

A project of the **TEXAS PUBLIC POLICY FOUNDATION**

REFORMING TEXAS' STATE & LOCAL PENSION SYSTEMS



FOR THE 21ST CENTURY

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Reforming Texas' State and Local Pension Systems for the 21st Century

by Arduin, Laffer & Moore Econometrics

Executive Summary

Wimpy J. Wellington, to be exact, cocks back his unkempt head and warbles to Roughhouse Reilly:

*“If you could a hamburger construct that would my hunger stay.
I'd gladly pay you Tuesday for that hamburger today.”¹*

Many people still remember Wimpy, from the popular Popeye cartoon, who was always willing to pay next Tuesday for a hamburger consumed today. Unfortunately, this humorous cartoon line too aptly describes the situation of most state and local pension systems today.

Most state and local pension systems are not fully funded. The problems created by an unfunded pension system are no longer an issue for tomorrow. Unfunded state pension obligations are already creating problems for states and municipalities. “Cities across the nation are raising property taxes, largely citing rising pension and health care costs for their employees and retirees. In Pennsylvania, the township of Upper Moreland is bumping up property taxes for residents by 13.6 percent in 2011. Next door the city of Philadelphia this year increased the tax 9.9 percent. In New York, Saratoga Springs will collect 4.4 percent more in property taxes in 2011; Troy will increase taxes by 1.9 percent.”²

The unfunded liabilities of the state and local pension systems are a serious problem that must be addressed. If the current liabilities and current assets are not aligned, the large unfunded liability will significantly reduce the economic competitiveness of the U.S. and significantly reduce the ability of the states to provide legitimate and necessary public services to its constituents. But, states and municipalities must address these problems with economically sustainable solutions. The municipalities in Pennsylvania and New York are further harming their economic competitiveness by attempting to improve the fiscal soundness of their pensions through property tax increases.

Texas' pension systems have at times travelled down a path similar to many other states and cities. According to the Pew Center on the States study, back in 1999 Texas' pension systems were 103.6 percent funded.³ However, between 1999 and 2008 the growth in liabilities significantly outpaced the growth in assets. By 2008, total assets were only 90.7 percent of total liabilities. According to the Pew Center, “Between 2003 and 2007, [Texas] paid less than 90 percent annually of what its own actuaries said was necessary. However, in 2008, it got back on the right track, paying 99 percent of its annual required contribution. Texas passed legislation in 2009 that increased the retirement age and service eligibility requirements for employees hired after September 1, 2009. This legislation also increased the employee contribution rates for members of the Employee Retirement System.”⁴

The problems facing Texas are not dire—but they are troubling. According to the Pew Center on the States as of the end of 2008 Texas' total pension fund liabilities were \$148.6 billion and total pension fund assets were \$134.8 billion implying that Texas' pensions were 90.7 percent funded—a \$13.8 billion unfunded liability.⁵ However, only 2.5 percent of the \$28.6 billion in health care and other retirement obligations were funded.⁶ Due to the vagaries that surround actuarial assumptions, the pension systems in Texas are currently considered to be acceptably funded—albeit the lower-end of acceptably funded.

The sustainable solution to the problems facing public pension systems (including Texas) addresses two distinct problems: (1) the current unfunded liabilities of the state pension systems, and (2) addresses the fundamental problems created by a defined benefit pension system.

When a state or local government provides a defined benefit pension, the state is creating a government entitlement program. Entitlement programs violate the criteria of sound budgeting principles. Based on sound public finance principles, tax funded programs should be predictable and sustainable, and not reliant upon estimators, actuaries, market conditions, or the legislatures resolve to be fiscally prudent. Entitlement programs create expenditures that are difficult to predict and limit the government's budget flexibility. Inevitably, entitlement programs lead to unsustainable government spending growth. Consequently, defined pension programs do not meet the criteria of sound fiscal policy.

State governments cannot solve the financial problems of entitlements—such as the Medicaid program—by simply acquiring more assets from which future obligations can be paid. In the case of Medicaid, fundamental reform of both the health care system and the state Medicaid programs are required to solve the Medicaid crisis. The same is true for state pension systems. As such, the defined benefit pension system is the wrong compensation policy for state and local governments.

This paper provides recommendations that Texas can implement to address the public sector pension problems facing the state without eroding Texas' economic vibrancy. These recommendations are summarized in the table below.

PENSION REFORM RECOMMENDATIONS

Step 1: Freeze the defined benefit (DB) plan to all new and unvested public sector employees.

Step 2: All new or current unvested employees transferred to a defined contribution (DC) plan.

- A) DC plan should meet average standards for a large private sector DC plan
- B) Attributes can include (rates should be actuarially verified)
 - i) No minimum length of service requirement for eligibility in DC plan
 - ii) Participation in DC plan permitted upon hire
 - iii) Non-matching contributions of up to 6.0 percent of pay, immediate eligibility
 - iv) Employer match up to a set percentage of pay, immediate eligibility

Step 3: Implement either hard freeze or soft freeze of system for current vested employees.

- A) Under a hard freeze, benefits earned at the time of the freeze honored
 - i) No public employee able to accrue any new benefits
 - ii) All vested public employees transferred to DC plan for any additional benefit
- B) Under a soft freeze, the benefits for vested employees continue growing
 - i) Vested employees choose between staying in the DB system or switching to the DC system.
 - ii) Benefits, employee contributions, and COLAs should be altered so that the DC system is favored by most workers
 - a) Raise employee contribution rates
 - b) Extend the salary period used for determining retirement benefits
 - c) Increase the age and service requirements for eligibility
 - d) Implement greater controls over post-retirement COLAs
- C) Retirees will maintain their current benefits with changes to COLAs

The Private Sector's Transformation

Over the past 30 years, the private pension system in the United States has gone through a radical transformation (see Figure 1); but the federal, state, and local governments have not followed the private sector's transformation. Defined benefit plans were once a sizable minority of all benefit plans. In 1975, out of over 311,000 benefit plans, one-third or 103,000 were defined benefit plans. The number of defined benefit plans peaked in the early 1980s and have been declining ever since. As of 2007, there are only slightly less than 49,000 defined benefit plans or 6.9 percent of the nearly 708,000 benefit plans that existed.

The number of people covered by each plan type has followed a similar pattern. Because defined benefit plans tend to cover more people, more people with a pension plan were covered by a defined benefit pension plan in 1975—nearly 71 percent of the 38.4 million people covered by a pension were in a defined benefit plan, see Figure 2. By 2007, the percentages had more than reversed themselves—only 22.5 percent of the 82.3 million people covered by a pension were in a defined benefit plan. More dramatically, in 1975, there were 27.2 million workers covered by a defined benefit plan. By 2007, only 19.4 million workers were covered by a defined benefit plan. Total coverage of defined benefit plans in the private sector has declined both in relative and absolute terms.

FIGURE 1
NUMBER OF RETIREMENT PENSION PLANS BY PLAN TYPE, 1975-2007

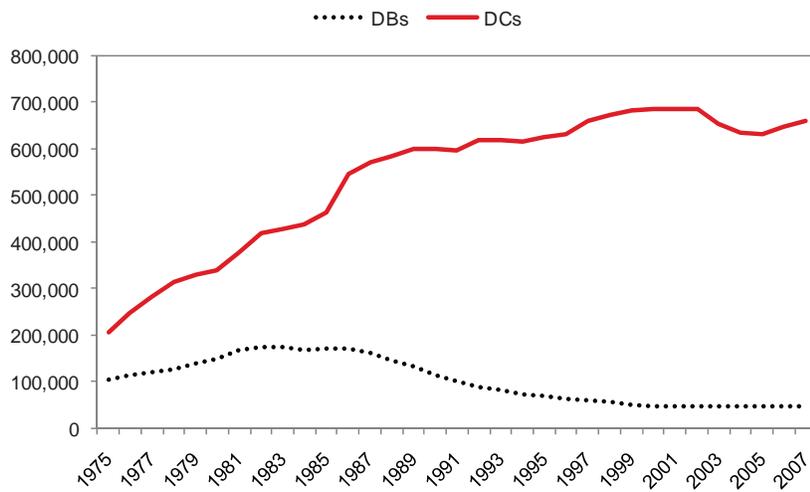
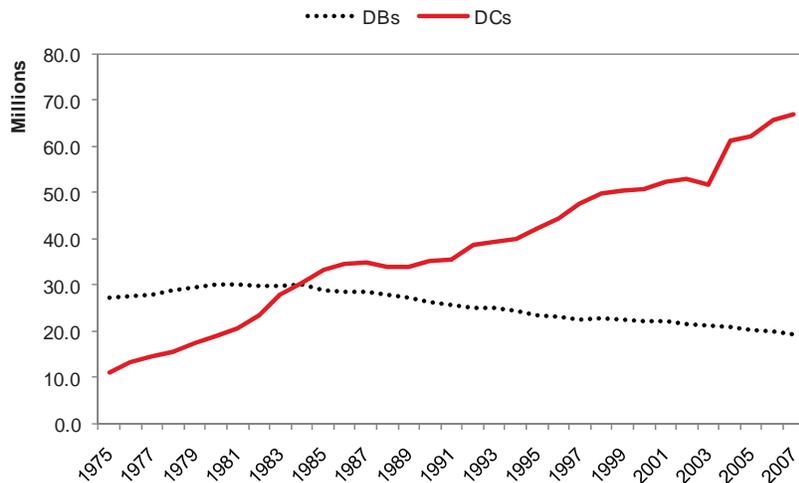
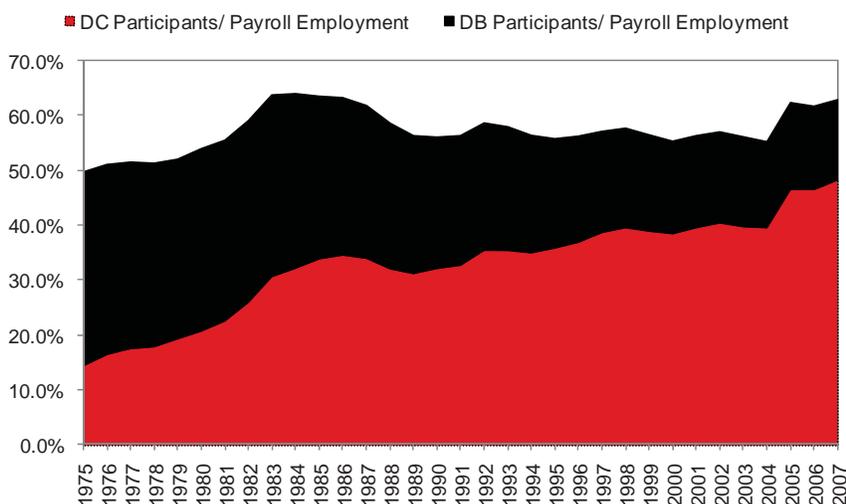


