

Pension Reform in Florida: Unfinished Business

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Many Floridians might think that pension reform in Florida is a done deal. After all, didn't the Legislature just pass pension reform this past spring? And didn't the State Board of Administration assert in its most recent report that the Florida Retirement System (FRS) is "one of the best-funded pension plans in the nation"?¹ Why should Florida mess with a good thing yet again?

Here's why Florida should consider further pension reforms to supplement what was done in early 2011. First, it is a dubious distinction to assert that Florida has one of the best-funded retirement systems in the nation. Other states' pension deficits are so unmanageable that some states could end up defaulting on their debt, which would be unthinkable bad. The point of pension reform is to keep Florida on the right track, rather than waiting until disaster is about to strike, as other states foolishly did.

Second, the Florida Retirement System's funding may not be that good after all, as it is based on overly optimistic assumptions. FRS currently assumes that its investments will continue to appreciate at the rate of 7.75 percent a year in perpetuity. But from 2000 to the present day, FRS's average rate of return has actually been 3.3 percent per year.² There is no reason to think that future investment returns will have an average that is *more than double* what returns have been so far in the 2000s.

Thus, a recent academic paper by Novy-Marx and Rauh estimated that while the

state of Florida currently contributes some \$5.5 billion a year to FRS, it actually needs to be contributing *\$11 billion* per year in order for FRS to remain on firm financial ground.³ Absent any further pension reform, these scholars estimate that taxes will need to be raised by \$765 per year for every household in Florida.

This policy brief argues that several supplemental changes would improve FRS's overall financial stability. These supplemental changes include the following: First, make a 401(k)-style "defined contribution plan" the default choice for new hires who express no preference concerning their retirement options. This would encourage new hires to choose a plan that cannot lead to unexpected deficits for the state budget. Second, limit the time horizon over which new employees may switch between the traditional defined benefit plan and the defined contribution plans. Currently employees may switch between plans at any point in their careers, but as is the case in Utah, employees should be limited to switching in their first year of employment. Third, lengthen the vesting period on the defined benefit plan to 10 years. In an era when remaining with the same employer throughout one's career is less common than in the past, lengthening the vesting period for the defined benefit plan would heighten the advantage inherent in the portability of the retirement accounts in defined contribution plans, wherein employees leaving state employment would

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retain the funds accumulating in their defined contribution accounts. Finally, the employee contribution rate should be increased to 4 percent from the current 3 percent – assuming that Florida Supreme Court does not toss out the employee contribution.

BACKGROUND

The Florida Retirement System (FRS) is the fourth-largest public pension plan in the country. According to the most recent valuation in 2010, FRS had nearly \$122 billion in assets, and served some 655,000 members with more than 300,000 retirees receiving monthly checks. Membership in FRS is required for all employees of a state agency, county government, school district, state university, community college, or participating city or charter school. It should be noted that some municipal governments have chosen not to participate in the FRS and maintain their own independent plans.

There are two main benefit plans under FRS: the Pension Plan and the Investment Plan. The Pension Plan is a traditional defined benefit plan, which guarantees a particular level of benefits for the duration of someone’s retirement, no matter how long that may be. Although defined benefit plans are supposed to be pre-funded, they can be underfunded if the Legislature fails to require enough money to be set aside, notwithstanding the Florida Constitution’s plain language (Article X, Section 14) that all pensions be funded “on a sound actuarial basis.” Underfunding often arises due to faulty assumptions about the rate of investment growth, employee longevity, or other factors.

During the 2000 Legislative Session, the Legislature created the Florida Retirement System Investment Plan, more commonly known as the Investment Plan.⁴ The Investment Plan is a defined contribution plan that is the equivalent of 401(k) plans that are familiar to employees in the private sector. When an employee chooses the Investment Plan, the government employer contributes 6 percent of the employee’s salary, and the employee contributes another 3 percent, for a total of 9 percent.⁵ The Investment Plan can never face unfunded liabilities that would have to be made up from state revenue. This is because employees’ benefits do not arise from a statutory formula that could end up being far above the rate of savings, but is directly based on the money set aside for each individual.

FRS members currently have a one-time option to switch between the Investment Plan and the Pension Plan.⁶ This is known as the “second election.” The switch may be made at *any point* in an employee’s career between the initial enrollment period and the retirement date. If an employee switches

from the Investment Plan to the Pension Plan, the employee is required to “buy” into the Pension Plan by paying the full “actuarial accrued liability,” which means the total estimated cost of funding the estimated pension benefit that the worker will one day receive. This means that the switch may require the worker to kick in extra money out-of-pocket, or even that the worker may be unable to afford the switch and thus has to remain in the Investment Plan. Workers who wish to switch from the Pension to the Investment Plan, however, can do so at no cost; the “accumulated benefit obligation” (or service credit) from the Pension Plan is simply transferred to the Investment Plan as an account balance.

