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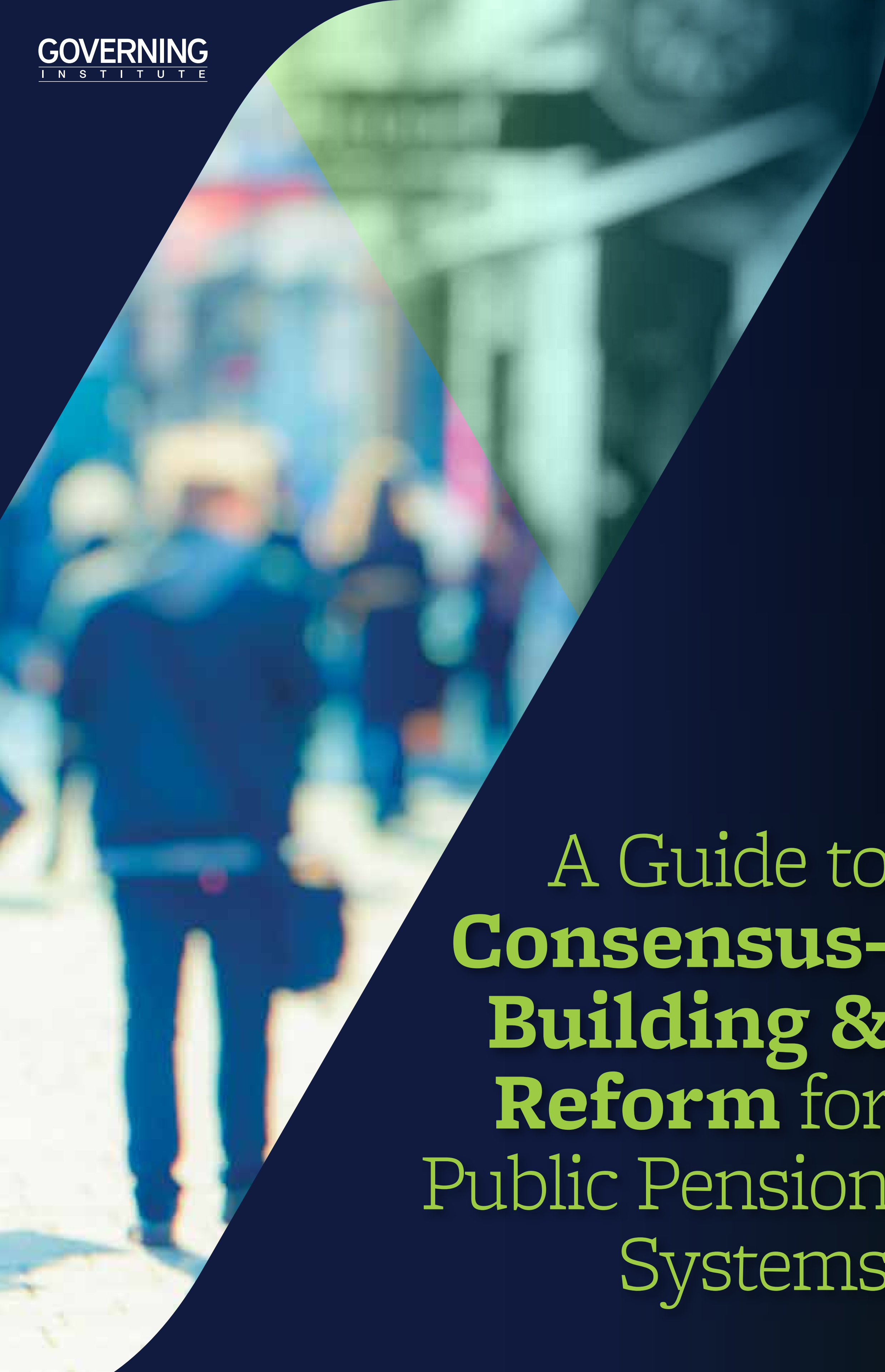

A Guide to **Consensus-Building & Reform** for Public Pension Systems

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>
> Chuck Reed, Former Mayor, City of San Jose, Calif.

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Introduction

Detroit. The California cities of Vallejo and Stockton. Central Falls, R.I.

Rising pensions costs have contributed to municipal bankruptcies in all these communities over the last decade.[1] Detroit's pension debt was so large it accounted for $7.4 billion of the city's $18 billion debt when it declared bankruptcy in 2013.[2] Stockton's pension obligations accounted for $37 million of its $196 million budget,[3] a debt so massive a federal bankruptcy judge called it "a bully wielding an iron fist."[4]

Like these cities, many states and municipalities today aren't even close to managing unfunded pension liabilities. Jurisdictions across the country may find themselves in financial situations like Stockton or Detroit if they don't take proactive steps to address rising pension costs.

The country's 4,000 public sector pension systems distribute more than $228 billion in benefits annually,[5] but all signs indicate many state and local governments likely can't afford the expense. Public sector pensions are woefully underfunded. Estimates vary depending on the assumed rate of return pension funds use, but public finance experts estimate unfunded pension liabilities total anywhere from $4 trillion to $6 trillion.[6] To put that in perspective, it's equivalent to the entire economy of Germany.

State and local government leaders need to address this gap immediately. If underfunding persists, there could be severe consequences for current retirees, future public sector employees, citizens and taxpayers.

