Plans should be at least 100 percent funded to avoid risks to taxpayers and to workers of higher future costs or failure to pay benefits.

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 with grow, etc. are crucial, but often neglected.

5. 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. The figure below shows for New York City teachers, just for example, how few stay in that one job long enough to reap full retirement benefits. 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.”¹¹



At the same time, current pension systems “[D]eny public employers an infusion of mid-career professionals from the private sector or talented but young workers who wish to commit only a few years to public service. It discourages job candidates who may wish to have a more active role in planning their retirement strategy.”¹²

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.

6. 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.

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.¹³

Chapter 2: 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 chapter we will examine pension reform measures passed in several states and highlight the lessons for policymakers that can be drawn from reform measures.

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 percent 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.¹⁴

What Rhode Island Did

(1) Suspended Cost-of-Living Adjustments

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 percent 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 four percent and will only apply to the first \$25,000 of an individual’s annual pension, rather than the first \$35,000.⁸⁰ The legislation also directs municipal pensions to suspend COLAs if they are not above an 80 percent funding level.

(2) Implemented 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) Focused on 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 percent or less to enact substantive reform.

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 one percent 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.¹⁵

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' 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 at the time. 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 option. This would have increased fiscal pressure on current state leaders and made Michigan worse off on the whole.¹⁶

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 four percent of each employee's salary

into the DC fund. The state also matches additional contributions made voluntarily by employees up to another three percent 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 percent of their accumulated benefits from state contributions to their DC fund after two years of service, 75 percent after three years of service, and 100 percent 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 percent 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. 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.

Lessons from Michigan

(1) Do not underfund a closed DB system

Missing or insufficient annual required contributions (ARC) payments will point out 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.

San Diego Reforms

In less than a decade, San Diego's pension system's funding ratio had gone from fully funded to only 67 percent funded in 2003. The 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.¹⁷

What San Diego Did

(1) Enacted Proposition G

Proposition G sought to amend 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. Proposition G was passed by voters with 54 percent of the vote in 2004.

(2) Enacted Proposition H

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. Proposition H was placed on the same ballot as Proposition G in 2004, and attempted to change 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. Proposition H was passed by voters with approximately 65 percent of the vote in 2004.

(3) Dropped DROP

One of the more controversial public employee benefits in the city is San Diego’s 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.

[A DROP plan is] designed to retain senior employees who are close to or beyond the regular retirement age. Under a standard DROP, an employee agrees to remain at his job a certain number of years (typically, three or five years) in lieu of retiring. In exchange, the employer deposits monthly checks in the amount the employee would have earned in pension benefits had he retired into an individual account (often earning generous interest rates of 8 or 8.5%, not counting cost of living adjustments). Thus, the employee is earning both a salary and a pension (with interest). Pension benefits are frozen at the time the employee entered the DROP. After the three- or five-year period has passed, the employee retires and cashes out his DROP account, receiving a lump sum.¹⁸

DROP was closed to city employees hired after June 30, 2005, Port employees hired after September 30, 2005, and Airport Authority employees hired after October 2, 2006. The city went to court with the Police Officers Association, who believed that DROP benefits were vested, and therefore could not be reduced. The city won decisions in 2009 and 2011, when 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

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 percent of the vote. Many other local governments in California have since followed suit.

(5) Rejected Tax Increases

In the November 2010 election, San Diego voters were asked to approve a one-half cent sales tax increase expected to raise over \$500 million over five years. This measure, Proposition D, was intended to shore up the city's budget, which was facing a deficit estimated at over \$70 million the next year. San Diegans, weary of both the city's ongoing pension problems and the effects of the 2008 recession that continued to depress the local economy, sided largely with the opponents and Proposition D was soundly defeated, garnering only 38 percent of the vote.

(6) Passed Proposition B in 2012

San Diego's pension reform efforts culminated with Proposition B in June of 2012. Proposition B's biggest reform called for switching 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. Proposition B passed with 66 percent of the vote and was implemented in June 2013.

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.

Lessons from San Diego

(1) You do not have to solve every aspect of a local pension problem with one large, comprehensive set of reforms

San Diego passed numerous pension reform measures over the course of nearly a decade before the "major" Proposition B measure in 2012.

(2) Address conflict-of-interest issues in pension governance early on by ensuring that most members of the retirement board are independent of the benefits which they consider or adopt

The board should consist of professional finance and investment experts.

(3) Conduct audits

Conduct audits of additional retirement benefits such as deferred retirement option programs.

(4) Develop ballot initiatives

Take reform directly to the voters through a ballot initiative, where possible.

(5) Communicate

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.

(6) Verify signatures and budget campaign

Take extra care to verify that signatures collected during efforts to get a pension reform measure on the ballot are legitimate—and budget your campaign accordingly.

(7) Seek outside legal counsel for questions on pension reform

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.

(8) 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.

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 percent, and by 54 percent 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.¹⁹

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 percent in 2007 to 7.5 percent in 2011, reduced payroll growth assumptions from 4.0 percent to 3.25 percent, and adjusted the discount rate for other post-employment benefits from 6.6 percent to 6.1 percent. 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) Passed Measure V in 2010

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, and
- creating new unfunded liabilities that the city would have to pay.

Measure V passed with 66 percent of residents' votes.

(4) Passed Measure W in 2010

Measure W 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. Measure W passed with 72 percent of residents' votes.

(5) Passed Measure B in 2012

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 was put on the ballot. Measure B sought to raise current employee contributions, create a new plan for new employees, stop the issuance of so called "13th checks" (bonus pension payments), reduce COLAs for new employees and some current employees, and have voters ratify all future pension benefit or OPEB increases. Measure B passed with 69 percent of the vote.

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:

Lessons from San Jose

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

(2) Second, recognize the true scope of liabilities from post-employment benefits and communicate these to voters and public employees.

(3) Third, if possible, put proposed reforms to the electorate.

(4) Fourth, use evidence-based arguments backed up by statistics and reports from reputable sources regarding the actual costs of city workers.

(5) Fifth, ensure that voters recognize the alternatives to reform (e.g., in San Jose's case, fewer services and fewer government jobs).

(6) Sixth, 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.

California Reforms

In 2011, the need for pension reform in California had become apparent on both sides of the political aisle. Public pension debt had already contributed to the bankruptcies of the cities of Stockton, Vallejo and San Bernardino, and the state's estimated \$240 billion unfunded pension liability threatened several other municipalities in the state. The California Public Employee's Pension Reform Act of 2013 (PEPRA), was California's response to the public pension crisis. While PEPRA made some changes to California's pension system and the rules and requirements for many local government pension systems in the state that will save money in the long run, the reforms in PEPRA did not go far enough. Rather than being a substantial reform bill containing the state's unfunded liability and overhauling its pension systems, PEPRA merely makes tweaks to the system.²⁰

What PEPRA Did

(1) Changed Benefits

The reforms were only applicable only to employees hired after January 1, 2013. Non-safety members will be provided 2.5 percent of compensation for each year of service for individuals retiring at age 67. Benefits decline to one percent at age 52, the new minimum retirement age. The majority of pre-PEPRA public employees in California receive benefits of two percent at 55, with the maximum benefit being 2.418 percent at 63. For new safety employees, PEPRA provides three possible formulas for benefit compensation. New safety employees may be eligible for benefits of 2, 2.5, or 2.7 percent at 57. The

minimum retirement age is 50, with a benefit of either 1.4 or 2.0 percent depending on the plan.

(2) Implemented 50/50 Cost Sharing

Under PEPRRA, new employees will be required to pay at least 50 percent of the total normal cost of their pensions (the annual cost to prefund pension liabilities). After January 1, 2018, employers may require employees in existing pension plans to pay at least 50 percent of the normal cost so long as the employee contribution does not exceed contribution caps set by PEPRRA.

(3) Changed Pensionable Compensation

For new employees, PEPRRA reduces the amount of employee compensation that can be counted as “pensionable compensation.” For new employees, pensionable compensation will no longer include “special compensation” such as severance payments, bonuses, unused vacation/sick time, employer-provided allowances, and some overtime compensation. As an additional anti-spiking provision, PEPRRA requires that the final compensation for calculating the pension benefit for new employees be determined by the average of the highest consecutive three years of earnings. Prior to PEPRRA, most agencies simply used the highest-earning 12-month period. For new employees, PEPRRA places a cap on the amount of earnings that can be used to determine pensionable compensation—around \$113,700 for employees who participate in social security and \$136,440 for employees who do not. These amounts will be adjusted on an annual basis.

(4) Eliminated of “Air Time”

Applicable to both new and classic employees, PEPRRA prohibits members from purchasing nonqualified service credits known as “air time.” Before PEPRRA, public employees had the opportunity to purchase up to five years of service credits—potentially unrelated to their state service—to count toward their retirement formula.

(5) Introduced Forfeiture of Pension upon Felony Conviction

Applicable to both new and classic members, PEPRRA requires elected officials and employees to forfeit pension benefits if they are convicted of a felony during the course of their official duties, or while seeking an elected office or appointment, or in connection with obtaining salary or pension benefits. Convicted public employees forfeit benefits earned or accrued after the date the offense occurred.

Weaknesses of PEPR

(1) Most Provisions Apply to New Employees Only

Most of PEPR's provisions apply only to "new employees" of the various California pension systems, a term that is too narrowly defined as it allows someone who has not been in the public workforce in 20 years to start work for a public employer in 2014 as a classic employee and receive all the benefits that classic employees receive. The pensionable compensation caps and benefit adjustments, some of the biggest changes in the law, only apply to new members.

(2) Failure to Address the Current Unfunded Pension Liability in California

One of PEPR's biggest weaknesses is its failure to address the unfunded pension liabilities in California's various pension systems. The 21 counties with independent pension systems face about \$130 billion in unfunded liabilities; CalPERS is facing a \$144 billion unfunded liability, and CalSTRS has \$71 billion in unfunded liabilities. None of the provisions in PEPR have any impact on the existing unfunded pension liabilities.

(3) No Changes to the California Pension Boards

PEPR fails to make any structural changes to the composition of the state pension boards. Perhaps no groups of people are more responsible for creating the state's current pension crisis than the pension boards that mismanaged funds and approved unrealistic actuarial assumptions.

(4) Good Provisions Can Be Undone Easily

PEPR's bill may provide only weak reform, but it does have some good provisions in it. The problem is that these provisions can be undone by a simple majority vote in the state legislature. If the economy improves and public scrutiny and pressure on the state's pension systems die down, the California legislature may see it as politically safe to increase benefits.

(5) No Defined Contribution Plan

Excluded from the PEPR was the creation of a 401(k) style DC plan or hybrid DC/DB plan for new employees. Governor Jerry Brown advocated for the creation of such a plan, but it was excluded from the final legislation. Watchdog group California Foundation for Fiscal Responsibility notes in a report that such a plan would have saved local governments \$3 to \$4 billion per year.

Utah Reforms

After the 2008 stock market meltdown, Utah's pension system faced serious financial trouble. Having lost 22 percent of its assets, Utah's retirement system faced a \$6.5 billion gap and dropped from being 100 percent funded in 2007 to 70 percent funded in 2009.²¹ 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 percent of its annual actuarially required contributions.

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. To offer a real world case, consider what happened in Utah. The state's pension fund lost 22 percent of its value in 2008. It made a 13 percent 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 percent loss actually led to a 30 percent gap between where the fund should have been and where it was. It was expected to have earned 7.75 percent in 2008. Instead, it ended 2008 far behind where its managers had called for—29.75 percent down, to be precise. To make up for loss, the pension fund would have had to generate a 68 percent return in 2009. Reformers had to explain to legislators over and over that of the 13 percent return in 2009, 7.75 percent was already assumed, and the remaining 5.25 percent 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 2009.²²

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.

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 percent of a worker's pay, which employees are free to supplement (for public safety employees, the contribution is 12 percent). 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 percent multiplied by years of service credit and the salary average of the five highest-paid years of employment.²³

(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.²⁴

(3) Limited Cost of Living Adjustments

COLAs were limited to 2.5 percent.²⁵

(4) Protected Taxpayers

Taxpayers are protected against having to make extra contributions to the DB plan. If in any given year that 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.²⁶

Lessons from Utah

(1) Request actuarial reports for future modeling

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. 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.

(3) Understand that pension reform is more than DC plans

In addition to a 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.²⁷ A 2012 analysis performed by two Brigham Young University economists estimated that the state’s pension fund had a 50 percent 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 percent chance of insolvency over the next decade or so.²⁸

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 2005.²⁹

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) Made No Changes to 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

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 percent 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 five percent COLAs.

(5) Changed Employee Contributions

Employee contributions have changed from 6.5 percent for public employees and 8.65 percent for teachers, to 8 percent for all public employees and teachers.

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 SB141 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 percent until 2011 when it was lowered to 8 percent. In the years after reform, PERS has averaged an actual rate of return of 4.80 percent; this was much lower than its assumed rate. The most recent data show that in 2012, PERS's actual rate of return on investments was a paltry 0.46 percent. 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. But it is not necessary because the initial pension reform back in 2005 failed—it is only necessary because the 2005 reform did not go far enough to correct Alaska’s pension funding errors and to anticipate the legislature skimping on its ARC payments in the years following.

The situation in Alaska would likely be much worse today had the defined benefit membership not been closed off.

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 illustrate strong pension reform efforts, but lessons can even be gleaned from weak pension reform measures like PEPPRA. Reoccurring themes among states and cities that are able to pass pension reform include the necessity of a strong and credible pension reform champion, good data, emphasis on the fiscal importance of pension reform, anticipation of legal roadblocks, continued diligence in maintaining pension systems even after substantive reform, and more reform than simply implementing a DC system.

Chapter 3: Researching Your Pension Problem

This scene happens regularly in city council and county board meetings across the country.

You are a local official sitting in a meeting of your budget committee and listening to your pension system's actuary give a yearly report to the board on the state of the fund and assurances that all is well and there are no problems.

You would like to believe this good news, but you are skeptical, so you ask a question: "How do we know we are financially secure and able to meet not just current pension payouts but future payouts?"

The actuary tells you and the rest of the audience that the projections show that when the system is required to pay its debts, there will be enough money to cover the costs. The actuary then proceeds to fire off a number of bold statements:

- *The system is 80 percent funded—a satisfactory standard for the industry—and once the market rebounds, all will be well.*
- *Any unfunded liabilities are negligible and do not represent a problem because those debts will be paid in the future, much like the mortgage on your home.*
- *A discount rate of 7.5 percent or 8.0 percent is acceptable, because the fund got over 10 percent last year and is projected to do the same for years to come.*

You have heard about other government pensions in pronounced distress, but it is tempting to accept the representations you just heard since few people seemed troubled by the numbers presented. What is the truth? Should you be concerned?

Does any of this sound familiar? If so, and you are looking for answers on how to break through the confusing and seemingly contradictory messages surrounding your jurisdiction's pension system, the essential first step for any reform effort is to do some rigorous research on your pension system and to identify any potential problems it may have and how extensive those problems may be. In thoroughly researching your pension system and fundamentally understanding how it works, you will begin to see where the flaws are and what is driving the costs. Once you understand the problem, then you can start collaborating with other sympathetic reformers and begin canvassing for solutions.

Shining Daylight on Pension Problems

The Costa Mesa, California City Council created a Pension Oversight Committee (POC) in February of 2013. Following public notice, volunteers were interviewed by council members and then appointed to the POC.

The mission of the POC is to focus on current and long-term pension obligations in a nonpartisan fashion.

Key points of emphasis include:

- Review annual and long-term pension commitments as they pertain to the city's California Public Employees Retirement System (CalPERS) retirement account with an emphasis on controlling unfunded obligations.
- Study and advise on what financial triggers led to an unfunded position of about \$196 million.
- Encourage the city to maintain adequate reserves and ratios per council guidelines and prudent fiscal management.
- Review negotiated pension and compensation packages as they pertain to each employee bargaining unit.
- Evaluate potential changes to pension benefits and advise the employees, city council and the residents of Costa Mesa of their anticipated impact.

Source: Costa Mesa Pension Oversight Committee, "Explaining the work of the Pension Oversight Committee," *Daily Pilot*, April 14, 2014, <http://www.dailypilot.com/opinion/tn-dpt-me-0416-psa-pension-oversight-20140414,0,3338834.story>

While any competent citizen is capable of asking these questions, it might be useful to know whom to engage; this will likely include key staff and/or decision-makers within the system, as well as outside experts. Follow up with

those who have been active in city council meetings or wherever the pension benefits or labor contracts have been decided. Consider inquiring of current staff and board or council members to see if you can get relevant information from them first. Perhaps partner with a forensic accountant, financial specialist, investment officer, labor lawyer, independent actuary, sympathetic members from other pension boards, taxpayer organizations, government watchdogs or public policy think tanks (such as Reason Foundation) who may have done research on these problems in the past. This ad hoc group will not only be crucial in identifying your pension problems, but will also be key in developing a committee who will recommend reforms and may even move forward on a political campaign either with the elected officials or from the outside through a ballot initiative.

At the early stages, it is important to keep research and operational costs down, so try to get as much of your work done pro bono. Watchdog or taxpayer groups may have an eager intern they are willing to put on the project. See if they are willing to sponsor a study. If you have difficulty finding the right kinds of experts, contact Reason Foundation for referrals.

