

## I. INTRODUCTION

Over the past 20 years, private sector employers have shifted sharply towards “defined contribution” pension programs. Under these programs, the employer pays a specified amount into an investment account for the worker and these funds plus accumulated returns over the years finance retirement benefits. The number of private sector employees in such plans soared from 11 million in 1975 to 43 million in 1995, an increase of about 300%.

By contrast, traditional defined benefit employer plans have stagnated. Under these plans, the employer promises a specified retirement benefit and saves and invests the funds in a common pool to finance those benefits. From 1975 to 1995, the number of private sector employees in such plans grew by less than 10%, from 33 million to 36 million. More private sector workers are now in defined contribution plans than defined benefit plans.

A trend is now developing among the states to begin to shift public employer pensions towards defined contribution plans as well. Michigan adopted a comprehensive defined contribution system for state workers in 1996. California began adopting such a plan for some of its workers that year as well. Ten states have now adopted defined contribution reforms for a portion of their workers. Legislation providing for such reform is now pending in 6 states, and formal legislative studies regarding possible reform are under way in 12 other states.

These reforms provide important benefits for both workers and taxpayers. For workers, the defined contribution plan is fully portable. Workers are able to take the funds paid into their accounts wherever they go. Those who work for a few years in the public sector and then move on, as most now do, would not lose all of their employer pension contributions, as with typical defined benefit plans. Moreover, the funds are under the control of each worker. They don't have to worry about politicians mishandling the funds, accumulating unfunded liabilities, or cutting their benefits. Indeed, in the private market even the longer term workers may well earn higher

benefits than promised in defined benefit plans. Such reform also provides workers with broad freedom of choice and control.

For taxpayers, the defined contribution plan avoids the risks of having the government responsible for investing huge pools of retirement funds. Instead, the government's expenses are fixed as a percentage of payroll each year, with no investment risk or danger of unfunded liabilities. This promotes certainty and stability in budgeting. In addition, the simple defined contribution plan saves large amounts in administrative costs, and possibly funding costs as well. At the same time, because of the above benefits of defined contribution plans for workers, such plans will help public employers recruit the best workers.

Basically, the defined contribution plan privatizes the investment function of the public employee pension system, producing these and other benefits. For all of these reasons, the movement towards defined contribution reforms in public employment pensions is called pension liberation.

This report will present the case for adopting pension liberation reform in Texas. A description of the Texas public employee retirement system is provided in Appendix A. First, it will discuss in more detail the advantages of defined contribution reforms for both workers and taxpayers. The following section will respond to various criticisms. Next, the report will summarize the reforms adopted and proposed in other states. The report will then offer a specific reform proposal for Texas.

## **II. ADVANTAGES OF DEFINED CONTRIBUTION REFORMS**

Under a pure defined contribution reform plan, workers would have the choice of switching from the current defined benefit plan to a defined contribution plan. They could stay in the current defined benefit plan if they prefer. Employers and workers would contribute to the defined contribution plan the same amounts they would contribute to the defined benefit plan,

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though workers could be given some freedom to choose to contribute more or less. The funds would vest and become the property of the worker upon contribution. Investment would be structured so that workers would pick among designated, qualified investment companies, and the chosen company would pick the investments for the worker's account. Part of the contributed funds would be used to buy private life and disability insurance to cover the death and disability benefits of the defined benefit system. The remaining accumulated funds at retirement would then finance the worker's retirement benefits.

Such a defined contribution reform plan would produce enormous advantages for the state workers and taxpayers of Texas.

**A. *Advantages for Workers***

**1. Portability**

The clearest advantage for workers of the defined contribution plan is portability. The funds would be paid directly into each individual worker's own account and immediately become the worker's direct property. When a worker leaves state employment for another job, he or she can then take this individual retirement account with them. This account would include all past employer and employee contributions plus full market investment returns. Consequently, the defined contribution plan provides for full

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***The current defined benefit plans for Texas, by contrast, have no real portability. When a worker leaves, he or she can take with them only the employee share of past contributions plus 5% interest. They must give up the employer contributions for all of their years of work, all investment returns on those contributions, and the full market investment returns on the employee contributions in excess of 5% interest.***

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portability.

This lack of portability is highly damaging to shorter term and younger workers. Shorter term here means those working less than about 15-20 years in state employment. For reasons discussed fully below, the current Texas plans, like defined benefit plans generally, do not provide good benefits for younger workers who stay less than 15-20 years or so in service. The system is skewed to favor the longest term workers. As a result, the shorter term workers cannot take anything but the employee share of past contributions plus nominal interest when they leave, and they are not offered good benefits if they just wait to receive what the system will later pay them. These workers would do much better if they could just invest employer and employee contributions through their own personal accounts.

While specific data was not available for Texas, the same is probably true here as for other states. As a result of the lack of portability and the plan's benefit structure, most state workers end up not getting any significant benefits from a typical defined benefit retirement system. They just end up leaving with their own money back. In California, which has defined benefit plans for their government workers similar to the Texas plans, 70% of state and local workers end up not getting any retirement benefits from the system. In Michigan, 45% of state workers and 65% of public school employees effectively receive no benefits under the old defined benefit system.

## 2. Vesting

The defined contribution plan also eliminates any vesting requirement. The funds paid into the worker's account immediately become the property of the worker and remain fully available to pay future retirement benefits. This includes the employer as well as employee contributions and all investment returns on those contributions. Under the current defined benefit system, by contrast, the 5 year vesting requirement eliminates any real benefit for workers who stay less than 5 years.

Consequently, the defined contribution plan is highly beneficial for

these shortest term workers. A vesting requirement can be imposed on a defined contribution plan, as in Michigan, allowing workers to take permanent control of the funds in their own accounts only after the vesting period. But there is really no good reason for such a requirement in the defined contribution context. A vesting requirement in a defined benefit plan makes sense to eliminate small and relatively inconsequential benefit payments to numerous short term employees, and the burden of keeping track of the financing and payment of such benefits. But in a defined contribution plan, the government simply pays a proportion of the worker's salary into the worker's own account and leaves it to the worker after that. Eliminating any vesting requirement would allow all workers to receive retirement contributions for the years they worked for the government employer, without any significant administrative burden on the system.

