

Modernizing the FRS

Switching to a Defined Contribution Plan

Table of Contents

Section 1 - The Florida Retirement System 3

 The History of the Florida Retirement System 4-5

Section 2 - Differences in Defined Benefit & Defined Contribution Systems 6

 Accounting 6

 Funding 7

Section 3 - Benefits of the DC Investment Plan 8

 Equity with the Private Sector 8

 Freedom and Discretion of Investment Decisions 8

 Portability of Retirement Assets 9

 Fewer Political Temptations 9

 Abuses of the System 9

 Other State Examples 10

Section 4 - Florida TaxWatch Recommendation 10

The Florida Retirement System

Due primarily to its substantial and unpredictable long-term costs, the Florida TaxWatch Government Cost Saving Task Force has made recommendations to reform the current Florida Retirement System (FRS) for the past several years. Given the complexity of this issue, this Report is a further expansion, clarification, and reinforcement of these recommendations.

Heading into the 2013 session, Senate and House committees are considering proposals to modify the FRS by limiting enrollment in the Defined Benefit (DB) Pension Plan and provide retirement benefits through the Defined Contribution (DC) Investment Plan.

The FRS provides retirement benefits to Florida's state employees through two plans: the DB Pension Plan and the DC Investment Plan.

The DB Pension Plan offers employees lifetime pension payments after retirement. The state is thereby obligated to pay defined payment amounts based on salary, years of service, and membership credit.

The DC Investment Plan is a 401(k)-style plan that provides employees with a retirement benefit in which the employer defines the contribution throughout employment. Benefits accumulate and earn interest in an individual's account, where they can choose differing types of investments, based on individual preferences.

There are currently over 319,689 retired members and beneficiaries; as of June 30, 2011, there were 643,746 total active FRS members, of which 540,701 (84 percent) participated in the DB Pension Plan, and 103,045 (16 percent) participated in the DC Investment Plan.¹

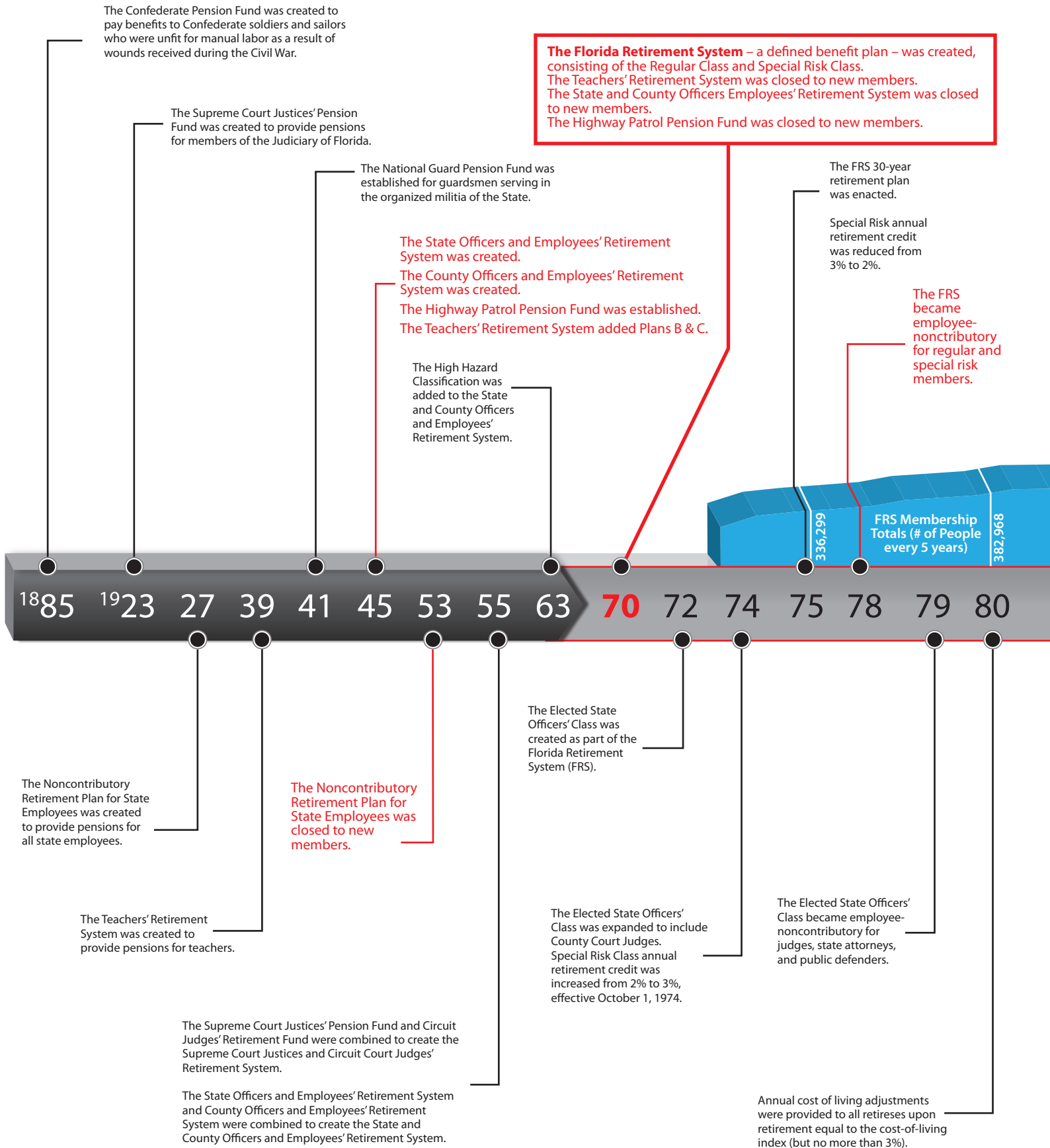
Three entities administer the FRS: the Legislature determines funding and benefit levels; the State Board of Administration (SBA) manages the assets and investments of the various funds; and DMS' Division of Retirement handles the administrative functions of providing retirement benefits to FRS members.²

