

Liberty Brief

Wyoming Liberty Group

Wyoming's Pension System: Afloat in Troubled Waters

Issue 21

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October 2014

Introduction

The state of Wyoming may not have massive pension debts like other U.S. states, but earlier this year, the Pew Foundation reported that Wyoming has \$1.7 billion in unfunded pension liabilities, which without reform to its flawed pension system, are a threat to its fiscal well-being now and in the future.¹ The state's continued use of defined benefit (DB) pension plans exacerbates a dangerous financial risk for state and local government balance sheets, putting taxpayers at risk for a retirement system bailout and government retirees at risk for decreased pension payouts. Elected officials need to put government employees on a path to retirement security that is fiscally sound for both them and the taxpayer.

Lawmakers need to act now and implement substantial reform to ensure that unfunded liabilities are paid down in a reasonable timeframe and pension systems are honestly and adequately funded with responsible governance, management and transparency controls. With reform, Wyoming's state and local governments will do much to avoid inevitable financial shortfalls that will affect taxpayers and government workers alike.

Background

In guaranteeing a specific pension payout for government employees, the DB plan is a remnant of an antiquated system in retirement planning. Private employers recognized decades ago that the risks and costs of these retirement funds were too high and transitioned to other types of plans. State and local governments, in large measure however, have not made this transition and continue to spend more on pension plans than taxpayers can reasonably afford.

Over the last three decades, the private sector abandoned this flawed system and replaced it with defined contribution (DC) plans to ultimately reduce the employer's liability. Research from the United States Social Security Administration shows that "from 1980 through 2008, the proportion of private sector workers participating in defined benefit plans fell from 38 percent to 20 percent. In contrast, the percentage of private sector workers covered by a defined contribution plan during that same time period increased from 8 percent to 31 percent."² This shift to DC plans also allowed the employee to have more control over their retirement

investments. The public sector, however, has largely avoided this logical shift, emphasizing short-term political decisions over long-term fiscal stability. Additionally, governments assume that despite the most robust accounting standards, when assumptions fail to materialize—and as a result, projected pension liabilities exceed assets—they can always raise taxes to bridge the gap. Consequently, Wyoming finds itself in a financial situation that leaves taxpayers facing a growing risk to their own incomes and future retirement security.

But what is it about the costs of these DB plans that so frequently overwhelms them? A DB pension program guarantees predetermined retirement payments to any employee who has fulfilled their obligation under the required vesting period. In order to provide the promised amount, actuaries use intricate predictive models based on many assumptions, including ages, career longevity, salaries, mortality rates, inflators and other multipliers. These assumptions, combined with assumed rates of return on investments, determine the normal costs of these pension benefits

that are paid for by a jurisdiction's annual required contributions, which pre-fund every retirement account in their system. If any of the assumptions or predicted returns on investments falls short, the pension fund will have a debt it must amortize over a number of years. Multiply this risk over thousands of public sector employees' lifetimes and fund managers often find themselves with growing unfunded liabilities.

The DB plan danger is real, but not all is doom and gloom for Wyoming because it is in a less bad position than most other states, making the achievement of successful reform more likely. According to state financial reports from all 50 states, in 2013, Wyoming had the 17th best plan funding ratio.³ However, being better in a bad bunch does not relieve lawmakers from the responsibility to fix the problem, and to deal sooner rather than later with growing debt and liabilities. The people of Wyoming should remember that any shortfall in pension funding today crowds out opportunities to fund other valuable programs and services – such as infrastructure development, education and public safety – and creates a growing unfunded liability in the future. Failure to act now will likely result in higher taxes and fewer services, as pension costs begin to take up a larger portion of state and municipal budgets.

Wyoming's State Pension System

According to the Wyoming Retirement System's (WRS) July 2014 report to Wyoming's Joint Appropriations Committee⁴, the Public Employee Plan (the largest of nine plans WRS manages), as of January 1, 2014 was 77.62 percent funded, up from 72.8 percent in February 2013. Although an improvement, it still means that if the plan closed down today, pensioners would receive 77.62 cents for every dollar promised during retirement, or taxpayers would be on the hook to bail out the plan.⁵ This presents a serious danger to current and future retirees, as the pension system currently lacks the ability to provide the promised benefits. Taxpayers, however, face the largest risk, as the financial burden of failure ultimately falls to them. Often, cities and states must use a combination of tax hikes and program cuts to pay for the benefits promised.