### 3. Fair Benefits

Under traditional defined benefit plans, benefits are skewed to favor the longer term and oldest workers and disadvantage the younger and shorter term workers. This occurs in the Texas plans as well, in several standard ways.

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***First, of course, the vesting requirements eliminate benefits for those working less than 5 years, with the funds devoted to benefits for those working longer term.***

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Secondly, the benefits are a percentage of average salary, which tends to be much higher for those who have worked the longest, and for older workers. Take the example of a worker who enters governmental employment at 22, continues that employment for 15 years, and then leaves for a private sector job. The final three years of salary will probably be the highest for the worker's period of public employment, and will be used to calculate the worker's benefits at retirement. This will be the salary during

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the years when the worker is 35-37. No salary increases for the next 25-30 years of the worker's career will be counted.

By contrast, suppose another worker starts employment at 22, continues working for the same government employer for 38 years, and retires at 60. As compared to the first worker, this employee's benefits will naturally equal an additional 2.25% of salary for each additional year worked past age 37, which fairly gives the worker credit for the additional years worked. But the 2.25% per year for all years will be taken against the three years of salary during ages 58-60, which will include 23 years of additional salary increases. This gives the second worker more benefits for each year of work than the first worker.

Indeed, compare the first worker to an older worker who also works 15 years for the government. Assume this older worker starts government employment at age 45, continues that employment for 15 years, and retires at age 60. That worker will receive benefits equal to 2.25% of final salary for each of the 15 years of service, or 33.75%, times the average salary at ages 58-60. The average salary at these ages will incorporate an additional 23 years of salary increases as compared to the average salary at ages 35-37 which is used to calculate the benefits of the first worker. That worker will receive 33.75% times this lower average salary. So the older worker will receive much higher benefits even though he worked the same number of years as the younger worker.

Thirdly, granting the same percentage of final salary for each year worked does not give the full value to younger workers of the contributions made for them. Consider again our worker who enters government employment at 22, works for 15 years, and then leaves for private sector work. The contributions paid into the system for him during his years of employment, including the employer and employee contributions, continue to earn investment returns for many years after he leaves government employment. Yet, this worker will only get the same 2.25% of salary for each of his 15 years of government employment as other workers. Consequently,

the worker will get no additional benefits for all the years of investment returns after he leaves employment on the contributions made for him. These returns will be redistributed to finance the higher benefits of older and longer term workers. Indeed, the contributions for the older worker who entered government employment at age 45 and retired at 60 only earn returns for 15 years before the worker's retirement, while the contributions for the younger worker earned returns over a 38 year period before retirement at age 60. Yet, the older worker receives more in benefits rather than less, with funds effectively redistributed to that worker from the younger worker.

Inflation makes the problem even worse. Salary increases over the years usually incorporate compensation for inflation. When benefits are calculated based on salary, they will incorporate the compensation for

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***But for younger, shorter term workers, this inflation compensation stops when they leave government employment, as the salary used for their benefit calculations is fixed at that age.***

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inflation included in the salary increases over the worker's career. So, for our 15 year worker who leaves for the private sector at age 37, the value of his salary for retirement benefit calculations will be depreciated by inflation over the next 23 years, until retirement at age 60. The value of the worker's benefits will consequently be depreciated by such inflation as well. By contrast, the longer term and older workers will be fully compensated for inflation through their salary increases over working years.

None of these distortions occur in the defined contribution plan. The contributions to the worker's account immediately vest as the property of the worker, so the worker gets to keep those contributions in any event. Each worker also gets the full market investment returns on the contributions for every year thereafter, giving him the full value of those contributions, rather

than redistributing some to others based on a calculated percentage of average salary. Finally, those investment returns over the years will also include an inflation compensation component, again giving the worker compensation for inflation for each year after the contribution is made.

Consequently, the defined contribution plan gives fair, undistorted benefits to each and every worker. Those who work longer get proportionally higher benefits to the extent they worked longer. But they do not get disproportionately higher benefits, skewed to favor them over other workers, and effectively redistributing funds from these workers to them.

#### 4. Personal Control

In the defined contribution plan, the retirement funds for each worker are under the direct ownership of the worker in his or her own individual account. Workers can then pick the private investment manager that will best serve them in the private competitive market. They consequently no longer have to worry about adverse changes in their retirement plan or politicians failing to make good on their promises, at least for the years already worked, as the contributions for those years already belong to them in full.

#### 5. Better Benefits

Younger and shorter term workers who work roughly 20 years or less in government employment would generally get much better benefits from the defined contribution plan, because of all the factors discussed above. However, even the longest term workers could get better benefits from the defined contribution plan as well.

This is shown in the accompanying Tables. The tables assume that 10% of salary is paid into the defined contribution system each year for retirement benefits. The remaining amounts currently paid into ERS and TRS should be sufficient to cover the same disability and death benefits through the defined contribution system as currently provided through those

systems.

The retirement contributions are assumed to be invested and to earn a 5.5% real rate of return over the long run. In fact, over the 70 year period from 1926 to 1996, going back before the Great Depression, the composite real rate of return on all stocks in the Standard and Poors 500 was 7.5%.<sup>1</sup> The composite real rate of return on smaller company stocks on the New York Stock Exchange over this period was even higher, at 9.5%.<sup>2</sup> A diversified portfolio of 75% large stocks and 25% small stocks would have earned a real return of 8%. Over the long term, the real return paid by investment quality corporate bonds has been 3-4%.<sup>3</sup> So a 5.5% real return is a quite fair assumption allowing for some diversification of stocks and bonds, and quite ordinary investment performance.

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<sup>1</sup> Stocks, Bonds, Bills and Inflation, 1997 Yearbook, (Chicago, Ill., Ibbotson Associates, Inc., 1997).

<sup>2</sup> Ibid.

<sup>3</sup> Calculated from Moody's Investor Services, Industrial Manual, Bond Survey.