The following two pages put the number of changes to the FRS over time in context, including the number of enrollees in the system.

¹ Florida Department of Management Services. Division of Retirement. "Florida Retirement System 2010-11 Annual Report."

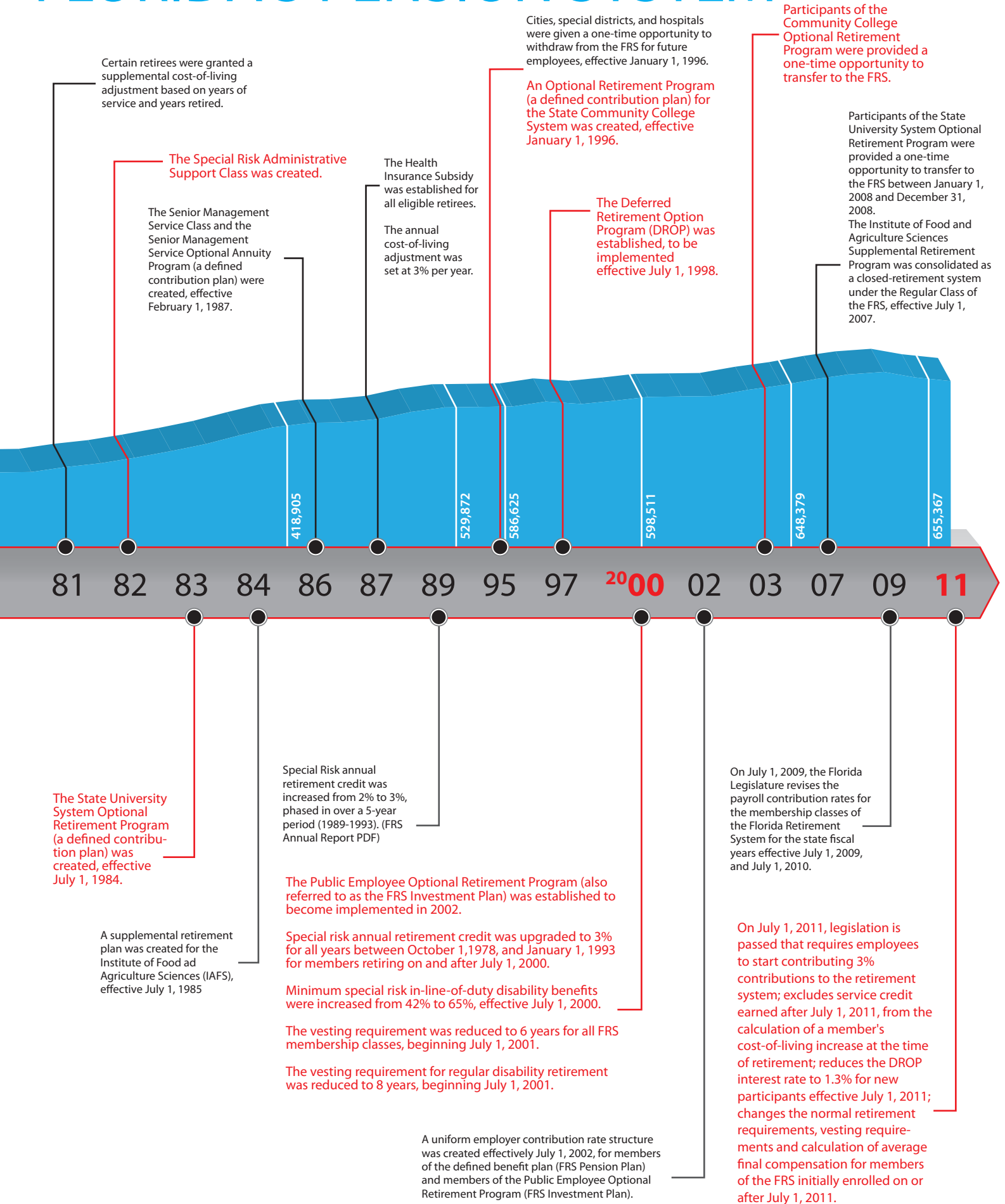
² State Board of Administration. "Florida Retirement System Pension Plan." October, 2012. <http://www.sbafla.com/fsb/LinkClick.aspx?fileticket=cjBnVEEM8P0percent3d&tabid=997&mid=2293>

MAJOR MILESTONES IN



Key: Events in Red indicate a significant change in the Florida Pension System. Blue graph shows FRS membership by number of people, data points shown every five years.

FLORIDA'S PENSION SYSTEM



SECTION 2 - DIFFERENCES IN DEFINED BENEFIT & DEFINED CONTRIBUTION PLANS

The DB Pension Plan and the DC Investment Plan differ in many ways, especially in terms of how taxpayer money is invested and dispersed. Understanding the positives and negatives of each plan are necessary for policymakers to make the right decision for the state and taxpayers of Florida.

Accounting