What Recent Governmental Accounting Standards Board (GASB) Rule Changes Mean for Pension Systems

The Governmental Accounting Standards Board (GASB) is an independent, not-for-profit professional association formed in 1984 that establishes Generally Accepted Accounting Principles (GAAP) to improve financial accounting and reporting standards for state and local governments in the United States.³⁰

Over the last decade, GASB has adopted several sets of rules that address how pension benefits and other post-employment benefits (OPEB) are reported by the state and local governments that provide these benefits. For instance, GASB 45 “establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities (assets), note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers.”³¹

Pension watchdogs have been concerned for years about how and when pension systems account for liabilities created either through collective bargaining or board action, including retroactive benefit increases, higher employee contributions, increased or suspended COLAs, etc.

To address several other concerns about how to more accurately report benefits, GASB adopted two new sets of rules at the end of June 2012—GASB 67 and

68. GASB 67 must be used for government pension fund audits beginning June 2014. GASB 68 must be used for audits of the governments themselves beginning June 2015. These updated rules change the way governments report pension finances requiring, for the first time, that pension liabilities be reflected on balance sheets, not buried in footnotes. Such a change is intended to provide more disclosure that will benefit decision-making, particularly for bond companies and insurers and in the collective bargaining process, though it will not necessarily change the way governments actually fund their pension systems, which is a separate policy and budgeting decision. Most pension expenses will now be reported as they create the government's pension obligation, not when it is paid. GASB 68 will force thousands of governments to begin reporting huge annual deficits.³²

One significant change addresses the discount rate to be used in measuring liabilities. If projected employee and employer contributions for current active and inactive workers will not be sufficient to cover their benefits, then the shortfall must be measured using a tax-free municipal bond rate. The shortfall cannot be reduced using contributions from future employees unless future employees' contributions are projected to exceed the costs for their benefits.³³

According to GASB, "The most significant effect of the recent OPEB Exposure Drafts would be to require governments to recognize their net OPEB liabilities on the face of their financial statements—providing all financial statement users with a more comprehensive understanding of these significant OPEB promises than is currently available."³⁴

There are concerns about the efficacy of these changes in GASB 67 and 68 and whether the way the assets and liabilities are reported will provide the right information for oversight in making necessary comparisons and judgments. In an article for *State Budget Solutions*, Cory Eucalitto suggests that "the near impossibility of accessing timely, comprehensive public sector financial information means that the changes will be unnoticeable for another several years." Eucalitto also considers some of the effects of excluding Annual Required Contributions from the reports. "Plans will instead choose between using an actuarially determined contribution or a statutory contribution. The ability to compare plans will be reduced because the guidelines for actuarially determined contributions will no longer be uniform across plans. Further, since plans that choose to use an actuarially determined contribution will have to report underlying assumptions while those that choose a statutory contribution will not, many will simply choose the latter."³⁵

Essential Documents to Consult

Labor Contracts:

One of the best places to find vital information is the labor contracts. They become the foundational documents for any pension research project. These documents can be very lengthy and complex, so it would be helpful to have the associated board meeting agendas, notes and minutes for context about the discussions. These documents can be found online with video of the meetings where they were discussed and ratified, if they are recorded and posted online. Be familiar with relevant terminology and related documents.

Jurisdictional Budgets:

Almost all jurisdictions have an annual process to build their budget. Some jurisdictions do bi-annual budgets, but can adjust their budget under certain conditions as a result of an unexpected circumstance or if a fiscal emergency arises. Review the budget and supporting documents over previous years and track the various forms of revenues and expenditures (distinguishing between general fund versus special funds and accounting for pass-through payments), bond sales and liquidation and debt repayments. Trace and validate the authority for every appropriation in the budget. Note those appropriations that seem to exist without proper authorization.

Meeting Agendas, Notes and Minutes:

Nearly every public meeting in government—where there is a majority or quorum of the membership present—has to post an agenda prior to the meeting being called to order (usually 72 hours in advance or within three business days) that includes minutes from the previous meeting. You may know others who attend who may have more complete and reliable notes.

Actuarial Analyses and Independent Audits:

Does your jurisdiction's pension system have a regular or consistent audit by an outside and competent auditor? Have the auditors made any suggested changes in standards and practices?

Social Security Website:

Every state has a Section 218 agreement that determines when public sector plans have to comply with the Social Security Act and when they do not.³⁶ There are some variations in the agreements. Each state agreement needs to be reviewed in that regard, but the measures need to track federal law. A note of

caution: if you have a plan that requires Social Security, that jurisdiction can never revert back out of Social Security according to current law.

W-2 Statements:

Government officials will often point you to budget documents that give broad details about salaries and wage classifications. If they are unlikely to provide more specific information, including total pay from all sources in the jurisdiction, specialty payments, all the step increases and any sort of overtime, ask for the W-2 stubs for all employees. This methodology for requesting salary data will allow for the calculation of net compensation because employers cannot lie to the Internal Revenue Service, at least not for long without strong and expensive consequences.

Bureau of Labor Statistics:

The Bureau keeps a comprehensive set of employment, economic and financial data for every county in the country. This is useful for comparing related jobs between the government and private sector.

EMMA (Electronic Municipal Market Access):

This useful database of publicly available finance documents around bond issuances provides information on a jurisdiction's debt and liabilities.

Employee or Pension Newsletters:

Once an employee retires, it is likely that he or she will receive a monthly or quarterly newsletter outlining any recent changes in laws or bargaining units' contracts. The newsletter may even provide an analysis of your projected reforms. Use those as sounding boards for opposition arguments for possible reform elements.

Dealing with the Bureaucracy

A note on dealing with government officials: While you are likely to encounter a substantial amount of resistance to your reform efforts, most governmental officials will behave in a professional and courteous way, cooperating with your requests in an honest and timely manner, even though any potential reform could very likely affect them personally. For elected officials, it may be prudent to talk with them and find out where they stand on the issue of pension reform. They may be sympathetic, adversarial or indifferent, but do not assume you know their position. Understanding their position will inform your approach. You may have to work with these people in council meetings, board meetings or

legislative hearings, so a professional attitude will help make sure you will be treated similarly in front of other elected officials or the media.

When looking for information, act at first as if you expect to receive your inquiries or requests in full, in a timely manner, recognizing that you will likely get specific answers to specific questions at the last legally required moment. Again, how you ask your question will determine the answer you are going to get. The system will not always give you what you want unless you articulate your request very specifically.

Further, most jurisdictions operate under some sort of open meeting or good government statutes or rules. While these laws often offer more transparency and accountability than those jurisdictions that do not have comparable laws, such transparency can also be a double-edged sword, with processing requirements that could delay your request. Anticipate a slow bureaucracy and prepare to implement a number of steps to mitigate the obstacles that are likely to be in your path.

If you are not able to get the information that you need through oral requests, you may need to submit your queries through formal public record requests or Freedom of Information Act (FOIA) letters.³⁷

Once you figure out the extent of the problem, it is time to search for solutions or alternatives that will bring about a fair and sustainable pension system for both the pensioners and the taxpayers. You are likely not alone in your quest and you will build a coalition as you gather your facts and in the development of substantial reforms. As you look around, there is very likely a group of engaged, dedicated individuals and elected officials and groups that are willing to assist and manage a reform project. However, you do not want to go public with your project until you understand the nature of your coalition. Ultimately, the breadth and depth of reform components will be driven by your coalition, so the stronger and more engaged they are, with the necessary buy-in, the more likely you are to succeed.

Finally, while your jurisdiction may have access to legal counsel (in-house, shared or contracted), these lawyers are not always well-versed on reforms and tend to be very conventional in their opinions on change. You may need to get outside and independent legal counsel to get a full exploration of what is possible.

Analytical Questions Checklists

Outlined below are a number of steps you can take and questions you should ask to ascertain and understand if a pension system has problems and the nature and extent of problems that do exist. While this is not an exhaustive list—your system and political culture will likely influence the questions you ask and the answers you will receive—this list will get you off to a good start. Those within your coalition may also be a great repository of essential questions. At a high level, an informed reformer is going to know something from all of the following categories. The following chapter outlines a wide ranging list of possible pension reforms that address issues raised by the answers to the questions on these checklists.

Pension System Overview

1. Identify any and all pension systems in your jurisdiction. Many agencies run several retirement programs. In fact, employees may actually have access to multiple retirement benefits in a single government position.
 - a. If you are in a state pension system, does it cover any combination of civilians, public safety employees or teachers? Does the state system also control other municipalities or other governmental agencies (e.g. colleges or universities, special districts)?
 - b. If you are in a local system, is it a subset of a larger state or regional system, or does it stand alone? Who has control over that system?
 - c. How did the system come into existence? You may also want to know when the system last expanded or contracted and how that affected the demographics of your system's beneficiaries.
 - d. Is your pension system a:
 - i. Defined Benefit plan (DB)
 - ii. Defined Contribution plan (DC)
 - iii. Hybrid Defined Benefit/Defined Contribution plan (Hybrid)
 - iv. Cash-balance plan (CB)
 - v. Some combination of the above?
2. Find out who belongs in which systems and how many members are in those systems—both those who are employed and retired.
 - a. Are employees or pensioners classified into different tiers based upon their job description or term of service?
 - b. Are there any supplemental, beneficiary or death and disability benefits or insurance programs related to your pension system?

Legal Framework

1. Which laws, charters or collective bargaining agreements govern the pension systems?
2. If dealing with a city or county, is the jurisdiction a “general law” or a “home rule/charter city/county”? General Law cities are subject to the general laws of the state and that applies in places like in Arizona and Minnesota. Home rule or charter cities or counties are allowed to develop their own rules, which usually govern two types of programs. There is the statewide program adopted by the legislature and there is the local program whereby the legislature delegates authority down to the local jurisdiction to do its plan. And even when you have that delegation, there are still some general rules that might apply.
3. What have been the most recent changes in the law, through legislation or ballot initiative?
4. Are there constitutional protections or judicial precedents (of any part of the system) that need special attention? ³⁸
5. If there has been litigation regarding your pension systems, what, if any, are the controlling precedents or requirements mandated by previous court settlements or cases?
6. Who controls changes to the pension benefits? Pension board? State legislature or local governing body (i.e., city council, county board, school board)? Do taxpayers have access to the ballot initiative or a referendum on pension benefit levels or increases?
7. Have there been any labor contracts or pension benefit packages that were negotiated and agreed upon that lack or do not conform with required municipal code or state statutes?

Plan Structure

1. What types of plans are offered? Is there only defined benefit, or is there a hybrid with a defined benefit option as well?
2. What are the pension calculation formulas? These determine an employee's benefits based typically on years of services, age and a percent of salary. So getting 3 percent of salary for each year of service, eligible to retire at 55 is more generous than 2 percent of salary for each year of service, eligible to retire at 65.
3. How is "final average salary" calculated? This is used as the salary for the pension calculating formula. A good practice is to use the average of the last 3–5 years of salary to avoid basing a pension on a exceptional last year. Many systems with funding problems use only the final year.
4. What are the contribution requirements for the employer and employees? This is the percent of a worker's salary each party is required to pay into the pension system. What are contribution schemes for paying into the pension system?
 - a. What percentage of salary does the employer pay?
 - b. Is the employee required to make any matching payments? Is there a threshold for which the jurisdiction will match pension payments made by the employee?
 - c. Are there "pickups," where the employer agreed in a labor contract to pay the employee share?
5. What is the cost of living (COLA) structure?
6. What are the allowed retirement ages?

Governance Structure

1. Who or what governs the system—is it an appointed board?
 - a. What are the requirements for membership on the pension board?
 - b. Are board members appointed or elected? By whom?
 - c. Are board members chosen for political considerations or because of a specific professional qualification or some combination of the two? What kinds of professional categories are there? How many members of the pension board are union members, current or future pensioners from the system? Are taxpayers represented at all on the board? Are there any direct or indirect conflicts of interest or other issues that would cloud judgment on the board's actions?
 - d. What is the term of service for each of the board members? Are there term limits or reappointment requirements?
 - e. Do they have specific or stated fiduciary requirements?
 - f. Have the board's previous activities and expenses been audited? Recently? Ever?
2. What are the system's former and current collective bargaining agreements, memoranda of understanding or labor negotiation procedures?
 - a. Pull existing labor contracts and read them verbatim. Some of them are hundreds of pages long, but it is absolutely critical to read and understand every caveat and provision.
 - b. If you are a legal novice, it might be helpful to have a friendly expert in labor law take a look at the agreements to help explain them.
 - c. Here are some important questions to ask as you are reading through these documents:
 - i. Are negotiations done in secret or are they subject to any open government laws that mandate transparency or public notice?

- ii. Who negotiates on behalf of the jurisdiction and do they have an inclination to regard their fiduciary responsibility to the taxpayer, or are they sympathetic to the union's position?³⁹
 - iii. Is there a mandatory actuarial analysis done for every single labor contract or collective bargaining agreement before it is ratified by the relevant jurisdiction?
3. What is the target funding ratio for the plan? The funding ratio is the ratio of the balance of assets in the plan relative to its liabilities. It is common to see plans operate on the assumption that a funding ratio of 80 percent—meaning the plan currently has 80 percent of the funds needed to meet current obligations. A funding ratio of less than 100 percent assumes that the future will somehow make up the difference.
4. Is information on the pension plan transparent and readily available? Is there a website providing easy access to detailed information about the pension plan?
5. What are the financial controls for the pension plan? Are they being followed? How do they stack up against those required of private pension systems?
6. What are the investment targets used by the plan? What is their track record at hitting investment return goals?

Fairness Issues

1. What are the vesting rules for each plan? How long does an employee have to work or be in the system before vesting pension benefits (acquiring a property right to the employer's contribution and related interest)?
 - a. What part of the employee's compensation is vested? Does that include:
 - i. Health care?
 - ii. Pension benefits?
 - iii. Contribution rates?
 - b. How many years of service or at what age are employees allowed to retire?
 - i. What is the minimum age of retirement?
 - ii. Is there a rule of 80 or 90 (number of years worked + age at time of retirement)?
 - iii. Are there rules or exceptions provided for early retirement because of disabilities, family circumstances or other extraordinary situations?
7. How portable are benefits and what limitations are there on workers taking benefits with them if they leave?
8. Does the plan offer Deferred Retirement Option Plan (DROP) or retired annuitant programs within the system that allows retirees to continue working for the jurisdiction and either get paid a regular salary in addition to pension payments or allow accrual of more or concurrent service time to their pension?
9. Do the employer and employees share costs when the plan fails to meet investment goals? Or do taxpayers make up losses alone?
10. Are death and disability benefits appropriate and secure for employees and their families? Are disability thresholds appropriate? Are there adequate controls on fraud and is the percent of workers receiving disability retirements in line with industry expectations?

11. Are “public safety” workers categorized appropriately? Have worker classifications been changed to shift workers that would not ordinarily be considered public safety workers into public safety classifications that qualify for more generous pension benefits?
12. Are workers in Social Security or out of it? Do employees have a choice?

Sustainability and Fiscal and Budgetary Impact

1. What is the current status of the fund—in real and future dollars—including all the liabilities on the system?
 - d. What is the total value of assets in the pension plan?
 - e. How much liability is counted against the plan?
 - f. Subtract all liabilities for the plan from total assets to get the unfunded actuarial accrued liability (UAAL).
 - g. What are the assumptions that play into these numbers? (See page 53: “Questions for Actuaries”)
 - h. Are there any cost escalators or cost of living adjustments (COLAs) that need to be considered or that are embedded in the system? If so, how many are there and what are their calculations?
 - i. Is there an extraneous benefit or a preservation of benefit for which the pension system is paying?
 - j. Are your jurisdiction’s disability payments routed through or comingled with the pension system? If so, how are these accounted for? Are disability payments counted in the unfunded liability valuation?
2. How has your jurisdiction handled its annually required contribution (ARC) payments?
 - a. How much has been appropriated to fund the system over the last 10 or 20 years (likely the ARC payment)? What are the current year and projected budget year ARCs?
 - b. What percentage of the jurisdiction’s budget has been ARC payments during the past 10 years? What does that percentage look like in the next 10 years?
 - c. Is there a legal requirement stipulating the percentage of ARC appropriations every year? Is the system allowed to contribute less than 100 percent of its ARC payment in a particular year?

- d. What is the discount rate associated with each of the ARC payments? How do those discount rates compare with actual returns on investment in previous years? Were those manipulated to drive down ARC payments?
3. What are the ranges and averages for payouts, including salary, health care and other benefits for the following classifications of pensioners?
 - a. Full-time
 - b. Part-time and/or seasonal
 - c. Retired annuitants
 - d. Others
4. How many of these pensioners have other supplemental pension funds, including a defined contribution plan with contributions from the jurisdiction?
5. Who are the top 10, 100 and 1,000 pensioners in the system and what do they make in pensions each year? What was their position working for the city? Ensure you ask the questions so as to ensure all pension payouts are included.
6. Are pension benefits in your jurisdiction out of whack with the labor market? Do you have a group of employees that make over \$100,000 per year? Is it enough to create a \$100K club? Is it the same with the pensioners? (It may be important to find out the years of service and age for each pensioner so that you can calculate their lifetime benefits using life expectancy rates.)
7. After you understand your jurisdiction's pension system, get comparative benchmarks of retirement contributions and retirement benefits in your local labor market. Fortunately, the Bureau of Labor Statistics has information on every county in the country and can furnish contribution rates and the nature of benefits that employers provide.
 - a. What are the comparative pay ranges for similar jobs and classifications?
 - b. How do the jurisdictions' and retirees' benefits compare?