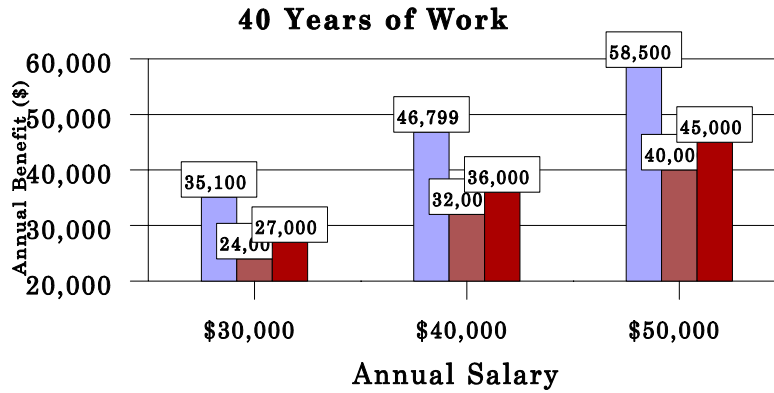
**40 Years of Work**

**Defined Contribution Plan**

**Defined Benefit Plan**

Annual Salary	Total Investment Funds Accumulated by Retirement	Annual Annuity Benefit	Replacement Rate	Annual Cash Benefit	Replacement Rate
\$30,000	\$344,381	\$35,100	117%	\$24,000 - \$27,000	80% - 90%
\$40,000	\$459,175	\$46,799	117%	\$32,000 - \$36,000	80% - 90%
\$50,000	\$573,968	\$58,500	117%	\$40,000 - \$45,000	80% - 90%

**Annual Benefits**



- Defined Contribution Plan
- Defined Benefit Plan (Minimum)
- Defined Benefit Plan (Maximum)

**30 Years of Work**

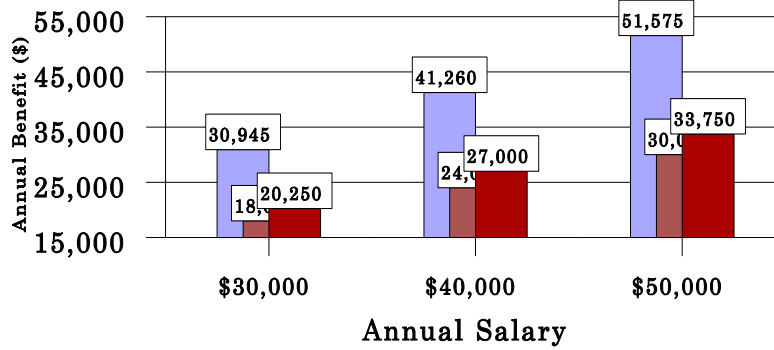
**Defined Contribution Plan**

**Defined Benefit Plan**

Annual Salary	Total Investment Fund Accumulated by Retirement	Annual Annuity Benefit	Replacement Rate	Annual Cash Benefit	Replacement Rate
\$30,000	\$303,620	\$30,945	103%	\$18,000 - \$20,250	60% - 67.5%
\$40,000	\$404,827	\$41,260	103%	\$24,000 - \$27,000	60% - 67.5%
\$50,000	\$506,033	\$51,575	103%	\$30,000 - \$33,750	60% - 67.5%

**Annual Benefits**

**30 Years of Work**



- Defined Contribution Plan
- Defined Benefit Plan (Minimum)
- Defined Benefit Plan (Maximum)

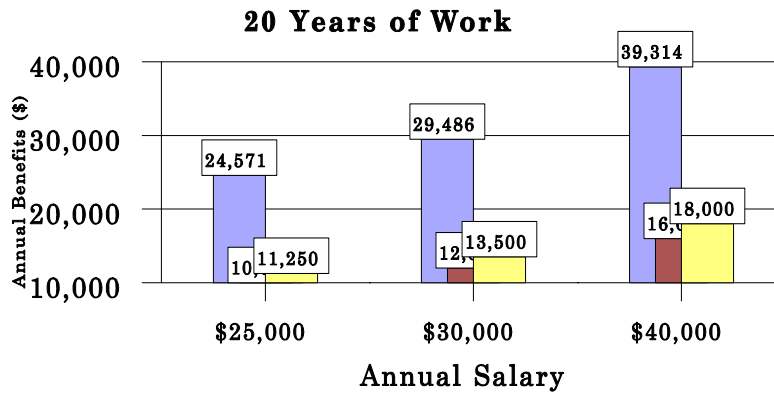
**20 Years of Work**

**Defined Contribution Plan**

**Defined Benefit Plan**

Annual Salary	Total Investment Fund Accumulated by Retirement	Annual Annuity Benefit	Replacement Rate	Annual Cash Benefit	Replacement Rate
\$25,000	\$241,086	\$24,571	98%	\$10,000 - \$11,250	40% - 45%
\$30,000	\$289,303	\$29,486	98%	\$12,000 - \$13,500	40% - 45%
\$40,000	\$385,738	\$39,314	98%	\$16,000 - \$18,000	40% - 45%

**Annual Benefits**



- Defined Contribution Plan
- Defined Benefit Plan (Minimum)
- Defined Benefit Plan (Maximum)

**10 Years of Work**

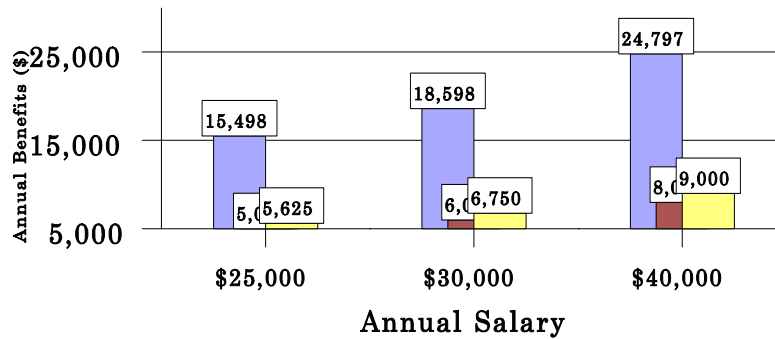
**Defined Contribution Plan**

**Defined Benefit Plan**

Annual Salary	Total Investment Fund Accumulated by Retirement	Annual Annuity Benefit	Replacement Rate	Annual Cash Benefit	Replacement Rate
\$25,000	\$152,062	\$15,498	62%	\$5,000 - \$5,625	20% - 22.5%
\$30,000	\$182,475	\$18,598	62%	\$6,000 - \$6,750	20% - 22.5%
\$40,000	\$243,299	\$24,797	62%	\$8,000 - \$9,000	20% - 22.5%

**Annual Benefits**

**10 Years of Work**



- Defined Contribution Plan
- Defined Benefit Plan (Minimum)
- Defined Benefit Plan (Maximum)

Note: All figures are in constant 1999 dollars and assume a 5.5% real rate of return on investment. The worker is assumed to enter public employment at 22 and retire at age 60, except in the case of the 40 years worker, who retires at 62. The defined benefit plan column states the range of cash benefits that would be paid under the TRS or ERS.