"Failure to properly fund benefits at the time they are earned creates debts that may not get paid when a state or city runs out of money. If a city or state cannot or will not pay those debts, payments to retirees and employees can be cut, as we have seen in municipal bankruptcies like Detroit and Central Falls, R.I.," says Chuck Reed, the former mayor of San Jose, Calif., who implemented numerous fiscal reforms and a 2012 pension overhaul during his time in office. "Taxpayers and future generations have a long time to recover from the impacts of a municipal insolvency. Retirees have far less time and much less ability to recover when they suffer a cut in benefits."

Rising unfunded pension liabilities have already forced some governments to cut hiring,[7] which effects constituent services. Taxpayers also shoulder the burden of paying high amounts of interest to reduce or eliminate unfunded liabilities.

"Because of the rising cost of pensions, particularly the debt payments required for servicing unfunded liabilities, public sector workforces are the smallest they have ever been when you look at them on a per capita-served basis," says Pete Constant, chief executive officer of the Retirement Security Initiative. "Public employers are having to do more with fewer people because of rising pension costs."

Increasing Unfunded Liabilities:

How We Got Here

When public pension systems were created in the 1950s and 1960s, these plans were generally small and they invested in relatively low-risk assets like government bonds. Over time, demographics, investment strategies and other factors have changed significantly, leading to the underfunding we see today.

First, plan size grew dramatically over the past half-century. This is the result of demographic shifts — government workforces are aging, producing more retirees, and those retirees are living longer — coupled with stagnant or declining state and local government employment levels, especially since the Great Recession.

"Plans have become much larger relative to the size of sponsoring governments' budgets and taxpayers' overall capacity to pay," says Dr. Josh McGee, an economist who is a research professor at the University of Arkansas and a senior fellow at the Manhattan Institute. "Total liabilities were about 12 percent of GDP back in 1960 and are now more than 40 percent of GDP according to Federal Reserve data."

To keep up with growing liabilities, pension plans have shifted away from low-risk investments in favor of stocks and other higher-risk alternatives such as private equity, hedge funds, real estate and commodities. According to Fitch Ratings, in the span of a decade, pensions tripled their average investment in these so-called alternative investments. In 2007, they averaged 9 percent of state and local public pension investment portfolios. By 2017, that number had risen to 27 percent.[8]

In some cases, these moves boosted investment returns and diversified portfolios, but they also made plans more vulnerable to market volatility and the risk of shortfalls. Now pension fund yields are highly correlated with swings in stock returns, a 2018 Pew report on public pensions points out, and even differences that at first appear to be relatively small can have a big effect on asset values. For example, a 1 percentage point difference in annual returns on the nation's total $3.8 trillion in state and local pension debt equates to a $38 billion impact on pension assets.[9]

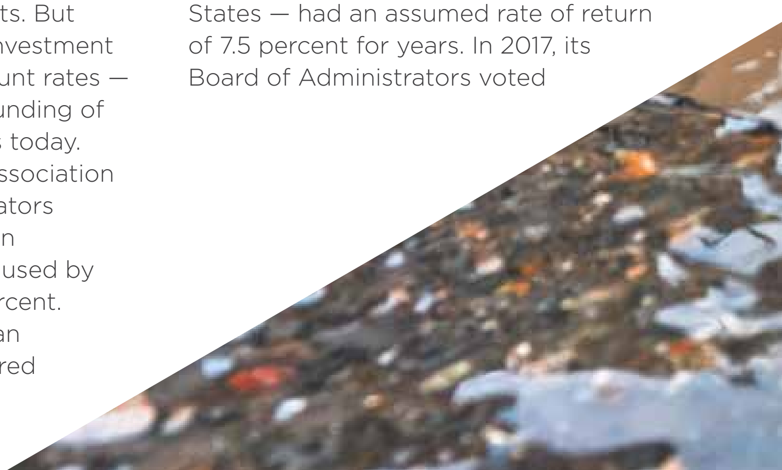
Magnifying this problem is the fact that many plans also started projecting unrealistic rates of return on their investments. This was politically expedient, since a higher assumed rate of return lowers estimated liabilities, allowing political leaders to appropriate less money from state and local budgets to support pension systems and require smaller contributions from employees to fund their retirement benefits. But unrealistic predictions about investment returns — also known as discount rates — contributed to chronic underfunding of pension plans which continues today.

According to the National Association of State Retirement Administrators (NASRA), until 2011, the median investment return assumption used by public pension plans was 8 percent. However, since 2009, more than 90 percent of plans have lowered their assumed investment returns, resulting in a reduction of the median return assumption to just below 7.4 percent.[10] Still, even these numbers may be overly optimistic, says Dr. Joe Nation, project director of the Stanford Institute for Economic Policy Research, which studies pensions.

While most pension systems bested their predictions in the last two years — with some even posting double-digit returns in 2017 — the average return over the last 10 years has been far below the assumed rate of return of 7.4 percent. According to a Pew study of 44 funds, the average 10-year total investment funds ranged from 3.8 percent to 6.8 percent, with an average yield of 5.5 percent.[11]

The Pennsylvania Public School Employees' Retirement System (PA-SERS) provides a good example of how market volatility can affect liabilities. In the early 2000s, PA-SERS had a published funding ratio of more than 100 percent. Fifteen years later, after assuming an 8 percent rate of return — and only realizing an average of 6 percent — the system's funding ratio fell to just over 60 percent. Between 2001 and 2015, PA-SERS only exceeded its assumed rate of return on three occasions.[12]

Similarly, the California Public Employees' Retirement System (CalPERS) — the largest pension fund in the United States — had an assumed rate of return of 7.5 percent for years. In 2017, its Board of Administrators voted



to lower the discount rate to 7 percent, but the system's realized average 10-year return (from 2008 to 2018) is only 5.6 percent, and CalPERS' official unfunded liabilities totaled around $140 billion as of 2018.[13]

"There have been warning bells going off for a long time now about the future of public employee pensions in California. Had we adjusted the discount rate and assumed rate of return 15 years ago, we'd probably be in pretty good shape right now," says Nation. "Liabilities have continued to grow, and because of that, the current funded ratio for CalPERS is only about 68 percent. You can imagine what the future would look like if we have another market downturn. It's really a scary prospect."