8. When the jurisdiction has returns above expectations, what is done with those excess funds?
 - a. Are these funds put back into the system in addition to or in place of other pension fund payments?
 - b. Are retired employees compensated with a “13th month” check?
9. Do pension payments affect the budget in other areas or are they crowding out other services?
10. What is the ratio of current employees versus retired employees supported in the jurisdiction’s pension plan? How do retired annuitants play into this calculation?
11. Does the plan allow pension “spiking” in which various methods such as counting unused vacation time, etc. are used to increase the values used in the pension calculation formula to raise total benefits?
 - a. Are vacation, overtime, sicktime and such counted in the pension calculation formula?
 - b. Does the pension system allow for purchase of service credit or “air time”? In other words, can workers pay to add to the time they are credited for working (whether it be in the relevant jurisdiction or outside it in another eligible job as defined by the governing body) in order to increase their pension benefits?

Questions for Actuaries

Pension plan actuaries should be presenting a cold, hard recitation of the facts and numbers, yet there are a lot of considerations and assumptions that must go into calculating the value and costs of any pension system. Actuarial analyses attempt to reconcile a vast realm of constantly changing numbers whose accuracy depends upon the data entered, rendering actuarial analyses educated guesses at best. While actuarial models are useful in looking at future costs, they are not always accurate in their predictions. And for those who are sympathetic to a tainted view of these analyses, some actuaries are not always honest in their assumptions and may manipulate the numbers to please their customer. After all, who wants to pay an actuary to give them bad news?

To conduct effective research, every inquiring citizen should ask the actuary:

1. What kind of modeling is used? How does it account for unexpected events that change outcomes from the assumptions used? Does the model use a dynamic or static approach (assumes parameters change over time or stay fixed)?
2. Overall, what are the assumptions that play into this analysis?
3. What is the range of discount rates used? Why is that range chosen? Is the range based upon sound financial planning, because of investment history or for political considerations?
4. What is the valuation of assets and liabilities?
5. For how long are the costs amortized (i.e., over what period does the jurisdiction pay down its pension debt)? Does the jurisdiction change the amortization periods from year to year, or reset them when there are major changes? Are the amortization periods consistent with the duration of beneficiaries' expected payments, or do they exceed their lifetime of benefits? When is it acceptable to shorten amortization periods in the actuarial analysis?
6. Do supplemental plans play into the analysis?
7. What is the total of other compensation, benefits, spiking and/or special payments?
8. How do longevity and mortality rates play into the calculation? Are new mortality tables incorporated? (Note: New mortality tables reflecting current longer expected life spans will often result in an increase in liabilities.)

9. Has the analysis split out part-time, seasonal and/or retired annuitants from full-time employees?
10. At which level are the pension benefits calculated? Are they just for new hires, or are they explicit and include every level or classification of employees?
11. How will the recent changes in Governmental Accounting Standards Board (GASB) standards change future analyses?
12. Has full funding of other post-employment benefits, such as health care, been accounted for?
13. What could be wrong with the analysis's projections?
14. What other factors might expose the jurisdiction's retirement fund to risk?
15. Which other analyses are utilized in the actuarial report?
16. Are the actuarial analysis numbers independently verified?
17. How regularly are the pension funds audited? Who performs the audits?
18. Does the plan sponsor have access to beneficiary data to make an accurate forecast or does he rely on aggregate data reported by the funds?
19. What are the jurisdiction's policies and procedures for approving disabilities? Can interested parties go back for the last five or 10 years and ask for the number of applications for disability and the number of denials? Is virtually every applicant approved for a disability? Are those disability applications automatically approved? Who conducts the approval process? Who are the actual people on disability and are they living a lifestyle consistent with their disability?
20. What are the year-to-year changes in costs to the pension system? Why do various numbers change from year to year? If the numbers have changed dramatically, why? Which kinds of assumption changes would be recommended?
21. Would the actuary advocate for any changes in the plan design? If so, what would he do differently and what effect would he expect?

Calculating Pensions

1. What are the system's calculations for pensions?
 - a. How does the jurisdiction define or determine "pensionable pay"—i.e., the portion of compensation received by an employee on which his pension is based?
 - i. Is there an average number of years, perhaps three or five years, on which the pension amount is based? Does the calculation include the highest pay within the system or the last year(s) of pay?
 - ii. Besides the base salary for the employee, what other forms of compensation are included in the calculation of the pension?
 - Specialty payments? (Do employees get specialty pay that counts toward benefits? Do they make sense?)
 - COLAs?
 - Step increases?
 - Overtime?
 - Air-time?
 - Service credits?
 - Vacation or sick time?
 - Other pension spiking maneuvers?
 - iii. Is there a cap to pensionable pay on both the front-end (before retiring) and on the back-end (when retired and collecting the pension)?
 - iv. Does the jurisdiction allow for terminal leave (allowing people to retire and cash out all of their sick leave, personal leave and vacation time per their labor contract, but also count those days as service credit toward their pension benefits)?
 - b. What percentage of pay does the employer (jurisdiction) pay into the system (contribution rate)?
 - c. What percentage of pay is the employee required to match?
 - d. What percentage of pay per years of service is paid to the employees (e.g., x percentage at y years)?
 - e. Are Social Security payments calculated into retirement benefits in the future and costs for retirement benefits today? Are Social Security payments factored into total pension contribution on behalf of employees eligible for Social Security?

Other Considerations

1. Are there any reciprocating agreements with other pension systems that allow for combining years of service, pensionable pay calculations or double-dipping?
2. How does the jurisdiction deal with conflicts of interest when approving or ratifying labor contracts, memoranda of understanding (MOU) or pension benefits? Are there clear disclosure requirements that allow some individuals to serve in multiple positions? Are there contractual relationships between members and interested parties?
3. Has there been any record of malfeasance in negotiations that would constitute a serious breach of law? Is there a case to recover any lost money through illegal pension negotiations?

Chapter 4: Approaches and Tools for Pension Reform: Exploring Ways To Solve Your Pension Problems

Organizing and Prioritizing Your Reform Needs

Given your analysis of your pension problems, you now need to align your needs with reforms that will meet them. To begin, you need to determine:

- What you want to accomplish. Based on your analysis of the problems, what kinds of changes are needed? Is it the costs of the benefits? The way they are paid for? How the system is managed? Other issues or some combination of the issues?
- What is possible. You need to understand the timetable of your current labor contracts. Have quality *outside* counsel review the relevant legislation and case law that applies to your jurisdiction and determine what changes are allowed under current laws and/or what laws need changing to accommodate your reforms.
- A menu of options. Much of this chapter summarizes the many ideas developed in various jurisdictions for reforming pensions. Use them to align what you want to accomplish with what is possible and create a set of reforms you want to put into place.
- Timing and location of reforms. You may need to prioritize and figure out which reforms are crucial first. Explore your avenues for implementing reforms (e.g. labor negotiations, legislative action, ballot initiative, legal challenges) and determine which path is most likely to get you what you want to accomplish.

It is important to get your reforms right from the beginning. Too many governments have passed “reforms” that did little but defer problems a few years or that imposed the costs of change on politically weak groups, or that in various ways simply did not get the job done. It is not unreasonable to break the reforms into chunks and implement them in phases, as long as the approach

allows for continued reform. San Diego successfully used the phased approach, for example. But it is crucial not to leave the job half done or further expose the system and create further problems.

Pension Reform Options

Pension plans have a lot of moving pieces, so there are a great many possible reforms, some with much larger overall impact than others, and some that are more or less simple adjustments to the system. In order to get the right reforms, you have to understand the scale and scope of the impact each reform will have on *your* system, independently and collectively. This chapter provides a menu of various types of reforms to pension plans. Some may fit your needs and some may not, but examining all the options is crucial to be sure you make the best reforms for your jurisdiction.

A system in crisis will most likely have to have two batches of reforms: One batch that stops digging the hole deeper, which typically means changes to the plans for new employees, and another batch that makes the current plan sustainable and pays down unfunded liabilities and debts.

The biggest pension reform enacted in some jurisdictions is converting from existing defined benefit plans to defined contribution plans.

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.⁴⁰

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.⁴¹

Potential Advantages of Defined Contribution Plans⁴²

1. Stability and Predictability of Contribution Levels. One of the greatest benefits of a DC plan, from an employer's perspective, is that it provides a great deal of stability since contribution levels (i.e., costs) are known in advance and do not change much from year to year. This is in sharp contrast to the volatility in contribution levels experienced under DB plans. Moreover, if lawmakers decide to increase benefits to government employees (which they still can do) it is transparent and will not create overnight actuarial liabilities.
2. Choice for Workers. DC plans allow employees the freedom to manage their own retirement accounts and invest their own money as they see fit, including the option to pool investments for less risk and lower costs. The value one places on this freedom will vary from individual to individual and cannot be captured in investment fund performance comparisons. Moreover, risk levels and investment strategies change with age. DC plans allow employees to choose aggressive, growth-oriented investments when they are young and then switch to more conservative investments as they approach retirement.
3. Portability. Since employer retirement contributions are paid directly into individual accounts under a DC plan, it is easy for workers to take their accumulated funds with them when they change jobs. In addition, the vesting period for DC plans is typically only a few years, whereas the vesting period for DB plans is often 10 years or more. Upon the employee's departure, both employer and employee contributions can be cashed out and "rolled over" to a future employer's plan. Under a DB plan, by contrast, only employee contributions may be cashed out. This portability is extremely appealing to employees in an age where the average worker switches jobs numerous times during his or her career.
4. Younger Worker Appeal. Shifting to a DC plan provides particular benefits to younger workers—a demographic government recruiters are desperately pursuing across the nation. They appreciate a benefit with the portability and flexibility and choice a DC plan offers.
5. Rational and Individual Investment Choices. No one has a greater interest in the proper investment of retirement funds than the future retiree himself. Government pension boards are inherently political bodies, whose investment decisions are often colored by political influence or ideology. Under a DC plan, depending upon the investment choices offered by the employer, the individual is free to invest in companies for the purpose of furthering a political ideology or cause—even if it means sacrificing greater returns—but others are not forced to suffer the consequences if such investments offend their values or post sub-par returns.
6. Accountability and Transparency. Since DC retirement accounts are managed by the participants themselves, and not a government pension board, there is complete accountability and transparency with regard to investment decisions; these decisions are simply the responsibility of the individual participant. Thus, there are no backroom deals, no conflicts of interest, and no need to worry about the lack of financial disclosure—all problems that have plagued the pension boards of government DB plans.

Looked at slightly differently:

The essential difference between the defined benefit (DB) and defined contribution (DC) models of pension compensation is the obligation of the returns. The sponsor of a DB plan promises the participant a certain level of perpetual monthly payments in retirement, typically calculated from four main factors—service time, salary, salary multiple, and annual cost of living allowance (COLA). In a DC plan (also known as a thrift plan), the participant is entitled to the money that has been contributed to his retirement account plus investment returns. This can typically either be accepted upon retirement as a lump sum or converted into an annuity. In the DB plan, the pension return is guaranteed; in the DC plan, it is a matter of investment earnings.⁴³

The private sector has largely converted to DC retirement systems, which are typically 401(k) plans or something similar. The federal government also made the shift to a largely DC system.

This conversion is a means to the end of a pension system that meets the principles discussed in Chapter One. Converting to DC is not the only way to achieve that goal, but it can often be the core of a set of reforms that meets all of the principles laid out in this handbook.

Reforms to Plan Structures

Defined Contribution Program

Reform should follow the clear and undeniable trend in the private sector and convert employees from DB plans to self-directed, 401(k)-style DC plans as much as possible. Converting to DC plans for new employees is straightforward, but for existing employees, conversion must be a choice in most cases, though incentives to convert can be provided.

These DC plans should have the following features:⁴⁴

- A modest, automatic employer contribution, with matching funds capped at a fixed percentage of salary. The employer contribution percentage should include Social Security contributions if those are paid.
- Mandatory employee contributions.
- A variety of investment options for each worker's season of life and risk preference. Include index funds to minimize transaction costs and provide lower risk options.

- Restrictions on borrowing from funds, or alternately, limitations on the size and duration of the loan.
- Encouragement that upon retirement, the funds be used to purchase a life or life-and-survivor annuity.

Note: If your government agency is not enrolled in Social Security, you must ensure that the combined employer and employee contributions and benefit structures are sufficient to meet the IRS's Safe Harbor Test for exemption from Social Security.

How to Structure a Good Defined Contribution (DC) Plan

A good public pension plan should balance the interests of three major stakeholder groups: taxpayers, employers and employees. Corresponding to these interests are three criteria: fiscal sustainability, workforce productivity and retirement security. In other words, a good pension plan should not impose an excessive burden on taxpayers (fiscal sustainability), should improve worker retention and recruitment (workforce productivity), and should provide some reasonable level of retirement income (retirement security).

DC plans, by definition, are fiscally sustainable thanks to the nonexistence of unfunded liability and the predictability of contribution levels. Unlike defined benefit (DB) plans, DC plans do not shift investment risks to taxpayers and create no lag between benefit promises and payments. In terms of workforce productivity, DC plans are an attractive retirement vehicle for the modern mobile labor force due to their portability, transparency and freedom of choice. Having a three- or five-year vesting requirement for the eligibility for employer contributions may further improve the retention of quality employees.

Retirement security may not be a strong aspect of traditional DC plans, not because of any inherent feature of the DC structure but because of workers' financial choices. Many individuals who are offered 401(k) plans fail to save early in their career, or simply do not know how much to save and how to invest. Many also fail to properly diversify their investments, exposing their retirement funds to excessive market risk. A number of modifications can significantly improve a DC plan's performance in this area:

- Automatic enrollment: Workers, by default, would be enrolled in the pension plan and have the option to opt out. This would prevent procrastination while still allowing for flexibility.
- Index funds: While the majority of ordinary workers do not possess advanced financial knowledge, and thus may not know how to optimally allocate their investment portfolios, they do not have to. Most professional investors (even "superstar" ones and mutual funds) do not beat the market.⁴⁵ This means that non-expert individuals could outperform most active fund managers by simply putting their pensions in passive index funds. Having index funds as default

investment options is a good way to make sure that workers' pension funds not only are well diversified but also generate greater returns than what an average professional investor could deliver. These investment vehicles are also low-cost, and thus would not chip away too much at the pension savings. A simple 60-40 stock-bond index portfolio composed of domestic stocks, foreign equity and municipal bonds could be set as the default asset allocation, which workers would be able to modify as they wish.

- Target-date funds: while younger individuals can pursue more aggressive investment strategies, those approaching retirement should have more conservative portfolios. A target-date fund does exactly that, by automatically adjusting the pension asset mix according to a selected time frame. This should be a default feature offered to workers, as many neglect to alter their pension portfolios over time. Again, workers should be allowed to opt out of this arrangement.
- Collective DC plans: by pooling individual accounts together and having them managed collectively by professional money managers, a collective DC plan would reduce administrative costs, improve investment decisions, and enable “intergenerational risk sharing,” allowing different age groups of employees to share risk and returns over time. While this DC design has certain advantages over traditional DC plans, it strips individual workers of the control of investment strategies and may allow for the politicized management and policies that have plagued some traditional defined benefit systems. These downsides should be considered if the plan is to be adopted.
- Annuity: DC plans should provide individuals with an option to convert their account balances into an annuity when they retire.

Hybrid Pension Systems

A hybrid option mixes DC and DB approaches for the same group of employees.⁴⁶ In recent years the most common major overhaul of state pension systems has been shifting from DC to a hybrid plan.⁴⁷

The idea behind hybrids is to have a small DB plan into which employees and employers put a small percentage of salary combined with a larger DC plan into which a higher percent of salary goes. The objective is to capture the benefits of both approaches. Of course, it can also capture the weaknesses of both approaches. A well-designed hybrid approach that truly addresses the problems that led to the need for reform may be more sound and sustainable than either type of plan alone, but may be tricky to design.

1986: The Federal Government Converts to a Hybrid System

Created in 1986, the Federal Employee Retirement System (FERS) is the result of a major pension overhaul at the federal level. FERS was to replace the Civil Service Retirement System (CSRS), a defined benefit pension system providing retirement benefits for most civilian federal employees. Like many current state and local public pensions, the CSRS was found to be highly generous, with an unfunded liability of \$575 billion in 1982, representing an implicit liability of \$5,000 per U.S. adult.⁴⁸

The 1986 reform lowered employer normal costs from 25 to 22.5 percent of payroll by reducing the annuity formula, raising the retirement age, capping the COLA, and eliminating the crediting of unused sick leave. At the same time, it created FERS, a three-tiered system with three basic elements:

- Mandatory Social Security coverage of civilian federal workers
- A basic and mandatory defined benefit plan, with a lower level of benefits than the CSRS
- A new voluntary thrift savings 401(k)-type (i.e., defined contribution) plan, which includes an automatic one percent agency contribution and employer matching up to five percent of payroll. An independent board was set up to administer the plan and invest in major index funds only, with no active investment responsibilities to avoid investment politicization.

Key factors to the success of the federal reform include: 1) recognition of the unsustainability of the old system, 2) the restricting of major changes to new hires and future workers after 1983, who lacked effective political capital to oppose reform, 3) the preceding enrollment of new federal employees in Social Security, and 4) the design of an attractive DC plan insulated from political manipulation.

Private Annuity Retirement Plans

An annuity converts a pool of money into a guaranteed stream of payments. So it is a means of protecting that pool of money from mischance or future bad decisions and providing certainty. This allows a DC plan to end up providing fixed and known payments much like a DB plan does, but without leaving the taxpayers on the hook for risk. Another benefit of Private Annuity Retirement Plans is they are portable for employees. That is, employees can continue to contribute to these plans even after leaving employment with the government agency.

Workers Choose Defined Contribution Plans

Nearly 100 years ago, the State University of New York adopted a pension system that allows workers to choose a traditional defined benefit plan or to choose defined contribution. In 2010, 71 percent of university workers were in the defined contribution plan.

