Public Pension Reform

The Issue

Texas is not immune to the problems that trouble pension systems across the country. In Texas, state and local governments employ about 16% of workers. Most of them have a defined-benefit pension plan that promises a regular payment to retirees based on guaranteed formulas and irrespective of investment returns. Underperforming investments and generational accounting issues are exhausting these plans, leaving them with mounting, unsustainable liabilities. In fact the Texas Pension Review Board (PRB) noted in its 2019 report to the Legislature that "despite a nearly 10-year bull market following the 2008 market downturn, the unfunded liabilities of many public retirement systems both across the country and in Texas continue to rise."

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). These are positive steps that will likely need to be repeated in the short term due to continued underfunding. In the long term, these pension systems need more systemic reforms moving from defined-benefit to defined-contribution plans, so they are sustainable for beneficiaries and limit the risk for and burden on taxpayers.

The PRB, the state agency charged with overseeing state and local retirement systems, shows that among the 100 systems monitored by the agency, actuarial unfunded liabilities amounted to $86.1 billion as reported in their *Actuarial Valuation Report* for June 30, 2020. That is an increase in pension debt from just $53.8 billion in 2014. Part of this increase is due to an increase in the number of plans and participants. However, the average funded ratio—a measure of a plan's current assets as a share of its liabilities—is just 77.4% across all plans in the PBR's latest report, which is down from 80.6% in 2014. In that report, TRS has a discount rate of 7.25% that results in unfunded liabilities of $49.5 billion with a funded ratio of 76.9%, and ERS has a discount rate of 7.5% resulting in unfunded liabilities of $11.7 billion with a funded ratio of 70.2%. It is generally agreed that a funded ratio of 80% or more signifies a firm financial footing, a ratio that these two large state pensions and many others in Texas do not reach.

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. Much more must be done. Moving Texas's public pension systems away from the defined-benefit (DB) system and into 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 employees in charge of their retirement 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 plans sustainable for beneficiaries long-term while eliminating potentially higher taxes to fund them.

This DB to DC transition could be done by implementing some form of 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, it will be outweighed by the benefits of lower future costs and certainty to taxpayers that these pensions will be fully funded. With DC plans, retirees can then determine how much risk they are willing to accept, something many of them already do with their own DC plans. Ultimately, moving to DC plans would reduce the risk to the state and ensure that the government would not default on retirement plans for state employees or fund losses with dollars from taxpayers.

Giving retirees more control over how to best retire and to leave a legacy for their family with DC plans will allow families to be in a much better position to prosper. Because of the efficiency, simplicity, and fully funded nature of DC plans, as well as the reduced risk to the employer, the private sector opted primarily for them long ago. Doing the same for public pensions would assure state employees that they will receive their retirement funds and assure taxpayers that less of their money will be at risk.

The Facts

- The state's two major retirement systems, TRS and ERS, are below the level considered to be adequately funded with funded ratios below 80%. Part of this is because of each system's excessively high assumed discount rate, especially given the recent hit to the market from COVID-19.
- Texas's retirement systems are legally liable to pay defined--benefits totaling 10 to 20 times state employee contributions—market volatility could put taxpayers at risk.
- Defined-contribution systems are more sustainable than defined-benefit plans since they are, by definition, fully funded, which is why the private sector moved in this direction.

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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 discount rate to a more realistic rate that better matches actual return trends for transparency of unfunded liabilities.
- Adjust benefit and contribution formulas as necessary to fully fund existing plans.
- Avoid increasing state spending on public pensions without major reform.

Resources

SB 12 Let People Prosper by Securing Teachers' Retirement by Vance Ginn, Texas Public Policy Foundation (March 2019).

Pension Solvency Overview: Teacher Retirement System (TRS) of Texas by Zachary Christensen, Leonard Gilroy, Steven Gassenberger, and Vance Ginn, Reason Foundation and Texas Public Policy Foundation (Dec. 2018).

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).

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