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Challenges Continue

Although plans have adjusted investment assumptions and made other changes, those reforms often have come too slowly and haven't gone far enough.

Many states still don't contribute enough to cover their liabilities even if they were to realize the assumed rates of return on their investments. A 2018 Pew report found even if plan assumptions had been met in 2016, the funding gap in state pension funds would have increased by $13 billion because states did not allocate enough funds to their systems.[14]

"The principal challenges we see are in states that have not made the actuarially determined contribution every year," says Anthony Randazzo, executive director of the Equable Institute, a nonprofit focused on public policy that has worked with several states on pension reform efforts.

Much of the problem is political as it behooves leaders reliant on constituent approval to continue kicking the proverbial can down the road.

"Public employee pension problems have reached crisis levels in many states and cities because the urge to overpromise and underfund is a powerful force that afflicts most elected officials," says Reed. "Decades of overpromising and underfunding have left most pension plans far short of having enough money to make good on their promises of retirement benefits to public employees."

While opinions differ on how to solve the problem, most experts agree the worst thing to do is wait.

"We already have sizable pension debt, and because these systems rely on compounding, the scale of the borrowing can increase quickly, pushing more and more cost onto future public workers and taxpayers," says McGee. "The sooner we act, the lower the overall cost is going to be."

Constant says it's incumbent upon state and local governments to consider solutions that prioritize both the financial health of their pension systems and retirement security for employees, so existing, earned benefits are never at risk. Often this requires a grand compromise where benefits already accrued are safeguarded and where governments and employees share in future financial risks.

But beyond the need for political will and shared sacrifice, state and local leaders in many jurisdictions face significant legal hurdles to pension reform. In most states, reductions to existing pension benefits for active and retired public employees are prohibited by federal contract law. Courts in these states view pensions as a contract between public employees and the government. The contracts clause of the U.S. Constitution, says "No State shall … pass any … Law impairing the Obligation of Contracts." Government employees and retirees who challenge pension reforms often cite this clause in their litigation. Their efforts have been bolstered by the fact that the standard for public contracts is often higher than private contracts under the clause.[15]

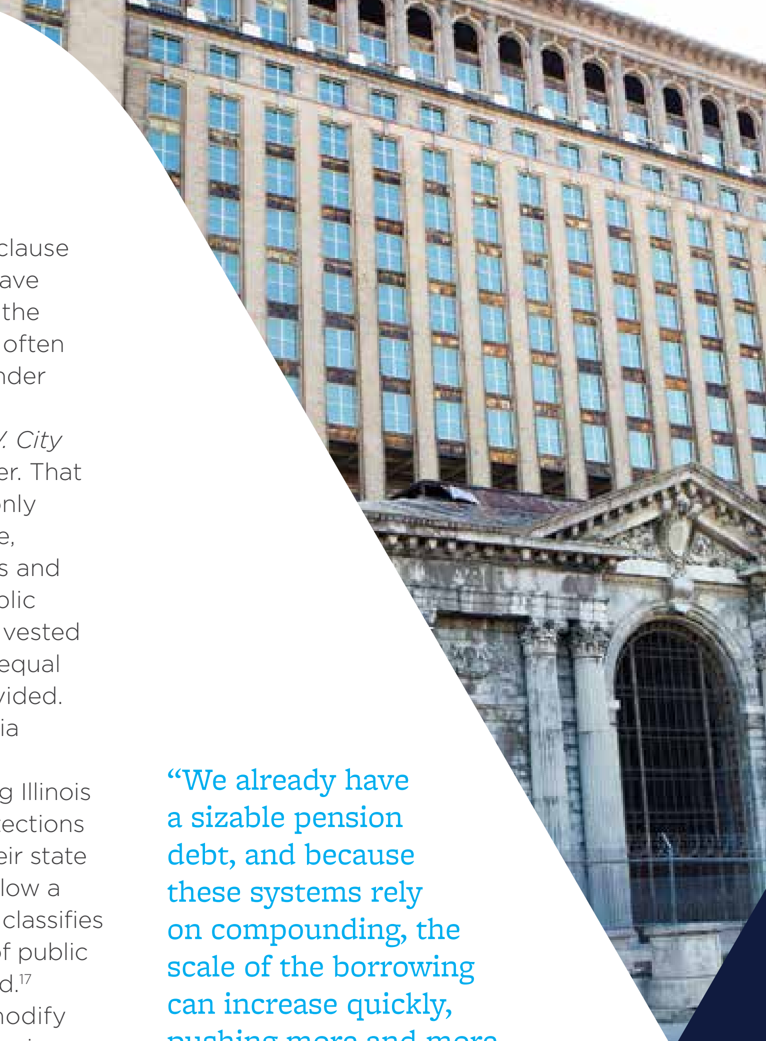
A 1955 California case, *Allen V. City of Long Beach,* goes even further. That case established what's commonly referred to as the California Rule, which declared pension benefits and pension benefit promises to public employees are inalienable once vested and can't be diminished unless equal or greater compensation is provided. A dozen states besides California follow this standard.[16]

Another seven states, including Illinois and New York, have explicit protections for public pension benefits in their state constitutions, while six states follow a property rights approach which classifies pension benefits as a property of public employees that can't be impaired.[17]

Besides making it tough to modify pension benefits, these legal barriers negate a key federal law designed to ensure employee retirement security and safeguard the fiscal health of pension plans. The Employee Retirement Income Security Act (ERISA) mandates proactive steps to help pension plans regain sound financial footing. While ERISA regulates private sector pensions, it does not apply to public sector plans, according to Constant.

