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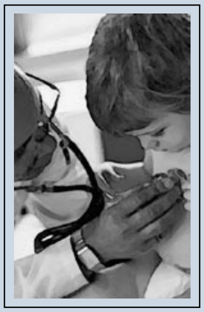

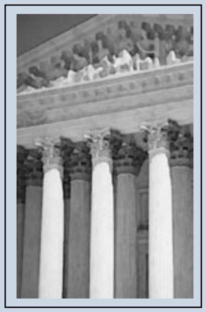

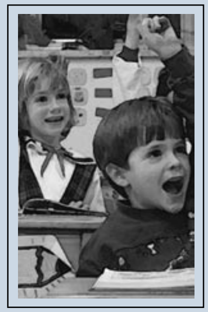

What Now For PERA: Déjà Vu All Over Again?

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Executive Summary

Colorado's Public Employee Retirement Association (PERA) is experiencing a financial crisis. The current financial crisis has resulted in a significant decrease in the value of PERA's portfolio. But the financial crisis in PERA is not just the result of the current financial crisis. PERA's defined benefit pension plan is fundamentally flawed; the problems in the plan have emerged over several decades. While the current financial crisis has exacerbated these problems, PERA is facing a long-run deterioration in its financial condition.

The legislature has enacted several reforms over the past decade to address PERA's financial problems. These reforms have included changes in benefits, increased contribution rates, and administrative changes. Unfortunately, these reforms have failed to address the fundamental flaw in PERA's defined benefit plan.

This Issue Paper explores the financial crisis in PERA. Different measures of the magnitude of the crisis are examined, and the flaws in PERA's defined benefit plan are analyzed. The failed legislative reforms of PERA are critically evaluated.

The Issue Paper concludes that the legislature should consider declaring a financial emergency and enacting the fundamental reforms needed to solve PERA's financial crisis. Other states have successfully reformed their own state employee pension plans by replacing a defined benefit plan with a defined contribution plan.

The legislature must not repeat the mistakes of the past with band-aid solutions that fail to address the underlying causes of the financial crises in PERA. This is no time for déjà vu all over again.

The Magnitude of the Financial Crisis in PERA

Unfunded Liabilities

During the past year the market value of the entire PERA portfolio fell precipitously, from $41.4 billion to $30.1 billion. The $11.3 billion decrease is a 27.2 percent drop in the value of the portfolio. At the beginning of the year unfunded liabilities, i.e. the excess of the present value of assets over liabilities, was $12.3 billion. With the decrease in the value of assets over the past year, the unfunded liabilities have almost doubled, to about $24 billion.[1]

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Another measure of the magnitude of the crisis is the funding ratio, i.e. the ratio of the present value of assets to liabilities in the fund. At the beginning of the year the funding ratio was 78 percent; at the end of the year it was 57 percent.[2]

Amortization Periods

To determine whether a pension fund is actuarially sound we can refer to standards set by the Government Accounting Standards Board (GASB). GASB statements No. 25 and 43 set a maximum amortization period of 30 years. In other words, to determine if a pension plan is sound, actuaries must determine if unfunded liabilities in the plan will be paid off in a maximum of 30 years. This maximum amortization period is also set in Colorado law[3], which requires state and local government pension plans meet the 30-year standard.

The following tables show the unfunded liabilities and amortization periods of pension plans as of December 31, 2007. Table 2 includes both the Amortization Equalization Disbursement (AED) and Supplemental Equalization Disbursement (SAED). These additional contributions to the plans are required by laws enacted in 2004 and 2006, and are discussed later in this Issue Paper. Even with these additional contributions, the state, school, and health care plans do not meet the standard maximum amortization period of 30 years. Given the decreased value of assets in these plans over the past year, it is likely that none of these plans meet the 30-year standard.

Table 1. Unfunded Liabilities as of December 31, 2007

Trust Fund	Unfunded Liability (in Thousands)	Amortization Period
State	$5,169,615	infinite
School	$7,170,659	infinite
Local Gov.	$670,352	25 years
Judicial	$32,982	94 years
Health Care	$1,044,819	38 years

*From Comprehensive Annual Financial Report, December 31, 2007, as reported in Briefing Issue. FY 2009-10 Joint Budget Committee Staff Budget Briefing, Department of Personnel and Administration, Dec. 22, 2008

Table 2. Amortization Period (with AED and SAED) as of December 31, 2007

Trust Fund	Amortization Period With AED	Amortization Period With AED and SAED
State	Infinite	69 years
School	Infinite	42 years
Local Gov.	24 years	14 years
Judicial	78 years	22 years
Health Care	38 years	38 years

*From Comprehensive Annual Financial Report, December 31, 2007 as reported in Briefing Issue. FY 2009-10 Joint Budget Committee Staff Budget Briefing, Department of Personnel and Administration, Dec. 22, 2008

Required Contribution Rates

An alternative way to measure the magnitude of the financial crises in PERA is provided by GASB. This measure is the Annual Required Contribution (ARC) rate calculation to meet the maximum 30-year amortization standard. The following table compares the ARC rate with the actual contribution rates for each fund, including the Amortization Equalization Disbursement (AED). Table 3 shows that actual contribution rates fell short of ARC rates for all the funds. The current shortfall in contribution rates is expected to be significantly greater than it was at the beginning of the year.

