TEXAS PUBLIC POLICY FOUNDATION

2019-20
# LEGISLATOR'S GUIDE
## to the issues

TEXAS PUBLIC POLICY
FOUNDATION

# 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).

# Experts

**Kara Belew,** *Senior Education Policy Advisor, Center for Innovation in Education*
kbelew@texaspolicy.com AREAS OF EXPERTISE: State Budget, Taxes, Public
Education Finance and Policy, Public Education Accountability

**Derek Cohen, Ph.D.,** *Director, Center for Effective Justice and Right on Crime*
dcohen@texaspolicy.com AREAS OF EXPERTISE: Juvenile Justice Reform,
Victims' Rights, Overcriminalization, Constitutional Limitations on Corrections

**The Hon. Chuck DeVore,** *VP of National Initiatives; Senior Fellow for Fiscal Policy*
cdevore@texaspolicy.com AREAS OF EXPERTISE: Tax and Fiscal Policy, Elections,
Foreign Affairs, Military Affairs, Energy and Environmental Policy

**Vance Ginn, Ph.D.,** *Director, Center for Economic Prosperity; Senior Economist*
vginn@texaspolicy.com AREAS OF EXPERTISE: State Budget and Tax Reform,
National and State Labor Market Trends, Tax and Expenditure Limits, Energy
Markets and Policy

**Michael Haugen,** *Policy Analyst, Center for Effective Justice and Right on Crime*
mhaugen@texaspolicy.com AREAS OF EXPERTISE: Civil Forfeiture,
Overcriminalization, Substance Abuse Policy

**The Hon. Talmadge Heflin,** *Director, Center for Fiscal Policy*
theflin@texaspolicy.com AREAS OF EXPERTISE: State Budget and Taxation,
Economic Stabilization Fund, Local Government Spending, Pension Reform,
Federal Funds

**Haley Holik,** *Attorney, Center for Effective Justice and Right on Crime*
hholik@texaspolicy.com AREAS OF EXPERTISE: Juvenile Justice, Grand Jury
Reform, Constitutional Limitations on Search and Seizure, Overcriminalization

**Marc Levin, Esq.,** *VP of Criminal Justice and Right on Crime*
mlevin@texaspolicy.com AREAS OF EXPERTISE: Adult Corrections, Juvenile
Justice, Overcriminalization, Victim Empowerment and Restitution, Law
Enforcement, School Discipline

**Thomas Lindsay, Ph.D.,** *Director, Center for Innovation in Education*
tlindsay@texaspolicy.com AREAS OF EXPERTISE: Higher Education, Culture Wars
(Political correctness, cultural decline, etc.), America's Founding Principles, Online
Learning, Federalism, Tenth Amendment, Interstate Compacts

**Brandon J. Logan, Ph. D.,** *Director, Center for Families & Children*
blogan@texaspolicy.com AREAS OF EXPERTISE: Child Welfare Policy, Foster
Care, Adoption, Family Law, Parental Rights

**Bryan Mathew,** *Policy Analyst, Center for Local Governance*
bmathew@texaspolicy.com AREAS OF EXPERTISE: Local Economic Regulation,
Local Economic Development, Municipal Annexation, Housing Affordability,
Property Rights, Special Districts

**Stephanie Matthews,** *VP of Public Affairs*
smatthews@texaspolicy.com AREAS OF EXPERTISE: Workforce Development, Charter Schools, School Choice, Virtual Learning

**Jennifer Minjarez,** *Policy Analyst, Center for Health Care Policy*
jminjarez@texaspolicy.com AREAS OF EXPERTISE: Medicaid Reform, Mid-Level Providers, Medical and Dental Licensure Reform

**Bill Peacock,** *VP of Research*
bpeacock@texaspolicy.com AREAS OF EXPERTISE: Electricity Markets and Renewable Energy, Insurance, Technology and Telecommunications, Tort Reform, Property Rights, Economic Development, Consumer Issues

**Randy Petersen,** *Senior Researcher, Center for Effective Justice and Right on Crime*
rpetersen@texaspolicy.com AREAS OF EXPERTISE: Policing Policy, Diversion Programs, Civil Asset Forfeiture

**James Quintero,** *Director, Center for Local Governance*
jquintero@texaspolicy.com AREAS OF EXPERTISE: Budgets, State and Local Spending, Debt, Taxes, Transparency, Pensions

**Kevin D. Roberts, Ph.D.,** *Executive Director*
kroberts@texaspolicy.com AREAS OF EXPERTISE: K-12 Education Growth, Increasing Public School Efficiency, Education Choice, Higher Education, Tenth Amendment

**Emily Sass,** *Policy Analyst, Center for Innovation in Education*
esass@texaspolicy.com AREAS OF EXPERTISE: K-12 Education, Education Choice, School Finance, Civic Education, Charter Schools

**Deane Waldman, Ph.D.,** *Director, Center for Health Care Policy*
dwaldman@texaspolicy.com AREAS OF EXPERTISE: Health Care, Medicaid, Telemedicine, Scope of Practice, Regulatory Issues

**The Hon. Kathleen Hartnett White,** *Distinguished Senior Fellow-in-Residence; Director, Center for Energy & the Environment*
khwhite@texaspolicy.com AREAS OF EXPERTISE: EPA Regulation, Energy and Environmental Policy, Free Market Environmental Policies, Endangered Species Act, Water Rights

The Texas Public Policy Foundation is a 501(c)3 non-profit, non-partisan research institute.

The Foundation's mission is to promote and defend liberty, personal responsibility, and free enterprise in Texas and the nation by educating and affecting policymakers and the Texas public policy debate with academically sound research and outreach.

Funded by thousands of individuals, foundations, and corporations, the Foundation does not accept government funds or contributions to influence the outcomes of its research.

The public is demanding a different direction for their government, and the Texas Public Policy Foundation is providing the ideas that enable policymakers to chart that new course.

**TEXAS PUBLIC POLICY**
F O U N D A T I O N

901 Congress Ave., Austin, Texas 78701 | 512.472.2700 phone 512.472.2728 fax
www.TexasPolicy.com