FIGURE 2
ACTIVE NUMBER OF RETIREMENT PLAN PARTICIPANTS BY PLAN TYPE, 1975-2007



Source: Employee Benefits Security Administration

FIGURE 3
TOTAL DEFINED CONTRIBUTION AND DEFINED BENEFIT ENROLLEES AS A
PERCENTAGE OF NONFARM PAYROLL EMPLOYEES, 1975-2007



Source: Employee Benefits Security Administration and Bureau of Labor Statistics

The growth in the defined contribution plans has not extended the total pension coverage for the U.S. workforce, see **Figure 3**. Figure 3 divides the total share of nonfarm payroll employees that are covered by a pension into either a defined benefit plan or a defined contribution plan between 1975 and 2007. As Figure 3 illustrates, the total number of enrollees in either a defined benefit or a defined contribution plan as a percentage of nonfarm payroll employment peaked in 1984 at 64.1 percent. The percentage of workers covered has been around these values ever since.⁷

The trends in Figures 1 through 3 illustrate the pension conversion story that has occurred throughout the private sector over the past 30 years. In the mid-1970s, about one-half of the work force had pension benefits. Of these workers, a majority was covered by defined benefit plans and employed by larger businesses (the reason why defined benefit plans were a minority of the plans offered but covered a majority of the people with a pension). Beginning in the mid-1980s the total number of defined benefit plans, and the total number of participants in defined benefit plans, began a steady decline that has continued through 2007 (the number of defined benefit plans actually stopped declining in the early 2000s and has stagnated around 48,000 to 49,000). At the same time, due to the explosive growth in defined contribution plans and enrollees, the majority of the workforce has converted to defined contribution plans. Defined contribution plans

are now the normal pension plan for the private sector workforce in the U.S. for those workers that have access to pension benefits.

According to Gale et al., the private sector's movement away from defined benefit plans (DB) toward defined contribution plans (DC) occurred for three reasons, "increased regulation of DB plans following passage of ERISA in 1974, the changing composition of the work force, and tax law changes."⁸ Munnell et al. (2007) similarly found that:

In the private sector, the Employee Retirement Income Security Act of 1974 (ERISA) imposes minimum standards for participation, vesting, and funding; state and local plans are not covered by this legislation. ERISA also established the Pension Benefit Guaranty Corporation (PBGC), which collects premiums from plan sponsors and pays benefits (within limits and subject to certain restrictions) in the event of plan termination. Public plans are not covered by ERISA or the PBGC. The absence of these regulations could increase the desirability of defined benefit plans by lowering administrative costs and allowing later vesting.

The enactment of ERISA raised the costs of running a private defined benefit plan. It was not just the effect of the original legislation, but during the 1980s Congress passed significant pension

*legislation every few years. Congress also repeatedly raised PBGC premiums and imposed an excise tax on employers who claim the excess assets of terminated defined benefit plans. The cumulative impact of the legislative changes increased the costs of defined benefit plans relative to those for defined contribution plans.*⁹

Other researchers echoed the findings that ERISA and other regulations significantly raised the costs for private sector employers to sponsor a defined benefit plan. Husted (1998) illustrated that due to higher regulatory costs, the cost for an employer to offer a defined benefit plan rose from 140 percent of the cost of offering a defined contribution plan in 1981 to more than 210 percent in 1996.¹⁰ Kruse (1995) found that rising administrative costs due to ERISA were a contributory factor in the decline of the defined benefit plan in the private sector.¹¹

The implementation of the ERISA regulations has clearly been an important cause of the private sectors long-term transformation toward defined contribution plans from defined benefit plans. Of course, state and local government pension plans are not subject to ERISA regulations explaining, in part, why the state and local governments still rely on defined benefit plans to such a large extent. Regardless of the efficacy of ERISA, the purpose of the regulation was, in part “to protect against private sector mismanagement of employee benefit plans which placed individual participants’ potential benefits at risk.”¹²

The trillion dollar unfunded liabilities of the state and local government pension systems has placed employees (or because these are government entities, taxpayers) at significant risk, essentially violating the purpose of ERISA. ERISA’s impact on the private sector provides an important lesson for the public sector pensions. The entitlement nature of the DB plans creates an unknown and heavy burden that, when coupled with budget constraints and current unfunded liabilities, inevitably lead to placing either potential benefits or taxpayers at risk.

The Problem with Defined Benefit Pension Plans—the Employee Perspective

The higher costs of administration have had the effect of a significant reduction in the supply of defined benefit plans by employers. Concurrent with the decline in the supply of defined benefit plans by employers, the demand for these plans by employees has also declined. Simply put: defined contribution plans are more appropriate for the modern workforce.

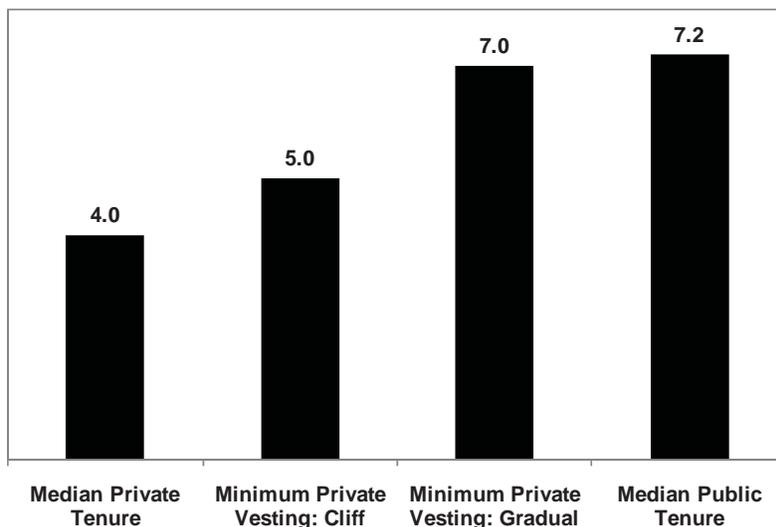
Defined benefit plans can offer employees that work for the same employer for most of their career a great deal. Benefits from defined benefit plans are generally based on the salary level and years of service (as is the case with most of the public pensions in Texas).¹³ Employees who accumulate many years of service and, based on those years of service, end their career with a generous salary can receive a generous pension. Employees that are more mobile may not have the opportunity to vest in a defined benefit plan. Those that do vest, may not have the time (or salary levels depending upon the stage of their career) to build up a meaningful pension benefit.

Data from the Bureau of Labor Statistics (BLS) illustrates that workers do not stay with the same employer throughout their careers and are consequently subject to significant “turnover risk”—the risk that their pension benefits will not be realized due to career changes. The median number of years that private wage and salary workers worked for their current employer was 4.0 in January 2010.¹⁴ In February 1996, the median tenure was 3.2 years, and the value has been bouncing around these levels for the past 15 years—speculation is that the higher tenure in 2010 is due to the recession and resulting difficulty for private sector workers to gain new opportunities.

In comparison to these average tenures, based on the Tax Reform Act of 1986, private sector defined benefit plans must allow workers who can gradually vest in the defined benefit plan (gradual) to be fully vested by their seventh year of employment; those workers that have no vesting benefits until a certain year (cliff) must be vested by their fifth year of employment.¹⁵ Most state and local pension plans have vesting requirements that are similar to the private sector.

The defined benefit plan is ill suited toward the modern private workforce because the average turnover of private sector workers is too high. Government sector workers have a much higher median tenure, however. The median tenure for a public sector worker (7.2 years in 2010) is nearly double the median tenure for a private sector worker (4.0 years), see **Figure 4**. This pattern has been consistent for many years. The longer tenure for public sector employees is related to the compensation package they receive. The government compensation package is designed to reward risk-averse behavior that keeps employees in the government sector and discourages people from transitioning between the public and private sectors. Reforming the defined benefit plan for public sector workers provides incentives for government workforce innovations and incentivizes employees to transition between the public and private sectors that could lead to increased overall effectiveness of the public sector.

FIGURE 4
MEDIAN TENURE FOR ALL EMPLOYEES OVER 16
1996-2010 (SELECT YEARS)



Source: Bureau of Labor Statistics, www.bls.gov; and Peter Brady, "A Look at Private-Sector Retirement Plan Income After ERISA" Investment Company Institute: Research Perspective (Nov. 2010) Vol. 16, No. 2.

The pension system should work effectively with current employment patterns. Under defined contribution plans, the benefits earned by an employee are completely portable—regardless of how many times an employee switches jobs, the retirement benefits accrued at a past job are not lost. Defined contribution plans, consequently, promote a dynamic workforce. Defined contribution plans also empower workers to more easily switch between private sector and public sector positions fostering stronger ties and understanding between the public and private sectors.

