Florida's Pension Plan Still Needs Fixing, as Other States Lead the Way

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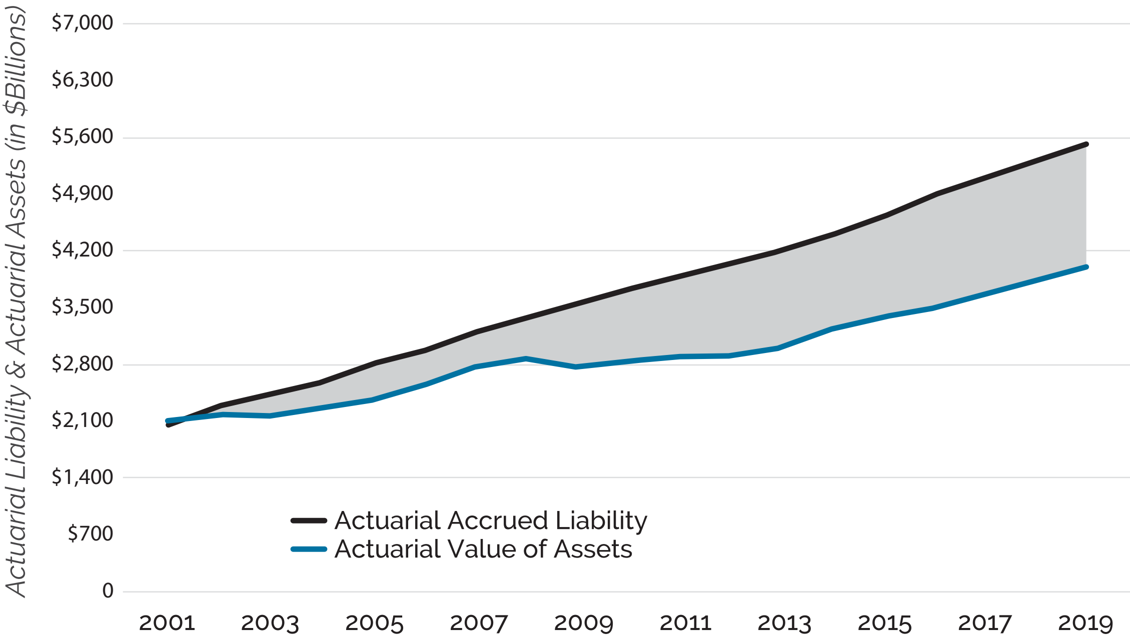
After 20 years of outdated funding policies, inadequate investment returns, and other factors, state and local government pension systems across the nation are now over $1.5 trillion in debt that grows and costs more the longer governments take to pay it off.

Pension debt puts a tremendous burden on states trying to balance their budgets. Each year they not only need to find a way to make that year's regular contributions into workers' pension plans, but they then must make additional debt payments in order to meet their promises to workers. Often that means crowding out other spending items. Just like household debt, paying down pension debt efficiently and quickly is the only way to stop the budget bleeding.

Figure 1: U.S. State and Local Government Pension Plans Assets vs Liabilities



Source: Reason Pension Integrity Project analysis of over 100 state pension systems' actuarial valuation reports through FY2020.

Since traditional public pension systems are funded by a combination of taxpayer dollars, employee contributions, and investment returns, it's no surprise that when the state does not contribute enough in a given year, or the plan investments don't hit their expected returns, pension debts go up.

Fortunately for proponents of financial sustainability in government, some states have successfully reformed their plans to protect worker retirement, get rid of pension debts, and keep the system financially sound.

Texas Leads the Way

While several states debated pension reform in the 2021 legislative session, Texas lawmakers went the furthest by enacting a major reform bill that paired the rollout of a new and financially sustainable retirement plan for all new state employees with a responsible plan to pay down over $14 billion in unfunded pension liabilities.