Table 3. Contribution Rate Sufficiency December 31, 2007*

Trust Fund	ARC	Employer Contribution	Health Care Contribution	AED	Contri-bution Available for Funding
State Division	18.45%	10.15%	-1.02%	1.00%	10.13%
State Troopers	N/A	12.85%	-1.02%	1.00%	12.83%
School Division	17.18%	10.15%	-1.02%	1.00%	10.13%
Local Gov.	11.95%	10.00%	-1.02%	1.00%	9.98%
Judicial Division	17.66%	13.66%	-1.02%	1.00%	13.64%
Health Care	1.10%	N/A	-1.02%	N/A	1.02%

*From Comprehensive Annual Financial Report, December 31, 2007, as reported in Briefing Issue. FY 2009-10 Joint Budget Committee Staff Budget Briefing, Department of Personnel and Administration, Dec. 22, 2008
N/A - Not Available

The Annual Required Contribution (ARC) rates can be used to calculate the impact of the financial crises in PERA on taxpayers. Legislative staff has calculated the increased contribution into the State Division of PERA that would be required to meet the maximum 30-year amortization period standard. According to a staff estimate, annual state contributions to that fund would need to increase $111 million, from $136 million to $247 million. This estimate was based on data at the beginning of 2008. Given the dramatic decrease in the value of assets in the fund over the past year, it is likely that required increased contributions may be double that amount.

Note that this estimate does not take into account the increase in contributions that would be required for other pension funds as well as the fund for state employees.

A recent National Bureau of Economic Research (NBER) study suggests the funding status of PERA is much worse than reported.

A recent National Bureau of Economic Research (NBER) study suggests the funding status of PERA is much worse than reported.[4] The reason is that PERA continues to assume an unrealistically high investment rate of return (8.5%).[5] Given the investment performance of PERA over the past decade, and especially over the past year, the question is why PERA continues to assume an unrealistically high investment rate of return. It is not clear what discount rate PERA uses to calculate the present value of Liabilities. The NBER study suggests these pension funds use an unrealistically high rate of discount that results in underestimates of liabilities, and this would appear to be the case with PERA.

The Joint Budget Committee staff concludes that "the current schedule of amortization is outside of statutorily established guidelines".[6] Additionally, it is outside of GASB guidelines.

The financial crisis in PERA occurs in a year when the state faces a revenue shortfall requiring budget cuts. The state simply does not have the funds to increase contributions to make the pension funds actuarially sound.

If the financial crisis in PERA were a short-term problem then one might argue that the legislature could continue to muddle along in hopes that the market will improve, and that revenues will recover to enable the state to meet the required increase in contribution rates. The flaw in this reasoning is that the financial crisis in PERA is a long-term structural problem that has occurred over several decades, and that will continue for the foreseeable future. Further, past reforms, including increased contribution rates, have failed to address the fundamental structural problem, and there is no reason to expect such reforms to do so in the future. It is essential to understand the causes for the financial crisis in PERA, and to enact fundamental reforms in PERA to solve the problem. The legislature can no longer stick its head in the sand and watch the financial position of PERA continue to deteriorate. When states fail to meet GASB standards in their pension plans, bonding agencies downgrade their bonds. Taxpayers end up paying higher taxes to cover the higher interest rates, as well as to meet the pension fund obligations.

Causes of the Financial Crisis in PERA

Management Decisions

In 2005 then-State Treasurer Mike Coffman appointed a "Commission to Strengthen and Secure the Public Employee's Retirement Association." The Commission held a series of hearings and also conducted research into the causes of the funding crises in PERA. The Commission concluded that the funding crisis was not simply the recent market declines; but rather a series of management decisions that collectively caused the crisis.[7]

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Increase in the Cost of Living Adjustment (COLA)

Beginning in the early 1990s, the COLA, an annual increase of benefits to compensate for inflation, was adjusted several times without, in the Commission's opinion, a clear strategic objective. This approach to setting a core actuarial variable statutorily culminated in the 2000 legislative decision to set the COLA at 3.5 percent per annum—regardless of changes in the economic environment or even the core inflation rate.

Lowering of the Retirement Age

Also a 2000 legislative change, the so-called "Rule of 80" was modified to allow for retirement with unreduced benefits as early as age 50 with 30 years of service credit. The decrease in the age of eligibility sparked a wave of retirements before the age of 55, from 124 in 1998 to 851 in 2004—a more than 680 percent increase.[8]

Purchase of Service Credits Below Actuarial Cost

Among the more damaging of changes to the PERA funding equation was the PERA Board of Trustees' decision to allow the purchase of service credits—essentially the financial equivalent of a year worth of work—at a level drastically below the actuarial cost of the credits. In 2003 alone, PERA members purchased $772 million of service at the drastically subsidized rate, resulting in a dramatic increase in unfunded liabilities.[9]

MatchMaker Program

Created in 1999, the MatchMaker program allowed PERA members to contribute to a voluntary defined contribution account and receive a matching portion from his or her employer. Unfortunately, the employer match came from contributions the employer already made to the existing defined benefit program, resulting in the defined benefit program subsidizing the defined contribution program.

Recent evidence reveals that PERA administrators continue to repeat mistakes they have made in the past, resulting in accumulation of even greater unfunded liabilities in the plan.