Comparison of Pension Plan Choices by State University of New York Employees

	<u>Defined Benefit</u>	<u>Defined Contribution</u>
Exec/Admin/Managerial	24%	76%
Faculty Members	26%	74%
Other Professional	33%	67%
Technical/Paraprofessional	46%	54%
Total	29%	71%

Source: E.J. McMahon, *Optimal Option: SUNY's Personal Retirement Plan as a Model for Pension Reform*, Empire Center for New York State Policy, February 2012, p.9.

Cash Balance Pension Plans

A cash balance plan is another means of trying to combine some strengths of both DB and DC plans. In a cash balance plan, the retirees' accounts are credited with a fixed percentage of their salaries each year. Those funds accumulate and when they retire, they take it out in a lump sum or can draw it out in payments. If they leave before retirement, the balance in their account is theirs to take with them in an IRA. The employer is responsible for putting money into the system and managing investments with that money to ensure the funds are there when each employee retires.

In 2012, Kansas created a cash balance plan that features:⁴⁹

- A six percent employee contribution.
- Employer-paid credits for each employee (three percent for new hires, moving up to six percent for employees with more than 24 years of service).
- A guaranteed return of 5.25 percent on accounts, with extra funding (zero to four percent) contingent on funding levels and investment returns.

Each employee's balance will be converted into an annuity upon his or her retirement. Employees who do not take an early retirement may take 30 percent of their balance as a lump sum payout.

Characteristics	DB Plans	DC Plans	Collective DC Plans	Hybrid Plans	Cash Balance Plans
Predictability of contributions	Low: required contributions can be volatile depending on market performance and change in demographics	Highly predictable: contributions are known in advance and do not change much over time	Highly predictable, just like DC plans	More predictable than typical DB plans, but the DB portion may cause some uncertainty.	More predictable than typical DB plans but can be uncertain when the market is volatile
Asset/Liability matching	Difficult to match asset and liability	Not applicable: there is no “liability” to match	Not applicable: there is no “liability” to match	The DB portion requires some asset/liability matching	Easier to match asset and liability than typical DB plans
Individual investment choices	No individual choices; plan managers make investment decisions for workers	Individuals make their own investment decisions	No individual choices; plan managers make investment decisions for workers	The DC portion allows individual choices, but the DB portion does not	No individual choices; plan managers make investment decisions for workers
Portability	Low portability: employees cannot easily transfer their funds to other plans	High portability	High portability	The DC portion has high portability; the DB portion does not	More portable than typical DB plans but less portable than DC plans
Accountability and Transparency	Low: it is not easy for workers to keep track of their retirement funds	High: workers have their own accounts that show contributions and investment performance	High: workers have their own accounts that show contributions and investment performance	High for the DC portion but low for the DB portion	Moderate: workers have their own accounts but they are only notional
Bearing of investment risk	The employer (ultimately taxpayers) bears almost all the risk; but in case of bankruptcy, employees can be subject to significant loss.	The employee bears the risk	The employee bears the risk	The employee bears the risk in the DC portion while the employer bears the risk in the DB portion	The employer (ultimately taxpayers) bears the risk
Interest rate sensitivity (for liabilities)	High: liabilities fluctuate dramatically with interest rates	No liability	No liability	Highly sensitive for the DB portion	Less sensitive than typical DB plans
Age sensitivity (for benefits)	High due to the back-loaded structure of DB plans: long-term (25+ year) workers get significantly more benefits than short-term ones.	Low sensitivity, no back-loaded structure	Low sensitivity, no back-loaded structure	High for the DB portion but low for the DC portion	Low sensitivity, no back-loaded structure
Risk of investment politicization	High: politicians can be motivated to invest the funds in political projects	No risk of politicization: individuals make their own investments	Some risk as individuals do not control the investments	High for the DB portion but no risk for the DC portion	High: politicians can be motivated to invest the funds in political projects
Plan expenses	Typically low, due to the collective structure	Can be high due to personalized individual accounts	Typically low, due to the collective structure	Low for the DB portion and can be high for the DC portion	Typically low, due to the collective structure
Longevity risk (for employees)	Low, as life-annuity is the default of most DB plans	Some risk of longevity risk, which can be lowered by an annuity option at retirement	Low, as life-annuity is the default	Low for the DB portion; the DC portion has some risk, which can be lowered by an annuity option at retirement	Low, as life-annuity option must be offered at retirement

Change Pension Calculation Formulas

Within a DB structure, the formula for determining an employee’s benefit—based on years of service, age and percent of salary—is a key driver of the cost of the system. Before the year 2000 and the explosion in pension costs, typical formulas would be two percent of “final salary” for each year worked, eligible for payouts at age 60. Now, costlier formulas like three percent of “final salary” for each year worked, eligible at age 50 have become more common. Setting

them to sustainable and fair levels like two percent at 60 for most workers and 2.5 percent at 55 for public safety workers is prudent.

Calculation of Final Average Salary

“Final average salary” should be an average of the worker’s last three to five years of service. Basing it on the final year alone leads to higher costs and to “pension spiking.” One option is to place a cap on the salary that is included in the calculation of average salary.

Increase Contribution Requirements

Many governments have offered workers reduced pension contribution requirements, say from five percent to three percent of salary, during labor negotiations. The government then has to increase its contributions if the pension fund is to remain sound. Employee contributions should be at least 50 percent of the total, and five percent of salary is a prudent amount. San Diego’s reforms included increasing the employee contribution requirements, but allowing employees to choose to shift to a less generous pension calculation formula rather than increasing contributions. Also, consider phasing in the increases over four years, or when labor contracts to expire, whichever is sooner.

Limit COLAs

There are a number of ways to limit the cost of COLAs, including:⁵⁰

- Impose a hard dollar cap. South Carolina caps future COLAs at \$500 per year.
- Limit COLAs to a certain percentage.
- Make COLA payments contingent on the investment performance of the pension fund.
- Limit COLAs to a given amount of an employee’s pension, such as the first \$25,000.
- Restrict or limit the granting of COLAs until the fund achieves a funding goal.

Fairness Reforms

Vesting Rules

Allow state and local discretion to modify or reduce pension benefit calculations for future service years, while respecting vested rights to pension benefits earned for prior service.

Move toward earlier vesting and more portability for workers. Portability is immediate with a DC plan, but other plans can also provide better portability than current plans do.

Sharing Both Investment Gains and Losses

For any retained DB system, adjustments to compensate for unexpected high or low investment returns should be shared by employees and taxpayers. Require that any investment losses that create unfunded liabilities for past service be paid entirely by employee contributions. Consider an option for employees to voluntarily reduce their benefit payouts to accommodate actual investment returns (an approach used in Idaho). Avoid waiving employee contributions, skipping employer contributions, or issuing extra pension payments, sometimes called the “13th check,” to retirees when the pension investment returns are higher than expected. Returns from good years are required to offset returns from bad years—a reality all too often overlooked.

Death and Disability Benefits

Reforms should include provision of appropriate death and disability benefits for employees—particularly for public safety personnel. At the same time, widely reported cases of disability fraud make it imperative to control those costs. For starters, disability retirements should be limited to cases where employees are incapable of engaging in any gainful employment for the government, even outside their current job description, but not yet eligible to retire.

Define “Public Safety” Workers Carefully

Since public safety workers typically get more generous pension benefits than other workers, there is an incentive to seek ways to redefine ever more workers as “public safety.” In some cases prison cooks, plumbers and groundskeepers have been reclassified and given the same enhanced benefits as employees in public safety whose jobs truly are riskier.

Employee Choice on Social Security

Labor agreements on retirement benefits typically either keep all employees under the agreement in Social Security, or keep them out of it. In either case, the value of future Social Security benefits should be included in determining pension benefit needs. Consider a system in which individual employees can choose between plans that include Social Security or do not.

How Much Do Reforms Save?

To figure out how much a given reform will save in your jurisdiction usually requires an actuarial analysis. Do not let that intimidate you—as several non-profit organizations (including Reason Foundation) can make referrals to actuaries well-versed in pension reforms, and even in some cases help you get the analysis you need.

A few broad estimates of savings of some reforms do exist, however. For some the financial savings may not be worth the other costs.

A Manhattan Institute study found the following:

We compare our model with a baseline model in which a hypothetical public worker who is hired at age 30 and allowed to retire at age 60, uses final year of employment for “Final Average Compensation (FAC),” and is entitled to a 2.5 percent COLA increase after retirement. Based on these criteria, which are representative of most public pension plans, we calculate a required accrual for pension benefits each year at 22.5 cents for every dollar of salary. By contrast, our calculations indicate that:

- Increasing the retirement age to 65 reduces pension costs from 22.5 cents for every dollar of salary to 16.8 cents (a savings of 25.3 percent).
- Changing the final average compensation base to the course of a career cuts pension costs from 22.5 cents to 15.1 cents (a savings of 32.8 percent).
- Removing the cost of living adjustment reduces pension costs from 22.5 cents to 17.2 cents (a savings of 23.5 percent).
- In the unlikely case that all three of these changes were implemented, annual pension costs could be reduced by 62 percent, from 22.5 cents to 8.4 cents per dollar of salary.⁵¹

A study in the *Journal of Pension Economics and Finance* found:

- A one percentage point reduction in cost-of living adjustments would lower total liabilities by 9 to 11 percent.
- Implementing actuarially fair early retirement (“reducing benefits in the event of early retirement such that the present value of benefits equals the present value of the benefits the employee would have received if he were to delay collecting benefits until the normal retirement age.”) would reduce liabilities by two to five percent.
- Increasing the retirement age by one year would reduce liabilities by two to four percent.⁵²

Sustainability Reforms

End Pension Spiking

“Pension spiking” occurs when employees can add vacation, overtime or other enhanced pay to their final compensation for pension calculations. This can lead to pension benefits higher than actual final salary, and/or encourages early retirement. Require that pension benefits be based solely on regular base salary, without inclusion of specialty pay, bonus pay, overtime, etc. Employees should be able to supplement their retirement savings on their own with private annuities or investments.

End Double-dipping like DROP (Deferred Retirement Option Plans)

Double-dipping is when employees retire and begin collecting their pension but then are rehired into the job in some fashion and are paid as well. Prohibit employees from retiring “in place” where they receive a pension allowance and a salary simultaneously. Individuals should not receive retirement payments from a jurisdiction that is currently paying them a salary or consulting fee.

A variation of double-dipping that should be avoided is Deferred Retirement Option Programs, or DROP, whereby an employee draws retirement while working at the same or similar job he retired from, thus taxpayers are paying him twice for the same work.

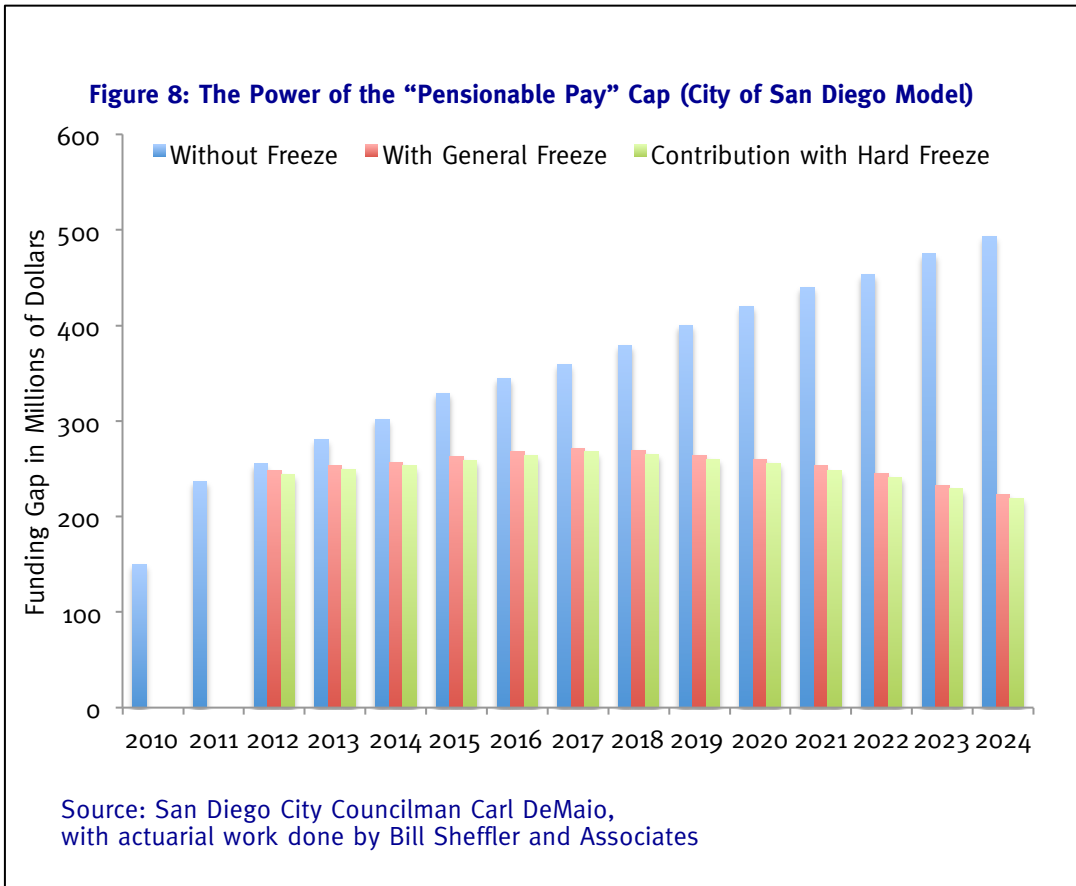
Cap Pensionable Pay in Distressed Systems

For any retirement system that is less than 90 percent funded, the state or locality should consider freezing “pensionable pay” to close the funding gap. Actual pay can increase with new labor contracts, but pay that counts for pension calculations should be frozen unless the system is at least 90 percent funded, similar to the San Diego model (see Figure 8 on the next page).

Increase Retirement Age

Increases in life expectancy mean that DB pensions must either pay lower amounts or start later, for example, increasing retirement ages to 57 for public safety, 67 for all other employees. Allow future increases in retirement ages by a supermajority (e.g., 2/3) vote of the governing board, or majority vote of the people. Also consider increasing the number of years of service required for benefits. Do not allow benefit eligibility based solely on years of service without an age requirement, as well. Alabama recently eliminated the 25-years-and-out rule for new hires; South Carolina replaced a 28-and-out rule with one that

requires employees to wait until age 65, with eight years of service (or retirement under the rule of 90).⁵³



Cap Pension Payouts

Avoid outlandish payouts and employees earning overly generous pensions from multiple agencies. Cap the total annual pension allowance at some fixed amount (e.g. \$60,000) adjusted annually by inflation. For employees with other public-sector pensions, include prior pension in calculation of cap. Once employees reach cap, require the employee to be enrolled in Social Security, if eligible. Another option is to limit pensions to replace a set percentage of final average salary, perhaps 60–65 percent.

Legislate Annual Required Contributions (ARCs)

Governments should not be legally allowed to fail to make actuarially determined ARCs and create unfunded liabilities. ARCs need to be calculated based on appropriate assumptions, or else full ARC payments may still result in shortfalls.

Net Compensation Model

The net compensation model is worth considering, rather than the usual base salary plus pension benefits. In this model employers determine a total compensation level and employees can choose how much is salary and how much is retirement contribution. For example a city might decide to set total compensation for a Police Officer I at \$60,000. Each officer could choose, say, a salary of \$50,000 and pension contribution of \$10,000, or some other division, and could adjust the split each year.

Governance Reforms

Create Independent Pension Boards

Require that state and local pension system board members be subject-matter experts, free from conflicts of interest and appointed solely as taxpayer representatives. This usually means prohibiting employees and labor unions from serving and voting on pension boards.

Establish Prudent Funding Ratio Requirements

It is a bad idea to have a pension plan funding ratio below 100 percent. The common notion that “80 percent is adequate” has helped fuel the current crisis so many plans are experiencing. Funding ratios should be monitored and projections stress-tested, and prompt action taken when lower than expected market returns reduce the ratio.

Public Vote on Vested Benefits

Require that any enhancement or increase in a “vested” benefit be put to a public vote, along with a requirement that a full actuarial impact study be conducted to disclose the true long-term costs of benefit changes.

Historically, pension benefits have been upheld as constitutionally guaranteed in both the U.S Constitution as well as state constitutions. As such, they have virtually the same long-term fiscal impact as a general obligation bond, which very frequently requires a vote of the public. When lawmakers approve benefit increases, they are committing the taxpayer to a long-term obligation that must be paid for into the future. In the event that payments into the system or investment returns do not fully fund these benefit increases, the taxpayers must make up the difference. Thus, approval of enhanced pension benefits should be subject to a vote of the general public just like a general obligation bond.

A voter approval requirement ensures that the taxpayers who pay government employees' salaries can operate as a final check against overly generous deals. The experience of San Francisco has shown that this is an effective means of controlling benefit levels while preserving local control and flexibility.⁵⁴

Pension Transparency

Ensure transparency by posting pension payouts online, with the following provided: position, agency, total annual payout, years of service provided, date retired, current employment status. If there is a compelling need, names may be redacted.

Financial controls for public pension systems should be as rigorous as they are for private financial institutions, including reporting requirements, internal controls, conflict of interest rules, and transparency requirements.

Use Sensible Investment Targets and Discount Rates

Too many governments have avoided making adequate payments into pension plans by assuming unrealistically high investment returns. The result has been a massive growth in unfunded liabilities.