More Pension Reforms Needed

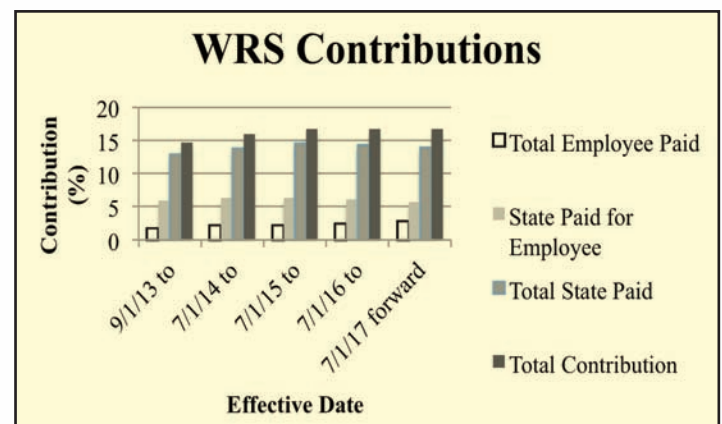
Recognizing the major funding problems and need for substantive reforms, to Wyoming's credit, the state legislature passed two bills in 2012 that signaled a willingness to start the

pension system reform process. Senate File 59 removed cost of living adjustments (COLAs) for most of the state-run plans until full funding is once again achieved.⁶ Senate File 97 essentially reduced benefits for new hires by lowering the cap on annual pensions from 66 percent to 60 percent of a worker's average annual salary. It also increased the minimum retirement age from 60 to 65, or under the Rule of 85, with 4 years of service.⁷ In total, these changes are estimated to save \$1.2 billion over 30 years, helping pay off at least part of Wyoming's unfunded liability.⁸

Meanwhile, to ensure the plan is around to actually pay retirees once they retire and minimize the risk of a taxpayer-funded bailout in the future, pension contributions are on the rise. The state employee pension plan, the largest state pension plan, held \$6.5 billion to pay benefits as of December 31, 2013—about \$2 billion less than what it needs to pay these benefits over the life of the plan. Legislators have recognized the problem and as a result, the total pension contribution will increase from 15.87 percent of a government worker's salary today, to 16.62 percent in July 2015. The employer's (read – taxpayer's) contribution share at the moment is 13.2 percent, while the employee picks up the remaining 2.055 percent. This means taxpayers pay \$6.71 for every \$1 contributed by government workers. This is in sharp contrast to the 50-50 split commonly seen in the private sector.

In July 2015, the employer's contribution will increase to 14.6 percent, meaning that for every dollar paid by the employee, taxpayers pay \$7.08. This funding inequality does not improve until July 2017, when employee contributions increase to 2.3 percent of their *own* salary to their *own* pension, and taxpayer's contributions actually fall a bit, to 14.32 percent.

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Source: Wyoming Retirement System Spring/Summer 2014 Newsletter.

Rising Costs

Pension contributions went up in 2013 and 2014 in recognition of the plan's continued unsustainability, but here's the rub. As discussed above, state employees contribute only a small portion of their pay to the so-called *employee* contribution, making the employer (read—taxpayer) pick up approximately 90 percent of the total contribution. This means that taxpayers, in 2013, paid \$220 million towards the retirement of someone else. We must begin to move to a system fair to taxpayers, with government workers picking up at least 50 percent of the contribution cost, as already exists in the private sector. Fairness to taxpayers requires no less.

Other jurisdictions have proposed raising taxes to cover their unfunded liabilities. If Wyomingites thought they were paying enough in taxes in return for services, think again. Additionally, think about which services may disappear.

In 2013, when pension and health care costs in San Jose, CA ate up 20 percent of its general fund, the city closed libraries and community centers.⁹ It also cut back staff and reduced salaries. When the pension fund in the town of Pritchard, Alabama ran out of money in 2010, the town violated its own law requiring pension payments in full when it stopped sending pension checks to pensioners. Some cities, such as Stockton and San Bernardino, California, and the granddaddy of them all—so far at least—Detroit, Michigan, have declared bankruptcy in part to reduce their pension liability. As a result, and depending on the extent of the fiscal reorganization, pensioners are seeing a reduction in their pension retirement checks.