Investment Performance

A decade ago PERA administrators had most of the assets of the plan in equities. When the stock market bubble burst in 2001, PERA suffered a sharp drop in the value of assets in the portfolio. PERA then shifted more of the portfolio into fixed income assets, and promised to pursue more prudent investment policies. Recent evidence reveals that PERA administrators continue to repeat mistakes they have made in the past, resulting in accumulation of even greater unfunded liabilities in the plan.

Table 4 shows the current market value of assets in the PERA portfolio. At the beginning of 2008 PERA had 60 percent of assets in domestic and international equities. The value of these equity shares has fallen 23 percent, accounting for most of the increase in unfunded liabilities. PERA appears to have made the same investment mistakes it made a decade ago.

Table 4. Market Valuation of PERA Investment Portfolio

Investment Type	Market Value Dec.31,2007	Percent of Total Market Value	Market Value Dec.12, 2008	Percent of Total Market Value
Domestic Equity	$17,894,976	43.3%	$10,931,745	36.3%
Intl. Equity	$6,501,567	15.7%	$3,764,375	12.5%
Fixed Income	$9,903,354	23.9%	$7,709,440	25.6%
Alternative	$3,204,459	7.7%	$3,162,075	10.5%
Real Estate	$3,120,362	7.5%	$3,222,305	10.7%
Timber	$462,255	1.1%	$451,725	1.5%
Cash and Short Term	$286,431	0.7%	$873,335	2.9%
Total	**$41,373,404**	**100.0%**	**$30,115,000**	**100.0%**

*From Comprehensive Annual Financial Report, December 31, 2007 as reported in Briefing Issue. FY 2009-10 Joint Budget Committee Staff Budget Briefing, Department of Personnel and Administration, Dec. 22, 2008

Decrease in Employer Contribution Rates

The employer contribution rates to PERA have fluctuated dramatically in the past few years, reflecting a lack of coherent strategic planning and an overreaction to changes in the market environment. For example, between 1997 and 2003 PERA's state and school division had six different contribution rates, from a high of 11.5 percent to a low of 9.9 percent to its current 10.15 percent.

Lack of Transparency

There has been very little public discussion of the financial crisis in PERA. The lack of transparency is one of the reasons there has been little serious effort to address the crisis. The tables presented in the first part of this Issue Paper were based on information provided by the legislative staff to the Joint Budget Committee. The data make it clear that PERA is not meeting the standards set in GASB rules, and in Colorado Statutes. Evidence for the amortization period and Annual Required Contribution Rates reveal serious deterioration in PERA's funding status. However, PERA's own reports and testimony to the legislature do not report that information; indeed, they have attempted to obfuscate the magnitude of the financial crisis.

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The legislative reviews of PERA have been cursory at best. In the January 14, 2009, review Representative Kent Lambert asked the PERA administrators why they don't declare an actuarial emergency and begin reforms to address the problem of unfunded liabilities immediately. Their response was that they needed a year to study the problem.[10]

There has been very little media coverage of PERA's problems. A few years ago a series of articles in the *Rocky Mountain News* by David Milstead identified a number of abuses of funds by the PERA Board.[11] Milstead documented a bevy of very generous pay and perks captured by PERA Board members, from private autos to costly travel and education benefits.

This media coverage focused attention on the ability of the PERA Board to use PERA resources to benefit their personal interests. The coverage led to a serious discussion of the lack of oversight of PERA by elected officials. However, there is still little public awareness or discussion of the financial crisis in PERA. The lack of transparency has made it difficult to generate discussion of the causes of the financial crisis and potential solutions.

Reforming PERA

While the origins of the financial crisis in PERA can be traced back over several decades, the magnitude of the crisis became apparent only in the last decade. The legislature has responded to the crisis with a series of reforms addressing specific problems in the plan.[12]

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2003

Legislation enacted in 2003 limited the number of years of non-covered service to a total of 10 years.

2004

In 2004 the PERA Board negotiated a reform package enacted by the legislature. This so-called "compromise" included several provisions:

- **Increase Retirement Age:** Increase in the retirement age for unreduced benefits from age 50 to age 55 for employees hired on or after July 1, 2005
- **Reduce Annual COLA:** Reduce annual COLA from 3.5 percent to the lower of 3 percent or the rate of inflation for employees hired on or after July 1, 2005
- **Terminated MatchMaker:** Terminated MatchMaker contributions for all members after June 1, 2004
- **Increase Employer Contributions:** Increase in the employer contribution rates, including a complicated new rate increase paid for by employers, termed an Amortization Equalization Disbursement that will continue to increase through 2012
- **Unreduced Service Retirement Eligibility:** Eliminated the eligibility requirement at age 50 with 30 or more years of service, for new employees hired on or after July 1, 2005

2005

The legislature agreed in 2005 that amortization equalization disbursements would be paid by employers on the salary they pay to Colorado PERA retirees who are working as independent contractors or in certain other arrangements, and who are performing services for Colorado PERA employers.