"Almost every corrective action requirement that exists in ERISA for private plans are actions that are prohibited for public pension plans," Constant says.

ERISA requires plan sponsors and pension boards to act when plans begin to experience funding problems. The law also classifies pension plans as threatened, endangered or currently at risk, providing a level of transparency desperately needed in public sector plans.



"We already have a sizable pension debt, and because these systems rely on compounding, the scale of the borrowing can increase quickly, pushing more and more cost onto future public workers and taxpayers. The sooner we act, the lower the overall cost is going to be."

Dr. Josh McGee, Senior Fellow, Manhattan Institute

Modernizing Pension Systems:

Case Studies from Cities & States

Jurisdictions have a range of options for providing pension benefits. But ultimately, a pension system must at the minimum provide retirement security for employees; be affordable for both employees and employers; and be sustainable in terms of its design, governance and funding mechanisms.

To date, much of the pension debate has been over plan design. Traditionally, public sector pensions are defined benefit plans in which employees are promised retirement payment based on a formula of their age, years of service and final average salary. The government agency invests on behalf of the employee and thus shoulders the investment risk depending on how the plan is structured.

Pension reform initiatives often include the introduction of defined contribution plans or hybrid plans intended to reduce costs and make them more predictable. With defined contribution plans, employees have their own retirement account, funded through a combination of their own contributions with a match by their government employer. The employer does not have any liability after the employee retires and thus has less or no investment risk. Hybrid plans combine elements of defined benefit and defined contribution plans — they are partly composed of guaranteed benefits and of benefits based on investment returns — with an individual retirement savings account in which employees and employers both make contributions.

While proponents of traditional defined benefit plans say defined contribution plans are more likely to leave public employees with inadequate retirement benefits, others say massive unfunded pension liabilities mean government agencies can no longer assume the risks and foot the bill.

But experts like McGee and Nation say the fundamental issue isn't necessarily plan design, it's the need for governments to fully fund benefits as they are earned and respond more flexibly to changing economics and demographics.

"It's challenging because people have strongly held preconceived notions about what a traditional defined benefit plan is versus what a defined contribution plan offers — and those are the traditional battle lines in this debate," says McGee. "But there aren't clear delineations between plan designs anymore and maybe there never were. I think the traditional defined benefit versus defined contribution argument is stale. We need to talk about the core things that matter for retirement security — benefit accrual, investment protection and longevity protection — and how we want to provide those things to workers."

Nation agrees, noting that even moving to a hybrid system is not a requirement for reform.

"I'm not someone who believes that you have to have a hybrid," he says. "You can have a defined benefit plan stand on its own if it is run well, if the assumptions are realistic, if you don't assume that you're going to have these high rates of return, and if you don't have processes and accounting principles that push cost to the future."

The following examples show how states and cities have reduced unfunded pension liabilities and worked toward solvency using a range of plan designs. In each case, leaders brought together stakeholders to fully understand the scope of pension problems and encouraged shared compromises that put their plans on a path toward providing employees retirement security at a price the government can afford.

Arizona: Blazing New Ground in Collaboration and Compromise

Efforts to make changes to pension systems — no matter how slight — often pit employers and taxpayers against public sector employees and labor interests. But Arizona was careful to take a different approach when leaders decided in 2015 they had to put the state's Public Safety Personnel Retirement System (PSPRS), which provides benefits to firefighters and law enforcement officers, on better financial footing. At the time, PSPRS had $6.6 billion in unfunded liabilities.[18]

"That system effectively found itself in a free fall. It was 100 percent funded in 2003 and less than 50 percent funded about 12 or 13 years later," says Len Gilroy, senior managing director of the Pension Integrity Project at the Reason Foundation, which provided technical assistance and extensive outreach to policymakers and stakeholders in Arizona's pension reform effort.

The system's method of adjusting retiree benefits over time was not tied to inflation and had a major design flaw that automatically increased benefit levels even in times of poor pension fund performance, severely harming the fiscal health of the plan. This caused funding levels to fall and employer contributions to dramatically rise.

Realizing they all had a stake in a solution, different coalitions, including various employee groups, retirees, government employers and business leaders came together to acknowledge the problem and develop potential solutions.

"They approached this with a sense of civic responsibility beyond whatever interest-based concerns they might have otherwise had," says Gilroy.

With the support of the state legislature, a working group formed that included these stakeholders. The group examined actuarial models to understand the scope of the problem and assess the fiscal impacts of various reform concepts. This collaborative process was key as Arizona leaders had previously enacted reforms that aggressively reduced benefits and were later ruled unconstitutional by the state's courts.

Ultimately, after more than 100 meetings, a compromise emerged. That compromise included not making any adjustments to benefits retirees had already accrued. Instead, for active workers and retirees, the system will adjust future benefits by aligning cost-of-living adjustments (COLAs) with the regional Consumer Price Index (subject to a 2 percent annual cap).