Central Falls, Rhode Island, shows how pension checks, even for police and firefighters, can be cut should legislators delay reform until disaster strikes. When Central Falls declared bankruptcy in 2011, pensioners first experienced a 55 percent cut to their pension check. After the state stepped in and bailed the plan out, most people's pension checks were cut by up to 25 percent for the first five years, but perhaps more after that.

Even police and firefighters took a hit, the first time this group has felt the impact of truly underfunding employee benefits in any municipal bankruptcy so far. In the past, the town declined to contribute sufficiently to its police and firefighter pension plans, and consequently, the plans ran out of money.

But the results of past bad management didn't end there. Prop-

erty taxes went up, making it even more difficult for pensioners to make ends meet. In addition, the city bureaucracy was cut by almost one-third and employees, both current and new hires, now contribute more to their pension and pay more for their own health insurance.

Recent pension reforms in Wyoming are a step in the right direction, but merely treat the symptom rather than cure the disease. These reforms suggest that elected officials are more interested in dealing with short-term budgetary issues rather than addressing the long-term needs. Simply tweaking the DB system can fool policy-makers and citizens into believing that current contributions are sufficient to fully fund future retirement costs, but the dangers fundamental to the plan remain. Much more needs to be done to avoid pension disaster.

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Experience in Other States

Jurisdictions throughout the country have reformed their pension plans. The following principles are useful in guiding decisions about the what, why and how of pension reform.

1. Reforms should reduce, and then realistically eliminate unfunded liabilities.
2. Pension plans should be affordable, sustainable and secure.
3. Reforms should manage and mitigate risk—for both workers and taxpayers.
4. Reforms should ensure a productive and stable workforce for government.
5. Pensions should provide fair benefits for government workers and fair controls for taxpayers.
6. Pension reform should strive for simplicity, clarity and transparency.
7. Policymakers must be sensible about projections and risks.
8. Pension benefits should be portable and secure.

Pension systems can be quite complicated and most people know very little about the subject. Legislators must make an effort to learn the strengths and weaknesses of different pension methods. Elected officials will find the motivation to do this if they see concern among their constituents. Building local understanding of pensions is the best place to start.

Bridging the Gap & Building a Functional DC system

The only way to ensure the state-run pension system remains afloat and eliminate unfunded liabilities for taxpayers is to switch to some variation of a DC plan, just as most of the private sector has already done. A DC plan is much like a 401(k), but is not limited to that model. Depending on how the system is designed, the employee may have some discretion as to where their funds are invested. And while the employee (not the employer) bears the burden of risk, options exist that will help ensure the employee has a pension at retirement time without leaving the future generations with a legacy of debt, higher taxes and reduced services.

A DC plan can be structured to ensure retirement security. In Wyoming, members of the WRS contribute to and will eventually collect social security payments. Depending on the goal for income replacement in the reforms, a DC plan needs a combined employee/employer salary contribution rate that will provide enough income in the long-term to adequately supplement social security benefits.

The DC plan itself may consider the following components to enhance retirement security.¹⁰

- **Automatic Enrollment:** Employees would be enrolled by default but have the option to opt out. Automatic enrollment would ensure employees start saving early in their career.
- **Annuity:** DC plans may provide an option to convert the pension account balance into an annuity at retirement. This replicates one of the main components of DB pension systems allowing retirees to have a consistent monthly payments.
- **Index funds:** As most people do not have the knowledge, time or ability to manage a complex financial plan, and even professional investors often do worse than the market, the best option would be to put pension funds into passive index funds.
- **Target-date funds:** As an employee approaches retirement, the asset mix of the retirement fund should move to a more conservative position. A target-date fund does just that, by automatically adjusting the pension asset mix according to

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a pre-determined time frame. As a default feature, it would adjust the fund mix automatically. This would also have an opt-out option.

- **Collective DC plans:** By pooling individual accounts together and having them managed by professional money managers, a collective DC plan would reduce administrative costs, improve investment decisions and enable “inter-generational risk sharing,” allowing different employee age groups to share risk and returns over time.

A switch to a DC plan would eliminate the dangers inherent with the current system, but this significant shift will not be easy. Elected officials proposed a change to a 401(k)-style pension system in 2012, but the bill failed to reach the floor. Those interested in saving Wyoming from pension failure may struggle among the choppy waters of opposition, but conditions are such that they may be able to catch a wave of reform in 2015.