The DB Pension Plan sets its funding level based on actuarial reports. Given the nature of defined benefit pension funding, these reports calculate future costs of retirement based on assumptions predicated on future economic and demographic conditions. The assumptions that predict funding liabilities in the actuarial reports are interest earned on investment,³ salary increases, payroll growth, and retirement age.⁴ Also, attempting to predict future costs requires consideration of variables such as employee mortality, disability, inflation, and economic fluctuations.

These assumptions are so variable that an accurate prediction of future retirement costs is difficult to determine, and often these predictions are a better analysis of retrospective trends rather than prospective outcomes.

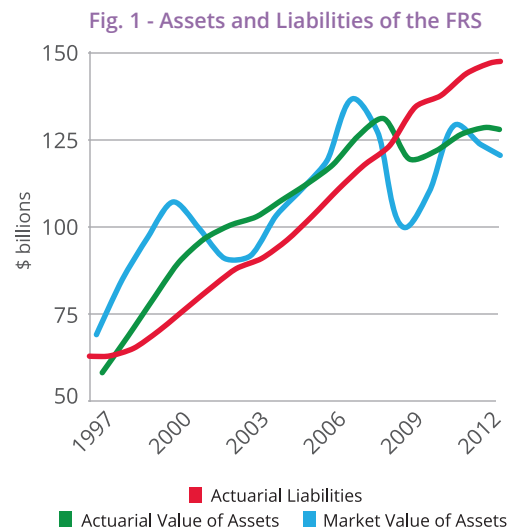
When actuarial predictions don't match up with realized outcomes, the deficit contributes to the FRS Unfunded Actuarial Liability (UAL), which as of July 1, 2011 was slightly more than \$18 billion.⁵

³ All assets before 2005 are expected to receive 8 percent interest returns; assets from 2005 forward are expected 7.75 percent interest returns.