Additionally, employees who have defined contribution plans can often access their retirement funds before retirement if specified hardships arise. This option is not available under defined benefit plans. The options of being able to access funds in a defined contribution plan create an additional value that is not available under a defined benefit plan.

An argument against defined contribution plans is the additional market risk that the employee must bear under a defined contribution plan that the employer bears under a defined benefit plan. However, studies by Samwick and Skinner (2004), Schragger (2005), Aaronson and Coronado (2005) and Poterba et al. (2006) all found that the turnover risks are high enough that for the majority of investors, the expected retirement income provided by 401(k) plans or other defined contribution plans is higher than the expected retirement income provided by defined benefit plans.¹⁶

With respect to income for retirement, research from Poterba et al. (2007) found that the spread of 401(k)s (the predominant defined contribution retirement plan) will help increase the amount of wealth retirees will be able to amass for retirement:

The sum of Social Security wealth and 401(k) assets held by households that reach retirement age in 2040 will be at least twice as large (in real dollars) as the sum of these assets in 2000. Moreover, retirement assets are projected to grow for households all along the distribution of Social Security wealth. The advent of personal account saving is projected to yield very large increases in the financial assets of future retirees across the lifetime earnings spectrum.¹⁷

Poterba et al. (2007b) found two very important results for our purposes here. The study concludes that:

Our estimates of the average level of wealth accumulated in DC plans depend on how the participant allocates assets across different investment options. Private sector DB plans almost always yield lower average retirement wealth accumulation than private DC plans, although they are also less likely to generate very low retirement wealth outcomes. The comparison between public sector DB plans and representative private sector DC plans is more difficult.

*If equity returns follow their historical empirical distribution, an individual in a DC plan who makes substantial equity investments will usually achieve a higher retirement wealth in a DC plan than in a public sector DB plan.*¹⁸

First, Poterba et al. (2007b) found that for well-balanced portfolios, defined contribution plans should produce greater wealth at retirement for workers than either private defined benefit plans or public defined benefit plans. However, the comparison between the wealth gained for retirement in private defined contribution plans compared to public defined benefit plans is much closer than the comparison between the wealth gained for retirement in private defined contribution plans compared to private defined benefit plans. Consequently, this also provides evidence that the generosity of public defined benefit plans is excessive compared to their private counterparts. We discuss this issue in more detail below.

Because defined contribution plans offer workers greater flexibility in their timing of payment, greater flexibility with respect to the length of tenure at their employer, and greater options and wealth at their time of retirement the demand for defined contribution plans from employees has risen at the same time that the supply of defined contribution from employers has increased. The result has been the transformation of the pension system throughout the private sector. Most private sector employees now have retirement plans that are either solely defined contribution plans or retirement plans that are a hybrid of defined benefit plans and defined contribution plans.

This migration has not occurred for public sector workers—including Texas. Pure defined benefit plans have inherent disadvantages compared to either hybrid or pure defined contribution plans—the possibility for an unfunded liability crisis being a critical disadvantage.

Applying the Lessons from the Private Sector Transformation to the Public Sector

As discussed below, increasing the investment returns for defined benefit pension plans is not feasible. While the market may be set for accelerated growth over the next several years, it could also be set for sub-par returns. Ultimately, financial theory suggests that higher returns are gained by taking higher investment risks.¹⁹ By definition, higher risks could mean higher returns; it could also lead to larger losses. Attempting to increase the investment returns as a means of “growing” out of the unfunded liability problem is a risky path akin to gamblers attempting to double down

at the blackjack table in order to overcome their gambling losses. It is also why raising investment returns is generally not viewed as a viable alternative for solving the unfunded liabilities problem.

Offloading the pension liabilities to the federal government is not a viable option either. Offloading the unfunded state and local pension obligations simply transfers responsibility from the state and local governments, where these problems were created, to the federal government. To the extent that one state attempts to offload its pension liabilities to the federal government, other states would also have the incentive to offload their pension liabilities on to the Federal government.

Texans, along with the citizens of the other 49 states, fund the Federal government. Therefore, offloading the unfunded state and local pension liabilities on to the federal government is simply transferring the burden from state and local unfunded liabilities to the federal taxpayers. The review of the unfunded liabilities across all the states below illustrates that in aggregate these costs are estimated to be at least \$1 trillion. The review below also illustrates that Texas has managed its future pension obligations more effectively than other states (although some concerns with Texas' system do exist). Therefore, unloading state pension obligations on to the federal government would require Texans to pay higher federal taxes and/or receive fewer federal government services due to the unfunded liabilities created by other state and local pension systems.

Increasing the revenues coming into the state pension systems is a feasible alternative. However, some methods for increasing revenues have larger unintended consequences than others. A similar dynamic holds with respect to benefits—some benefit changes are more justifiable than others. Therefore, feasible changes to the revenues and benefits of the pension system are not only possible, but are the only sound options to addressing the unfunded liabilities crisis facing the states.

When private sector firms transformed their defined benefit plans into defined contribution plans the typical approaches were to either terminate the plan at once or to freeze the plan. A defined benefit plan termination ceases the operations of the plan. When private sector firms terminate their defined benefit plan, typically, the plans are adequately funded such that the firm can purchase an annuity to cover the obligations. According to the Pension Benefit Guaranty Corporation (PBGC), between 1986 and 2004, “... 101,000 single-employer plans with about 7.5 million participants were terminated. In about 99,000 of these terminations, the

plans had enough assets to purchase annuities in the private sector to cover all benefits earned by workers and retirees (a 'standard termination').²⁰

In lieu of terminating their plans, another option used by the private sector is to freeze their current retirement plans. When a defined benefit plan is frozen, the plan continues to exist but the growth and operations of the plan are curtailed. The purpose and extent of freezing a defined benefit plan varies. According to the PBGC:

Some plans are frozen because the sponsor falls on hard economic times and decides to temporarily freeze its plans to reduce the contributions it is required to pay into them. Other plans are frozen because the sponsor wants to cover its workers under a defined contribution or hybrid plan and does not want to terminate or convert the old plan. Still others are frozen after one company acquires another, and the plans of the two companies cannot easily be merged.

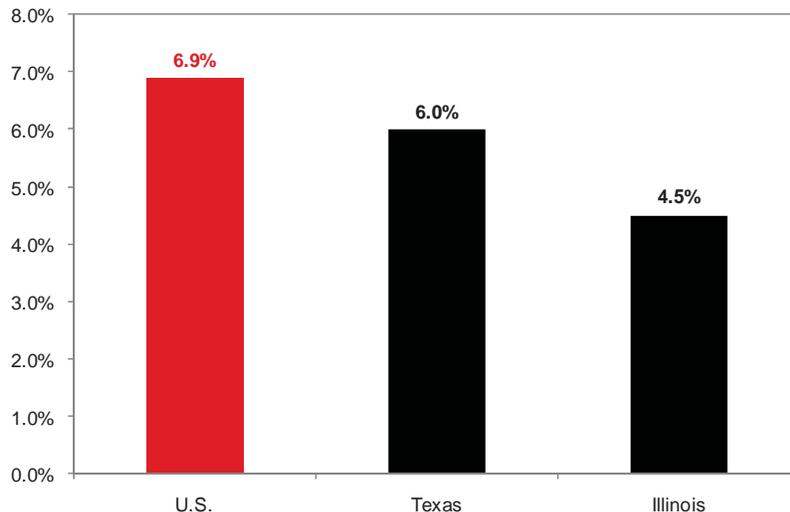
... a plan can be frozen in several ways. It can be closed to new entrants so that only those in the plan at a point in time continue to accrue benefits. The plan can be frozen for some, but not all, participants. Such a partial freeze could be based on age, tenure, job classification or plant location. Under a hard freeze, no participant accrues any further benefits based on either job tenure or compensation growth. Under a soft freeze, benefits are generally not increased for

additional tenure but are increased for compensation growth.²¹

The private sector transformation from defined benefit plans to defined contribution plans has represented a shift in both the incentives for firms to supply these plans and the incentives for workers to demand these plans. Unlike the private sector, states do not need to bear the regulatory costs created by ERISA that has diminished the incentive for firms to supply pension plans. However, as the \$1 trillion unfunded liabilities illustrates, maintaining a well-funded pension system creates large potential costs. The experience of Illinois is a great case study illustrating how fragile a well-funded pension system can be.

Illinois' pension system has been teetering on being adequately funded for many years. According to the Pew Center, Illinois' pension system was 73 percent funded in 1999—slightly below the level considered adequately funded.²² However, between 1999 and 2008 the average annual growth in contributions from employees and the government has been 4.5 percent in Illinois compared to 6.9 percent for the states as a whole and 6.0 percent in Texas, see **Figure 5**.²³ As a result, by 2008 Illinois' pension system was an even bleaker 54 percent funded.²⁴ And, these figures do not even include the liabilities from retirement health care obligations or other retirement obligations promised by the state. The consistent underfunding of Illinois pension obligations has coincided with continued budget problems for the state.

FIGURE 5
GROWTH IN EMPLOYEE AND STATE & LOCAL GOVERNMENT CONTRIBUTIONS TO STATE & LOCAL DEFINED BENEFIT PENSIONS 1999 - 2008



Source: ALME calculations based on state and local pension data from the U.S. Census; www.census.gov.

Money is fungible. Because contributions to the state pension system can also be used to pay for current programs, state budget problems can quickly make a poorly funded state defined benefit system worse, as the case of Illinois illustrates.