Opposition to Reform

Few people understand how the state pension system works, but objections to reform often overstate the perceived problems.

When considering major pension reform, legislators should anticipate some opposition from unions and interest groups. Many of these groups will view a transition to DC as a loss of benefits. While less influential in Wyoming than in other states, unions that depend on support from public employees will likely object, but many government workers remains undecided on the issue. According to a 2011 survey of government workers across the U.S., only 3.3 percent of this group is in favor of changing to a DC plan. However, 42.8 percent indicated that they would like more information before deciding.¹¹ This illustrates the importance of building awareness on the issue, as a significant group remains undecided. Once educated, even more liberal cities like San Jose and San Diego were able to pass substantive reforms with support from almost two thirds of the voters.

One of the main arguments against reform is that Wyoming’s pension system isn’t that bad. As mentioned above, the Public Employee Plan (the largest of the state’s plans), as of January 1, 2014, was 77.62 percent funded. But even 100 percent funded is sometimes not good enough, especially when high funding rates, such as the reported 77.62 percent, are often inflated by generous

discount rates, such as Wyoming's 7.75 percent assumed rate of return, that do not properly account for the risks in the plan. According to former Utah State Senator Dan Liljenquist, who led the reform for his state's system:

We had the best-funded pension system in the country going into the 2008 downturn, but during the downturn we lost about 22 percent of the value of our pension fund almost overnight. [...] [E]ven though we were well-funded, that the 22 percent loss in value actually opened up a 30 percent gap in our pension funding ratio—our funding ratio dropped from about 100 percent in 2007 to a projected 70 percent by 2013—even though we had paid every penny that the actuary had asked us to over the previous several decades. [...] [W]e realized that if this system was dependent on stock market returns with the legislature and taxpayers required to come back and cover any funding gaps if the markets do poorly—then we felt like it was a risky proposition and one that we wanted to try and mitigate moving forward.¹²

Another objection is that Wyoming has billions of dollars saved in special accounts so the plan could be bailed out without a problem.

Wyoming has six permanent funds, which, according to the state treasury's 2013 annual report (as of July 2013), held assets worth \$16.8 billion. The Wyoming Permanent Mineral Trust Fund, the largest of these funds, held \$6.1 billion. With the unfunded pension debt totaling about \$2 billion, it would appear there is plenty to bail it out when the time comes. However, assets in some of the largest permanent funds required a constitutional amendment to access. Additionally, saving large amounts of tax revenue in separate accounts held by government instead of cutting taxes or distributing this tax revenue to citizens has been rationalized as a way to create a safety net to cover state spending priorities during emergencies. If all this money has been squirreled away to cover state spending priorities during emergencies, should it be used to bail out bad management decisions instead? Given the threat of foreseen, but ignored, pension debt and the possibility that it may infringe on state savings accounts, this is a question legislators must confront now.

Another objection heard, often from WRS employees, is that government workers just won't save for their own retirement. But if people working in the private sector save, government workers can too. As shown above, there are ways to ensure employees save even if they have a DC plan. For instance, new employees could be automatically enrolled in a DC plan with a choice to opt out. There is no reason that a new DC plan could not be managed by the existing retirement system staff, which should assuage job-loss worries at WRS. Or, as is done with faculty and staff in Wyoming's colleges and universities, thousands of faculty and staff have chosen a DC plan embedded with a guaranteed annuity at their discretion, which guarantees a level of lifetime income. This keeps the risk away from the taxpayers and provides the employer predictability and flexibility in their budgets.

Naysayers to reform are nothing if not imaginative. A more sophisticated objection to reform goes like this: If new employees joined a DC plan instead of the DB plan, the unfunded liability in the old plan would still be there. Yes, this is true, but it is important to contain excessive costs and reform the system so that no new pension debt is created. Further, it is unwise for newer employees to be forced to subsidize retirees. Each group should, respectively, have been and be fully pre-funded. Pension systems are not a pay-as-you-go system, much like the beleaguered federal social security system. According to the Reason Foundation:

A DB plan's total costs consist of two elements: (1) the normal costs of accruing benefits, and (2) the amortization costs for unfunded liabilities (akin to debt service). ... [T]he normal costs paid by government employers are used to pre-fund the pension system. Amortization costs—the cost component used to pay down pension debts—are separate, and the government will still be responsible for covering amortization costs, regardless of whether normal cost contributions flow to the old DB plan or to a new DC plan.¹³

The last objection to reform discussed here is easily debunked: that DB plans are an important benefit used to attract employees. The workforce of today has changed and people no longer spend decades laboring away with the same employer. In fact, the mobility of young employees today means a portable pension such as a DC plan is more attractive than a plan that takes years to become eligible for. Indeed, those in the DC system own their retirement portfolio – all of it – including the contribu-

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tions made by a government employer. That is not the case in a DB plan, where an employee who wishes to withdraw early only gets to keep their contribution (which does not include the contribution made on his or her behalf by the employer) and a paltry amount of interest. When discussing Wyoming pensions, this adds up to real money, as approximately 90 percent of the contributions into a DB system come from the employer. Additionally, a better tool to attract tomorrow's workforce is higher pay, something a reduction in pension costs would allow to the state to offer.

Let's face it, companies in the private sector are eliminating the risks created by DB plans and so should government. None of the arguments against reform stand up to careful analysis. To ensure retirees have a secure retirement without sacrificing the financial future of our children and grandchildren, Wyoming's state pension plan must be reformed.

Decline in Spite of Reform

But what happens when a government makes the switch to a defined contribution system and things still don't get better? Alaska and West Virginia are two examples of states that have made the transition from a defined benefit to a defined contribution system but have also seen their pension finances continue to decline in the years following reform. These declines though are in *spite* of pension reforms, not *because* of them.

In 1991, facing a large unfunded liability, West Virginia closed its DB plan to new teachers and put them in a 401(k) style DC plan. Since the reform, several myths have been perpetuated about West Virginia's pension system. One is that the pension reforms in 1991 caused the unfunded liability to get worse. Reports pegged West Virginia's Teachers Retirement System (WVTRS) at 14 percent funded in 1990, the year prior to reform.¹⁴ In 1994, WVTRS's funding ratio dipped to 11.6 percent funded, but a decade after reforms, in 2000, WVTRS was 21.4 percent funded. By 2005, the DB system was up to 24.6 percent funded. Clearly, these are all terrible funding ratios, but they were low to begin with and were getting better post reform, given at a very slow rate.

Critics of West Virginia's pension reform, like Diane Oakley of the National Institute on Retirement Security (a lobbying or-

ganization for pension plans), note that by 2005 WVTRS was paying benefits to nearly two retired teachers for every active teacher still contributing to the closed DB plan, presenting a problem.¹⁵ But presenting this as a problem demonstrates a fundamental misunderstanding by Oakley in the way DB pension systems are funded. As explained earlier in this brief, DB pension benefits are prefunded; the normal cost paid every year should be enough to pay for the future benefits. If the normal cost isn't enough to cover future benefits and the unfunded liability is growing, then the actuarial assumptions being used are flawed, but you can't blame this on the closing of the DB system.

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In 2005, West Virginia closed its DC plan and reopened the DB plan to new teachers. Critics of pension reform like Oakley make the claim that West Virginia's pension system improved after the closure of the DC plan. Have West Virginia's pension finances for teachers gotten better since ending their reform effort? Yes, but not because shutting down the DC system created savings. The reason WVTRS's funding ratio improved from 24.6 percent funded in 2005 to 51.3 percent funded in 2007 was because of a spike in annual required contributions made in 2006 and 2007. Prior to 2006, the highest ARC payment made by the state was 110.19 percent, but in 2006 and 2007 West Virginia made contributions of 191.52 percent and 425.99 percent respectively.¹⁶ The excess contributions came from \$807 million from a tobacco settlement that the state used to shore up its pension system. The increased contributions and improved funding ratio had nothing to do with the closure of the DC plan.

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Similar criticism have been leveled against the state of Alaska since its transition to DC plans for all public employees and teachers hired after 2006. Nine years since Alaska's pension reforms, the state's unfunded liability has doubled from roughly \$6 billion to \$12 billion dollars.