2006

In 2006 the PERA Board also reached a compromise with the legislature enacted into law with the following provisions:

- **Supplemental Amortization Equalization Disbursement:** This additional contribution is scheduled to come from salary increases that would have otherwise been awarded to employees over a six-year period. The collection of 0.5 percent of salaries began in January 2008. However, if the salary increase is not funded it is not clear where the funding for this contribution will come from.
- **Two-Tiered Benefit Plan for New Employees:** Modified benefits for new employees hired on or after January 2, 2007. The annual percentage used to calculate benefits for new employees is lower than that for employees hired prior to that date.
- **30-Year Amortization:** Specified a 30-year amortization period in statute.
- **Actuarial Study:** Required that an actuarial study be commissioned by the General Assembly before any benefit enhancement can be made.
- **PERA Board of Trustees:** Modified the structure of the PERA Board of Trustees. The Board was expanded to include three trustees appointed by the Governor who are not members of PERA, and who have financial expertise.
- **Defined Contribution Plan:** Eligible employees can elect to participate in PERA's voluntary defined contribution plan as an alternative to the defined benefit plan. The 2006 legislation expanded the voluntary defined contribution and defined benefit plan to new employees of institutions of higher education.

The Need for Fundamental Reform of PERA

The information provided above makes it clear that PERA is in a financial crisis. Clearly the reforms of PERA that have been enacted have failed to improve the funding status.

> ***Clearly the reforms of PERA that have been enacted have failed to improve the funding status.***

Sadly, there has been very little concern or even discussion of this financial crises. This complacency was evident in testimony by the PERA Board before the Tax Commission. PERA Director Meredith Williams implied that there was no funding crisis, and that PERA could continue to muddle along as they have in the past.[13]

Williams' response to the legislature in testimony this year was that "immediate action is premature", and that PERA needs a year to study the problem.[14] PERA leaders claim they can muddle through the crisis as they have for the last decade, even as the funding status has continued to deteriorate. PERA proposed a number of studies over the next year, none of which will analyze the impact of fundamental reform of the pension system.[15]

PERA cites the Nov. 18, 2004, Attorney General opinion as an excuse not to consider fundamental reform of the pension system; this is the same tactic that PERA has used any time that serious reform efforts are considered:

> Even if certain pension benefits are contractual rights protected by the Colorado Constitution, and even if such pension rights are partially vested pension rights, Colorado courts have consistently allowed changes under certain conditions. The test is that any adverse change must be balanced by a corresponding

> change of a beneficial nature, a change that is actuarially necessary, or a change that strengthens or improves the pension plan.[16]

That opinion is of course subject to different interpretations, and has not yet been tested in a court of law.

It is clear PERA will not declare an actuarial emergency, no matter how badly the funding ratio deteriorates. The legislature could declare an actuarial emergency, which would establish the legal basis for fundamental reform of PERA. It is also possible that the legislature could enact such reforms without declaring an actuarial emergency.

It is clear PERA will not declare an actuarial emergency, no matter how badly the funding ratio deteriorates.

Each time the legislature has attempted to address the problem of unfunded liabilities, it has entered into a compromise with PERA. The result has been legislation that applies a band-aid solution without addressing the fundamental problem.

Few politicians in Colorado seem to acknowledge the existence of a funding crisis in PERA. When political leaders, such as former State Treasurer Mike Coffman, have acknowledged a funding crisis exists they immediately come under fire from the PERA Board, public sector employee unions, and other special interests who have a vested interest in continuing the existing PERA pension plan, regardless of the cost to taxpayers.

The crisis is not simply the result of poor judgment by PERA policy makers and the politicians who are supposed to exercise oversight. The funding crisis in PERA reflects a systemic flaw resulting from what economists refer to as "moral hazard."

A "moral hazard" exists when individuals make decisions for which they will not bear the consequences. In these circumstances individuals have little incentive to make good long-term decisions. In the case of the PERA Board this moral hazard is exacerbated by the fact that most Board members are beneficiaries who have a direct financial interest in PERA pension benefits.

Moral hazard is inherent in the defined benefit plan offered by PERA to employees. The costs of the unfunded liabilities in the system will be incurred over several decades. The PERA Board, public sector union negotiators, and elected officials make key decisions about the operation of PERA. In the long run these decision makers will not be held accountable to the taxpayers who must bear the costs—because they will have left office decades before the system goes bankrupt, or massive spending cuts on other state programs (probably coupled with massive tax increases) are needed to keep it solvent. The PERA Board has negotiated generous pay and pension benefits for themselves and other employees, the full costs of which will not be seen for many years, long after they have left the Board. Elected officials have significantly increased employer contributions to PERA, contributions that will increase taxes for many decades after they have retired.

... one way to eliminate the politicization of pension decision making and remove the moral hazard is by replacing the defined benefit plan with a defined contribution plan. In a defined contribution plan, individual employees own the assets in their personal pension accounts.

The moral hazard will continue as long as the PERA pension plan is based on defined benefits. Third parties will continue to negotiate pension benefits and costs under a defined benefit plan. However, one way to eliminate the politicization of pension decision making and remove the moral hazard is by replacing the defined benefit plan with a defined contribution plan. In a defined contribution plan, individual employees own the assets in their personal pension accounts. The individual employee assumes the costs as well as the benefits of ownership of these pension assets.

This Issue Paper will now explain how a defined contribution plan would empower PERA employees to make their own pension decisions free from intervention by bureaucrats, politicians, and special interests.