Take a worker who enters government employment at 22, works for 10 years, and then leaves for the private sector. Assume he earns \$25,000 per year after inflation during his period of government employment. Payments equal to 10% of salary are paid into his retirement account each year during his government employment, but all further contributions stop after that. However, the funds continue to be invested and earn investment returns over the years after government employment.

By age 60, the worker would retire with a fund of \$152,062 in today's 1999 dollars. That fund would finance an annuity about 3 times as large as the cash benefits that would be paid by TRS or ERS, which is the range shown in the Defined Benefit Plan column in the table. Even if we add \$200 per month to the ERS or TRS benefit to account for retirement health benefits under those plans, the defined contribution benefit is still twice as much. The relative results are the same for workers at \$30,000 and \$40,000 per year.

A large advantage for the defined contribution system is similarly maintained if the worker remains in government employment for 20 years. A worker earning \$30,000 each year after inflation would retire at 60 with \$289,303 in today's 1999 dollars. That fund would finance an annuity over twice as large as TRS or ERS would pay. Even adding \$200 per month for TRS or ERS retirement health benefits, the defined contribution benefit is still twice as large. The relative results are the same for a worker earning \$25,000 or \$40,000 per year.

A major advantage remains as well for the defined contribution plan for a worker who continues government employment for 30 years. A worker earning \$30,000 per year would reach retirement at 60 with \$303,620 in today's 1999 dollars. Such a fund would finance an annuity 50%-70% larger than TRS or ERS would pay in cash benefits. Counting the health benefits under TRS or ERS, the defined contribution benefit is still 35% - 50% greater. For workers earning \$40,000 or \$50,000 per year, the advantage for the defined contribution plan is slightly greater because the health benefits are a

fixed amount that is relatively smaller compared to retirement benefits at those higher income levels.

Finally, the defined contribution plan outperforms the defined benefit plan even for the longest term workers. At \$30,000 per year in average salary after inflation, after 40 years of government employment the worker would retire with a fund of \$344,381 in today's 1999 dollars. (This worker was assumed to retire at 62 so we could have a 40 year worker example.) That fund would finance an annuity paying 30% - 50% more than TRS or ERS cash benefits. Counting the health benefits for TRS and ERS, the defined contribution benefit is still 20% - 30% more for this longest term worker. Similar results again prevail for a \$40,000 or \$50,000 worker.

The reasons for the advantage of the defined contribution plan for the shorter term workers were discussed above. But how can the advantage for the longer term workers as well be explained? Workers just do not seem to

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*The current Texas retirement funds do seem to be earning better returns than most other public defined benefit plans across the country. But a worker earning just standard market investment returns, with the help of a major investment firm investing the account funds, would still get better benefits through the defined contribution plan.*

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be getting the most for their money in defined benefit plans.

Some of the returns to the defined benefit plans seem to get siphoned off to benefit the employer or others, and generally across the country these plans do not maximize returns for workers sufficiently.

### ***B. Advantages for Taxpayers***

#### ***1. No Investment Risk***

The most obvious advantage for taxpayers of the defined contribution plan is that it eliminates investment risk for them. With the government managing a common pool of investment funds under a defined benefit plan

like ERS or TRS, the taxpayers bear the complete risk of poor investment performance. If such poor performance leaves the pool unable to pay the promised defined benefits, then the taxpayers will have to make up the difference.

Under the defined contribution plan, however, the taxpayers through the government simply make a specific contribution to the accounts of the workers each month. The taxpayers are then not liable for the investment performance.

## 2. No Political Risk

Defined contribution plans greatly reduce another set of risks that are usually overlooked -- political risks. With the government specifying benefits far in the future, as under a defined benefit plan like the ERS or TRS, there is always a strong danger of political giveaways by short-sighted politicians. These politicians can promise higher retirement benefits, while leaving future officials and taxpayers to pay for them. Under a defined contribution plan, where the government does not specify future benefits but only makes regular investment contributions, this risk is eliminated.

Moreover, a large government investment pool, as under a defined benefit plan, is always subject to the danger of political interference that could raise costs. Political favoritism may influence investment policy, prohibiting some investments and forcing the fund into others. By taking the focus off of simply maximizing investment returns, such political favoritism will reduce investment returns and increase the cost of funding the specified defined benefits.

Politicians may seek to raid the large, tempting investment pool in other ways as well. They may seek to draw supposedly excess funds out of the pool in one way or another, perhaps by replacing an overfunded plan with a new one, or reducing the government's contributions. Or they may try to use the funds for short-term added benefits. Politicians and bureaucrats have been known even to siphon funds out of these plans improperly or

illegally. These actions would again raise costs for taxpayers.

Government management of the funds also creates the risk of less than competent handling of the funds by bureaucrats who lack the incentives, competitive pressures, and expertise of private investment managers. Attempts to insulate the funds from political and bureaucratic control by contracting out to private investment managers may not be entirely successful. The investment managers can still be subject to political pressure, political mandates in their contracts, or even counterproductive legislative mandates.

Finally, a large government investment pool creates the risk for taxpayers of greater government control of the private economy. Through such a pool, the government may end up owning large shares of private companies. The government would also hold a large share of investment capital that it could use to impose mandates on the private sector.