The effort came as plan managers spent the latter part of 2019 and all of 2020 warning lawmakers that their plan was running out of money; the question was not if the system would become insolvent, but when. Retirees also complained about the lost value of their benefits over a decade without any sort of cost-of-living adjustment.[1]

Not only did Texas legislators commit more funds today to protect earned benefits and avoid passing an expensive debt to future generations, but the new law enrolls all future employees into a new, low-risk "cash balance" retirement plan that provides a guaranteed minimum four percent return on investment as long as the employee keeps their account. When combined with already existing supplemental retirement savings plans in the state, new Texas public employees will receive as good a benefit as previous employees, but will also be able to enjoy the portability of their cash balance benefit if they decide not to spend a full career in public employment.

The Texas law took the ideal approach to reforming a large state public pension system, replacing the debt-loaded legacy plan with an updated benefit design, and committing to fully paying for the retirement promises made to generations. The new design considered the fact that only 14 percent of the employees stayed with the state long enough to earn a full, unreduced pension benefit; hence a benefit design built to reward the increasingly scarce full-career public servant is not necessarily an attractive one for the future state workforce. And Texas also set a clear date for when all unfunded liabilities will be fully paid, while also rejecting a hardcoded, statutorily-set employer contribution rate in favor of a dynamic actuarially determined rate.

All that said, the Texas policy package is not perfect. It still leaves needlessly risky assumptions in place likely to distort the cost of benefits over time. But overall, since the Texas effort addresses so many of the same challenges almost all other public pension plans are facing right now, it's worth a look.

A Changing Workforce

Meeting the needs of a changing workforce is vital for recruiting and retaining the best and brightest to serve in the public sector just as it is in the private sector. Union groups and their supporters testify every year as to how maintaining a state or municipality's pension system as is, regardless of debt and cost, is necessary to sustain recruitment and retention of employees.

However, direct data from state personnel offices and the pension systems themselves tell a much different story. In the public sector, generally, less than 20 out of 100 newly-hired public workers will stay in public employment for a full 25+ year career, making retirement savings portability in the direct interest of every new public employee. State and local retirement plans need to keep up with that reality and offer a competitive and sustainable retirement benefit, but one that is portable and does not require lengthy vestment periods.

Florida's Challenge

At the turn of the century, the Florida Retirement System (FRS) held a $13.5 billion surplus, but an over-reliance on investment returns and other rosy actuarial assumptions—rather than appropriate employer and employee contributions—meant the recession that followed ended that surplus, and then some. A year after the 2008 financial crisis, FRS held nearly $20 billion in pension debt. In less than a decade FRS went from a $13.5 billion surplus to nearly a $20 billion debt, a $33 billion shift in the wrong direction.

Today that debt has grown to $36 billion despite a historic bull market. Florida lawmakers and system managers have seen major shifts in the states' public pension system over the years and have successfully updated a few elements of the system in response: opening the more portable Florida Investment Plan to new hires in 2000, eliminating unfunded post-retirement benefit increases in 2011, and defaulting short-term employees into the Florida Investment Plan in 2017. Without those changes, the state of FRS would likely be much worse, but $36 billion in debt and growing is still a massive problem.

Only adopting more realistic actuarial assumptions and investment return goals, making full actuarially determined annual payments into the plan, and amortizing the debt in less than 20 years can put FRS on a path to pay off the unfunded liabilities.[2] That will stop the bleeding and allow for a better designed FR pension plan for new workers, with the same level of benefits as the current plan but with features to reduce long-term governmental risks and costs (e.g., 50/50 employer/employee cost sharing and a conservative investment return assumption).

At the same time the FRS Investment Plan needs fixing, as well. This is the defined contribution (DC) option for workers. Financial experts strongly recommend contributions at a rate of about 10 percent to 15 percent of pre-tax earnings in order to secure an effective retirement nest egg. Older workers with a closer retirement horizon and inadequate savings may need to contribute even more. Well-designed DC plans should also offer the correct age-appropriate investment mix. This is generally accomplished by using target date funds that adjust investment risk to the employee's retirement horizon to protect the account's value from market fluctuations as the worker nears retirement.

Florida has taken important steps to protect retirees and taxpayers and put FRS on a sustainable footing, but the job is far from done. The volatile stock market, changing workforce, and budget constraints all continue to apply pressure on FRS managers and stakeholders to constantly look for opportunities to adapt. The 2022 legislative session is a key opportunity to take some important next steps.

REFERENCES

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