A Defined Contribution Plan: Solving the Funding Crisis in PERA

The financial crisis in PERA will not be solved until the legislature enacts fundamental reform in the pension plan, similar to reform enacted in other states. Establishing the model, the Alaska legislature replaced a defined benefit pension plan for public employees with a defined contribution plan. The administration of the old defined benefit plan was eliminated, and a new administration of the defined contribution plan appointed by the state.[17]

PERA was designed for a bygone era. Today, the trend in both the private and public sector is to replace defined benefit plans with defined contribution plans. Across the country state and local governments are adopting defined contribution plans to provide workers with greater control over their retirement future, and to ease the burden on taxpayers. The result has been a convergence of public sector pension systems with those offered in the private sector.[18]

Colorado's PERA system needs to be greatly simplified and rationalized so that the system is not so detrimental to the taxpayers.

Colorado's PERA system needs to be greatly simplified and rationalized so that the system is not so detrimental to the taxpayers. Well-structured reforms can provide generous benefits to workers while actually reducing costs for both workers and taxpayers. Reform of PERA should focus on designing a new defined contribution system for newly-hired workers. Over time, as the newly hired workers become an increasingly larger component of the workforce, the problems in the current system would disappear. Most importantly, the unfunded liabilities in PERA could be gradually reduced and eliminated.[19]

Employers in the new defined contribution system could make smaller contributions than they currently contribute to the defined benefit plan. Employers would then pay these saved amounts towards covering the unfunded liabilities of the current system for current workers. This would reduce the burden on taxpayers, who must assume the burden of unfunded liabilities in the current system. After all funding gaps are eliminated, these savings would then remain with the employer, resulting in a continuing net reduction in the burden on taxpayers.

In this proposed reform all new workers would be automatically enrolled in the defined contribution plan from the start of their employment. Each worker would make contributions to a personal account, choosing from an approved list of investment options. The options would include a list of stock funds, bond funds, and a range of fixed investments. The list might also include approved money managers who would pick the investments for the workers.

Workers who leave public employment could take their personal accounts with them as an IRA or 401(K) asset for their future retirement.

The defined contribution plan would carry no vesting requirements. Workers immediately would own the assets in their personal accounts. As long as the worker continued to work for a Colorado public employer covered by the system, he or she would not be permitted to withdraw funds from the account before retirement. Workers who leave public employment could take their personal accounts with them as an IRA or 401(K) asset for their future retirement. Funds in those accounts would then accumulate tax-free until withdrawn at retirement.

When the worker in the defined contribution system retires, their retirement benefits would equal what the funds accumulated in their personal accounts could pay. When the worker chooses to retire and receive these benefits would be entirely up to the worker, subject to any federal restrictions on withdrawal of these funds.

Current workers would be given the freedom to choose to switch to a defined contribution plan in place of their current defined benefit plan. Many of these current workers may find the benefits of a defined contribution program desirable. Younger workers or workers who plan to leave public sector employment within a 10-year period would find the option particularly appealing.

This proposed reform would make no change in the benefits received by current PERA retirees. Further, there would be no change in the benefits of current employees who choose to remain in the defined benefit plan.

For those employees who switch to the defined contribution plan, all past employee contributions to the defined benefit plan would be transferred to the defined contribution plan. Vested current employees who choose to switch would receive an equivalent to the retirement benefits promised to them under the current PERA plan. An amount equal to the present value of their accumulated retirement benefits would be transferred to their defined contribution accounts.

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Advantages of the Defined Contribution Program

Advantages for Workers

A defined contribution plan has a number of potential advantages for Colorado workers depending upon how it is implemented.

Lower Cost

One potential advantage is lower cost for workers. In other states in which the defined contribution plan replaces a defined benefit plan employee contribution rates are reduced. This fact is especially important for Colorado because proponents of the defined benefit plan have proposed increasing employee contribution rates as a way to bail out the program.

Vesting

In Colorado, employees in PERA must work for an employer at least five years before he or she is eligible for benefits. A defined contribution reform plan would eliminate any vesting requirement. In a defined contribution plan, both employer and employee contributions are immediately paid into the personal account for each worker and become the personal property of that worker.

A defined contribution plan is especially advantageous for shorter-term workers who may remain in state and local employment less than the current vesting period of five years. Currently, under PERA's defined benefit plan these workers lose all employer contributions plus associated investment returns when they leave. Under a defined contribution plan these funds plus their own contributions and returns would remain in their personal accounts and go with them when they take a new job.

Portability

The current PERA plan has limited portability. PERA employees who leave can only take their past employee contributions plus investment returns. They then lose all past employer contributions plus associated investment returns.

If PERA employees are vested, they can leave all of their money in the system and receive in the future the benefits for which they are eligible based on their limited period of service. But in that case they still are not able to take their money with them. They must leave behind all past contributions and returns.

PERA's defined benefit plan is clearly biased toward older workers. It was created in an era when it was common for workers to stay with one employer their entire career...

PERA's defined benefit plan is clearly biased toward older workers. It was created in an era when it was common for workers to stay with one employer their entire career; but it is not a fair system for a modern workforce in which it is common for workers to change employers several times during their career.

A defined contribution plan would provide workers with complete portability. Workers who leave government employment would take their entire individual account with them, including all past employer and employee contributions plus full market investment returns

Fair Benefits for All Workers

PERA's defined benefit plan is biased toward older and longer term workers. This bias results from several factors. First, the benefits are a percentage of average salary, which tends to be much higher for older workers and those who have worked the longest.

