Texas Public Policy Foundation

Spending

Legislator's Guide to the Issues 2017-18

Public Pension Reform

The Issue

Recent analyses documenting the imminent threat posed by unfunded state pension liabilities contributed to several reforms by the 2013 Texas Legislature, including raising the retirement age and increasing contribution rates, to the two largest state pension systems—Teacher Retirement System (TRS) and Employees Retirement System (ERS). The 2015 Legislature raised the ERS member contribution rate to 9.5% to improve its solvency.

While these are positive first steps, these pension systems should be changed from defined benefit to defined contribution plans to make them sustainable long term for beneficiaries and not burden all Texans with higher taxes.

For decades, state and local officials have overpromised on and underfunded government-run retirement plans, resulting in the accumulation of trillions of dollars in unfunded liabilities across the nation. Unfunded liabilities are the difference between promised benefits to future retirees and money available to fund those benefits. In fact, one study pegged total unfunded state and local pension liabilities nationwide at more than $4.7 trillion—or almost $15,000 per American.

In Texas, state and local governments employ 14% of workers. Most of them have a defined benefit pension plan that promises a regular payment to retirees regardless of contribution. Volatile annual rates of return and fewer contributors paying for more beneficiaries are exhausting these plans, leaving them with mounting, unsustainable liabilities.

The Pension Review Board (PRB), the state agency charged with overseeing Texas' state and local retirement systems, shows that among the 93 systems monitored by the agency, unfunded liabilities topped $60 billion in early 2016. That is an increase in pension debt of $2.7 billion since June 2015 and an increase of $7.7 billion compared with two years prior.

The funded ratio—a measure of a plan's current assets as a share of its liabilities—averaged 80% across all plans. It is generally agreed that a funded ratio of 80% or more signifies a firm financial footing, something that many of Texas' systems are on the brink of falling below.

Looking at these plans' amortization periods also hints at trouble. The PRB's guidelines for actuarial soundness recommend that a plan's amortization period ideally range between 15 and 25 years. However, 56 of the 93 plans exceeded that target in early 2016. Over a longer time horizon, fewer plans are able to achieve the recommended amortization period. A 2014 PRB report compares the financials of Texas' 93 monitored plans in 2000 and 2013. The report finds that in 2000 roughly 46%, or 43 of the 93 plans, had amortization periods at or above 25 years. By 2013, however, that figure had grown to 65%, or 60 of the 93 plans.

In 2015, TRS, the state's largest pension fund, had unfunded obligations totaling $33 billion, or $22,592 per member, and ERS, the second largest fund, had unfunded liabilities totaling $8 billion, or $32,126 per member. Assuming an overpromised 8% annual rate of return, the actuarial funded ratio for TRS is 80% and ERS is 76%, meaning that these are at or below the 80% threshold considered actuarially sound.

State pensioners have also been aging as baby boomers continue to retire leaving fewer contributors paying for more beneficiaries. According to the State Budget Crisis Task Force, the ratio nationwide of active public employees to retirees has fallen from 7-to-1 in 1950 to less than 2-to-1 today, putting more pressure on pension investment losses. A similar decline burdens Texas' pensions.

Lower rates of return and an aging population make pension reform in Texas vital. Modifications like those passed in 2013 and 2015 have bought some time for the plans, but these adjustments do little to change the long-term cost trajectory. Much more substantive changes are needed to retain solvency.

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Moving Texas' public pension systems away from the defined benefit system and into a defined contribution model would restore sustainability in the system, benefitting both the taxpayers and state employees. Defined contribution plans put the power of an individual's future in their own hands instead of depending on the uncertain fortune of government-directed defined benefit plans.

The Facts

- The state's two major retirement systems, TRS and ERS, are at or below the adequate actuarial funded ratio of 80%.
- Texas' retirement system is legally liable to pay defined benefits totaling 10 to 20 times what state employees paid into the system—if investing returns drop or benefits are increased, taxpayers would be on the hook for the added exposure.
- Defined contribution systems are more sustainable than defined benefit plans since they are, by definition, fully-funded, which is why the private sector is moving in this direction.

Recommendations

- Freeze enrollment in the current defined benefit system and enroll newly hired or unvested employees in a 401(k)-style defined contribution pension plan.
- Implement either a hard or soft freeze of the system for vested employees.
- Replace current employee health care plans with Health Savings Accounts.

Resources

"A Solution to Our Public Pension Problem" by Vance Ginn and James Quintero, *Forbes* (May 2, 2016).

Now is the Time for Pension Reform by Sarah Curry, State Budget Solutions (Aug. 2015).

Keeping the Promise: State Solutions for Government Pension Reform by Senator Dan Liljenquist, American Legislative Exchange Council (Sept. 2013).

Reforming Texas' State and Local Pension Systems for the 21st Century by Arduin, Laffer & Moore Econometrics, Texas Public Policy Foundation (April 2011).