State budget problems can also reduce the adequacy of well-funded state defined benefit systems, as is the case with New York. New York's pension system was 128 percent funded in 1999—well above the level considered adequately funded.²⁵ The consistent underfunding of New York's pension obligations has coincided with continued budget problems for the state, and has reduced the funding level to 107 percent in 2008. As New York continues to struggle with budget problems, the adequate funding status of its pension obligations will continue to face pressures. **Figure 6** illustrates the degradation of the health of the state defined benefit pension systems in New York, Illinois, and California—all states that continue to struggle with significant budget problems—compared to Texas.

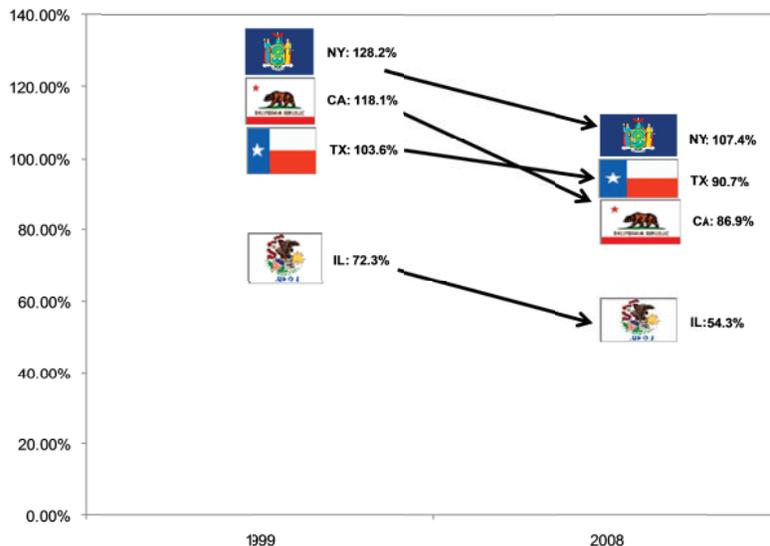
Texas' pension systems have been traveling down a similar path as New York's, Illinois,' and California's. According to the Pew Center on the States study, back in 1999 Texas' pension systems were 103.6 percent funded.²⁶ However, between 1999 and 2008 the growth in liabilities

significantly outpaced the growth in assets. By 2008, total assets were only 90.7 percent of total liabilities. According to the Pew Center, “Between 2003 and 2007, [Texas] paid less than 90 percent annually of what its own actuaries said was necessary. However, in 2008, it got back on the right track, paying 99 percent of its annual required contribution. Texas passed legislation in 2009 that increased the retirement age and service eligibility requirements for employees hired after September 1, 2009. This legislation also increased the employee contribution rates for members of the Employee Retirement System.”²⁷

While the decline in the funding ratio has declined the least in Texas, the lesson from the experiences of New York, Illinois, and California is that a well-funded defined benefit plan is fragile. Current budget problems can (and often do) turn into longer-term structural pension problems due to the states offering defined benefit plans. This risk reduces the benefits to the state from offering defined benefit pension plans to its employees.

On the demand side, the same factors reducing the demand for defined benefit plans for private sector workers exist for public sector workers—greater worker mobility and the need for greater pension flexibility. The current defined benefit plan system also:

FIGURE 6
FUNDING RATION FOR NEW YORK, CALIFORNIA, ILLINOIS, AND TEXAS
1999 AND 2008



Source: “The Trillion Dollar Gap” Pew Center on the States (18 Feb. 2010).

- Creates a culture that locks workers into their current career path,
- Encourages risk-averse behavior of employees (maximizing longevity is a key consideration in maximizing benefit payments), and
- Discourages an interchange of employees between the public and private sectors and therefore diminishes the transfer of private sector workforce innovations into the public sector.

Switching the government retirement plans from defined benefit plans to defined contribution plans is an important part of an overall public sector workforce innovation reform. Texas, along with the other 49 states, should expect overall cost and productivity efficiencies by switching their current retirement plans from defined benefit plans to defined contribution plans.

Inequitable Transfer of Wealth and Government Reform

One theoretical solution to the unfunded liabilities issue is to increase the cost of government by either increasing taxes or reducing other government services effectively raising the costs to provide government services. This solution makes no sense. The current defined benefit entitlement already creates two inequitable wealth transfers that should be eliminated:

- Wealth is transferred from shorter-tenured public sector workers to the longer-tenured public sector workers, and
- Wealth is transferred from private sector workers who earn less money and have less generous pension benefits to public sector workers who earn more money and have more generous pension benefits.

According to the latest government data from the Bureau of Labor Statistics, the median tenure for a public sector worker is around seven years. By definition of a median, this figure means that one-half of the public sector workers have a tenure that is long enough to vest in the vast majority (if not all) public pensions (somewhere around five to seven years), one-half of the public sector workers do not. Any public sector worker who fails to vest in the current public sector pensions will not receive any of the money the government paid into the defined benefit pension on his or her behalf. Instead all of these funds are simply transferred from them to public sector workers with longer tenures by adding them to the fund.

Transferring money across public sector workers creates many unintended, and unwarranted, wealth transfers. For instance, according to the Bureau of Labor Statistics, "...the median tenure of workers ages 55 to 64 (10.0 years) was more than three times that of workers ages 25 to 34 (3.1 years)."²⁸ Because younger workers starting their career will often have shorter tenures, the public sector defined benefits plan transfers wealth from younger workers who tend to be paid less toward older workers who tend to be paid more. Wealth transfers from poorer individuals to wealthier individuals violate common equity perceptions. Based on the unfunded liabilities problem, the wealth transfers also resemble a Ponzi scheme where the earlier entrants into the scheme are paid a high return at the expense of those who come later.

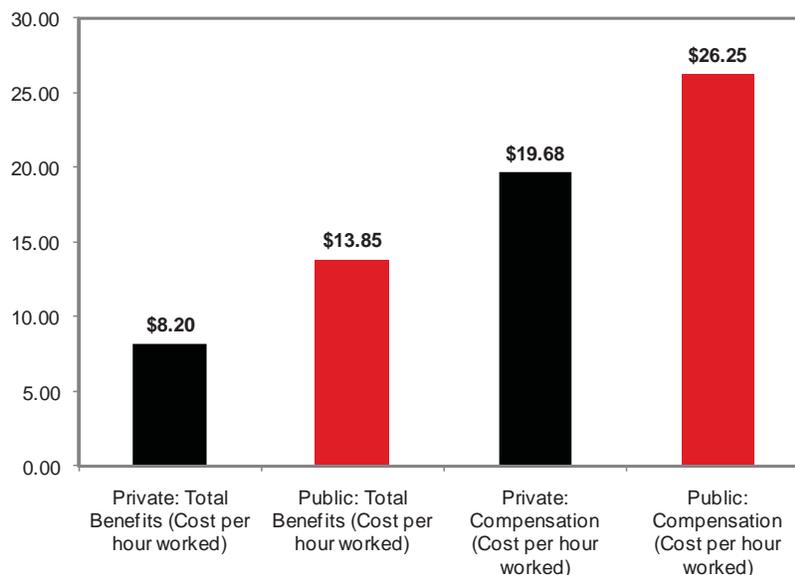
Taxpayers fund all government expenditures. According to data from the Bureau of Labor Statistics, both the average salary and the average benefits package of a public sector worker exceed the average salary and the average benefits package of a private sector worker, see **Figure 7**.

The generous public sector salaries and benefits has set up a situation where taxpayers with fewer monetary resources are paying taxes to, in part, support government workers with a greater amount of monetary resources. Justifications for this discrepancy ultimately must be based on higher marginal productivity for the public sector compared to the private sector—a dubious argument.

Both of these inequitable transfers should be eliminated regardless of whether the state pension systems are unfunded. Decreasing the unfunded liabilities by either raising taxes or cutting other government services expands these transfers. As of the third quarter of 2010, the government compensation premium over the private sector was over 33 percent; however the government benefits premium over the private sector was nearly 69 percent. Transferring more wealth from the taxpayer to public sector employees in order to maintain public sector employees' large benefits premium makes absolutely no sense.

Raising taxes or cutting other government spending maintains the current inequitable wealth transfers the current defined benefit entitlements create. The problems associated with the defined benefit pension systems should be fixed by fundamental pension reforms not by looking for new revenue sources or diverting current revenue sources toward pension costs.

FIGURE 7
BENEFITS AND COMPENSATION PER HOUR, PUBLIC SECTOR VERSUS PRIVATE SECTOR
2010 QIII



Source: U.S. Bureau of Labor statistics; www.bls.gov.

The Unfunded Pension Liabilities Problem in Texas

The problems facing Texas are not dire—but they are troubling. According to the Pew Center on the States as of the end of 2008 Texas' total pension fund liabilities were \$148.6 billion and total pension fund assets were \$134.8 billion implying that Texas' pensions were 90.7 percent funded—a \$13.8 billion unfunded liability.²⁹ However, only 2.5 percent of the \$28.6 billion in health care and other retirement obligations were funded.³⁰ Due to the vagaries that surround actuarial assumptions, the pension systems in Texas are currently considered to be acceptably funded—albeit the lower-end of acceptably funded. According to the Government Accountability Office:

Many experts consider a funded ratio (actuarial value of assets divided by actuarial accrued liabilities) of about 80 percent or better to be sound for government pensions. We found that 58 percent of 65 large pension plans were funded to that level in 2006, a decrease since 2000 when about 90 percent of plans were so funded. Low funded ratios would eventually require the government employer to improve funding, for example, by reducing benefits or by increasing contributions ... many governments have often contributed less than the amount needed to improve

or maintain funded ratios. Low contributions raise concerns about the future funded status.³¹

Experts generally consider an 80 percent funded ratio or better to be sound due to the vagaries of the calculation being made. In order to determine whether a pension is adequately funded the changes in the systems assets and liabilities over a long period (anywhere between 30 and 50 years) must be calculated. Assumptions regarding the number of employees, tenure of employment, salaries, benefit levels, employee contributions, employer contributions, retirement age, benefit periods, benefit levels, lifespan and investment returns over the next 30 to 50 years must be made. As a consequence of the large number of assumptions that are made in order to determine how well the pension system is funded, actuaries allow for a wide range of error.

