Texas Public Policy Foundation

Public Pension Reform

Legislator's Guide to the Issues 2015-16

Public Pension Reform

The Issue

Recent analyses documenting the imminent threat posed by unfunded state pension liabilities contributed to the 2013 Texas Legislature making several reforms, including raising the retirement age and increasing contribution rates, to the two largest state pension systems—Teachers Retirement System (TRS) and Employees Retirement System (ERS).

While these are positive first steps, ultimately these pension systems should be changed from defined benefit to defined contribution plans to make them sustainable for beneficiaries and not burden all Texans in the future.

For decades, state and local officials around the country have overpromised on and underfunded government-run retirement plans, resulting in the accumulation of trillions of dollars in unfunded liabilities, or debts owed for which there is no current funding available. In fact, one recent study pegged total unfunded pension liabilities for all systems nationwide at more than $4 trillion—or $13,000 per American.

In Texas, state and local governments employ roughly 16% of workers. Most of these workers 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.

Total unfunded pension liabilities in Texas are estimated to be around $55 billion; other studies, including one by Joshua Rauh of Northwestern University, that include more realistic accounting practices provide a substantial amount of $188 billion, $7,200 per Texan. The aggregate funding ratio—all plans' current assets as a share of liabilities—dropped to slightly above 80%, down from 104% in 1999.

As state pensions continue to generate lower rates of return than their overly optimistic 8% projection, declining funding ratios will inevitably result in more taxpayer money allocated to pensions and away from other essential functions.

In 2013, TRS—the state's largest pension fund—had unfunded obligations totaling $28.9 billion, or $35,498 per member, and the second largest fund, ERS, had unfunded liabilities totaling $7.2 billion, or $53,673 per member. Assuming an unmatched 8% annual rate of return, the market funding ratio for TRS is 80.8% and ERS's is 77.4%—both are near the 80% threshold considered to be actuarially sound.

With new Governmental Accounting Standards Board (GASB) rules aimed at improving the accuracy of financial reporting taking effect in 2014 and 2015, funding ratios for these pension funds are expected to decline.

State pensioners have also been aging as baby boomers continue to retire. This situation of fewer contributors paying for more beneficiaries is known as generational accounting. 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 investments. This same decline burdens Texas' pensions.

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Lower rates of return and an aging population make pension reform in Texas vital. Modifications like those passed in 2013 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 and keep the state's pension system above water.

Moving Texas' public pension systems away from the defined benefit system and into a defined contribution model would go a long way to restoring sustainability in the system, benefitting both the taxpayers and state employees.

The Facts

- The state's two major retirement systems, TRS and ERS, have funding ratios near 80%—the threshold considered to be actuarially sound.
- Texas' retirement systems are 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 because 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

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

Reforming Texas' Public Pension Systems: Testimony before the Committee on Pensions, Investment, and Financial Services by Talmadge Heflin, Texas Public Policy Foundation (Apr. 2012).

Reforming Texas' State and Local Pension Systems for the 21st Century by Arduin, Laffer & Moore Econometrics, Texas Public Policy Foundation (Apr. 2012).

Your Money and Pension Obligations by The Comptroller of Public Accounts (Dec. 2012).

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