Consider using a long-term average of past actual investment returns the plan has earned as the expected future return, or using an expected rate of return based on low-risk investments. Assumed returns should be adjusted according to the riskiness of the assets the plan invests in. Higher returns are typically associated with higher risks and more volatility, either of which make outcomes less certain and budgeting more difficult. Adequate payments and safer investments provide more protection to taxpayers. As the Rockefeller Institute of Government put it:

Pension funds and governments should value liabilities and expenses, for financial reporting purposes, using a discount rate that reflects the riskiness of expected benefit payments. Funds also should disclose projected cash flows used to calculate liabilities so that they can be discounted at alternative rates. . . . Governments, taxpayers, and others should know the full cost of promises that have been made, and what it could take to fund those promises without risk. A pragmatic variant would be to base the discount rate on a high-quality municipal bond rate. Funds could and would continue to hold some equities and other assets that are not risk free.⁵⁵

At the same time, government decision-makers should be fully aware of what assumptions are used in planning pension payments and benefits, and know the consequences of missing any of those assumptions' targets. Projections should run out at least 30 years and show alternate scenarios (high, middle and low, at minimum) based on plausible changes in actual conditions. There should be an alternate plan for funding strategies in place in case projections are not met.

Local Discretion

States should not bar or restrict local decisions on pension reform. Indeed, statutes that have previously restricted local control over pension funding and governance, or decisions on benefit structures and calculations, should be repealed or amended to give those powers back to local elected officials and decision-makers.

Sensible and Updated Actuarial Assumptions

Actuarial assumptions should not be based on the status quo or “what we’ve always done” but should take into account how longevity, retiree behavior, government funding, and the markets are behaving and are likely to behave in the future. Assumptions should not be point estimates, but provide a range of likely outcomes that policymakers can use to make prudent decisions.

Adopt, adhere to, and frequently re-evaluate sound actuarial assumptions... Governments should impose strict penalties (i.e., fines, removal from office, and jail time) on pension board trustees or politicians that are negligent in their fiduciary duties to pension beneficiaries and responsibilities to taxpayers. It is often said that government management failures, and accounting, in particular, would be criminal if performed as such in the private sector. There should be no double standard. Public officials should adhere to the same standards as corporate CEOs and be subject to the same consequences. In addition, states and municipalities should consider [requiring] an independent analysis of any legislation or other changes that could alter the actuarial soundness of a municipal pension fund, in addition to the municipality's internal analysis.⁵⁶

The goal is actuarial assumptions that help protect benefits for workers, reduce volatility and risk for government employers, and are transparent and easily understood by policymakers and the public.

Chapter 5: Create the Reform Coalition

Accomplishing major policy change like pension reform will almost always require a coalition formed and organized to push for change. There is no uniform approach or single solution. Coalitions are likely to reflect the uniqueness of the jurisdiction and community's values providing for slightly different organizational structures.

The Purpose of the Coalition

The central organizing principle of a pension reform coalition is creating one that can make reform happen. Everything else is secondary. The coalition is not there to make people feel included, powerful or good about themselves—it is there to make reform happen.

To begin thinking about your coalition you will have to grapple with who should be in it, what activities it will undertake, and how to manage it. But even before you address those issues, you need to understand your starting point. We have already discussed the need for researching your pension problem and possible solutions. Next, you need to look at the political landscape. Is change likely to happen legislatively? Or will you have to go to the public with a ballot initiative? Or do you need to take legal action? The approach to reform will be a crucial driver of what people and capabilities you need in your coalition.

Your approach to reform will also shape which audiences your coalition will be trying to reach. If you are pushing for legislative change, you need to convince a certain number of individual legislators to support reform. If you are looking to put reform on the ballot, you have to convince the majority of voters to support reform. With legal action, you have to convince the judge, who may have to juggle years of tangled precedent and legal uncertainty. Influencing the public is one way to convince legislators to support reform, and vice versa, so there is some overlap there. In any case, you need to start out knowing what audiences you have to persuade.

Who Should Be in the Coalition?

A grave mistake is to build a coalition for its own sake, to see how many warm bodies and groups will sign on. That can be a big distraction from actually having a coalition of interested people and groups that matter. A lot of people who might be willing to sign on to your effort do not bring anything of value to the group. There may be no harm in them being involved, but the time you spend working with them is time displaced from actual reform.

For starters, identify the power centers that drive policy in your jurisdiction and that have a stake in good government, those that might support reform. Ideally, these are not individuals or groups primarily motivated by partisan politics, but by a real desire to see things work well.

Your initial coalition members should be the “must haves,” the influential individuals or groups that have the talents, political clout and resources to enable the coalition to succeed. Think in terms of the “voting blocks” that have to be persuaded. Once those key members are on board you can move on to grassroots, or “good to have” members if desired.

You need members who can be spokespersons to each audience you need to target. Indeed, for each audience you need to reach, you need the best possible spokesperson. All effort put into getting these key spokespersons on board will pay big dividends. Is this the right person to go to talk to the unions when you need to talk to the unions? Is this the right person to talk to the elected bodies? Is this the right person to talk to the media? Not very many people are right for every audience. If you need funding for the reform effort—for advertising or events, or to run a ballot initiative—who’s going to be the person who can talk to the funders, so, in other words, who has a lot of credibility and can connect the right dots with those folks who might write the checks to fund reform? You may need people who are outstanding at speaking to such groups as:

- Democrats
- Current elected officials
- Republicans
- Independents
- Government workers
- Young people
- Business leaders
- Former elected officials
- Media
- Civic groups
- Union leaders
- Retirees
- Minority groups
- Credible candidates for office
- Funders
- Townhalls
- Non-profits
- Activists

One thing that helps any coalition get more attention and gain credibility is bringing together “unusual suspects”—folks that normally do not pull together for the same thing. The classic version is a “bipartisan” effort. Note that bringing representatives from both parties together behind the reforms is a big deal and very important. The more unusual the pairing, the better. Traditional rivals in the community, groups that typically are on opposing sides of issues, etc. Media and individuals take notice when people who do not normally agree come together to support a big change like pension reform.

Starting Your Coalition Planning

A useful exercise to go through when you are getting started is to seriously work through the following questions.

1. Who are the top 10 political players in your jurisdiction? Take the pension reform issue off the table and just think who are the top 10 influential, political heavyweights—Democrat, Republican or independents. Sometimes, the influential people are not elected officials. Sometime they are the local radio show host that everyone seems to tune in to or it is the former mayor of the city or some other former elected official. It could be a community leader, business leader or land owner.
2. Who are the fiscal hawks? Who are the good government advocates? What individuals and groups are focused on fiscal responsibility and ought to be on board with your pension reform effort? Which individuals or groups are focused on government effectiveness and quality and might be interested in pension reform?
3. Who are the most receptive media? Most media will likely not be in your coalition, but they will be a crucial audience and you need to think about who the individuals are you will want to communicate with, and have coalition members who can do so. Some media organizations may fully support the reform effort and provide in-kind or other support to your effort and even be in the coalition.
4. Who are the rising political stars? Rising political stars are important because they may be willing to work harder for reform than anyone else if they see pension reform as an issue that will help them politically. They also may be the ones that threaten the political players in the top 10 and you can use the threat of a rising star to get an old guard person onboard.
5. Who would be your natural coalition partners? These are people that you know you’re going to be able to count on no matter what. They are a crucial group at the beginning to help you get off the ground.

If you do not know some of the folks on your list, get to know them. Think about who you know who can introduce you.

Activities of the Coalition

A crucial aspect of your coalition is building the capabilities you need to succeed. Different members of the coalition can bring different capabilities or resources or credibility—all positive attributes to the effort. Think about the most important attributes your effort needs. If you are trying to persuade the legislative body to do something, that requires different capabilities than an effort to get an initiative on the ballot and getting a majority of voters to choose reform.

If you are pushing legislative change, you may need to figure out how to get Councilman Smith or Legislator Jones to support reform. Who has influence with them? How do you persuade one of them to pass on the need for reform? If you are pushing a ballot measure, you need capabilities to gather signatures and outmaneuver union opposition to signature gathering. Since debates over pension reform often entail arguments about numbers, a good capability to think about is who would be really credible with a lot of audiences on the numbers issue. A respected community accountant, former pension board member, or professor from a local college would be great spokespeople, for example.

Coalition Capabilities Aligned with Reform Approach

Your approach to reforming the pension system will to some extent determine who you need in your coalition. A lawsuit requires different talents than running a ballot initiative, for example. Here are some initial thoughts on capabilities you need with different reform approaches:

Legislative Change

- Political leaders
- Actuarial knowledge
- Someone who is good at meeting with legislators to answer questions and make the case for change
- Someone who is good at speaking at public meetings about the problem and changes needed

Public Vote

- Media relations
- Individuals who can speak to different citizen groups
- Legal expertise
- Advertising and publicity expertise
- Funders and fundraising

Legal Action

- Legal expertise
- Expert witnesses
- Funders and fundraising

Polling shows that pension reform is fundamentally popular. So the question is not so much how to create a coalition that is going to be able to sell this fundamental idea to a broad group of people. When you are trying to convince people of something that they do not already believe, you need a different kind of coalition from when you are trying to sell people on a solution for a problem you all agree on. Selling a solution is a bit different from selling a problem. You may need to do both, but understand the difference.

Managing the Coalition

Managing a coalition can be a real headache. Here are some ideas to make it easier.

1. Create a “steering committee,” a small group of key individuals and leaders who make the operational decisions for the coalition and provide leadership. It can be an informal group, but you need to control it.
2. Always think about decision rights. As you are bringing people in to the coalition, you have to figure out who needs to be a part of the inner group that really gets to call the shots for the coalition. If you are the one starting the process, you have a lot of influence over that decision, but that is a dynamic you have to control.
3. At the same time, you have to give key members what they want. Some want to be involved in decisions, some want public recognition, some want certain connections. You have to keep your coalition happy, as well as on track.
4. Do not reinvent the wheel. Others have done what you are trying to do. Learn from their experience; consult with them if at all possible. Reason Foundation can provide introductions or other help.

Chapter 6: Building the Case for Reform

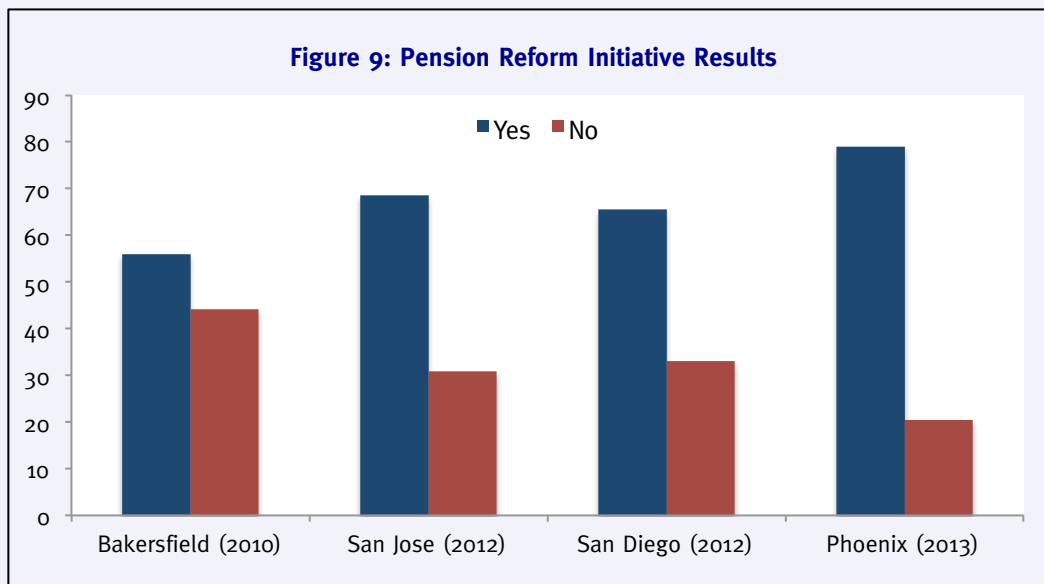
You have researched your pension problem so you know what the problem is; now you need to be able to explain it in terms each crucial audience can understand. You have researched the various solutions and changes to pension systems that have been tried, and analyzed which are most appropriate to solve your jurisdiction's problems. And you have built at least the first part of a coalition to move forward on the reforms. Now you are ready to build and articulate the case for reforming the pension system.

Draft Your Pitch

You need to put a distillation of what you have learned down on paper or into words. This is your pitch: your statement of the problem, the solutions, and how you are going to get the solutions into place. Work hard on it, so it is clear and simple, covers the most necessary points, and is understandable to any audience. This will be a "living document" as they say; you will add to it and modify it along the way, and create different versions for different audiences. The more expertise you bring into your coalition and the more conversations and debates you enter into, the more you will refine your pitch. Do not be afraid to make changes if needed, but do not lose sight of the problem and the solutions that are needed.

Polling and Pension Reform

The good news is: *pension reform is popular*. Polls around the nation tend to find a great deal of popular support for pension reforms. Headlines like “Poll: Illinoisans want pension reform”⁵⁷ and “Even public workers want pension reform, poll finds”⁵⁸ happen all the time. Even more indicative of public support for pension reform are the results from public ballot initiatives on reform, which tend to pass handily. (See Figure 9)



Since there is a lot of public support for pension reform, conducting a local poll to show that support can be valuable. At the same time, you can use polling to help you craft your messages and see what resonates in your area for making the case for reform. Table 2 shows some messages that were tested in San Diego and how strongly they resonated with likely voters (Note: a higher **MPower™** score means stronger positive reactions by respondents).

Supporter Messages	MPower™
Supporters say that the city’s pension deficit stands at more than \$2 billion and pension costs will increase by \$100 million over the next ten years if we don’t take action. By <u>saving \$396 million over the next ten years, this measure will free up money that can be used to <u>reinstate library hours and re-open park and recreation facilities.</u>*</u>	137
Supporters say that the city’s pension deficit stands at more than \$2 billion and pension costs will increase by \$100 million over the next ten years if we don’t take action. By <u>saving \$396 million over the next ten years, this measure will free up money that can be used to <u>repair streets, fix potholes and maintain infrastructure.</u>*</u>	124
Supporters say that without this measure city employees have been able to “spike” their pensions by adding bonuses and extra pay to their base salaries to calculate their pension benefits. This measure eliminates this practice and San Diego taxpayers will save millions when, just like in the	124

Table 2: San Diego Pension Reform Test Messaging	
Supporter Messages	MPower™
<u>military, only base salaries are used to calculate pensions.</u>	
Supporters say we need this measure because taxpayers have been paying much more for the cost of pensions than city employees have. We should cap the city's pension contribution and require city employees to pay a fair share of their pension costs.	123
Supporters say that by moving city employees — except for police officers — to a 401k-type system, ensuring that all city employees pay their fair share, and calculating all city employee's pensions only on base salaries, this comprehensive pension reform measure will provide hundreds of millions of dollars in future savings so that we have a long-term, permanent solution to San Diego's pension problems.	115
Supporters say that we need to <u>quickly bring down pension costs</u> in order to reduce the city's 2.2 billion dollar pension deficit. This measure does that by <u>freezing the pensionable pay</u> of all city employees for the next five years..	105
Supporters say it's <u>unfair that city employees</u> — other than police — <u>receive better and more expensive benefits than private sector workers</u> . This measure will fix that by putting new city employees — except police — in a 401k-style system	98
Supporters say Prop B takes the discretion of <u>awarding higher employee pensions away from the politicians</u> so that the city won't have a pension crisis in the future.	95

In San Diego they also tested the opponents arguments, which are pretty typical of those seen in other locations. All but the first argument listed actually *increased* support for pension reform!

Table 3: San Diego Pension Reform Test Messaging	
Carve Out Opponent Messages	MPower™
Public safety personnel are excluded from some of the reforms contained in this measure. Opponents ask, what is so special about public safety personnel? If we're really going to get the cost savings we need to fix the city's financial problems, <u>the reforms should apply to all city employees.</u>	79
Opponents say the measure will <u>impose significant risk on city employees</u> because they will no longer be given a reliable safety net like Social Security or a defined benefit pension. They may not have enough money to live on if the stock market goes down.	50
Opponents say the measure includes the harsh step of capping the pensionable pay of all city employees for five years. That will <u>make it too hard for the city to recruit and retain police officers, fire fighters, paramedics, lifeguards and other important city employees.</u>	33
Opponents say even the measures supporter's concede that moving most employees to a 401k-style plan will cost the city more in the short-term. And, because the measure excludes public safety personnel from having to move to a 401k-style plan, the cost savings will not be enough to make real progress on the budget deficit. We should not support this <u>poorly conceived measure because it makes matters worse.</u>	29
Opponents say the cost savings cited by the measure's proponents are exaggerated. We should adopt some reforms but <u>this measure is flawed and will not fix the city's financial problems.</u>	28
Opponents say the measure <u>will lead to reductions in City personnel</u> as they go find higher paying jobs in other cities. Services for residents will suffer, there will be more fire station brownouts and potholes will go unfilled.	-7

Public Polling

A public opinion poll is another great way to find out what your best arguments are and what the opposition's best arguments are. Using a good polling firm is crucial but also look at polls that have worked in other jurisdictions and the resources available to help you. (Reason Foundation has polling experts who can provide advice and assistance on polling.)

Some key elements to include in a poll:

- Initial Ballot Test – Describe your reform package in simple terms and test where the public starts out on your ideas.
- Arguments For and Against – Summarize three to four arguments for and three to four arguments against the measure.
- Informed Ballot Test – Repeat the Initial Ballot Test question verbatim to see who was moved by the arguments for and against.
- Endorsers – Identify five to eight possible endorsers for and against the measure. These data will guide where you put your energy in seeking spokespeople for building your case later.
- Linkage to Other Campaigns (if near election) – Ask the question: “Would you be more or less likely to vote for a candidate for office who supported (or opposed) pension reform?” These data may give you ammunition to seek additional supporters from elected officials, candidates, political parties and business groups.