The reform also created a new plan design for future employees, giving them the choice of entering a full defined contribution plan or a risk managed defined benefit plan, which reduced the pensionable pay cap from $265,000 a year to $110,000 a year, increased the retirement benefit eligibility age from 52.5 to 55 years old, restricted or eliminated COLAs when the plan falls below 90 percent funded, and requires employees to pay 50 percent of all retirement costs if the plan's experience does not meet actuarial assumptions, among other changes. All these changes required a constitutional amendment, which voters passed by a 70 percent margin in 2016. Last November, Arizona residents again voted to make similar changes in the pension systems for correction workers and elected officials. The 2016 reforms are expected to save Arizona $1.5 billion over 30 years, while the 2018 reforms will save the state $275 million and preserve retirement security for current and future employees.[19]

The Arizona experience shows that stakeholders with different interests and perspectives can work together to compromise when changes must be made — even if it's a feat that seems impossible.

Remarking on the reforms in an *Arizona Republic* op-ed, columnist Robert Robb noted: "Politically, public employee unions and libertarian wonks blazed new ground on a difficult and emotional topic that is producing paralysis around the country."

Pennsylvania: Embracing a Hybrid System

In Pennsylvania, previous court rulings had deemed pensions contract obligations, making it difficult for lawmakers to address unfunded liabilities. At one time the state's pension system was only 60 percent funded, says Pennsylvania State Rep. Seth Grove.

Grove says lawmakers considered different plan designs, and after much debate, the state achieved bipartisan support in 2017 for a hybrid defined benefit and defined contribution plan for new employees that better manages its financial risks. New employees are automatically enrolled in the hybrid plan but can also choose a defined contribution plan. The reform package, which addressed pension plans for state and public school employees, also capped employer contributions at 5.5 percent.

The changes, which provide lifetime payments from the defined benefit portion of the hybrid plan, increase retirement security for workers, since estimates say the plan (along with Social

Security) will provide employees with a retirement income equal to 90 percent of their final salary.[20]

Pennsylvania's pension changes are expected to save taxpayers between $8 billion and $20 billion over the next 30 years. Grove is cautiously optimistic about Pennsylvania reforms and says they were a good start to making the system more sustainable. He says as states face ongoing budget constraints, it's crucial for legislators to focus on making sound financial decisions — not just political ones.

"If you do the right things, you can protect your pension plan against economic cycles, but it's very tough to protect it against political decisions. I think that's where governments need to start moving," Grove says. "They need to move away from making political pension decisions and focus on the financial decisions and limiting risk."

Michigan: Eliminating Future Unfunded Liabilities for Teacher Pensions

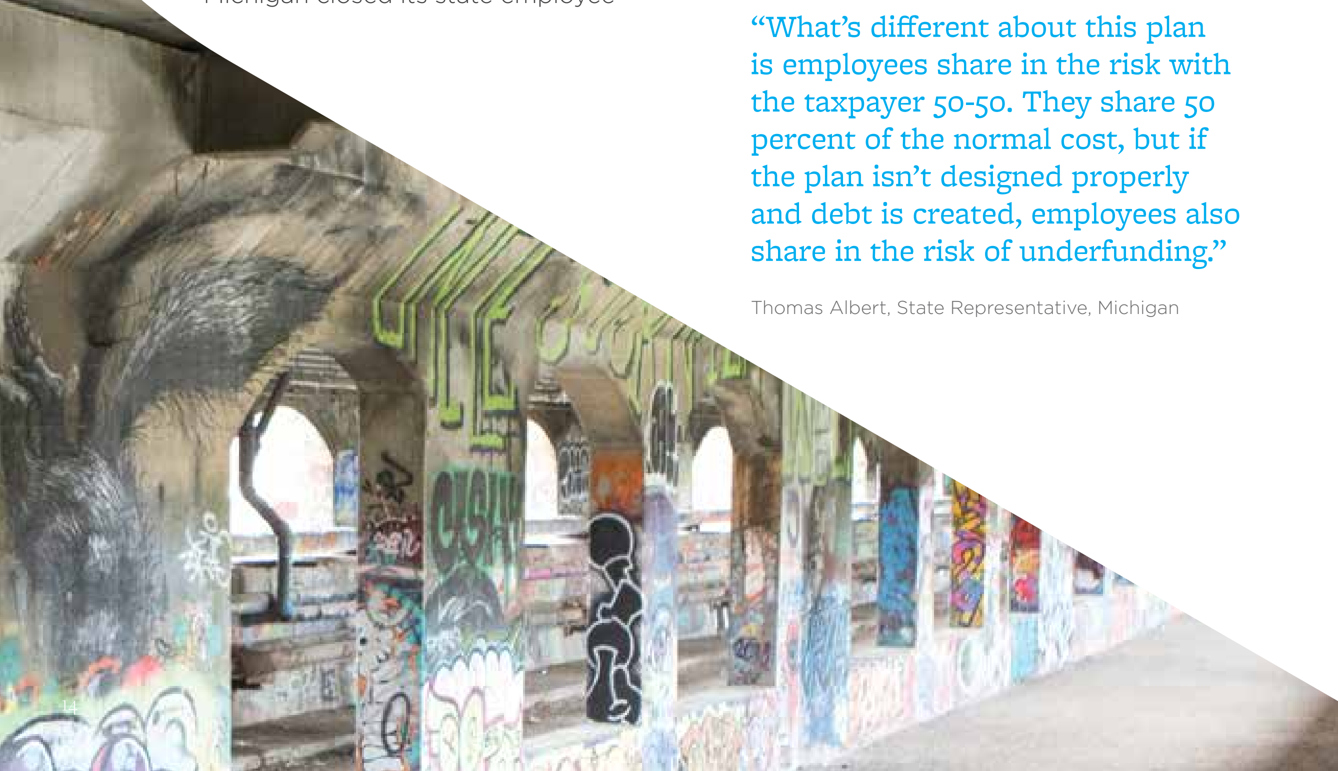
Michigan has a long history of enacting pension changes. In 1997, Michigan closed its state employee retirement system and transitioned new employees to defined contribution plans. But the state — which has four statewide pension systems — still faced significant financial risks because of its teacher pensions, which account for 80 percent of the assets across all its plans.