⁴ Investment return is 7.75 percent, salary increase 5.85 percent, payroll growth 0 percent, and average retirement age (male-59.6, female-59.3, special risk-53.1) Florida Department of Management Services, Division of Retirement. "Florida Retirement System 2010-11 Annual Report."

⁵ *Ibid.*

The funding ratio of the DB Plan's pension fund is the measure of its assets to liabilities. The liabilities of the pension fund have been increasing steadily overtime while assets have fluctuated with market conditions (Figure 1).



The funding ratio of the pension fund has been as low as 53 percent and as high as 118 percent in the past 25 years. Although recently, the funding ratio has been consistently dropping: 88.5 percent in 2009, 87.9 percent in 2010, 87.5 percent in 2011, and 86.9 percent in 2012.⁶

Credit rating agencies are placing increasing weight on the liabilities of pension funds,⁷ and while the DB Plan's pension fund has performed well during times of economic growth, it clearly has shown to be susceptible to business cycles.

⁶ Florida Government Efficiency Task Force. Subcommittee on General Government. Recommendation Analysis, Florida Retirement System. May 2, 2012

⁷ State of Florida 2012 Debt Affordability Report, (Slide 12) http://www.flsenate.gov/PublishedContent/Committees/20122014/AP/MeetingRecords/Meeting-Packet_1977.pdf

A DC Investment Plan, by definition, is fully funded. Instead of sophisticated guesswork determining what today's contribution should be to cover the costs 30 years down the road, costs are calculated in real time based on actual salary and membership class, and cannot have unfunded liabilities. The DC Investment Plan relieves the state and taxpayers of Florida from pension-related funding liabilities, and strengthens the financial health and security of the state through more predictable budgeting.

Funding

Funding the DB Pension Plan has become increasingly difficult because during times of economic growth, rampant increases in benefits such as COLAs, risk class eligibility, and service credit, in conjunction with decreased employer contributions and extraction of pension fund monies for other budgetary appropriations, creates a heavy burden on the financial health of the pension fund.

"The Legislature has used surpluses in the defined benefit plan to reduce contributions to both the Pension Plan and the Investment Plan. These surpluses existed between Fiscal Years 1998-99 through 2008-09, and ranged up to \$14.5 billion in Fiscal Year 2000-01. The Legislature used \$12.3 billion of these surpluses to reduce employer contributions and fund benefit improvements. The surpluses primarily existed because investment returns exceeded the levels actuarially required to fund pension obligations. These surpluses are now depleted, and in Fiscal Year 2008-09, the pension plan incurred an actuarial deficit of \$15.4 billion. As a result, required contributions to the FRS will increase beginning in Fiscal Year 2010-11."⁸

Benefits under the DB Pension Plan are long-term promises based on short-term returns, resulting in its inherent liability of overpromising and under-producing during times of unfavorable economic conditions. The 1990's were the longest period of economic expansion in U.S. history, seeing nearly a decade of sustained economic growth. During that time the pension system was in surplus, which led to terrific benefit expansions. However, once the growth ended and the global economy plummeted, not only was it impossible to provide the terrific benefits once promised, but it also became difficult to sustain the basic pension system.

This effect is mitigated with the DC Investment Plan because investments are added to an individual's assets in real time. The DC Investment Plan provides realistic benefits based on actual returns and contributions, insulating the state from the deleterious effects of market volatility combined with long-term benefit obligations.

Clearly, switching public employees to a DC Investment Plan has long-run financial benefits for taxpayers; however, there are initial costs associated with this transition. One mitigation option would be to change the vesting period of the DC Investment plan to a graduated vesting schedule, in order to offset some of the costs.