Once you get your polling results back, you can start building your summary and materials and prioritize who you need to target to build your public case.

Test the Waters

Even as you build an effective case for reform, find out what case and arguments the opposition will build against you to prevent reform. Involve attorneys who specialize in your jurisdiction's finances and pension issues. Engage the independent retirement administrator by posing relevant questions during board or council hearings. Their feedback will be essential in understanding how certain elements of your reform package will be viewed. You can provoke conversations by issuing a couple of memos or publishing some Facebook posts or Tweets. As you learn the opposition's arguments, develop rebuttals and incorporate them into your pitch.

Testing the waters gives you a chance to strengthen your case. It also may give you a chance to decide that you are not going to present a certain concept a certain way or even ditch a certain policy proposal because you think it's going to be too hard to overcome the arguments.

Actuarial and Fiscal Reporting

You will likely need an analysis of the fiscal effects of your reforms compared to current policies, and may even need a comprehensive actuarial study. The first question people tend to ask is if your reforms will save money. Questions about fairness, legality, etc. will come, but usually after the fiscal questions.

If possible the fiscal or actuarial analysis should be done by a third-party. Hire an independent fiscal analyst to run the models and the simulations. If you have a pension pay cap, identify the savings you get immediately. Be very conservative on your long-term assessments of cost savings. They will be there, but because reforms do not typically affect costs of existing retirees, it will take some time before you will get significant savings.

Create Buzz with Stakeholder Groups

Talk to neighbors, employee groups, civic organizations, teachers and friends in the community about the pension problem and possible reforms. Ask them what they think is fair and sustainable. Talk about how the costs of the current problems with the pension system take resources away from other public services and what they would like to see different. Creating a buzz around reform is important, but the conversation only begins there. You need to figure out who the right people to convince are and what arguments they are interested in hearing.

Once the conversation is started, you should formalize a communications plan. Think about what groups or individuals you need to convince and how to communicate with them. Assign responsibilities to members of the coalition and evaluate the buzz periodically and make changes where needed in the messaging.

Seek Formal Endorsements and Tap Spokespeople

You need to look beyond your coalition of sympathetic and informed reformers and identify the top political players, fiscal hawks and other natural partners. These people are potentially the faces and voices of the reforms for other decision-makers, like elected officials or the voters, if you take your reforms directly to the ballot. These people may include:

- Mayor
- County Supervisors or Trustees
- State Legislators
- Business Groups
- Like-Minded Union Leaders
- Newspapers, Editorial Boards
- City Councilors
- Governor
- Taxpayers Association
- Civic Club leaders
- Government Watchdogs
- Other Media (television news, public broadcasting, bloggers, columnists)

Perhaps many of these people were already in your coalition. Now it is time to encourage your group to engage in the process and to find ways to involve others. They will need to be brought up to speed on all of the proposal's elements. This can be done through a private gathering, a townhall presentation, via email, through a website or during a weekly conference call.

Create Simple Talking Points

You need to have a handful of facts and figures and a few talking points in support of reform that may be easily repeated over and over. You will also need talking points to rebut the oppositional arguments. Some typical topics include:

- How much your reforms will save and how the savings will come about
- The benefits and costs of paying off the unfunded liability debt
- Sensible assumptions about rates of return for pension fund investments, employee turnover, longevity etc.
- Examples of successful pension reform and reports and studies on successful pension reform
- How pension reform does not reduce a jurisdiction's ability to recruit quality workers

The list can go on, but should be limited so as not to overwhelm any of the spokespeople from your coalition. Most of these issues are easy to address; the simpler the talking point, the easier it is to convey to the layman regardless of who is speaking. As you develop the message, you will need to keep refining it and testing it out on different constituencies.

As the conversation progresses over the weeks and months of your campaign, reasonable people across the spectrum will begin to understand both the problems with the current pension system and the need for reforms. No tax

increase is ever going to be big enough for those promoting the continuation of a broken pension system and unfortunately, no painful cut in public services will be deep enough to feed their insatiable appetite for more revenues. This is your opportunity to go from laying out the cold, hard numbers to giving relevant examples of popular programs threatened by the costs of expensive pension policies. If pensions are not reformed, how many libraries would have to be closed down? How many fire stations would be browned out? Which parks would be left without maintenance or security? Which potholes will go unfilled? Which roads would not be repaved?

Focus on both the benefit to workers and about the fairness to taxpayers who have to pay the bills. Emphasize the openness and transparency of a reformed pension plan.

If the media is doing its job, you should have regular articles on your key topics in the paper. Prepare press conferences with this material. Find the stories about the costs, or in some cases abuses, of the current system or policies. Tell the stories about successful reforms. Share the information from polls that show people support reform. Give the media more material to report and perhaps they will be motivated to find more material themselves.

Lay out what your pension reform ballot measure does. Do not spend a lot of time on arcane or nuanced details. Have any of the specific details available as an appendix or on your website, but focus on the fact that in your conversion to a DC system, you propose that public employees have retirement benefits that are no better, and no worse, than their tax-paying neighbors.

Show how you can benchmark public salaries with comparable jobs in the private sector. Benefits will be based upon the public employees' regular base salary and pension spiking will be prohibited. A good comparison that has been successfully used in military towns is that the U.S. military provides specialty pay for people who are in combat zones when they are deployed, but that their pension in the military is based only upon their base salary. If it is good enough for our men and women in Afghanistan, it should be good enough for the cop in your city.

Death and disability benefits are a very important issue to deal with directly and overtly. This argument will constantly resurface, even if your jurisdiction already has a requirement that police officers and firefighters receive death and disability benefits. Write explicitly into the ballot measure duplicative language that requires the governing body of your jurisdiction to take out some sort of policy to cover all public safety employees for death and disability. You want to

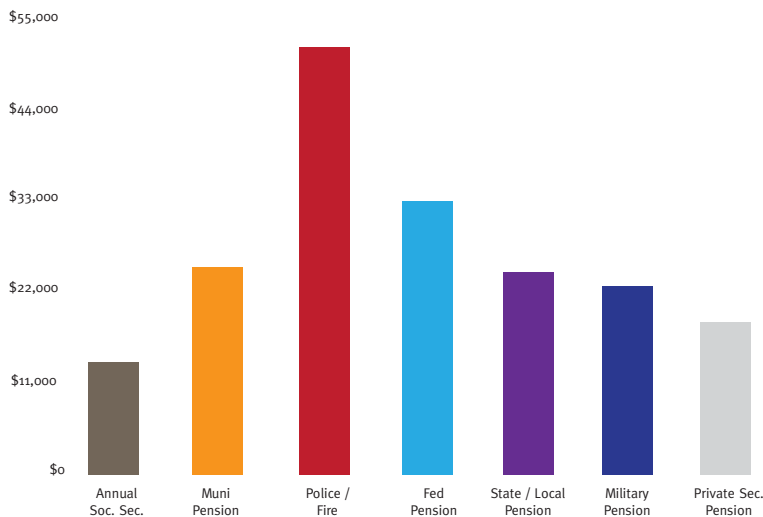
be able to stand up and say your measure contains the protective language even though putting it in there a second time does not legally do anything. Politically, it's absolutely necessary and removes an easy target for any of your opponents. Even with this language in there, the opposition will still make false claims about death and disability benefits on the campaign trail.

People appreciate transparency and like the idea of online disclosure of pension payouts and costs.

Benchmarking Retirement Benefits in Your Jurisdiction

It can be powerful to look at how benefits stack up. Florida Tax Watch compared average municipal worker and police and fire worker pension benefits to those received by many other classes of worker in Figure 10. Seeing how your jurisdiction's government worker benefits stack up against social security, private pension, and military pensions can be an eye opener.

Figure 10: Average Annual Benefits in Florida



Source: Florida Tax Watch

Make sure to remind people that this is not the city employees' fault. They are not to be demonized. You want them to have secure retirement. Taxpayers, like good businessmen, are all about recruiting and retaining quality employees. If your measure would be bad for recruitment and retention, you wouldn't be supporting it. In fact, your measure will give your jurisdiction recruitment and retention, because instead of cutting firefighters and police officers, you will be hiring. You will have employees with retirement security.

Accentuate the strengths of a DC benefit, highlighting the fact that the employee owns the asset and it is also transferable. Right now, DB plans are based on the old paradigm of employment where someone works for one employer for their whole career, perhaps 30 years. The new generation, Millennials (18 to 30 year olds) will soon be the largest segment of the workforce, and they change employers every three to four years on average, much more often than the previous generation. You can actually retain the best young employees by helping them recognize that they can save for their retirement in a system that will give them a challenge and opportunity that fits their lifestyle and their economic goals. Plus, they often value keeping more of their money in their pockets.

Begin to Act Locally

As discussed above, there are a lot of people who should have an inherent interest in having a sustainable pension system. Those that often have the most direct interest are local stakeholders. Start the conversation on the need and pathways to reform locally, perhaps with local taxpayers or business groups. This is likely an issue that they have been watching with regional municipalities and school boards, since the costs of government affect their fees, license and permit costs and taxes. If they have been involved and have testified in recent board or city council meetings, find their lead consultant on the issue and see what kinds of talking points they are using. They may have compelling and interesting talking points that include statistics, charts, graphs or other memos that could be of some use. Since they are interested in educating their membership about pension costs and the impact it has on the city, they may have already done the difficult job of breaking down the talking points for general use.

You will also need to track down other business or trade associations that, like the local Chambers of Commerce, have a particular interest in the costs pensions impose upon their projects and proposals. Further, they may have even presented plans to contract out or privatize services that were not essential to government work and that could have been more economical. If there were such proposals, the costs of employee salaries, benefits and retirement options would have been a part of their proposal. They may have relevant, accessible and easy to understand numbers that can show the cost of pensions for the local government. And since they likely went through a contract process, their documents are likely to be in the public domain, if you are not able to get the information from the business association directly.

Most major cities have a taxpayer or government watchdog organization. You can be sure that these groups have a laser-like focus on any issue that happens in the state capitol, in the county board room or in the city council. They will not only be a repository of information, but they may also be able to help you create a timeline for the policy changes over the years that led to the jurisdiction's pension problems. This information is valuable as it provides context and perspective about how various changes were made in the past. Indeed, a descriptive timeline can also be a strong piece in rebutting the argument that the pension system "has always been that way."

Neighborhood groups are also going to want to know about your reform effort. Increasingly, high pension costs are "crowding out" other essential services like paving streets, providing for more police on the streets or closing parks and libraries. Local neighborhood groups have their social networks and ties to the other community and business leaders that you need to recruit for your cause. They are also taxpayers and citizens, who, if given the facts clearly and succinctly, will be allies in your efforts to address elected officials, candidates for political office and other policymakers.

Few People Really Understand Pensions ... or Want To

Most people have very little practical knowledge about how pension or retirement plans work, usually because they have other more productive uses of their time. Those that wish to understand the intricacies of pension systems have a difficult time simplifying the information for public consumption, or have a very narrow audience—or echo chamber—of concerned citizens and activists. Very few people know more than some basic concepts around the inner workings of pension systems, including many finance professionals and elected officials.

Addressing Common Objections to Shifting from Defined Benefit Pensions

Converting from a defined benefit system to defined contribution or hybrid or cash balance 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 they are implemented, 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.⁵⁹ 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.⁶⁰

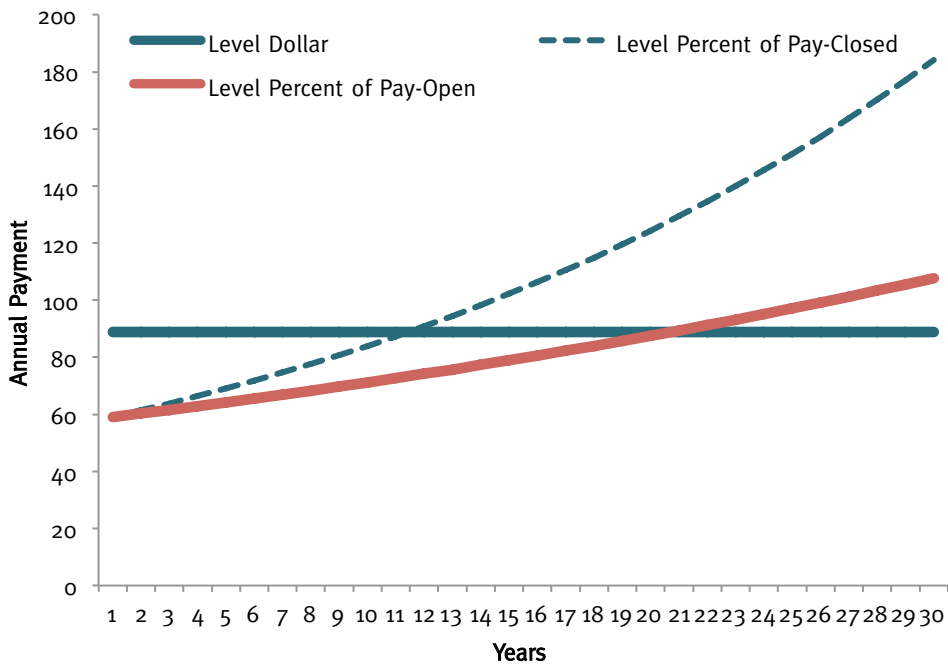
Breaking that first point down further, let’s look at different ways of scheduling, or amortizing, debt payments. In Figure 11 you can see how payments change over time depending on the payment schedule chosen. Level dollar—making fixed annual payments that will pay off the debt over the amortization period—is the most prudent as it makes steady payments over all years. But most plans choose to use a level percent of payroll 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 11 also shows that for the schedules based on level percent of payroll, the payments rise much more steeply for a plan that is closed to new entrants than for an open one. But while higher payments may be painful, they reduce total costs and are a result 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 12 shows that using a level dollar payment schedule always pays down the principal without adding more debt. And it shows that level percent schedules add to the debt in the early years and require much higher payments in later years.

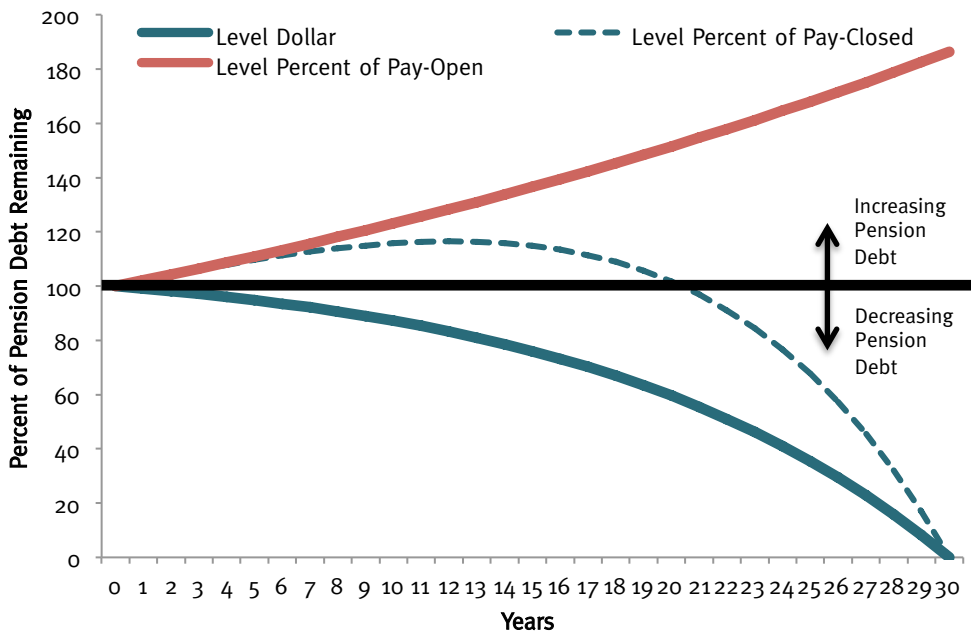
So any increase in payments due to closing a plan is strictly a matter of paying off the debt that was incurred by earlier choices.

Figure 11: Debt Service Schedule (Nominal Dollars)



Source: Laura and John Arnold Foundation

Figure 12: Pension Debt Payoff Using Different Amortization Schedules



Source: Laura and John Arnold Foundation

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.⁶¹ 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 however misses an important point, 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 than a DB plan, as demonstrated in the private sector.⁶² 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.⁶³

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 percent and 0.95 percent of assets, respectively.⁶⁴ 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.⁶⁵ 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 account 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 2011.⁶⁶ 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.⁶⁷ 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.⁶⁸

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. 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.⁶⁹ 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 percent funded with the total unfunded liability being \$4.1 trillion based on a fair-market valuation.⁷⁰ The danger is compounded by the fact that most DB plan managers assume overly optimistic rates of return, which pressure them to invest in riskier assets, exposing government budgets to 10 times more risk than in 1975.⁷¹ A recent report by the influential hedge fund Bridgewater Associates predicts that 85 percent of public pension funds could go bankrupt in three decades.⁷² Indeed, municipalities across the nation are looking for opportunities to significantly reduce their pension liabilities before—or even as—bankruptcy becomes an option.⁷³

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.⁷⁴

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 servant or police department job because of the idea of retirement security. However, this is certainly 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.⁷⁵ 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.⁷⁶ 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 some 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.⁷⁷

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. Pension scholar Andrew Biggs notes this fact in his recent paper.⁷⁸

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). As discussed above, 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.

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.⁷⁹ 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.

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 is 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.⁸⁰

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.