According to the Texas Pension Review Board for FY2009 “The combined assets of the state’s public retirement systems are approximately \$190 billion. The total membership of Texas public retirement systems exceeds 2.3 million active and retired members.”³² In total there are (as of January 2009) 1,788 public retirement systems in Texas.³³

The largest pension system in Texas is the Teachers Retirement System of Texas (TRS). Of the \$190 billion in

total state and local pension assets in Texas as of the end of FY2008, TRS was \$110 billion, or more than 57 percent of the total assets of all pension systems in Texas. Since FY2008, the performance of the TRS has worsened and at the end of FY2009, net assets were down to \$88.7 billion.³⁴ The unfunded portion of the health benefits trust fund of the TRS is in even worse shape. As of August 2009, the actuarial value of the systems assets was only 3.3 percent of the actuarially accrued liabilities.³⁵

According to the FY2009 annual report, the funding ratio was 83.1 percent (actuarially accrued liabilities significantly exceed the actuarially valued assets) and due to "...the two significant market downturns in the last 10 years, current contributions are not sufficient to amortize the unfunded liabilities and therefore the funding period is never. Absent significant investment gains in excess of 8 percent, adjustments will need to be made to contributions and/or benefits to bring the fund back into a position to amortize unfunded liabilities over 30 years."³⁶ A similar sentiment was repeated in FY2010.³⁷

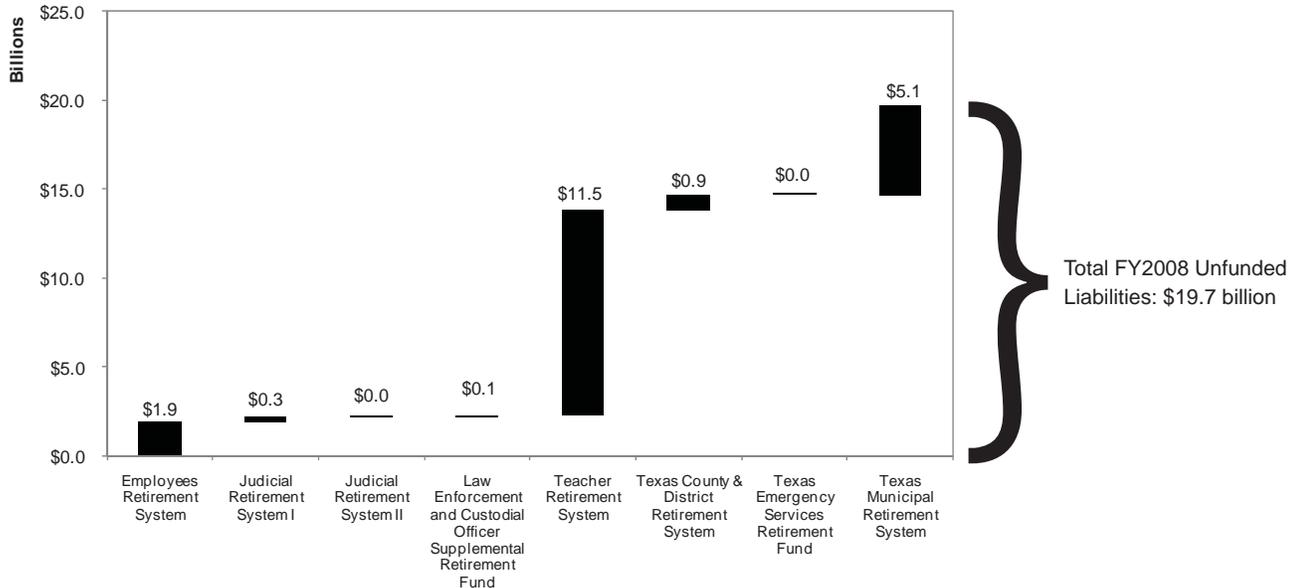
Although net assets grew 7.9 percent to \$95.7 billion in FY2010, the funding ratio fell to 82.9 percent, and the unfunded liabilities of the health benefits trust fund grew from \$23.6 billion to \$25.0 billion.³⁸ According to the TRS,

the one year rate of return for the TRS investments for the periods ending August 31, 2010 was 10.7 percent. This is significantly higher than the three-years return (-2.8%), five-years (2.9%) and 10-years (3.1%).³⁹

The other major retirement systems include the Employees Retirement System, the Judicial Retirement Systems (Plan I & II), the Law Enforcement and Custodial Officer Supplemental Retirement Fund, Texas Emergency Services Retirement System, and two pooled local systems (the Texas County & District Retirement System and the Texas Municipal Retirement System), which are comprised of 1,401 member plans.⁴⁰ In total, there are nearly 1,800 retirement systems in Texas.

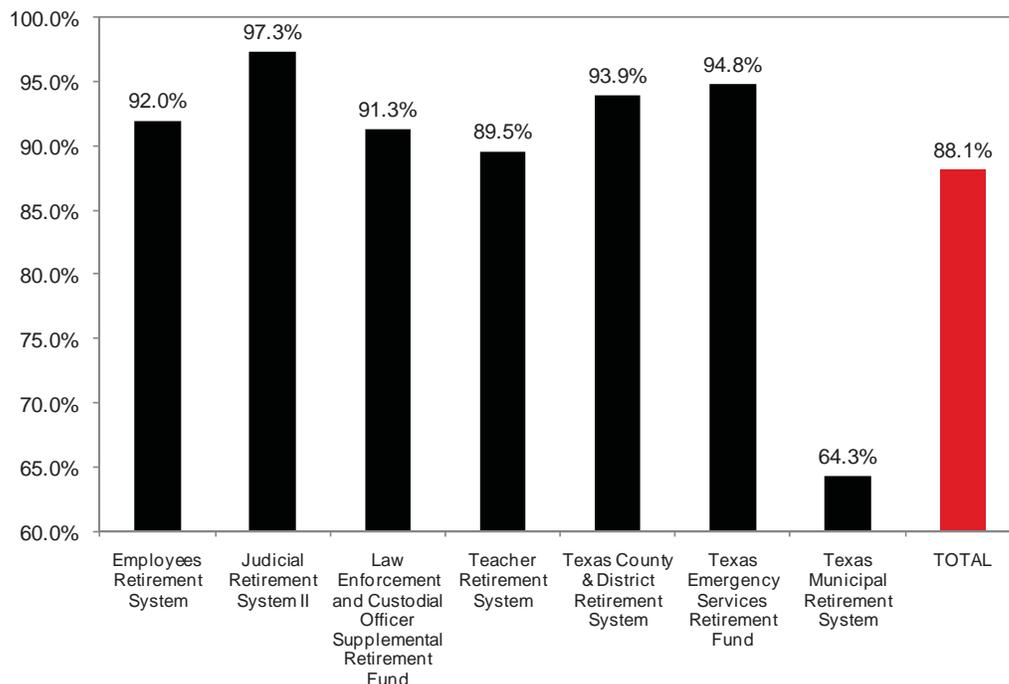
Figure 8 illustrates that during FY2008, the Texas Pension Review Board found that the estimated unfunded liabilities for state retirement systems in Texas was \$19.7 billion, which is similar, but larger, than the findings from the Pew Center (\$13.8 billion). Figure 8 breaks the dollar value of the unfunded liabilities out by major pension system in Texas. As expected, the largest dollar exposures from the unfunded liabilities are created by the largest pension systems—the Teacher Retirement System, the Texas Municipal Retirement System, and the Employees Retirement System comprising the vast majority of the unfunded liabilities.

FIGURE 8
ESTIMATED UNFUNDED LIABILITIES, TEXAS PENSION SYSTEMS
FY2008



Source: "Guide to Public Retirement Systems in Texas: A Comparison of Statutory Public Retirement Systems in Texas" Texas Pension Review Board (Jan. 2009).

FIGURE 9
ESTIMATED FUNDED RATIOS, TEXAS PENSION SYSTEMS
FY2008



Source: ALME calculations based on "Guide to Public Retirement Systems in Texas: A Comparison of Statutory Public Retirement Systems in Texas" Texas Pension Review Board (Jan. 2009).

Figure 9 examines each pension system's unfunded liabilities relative to its assets. Relative to assets, the Texas Municipal Retirement System has the highest unfunded liabilities (the lowest funded ratio) compared to all of the other pension systems. When coupled with the large absolute dollar value of the unfunded liabilities (\$5.1 billion as of FY2008), it is clear that significant reforms to the Texas Municipal Retirement System are needed. The Teacher Retirement System (TRS) is the next system with the highest unfunded liabilities. Since FY2008, the TRS has fallen to the aforementioned 82.9 percent funded ratio, which exceeds the 80 percent threshold cited by GAO as acceptable, but not by much.

These programs are 'defined benefit' programs, meaning that, regardless of an employee's contribution or the current economy, the state is liable for paying a promised amount of retirement benefits. Defined benefit programs create an ever-increasing financial liability on the state government.

The benefits and eligibility rules vary across these systems. The retirement age varies from a low of 50 with 20 years of service (the Law Enforcement and Custodial Officer Supplemental

Retirement Fund) to a high of 65 (Teachers Retirement System and Judicial Retirement System). Most other systems have a retirement age of 60 with certain years of service requirements.