Even where there has been a good record of avoiding these abuses in the past, the danger is always present. However, none of these risks arising from a large government investment pool exist in a defined contribution plan, where the government does not maintain such a pool.

### 3. No Unfunded Liability

The defined contribution plan eliminates the danger of any unfunded liability, from any source, that must be covered by taxpayers. Under a defined benefit plan, like ERS or TRS, any shortfall in the common investment pool that leaves the pool unable to pay the promised benefits, creating an unfunded liability, must be covered by the taxpayers, regardless of the cause of the shortfall. In the defined contribution plan, where the government does not maintain a common investment pool but only pays a specified amount to each worker's individual account each month, there is no possibility of an unfunded liability that taxpayers would have to cover.

### 4. Greater Control Over Costs

The defined contribution plan provides the government and taxpayers greater control over costs. Costs under a defined benefit plan, where the government has pledged to provide a certain benefit amount regardless of cost, can vary greatly, depending on a wide range of factors outside the government's control. Retirees can live longer, greatly increasing costs. More workers may stay with the government employer long term, increasing costs. Interest rates or the stock market may decline, requiring increased contributions to make up the difference.

With the defined contribution plan, by contrast, the government is responsible only for a specified contribution each year. This contribution is completely dependent only on what the government agrees with workers or their union to pay. This means greater certainty and predictability in budgeting. There is no possibility that taxpayers will be surprised with a large, unexpected unfunded liability requiring increased taxes.

#### 5. Reduced Costs

A defined contribution plan will also significantly reduce costs. Defined benefit plans have substantial administrative costs for the government employer. The government must maintain and pay for the management of the large common pool of assets. It must also administer the benefits, determining eligibility and making payments.

With a defined contribution plan, by contrast, administrative costs for the government employer are negligible. The government simply pays an amount into each employee's own account as part of payroll processing. The worker and his investment company take over administration of the account after that.

#### 6. Improved Employee Recruitment

Finally, because of the advantages to employees noted above, defined contribution plans can help state and local governments attract employees. Highly talented workers may not be willing to commit to state government employment long term. But they may be willing to work for a state or local

government for a few years. The defined contribution plan would make it easier to recruit such workers because it is fully portable, and the workers can take the saved contributions with them when they leave one job for another. Moreover, workers would favor the freedom of choice, personal control, and possibly higher benefits that they could get through defined contribution plans.

### III. CRITICISMS OF DEFINED CONTRIBUTION PLANS

#### A. *Unsophisticated Workers*

One of the major criticisms of defined contribution plans is that most workers are too unsophisticated about investing to handle the responsibility of directing their own retirement investments. This underestimates the capabilities of working people. Nevertheless, the reform plan can be carefully structured to avoid this problem. As suggested above, workers can simply pick from a range of sophisticated, highly reliable, investment management companies among those designated and approved by the government employer. These would include large banks, insurance companies, stock brokerage firms, and others. These highly sophisticated investment managers would then be picking the individual stocks, bonds and other investments, not the workers.

#### B. *Investment Risk*

Probably the main criticism of defined contribution plans is that they shift investment risk from the employer to the worker. In a defined benefit plan, the worker receives the specified benefits regardless of investment performance, so the worker apparently bears no investment risk. In a defined contribution plan, the worker's benefits depend entirely on the investment performance of his retirement account, so the worker bears full investment risk. Poor investment performance leads directly to lower

benefits.

Often overlooked, however, is that even in a defined benefit plan the worker will bear some investment risk. If the investment fund does poorly,

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***Also not widely recognized is that while defined contribution plans leave workers subject to investment risk, defined benefit plans without inflation adjustments leave workers subject to inflation risk.***

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the contribution rate for the worker will likely be increased.

As inflation rises, the specified benefit in an unadjusted defined benefit plan is worth less and less. Under a defined contribution plan, by contrast, the worker's investments would rise along with inflation over the long run, providing a real, above inflation, market rate of return. This would tend to keep prospective long run benefits rising with inflation. While wage increases during working years generally would incorporate inflation as well, this adjustment stops during retirement. Moreover, this adjustment only continues for the number of years of public employment. It stops once a worker leaves public employment.

Finally, workers can fully handle the investment risk posed by defined contribution plans, for several reasons. First, retirement investments are very long term. The worker is investing not only for his entire career, but, indeed, for his entire life, as the remaining retirement fund will continue to be invested to support benefits throughout retirement. With such a long term investment horizon, perhaps 60 years or more, workers can weather many ups and downs in investment performance, with the average return on a diversified portfolio very likely over the long run to close in on the average long term market return.

Secondly, workers can easily invest in simple, widely available, highly diversified pools of stocks, bonds and other investments, through mutual funds and other vehicles. Such diversified pools will track the general

market investment returns discussed above over the long run. Indeed, with a sufficiently broad based investment pool, the worker would basically own a piece of the economy as a whole. If the entire economy collapses, state and local governments will not be able to support defined benefit plan promises either.

Thirdly, with professional investment managers handling the specific investments for workers, investment risk can be minimized in a sophisticated and reliable manner through diversification and other market strategies.

Workers, indeed, may be able to handle this investment risk better than state and local governments. For they can do so without all of the political risks discussed above.

### *C. Transition Issues*

Another argument is that the transition to a defined contribution plan will be costly because the government will have to pay the workers leaving the defined benefit plan their share of accumulated funds to take to the new plan. But if the defined benefit plan is fully funded, then it will have the money saved in its common trust fund to pay the departing workers. If the defined benefit plan is not fully funded, then it needs to be in any event, and the government will have to bear that cost anyway.

Moreover, experience shows that those who leave defined benefit plans to take a defined contribution option are primarily the shorter term and younger workers with little in accumulated funds in the defined benefit plan.

As a result, while 63% of the government workers in West Palm Beach, Florida chose the newly offered defined contribution plan, they took with them only 14% of the assets of the old defined benefit plan. The assets of that plan actually continued to increase through the transition, climbing from \$80.7 million before the conversion to \$86.4 million after the conversion.<sup>4</sup> Similarly, while 42% of the government workers in Oakland

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<sup>4</sup> Peter J. Ferrara, *Pension Liberation*, American Legislative Exchange Council, State Factor, 1996.