As for this year’s reform, Senate Bill 2100 instituted several changes that were effective as of July 1, 2011. For the first time, state employees must contribute 3 percent of their salary to the pension system (previously, they had contributed nothing). The new law eliminated the accrual of cost-of-living adjustments (or COLAs) for service earned after July 1, 2011, while retaining a pro-rated COLA for service earned prior to that date. And for new employees, the vesting period was raised to eight years from six years, the retirement age was raised, and the final average salary (used to calculate pension benefits) was changed to the highest eight years of salary.⁷

SUMMARY OF RECOMMENDATIONS FOR FURTHER REFORMS

1. Make the Investment Plan the Default Option for New Hires

The Florida Retirement System should make the Investment Plan – the equivalent of 401(k) plans – the default choice for new hires. Although new hires would retain the option to choose the Pension Plan, making the Investment Plan the default would encourage them to stick with that option.⁸

Currently, about 16 percent of FRS members belong to the Investment Plan, while the other 84 percent belong to the Pension Plan. New employees are automatically enrolled in the Pension Plan, but can choose the Investment Plan within five months of the start date.

But the Investment Plan makes much more sense for new hires. The Investment Plan is far more portable, given that the full amount in each employee’s account (after vesting) belongs to him or her, making it easier to transition into different careers or to move to other states if necessary. Today’s highly mobile workforce is not well-served by a Pension Plan that assumes employees will stick with the same career at the same employer for 28-30 years, and that highly penalizes them if they move.

Moreover, the Investment Plan does not create the same risk of state liability for underfunding. Indeed, unfunded liabilities are impossible with the Investment Plan; as long as the state kicks in its promised contribution each year, its obligations are satisfied. Taxpayers 20 or 30 years down the road will not find themselves on the hook for many extra billions of dollars just because FRS made improper investments or a future Legislature authorized an unaffordable level of defined benefits.

Some may argue that being in the Investment Plan is inherently risky for workers, who will be tricked into making foolish investments. This is a canard: Investment Plan members do not pick individual stocks or other investments. Instead, they are given a choice between 20 professionally-managed funds that are rated by the FRS according to their level of risk. Funds include money market funds, inflation-protected securities, bonds, U.S. stocks, foreign stocks, and “balanced” funds that include a mix of investments. Investment Plan members are also restricted from engaging in certain types of short-term trading in and out of the various funds.

2. Limit Employee Switching Between Plans

Currently, employees are allowed to switch once between the Pension Plan and the Investment Plan at any point during their careers. Although an employee’s switch is theoretically supposed to provide the same level of pension benefit either way, it is conceivable that late-career switching could provide an opportunity for taking unfair advantage of the system, depending on exactly how FRS calculates all of the many assumptions necessary.

For example, employees could switch plans based on personal information that only they know, such as their probable lifespan. Imagine a near-retiree in very poor health who switches from the Pension Plan to the Investment Plan because he knows he will be able to leave a more sizeable inheritance to his relatives in a few years. On the other hand, imagine a near-retiree in perfect health, whose parents both lived to over 100, who switches from the Investment Plan to the Pension Plan, and starts receiving 40 years worth of benefits that were originally calculated based on a much shorter lifespan. Although each employee’s case may seem sympathetic, FRS’s ability to maintain a sound and solvent investment system depends on being able to make accurate predictions and assumptions, and it cannot do so if all employees are allowed to make last-minute changes that maximize their own withdrawals from the system.

In order to prevent gaming of the system and be better prepared for the future, FRS should allow employees to switch

between plans only during the first year of employment. After the first year, employees should stick with that plan through the duration of their careers.

3. Lengthen the Pension Plan’s Vesting Period to 10 Years

This proposal is quite simple: The Pension Plan’s vesting period should be lengthened to 10 years from the current eight. A longer vesting period for the defined benefit plan would encourage employees to stay longer and contribute to the system, thus helping that system stay solvent over the long-term.

4. Increase the Employee Contribution Rate to 4 Percent

This proposal is also quite simple: The employee contribution rate should be raised to 4 percent from 3 percent. Although state employees have filed a lawsuit against even having to pay 3 percent towards their own pensions, that 3 percent rate is rather low compared to state pension plans elsewhere. Nationally, the average employee contribution rate for state and local pension plans is 5 percent (or 8 percent in those states where employees do not receive Social Security).⁹

As noted above, Novy-Marx and Rauh have recently found that for FRS to be truly well-funded, the state of Florida should double its yearly contributions, from \$5.5 billion to \$11 billion. A 4 percent employee contribution rate would lessen the future financial burden on the state of Florida, and would bring the Florida contribution rate closer to the national average.