Benefits for the Employees Retirement System and Teachers Retirement System if hired before September 1, 2005 are based on a percentage of the average salary for the final three years (the benefits for TRS employees hired after September 1, 2005 are based on the average salary for the final five years). The benefits for the other pension funds are based on 50 percent of final compensation (Judicial Retirement Systems).

In Texas, the governments' contributions into the Texas Employee Retirement System, Teacher Retirement System, and other government retirement programs have been 2.4 percent of General Revenues on average since 1993, see **Table 1**. This is lower than the average burden in the U.S. of 3.1 percent, see **Figure 10**. However, the volatility of the percentages for California, Illinois, and New York illustrated in Table 1 demonstrate how defined benefit programs can have a destabilizing impact on state budgets.

Total State and Local Revenues (000's)

	TEXAS	CALIFORNIA	ILLINOIS	NEW YORK	U.S.
Average (Median)	99,856,917	217,508,700	65,946,247	148,003,863	1,589,631,348
1993	63,086,881	134,361,476	43,526,553	107,972,282	1,041,643,379
1994	66,108,570	140,954,294	46,374,031	113,354,024	1,100,490,377
1995	69,510,130	149,714,116	50,483,467	118,446,573	1,169,504,619
1996	74,846,554	155,497,379	52,881,930	122,096,568	1,222,774,282
1997	78,725,538	161,680,383	54,794,498	129,554,327	1,289,237,245
1998	83,521,992	174,426,572	57,566,597	134,624,016	1,365,761,964
1999	90,326,629	185,730,774	60,333,633	137,113,621	1,434,028,908
2000	95,539,213	208,373,379	64,419,965	143,901,343	1,541,322,481
2001	104,174,620	228,223,259	67,472,529	152,106,383	1,637,940,214
2002	108,927,429	226,644,021	69,180,799	155,541,158	1,684,879,080
2003	116,145,571	239,589,210	71,107,118	166,304,608	1,771,395,519
2004	123,893,330	250,206,389	76,599,604	181,366,366	1,887,396,886
2005	131,986,152	271,330,520	80,126,880	194,245,258	2,026,724,351
2006	144,880,569	293,049,192	87,469,650	209,640,987	2,186,018,089
2007	155,715,895	316,409,534	91,714,340	222,608,935	2,335,894,452
2008	164,174,822	327,817,087	95,513,332	228,845,478	2,425,778,485

Government Contributions (State and Local, 000's)

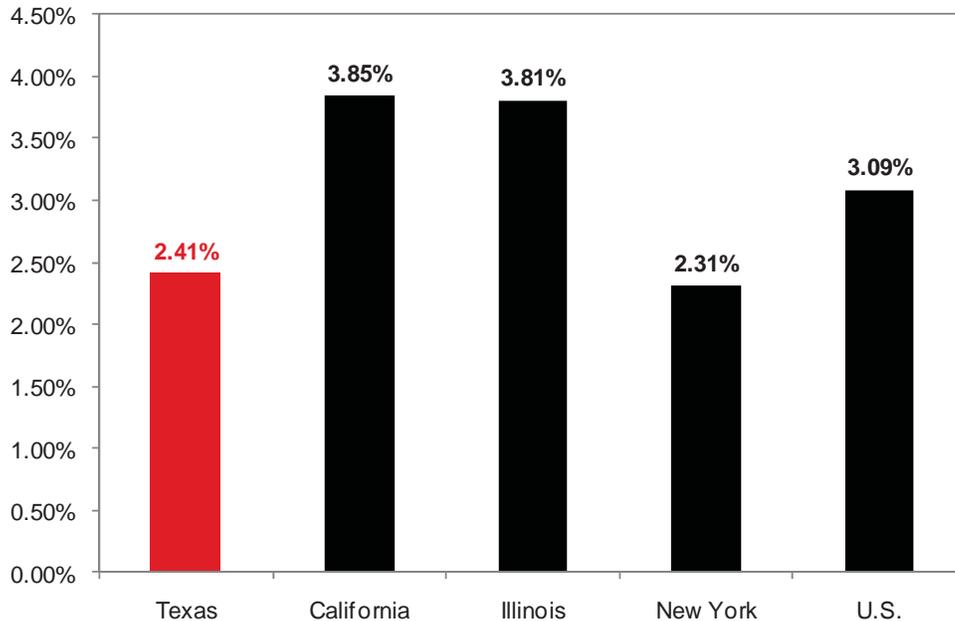
	TEXAS	CALIFORNIA	ILLINOIS	NEW YORK	U.S.
Average (Median)	2,326,977	6,317,312	2,511,487	2,689,838	41,791,898
1993	1,657,382	5,256,744	1,471,507	2,654,441	34,991,684
1994	1,653,333	5,329,179	1,769,360	2,653,414	36,772,434
1995	1,833,537	6,998,208	2,032,248	2,725,235	41,011,466
1996	1,806,266	6,524,723	1,690,489	2,780,909	41,522,538
1997	1,855,801	5,999,698	1,814,225	3,172,803	44,901,913
1998	1,989,386	6,109,900	2,003,901	2,380,322	41,850,145
1999	2,103,580	4,759,470	2,279,334	2,115,149	41,733,650
2000	2,356,400	4,290,880	2,448,395	1,506,988	40,155,114
2001	2,297,554	4,368,895	2,574,579	1,502,331	38,844,791
2002	2,642,686	4,938,283	2,659,475	1,941,653	39,525,771
2003	2,789,948	7,695,578	3,122,437	2,375,255	46,212,289
2004	2,847,223	11,349,933	10,542,207	4,205,745	60,995,984
2005	3,253,151	12,440,192	3,183,118	6,854,558	60,596,511
2006	3,854,750	12,806,674	2,702,690	8,160,577	64,481,052
2007	3,592,180	13,868,983	3,244,257	9,442,989	72,575,237
2008	3,670,762	15,767,098	3,932,536	10,419,877	81,996,539

Government Contributions % Total State and Local Revenues

	TEXAS	CALIFORNIA	ILLINOIS	NEW YORK	U.S.
Average (Median)	2.4%	3.8%	3.8%	2.3%	3.1%
1993	2.6%	3.9%	3.4%	2.5%	3.4%
1994	2.5%	3.8%	3.8%	2.3%	3.3%
1995	2.6%	4.7%	4.0%	2.3%	3.5%
1996	2.4%	4.2%	3.2%	2.3%	3.4%
1997	2.4%	3.7%	3.3%	2.4%	3.5%
1998	2.4%	3.5%	3.5%	1.8%	3.1%
1999	2.3%	2.6%	3.8%	1.5%	2.9%
2000	2.5%	2.1%	3.8%	1.0%	2.6%
2001	2.2%	1.9%	3.8%	1.0%	2.4%
2002	2.4%	2.2%	3.8%	1.2%	2.3%
2003	2.4%	3.2%	4.4%	1.4%	2.6%
2004	2.3%	4.5%	13.8%	2.3%	3.2%
2005	2.5%	4.6%	4.0%	3.5%	3.0%
2006	2.7%	4.4%	3.1%	3.9%	2.9%
2007	2.3%	4.4%	3.5%	4.2%	3.1%
2008	2.2%	4.8%	4.1%	4.6%	3.4%

Source: ALME calculations based on state and local government finance and pensions data from the U.S. Census, <http://www.census.gov/govs/>.

FIGURE 10
GOVERNMENT PENSION CONTRIBUTIONS AS A PERCENTAGE OF STATE AND LOCAL REVENUES, AVERAGE ANNUAL CONTRIBUTION 1993 - 2008



Source: ALME calculations based on state and local government finance and pensions data from the U.S. Census, <http://www.census.gov/govs/>.

For fiscally responsible budgeting, it is essential that Texas' liability be predictable. Under the current system the possibility that the state will be required to increase its contribution to retirement pensions creates a significant and ongoing risk to the state budget. Health insurance benefits provided through the retirement systems to both active and retired employees, which have experienced cost increases at a rate higher than that of inflation, creates additional risks to the state budget.

Like states across the country, Texas is facing severe budget crises and must find real budget solutions and cut ineffective spending. This situation creates an ideal opportunity to address the challenges of the retirement system. By effectively reforming the retirement system in Texas, Texas can improve its financial footing, which is discussed in more detail below.

Texas also continues to assume weighted average investment returns of 7.6 percent.⁴¹ While this is lower than the average state assumption of 8.0 percent, it could still be overly optimistic. For instance, between 1950 and 2010 the average annual return of the S&P500 was 7.1 percent.⁴² Successive 30 year periods between 1950 and 2010 provided an average annual return of 7.2 percent, on average.⁴³ While it is certainly possible that a well-managed diversified portfolio could exceed these investment return averages; it is also possible that such a portfolio would return less.

The Unfunded Pension Liabilities Problem throughout the Country

Over the next several decades the liabilities of federal, state and local governments will vastly exceed the assets available to fund these expenditures—and by vast amounts. Estimates for the federal government are estimated to be around \$56.4 to \$59.1 trillion.⁴⁴ And, these estimates do not include the potential liabilities that could arise due to the exposure to the housing crisis from Fannie Mae, Freddie Mac, and the Federal Reserve. These unfunded bills represent a looming crisis for the country.

The financial burden and impending insolvency of government retirement programs are a challenge for every state in the nation. State and local governments also face a significant unfunded liabilities crisis in addition to the federal problem. Wilshire Consulting performs an annual review of state public retirement systems.⁴⁵ Based on the 2010 report, the 2008 market value of state assets (\$1.6 trillion) are \$400 billion below the \$2.0 trillion in accrued pension liabilities as of 2008. Put another way, the pension

funds are currently 79 percent funded.⁴⁶ According to the U.S. Government Accountability Office, “The total unfunded OPEB [other post-employment benefits] liability reported in state and the largest local governments’ CAFRs exceeds \$530 billion.”⁴⁷ The combined \$930 billion unfunded liability estimate is consistent with results from a comprehensive analysis of the state unfunded liability problem published by the Pew Center on the States.