County, Michigan chose the new defined contribution plan, they took with them only 13% of the assets of the old defined benefit plan. That plan's assets continued to increase throughout the transition as well, climbing from \$440.4 million before the conversion to \$513.6 million after.<sup>5</sup>

Since the ERS and TRS are both fully funded, defined contribution reforms should not create transition problems for those two plans.

#### **IV. PENSION LIBERATION ACROSS AMERICA**

Twelve states across the country have implemented defined contribution plans for government employees, in place of the older defined benefit plans, and at least nine other states are actively considering it. The leader was Michigan, which adopted a comprehensive plan in 1996 proposed by Governor John Engler.

##### ***A. Michigan***

Under that reform, current state employees can choose the new defined contribution plan or stay in the old defined benefit plan. All newly hired employees will be in the defined contribution plan. The reform originally committed to including all public school employees in the reform. But since the old defined benefit plan was not fully funded, this has been delayed to avoid transition funding problems.

Under the defined contribution plan, the state contributes a minimum of 4% of the worker's salary to an individual investment account for each worker. The employer will then match voluntary employee contributions up to an additional 3% of salary, making a total contribution of 10%. The worker can contribute up to an additional 13% of salary without employer match at the worker's choice.

The plan includes a vesting feature added to the traditional defined

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<sup>5</sup> Ibid.

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contribution model. The employer contributions are vested 50% after 2 years, 75% after 3 years, and 100% after four years. Before such vesting, a share of the employer contribution to a worker's individual account is withheld if the worker leaves to work for another employer.

Current employees could choose to switch to the new defined contribution plan only during an "open season" in the first four months of 1998. For those who made the switch, all past employee contributions to the defined benefit plan were transferred to the defined contribution plan. In addition, for workers who were vested in the defined benefit plan, an amount equal to the present value of their accumulated retirement benefits was transferred to their defined contribution account as well. Workers who switched to the defined contribution plan cannot later choose to go back to the defined benefit plan. On the other hand, after the four month window in early 1998, workers in the defined benefit plan can no longer choose to switch to the defined contribution plan. For current workers who did switch, their prior service in the old defined benefit plan is counted toward the 4 year vesting requirement of the defined contribution plan.

Investment options are structured for workers to make investing easy. First, they can choose from three core investment funds with set percentages of asset allocations in different investment areas, reflecting a range of risk and return variations. State Street Global Advisors, the third party administrator for the plan and one of the largest pension investment firms in the world, maintains these three funds, choosing the particular investments and holding to the preset asset allocation requirements.

Secondly, the worker can choose from among 12 pre-selected mutual funds considered the best in their primary investment areas, whether stocks, or bonds, or other private investments. Finally, the worker can choose a self-directed option which includes the choice of hundreds of mutual funds determined to be sound and suitable for retirement investment.

Workers who leave state employment under the defined contribution plan can leave their assets in the same structured investment system, or roll

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them over into an Individual Retirement Account or a retirement plan maintained by their next employer.

Current workers who switched to the defined contribution plan will receive the same retiree health benefits as under the old defined benefit plan.

For new workers in the defined contribution plan, the state will pay 3% of the cost of the health benefits for each year of service, up to a maximum of 90%. The retiree pays the rest. These benefits vest after 10 years of service.

Retirees can choose any alternative private health plan and direct the state premium contribution towards payment of that plan. This includes private Medical Savings Account plans.

The state's reform plan provides for no change in the benefits of current retirees. Moreover, there will be no change in benefits as well for

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***The state Department of Management and Budget estimates that Michigan will save almost \$100 million in the first year alone because of the new defined contribution plan, due to savings on employer contributions and administrative costs.***

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employees who choose to stay in the old defined benefit plan.

Yet, 45% of state employees who effectively received no benefits under the old plan because they left state employment too early will now be able to benefit under the new system after state employment of only 2 years, with fully vested benefits after only 4 years.

In addition to the state, four major counties in Michigan have switched to defined contribution plans for their workers. These include Oakland County, Saginaw County, Washtenaw County, and Wayne County. The state capital, Lansing, has switched as well, and the city of Kalamazoo has a partial defined contribution plan.

## ***B. California***

The reform process in California began with legislation proposed in

1996 by Assemblyman Howard Kaloogian (R-San Diego). His bill would have authorized, but not required, state and local employers throughout the state to offer defined contribution plans as an alternative to their defined benefit plans. The defined benefit option would have to be maintained as well.

The bill required employers to transfer accrued benefits from the defined benefit plan to the worker's defined contribution account, for workers who chose the new plan option. Otherwise, remaining details of the defined contribution plan, such as employer and employee contributions, would be left to negotiations between employers and workers. The bill would allow immediate vesting of all employer contributions to the defined contribution accounts. It would also allow a structured investment system as under the Michigan reforms discussed above.

The bill would expand benefits to 70% of state workers, who receive no benefits under the state's existing defined benefit plan because they never

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***At the same time, because of savings on administration and funding costs, the California Department of Finance estimated that the bill would save a whopping \$1,642 each year for each new employee who chose the new system.***

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satisfy the vesting requirements.

The bill would affect 1.2 million workers in the California Public Employees Retirement System (CalPERS) and State Teachers Retirement System (STRS) plans, which hold \$165 billion in vested assets.

A limited version of Kaloogian's plan passed in 1996, providing for new defined contribution options for employees of the state's colleges and universities. Kaloogian is continuing legislative efforts to expand this option to all government workers in the states. His most recent bill would expand the option to all employees of the state legislature.

### ***C. Reforms in Other States***

Other states with defined contribution systems for some of their employees include **Ohio** (university employees), **Illinois** (university employees), **Washington** (public school employees), **Alabama** (university employees), **West Virginia** (public school employees), **South Dakota** (university and some other employees), **Colorado** (public school employees) and **Missouri** (university employees). **Colorado** and **Vermont** enacted a defined contribution plan for limited numbers of additional workers last year. Legislation to provide for such plans for more government workers is pending in **California, Illinois, Ohio, Montana, South Carolina, Florida, Oklahoma,** and **Arizona**. Legislative activity is also already under way in **Texas**, with bills (SB 292 and SB 585) introduced by Sen. Nixon and further proposals forthcoming. About a dozen states also have studies underway to consider such reform.