8 Office of Program Policy Analysis and Government Accountability. "FRS Defined Contribution Plan Costs Are Typically More Predictable; the Fiscal Impact of Requiring New Employees to Enroll in the Plan Is Influenced by Many Factors." Report No. 10-29. March 2010.

Equity with the Private Sector

In 1974, the Employee Retirement Income Security Act (ERISA) was passed, which made pension regulatory costs more expensive, but also created an alternative retirement option in section 401(k) of the Internal Revenue Code.

“In 1975 in the private sector, there were 2.4 active defined benefit plan participants for each active participant in a defined contribution savings plan. By 2007, these proportions had almost reversed, with 3.4 active defined contribution savings plan participants for each active defined benefit plan participant.”⁹

Several factors contributed to the private sector moving away from DB plans: first, ERISA increased administrative costs of DB plans; second, the benefits provided by DC plans reduced employer liabilities; and third, DC plans are perceived as attracting young, mobile employees.¹⁰

The FRS currently has 84 percent of its members enrolled in the DB Pension Plan, while nearly the opposite statistic is seen in the private sector. Having similar retirement programs would better align the two sectors as well as provide a better standard of comparison.¹¹ In order to improve equity between the private and public sectors, the state should consider the benefits the private sector has capitalized on.

⁹ NBER State and Local Pensions Conference. “Defined Contribution Savings Plans in the Public Sector: Lessons from Behavioral Economics.” September 15, 2010

¹⁰ Clark, Robert L. and Munzenmaier, Fred W. “IMPACT OF REPLACING A DEFINED BENEFIT PENSION WITH A DEFINED CONTRIBUTION PLAN OR A CASH BALANCE PLAN.”

¹¹ NBER State and Local Pensions Conference. “Defined Contribution Savings Plans in the Public Sector: Lessons from Behavioral Economics.” September 15, 2010

Freedom and Discretion of Investment Decisions

The DC Investment Plan provides significantly more independence than the DB Pension Plan for an FRS member to personalize their retirement. The DC Investment Plan allows FRS members to choose the way in which their assets are invested and gives individuals the ability to make investment decisions based on their specific needs such as portfolio diversity and varying levels of risk based on when they decide to retire.

This independence also incentivizes individuals to pay more attention to their retirement plans. This encourages individuals to pursue knowledge of investment earnings and place more care and attention into future retirement plans. Having control over one’s finances encourages people to increase their financial knowledge base, think about their future, and plan for retirement rather than having an independent entity with out knowledge of the individual do it for them.

Furthermore, given the fact that Social Security benefits are provided by the Federal government, state employees enrolled in a DC plan would retain the “safety net” of a guaranteed retirement benefit. This is a “best of both worlds” scenario where the employees have independence and flexibility in their investments, and Social Security guarantees supplemental benefits, wherein the federal government assumes long-term benefit obligations.

Portability of Retirement Assets

The DC Investment Plan is significantly more portable than the DB Plan. In the DB Plan, if an employee leaves state employment before being vested (8 years for those enrolled after July 1, 2011), they lose all accrued contributions. In the DC Investment Plan, an employee's assets are individualized within a fully portable 401(k)-style plan, affording the employee a much easier shift between retirement plans as they change jobs.¹²

Considering the transient nature of public employment, a plan that allows employees to move their assets as they see fit is important. The Florida Government Efficiency Task Force (GETF) has recommended prioritizing portability and transferability in the FRS.¹³

Fewer Political Temptations

Another important benefit of the DC Investment Plan is that it is insulated from political temptations. "Pension Holiday" is a term used to describe times when employers stop making contributions to DB plans and can even take money out of pension funds for other unrelated uses. This is a political temptation, especially in years with pension fund surpluses, because the negative effects of such actions are not realized for many years. A sharp downturn in economic conditions after a "pension holiday" can be devastating.

Any benefit given under a DC plan must be paid for in that same year because it cannot be legally underfunded. This improves the financial health and security of the FRS because retirement assets belong to the individual state employees and are therefore not susceptible to the whims of the state.

