



# Reforming the Florida Retirement System

by Randall G. Holcombe

**R**eforming the Florida Retirement System (FRS) has been high on the agenda of Governor Scott and many legislators for the past four years, and while some reform has occurred, it has stopped well short of the reforms many Florida leaders have proposed. Two major reasons for this are opposition from interest groups who support the status quo, and the argument that the system is working well as it is currently designed. These reasons are related. If the system is working well as it is currently structured, this provides an argument for the interest groups against reforming the state's retirement fund.

## **The Florida Retirement System**

The FRS is primarily a defined

benefit retirement system, with an option to enroll in a defined contribution plan. A defined benefit plan provides a retiree with a pension amount determined by the retiree's income at the time of retirement and years of service, according to a set schedule. With a defined contribution plan, funds are deposited into an account belonging to the employee, and those funds are invested. The amount the employee is entitled to upon retirement depends on how much money is in the account when the employee retires.

The FRS also includes annual cost-of-living increases in the defined amount of the pension. Financial risk under the defined benefit plan is borne by the FRS. Part of the risk is that the assets held by the FRS

may not perform well enough to pay the promised pension, but another part of the risk is that retirees may have unexpectedly high retirement salaries, and unexpectedly long lives. The financial risk with the defined contribution plan is borne by the employee. Approximately one-sixth of FRS enrollees have opted for the defined contribution plan since that option became available in 2003.

Recent reforms have lowered the attractiveness of the defined benefit system. The plan's cost-of-living escalator is being phased out, and the generous drop program—that allowed employees to enroll and have pension earnings allocated to an account for five years while the employee was still working, to be paid out as a lump-sum after retiring—has been made less generous because the interest rate at which those drop accounts grew was cut. New hires will not receive any cost-of-living increases.

### **Arguments for Reform**

Opponents of FRS reform say the system is working well as it is currently structured, so changes to the system are not needed. Currently, the FRS is about 85 percent funded, according to the state's calculations, which means that it has 85 percent of

the assets it estimates it will need to pay off its future pension liabilities.

The system is not in immediate danger of defaulting, and is in relatively good shape when compared to most other states.<sup>1</sup> The 85-percent figure may be an overestimate of FRS's funding level, according to some studies, because of overly-optimistic assumptions that stand behind that estimate.<sup>2</sup> Even if the state's

85-percent estimate is accurate, the plan is still underfunded, and the state will have to put additional money into it to pay off its pension obligations. Currently, the state allocates about \$500 million a year to cover the unfunded liabilities of the FRS.

While the FRS is underfunded now, the strongest argument for reform is to keep it from becoming increasingly under-

funded, which would place both the state's budget and the pension payments of retirees in jeopardy. Many states now find themselves in that position. California and Illinois, which are among the nation's highest-income states, are but two of the states that have promised benefits that they are now struggling to pay. After the bankruptcy in Detroit, pensions to current and future retirees were cut, showing that when defined benefit pension plans are underfunded, the risk extends to

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employees and retirees, who may not get the benefits they were promised. Money contributed into a defined contribution account belongs to the employee and cannot be cut, so while much of the opposition for shifting the FRS to a defined contribution system comes from employee groups, recent events show that defined contribution plans cut the default risk for employees. Even if the FRS is adequately funded now, employees looking decades ahead toward the time when they will retire and receive their pensions should realize that the risk of underfunding falls much more on them with a defined benefit plan than with a defined contribution plan.

The argument that the FRS is financially on sound footing, and therefore, reform is unnecessary, falls short when one looks at the experiences of other states. The time for reform is before major problems have arisen, not after problems have already generated excessive liabilities, thereby making any proposed reforms doubly challenging.

### **FRS Alternatives**

The most straightforward reform would be to require all new state government hires to enroll in a defined contribution pension plan, allowing current workers to stay with the defined benefit plan if they so choose. This would come at no cost to current workers, and new hires would be able to judge whether the combination of salary plus benefits (including retirement benefits) would make it worth their while to accept employment. Defined contribution

plans have become the norm in the private sector, and this idea would be a fair way to transition toward defined contribution pension plans.

An alternative considered in the 2014 legislative session was a hybrid plan that would work like a defined contribution plan, but would guarantee a 2 percent rate of return to the employee. If the actual rate of return on the pension fund was above 2 percent, the employee would receive 75 percent of the return above the guaranteed amount. This alternative would be a bad deal for the typical employee, but good for the state. When one thinks of the long-term goal of retiring after several decades of work, the average return over good years and bad should well-exceed 2 percent, and this hybrid plan would take away a quarter of the worker's investment returns in exchange for very little security, when one considers the long run.

The legislature should be looking at moving toward a defined contribution plan for all employees, which is the norm in the private sector, and not only mitigates the state's financial risks, but also insulates workers and retirees from the risk of default in a defined benefit plan.

### **Privatizing State Pension Plans**

Many private companies offer federally-insured defined contribution pension plans. As the FRS moves toward defined contribution retirement plans, there is no reason for the FRS to manage those accounts. The state should solicit proposals from private sector

financial firms to offer 401(k)-style pension plans for state workers. Workers could choose the firm that would manage their pensions, and typically, such plans offer workers a variety of investment alternatives, such as stock index funds, bond funds, or combinations of funds. The firms themselves could offer workers recommended portfolios, but allow workers to choose if they would prefer a different option.

If all new workers were enrolled in plans run by private firms, when the last of the current FRS workers retired and then passed away, the FRS would be closed. The state would be completely free of any obligations from unfunded pension liabilities, and employees would be completely free of any threat that their pensions would be reduced because of underfunding.

This leaves the issue of dealing with the current unfunded liabilities of the FRS. Currently, the FRS has an unfunded liability of about \$21.6 billion, which must be addressed regardless of any reforms. This is not an issue related to proposed privatization of state pensions; it is the result of past underfunding. The best way to address it is to privatize all future state pensions now, and pay off the current liability to keep it from growing.

### **Best Option: Complete Privatization**

Florida's best option for dealing with its pension plan is to privatize all state pensions. State workers should be enrolled with a private

pension firm that would keep their accounts and invest their money in approved investment vehicles. This is common in the private sector, and would provide benefits to both the state and to its workers. The state would no longer be in a position of accumulating unfunded pension liabilities, and workers would have the security of knowing that their pension plans would not be subject to possible problems that have occurred elsewhere in the U.S. as a result of underfunded plans. Ultimately, this would lead to the closing of FRS as its current enrollees passed away.

Current proposals to shift the FRS toward defined contribution plans are a good first step, but they do not go far enough because they envision the FRS managing the defined contribution plans. There is no reason for the FRS to do this because there are many private sector alternatives. The ultimate goal should be for the state to completely eliminate its pension plans and have them administered in the private sector, as many private businesses do. &

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#### **ENDNOTES**

<sup>1</sup> See [www.governing.com/gov-data/state-pension-funds-retirement-systems-unfunded-liabilities-obligations-data.html](http://www.governing.com/gov-data/state-pension-funds-retirement-systems-unfunded-liabilities-obligations-data.html), which ranks Florida 9th lowest among states for unfunded liabilities.

<sup>2</sup> See Milliman, "Study Reflecting the Impact to FRS of Changing Investment Return Assumption to One of the Following: 7.5%, 7.0%, 6.0%, 5.0%, 4.0%, or 3.0%," March 11, 2011. See also Brooks Apostolu, "The GA(A)P in Underfunded State Pension Liabilities," *CPA Journal* 81, no. 5 (2011), pp. 17-21.