Transitioning from DB pensions to DC retirement plans—and paying the costs of employee retirement benefits today—can have a significant impact on risk. A 2012 analysis by two Brigham Young University economists estimated that Utah’s pension fund had a 50 percent chance of becoming insolvent by 2028 in the absence of that state’s 2010 pension reforms; with the reforms, there is now just a 10 percent chance of insolvency.⁸¹

Chapter 7: Engaging Elected Officials and Labor Unions

While the previous section dealt with building a case for reform, this section addresses the ultimate targets of pension reform—those who hold the votes to make pension reform happen.

For a city, this would be the mayor and city council members. For a county, the County Board and county supervisor (if elected). For a state, reform may fall to the governor and state legislators.

The labor unions representing government employees may also be the targets of change, depending on how the labor laws and contracts are established in your jurisdiction. In many, if not most, jurisdictions, government employee unions will oppose serious pension reform. In some jurisdictions, the unions may have little political power or may not be opposed to reforms. In other jurisdictions, the unions have more political clout and may have to be brought on board or overcome. In those cases, the unions should be treated like elected officials—ultimate targets of reform.

If efforts to secure the support of elected officials are not successful, you must be prepared to go to the ultimate decisionmakers: the people. In some jurisdictions, you can file a ballot measure and place pension reform up for a public vote. In all jurisdictions, you have a chance to make pension reform an election issue for candidates in the races for every elected office.

Perhaps some of the elected officials are in your coalition already. Now it is time to encourage your group to engage in the process and to convince a *majority* of elected officials to agree to reform.

Count Your Votes and Select Your Targets

You should begin by determining who is supportive, who opposes, and who is up for grabs. Do *not* assume that your supporters will remain supporters throughout the process, so keep having conversations with them and answering

any questions they develop. Prioritize the votes you think are easiest to win over and move on from there until you have the majority you need.

Organize Your Campaign

You should treat this engagement phase as a stand-alone political campaign with the goal to win the votes of the elected officials, or win the votes of the people for a ballot measure or a change in elected officials at the next election.

There should be a committee that formalizes itself at some juncture, organized with a chair and subcommittee chairs ready to handle any responsibilities that come their way. This process is contingent upon a few things including available resources, services and operational space, all of which can be donated or bought with funds raised for the project. You need to be familiar with all applicable state laws and regulations regarding open meetings or public disclosure, legal constraints, tax implications or exemptions, finances, etc. It would benefit your cause to get sound legal advice, pro bono if possible, by someone who has done this before.

However, if you are a grassroots organization, be cautious of putting your success in the hands of consulting firms, even if they offer to do much of their work for free. Consultants have a lot of expertise and capability. But they also have long-term customers embedded in the status quo and may bring with them ulterior motives or baggage that could sink your efforts if you are not sufficiently aware of the political landscape. Understanding all this, there are many reform-minded consultants who can capably aid you through the very complex maze of policy reform, but make sure that your coalition members, whom you have come to trust, are always checking the decisions that are made.

Communications

Here are some tips for communication on pension reform, particularly addressing elected officials and the public so that your statements and inquiries stand out among the hundreds, if not thousands, of commentary they receive every week.

Start with the Web. With the cost of technology being so low, creating a website as a clearinghouse for all of the relevant facts and reports on your proposal, as well as a point of contact for your coalition, makes sense. It should be clean, simple and dynamic, accessible on computers as well as tablets and

smartphones. With any website, access to social media and local blogs is an easy way to spread your message.

Form as well as function. If you write a letter, keep it to one page and make sure it is legible. While handwritten letters may show sincerity, a typewritten letter is preferable because it is easier to read. Make sure your letter contains a proper and respectful introduction and greeting. If you expect your letter to be taken seriously, and possibly responded to, then sign your name and inscribe your return address not only on the envelope, but also on the letter itself. If the issue is such that you require confidentiality, declare it in the letter, but still sign it, as anonymous letters are usually ignored.

Keep your statements short and simple. Select a core topic within the issue of pension reform and do not vary from it. Describe the issue succinctly and declare your position for change within the first few sentences. Limit the background that you would like to give and avoid barraging your audience with extraneous details, no matter how interesting they may be to you. With public officials, often an aide or intern is going to be the first reader of your letter or is going to answer the door or your phone call, so they have to find your narrative persuasive enough to move it up the chain. If you are advocating an adversarial position, disagree without being disagreeable.

When talking to public officials, you do not have to be an expert on pensions. After all, they aren't. In forums where experts are needed, bring them in. The rest of the time, avoid using big words and obtuse legal terms. You do not want your comments to sound like the legislation they already ignore in the first place. If you have other documentation that confirms your position, attach copies of the most important pieces with an explanation of each and promise more material if they are interested. Elected officials will not filter through a package of superfluous information.

Details, specifics. Persuasive commentary and letters contain specific issues and avoid vague generalities. One or two prominent examples of the system's pension problems to prove your point should suffice. Your first encounter with an elected official's office should feature your best and most relevant arguments and examples.

Personalize the issue. Your first encounter could be the only real attention your opinion will get. As you formulate a solution or alternative to the jurisdiction's pension problem, suggest pragmatic means that would get elected officials to agree with and support your plan. If you are opposed to a policy change they are interested in making, or they do not want to reform anything, let them know why

you are opposed to their position or intransigence. Even if you cannot convince them of your alternate plan, sound and articulate arguments may give them pause.

Tell the truth always. While your ideology may formulate your opinion, using constitutional principles, historical precedent, obvious common sense or indisputable facts and logic as a reason is important. The facts are on the side of reform. There is no need to exaggerate the reasons for reform.

Speaking of audience. Remember who your audience is and the one concept you want them to remember when you are done. Thoroughly know your audience, including which level of government you are talking to and which people will be the decision-makers. By and large, city councils do not decide state budget issues any more than Congress decides school district policies. However, each level of government is going to have some interest in the pension reform movement, and while the state government is different than local government entities, you need to understand where there is control and/or decision-making ability. Often, local jurisdictions are constrained by state or federal mandates, but make sure you are aware of that before you try and sell your reform proposal. Tailor your arguments appropriately.

Do not be afraid to be outraged. If polite correspondence is ignored, you may have to show a little gumption. You may have to raise a point about your pension reform plan in a significant way—one that gets their attention without undermining your cause—realizing that your actions may also exclude you from invitations to future functions or discussions.

Avoid ad hominem attacks. There is no need to personally attack someone for what they believe or support. Go after their arguments and challenge their use of facts and statistics. Take the high road. Substantive pension reform will happen on the merits.

Write your lawmakers only when something needs to be done, not regularly. While you may be steadfast in the cause of reform, recognize that elected officials get a lot of correspondence through mail, emails, faxes, phone calls and other messages. If you are writing them just to write, you will eventually be dismissed and when there is a need for urgent action, your letter may be ignored. Do not be the boy who cried wolf.

With legislators, find out who sits on applicable committees and write to them. While you should initially engage your particular elected official, find out if there is a committee, standing or ad hoc, that is dealing with the pension issue

either as a policy or a budget issue. Depending on the jurisdiction, committees can wield enormous power over legislation or budget items.

Letters are good, phone calls are better, but personal visits are the best. You need to keep a public record of your correspondence with public officials, and letters and emails are a great way to do this. In some jurisdictions, every single email that is sent to an elected official is stored on a server and open to the world. Letters to committees or boards may also be a part of the public record. Redundancy is appropriate: send hardcopy letters via the postal service and make sure that it is also sent by email with an attachment of your original letter.

However, if you do not think that your proposed reforms are being heard by the right people, calmly call your elected official's office and work up the chain. In the event of an inadvertent disconnection or follow-up calls, state your name and phone number to the first person you talk to. You will most likely be initially connected with a receptionist, so ask for the person who deals with pensions. If you are articulate and timely, you may be referred to a senior staffer who makes the ultimate decisions on which issues are raised with your elected officials, so be respectful of his or her position and time.

If you can, find the key leaders in your coalition and set up a time to meet with relevant elected officials. Make sure that you have at least a one page information sheet, pamphlet or something for them to hold onto after you leave. The in-person meetings will have a significant impact on the future decisions of elected officials. Be confident and assertive—they need to know what you have to say.

A few other thoughts. Blast faxes of form letters are a waste of time and will be recycled almost immediately. Further, emails are more convenient to send, but they are just as convenient to erase. You are more likely to be ignored and get a canned response if you email. If you expect a response, say so in your letter or email and set a deadline. If you have not heard back by that deadline, call their office to follow up. Keep a copy of your letter; this can easily be done in your email outbox. In the event that they “didn't receive the letter,” send it again. And if you did get a response, or if the elected official made the right decision on a certain policy, drop them a quick, handwritten note thanking them.

Working with the Media

Educating the reporter on the budget or pension beat is essential. Do not let them perpetuate myths or propaganda by the opposition. Like anyone else, they are

prone to accept arguments that are understandable and come with relevant facts and figures.

Make the argument for reform intriguing or relate it to a problem that their readers will react to. Define the costs of inaction or the status quo and how much your reforms will save. For instance, how many parks will have to close, how many fire stations will be browned-out, how many teachers will have to be let go if the pension debt is not brought under control? Simplify the terms of the situation in a way that is easy to convey in their stories. Feed them key statements from think tank reports, pithy quotes on reforms, outrageous cases of pension abuse and little known facts that they would not find on their own.

When you have a reporter you can trust, promise them priority on the breaking story. That's the kind of the relationship that you need with the media in order to get something this big accomplished, so by doing this, you are doing two things:

1. Giving legislators cover, letting them know that their local newspapers get it and they're watching.
2. Encouraging other newspapers and media outlets to get into the fight as well.

With that, you may still get a story or two that is not in your favor, whether it is intentional or sold as “balancing your arguments.” Be patient and allow a robust discussion, even if and when you cannot control it.

Meet with the editorial board of your local newspaper and educate them on the issue and your reforms. Show how your reforms are thoughtful, sustainable and fair to start a dialogue and encourage them to write about public pensions often.

Appoint one of your articulate coalition leaders to be the spokesman for every television and radio interview. Get them to speak at board and council meetings, civic group events, taxpayer rallies or neighborhood groups.

Clip and highlight all the stories—video, print and internet—that showcase your reform initiative in a positive light. You can use their endorsements on your website or other publications. You are looking to obtain all the free or “earned” media that you can get.

If you have the money and expertise in your coalition you should consider using advertising in media to advance your message as well.

Finding the Key Citizen

Every community and state has those select and key leaders, who because of their life of public service, their business acumen, their undaunted courage and integrity or their sheer charisma, may be able to provide the gravitas for your coalition. Find at least one who can digest the problem and provide you with leadership and sound endorsement. If you create a board for your coalition, that person could be the face of the discussion and serve as an honorary chair.

Commit him or her to connect you with contacts and to talk to other key political and civic leaders. Invite these people to author or sign onto opinion editorials, press releases, letters of inquiry. They should be able to commit to your efforts for the duration.

Do Not Overlook the Unions: Labor Negotiation Strategies for Pension Reform

Not All of the Unions Are Against Reform

Or, more accurately, not all of the people in public sector unions are opposed to reform. Those who understand budgets know that there are only so many dollars to go around. They realize that bankruptcies in cities like Detroit—as well as in the private sector—show that pension benefits may be lost if they become unaffordable and unsustainable. You have to find those allies from the inside and get their strategic counsel about how to deal with the most significant arguments and concerns in their bargaining units. Understanding where there are potential roadblocks will help you navigate some pitfalls.

Union leadership's reaction to your reforms is going to be sudden and abrupt. Figure out how to deal with the opposition arguments from both the union leadership and the union members. And since unions are not monolithic, your response will be different for both groups. The starting point is to reach out to them. If they are not willing to be civil, then there is not much you can do, but if you start things off civilly, it will likely stay civil.

It is easy to demonize the benefits that union members receive in the compensation packages, but you should be careful to attack bad policy decisions without making it overly personal against the union member who is playing by the rules in place when he took the job, whether it was fair to the taxpayer or not.

For the individual union members, appeal directly to their sense of fairness and you may be surprised to see how many union members are on your side. Help

them understand the goal with pension reform is to provide retirement security for them and their families as they were promised. It does no one any good for a jurisdiction to go bankrupt and default on its pension obligations. Additionally, if pension costs increase, there are fewer resources for them to adequately and safely do their job. Finally, you want them to know that it is your intention to remove the ability for politicians to play games with or raid their pension funds so that the jurisdiction never has to contemplate serious cuts to their retirement plans. You want to put them in control of their retirement.

For those who are less than conciliatory in their approach, a respectful conversation on the merits of your reform is the best tool you have for winning their support, or even neutrality. Also, as more union members come to your side, it undermines their leadership, who often use pension benefits as leverage to prolong their leadership tenure.

For the union leaders, the discussion is less about the merits of policy change, but more political in nature. The following paragraphs demonstrate how you might deal with their opposition.

Understand that You Are at a Legal Disadvantage

State labor laws have often been written with the influence of labor unions for their benefit rather than to protect taxpayers. In jurisdictions where elected officials are seeking to make changes to pensions, there are likely statutes that require them to meet in good faith with their bargaining units and if they get to impasse, only then are they able to impose terms by vote of the legislative body. Before they get to that point, they have to actually go through and document that they tried negotiating, that they listened to the terms and ultimately could not reach an agreement. It doesn't mean they have to agree.

Seek Outside Counsel

There are numerous examples where in-house government lawyers have incorrectly interpreted pension reform law or have provided inept guidance on the rules for labor negotiations. Whether intentional or simply the result of lazy or risk-averse thinking, in-house government lawyers in most cases will need to be pushed to do the right thing on pension reform.

To underscore the point, even if you are a member of the minority in your city council or in the state legislature and your vote can easily be overridden, obtain outside counsel that understands public sector labor law because they will see

dangers and opportunities for advancing reform that you may not be considering. Fortunately, those lawyers do exist and many offer free counsel through a variety of vehicles.⁸²

Understand the Rules

Successful labor negotiations in government must begin with a full and correct understanding of the rules. Labor unions representing government employees know the rules and tactics for labor negotiations far better than elected officials and even career government managers. It is imperative that pension reformers carefully research state law and local rules for how to negotiate changes in retirement benefits.

Those rules can be found in a few places, including:

- State statute
- Local code
- Within the individual labor contracts themselves

In addition, you should review applicable case law that interprets these rules, as courts may have overturned or outlined additional requirements beyond what is spelled out in the laws and contracts.

It is important to research and understand the process by which you can “declare impasse” and “impose contract terms” on the labor unions should you not achieve a mutual agreement during negotiations. In some jurisdictions, public officials have wide powers to simply impose changes in pensions without agreement from the unions. In other jurisdictions some sort of “arbitration” that may be advisory, or binding on the parties may be required. Understanding how much authority you have will define how much leverage you have at the bargaining table.

Pension reformers should prepare a checklist or step-by-step process for what they are legally required to do and negotiate in implementing pension reform. Failure to follow the rules will definitely result in a legal challenge from the labor unions and may result in the reforms being delayed or overturned.

Timing Is Everything

Most labor contracts in government extend for several years and in many cases changes to compensation and benefits may not be made until the contract is up for renewal. Understand the timeline for your labor contracts and whether you

have any ability to “re-open” the contract midterm. In addition, allow yourself proper lead time to get your pension reform language ready and any fiscal studies completed before heading to the bargaining table.

Appoint a Lead Negotiator

Most labor negotiations are handled by a few top government managers. These are usually the same individuals who put in place the existing pension benefits and personally profit from them. In other cases, these managers are sympathetic to labor union positions on issues or are reluctant to “rock the boat” during negotiations.

It is imperative that government officials leading pension reform consider bringing in an outside labor negotiator who is completely free from conflicts but also possesses a demeanor to win some level of respect and trust from all sides.

Whether you use an in-house or outside negotiator, pension reformers should give clear direction to the labor negotiator on what is the “last, best and final” offer you are willing to accept. It is vital that you establish a clear “walk-away” position at the outset and ensure your labor negotiator understands and agrees with it.

Build Your Case

Labor negotiations are a key time to keep the public pressure high in favor of pension reform. While negotiations are going on, your coalition on the outside should ramp up public events and communications to remind the labor unions that the people are on your side.

The unions will balk at the efforts at the table and may demand these activities stop while negotiations occur. This is no surprise as it indicates your pressure is working.

Maintain Your Coalition

You can only succeed at the bargaining table if you have the votes on your side. Labor unions are adept at back-channeling mayors, councilmembers, legislators, etc. during the negotiation process to try to win over votes to their position. If that happens, your negotiator will have no leverage to get a good deal.

Do not fall victim to this standard play by the labor unions. First, push your coalition to remain silent on the issues and if possible decline meetings. You strengthen the position of your negotiator by reaffirming all communications and decisions go through them, not individual politicians.

Second, knowing that some politicians will take these meetings with the labor unions, make sure that you have outside pressure on each politician who may be susceptible to union arguments. If politicians are hearing from the labor unions, make sure they are hearing from reform advocates at the same time.

Finally, keep score of your own votes at all times. You can be sure the labor unions are.

Chapter 8: Taking the Case Public

You have spent months researching your pension system and its problems, examining options for reform, creating and engaging a reform coalition and building the case for reform. Now, it is time to take the case to the public. By this time, there should be no surprise that you have a major pension reform. Reformers should explain the rationale and pros and cons to the public right away to ensure a full debate and to rally public support behind the right decisions. Essentially, you have to put the crisis in terms that people can easily understand and relate to. Just because you have all the facts on your side, does not mean that you will win the debate.

