Executive Summary

One step further on PERA reform

How to build on proposals from Colorado PERA and Governor Hickenlooper to eliminate unfunded liabilities and reduce burdens on state, local and school budgets

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About the REMI Partnership

A partnership of public and private organizations announced in July 2013 the formation of a collaboration to provide Colorado lawmakers, policy makers, business leaders, and citizens, with greater insight into the economic impact of public policy decisions that face the state and surrounding regions. The current partners include the Common Sense Policy Roundtable, the Colorado Association of REALTORS®, Colorado Concern, Colorado Bankers Association and the Denver South Economic Development Partnership. The partnership meets monthly to discuss pressing economic issues impacting the state and to prioritize and manage its independent research efforts.

Executive summary

For the fourth time in less than 20 years, Colorado's public pension system has reached a major inflection point. The long-term fiscal health of the state is on the line, and the situation cries out for determined, pragmatic and far-sighted leadership from our elected leaders. The threat is serious: Failure to control retirement costs has dragged down states like Illinois, where pensions consume one quarter of the budget, and bankrupted giants of U.S. industry like General Motors.

Currently, the Colorado Public Employees' Retirement Association (PERA) has an estimated $32 billion unfunded liability. The problem is a massive imbalance between the generous benefits offered by PERA and what state agencies, local governments and school districts can afford.

The PERA Board and Colorado Governor John Hickenlooper have recognized the urgency of the situation and have put major reform proposals on the table, urging action this year. Both the Governor and PERA deserve credit for their forward-leaning posture. But the Hickenlooper Administration has gone further, acknowledging a largely overlooked issue in the PERA debate: The escalating impact of taxpayer-funded employer contributions on state agencies, local governments and school districts, and how rising pension costs are crowding out other budget demands.

Last year, those taxpayer-funded state, local and school district employer contributions to PERA likely exceeded $1.6 billion, a number that has almost doubled over the past 10 years. This budget dilemma is not unique to Colorado. Eight years ago, a top official under New York Mayor Michael Bloomberg stated the problem in the following way:

> *"We've seen how General Motors became a pension fund that also made cars. Unless we make real changes, New York City's government is in danger of becoming a pension fund that occasionally delivers city services to the people who live here."*

No one wants to see Colorado become a giant pension fund that occasionally provides basic services to the people of our state, of course. But if we refuse to acknowledge the growing burden of pension costs on state agencies, local governments and school districts, and if we fail to explore the alternatives, that is the direction our state will be headed.

As a state, we must change course while we still can. Pension costs should not be allowed to crowd out funding for essential public services, including road maintenance and construction, new and expanded schools, police and fire departments, and more. We must put PERA on a sound financial footing, but not at the expense of other essential budget priorities in Colorado. This is common sense.

To foster a comprehensive and productive debate over public pension reforms in Colorado, the REMI Partnership has closely examined the PERA and Hickenlooper Administration reform proposals. Using these proposals as a foundation, we built a series of new scenarios that tackle the long-term solvency challenges of PERA while providing real savings for state agencies, local governments, school districts and, ultimately, Colorado taxpayers.

Developing and testing new reform scenarios is not intended to express support or opposition in relation to the proposals already offered by the PERA Board and Hickenlooper Administration. Rather, we seek to promote a thorough debate by informing the public and policymakers about a wider range of options and tradeoffs they can consider.

The table below outlines the major elements of the existing reform proposals, followed by a series of new "Hickenlooper Plus" scenarios developed for this report that build on the Governor's response to the PERA Board's proposal:

Major Elements of PERA Board, Hickenlooper and 'Hickenlooper Plus' Reform Scenarios

Scenario	Retirement Age for New Hires	Highest Average Salary	Annual Increase Suspension	New Annual Increase	Employee Contribution	Taxpayer Contribution	Assumed Rate of Return
PERA Board	65 (except state troopers)	5-year HAS	2 years	1.5%	+3% (existing) +2% (new)	+2%	7.25%
Hickenlooper	65 (except state troopers)	5-year HAS	2 years	1.25%	+2% (existing) +2% (new)	No change	7.25%
Hickenlooper Plus 1	65 (except state troopers)	5-year HAS	2 years	0.5%	+2% (existing) +2% (new)	-0.5% per year over 5 years	7%
Hickenlooper Plus 2	65 (except state troopers)	5-year HAS	5 years	0.5%	+2% (existing) +2% (new)	-0.5% per year over 5 years	6.8%
Hickenlooper Plus 3	65 (except state troopers)	7-year HAS	2 years	0.5%	+3% (existing) +2% (new)	-0.5% per year over 5 years	6.8%
Hickenlooper Plus 4	65 (except state troopers)	5-year HAS	2 years	0%	+2% (existing) +2% (new)	-0.5% per year over 5 years	6.5%