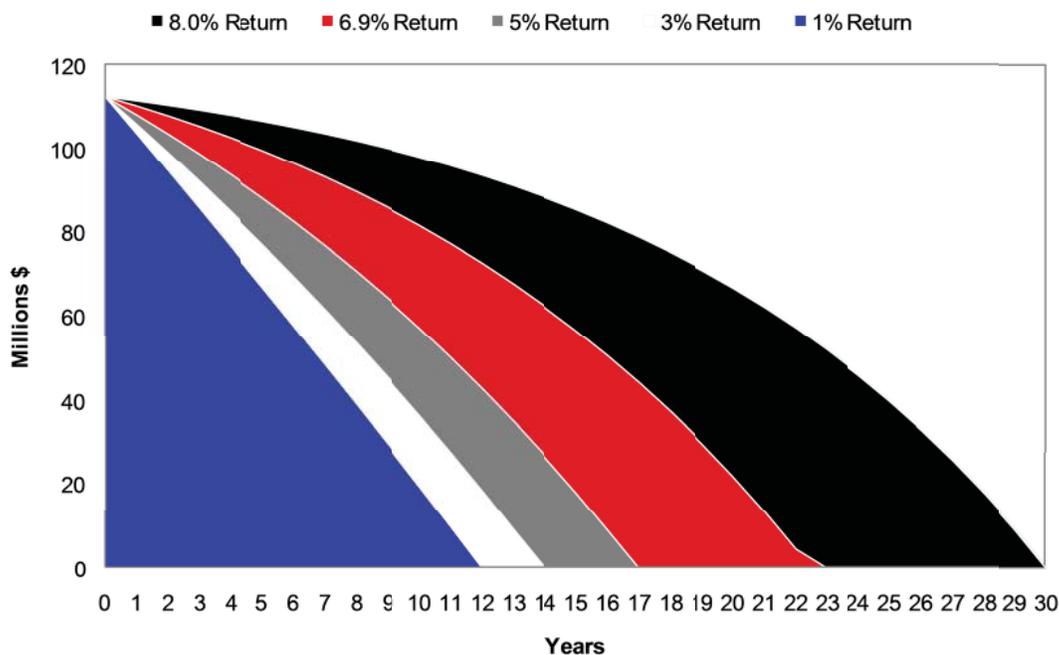
The Pew Center on the States analyzed the total unfunded liabilities of the states—pension and other liabilities. According to the Pew Center on the States, the states have only set aside \$2.35 trillion to fund employees’ retirement benefits and virtually nothing to fund the health care and other liabilities. However, the total value of the promises made by the states for pension and other benefits totals \$3.35 trillion, leaving the states with a current \$1 trillion deficit.⁴⁸

Equally important, the value of the unfunded liabilities of the states depends on certain assumptions. Most relevant is the expected return to the investment portfolios. The higher the expected return to the investment, the fewer dollars the state and participating municipalities actually need in order to meet future liabilities. As a simplified example, suppose a state’s estimated annual payout over the next 30 years is \$10 million (a liability). Facing this payment schedule, and assuming an 8.0 percent return, then a state’s liabilities would be completely funded with a portfolio worth \$112.6 million today, see **Figure 11**.

But, what happens if the portfolio does not earn 8.0 percent; what if the state only earns 6.9 percent from its portfolio. If this situation were not corrected, then the state would not be capable of paying out all of the accrued liabilities—under this example if the state continued to pay out \$10 million a year by the 23rd year the portfolio would be equal to 0, see Figure 11. The pension was actually unfunded even though on paper it looked as if the liability was fully funded. This may be the situation in which the states currently find themselves.

The states and participating municipalities are making very optimistic assumptions regarding the annual returns on their portfolios. According to Wilshire, the median (average) state expects an 8.0 percent return across their entire portfolio. According to Wilshire’s calculations, “... the median state pension fund has an expected return of 6.9 percent. This result is 1.1 percent less than the current median actuarial interest rate of 8.0 percent.”⁴⁹ If Wilshire is correct, the unfunded liabilities of the states are actually larger than the \$1 trillion estimate from the Pew Center.

FIGURE 11
THE NUMBER OF YEARS A \$112.6 MILLION PORTFOLIO CAN FUND AN ANNUAL \$10 MILLION PENSION LIABILITY, BASED ON ALTERNATIVE RETURN ASSUMPTIONS



Based on the market value of \$1.6 trillion, a 6.9 percent annual return would yield \$17.6 billion less a year than a portfolio that grew at 8.0 percent. Through the power of compounding, such differences can become very large very quickly. As cited earlier, Texas is assuming an annual return of 7.6 percent. While applied to state portfolios overall, the Wilshire findings are another indication that Texas’ assumed 7.6 percent annual investment return may be too generous.

Taxpayers will suffer twice should market under-performance create an unexpected unfunded liability in Texas’ pension funds. The average taxpayer working in the private sector is either covered by a 401k or other defined contribution retirement plan or does not have access to a retirement plan at work. Either way, he must fund his retirement and bear all of the market risk associated with his investments. Should the market under-perform, then this taxpayer will not only have a pension that is smaller than desired, but will also face the threat of higher taxes to cover the investment losses that the government worker’s pension plan experienced. In effect, the taxpayers must bear the burden from market losses twice—once in their own portfolio, once to cover the losses in the government workers portfolio. The fact that the government worker likely earns more only increases the injustice of this transfer even more.

Public Sector Pension Reform

As we illustrate above, there are two problems that Texas needs to address: ensure that the current defined benefit pension obligations are fully funded and reform its current pension system to increase its efficiency and eliminate the growing entitlement problem the public pensions are creating. Transitioning from a defined benefit pension system to a defined contribution pension system achieves both of these goals.

A primary defined contribution benefit system for public sector workers is not an untried phenomenon—Michigan, Nebraska, and Alaska have defined contribution plans as their primary retirement plan; and Washington, Oregon, Indiana, and Georgia have hybrid plans that contain elements of both a defined benefit plan (a minimum guaranteed benefit) and a defined contribution plan (an investment component that provides benefits based on the market returns).⁵⁰

According to the GAO, the Texas Constitution has provisions that establish standards regarding how the pension will be funded; mandates that assets in the trust fund are for the exclusive purpose of the retirement system and cannot be diverted to nonretirement uses; and, requires a retirement system.⁵¹ Importantly for reform, Texas’ Constitution does

not prohibit changes in the accrued financial benefits.⁵² Based on the GAO's assessment, Texas has flexibility to adjust to a more financially sustainable pension system that is aligned with current private sector workplace trends.

One option to transform Texas' public pension systems into a defined contribution plan would terminate all current defined benefit plans. Under this option, every defined benefit pension system in Texas would need to purchase annuities that would cover all benefits earned by current workers and retirees. Given the funding status of many of Texas' pensions, a full termination of the public defined benefit plans is likely unfeasible.

A more feasible option for Texas is to freeze all current defined benefit plans. A freeze in Texas' defined benefit plan would affect public sector workers differently depending upon their present circumstances.

Future Employees and Unvested Current Employees

A freeze in the defined benefit plan should close the defined benefit pension plan to all new public sector employees and, ideally, apply to any current unvested public sector employee. All new employees or current unvested employees would be transferred to a defined contribution plan that should meet the average standards for a large private sector defined contribution plan. According to a Watson Wyatt survey of the defined contribution plans of the Fortune 100 companies, these standards could include:⁵³

- No minimum length of service requirement for eligibility in the defined contribution pension plan,
- Participation in the defined contribution plan permitted upon hire,
- Non-matching contributions of up to 6.0 percent of pay, immediate eligibility, and
- Employer match up to a set percentage of pay, immediate eligibility.

The standards across the Fortune 100 surveyed by Watson Wyatt varied, of course. As such, the standards are illustrative of the type of terms Texas should consider. The actual defined contribution standards adopted, especially the matching and non-matching contribution rates, should be determined following an actuarial analysis determining the estimated costs to the government for the terms provided.

Current Vested Employees and Retirees

Removing all current unvested and new employees

from the defined benefit system changes the actuarial forecasts of the system, and will likely weaken the current system if changes are not made. One method for addressing this problem is to implement what the PBGC refers to as a hard freeze of the pension system. Under a hard freeze, the benefits that had been earned at the time of the plan's freeze would be honored, but no public employee would be able to accrue any more benefits. All vested public employees would then be transferred to the defined contribution plan subject to the same benefits as all new employees or current employees who were not vested. The defined benefit plan would continue operating with the purpose of paying out current obligations; however the current obligations may need to be altered in order to ensure financial viability of the fund. The altered benefit levels will be similar to the changes that would need to be made if Texas does not implement a hard freeze of the pension system.

If a hard freeze of Texas' public pension systems is not desired, then Texas should implement what the PBGC refers to as a soft freeze that will allow the benefits for employees that are currently vested in the pension system to continue growing with their salary and tenure growth. Retirees will maintain their current benefits; however future adjustments to the growth in the pensions should be implemented.

Under the soft freeze scenario, employees vested in the public pension systems should be given a choice for their future benefits between staying in the defined benefit system and joining the defined contribution system. Based on the financial realities, the benefit levels, employee contributions, and expected cost of living adjustments once retired will need to be altered. From an efficiency perspective, the terms of the defined benefit plan should be adjusted such that the defined contribution pension system will be favored by all but the most risk-averse public sector workers. The benefit changes that Texas should consider include:

- Raising employee contribution rates,
- Extending the period over which salary is calculated for the purpose of determining retirement benefits,
- Increasing the age or service requirement—or both—for eligibility for retirement benefits, and
- Implementing greater controls over post-retirement cost-of-living adjustments.