Second, granting the same percentage of final salary for each year worked does not give younger workers the full value of their contributions. Even though contributions for younger workers earn investment returns for many more years than for older workers, they get no credit for the additional years of returns.

Inflation can make the problem even worse. When benefits are calculated based on salary, they incorporate an adjustment factor for inflation. But for younger, shorter-term workers, the inflation adjustment stops if they leave government employment.

A defined contribution plan would provide all workers with completely fair benefits.

A defined contribution plan would provide all workers with completely fair benefits. They would be completely fair because all workers would get the same market returns on the contributions into their accounts every year throughout their careers. Workers would earn these returns on their accounts throughout their careers regardless of where they work.

A defined contribution plan is similar to a 401(K) plan in the private sector. Individuals would own and control of their own accounts. There are a number of reasons why workers could expect to earn returns at least as good or better than the returns in a defined benefit plan.

Investment managers for defined benefit plans often invest to meet some defined benefit target. The flaw in these defined benefit plans is the disconnect between the benefits that workers receive and the return on assets in the plan. If the assets do earn a higher return than the target rate of return, those higher returns do not necessarily accrue to workers. Most of these defined benefit plans earn a lower return than the target rate of return, which is the case with PERA. When earnings are below target rates of return, then workers and taxpayers are at risk because earnings plus contributions are inadequate to fund benefits promised.

Most of these defined benefit plans earn a lower return than the target rate of return, which is the case with PERA.

With a defined contribution plan, workers would have access to a number of professionally-managed investment options. They could design a retirement investment strategy best suited to their personal needs. The risk-return ratio in their portfolio is consistent with their preferences rather than that of an administrator of a defined benefit plan.

A common criticism of defined contribution plans is that individuals assume the risk of the portfolio in their plan, and they could reach retirement without a minimum level of assets to meet their retirement needs. However, it is possible to structure the defined contribution plan to minimize this risk, as is the case in Michigan. Individuals may be given a choice of retirement funds that excludes riskier investments such as hedge funds. The default portfolio could be a target fund that shifts from stocks to bonds as the individual approaches retirement. Individuals might be required to allocate a minimum amount of their contribution to a fixed annuity.

Advantages For Employers

An important advantage for employers in a defined contribution program is greater control over costs. In a defined benefit plan such as PERA, where the government agrees to make specific payments to beneficiaries, costs may increase for a number of reasons. Employees may choose to remain employed for longer periods. With longer life expectancies, benefit payments must be extended over longer life spans. If market performance deteriorates, government employers must make larger contributions to the plan to make up the difference. All of these factors have resulted in greater costs to employers in the PERA system.

In a defined contribution plan the employer agrees to a specified contribution to the plan. There is no uncertainty regarding the amount of the contribution due to external factors. As a result the employer faces greater certainty and predictability in budgeting.

Advantages for Taxpayers

A defined contribution plan would have many advantages for Colorado taxpayers compared to the current defined benefit plan in PERA.

Lower Costs

In states in which a defined contribution plan has replaced the defined benefit plan, taxpayers benefit from reduced costs. Contribution rates for employers as well as employees are reduced.

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Cost savings also are generated by reducing operational overhead to manage the defined contribution plan. This advantage is especially relevant in the case of PERA. As noted above, investigative reporting by the *Rocky Mountain News* uncovered many questionable management practices and excessive expenditures by the PERA Board and Management.

Eliminating Investor Risk

A major advantage of a defined contribution plan is that it eliminates investment risk for taxpayers. Under PERA, taxpayers bear the complete risk of poor investment performance. Because of poor investment decisions, PERA has accumulated a pool of assets worth less than the liabilities to beneficiaries. Taxpayers must now make up this difference. A defined contribution plan completely eliminates this investment risk, because taxpayers are not liable for the investment performance.

Eliminating Unfunded Liabilities

A major advantage of a defined contribution plan is to reduce and ultimately eliminate unfunded liabilities in the state pension system. With PERA's defined benefit plan, it is taxpayers who ultimately must bear the risk of investment and management decisions. If those decisions result in unfunded liabilities, as they have under PERA, taxpayers must assume that liability. New workers covered by a defined contribution plan would not have any unfunded liability associated with them. Their future benefits would be fully funded through their personal accounts.

As newer workers become an ever greater fraction of the public workforce, the unfunded liabilities of a defined contribution plan would decline because the number of workers producing those liabilities would be smaller. In the long run, eventually all workers and then all retirees would be covered by the defined contribution plan, and the unfunded liabilities would be eliminated.

Adopting a defined contribution plan would of course not eliminate the existing $24 billion in unfunded liability in the PERA system. However, this reform also could produce additional funds to help reduce the unfunded liabilities more quickly over time. If employer contribution rates are reduced, some of the saved funds could then be devoted to closing projected unfunded liability gaps. Only a relatively small amount of savings would be generated in the short run; however, in the long run these saved funds would add up to larger amounts, making a much bigger dent in projected unfunded liabilities.

Perhaps the greatest advantage of a defined contribution plan is that it eliminates the danger of any future unfunded liability from any source that must be covered by taxpayers.