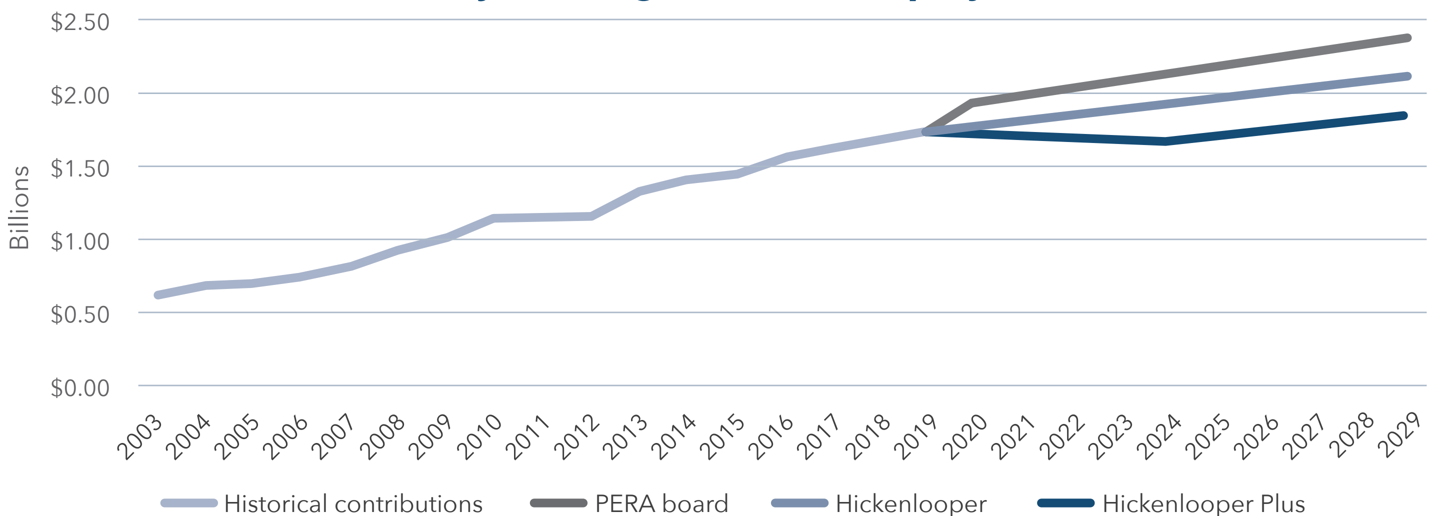
To develop the Hickenlooper Plus scenarios, we were granted permission to view PERA's forecasting tools, but our analysis was carried out independently of PERA. In developing these additional scenarios, we began with the following core objectives:

- Eliminate the $32 billion unfunded liability in Colorado's public pension system.
- Restructure PERA benefits to reflect economic realities, including a retirement age consistent with the federal Social Security program and other state-level defined benefit programs, base benefits that are more representative of a retiree's salary history in the workforce, and lower automatic annual increases in benefit payments.
- Use a lower assumed rate of return for PERA's investments, reflecting separate research that suggests we should prepare for lower rates of return over the long-term.
- Reduce the burden of PERA employer contributions on the state budget, local governments and school districts, by using a whole-of-government approach that recognizes other worthy budget priorities instead of viewing PERA's unfunded liability in a vacuum.

The Hickenlooper Plus scenarios were created to reach these objectives via multiple pathways, using different combinations of the Highest Average Salary (HAS) calculation, Annual Increase, employee contribution rates and the assumed rate of return.

After testing the Hickenlooper Plus scenarios, we observed large cost reductions from just a few adjustments to the reform proposals developed by PERA and the Hickenlooper Administration. These focused and strategic alternatives produce major savings, which could be put towards other pressing needs at all levels of government across the state, including schools, roads and public safety.

Taxpayers face higher costs under PERA and Hickenlooper reform proposals, but 'Hickenlooper Plus' scenarios yield major savings for PERA employers



Potential Savings Available to PERA Employers From 'Hickenlooper Plus' Scenarios

(millions of dollars)

	2020	2024	2028	2029	5-year sum	10-year total
Hickenlooper Plus savings Against PERA Board Plan	$220.31	$439.77	$480.10	$490.75	$1,638.94	$3,988.49
Hickenlooper Plus savings Against Governor Plan and Current Baseline	$45.63	$249.07	$271.91	$277.94	$725.93	$2,056.63

Note: Cost estimates using a 5-year weighted average of 2.2% for the 10-year increase in total compensation across all divisions. If using the PERA assumption of 4% annual increase in compensation, then our cumulative savings estimates would increase by over 20%.