Due to the problems with unfunded liabilities, there has been a flurry of activity by many states (including Texas) to implement benefit changes that will help control costs in these

areas as well as reforms to help reduce overall abuse in the pension system. Below we provide a quick review of the reforms implemented to provide Texas policymakers with a review of the types of cost control measures other states are implementing.

Raising Employee Contribution Rates

- **Alaska Public Employees and Teachers' Defined Contribution Plans (2006):** Increased employee contribution from defined benefit plan level to 8 percent of salary, and provided for a flat employer contribution of 5 percent.
- **New Mexico Public Employee plan and teachers' plan (2009):** Increase of 1.5 percent of salary for fiscal years 2010 and 2011, affecting current employees.
- **Georgia Public Employees Retirement System (2009):** For new hybrid plan, employee contribution to the defined benefit portion is 1.25 percent of salary; for personal accounts, it may range from 0 percent to 5 percent of salary.
- **New Hampshire Retirement System (2009):** Increased from 5 percent to 7 percent of salary for new employees.
- **Nebraska School Employees (2009):** Increase of 1 percent for five years (current employees).
- **Kentucky Public Employee Retirement Plan (2008):** Additional 1 percent of salary dedicated to the retiree health insurance plan.

Calculation of Benefits

- **Nevada Public Employees Retirement System (2009):** Formerly allowed a benefit factor of 2.67 percent for service after July 1, 2001. This was reduced to 2.5 percent.
- **Rhode Island Public Employees System (2009):** Base for final average salary increased from three highest consecutive years to five highest consecutive years. Applies to current employees.
- **New York State & Local Employees (2009):** Raised the minimum retirement age from 55 to 62; increased the minimum retirement age for the NY State Teachers system from 55 to 57 with 30 years of service. Boosts the employee contribution rate from 3 percent to 3.5 percent of annual wages and increases the 2 percent multiplier threshold for pension calculations from 20 to 25 years.

- **Vermont** changed the vesting period for receiving full health care benefits so that a new employee now has to work 10 years to receive 40 percent coverage on health premiums and 20 years (instead of 5 years) to get the full 80 percent coverage.

Age and Service Requirements

- **Texas Employee Retirement System (2009):** Minimum eligibility at age 65 with 10 years of service rather than 60/5.
- **Nevada Public Employees Retirement System (2009):** Retirement age raised by two years to 62.
- **Kentucky Public Employees Retirement System (2008):** Previously allowed general employees to retire at age 65 with four years of service, or any age with 27 years of service. For subsequent hires, it will be age 65 with five years of service, or 57 with 30 years of service.
- **Kansas Public Employees (2007):** Increased to age 65 with five years of service or age 60 with 30 years of service.

Post-retirement Increases

- **Louisiana State Employees (2009):** Future permanent benefit increases require age of 60 for eligibility (previously age 55) and link them to the system's actuarial funding level and investment return.
- **Kentucky Public Employee Retirement Plan (2008):** Replaced a COLA at the rate of the consumer price index, capped at 5 percent, with an annual 1.5 percent, for all future retirees.

Prevention of Abuse in the System

- **Georgia all systems (2009):** For all members, the employer must pay the system the actuarial cost of benefits whose calculation includes a pay increase of more than 5 percent in the last 12 months before retirement; for future employees, such salary increases will not be included in the benefit calculation. Overtime preferences towards senior employees are monitored.
- **Nevada Public Employees Retirement System (2009):** Annual salary growth for calculation of benefit capped at 10 percent for last five years of service.

- **New Hampshire, all members (2008):** If compensation in the final year of service exceeds 125 percent of final average compensation, the retiree's last employer will be assessed the cost of the excess benefit.
- **Kansas Public Employees (2007):** Annual salary growth for calculation of benefit capped at 7.5 percent, down from 15 percent.
- **Louisiana State Employee System (2005):** Annual salary growth for calculation of benefit capped at 15 percent, down from 25 percent.

Health Savings Accounts to Address the Unfunded Medical Costs

In addition to the reforms above that would address the problems with the current defined benefit entitlements, Texas also needs to address the unfunded medical costs. These unfunded costs are \$25.0 billion for the TRS pension fund alone! The most effective method to address these costs is to change how the government pays for the health insurance of its employees. Regardless of whether an employee is covered by the defined contribution or defined benefit pension system, the health insurance coverage for public employees should include a high deductible catastrophic plan coupled with health savings accounts (HSAs) that allow employees to use pre-tax money to cover routine health expenditures. The money not used in one year can be rolled over into future years thereby allowing the employee to amass a sizable savings to cover health care costs. The government can help cover routine health expenditure costs by contributing money into workers HSA accounts up to a pre-determined limit.

Implementing HSAs would have several positive impacts on Texas. First, it would immediately reduce the current unfunded medical liabilities of the state pensions. Second, by empowering such a large pool of people with HSAs, Texas would help establish a patient centered health care system that would be capable of effectively controlling costs. For instance, as Laffer (2010) argued:

Rather than expanding the role of government in the health-care market, Congress should implement a patient centered approach to health-care reform. A patient-centered approach focuses on the patient-doctor relationship and empowers the patient and the doctor to make effective and economical choices.

A patient-centered health-care reform begins with individual ownership of insurance policies and

leverages Health Savings Accounts, a low-premium, high-deductible alternative to traditional insurance that includes a tax-advantaged savings account. It allows people to purchase insurance policies across state lines and reduces the number of mandated benefits insurers are required to cover. It reallocates the majority of Medicaid spending into a simple voucher for low-income individuals to purchase their own insurance. And it reduces the cost of medical procedures by reforming tort liability laws.

By empowering patients and doctors to manage health-care decisions, a patient-centered health-care reform will control costs, improve health outcomes, and improve the overall efficiency of the health-care system.⁵⁴

Transforming Texas

Today is no time to be “Wimpy.” Texas is facing two distinct problems with respect to its defined benefits pension plan. First, the current value of the systems assets, while better than other states, may still be inadequate. The experience of California, Illinois, and New York illustrate that defined benefit plans financial viability can turn quickly. In the face of difficult fiscal conditions these states under-funded their pension systems in order to maintain expenditure levels in other parts of the state budget. The result has been significant deterioration in the health of these pension systems.

Second, a defined benefit plan is less efficient. Public sector defined benefits plans creates large entitlement costs that the state must fund, creates unfair wealth transfers across public sector employees, and is becoming an excessive burden relative to private sector pensions that the taxpayer (generally the recipient of the less generous pension) must fund.

Freezing the current defined benefits plan and replacing this plan with a combination of a defined contribution pension plan coupled with Health Savings Accounts helps ensure that Texas' pension liabilities remain financially viable. By implementing reforms today Texas will not only ensure that the pension systems of the state remain on a financially sound basis, Texas would also align the state pension systems with the current standard industry practice of the private sector.

PENSION REFORM RECOMMENDATIONS

Step 1: Freeze the defined benefit (DB) plan to all new and unvested public sector employees.

Step 2: All new or current unvested employees transferred to a defined contribution (DC) plan.

- A) DC plan should meet average standards for a large private sector DC plan
- B) Attributes can include (rates should be actuarially verified)
 - i) No minimum length of service requirement for eligibility in DC plan
 - ii) Participation in DC plan permitted upon hire
 - iii) Non-matching contributions of up to 6.0 percent of pay, immediate eligibility
 - iv) Employer match up to a set percentage of pay, immediate eligibility

Step 3: Implement either hard freeze or soft freeze of system for current vested employees.

- A) Under a hard freeze, benefits earned at the time of the freeze honored
 - i) No public employee able to accrue any new benefits
 - ii) All vested public employees transferred to DC plan for any additional benefit
- B) Under a soft freeze, the benefits for vested employees continue growing
 - i) Vested employees choose between staying in the DB system or switching to the DC system.
 - ii) Benefits, employee contributions, and COLAs should be altered so that the DC system is favored by most workers
 - a) Raise employee contribution rates
 - b) Extend the salary period used for determining retirement benefits
 - c) Increase the age and service requirements for eligibility
 - d) Implement greater controls over post-retirement COLAs
- C) Retirees will maintain their current benefits with changes to COLAs

- ¹ Elzie Crisler Segar, "Opera in the Raw," *Thimble Theatre* (3 Mar. 1933) *Big Spring (TX) Herald*, pg. 1, col. 2.
- ² Jeanette Neumann, "Pensions Push Taxes Higher: Cities Tap Homeowners for Revenue as Workers' Retirement, Health Costs Rise," *The Wall Street Journal* (24 Dec. 2010) A1.
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- ⁴ *Ibid.*
- ⁵ *Ibid.*
- ⁶ *Ibid.*
- ⁷ Beginning in 2004 there was a discreet change in the data collected by the Employee Benefits Security Administration on employees covered by either defined benefit or defined contribution plans. As a consequence, this creates the increase in coverage ratio that is evident in the chart. This change does not alter the coverage ratio between employees with defined benefit plans versus defined contribution plans; nor does the change alter the conclusion that there has not been any growth in pension coverage in the U.S. since the mid-1980s.
- ⁸ William Gale, Leslie Papke and Jack VanDerhei, "Understanding the Shift from Defined Benefit to Defined Contribution Plans" Working Paper (Sept. 1999).
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- ⁴² ALME calculations based on monthly data from S&P500.
- ⁴³ ALME calculations based on monthly data from S&P500. The analysis calculated the CAGR for the period from January 1950 through January 1980; then the CAGR for the period February 1950 through February 1980. This procedure was repeated through the period December 1980 through December 2010. The 7.2% value is the average of these returns.
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