

Research Report

April 1999



Optional Retirement Plan is Essential First Step

As Florida enters the 21st Century, the ability of public sector employers to attract and retain highly trained, productive employees is being challenged by marketplace competition. Long gone are the days of the 20+ year employee. By some reports, the average employee today will change jobs seven times during their employment career. Employers, both public and private sector, must offer this mobile workforce salaries and benefits that can accommodate this new reality and reward excellent performance and productivity.

This report discusses public employees' retirement options, both current and proposed, and how well each addresses a series of **guiding principals** that promotes the interests of the employee and the employer. The goal of this report is to provide a strategy to enhance Florida's public employers' competitive position to attract and retain a productive and high quality workforce.

Florida's Public Employee Retirement System Guiding Principals

An effective and modern retirement system must:

- be market-driven and **competitive**
- be **affordable**
- be funded in an **actuarially sound** manner
- be **independent** of political manipulation
- be **portable**
- be easily understood (**clarity**)
- be **easily administered**
- be **flexible**
- be **predictable** with known costs and benefits
- be **equitable**

Current Status

The Florida Retirement System

The Florida Retirement System (FRS), in its current configuration, is almost 30 years old. FRS is the fifth largest public employee retirement system in the country, with more than \$83 billion in assets. Formed from the combination of individual retirement systems

(Teachers Retirement System, etc.), FRS now has more than 600,000 covered public employees and 166,000 retirees from almost 800 public employers (State Agencies and the University System, County Governments, County School Boards, Community Colleges, Special Districts and City Governments).

FRS is a "Defined Benefit," employer-funded retirement plan, providing a guaranteed, inflation adjusted pension (with a survivors' benefit option) and disability income benefits. Benefits are based on an employee's "Average Final Compensation" (highest 5-years earnings), years of service and benefit accrual rate. For "Regular" class membership, the "normal" retirement age is 62, with reduced benefits at age 55, or retirement at any age (without benefit reduction) with 30 years of creditable service.

Over its life, the FRS has been amortizing an "accrued unfunded liability" generated, in part, by the assumption of previous retirement systems and plans, which reached a high unfunded liability of \$16.0 billion in 1992. Because of significant gains in the market value of FRS investments over recent years, the accrued unfunded liability in the plan has been effectively "paid-off." This will allow the employer contribution rate (composed of a normal cost component and an accrued unfunded liability cost component) to be reduced from an aggregate rate of 16.66% in 1998-99 to 10.55% for 1999-2000.

The Defined Contribution Alternative

A defined benefit system, FRS entitles an employee to a certain level of retirement income based upon earnings and length of service, as determined by the employer in the plan provisions. A defined benefit system entitles an employee to a certain level of retirement income based upon earnings and length of service, as determined by the employer in the plan provisions. In the FRS, how that level of income is obtained is as a variable cost, bourn entirely by the employer. Through employer contributions and investment income and appreciation, at the end of a covered employee's employment, sufficient funds will be available to meet that obligation. In effect, the benefit amount controls the employer's cost (variable), with investment return (positive or negative), reducing or increasing that cost (see previous discussion of FRS).

In a **Defined Contribution (DC)** retirement plan, the employee retirement benefit amount is variable and unknown, with the employers's cost being known (a percentage of covered employees' earnings). While there are many variations of Defined Contribution plans, in general, the employer assumes no "risk" since there is no stated benefit amount. The amount of an employee's retirement income is still a function of length of employment and earnings, but investment return assumes a larger importance in the total benefit. While investment return (positive or negative) can reduce or increase an employer's cost in a Defined Benefit plan, the employee's retirement benefit remains "fixed." In a Defined Contribution plan, the employee's retirement benefit is variable, dependent upon investment return. Major advantages and disadvantages of Defined Benefit and Defined Contribution retirement plans can be directly compared as follows:

Defined Benefit/Defined Contribution Pros and Cons

PRO

CON

Defined Benefit Retirement Plan

- | | |
|---|--|
| ◆ Guaranteed benefit, regardless of investment return | ◆ Limits maximization of potential benefit from high investment return |
| ◆ Cannot outlive retirement income | ◆ Potentially lower income due to lower investment return |
| ◆ Generally benefits long-term employees | ◆ No benefit for short-term employees (10-year vesting requirement) |
| ◆ Employer costs reduced when investment return is higher | ◆ Employer bears the risk of poor investment performance |
| | ◆ Age bias loss of purchasing power; benefit inequity |

Defined Contribution Retirement Plan

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|--|---|
| ◆ Employee fund is portable | ◆ Younger employees may "cash-out" fund when they leave employment |
| ◆ Employer knows what cost will be (percentage of employee earnings) | ◆ Without vesting requirement, short-term employee turnover is a "lost cost" |
| ◆ Benefit equity | ◆ Employer controls investments (employee may not have sufficient investment knowledge) |
| ◆ Employees can control own investments to fit their level of "risk" tolerance | |
| ◆ May allow employee loans | |
| ◆ Estate transfer of wealth to next heir | |

As the pro and con comparison shows, each type of retirement plan has its benefits and concerns. Florida TaxWatch supports the position that current and future public employees should be given the option to determine which plan is right for their particular circumstancecircumstances.

The Legislature is considering a Defined Contribution (DC) retirement plan option this session as an optional alternative to FRS. **TaxWatch believes that the consideration and adoption of the DC option is appropriate because it provides the potential for a higher level of competitive, market-driven retirement benefits to public employees, while at the same time providing employers with a better recruitment tool and potentially lower costs (both benefit and administrative).** The Defined Contribution option accomplishes the following:

- ▶ Retirement benefits are reasonable, affordable, competitive and portable.
- ▶ Retirement benefits can provide the potential for an appropriate level of income, that, upon normal retirement age and years of creditable employment, together with other retirement assets (Social Security, personal savings, etc.), provide the employee with the expectation of a reasonable standard of living at retirement.
- ▶ Funded in an actuarially sound and sustainable manner.
- ▶ Benefit equity is maintained among plan participants, consistent with employment earnings, length of employment and age at retirement.
- ▶ Plan costs are spread equitably across taxpayer generations, so that "cost-shifting" does not occur and ensures longitudinal consistency and predictability.
- ▶ Benefits can be maximized, consistent with "informed knowledge" of investment riskrisk, or risk can be reduced because of enhanced investment options.
- ▶ Independent retirement planning and participant education is enhanced.
- ▶ Employees take more responsibility for their retirement.

The Florida Retirement System has performed well. The State Board of Administration has done a good job to protect the important investment principal and secured a reasonable investment return. However, times change, and Florida public employers must have the tools necessary to compete for a more flexible, adaptable and competent work force in the 21st Century. Providing a Defined Contribution retirement plan option is an important step toward providing that opportunity.

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