5. Apply These Reforms to Municipalities

Currently, 130 municipal pension plans in Florida are less than 80 percent funded,¹⁰ and some of Florida’s major cities have unfunded liabilities in the neighborhood of a billion dollars.¹¹ Unlike state governments, municipalities can and do go bankrupt on occasion under Chapter 9 of the federal bankruptcy law; recently, Central Falls, Rhode Island, and Jefferson County, Alabama (Birmingham) went bankrupt because of looming pension payments that they could not meet. Municipal bankruptcy is about the worst possible outcome for municipal employees and everyone else, even shaking investors’ confidence in the solvency of unaffected municipalities and the state government. Therefore, the Florida Legislature should make it clear that Florida municipalities may apply all of the above four reforms to their own pension plans.

Endnotes

- 1 See www.sbafla.com/fsb/LinkClick.aspx?fileticket=1KGUzNfF0IQ%3d&tabid=749&mid=1957.
- 2 This is the geometric average of the yearly returns reported from 2000 to 2010. Geometric averages are the customary way to analyze investment returns, since a 50% loss is not the mirror image of a 50% gain (it leaves you with far fewer assets upon which any future gains could be based). Specifically, the calculation is $(\sqrt[11]{1.105 \cdot .924 \cdot .919 \cdot 1.028 \cdot 1.166 \cdot 1.102 \cdot 1.106 \cdot 1.181 \cdot .956 \cdot .81 \cdot 1.14}) - 1$.
- 3 See Robert Novy-Marx and Joshua D. Rauh, "The Revenue Demands of Public Employee Pension Promises" (June 2011), Appendix Table 5, available at <http://kellogg.northwestern.edu/faculty/rauh/research/RDPEPP.pdf>.
- 4 See Florida Statutes, Chapter 121, Part II. See www.myfrs.com/imageserver/pdf/forms/frs_ip_spd.pdf for a full explanation of how the Investment Plan works.
- 5 Employer contribution rates are substantially higher for law enforcement personnel and elected officials.
- 6 For more details on how the second election works, see www.myfrs.com/imageserver/pdf/forms/2nd_election.pdf.
- 7 For a summary of the new law, see www.myfrs.com/imageserver/plumtree/remote/custom/2011_Legislation_Summary.pdf.
- 8 See Brigitte C. Madrian and Dennis F. Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *Quarterly Journal of Economics* 116 no. 4 (2001):1149–1187. This study found that changing to automatic enrollment in a 401(k) increased the participation rate by about 50 percentage points.
- 9 See Table 7 of "State & Local Pensions: An Overview of Funding Issues and Challenges," Center for State and Local Government Excellence, Jan. 2011, available at www.slge.org/vertical/Sites/%7BA260E1DF-5AEE-459D-84C4-876EFE1E4032%7D/uploads/%7BDE913A11-1C4F-475D-BF0E-1662B0C67612%7D.PDF.
- 10 See Table 1, <http://collinsinstitute.fsu.edu/sites/collinsinstitute.fsu.edu/files/Tough%20Choices%20Report%20Card%20Nov%202011.pdf>.
- 11 See "Essential Elements of Public Employee Pension Reform," www.jamesmadison.org/wp-content/uploads/pdf/materials/2010_LegisIssueAnalysis_PubPensions.pdf.

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Talking Points

- The Florida State Retirement System (FRS) is the 4th largest public pension plan in the U.S and offers a traditional defined benefit/pension plan (84% of members) as well as a defined contribution/investment plan (16% of members).
- Asserting that Florida has one of the best-funded retirement systems in the nation is a dubious distinction since other states' pension deficits are so unmanageable that some could end up defaulting on their debt.
- FRS's funding is based on overly optimistic assumptions—currently assuming 7.75% rate of return per year yet since 2000 is actually averaging 3.3% per year.
- The State of Florida currently contributes \$5.5 billion per year to the FRS but needs to contribute \$11 billion per year to remain solid—without pension reform this would equate to \$765 in additional taxes per household per year.
- Recommendations for further reform:
 1. Make the defined contribution/investment plan the default option for new hires who don't express a preference.
 2. Limit employees switching between plans to the first year of employment (in order to prevent gaming the system and to allow for more accurate predictions/assumptions.)
 3. Lengthen the defined benefit/pension plan vesting period to 10 years from 8.
 4. Increase the employee contribution rate to 4% from 3%. (This would still be below the national average of 5%.)
 5. Apply the above reforms to municipalities. (Currently 130 municipal pension plans in Florida are less than 80% funded.)

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