Perhaps the greatest advantage of a defined contribution plan is that it eliminates the danger of any future unfunded liability from any source that must be covered by taxpayers. Under a defined benefit plan, such as PERA, a shortfall in the common investment pool that leaves the pool unable to pay the promised benefits creates an unfunded liability that must be covered by the taxpayers. In the defined contribution plan, the government does not maintain a common investment pool; rather, retirement benefits equal what the account funds can finance. A defined contribution plan is always fully funded so there is no possibility of an unfunded liability that taxpayers would have to cover.

Eliminating Political Risk

In any defined benefit program there are always political risks, and some of these risks are clearly evident in Colorado's PERA system. The fundamental flaw here is the moral hazard. Politicians extend benefits to teachers and other beneficiaries that are not financially sustainable. The problem was especially apparent during the prosperous 1990s when the stock market was booming. During that period the PERA Board made investment decisions that exposed beneficiaries to great volatility. Those decisions were largely hidden from the most important stakeholders in the PERA system: taxpayers, who must ultimately foot the bill for unfunded liabilities.

The PERA Board is dominated by public sector employees and beneficiaries. These Board members lack the expertise and experience of private investment managers.

Clearly, there also is a fatal flaw in the governing structure of the PERA system. The PERA Board is dominated by public sector employees and beneficiaries. These Board members lack the expertise and experience of private investment managers. While there is some attempt to limit bureaucratic control by contracting out some investment decisions to private investment managers, this has not been successful. Clearly there were pressures from self-interested Board members to make investment decisions that carried great risk.[20]

It should not be surprising that politicians largely failed to exercise the oversight function that would have protected taxpayer interests from the abuses in the PERA system. That oversight function is very loosely defined in the case of PERA. Even if the oversight function had been clearly specified, it is not clear politicians have the incentive to protect taxpayer interest in the state pension system. Teachers unions and other public sector unions have a great deal of clout in the state political system. Politicians are reluctant to confront these special interests in exercising an oversight function over PERA. A defined contribution plan removes investment decisions from the influence of politicians and special interests.[21]

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There are also political risks in the large pool of assets accumulated by PERA. Political pressures can be used to allocate the funds to special interest groups within the state. Those assets also can be used to apply pressure in the private sector. For example, private corporations could be pressured to reach collective bargaining outcomes, or to take a particular position on public policy issues such as social security reform. PERA seems to have avoided these specific political risks, but the potential for abuse is always present in a defined benefit system. There has been a major problem in California, where the state pension system has used funds investment as a way to influence all sorts of decisions. It is certainly a potential hazard in Colorado, especially given the current PERA Board. In a defined contribution plan, where the government does not maintain a large pool of assets, these political risks are nonexistent.

Conclusion

If PERA were a private pension fund it would be declared insolvent. Insolvency is the basis for restructuring pension plans in the private sector, including the replacement of defined benefit plans with defined contribution plans. But because PERA is a public pension system it is ultimately the responsibility of Colorado taxpayers. Make no mistake, it is taxpayers who must make up the difference between assets and liabilities in PERA.

Taxpayers are already on the hook for $24 billion in unfunded liabilities, and they will have to pay for any future unfunded liabilities incurred in the system.

Colorado citizens may well ask how we got into this PERA mess. The explanation is that the people making these pension decisions do not have to bear the cost. The PERA Board and the unions who represent public sector employees negotiated benefits for those employees for which they are unable to pay. Elected officials charged with oversight of the state pension system failed to fulfill their charge. As a result, taxpayers will be paying taxes to finance these benefits long after these bureaucrats and politicians have left. Without reform, spending on almost every other state-funded program will have to be cut drastically.

It is interesting to note that politicians have not been willing to ask Colorado taxpayers directly to foot the bill for the unfunded liabilities in PERA. Some states have issued new debt and used the proceeds of the debt to offset unfunded liabilities in their state pension system. Politicians know that under the Taxpayer's Bill of Rights, they must ask for voter permission to issue such debt. If voters were asked via a referendum to incur huge additional debt, voters would ask the obvious questions. The unfunded liability in PERA is the result of overly generous benefits extended to public sector employees that are not available to citizens in private pension plans.

There is no reason why benefits in public pension plans should not be brought into line with benefits in private pension plans, and for most citizens that is a defined contribution plan.

There is no reason why benefits in public pension plans should not be brought into line with benefits in private pension plans, and for most citizens that is a defined contribution plan.

The reality is that Colorado citizens cannot do much about the funding crisis that already exists in PERA. But we can stop the bleeding by enacting a fundamental reform in the state pension system: replace the defined benefit plan with a defined contribution plan.

In the current defined benefit plan PERA agrees to pay retirees a given benefit, and employees and employers make contributions into a common pool of assets to fund these benefits. The PERA Board is responsible for this pool of assets. If the value of the assets is less than the liabilities in the system, then taxpayers must make up the difference. This is why a defined benefit system such as PERA becomes so politicized.

It would be relatively simple to switch PERA from a defined benefit plan to a defined contribution plan. In fact, most private pension systems and a growing number of public pension systems have already made the switch. New employees are required to sign up for the defined contribution plan. Current employees are given the option of signing up for the defined contribution plan or sticking with the defined benefit plan. For those who make the switch, all past contributions to the defined benefit plan are transferred to the defined contribution plan. For those workers vested in the defined benefit plan, an amount equal to the present value of their accumulated retirement benefits is also transferred to the defined contribution plan. Current retirees continue to receive the benefits they have accrued in the defined benefit plan.

Citizens may well ask: If this switch to a defined contribution plan is so simple, why hasn't it happened?

