

2019-20

LEGISLATOR'S GUIDE to the Issues

Public Pension Reform

The Issue

For decades, state and local politicians across the nation have overpromised on and underfunded government-run retirement plans, resulting in the accumulation of trillions of dollars in unfunded liabilities. 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 \$6 trillion—or \$18,676 per American.

Texas is not immune. State and local governments employ [14%](#) of workers. Most of these workers have a defined benefit pension plan that promises a regular payment to retirees regardless of contribution. Underperforming investments and generational accounting issues are exhausting these plans leaving them with mounting, unsustainable liabilities.

Recent analyses documenting the imminent threat posed by unfunded state pension liabilities contributed to the Texas Legislature making several reforms in the last decade, 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). While these are positive first steps, these pension systems should be reformed from defined benefit to defined contribution plans so they are sustainable for beneficiaries and limit the burden on taxpayers.

The Texas Pension Review Board (PRB), the state agency charged with overseeing state and local retirement systems, shows that among the 93 systems monitored by the agency, unfunded liabilities were [\\$69.3 billion](#) in March 2018. That is an increase in pension debt of \$3.7 billion since August 2017. The funded ratio—a measure of a plan's current assets as a share of its liabilities—averaged 79.8% across all plans. It is generally agreed that a funded ratio of 80% or more signifies a firm financial footing, a ratio many of Texas' systems do not reach.

The seven state public pension plans include the vast majority of total state and local unfunded liabilities to the tune of \$55 billion. The largest state pension plan is TRS with assets of \$147.4 billion, but it is plagued with unfunded liabilities totaling at least \$35 billion and a funded ratio of 80.5%, assuming an 8% annual rate of return. Given the average market valued investment return of TRS is 5.8% for the last 10 years, unfunded liabilities jump to about \$80 billion with a 6% discount rate. ERS is the next largest plan with assets of \$26.4 billion, but again this plan also has massive unfunded liabilities of \$11.3 billion and a funded ratio of only 75.2% with an expected annual return of 7.5%. With the average annual rate of return for the last decade of 5.5%, a more realistic rate of 6% brings the unfunded liabilities up to \$19 billion.

These concerning statistics are driven by underperforming investments and an aging population that make pension reform vital. Recent modifications have bought some time for these plans, but these

adjustments do little to change the long-term cost trajectory. Moving Texas' public pension systems away from the defined benefit (DB) system toward a defined contribution (DC) model similar to a 401(k), that is by definition fully funded, would restore sustainability in the system, benefitting both the taxpayers and state employees.

DC plans put the power of employees' future in their own hands instead of depending on the uncertain fortune of government-directed defined benefit plans. [Research](#) finds that this transition could come with little to no transaction cost to make them sustainable for beneficiaries long-term while [eliminating](#) potentially higher taxes to fund them.

This DB to DC transition could be done by implementing a hard or soft freeze of the pension systems for vested employees, and a hard freeze on enrollment in the current DB plans while enrolling newly hired or unvested employees in a DC plan. Ultimately, whatever the initial transition cost may be, they will be outweighed by the benefits of lower future costs and certainty for state employees and taxpayers that these pensions will be fully funded. With DC plans, retirees will finally have the opportunity to determine how much risk they are willing to accept. They also reduce the risk that the government will default on their retirement or will fund those losses with dollars from taxpayers who never intended to use these pensions.

Because of the efficiency, simplicity, and fully funded nature of DC plans, the private sector moved primarily to them long ago. Doing the same for public pensions would assure state employees that they will receive their retirement funds and assure taxpayers that more of their money will not be at risk.

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 systems are legally liable to pay defined benefits totaling 10 to 20 times state employee contributions.
- Defined contribution systems are more sustainable than defined benefit plans since they are fully funded, which is why the private sector moved in this direction.

Recommendations

- Freeze enrollment in the current defined benefit system and at least enroll newly hired or unvested employees in a 401(k)-style defined contribution pension plan.
- Lower assumed rates of return to more realistic rates.
- Avoid increasing state spending on public pensions without major reform.

Resources

[Unaccountable and Unaffordable](#) by Thurston Powers, Erica York, Elliot Young, and Bob Williams, American Legislative Exchange Council (Dec. 2017).

Reducing the Burden of Texas' State Liabilities on Current and Future Generations by Vance Ginn, Talmadge Heflin, and Melissa Schlosberg, Texas Public Policy Foundation (Feb. 2017).

Are There Transition Costs to Closing a Public-Employee Retirement Plan? by Andrew Biggs, Mercatus Center (Aug. 2016).

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