As discussed in previous chapters, you should have properly defined the problems first, translating what the pension crisis in your area means in opportunity costs. Again, this is more than telling everyone that there is an unfunded liability and the jurisdiction is in major fiscal straits unless something is done. You need to show the public that you are a credible coalition, that you empathize with their real life fiscal challenges and you are working for a way that will strengthen your community and provide for sustainable pensions while being fair to taxpayers. Your task is now to provide comprehensive outreach to the public via Web resources, news media, public meetings, and direct outreach to community groups, bloggers, taxpayer advocates and others.

If you have made it to this point in the reform process, you need to continually engage reporters and editorial boards on the problems you uncovered, if you have not done so already. Again, by this point, they should be doing regular stories in the newspaper and on television, aided by facts, charts, quotes and other material you have been preparing for public consumption. Press conferences in front of strategic locations will also aid you in getting the message out. Develop a comprehensive communications strategy that combines traditional and social media channels, including bloggers, podcasters, social media aficionados, etc., and provide them with the same media packages you

would give the traditional media sources. Review Chapter 7 for more on dealing with the media.

The public will also be interested in legislative or board hearings when properly advertised. Town halls are also effective mediums for demonstrating the need for reform to taxpayers and concerned citizens. A communications strategy in promoting these events should include formal notices, agenda and minutes; a schedule of meetings with stakeholders, editorial boards, bloggers, and civic and business leaders; presentations to government entities and local service organizations; preparation and submission of letters to the editor and editorials; participation in online discussions, and availability of spokespersons to reporters, bloggers and talk radio show hosts. These kinds of events should be organized so that important information is imparted, and key leaders speak and persuade, and so that future reformers can be recruited by gathering their contact information in anticipation of future action. They must leave any meeting with a task to get more support from their friends and neighbors.

Message, Message and Message

Once the reform measure is out there, the biggest message is to be constantly messaging. Message not only to the voters, if that is the route you are going, but you must message to all of the different advocacy groups out there, and even with your own colleagues if you serve in a legislative body.

If your messaging is strong enough, it may deflect or deter the opposition from even putting together a viable or aggressive campaign. Lead your opponents to believe that you dominate the messaging so much that there is no way they would be able to get their message across at the ballot box.

Legislative Leadership

As an elected official you may not have a majority with you on reform at the beginning, but you might have a majority of reformers on a committee. You want the pension issue to be discussed at every juncture and with every possible policy decision or vote. Grill the pension fund managers on their decisions and the actuaries on their models. Get them to defend and put their views and assumptions on record. Sometimes your ability to advance the reforms may not be the forum where you think it should go and you may say, “I don’t have the votes in the legislature, but on a committee basis, I might very well have the reform votes to move things forward.”

Look for five or six ideas on how you can assert your issue out there in the public. Take every opportunity to creatively maneuver or link to a pension issue.

Connecting with the Community and Voters

Use the talents you have in your coalition. Start by reaching out to audiences where you have solid networks and connections or good spokesmen in your coalition. Success builds success and it will make it easier to broaden your coalition with new talent and connections to other audiences and even lead to invitations from new audiences. An appearance in a newspaper column or on a local talk radio show, or speaking out at a city council meeting, or at a Chamber of Commerce forum can get the attention of other civic groups who might invite you to come speak to them. Build on each new audience to reach the next.

Robo-calls are automated calls to registered voters urging them to call their elected officials in support of reform. They are an inexpensive and effective way to put pressure on officials to support reform. Eventually, candidates for office will start talking about all the good things that they want to do on pension reform and you can get them on the record.

Email blasts are also very cheap and you can send an email out saying “send an email message to this council member” and you click on it and it directs them to a form-email that they fill in for the council member. When completed and they hit send, it goes to that council member in the form of an email, but what you get to retain is the email address of the person who sent the form out, so you are building that repository. In building your repository, it takes some time, but sooner or later, you start seeing that you have an email list that is several thousand people long.

Make Reforms an Issue for Candidates

Endorsements and surveys and scorecards from your local Chamber of Commerce or business groups, party organizations, civic clubs are very effective for both you and the organization(s) that you will be partnering with. Brief them on the importance of pension reform and get them to commit to asking a few questions on pension reform in their survey. For those candidates running and incumbents running, they start seeing this and know that these organizations are interested in this issue. It also gets them on the record committing them to a position they must follow.

Once the problem is well-defined, reveal solutions. Make the reform measure oppose bad ideas and policy choices like increased taxes, more expenditures on capital your jurisdiction cannot afford, or additional budget cuts for essential programs and services in the community. Elevate this issue above all others.

Ballot Measure Campaigns

The ballot measure campaign in and of itself is helpful because not only is it a vehicle for advancing the reform, but it also, once that clock starts ticking, puts pressure on legislators to reform the process themselves. Use a ballot measure threat to implement incremental changes through the legislative body.

Be prepared for all kinds of union chicanery and intimidation tactics. You will need to have a tight signature collection program with a 100 percent verification. With that you will also be able to target likely supporters who may have not signed petitions to get your measure on the ballot.

Labor unions have been reported to break into the campaign offices in previous campaigns. You may have to employ discreet measures to protect your information and signatures.

Court Cases

If you are already working with lawyers on defining your problem and trying to come up with solutions, typically the lawyer will find in the course of that existing research some violations of law that you may want to go ahead and prosecute and move forward on, even before you move out your reform proposal.

Engaging the public sometimes means that in order to check your elected officials' fortitude for supporting reform proposals, let them know that several citizens are willing to fund a lawyer to file a lawsuit against them and the city for failure to comply with the law. The great thing about some of these groups is that they actually have pro bono legal counsel and they like winning easy cases like yours because most states have a prevailing party reimbursement rate whereby you win your lawsuit and the pension system will be paying your lawyer for the courtesy of holding them accountable. Do not overlook the concept of having a group of citizens standing in front of a courthouse holding a press conference saying the city has seven days to cure this problem or they are filing a lawsuit and they believe that they are going to prevail on one of these

counts. It only takes one count to cover the cost of the court case, even if you lose on several of the claims that you have in the court.

Should your measure pass and you anticipate some form of litigation, make sure to beat the unions to court. Your pension reform measure should include the stipulation that you will file an action of declaratory relief in the court of original jurisdiction the day immediately after the election is over. This will assure your voters you are confident that you are right and your actions are legal, but that you want to be on the offensive and not caught flat-footed by spurious lawsuits by the opposition.

Have severability clauses written into your pension reform in anticipation that opponents will sue on any defect, real or perceived. You do not want one issue to sink all the work you have put into your proposal.

Keep Your Head Up

Be optimistic about your chances for reform but remember that it is not going to happen overnight. But if you have a felt need for change from the beginning, you have a very good chance at getting a majority of voters behind your reform measure. A lot of people are looking to throw the long ball, make the Hail Mary pass. You are going to find that through successive passes you will end up chipping away and getting more and more momentum by educating the public, laying the groundwork, building the coalition, and making the case for an overall comprehensive set of reforms down the line, all together or one piece at a time.

Partners and Resources for Reform

In the end, there is always someone willing to help you with reform. Reason Foundation has resources already committed at your disposal, as well as willing policy consultants to come in help you construct a viable reform effort. This includes access to legal advice, actuarial analysis, case studies and economic research. Additionally, Reason Foundation has partnered with several organizations, think tanks and mentors who have already successfully navigated the process in their respective jurisdictions, for which any of these projects have open access. Reason will make sure that you have everything you need to succeed.

Glossary

13th checks: Bonus checks paid to retirees based on investment fund performance that is usually above projections.

401(k): The most common defined contribution plan. Employees can contribute to this retirement fund without the burden of taxes on the contributed amount. The fund is managed either by the employee, a plan administrator, or a combination thereof. *See **Defined Contribution Plan**.*

Active member: Any member who is employed and receiving benefits from a respective pension plan. Active member eligibility varies depending on the plan and jurisdiction.

Actuarial analysis: An estimate of the assets and liabilities in a pension plan or program. Actuaries perform extensive analysis on future probabilities that include human factors such as mortality rates and life expectancy, and financial factors such as inflation rates and trends in the investment markets.

Actuarial assumptions: Factors actuaries use to estimate the cost of funding a pension plan. Examples include the rate of return on plan investments, mortality rates, and the rate plan participants are expected to receive when they leave the system because of retirement, disability, termination, etc.

Annual required contribution (ARC): An employer's yearly required contributions, expressed as a dollar amount or a percentage of covered plan compensation. The ARC consists of the employer normal cost and the amortization payment on pension debt.

Air time (service credit): A perk allowing public employees to purchase extra years of service that are credited toward their pension benefits, a function of the employee's final salary and his number of years of employment. In other words, air time is credit for work not performed.

Amortize: To pay down a debt or obligation over a long period of time with regular (often predetermined) payments of money.

Annual report: A report published by the trustees of the pension system that is used to communicate information about the pension, its administration, and its financial position on a regular basis.

Annuity: A series of periodic payments, usually for life, payable monthly or other specified intervals. The term is often used to describe the part of a retirement allowance derived from a participant's contributions.

Cash-balance (CB) plan: A defined benefit pension plan that looks and expresses its benefits like a defined contribution plan (i.e., accounts and account balances, contributions and interest credits). However, the investment risk is borne by the plan sponsor, not the participant. *See **Defined benefit plan**.*

Consumer price index (CPI): A measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. It is often used to reflect inflation rates.

Cost of living adjustments (COLAs): Adjustments made to pension benefits to counteract the effects of inflation. These adjustments can be tied to a cost-of-living index such as the Consumer Price Index (CPI).

Crowding out: The phenomenon that occurs when other budget priorities are displaced to mitigate the impact of higher than expected costs incurred by large retirement liabilities in a pension plan.

Declaratory relief: Refers to a judgment of a court that determines the rights of parties without ordering anything be done or awarding damages. By seeking a declaratory judgment, the party making the request is seeking an official declaration of the status of a matter in controversy. Optimally, the resolution of the rights of the parties involved will prevent further litigation. For example, a party to a contract may seek the legal interpretation of a contract to determine the party's rights.

Defined benefit (DB) plan: A pension plan that is designed to provide participants with a predefined, predictable and guaranteed benefit based on a formula that takes into account an employee's compensation, years of service, and age, or a combination thereof.

Defined contribution (DC) plan: A pension plan in which the employer, employee or both make fixed, regular contributions (usually pre-tax) of a certain amount or percentage of money on a regular basis designed for the benefit of the employee post-employment. The amount contributed is fixed and combined with any investment earnings in the account, but the benefit is not guaranteed. There are restrictions as to when and how a beneficiary can withdraw these funds without penalties.

Deferred retirement option plan (DROP): An arrangement where an employee agrees to remain at his job a certain number of years instead of retiring. In exchange, the employer deposits monthly checks in the amount the employee would have earned in pension benefits had he retired into an individual account. Thus, the employee earns both a salary and a pension (with interest) concurrently. Pension benefits are frozen at the time the employee entered the DROP. After the three- or five-year period has passed, the employee retires and cashes out his DROP account, receiving a lump sum.

Discount rate: Used by pension plans and insurance companies for discounting their liabilities.

Double-dipping: When a public employee retires and begins collecting his or her full pension, and then is rehired (often by the same agency from which the employee retired), the employee collects a salary plus his or her full pension and full health insurance benefits.

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.

Entry age normal actuarial cost method: Entry age normal cost allocates the cost of benefits from the time an employee is hired (the entry age) to the date of expected retirement either as a level dollar amount or as a percentage of payroll.

Fiduciary duty: The legal or ethical relationship of trust between two or more parties, particularly in the care of money by the fiduciary (who carries out the duty) to the principal (for whom the duty is owed).

Final average salary (FAS): The calculated annual salary based on an average of a set amount of years at a certain period in employment. This number is used to calculate the pension owed to a retiree from the employer. *See Pension Spiking.*

Final salary plan: In this system, the pension is based on an employee's final salary upon retirement.

Funding ratio: The ratio of the actuarial value of assets to the actuarial accrued liability. Plans may calculate a market-funded ratio, using the market value of assets, rather than the actuarial value of assets.

Funding risk: The risk that the individual or the employer does not put away enough money to adequately fund the needs of an individual or a group.

General law cities/counties: Cities/counties that are subject to the general laws of the state. *See Home rule cities/counties.*

Generally accepted accounting principles (GAAP): The standard framework of guidelines for financial accounting used in any given jurisdiction, including: standards, conventions and rules that accountants follow in recording and summarizing and in the preparation of financial statements.

Governmental accounting standards board (GASB): The independent organization that establishes and updates standards of accounting and financial reporting for state and local governments. GASB is recognized by governments, the accounting industry, and the capital markets as the official source of generally accepted accounting principles (GAAP) for state and local governments.

Home rule cities/counties: Cities/counties that are allowed to develop their own rules or charter based upon authority found in the respective state's constitution or statutes. *See General law cities/counties.*

Hybrid plan: A mix of defined benefit and defined contribution approaches for the same group of employees. The idea behind hybrids is to have a small defined benefit plan in which employees and employers put a small percentage of the employee's salary combined with a larger defined contribution plan in which a higher percent of salary is invested. *See Defined contribution plan and Defined benefit plan.*

Inactive member: A member who is no longer employed at the governmental entity and does not contribute a set percentage of wages into a pension plan.

Index fund: A type of mutual fund with a portfolio constructed to match or track the components of a market index, such as the Standard & Poor's 500 Index. An index mutual fund is said to provide broad market exposure, low operating expenses and low portfolio turnover. *See Mutual fund.*

Inflation risk: The risk that the value of the accrued benefits will be eroded by inflation.

Investment: The process by which contributions and net income of a pension are used to increase the value of the pension fund assets such as purchasing equities or bonds.

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 or the obligations of the plan to a group of retirees.

Mutual fund: An investment vehicle that is made up of a pool of funds collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and similar assets. Mutual funds are operated by money managers who invest the fund's capital and attempt to produce capital gains and income for the fund's investors. A mutual fund's portfolio is structured and maintained to match the investment objectives stated in its prospectus. *See Index fund.*

Negative amortization: An increase in the principal balance of a loan caused by making payments that fail to cover the interest due. The remaining amount of interest owed is added to the loan's principal, ultimately causing the borrower to owe more money.

Normal cost: The annual cost to prefund pension liabilities. Normal cost plus the cost to pay off unfunded pension debt equals the ARC payment.

Other post-employment benefits (OPEB): Benefits other than the standard pension benefit paid to an employee at the beginning of retirement, including health care premiums, life insurance premiums and other deferred compensation.

Overfunding: The situation where a plan's assets are greater than its liabilities. This is rarely seen or sustained for any length in time in a pension system.

Pension obligation bonds (POB): Debt securities issued to fund unfunded liabilities in public pension plans. POBs are a financing maneuver allowing state and local governments to "wipe out" unfunded pension liabilities by borrowing against future tax revenue, then investing the proceeds in equities or other high-yield investments. The idea is that the investments are expected to produce a higher return than the interest rate on the bond, earning money for the pension fund. *See Unfunded actuarial accrued liability (UAAL).*

Pension spiking: The practice of adding vacation, overtime, or other enhanced pay or specialized benefits to employee's final compensation for pension calculations. This may lead to pension benefits higher than actual final salary and/or may encourage early retirement.

Pensionable pay: The portion of compensation received by an employee on which the employee's pension is based.

Phased retirement: When an individual is allowed to retire and receive benefits while continuing to work (typically part-time).

Pickup: The public employer's practice of paying, as a benefit, the employee's required pension contribution.

Portability: The ability of an employee who changes jobs and joins a different retirement system to bring her retirement assets with her without penalty.

Retired annuitant programs: Programs that allow retirees to continue working for the jurisdiction and either get paid a regular salary in addition to pension payments or allow accrual of more or concurrent service time to their pension. *See **Deferred Retirement Option Plan (DROP)**.*

Risk-free rate of return: The theoretical rate of return of an investment with zero risk. The risk-free rate represents the interest an investor would expect from an absolutely risk-free investment over a specified period of time. In practice, however, the risk-free rate does not exist because even the safest investments carry a very small amount of risk. Thus, the interest rate on a three-month U.S. Treasury bill is often used as the risk-free rate.

Risk pooling: The spreading of financial risks evenly among a large number of contributors to a financial program.

Rule of 80 (or 90): A threshold to determine retirement eligibility that usually combines an employee's age with number of years of service credit while in government employ, which must equal 80 (or 90) to qualify for an unreduced service retirement benefit (normal age retirement). This rule usually requires a minimum number of years of service credit, such as five years.

Severability clause: A contract provision that keeps the remaining portions of the contract in force should a court declare one or more of its provisions unconstitutional, void, or unenforceable.

Smoothing method of asset valuation: Smoothing incorporates any deviation between expected returns and actual results over a period of years. Assuming a five-year smoothing period, which is common, 20percent of any variation between expected and actual results for a given year would be incorporated into the actuarial value of assets for each of the next five years.

Transition costs: The alleged "cost increases" that occur when paying down unfunded liabilities after shifting new employees from defined benefit plans to alternate plans.

Unfunded actuarial accrued liability (UAAL): The excess, if any, of the actuarial accrued liability over the actuarial value of assets. In other words, the present value of benefits earned to date that is not covered by current plan assets.

Vested right: An absolute and unconditional constitutionally protected right.

Vestment: A determination that an employee has reached a defined number of years of service to be eligible to receive a pension benefit based on the benefits he or she has accrued, or some portion of them, even if employment under the plan is terminated.

Related Reason Studies

Studies available at <http://reason.org/areas/topic/pension-reform>

Overprotecting Public Employee Pensions: The Contract Clause and the California Rule, 2014.

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