Citizens may well ask: If this switch to a defined contribution plan is so simple, why hasn't it happened? One reason is that media and policy-makers have done little to inform the public of the PERA funding crisis. While the media has revealed problems of mismanagement and misuse of funds in PERA, such as free cars for PERA officials, there has been little coverage in the media of the funding crisis.

There is also a more fundamental explanation for the failure to reform the PERA system. Those who have made decisions creating the funding crises—PERA Board members, public employee union negotiators, and elected officials responsible for overseeing the state pension system—have not been held accountable for those decisions. Unfortunately, the same decisionmakers would have to introduce and implement reforms in the system. All of them have a vested interest in keeping the existing defined benefit plan intact, despite the cost to taxpayers. This is especially true of PERA Board members and public sector unions, who are the direct beneficiaries of the generous pay, pension benefits, and other perks. Many elected officials supported by these special interests are unwilling to confront them over the pension issue; and elected officials who advocate systemic pension reform are subject to attack.

The question then is if other states have successfully reformed their state pension system, why can't Colorado? Our state will make the switch from defined benefits to defined contributions only when there is transparency and accountability in the pension system. It is unrealistic to expect the current PERA Board to implement this reform. The current PERA Board, which is comprised of public sector employees who are beneficiaries of the current pension plan, must be replaced. Other states that have adopted a defined contribution plan, such as Alaska, create a governing board comprised of individuals with expertise and experience in managing pension funds, and with no direct vested interest in the benefits of that pension system.

Colorado citizens can no longer afford a state pension system dominated by special interests.

Colorado citizens can no longer afford a state pension system dominated by special interests. Reforming PERA will require grassroots support from citizens who understand the funding crisis and who are willing to work to reform the state pension system. It will also require courageous politicians willing to stand up to the special interests in PERA, and begin to protect taxpayers from their rent-seeking. Reforming PERA is a formidable task, but one that is both doable and worth doing.

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Endnotes

[1] Legislative Staff, Briefing Issue, FY 2009-10, Joint Budget Committee Staff Budget Briefing, Department of Personnel and Administration, December 22, 2008.

[2] Ibid.

[3] Colorado Revised Statutes § 24-51-211.

[4] Robert Novy-Marx and Joshua D. Rauth, "The Intergenerational Transfer of Public Pension Promises", National Bureau of Economic Research Working Paper 14343 (September 2008).

[5] Report of the Independent Actuary, Cavanaugh Macdonald Consulting, LCC. May 29, 2008, p.88.

[6] Briefing Issue, p. 17.

[7] The following information is a compilation of PERA testimony, PERA Annual Reports, and the Final Report, Commission to Strengthen and Secure the Public Employees Retirement Association, 2005.

[8] PERA Report to the House and Senate Finance Committees, January 20, 2005.

[9] In 2002, the Board of Trustees did begin a gradual increase in the cost of service credits so that by 2006 all service credits were priced at their full actuarial cost.

[10] Michael Booth, "PERA Won't Seek Changes Until 2010", *Denver Post*, January 14, 2009.

[11] David Milstead, "The PERA Puzzle", a four-part series of editorials in the *Rocky Mountain News*, various issues.

[12] Legislation enacted over the past decade includes Senate Bill 04-132, Senate Bill 04-257, Senate Bill 05-73, and Senate Bill 06-235.

[13] Colorado PERA Presentation to the Treasurer's Commission, March 4, 2005.

[14] Michael Booth, "PERA Won't Seek Changes Until 2010".

[15] Briefing Issue.

[16] Changes to PERA Retirement Benefits and Contributions, Formal Opinion of Ken Salazar, Attorney General, State of Colorado Department of Law, p.1.

[17] Barry W. Poulson, "Pension Liberation for Colorado: A Proposal to Reform PERA," Americans for Prosperity Foundation, (September 2005).

[18] For a survey of state pension and post employment benefit plans for public employees see. Standard and Poor's, "Market Volatility Could Shape Up State Pension Funding Stability", *Ratings Direct*, February 20, 2008; and "U.S. States are Quantifying OPEB Liabilities and Developing Funding Strategies As the GASB Deadline Nears", *Ratings Direct*, November 12, 2007.

[19] The states that have been most successful in replacing their defined benefit plans with defined contribution plans are Alaska, Michigan, and Oregon. Michigan's defined contribution plan for state employees has significantly reduced costs and made significant progress in reducing unfunded liabilities. A Michigan report notes that as the MSERS (Michigan State Employees Retirement System) gets closer to retiring its final defined benefit employees (in about 50 years), it will rely more and more on the assets in the system rather than on contributions of the active members, since the number of active members will continue to decline., Joe Carrasco, Jr., "Membership and Contribution Rate Changes for Michigan's Two Largest Retirement Systems---A 10-Year History", *State Notes Topics of Legislative Interest*, March/April 2005.

[20] When Alaska replaced its defined benefit plan with a defined contribution plan the state required that all Board members of the defined contribution plan have financial expertise; and also precluded any Board member in the defined contribution plan from being a beneficiary of the plan. This reform eliminates any conflict of interest on the part of Board members; and also helps to insulate the defined contribution plan from political influence.

[21] When individuals control their own assets in a defined contribution plan they will manage those assets in their own interests, not that of politicians and special interest groups.