Texas Public Policy Foundation

Keeping Texas Competitive

A Legislator's Guide to the Issues 2013-2014

Reforming Texas' Public Pension Systems

★ Keeping Texas Competitive Priority

The Issue

Not long ago, efforts to reform Texas' public pension systems into something more sustainable went largely unnoticed. But ongoing turmoil in the market and a series of recent analyses documenting the imminent threat posed by unfunded liabilities to state and local governments have caused many to reconsider just how necessary pension reforms really are.

Historically, the public sector used the promise of a comfortable retirement as a way to draw skilled workers away from higher-paying private sector jobs. Lucrative retirement benefits and ironclad job security made up for the lower wages.

However, the wage gap between the two sectors has closed with government workers usually earning more than non-government. Taxpayers providing state employees with generous retirement benefits have now become a questionable expense.

According to the U.S. Bureau of Labor Statistics, the average state or local government employee in Texas earned an annual salary of $40,024 in 2010, while the average private sector worker earned $39,832.

In Texas, the aggregate funding ratio for public pension funds have dropped to near 83%, down from 103.6% in 1999, and just 3% above what is considered actuarially sound or adequately funded. As governments continue to fall short of their overly optimistic 8% projected rates of return, declining funding ratios will inevitably result in more taxpayer money being allocated to pensions at the expense of other, more critical government services.

Texas estimates its total unfunded pension liability to be around $54 billion, which will continue to grow without substantial reform. Supporting this are other studies, including one by Joshua Rauh of Northwestern University, which estimates that when using more realistic accounting practices, total unfunded liabilities are closer to $188 billion.

During the past several years, state and municipal pension systems have implemented changes designed to rein in excessive liabilities. Modifications such as an increased minimum retirement age and readjusted benefit calculations 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 systems above water.

Such changes could include:

- Freezing the current defined benefit pension plan to all new and unvested employees.
- Enrolling newly hired or unvested employees in a 401(k)-style defined contribution pension plan.
- Implementing either a hard or soft freeze of the system for vested employees.
- Replacing current employee health care plans with Health Savings Accounts (HSAs).

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—a benefit for both taxpayers and state employees.

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The Facts

- The state's two major retirement systems, the Employees Retirement System (ERS) and the Teacher Retirement System (TRS), are considered to be adequately-funded—though just barely. Both funds were above the 80% threshold in fiscal 2011, with ERS' funding ratio at 82.8% and TRS' funding ratio at 82.7%.
- The Texas retirement system, while fairly well-funded compared to other states, is still legally liable to pay defined benefits totaling 10 to 20 times what state employees paid into the system—if investment returns drop or benefits are increased (as was done in California in 1999), taxpayers would be on the hook for the added exposure.
- The tendency in the private sector, unlike government, has been to move away from the defined benefit system and transition into defined contribution plans.
- Defined contribution systems are more sustainable than defined benefit plans since they are, by definition, fully-funded.
- Private sector taxpayers receive about 30.6% of their compensation in benefits, including deferred compensation, whereas Texas state employees receive about 40% of their compensation in benefits.

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 HSAs.

Resources

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

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

Changing Public Pensions from Defined Benefit to Defined Contribution: Testimony before the Committee on Pensions, Investments, and Financial Services, by Donna Arduin, Texas Public Policy Foundation (Apr. 2012).

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