In its first year, the Hickenlooper Plus scenarios would reduce the cost to taxpayers, the general fund and school districts by more than a combined $220 million compared to the PERA Board's proposal, and $45.6 million when compared to the Hickenlooper Administration's plan. Over 10 years, the cumulative savings to taxpayers, state agencies, local governments and school districts would be almost $4 billion when compared to the PERA Board's proposal, and over $2 billion when compared to the plan offered by the Hickenlooper Administration.

Based on our own analysis, we anticipate the Hickenlooper Plus scenarios will erase the state pension system's $32 billion unfunded liability on a similar amortization timetable, within 30 years, as the PERA Board and Hickenlooper reform proposals. At the same time, we would urge lawmakers and other stakeholders to request from PERA more detailed forecasts on these scenarios and other alternatives to understand the exact amortization timeframe and to better inform the pension reform debate this year.

Past reforms have increased pension costs for taxpayers

Colorado is far from alone in grappling with the escalating cost of public pensions, of course. The debate, iterative and seemingly unending, continues to play out in statehouses across the country.

In Colorado, major reforms passed by the state legislature in 2004, 2006 and 2010 reduced benefits and provided multiple new taxpayer-funded revenue streams to bolster the finances of the PERA. But these reforms, while made in good faith, were overwhelmed by more powerful demographic and economic trends. Retirees are living longer, and the investment community is bracing for lower long-term returns, forcing policymakers to once again revisit old assumptions about Colorado's retirement system for state, local and school district employees.

Starting in the mid-2000s, taxpayer-funded state, local and school district contributions to PERA started a dramatic climb. Today, the taxpayer contribution from state, local and school district budgets into PERA is just over 20 percent of salary for most active public employees, much higher than private sector workers typically see, with 19.13 percent going towards retirement benefits and 1.02 percent going to PERA's Health Care Trust Fund. The increase came in the form of two new taxpayer-funded contributions, on top of the preexisting statutory employer contribution rate of 10.15 percent for most public employees. These extra

taxpayer-funded contributions, known as the Amortization Equalization Disbursement (AED) and Supplemental Amortization Equalization Disbursement (SAED), were created to pay off PERA's unfunded liability.

In the years since the AED and SAED were introduced, PERA's unfunded liability has gotten worse, not better, and state, local, and school district budgets are now saddled with the costs of higher taxpayer contribution rates. In 2016, the contributions to the AED and SAED alone totaled $720 million. With the full increase in the AED and SAED, going forward this annual figure will likely exceed $800 million.

It must be noted that the AED and SAED contributions were approved by the state legislature with a good motive, i.e. closing the gap between the cost of benefits and PERA's ability to continue to pay those benefits. But as we know today, when taxpayer-funded state, local and school district contributions to PERA climbed, the cost of benefits grew even faster, creating today's $32 billion unfunded liability.

More than a decade of escalating employer contributions to PERA have put a significant strain on state, local and school district budgets and crowded out other major priorities. For example:

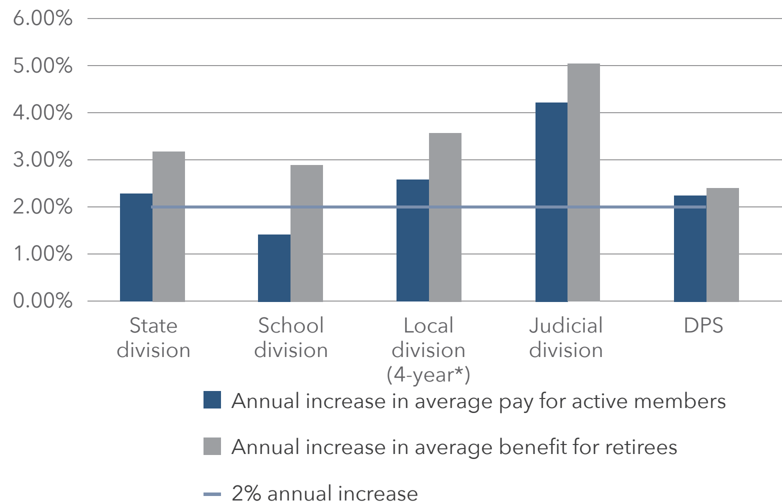
- $720 million per year could support roughly $8 billion in bonds for transportation infrastructure projects, erasing most of the state's $9 billion backlog for road, bridge and transit investments.
- The same amount could pay for a 10-fold increase in state support for school construction projects, through the Building Excellent Schools Today program.
- With an extra $720 million a year, state agencies, local governments and school districts could give every public employee in the PERA program a raise of almost $3,500.