The state's unfunded liabilities in the Michigan Public School Employees' Retirement System (MPSERS) totaled $29 billion in 2017.[21] To make its system solvent in the coming decades — and attempt to eliminate the possibility of unfunded liabilities for new hires — it enacted reforms that offered employees more choice.

For example, new employees are automatically enrolled in a defined contribution plan with a default 10 percent contribution rate, while the employer contribution increases to a max of 7 percent. Alternatively, employees can switch to a new pension plan that is based on a more conservative assumed rate of return and with similar cost-sharing provisions as Arizona. While the law does not end the hybrid pension

"What's different about this plan is employees share in the risk with the taxpayer 50-50. They share 50 percent of the normal cost, but if the plan isn't designed properly and debt is created, employees also share in the risk of underfunding."

Thomas Albert, State Representative, Michigan



option, it contains a trigger to close the system if it is less than 85 percent funded for two consecutive years and legislators do not kick in extra cash to sustain it.

"What's different about this plan is employees share in the risk with the taxpayer 50-50. They share 50 percent of the normal cost, but if the plan isn't designed properly and debt is created, the employees also share in the risk of underfunding," says Michigan State Rep. Thomas Albert, who formerly worked at the pension fund as an investor and who played a key role in the negotiations. "This new hybrid plan also had very conservative assumptions that were used, so the likelihood of there being any debt is low."

Houston: Cutting Pension Liabilities with Grand Compromise

$1 million a day.

That's how much Houston's pension debt was growing before the city enacted reforms in 2017, according to City Controller Chris B. Brown. Houston had $8.2 billion in unfunded liabilities. In 2000, amid budget constraints, the city renegotiated the pension benefit structure through its defined benefit plan. Houston agreed to increase deferred compensation in lieu of raises for police, fire and municipal workers, which allowed employees to spike their pension payments with accrued vacation, sick and overtime pay.

These changes increased pension costs, but the financial assumptions made by the actuarial firm Houston hired also were wildly off, leading the city to go from a $100 million surplus across three pension plans to $2.4 billion underfunded just four years later.[22] Faced with rising pension debt that would have become even more costly to service — along with the biggest budget gap in the city's history — stakeholders came together to solve the problem.

"From the very beginning, Mayor Turner set a tone of shared sacrifice," Brown says. "He said, 'Look, we must solve this very big problem. It's not going to be solved by balancing it on the backs of all the hard-working public employees. The city administration, the taxpayers, everyone is going to have to compromise and give a little.' That theme of shared sacrifice was something we had to embrace."

That shared sacrifice manifested itself in the form of what Brown calls a 2-2-2 plan — a 2 percent reduction in retiree benefits, a 2 percent increase in employee contributions and a 2 percent increase in employer contributions.

The city also didn't mandate how employees and retirees would pay their share and left it up to both groups to put forth their own concessions to help the city cut its yearly pension costs in half.

"Rather than taking an authoritarian approach and saying, 'Hey, this is what we're cutting. Take it or leave it,' we had that shared sacrifice theme, and we brought all the stakeholders to the table," Brown says.

He adds that Houston's final pension solution, which was passed by the state legislature in May 2017 and signed into law by Gov. Greg Abbott, closely mimics this framework. In its reforms, Houston kept its defined benefit plan intact but implemented a cost corridor to better manage its risk.

The cost corridor sets a lower and upper range for the city's pension costs, based on a percentage of payroll. If the city's costs exceed this upper limit, the city, the unions and the pension funds must figure out how to reduce costs.[23]

The city did have to take out $1 billion in pension obligation bonds to begin paying off its unfunded liabilities,[24] but even with this debt, its reforms have dramatically reduced its pension costs. The city is on track to pay off its pension debt in 30 years. And in just two years, Houston has gone from $8.2 billion in unfunded liabilities to just over $4 billion — cutting its pension debt by half.

Colorado: Succeeding with a Second Shot at Reform

Colorado leaders previously attempted to reform the Public Employees' Retirement

Association (PERA) — which oversees retirement benefits for more than 560,000 teachers, state troopers and other public employees — by passing a bill in 2010 designed to increase the funded ratio from its 2009 level of just under 69 percent to 100 percent funded in 30 years.[25]

But those 2010 reforms, which raised the retirement age and increased employee contributions, didn't fully put Colorado's pension system on the path to solvency — largely because it assumed an unrealistic rate of return. Four years later, the state conducted a stress test on the plan — a rigorous analysis showing likely outcomes under various scenarios of tax collection, market performance and fiscal health — and found the chances were 1 in 4 that the assets in PERA's main funds would be depleted within 25 to 30 years.[26] By 2016, PERA's funded ratio had dropped to 58 percent.[27]

"We were seeing that a lot of the reforms wouldn't have an impact for a very long time. Things were getting worse and the liabilities kept increasing. It really was critical that we act," says State Rep. K.C. Becker, speaker of the Colorado House of Representatives.