## V. A DEFINED CONTRIBUTION PLAN FOR TEXAS

Texas should offer its workers an alternative defined contribution retirement plan as well. This plan can be structured as follows.

Workers and employers would each pay the same amount into this defined contribution retirement plan that they pay for the current retirement system. Employers would be required to assume the employee contribution share for the defined contribution plan to the same extent that they do for their defined benefit plan. Workers can be allowed to voluntarily contribute additional amounts, up to a total of 20% of their wages counting the employer contributions, or any higher limit allowed by federal tax law.

All contributions to the defined contribution plan would go into an individual investment account for each worker. These contributions would immediately become the private property of each worker *with no vesting period*. The worker would then choose an investment company to manage his or her account and to pick the particular investments for the account. The workers could choose from a wide range of different companies approved by

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the state. Companies that wanted to manage such funds would apply to the state for approval. The state would approve only reliable firms with established expertise, which would commit to comply with the state's rules and regulations. Such companies would include major stock brokerage firms, banks, insurance companies, mutual funds and others. Workers could switch among these investment companies during an open season each year.

The investment companies would then determine what particular stocks, bonds and other investments to buy with the funds in each worker's account. Highly risky and speculative investments would be prohibited. But the funds could be invested in domestic and foreign stocks and bonds, government securities, perhaps certain real estate vehicles, and other instruments. The Federal regulations currently applying to investments in Individual Retirement Accounts and 401(k) plans would be a good model to follow.

Investment returns to the accounts would be tax free over the years. Some of the contributed funds would be set aside to buy private life and disability insurance matching the survivors and disability benefits of the current defined benefit system. The investment company chosen by the worker would be responsible for obtaining such insurance. No withdrawals from the defined contribution investment account would be allowed before retirement.

The worker could retire at any age at which retirement is permissible under the current defined benefit system. Retirement benefits would equal what the funds accumulated in each worker's retirement account could support. Workers could choose to buy a private annuity with some or all of the funds, which would guarantee specified benefits for the rest of the worker's life. Or the worker could rely on periodic withdrawals from the accounts, which would be limited to ensure that workers would not run out of funds before a reasonable life expectancy.

Workers today who have already paid into the current defined benefit plan for any number of years would be free to switch to this new defined

contribution plan. They would each receive a lump sum payment from the current defined benefit plan into their new defined contribution retirement accounts. This payment would be equal to their share of the assets in the current defined benefit plan set aside to finance their accrued retirement benefits. This should compensate them sufficiently for both the employer and employee contributions paid into the system over the years.

The new defined contribution plan would only be an option for all current and future government workers in the state covered by any of the current defined benefit plans. Each would be free to choose it or to choose to stay in the current defined benefit plan. Workers who remain in the defined benefit plan would continue to be free to choose the new defined contribution alternative during an open season each year.

## VI. CONCLUSION

Texas should adopt the defined contribution reform plan advanced in this study. That plan would offer state and local government workers the choice of a defined contribution retirement plan in place of their current defined benefit plans. Such a plan offers great advantages for both workers and taxpayers.

## APPENDIX A: THE TEXAS PUBLIC EMPLOYEE RETIREMENT SYSTEM<sup>6</sup>

The retirement system for public employees in Texas consists of two separate major plans. All employees of the state are in the Employee Retirement System of Texas (ERS). The Teacher Retirement System of Texas (TRS) covers all teachers and other employees of the public schools of Texas.

The ERS includes a separate fund and retirement plan for law enforcement officers and custodial officers for the state's prisons and jails. Separate funds and plans also cover the state's judges (an older plan is being phased out and replaced by a new plan). This report will focus on the main

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<sup>6</sup> The information in this section comes from Employee Retirement System of Texas, Comprehensive Annual Financial Report, Fiscal Year 1998; Employee Retirement System of Texas, Summary of Benefit Programs for State Agency Employees, November, 1997; Teacher Retirement System of Texas, Comprehensive Annual Financial Report, Fiscal Year 1998; Teacher Retirement System of Texas, Benefits Handbook, 1997.

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ERS retirement plan covering all other state employees, which accounts for the great bulk of ERS assets.

The state and its employees each pay 6% of wages into the main ERS plan. In return, the system provides state employees with retirement, death, and disability benefits.

Apart from elected officials, all other state employees may retire at age 60 with 5 years of credited state service, or at any other age where the combination of age and state service equals 80. For example, a worker may retire at age 55 with 25 years of state service.

Retirement benefits are based on average monthly salary while working, calculated from the 3 highest years of earnings. The benefit amount equals 2.25% times years of service times the average monthly salary. So for a worker employed 30 years in state service, the benefit would be 67.5% (2.25% times 30) of the worker's average monthly salary.

For disability benefits for an on the job injury, called occupational disability, there is no minimum age or length of service requirement. For other disabilities, benefits are payable only to those who have at least 10 years of state service. Disability benefit amounts are calculated in the same way as retirement benefits (2.25% times years of service times average monthly salary), except that for on the job disabilities the actual salary at time of disability is used, and the minimum benefit is 35% of that salary.

Retirees can choose various options for survivors benefits, with the retirement benefit actuarially reduced accordingly. For example, the retiree can choose to continue retirement benefits for the life of a chosen beneficiary, or 75% of those benefits. The ERS also pays a lump sum death benefit of \$5,000 to survivors of a deceased retiree.

The surviving beneficiary of a worker who dies before retirement and who had 10 years of service credit can receive a lifetime annuity equal to the worker's retirement benefit, or a certain annuity payable for 10 years, both actuarially adjusted for the beneficiary's age. For deceased workers with less than 10 years of service, survivors benefits equal a refund of past ERS employee contributions plus interest, plus an additional 5% of the ERS employee account balance for that worker at the time of death. If death was due to an injury or illness related to state employment, then the survivors will also receive a lump sum payment equal to one year's salary. But only a surviving spouse or surviving dependent children are eligible for this latter benefit.