On the issue of pay raises, the budget squeeze created by escalating PERA costs has been tough on teachers, state agency workers and other public employees. Under state law, money slated for pay raises has been redirected to fund the increase in PERA contributions from taxpayers. As a result, active public employees have lost as much as 5.5 percent of total pay, according to recent comments from PERA officials to the state legislature.

Retirement pay is growing faster than member pay

The restrictions on pay increases for active PERA members, when combined with escalating benefit costs, have produced a strange outcome. Average pay for active PERA members has increased at 2.2 percent per year over the past five years, while average benefit payments for PERA retirees have increased 2.98 percent per year. In the School Division, the average increase in annual pay is lower than the 2 percent Annual Increase paid to most PERA retirees each year.

Therefore, retired public employees are receiving larger raises, in the form of Annual Increase payments, than many public employees who are still working and contributing a percentage of their salaries into the PERA system.



PERA investments grow – but below the assumed rate or return

To make matters even more challenging, PERA's investment returns have on average come in below the assumed rate of return. From 2001 to 2016, a period that included two major recessions, the average rate of return has been 6.14 percent per year, compared to the 8 percent or higher target in place for most of that timeframe. In late 2016, PERA lowered its assumed rate of return to 7.25 percent.

The problem is not PERA's investment strategy. Instead, there is significant research suggesting the environment for long-term investing is growing tougher. For example, the McKinsey Global Institute published a study in 2016 predicting an end to the "golden era" of investment and warning of significantly lower returns in the decades to come. The experience and expectations of many investors are derived from the period of 1985 to 2014, when "an extraordinarily beneficial confluence of economic and business factors" helped boost returns, according to McKinsey. But many of those factors, including sharp declines in inflation and interest rates, strong global GDP growth, and higher corporate profits from investments in emerging markets, appear to have "run their course."

Lower than expected investment returns, together with longer average life expectancies for retirees, are making it harder for PERA to cover the rising cost of past service from public employees in Colorado. This reality has prompted the current debate over what will be the fourth round of public pension reforms since 2000.

PERA and Governor Hickenlooper open the debate with similar proposals

Both the PERA Board of Trustees and the administration of Gov. John Hickenlooper have stepped forward to propose a series of public pension reforms. There is a great deal of overlap between these proposals on issues such as raising the retirement age, reducing the rising cost of Annual Increase payments, and recalibrating the calculation of base benefits by using a percentage of an employee's five-year Highest Average Salary (HAS) instead of a three-year HAS. Both proposals continue with PERA's new assumed rate of return of 7.25 percent per year, adopted in late 2016.

The Hickenlooper plan contains some differences. It rejects PERA's proposed 2 percent increase in taxpayer-funded state, local and school district employer contribution rates, noting that "public employer contributions have grown substantially in recent years and would remain at 20.15 percent of payroll for most covered employees." The Hickenlooper plan would ask for an additional 2 percent contribution from existing employees, not 3 percent as requested by PERA. To further curb the growth in benefit costs, the Hickenlooper plan would cap Annual Increase payments at 1.25 percent per year instead of the 1.5 percent proposed by PERA.

To this end, using data and forecasting tools from PERA, we developed and tested the Hickenlooper Plus scenarios. As previously noted, we identified an opportunity to potentially lower the cost by $2 billion to $4 billion over the next 10 years for taxpayers, state agencies, local governments school districts compared to the other reform proposals on a similar amortization timetable. The Hickenlooper Plus scenarios used different values for the HAS, Annual Increase, employee contribution, and assumed rate of return to illustrate the choices and tradeoffs available to policymakers who want to reduce PERA costs to taxpayers rather than increase them.

The results of our analysis show that the PERA and Hickenlooper reform proposals serve as an excellent starting point for negotiations over the coming round of reforms to the state's public pension system. At the same time, there is a clear opportunity to take these proposals a step further, assuming there is interest on the part of state legislators, concerned citizens and other stakeholders.

Conclusion

In light of these findings, we believe state legislators, PERA officials, the Hickenlooper Administration and other stakeholders should evaluate additional pension reform scenarios that achieve solvency in a way that reduces the cost of taxpayer-funded state, local and school district employer contributions.

By asking the right questions and making full use of the financial tools and expertise available at PERA, lawmakers have the chance to find ways to stabilize Colorado's public pension system over a reasonable amortization timeframe while providing some relief to PERA member agencies and taxpayers after many years of escalating costs. Moreover, by freeing up resources for state agencies, local governments and school districts to put towards other pressing needs, the State of Colorado can invest in the future of all its citizens while also maintaining retirement security for public employees.