To help solve the problem, the Denver Chamber of Commerce held working group meetings with a full slate of stakeholders for nearly a year to allow groups and individuals to get on the same page about the sustainability problems before the legislature debated the solution.

On the last day of the legislative session in 2018, the state's split legislature passed a compromise bill to address PERA's $32 billion in unfunded liabilities.[28] The new law increased the retirement age for new employees from 58 to 64, reduced COLAs from 2 percent to 1.5 percent for new employees and increased employee contributions so that most plan participants contribute 10 percent of their pay by the year 2021. New employees can choose to enroll in the defined benefit plan or a hybrid plan.[29]

The law also increased highest-average salary calculations for certain employees

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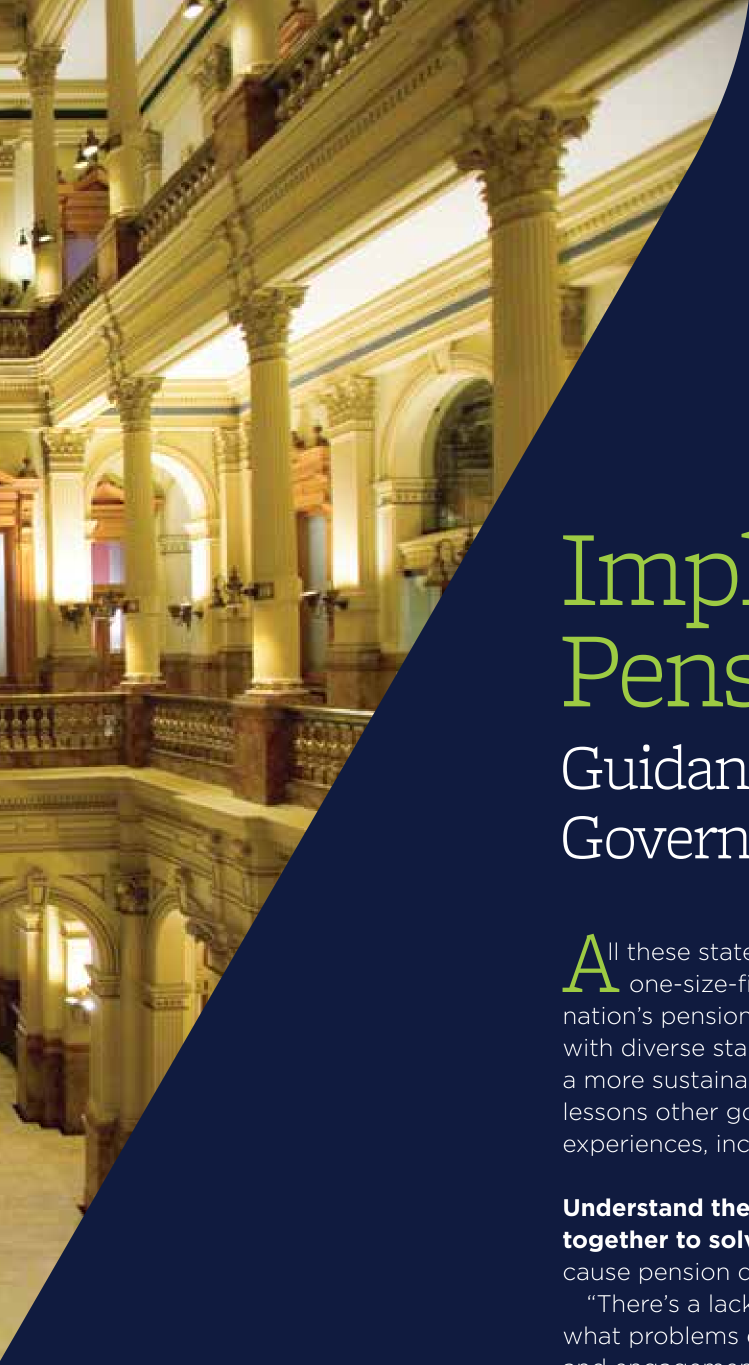
KC Becker, State Representative, Colorado

depending on their years of service and mandated the state contribute $225 million to the pension fund. But perhaps the most important feature of the law is an automatic adjustment provision that will allow legislators to assess whether employee and employer contributions and the pension fund's investment returns are keeping the system on track to be fully funded by the 30-year goal. The provision automatically triggers changes — including increasing employee and employer contributions by 0.5 percent and state contributions by $20 million in one year — if the statutorily defined contributions from employees, employers and the state supplemental payment collectively are less than the actuarially determined contribution.[30]

Becker says the legislation also includes regular stress tests that are reported back to the audit, finance and other committees in the state legislature. The state even formed a committee that includes financial experts outside the state legislature, which is tasked with ensuring PERA stays on the path to solvency.

Although balancing the interests of various groups engaged in pension reform was a challenge, Becker says she's glad the state decided to act.

"A lot of people were arguing to just kick the can down the road, and I'm so glad we did not do that," she says. "If we had not done this in 2018 — knowing where we are politically and financially in 2019 — it would have been nearly impossible."