The ERS also provides group health insurance for the families of retirees who had at least 10 years of service. For the retired worker, the

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system pays 100% of the premiums for the basic plan offered. The system also pays 50% of the premiums of the basic plan for dependents. More expensive coverage options can be chosen, with the beneficiary paying the extra premiums. These health benefits continue for a surviving spouse and for surviving minor children. In 1998, the ERS paid about \$190 per month for basic plan coverage for single retirees, and about \$300 per month for a retiree and spouse.

Retirement benefits are subject to a vesting requirement of 5 years of service. Workers who leave state service before 5 years receive back only their own contributions plus nominal interest of 5%. They do not receive the benefit of any employer contribution, the investment returns on those contributions, or any investment returns on their own contributions in excess of the nominal interest of 5%. Workers who leave state service after 5 years may receive a retirement benefit when eligible. For a 5 year worker, this would be 5 times 2.25%, or 11.25%, of average monthly salary in state service. Or the worker may again choose to withdraw only his or her own contribution plus nominal interest of 5%, foregoing all future benefits from the system.

Elected officials may retire at age 60 with 8 years of service, or age 50 with 12 years of service. Their benefit is 2.25% times years of service times the current monthly salary of a state district judge. Survivors benefits are quite similar to those payable to general beneficiaries, except that the surviving spouse of a deceased elected official with 8 years of service is eligible for a life annuity of 50% of the retirement benefit the official would have received at age 60.

Occupational disability is again available with no minimum age or service requirement, but benefits for other disabilities require 8 years of elected service. The benefits are calculated the same as retirement benefits, with a minimum of 18% of the state salary of a district judge.

Elected officials receive retirement health coverage on the same terms as other ERS members. Retirement benefits for elected officials vest after 8 years of service. They have the same right to withdraw their own contribution plus interest and forego state contributions and returns as other workers. Legislators pay 8% of wages into the ERS, compared to 6% for everyone else, with the state still paying 6% of wages for elected officials.

At the end of the 1998 fiscal year, the ERS had net pension reserves of about \$16 billion. These reserves covered about 103% of liabilities, with a total funding surplus of about \$500 million. The ERS, therefore, is more than fully funded.

ERS paid benefits to about 39,200 retirees and other beneficiaries in 1998. It covered about 155,000 current employees, with almost half not

vested. About 20,000 additional workers, or about 13% of the continuing work force, left state employment that year and took a refund of their own contributions. Another 27,600 workers had terminated state employment but remained vested to receive future benefits. These figures indicate a high proportion of shorter term workers probably not getting a good value out of the system.

The TRS is quite similar to the ERS. The state pays 6% of wages for each worker, and the workers each pay 6.4% of wages, with the system again paying retirement, survivors, and disability benefits. Almost all employees of public educational institutions in the state are covered by the system.

Retirement benefits are payable to workers at age 65 with 5 years of service, or when the sum of age and service for a worker equals at least 80 years. Early retirement can be chosen at age 55 with 5 years of service, with benefits actuarially reduced accordingly.

Retirement benefits equal 2% times years of credited service times average salary again computed based on the three highest years of earnings. So for a worker employed for 30 years, the benefit would be 60% (2% times 30) of average salary. For a worker employed 10 years, however, the benefit would be only 20% of average salary.

The retiree can again choose various options for survivors benefits, with the retirement benefit actuarially reduced accordingly. A cash payment of \$10,000 is also payable to the survivor of a retiree. A surviving spouse may choose instead a \$2,500 lump sum payment plus \$200 per month for life starting at 65. A surviving spouse with children receives as well \$300 per month until the children reach 18.

If a worker with 5 years of service dies before retirement, the surviving beneficiary can again receive a lifetime annuity equal to the worker's retirement benefit, actuarially adjusted for the beneficiary's age, or a certain annuity payable for 5 years equal to the worker's retirement benefit with no reduction for age. For a worker who dies with less than 5 years of service, the beneficiary can receive a lump sum payment equal to twice the worker's annual salary, up to a maximum of \$80,000. The survivor can also choose instead the alternative payments to the \$10,000 cash payment for deceased retirees discussed above.

Disability benefits are payable when a worker cannot continue his or her current duties and the disability is likely to be permanent. Those with 10 years of credited service receive the same benefit as for retirement, with a minimum of \$150 per month, for as long as the disability continues. Those with less than 10 years of service receive \$150 per month for the number of months the worker was employed by the school system.

Retirees with 10 years of service also receive group health insurance coverage similar to the coverage under ERS. However, TRS does not contribute to coverage for dependents. Such dependent coverage is optional and at the expense of the retiree. The free coverage for retirees is financed by an additional assessment during working years of 0.5% of wages paid by the state and 0.25% paid by each worker.

Retirement benefits are again subject to a vesting requirement of 5 years. Workers who leave school employment before 5 years, or those who leave after 5 years who choose to withdraw their contributions, receive back only their own contributions plus nominal interest of 5%. They again do not receive the benefit of any employer contribution, the investment returns on those contributions, or any investment returns on their own contributions in excess of the nominal 5% interest. Workers who leave school employment once vested may receive retirement benefits when eligible. For a worker with 5 years of service, however, these benefits would only be 10% (2% times 5) of average salary during the period of service.

The TRS is much bigger than the ERS in terms of assets and retirees and workers covered. By the end of 1998, the TRS had net pension reserves of about \$66.5 billion. This covered about 104% of liabilities, leaving a net reserve surplus of about \$2.5 billion. Consequently, the TRS is also more than fully funded. The TRS reserves have been aggressively invested in equities and have earned strong returns over the last several years. For the last 10 years, the real rate of return on TRS pension reserves has been just over 10%.

The TRS paid about \$2.5 billion in benefits in 1998 to about 164,000 retirees and other beneficiaries. It covered about 700,000 employees in almost 1200 school districts, colleges, universities, and medical schools, with about 42% not vested. About 42,000 workers left school employment and withdrew their contributions from the system in 1998. Only about 13,500 workers who have left school employment in all prior years presently keep their past contributions in the system. This suggests the great majority of workers who leave are withdrawing their contributions and getting no benefit from the employer contribution or the system's investment returns.