Politicians like State Rep. Mike Hawker (R-Anchorage), have already begun to distance themselves from the 2005 reforms. In April of 2014, Hawker was quoted as saying;

I very much was concerned when we closed our retirement systems and went to a defined contribution that by closing those systems we were going to find ourselves in the position we are in today, which was ultimately having to step in with

a significant financial bailout... That switch was a mistake.¹⁷

But Rep. Hawker, like Diane Oakley, is very wrong in his understanding of the transition costs of pension reform. Contributions into the old defined benefit plan have been the same as they would have without reform. The unfunded liability that existed and grew since the reforms passed would still exist even with more employees in the defined benefit plan.

The problem is that Alaska didn't make the necessary amount of annual required contributions to keep the system well-funded and the pension system's investment return assumptions weren't being met post-reform. Alaska's Public Employee Retirement System and its Teachers Retirement System have averaged ARC payments of 85 percent and 81 percent respectively post-reform—anything less than 100 percent means the system is being underfunded unless investment returns were well over the assumed rate. Alaska continued to assume a rate of return on investments of 8.25 percent post-reform, but since 2005 Alaska's public employee retirement system has averaged a rate of return of only 4.8 percent.¹⁸ Low investment returns and low ARC payments have led to the decline of Alaska's pension system in spite of pension reform. The situation in Alaska would likely be much worse today had the defined benefit membership not been closed off.

Recommendations

A realistic assessment of the state's unfunded liabilities leads to the conclusion that it is time for Wyoming to make real reform, not just tinker around the margins with the current DB plans. To provide security to current and future government retirees, and to ensure that taxpayers are also able to save for their own retirements, the state must consider moving to a DC plan in parity with private sector pension benefits. If moving new employees to a DC plan is politically or pragmatically not likely to happen, there are variations of hybrid reforms or cash balance plans that may be acceptable to the people of Wyoming.

Indeed, model reform exists in other jurisdictions and Wyoming can use their best practices and lessons learned. For specific recommendations on the DC conversion, consider the following pieces to ensure a workable model:

- Professionalize the governance of the pension system, which will address conflict-of-interest issues, provide

transparency and improve oversight over benefit and investment decisions.

- Ask for annual and independent audits on the pension systems.
- Require all classes of new employees, including civil servants, teachers and public safety, to be placed into the new program. Provide the option for current employees to opt-in to a new plan, DC or otherwise.
- Mandate full payment of annual required contribution every year to both the closed system and new system, making sure that debts are paid down.
- Match employer and employee contribution rates.
- Eliminate any pension spiking and cap pensionable pay.
- Restrict cost of living adjustments in future years.
- Vest the employees' plan immediately or phased-in within a shorter timeframe than is currently allowed in the DB system.
- Increase retirement ages.
- Maintain reasonable multipliers when calculating pension salaries.¹⁹

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Reforms may require piece-by-piece implementation while educating the public on the issues and setting the stage for comprehensive policy change. A key to any success depends on leaders as well as a competent and reliable coalition developed from the reform movement. Engaged citizens and taxpayers are likely to drive the debate in the jurisdiction they are trying to reform, focusing grassroots support. They need to be conversant on the principles of reform and be able to address any objections to reform.

The work doesn't end, however, even after successful reform. Once implemented, reforms require constant vigilance to maintain and sustain them so that the retirement system becomes and remains affordable, sustainable and secure for the employee and taxpayers. DB plans must continue to be fully funded as they close based upon an amortization schedule that makes fiscal and budgetary sense. Wyoming can address the systematic issues now, and continue to monitor and tweak the system in the

Conclusion

Wyoming's pension system is not as troubled as those in other jurisdictions, however, that doesn't mean Wyoming's situation is good. Problems have already appeared on the horizon and any reform will require years to take hold. Meanwhile, Wyoming's citizens and policymakers find themselves in a comparatively advantageous position. Those interested in saving the state from higher taxes and fewer services should work to raise awareness in the community on these issues. Proper engagement will eventually lead to meaningful dialogue, and will hopefully result in meaningful pension reform.

About the Authors

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Mr. Christensen has testified before state and county legislative bodies on pension issues. In addition to publishing several articles, commentaries and studies at Reason.org, Mr. Christensen was also the coauthor of *Pension Reform Handbook: A Starter Guide for Reformers*. His work has also been featured in the *Orange County Register*, *Ventura County Star*, *FlashReport*, and *Fox and Hounds Daily*. He is based in Sacramento, California.

This piece was produced with research and writing assistance by Zachary Christensen, intern at Reason Foundation.

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