Implementing Pension Reform:

Guidance for Local & State Government Leaders

All these states and cities show there isn't a one-size-fits-all solution to addressing the nation's pension crisis. It takes different solutions with diverse stakeholders working together to create a more sustainable system. However, there are several lessons other governments can learn from their experiences, including:

Understand the problem — and bring people together to solve it. Different accounting methods cause pension debt calculations to vary.

"There's a lack of clarity for most stakeholders on what problems exist, a lack of legislative oversight and engagement, and a lack of taxpayer interest in this very complex topic, all of which has led to a lot of challenges," says Randazzo of the Equable Institute. "It's probably why there's a lot of apathy — even among plan participants — toward the need to make improvements to retirement system funding."

Amid this climate, it's important for state and local government leaders to start by bringing individuals and groups together to understand the problems before working toward a solution.

"Leaders need to take a hard look at their current unfunded liabilities and craft a workable plan to pay that debt down over a reasonable time frame (30 years or less)," says McGee. "Because of the size of underfunding, in some places that requires shared

sacrifice. There needs to be a negotiation between labor and policymakers and taxpayers about how they are going to share the sacrifice to make the budget math work."

As the Houston and Arizona cases illustrate, engaging in conversation with diverse stakeholders from the outset will make future reforms more sustainable, and potentially help state and local governments avoid undergoing protracted legal battles to defend proposed pension changes. In places where pension obligations are codified in state statutes, this is especially important to make progress and keep pension debt from ballooning to the point where municipalities must make even more severe cuts.

"The best way to ensure plans are well-designed, fully funded and solvent in the longterm is to divide performance risk between the municipality and the employees," Reed says. "We need public employees to have more of an incentive to keep governments from overpromising and underfunding. In addition, plan governance reforms should be implemented to reduce incentives to overpromise and underfund."

Undergo stress testing. Stress testing can help policymakers prepare their pension plans for the next economic downturn and provides an underpinning for them to understand and respond to the impact of economic volatility on pension plans, according to Dr. Susan Urahn, executive vice president and chief program officer for the Pew Charitable Trusts.

In Colorado, a second round of reforms was needed after the state conducted a stress test and found its 2010 changes would likely not have enough of an impact.

Colorado, Connecticut, Hawaii, New Jersey and Virginia now all require pension plan stress testing. Each state passed legislation requiring that a stress test capture a complete picture of the solvency and durability of the pension system, including revenue forecasts, the state's record of making required contributions, and the ability of legislators and managers to maintain a balanced budget while ensuring the solvency of a multibillion-dollar pension plan.[31]

Constant says it's important that leaders do their due diligence in looking at what effect changes will ultimately have.

"Before you rush in to reform pensions, you need to do a deep dive and stress testing to ensure the solution you're ultimately choosing is addressing the problem that exists," he says.

Implement financial oversight and encourage transparent reporting. Jurisdictions should consider an oversight body or mechanisms as a key part of their reforms.

The Texas Pension Review Board is an oversight body focused on improving measurement and reporting, a critical function that provides more transparency regarding pension liabilities. It also provides cities with pension funding and benefit design guidelines. The Funding Soundness Restoration Act enabled the board to increase the amount of oversight it applies to municipal plans by conducting intensive actuarial reviews and helping cities develop sustainable solutions.

As part of Pennsylvania's reforms, the state created the Public Pension Management and Asset Investment Review Commission, which provides additional oversight and issues recommendations "regarding investment fee transparency, pension system stress testing, and active versus passive investment strategies and performance."[32] In December 2018, the commission found the state could save $10 billion on pension costs with more transparent reporting and reduced investment fees.[33]

Start small, if necessary, and work toward larger reforms. Pension changes often come with dire warnings about

the financial impact to government workers, but once changes are implemented and the sky doesn't fall, lawmakers, labor unions, employees and taxpayers may be more willing to get on board with future changes.

Michigan and Arizona's reforms provide successful examples. In Arizona, residents voted for another round of pension changes two years after 70 percent approved the first reforms. In Michigan, the state legislature passed a payroll growth bill in 2018 that will phase in a lower payroll growth assumption over time until it reaches zero, which means the state will contribute the same amount each year to teacher pension plans rather than making contributions based on assumptions about projected future income. The statute, which goes into effect in 2020, is estimated to save taxpayers $2.9 billion over the next 20 years — without putting anyone's retirement at risk.

"If I had to give any advice, it's to take the wins you can get — when you can get them. Then just keep going," Albert says.

Conclusion

Finding a solution that is sustainable and fair to retirees, employers, current and future employees, and taxpayers may seem impossible, but several states and cities have succeeded. Implementing changes to pension systems is so challenging because the issue is as much political as it is financial, and these political decisions are often made without a good understanding of how pension plans work or what's possible to both protect retirement security and make plans more sustainable.

No one wants to cut benefits to workers who have dedicated themselves to public service, but state and local governments also can't always afford these mounting costs. The good news is that it's almost always possible to make progress without any reduction in earned pension benefits. Successful states and cities prove that with compromise, transparency and collaboration, governments can provide retirement security to employees. The risks of doing otherwise are just too great for everyone involved, so working across various interests is the only way to enact meaningful reform.

"Focus on the math and focus on the risk, because the risks are pretty substantial," says Nation of the Stanford Institute for Economic Policy Research. "Go to Stockton and ask employees who lost their retiree healthcare because the city filed bankruptcy. Go to Detroit and ask employees and retirees who've taken big reductions in their payments because the city didn't plan well. They would probably say, 'I wish someone had told me. I wish someone had told me what the risk was.'"

This piece was developed and written by the Governing Institute Content Studio, with information and input from RSI.

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