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**The Growing Urgency for Serious Public Pension Reforms**

It's bad enough that they're underfunded. Paltry investment returns are likely to make things even worse.

BY [CHARLES CHIEPPO](http://www.governing.com/authors/Charles-Chieppo.html) | AUGUST 18, 2016

In June, I wrote that public-sector pension plans were [facing an existential crisis](http://www.governing.com/blogs/bfc/col-public-pension-funding-outlook-problems-ahead.html). Even though many states have adopted reforms, [a sampling](http://slge.org/wp-content/uploads/2016/06/The-Funding-of-State-and-Local-Pensions-2015-2020.pdf) by the Center for State and Local Excellence of systems that cover 90 percent of the nation's state and local government pension-plan members found that in the last year the plans had on average of 74 percent of the money needed to fund their liabilities -- only a slight uptick from the previous year's figure of 73 percent.

That news was particularly troubling in light of [a McKinsey Global Institute report](http://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/why-investors-may-need-to-lower-their-sights) earlier this year suggesting that pension funds were likely to see lower investment returns going forward. Those McKinsey folks are looking awfully smart: A recent report from the Wilshire Trust Universe Comparison Service found 20-year annualized returns for U.S. public pension systems at their lowest point in the nearly 15 years the service has tracked the statistic.

A look at public pension fund performance in Massachusetts suggests just how bad things might get and underlines the need for far more fundamental reforms if we are to pay for pensions without having to raise taxes or shift money away from core government functions. According to a recent *Boston Business Journal* report, in fiscal 2016 the state pension fund achieved a mere 1.14 percent return on its investments, just a fraction of the 7.5 percent assumed annual return on which the fund's financial projections are based.

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And the state fund's performance looked pretty good compared to other Bay State public pension systems. Including the state fund, the 107 funds averaged returns of less than 1 percent. Twenty-two of the Massachusetts systems actually saw negative returns last year, and 20 have less than half of what they owe to current and future retirees. The pension system for Springfield, the state's third-largest city, is only 26 percent funded.

State officials have tried to put the pension funds on a path to solvency. In 2011, Massachusetts enacted reforms that included increasing the minimum retirement age and limiting the degree to which large salary increases just prior to retirement can boost pension payouts. But the impact of those reforms has been marginal.

Increasingly, it looks like sustainable pension programs will require reforms more like[those enacted earlier this year in Arizona](http://www.governing.com/blogs/bfc/col-arizona-public-safety-pension-reform-national-model.html), whose Public Safety Personnel Retirement System had in just over a decade gone from being fully funded to having less than half the assets needed to cover its liabilities. The fund's outlook is a lot better in the wake of a series of bold reforms. The maximum salary for purposes of pension calculations was reduced from $265,000 to $110,000. Current and future pension costs will be split evenly between employers and employees. And to reflect the shared risk, the number of labor representatives on the fund's board was increased.

Under the reformed system, new employees will choose between [a defined-contribution plan](http://www.investopedia.com/terms/d/definedcontributionplan.asp) and a hybrid that combines defined-contribution elements with those of [traditional defined-benefit plans](http://www.investopedia.com/terms/d/definedbenefitpensionplan.asp). While those new employees can't begin to collect retirement benefits until age 55, they can retire at any time. This important change makes pensions portable, so employees wanting to move on no longer have an incentive to stick around just so they can vest in the retirement plan.

The overhauled system will be so much less expensive that new employees will likely be required to make smaller pension contributions than current employees. In all, 30-year savings are expected to be more than a third of accrued liability.

Comprehensive reforms like those that Arizona has produced become all the more important in an era of paltry pension fund investment returns. While officials in other states may feel that they've already enacted politically difficult pension changes, it's become clearer than ever that the time for more sweeping action is upon us. And we know that nothing does more to add to the pain of necessary reforms than procrastination.

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