Abuses of the System

The DC Investment Plan is structured in such a way that limits abuse of the system much more than DB Plan does. Chief among these abuses is a practice known as spiking. Spiking occurs when a public employee nearing retirement takes on significant amounts of overtime and defers sick leave in order to bolster their Average Final Compensation figure in their final years to increase retirement payouts. A notorious case in Florida was of a Broward County 911 operator who earned a \$60k salary, yet receives an \$182k annual retirement; this is a common illustration of the damage caused by abuses of spiking.¹⁴

In a similar, yet slightly inverted case, a high paid official who has already earned a substantial salary can take a lower paying job with fewer responsibilities to increase years of service and subsequent retirement payouts.

Other State Examples

Considering the recent recession, many states have realized the liability associated with DB pension programs and have undergone significant reforms. The National Conference of State Legislatures' Ron Snell concludes that pension reform is considered "radical and conservative" by the public, but states are "not just now awakening" to the harsh reality of the necessity of pension reform. Since the mid-2000s, states have been trimming benefits by increasing employee contributions, changing vesting periods, and limiting COLAs.¹⁵

Michigan enacted progressive pension reform in 1997 when the state legislature replaced its DB pension program with a DC plan.¹⁶ The decision

12 Florida Government Efficiency Task Force. Subcommittee on General Government. Recommendation Analysis, Florida Retirement System. May 2, 2012. slide 15

13 *Ibid.*

14 Miami Herald. "Municipal employee pensions of past have been bonanza for workers, strain for cities." September 17, 2012. <http://miamiherald.typepad.com/nakedpolitics/2011/09/municipal-employee-pensions-of-past-have-been-bonanza-for-workers-strain-for-cities.html>

15 Snell, Ron (2010a). "Pension Reform: Not Easy, but Worth It," State Legislatures. August 2010. <http://www.ncsl.org/?tabid=20716>.

16 National Conference of State Legislatures; Snell, Ronald.

came when the state's pension system was in relatively good health (funded at 109 percent¹⁷), but concerns over the long-term financial viability of a DB pension program convinced the state to abandon it, and Michigan taxpayers have seen considerable value.

"...since the advent of the MSERS defined-contribution plan in 1997, Michigan taxpayers have saved approximately \$167 million in lower pension normal costs and between \$2.3 billion and \$4.3 billion in lower unfunded liabilities. An additional and important advantage, though difficult to quantify, is the reduced political temptation to provide benefits whose costs are largely deferred to future generations. In other words, a defined-contribution plan is less prone to potentially harmful political interventions."¹⁸

Alaska also switched over from a DB pension program to a DC plan in 2006. The change came because of growing fears of the financial health of the pension fund (funded at 63 percent¹⁹). The switch has not had enough time to mature to consider a cost-benefit analysis.²⁰

The District of Columbia has had a DC retirement plan since 1987.

"State Retirement System Defined Contribution Plans." September 2009.

17 Pension Review Board. "A Review of Defined Benefit, Defined Contribution, and Alternative Retirement Plans." Research Paper No. 12-001. May 2012.

18 Dreyfuss, Richard C. "Estimated Savings From Michigan's 1997 State Employees Pension Program Reform." Mackinac Center for Public Policy. June 23, 2011.

19 Pension Review Board. "A Review of Defined Benefit, Defined Contribution, and Alternative Retirement Plans." Research Paper No. 12-001. May 2012.

20 *Ibid.*

SECTION 4 - FLORIDA TAXWATCH RECOMMENDATION

Recommendation

Florida TaxWatch recommends that the Legislature reform the FRS to improve equity between the private and public sector, provide predictable budgeting for the Legislature, reduce future UAL concerns for Florida taxpayers, and allow current FRS members to maintain their earned benefits and stay in the plan of their choice.

This reform, which would modernize the FRS, would be most successful through a soft-freeze.

ABOUT FLORIDA TAXWATCH

As an independent, nonpartisan, nonprofit taxpayer research institute and government watchdog, it is the mission of Florida TaxWatch to provide the citizens of Florida and public officials with high quality, independent research and analysis of issues related to state and local government taxation, expenditures, policies, and programs. Florida TaxWatch works to improve the productivity and accountability of Florida government. Its research recommends productivity enhancements and explains the statewide impact of fiscal and economic policies and practices on citizens and businesses.

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