Paying More for Less

Senate Bill Increases Pension Costs and Puts More Employees in Underperforming Retirement Plans

By Stephen Herzenberg | April 25, 2013

Executive Summary

The Florida pension debate has refocused on a Senate proposal that would reduce the share of new Florida public employees who receive a defined benefit pension based on the employee's salary and years of service. The Senate proposal would increase the share of new hires that participate in Florida's 401(k)-type defined contribution retirement plan, which defines only the amount contributed by employer and employee each year.

The Senate proposal is a less dramatic restructuring of pensions than a House proposal that would eliminate entirely the defined benefit option for new employees. Nonetheless, the Senate proposal still flies in the face of the results of Florida's real-world experiment with a defined benefit pension and a defined contribution retirement plan, which showed the superior performance of the defined benefit pension over the past decade. The Senate plan also contradicts a larger body of research documenting the cost-effectiveness of defined benefit pensions and would harm taxpayers, employees, and schools and other public employers seeking to retain talented workers.

The Senate proposal would:

- Shift more public employees into individual accounts that experienced lower investment returns than the state's defined pension plan from 2004 to 2012;
- Increase the cost to taxpayers of both Florida's defined contribution and defined benefit retirement plans;
- Result in more teachers, police officers, and other public servants having defined contribution retirement plans that are less likely to provide them with an adequate retirement income; and
- Make it more difficult for Florida schools and other public employers to hold onto high-quality employees.

Because shifting employees from defined benefit to defined contribution plans increases taxpayer costs and results in lower-quality pensions, a dozen states that considered this option chose instead to maintain their defined benefit plan as the primary (and usually the only) option.

The Senate proposal is also unnecessary because Florida has one of the healthiest public pension funds in the nation, one of only 11 states to receive the highest rating ("solid performer") from the Pew Center on the States.

The Senate Proposal

Under the Senate proposal, newly enrolled members of the Florida Retirement System (FRS) would have five months during which to choose either the defined benefit plan or the defined contribution plan. If members do not make their own choice, they would "default" into the defined contribution plan. Under current law, new hires who do not elect one of the two plans themselves become members of the defined benefit pension. Currently, with the defined benefit plan as the "default," 75% of new employees become members of this plan. FRS consulting actuarial firm, Milliman, estimates that the Senate proposal would lower the share of new employees entering the defined benefit plan from 75% to 46%.[1]

Higher Costs for Taxpayers

The Senate proposal would increase the cost to taxpayers of Florida's defined contribution and defined benefit retirement plans.

It increases the cost of the defined contribution plan because, as an incentive to get more employees to join the defined contribution plan, the Senate proposal lowers the required employee contribution from 3% of salary to 2%; employers—hence taxpayers—would contribute an additional 1% of employees' salaries to offset lower employee contributions.[2] In 2011-12, this additional 1 percentage point would have added $43 million to the taxpayer costs of Florida's defined contribution plan. As more individuals shift into the defined contribution plan, the cost of the additional 1% of covered payroll that taxpayers contribute to the plan each year will grow steadily.[3]

The Senate proposal would also increase the costs of the state's defined benefit pension. By shifting more new young employees into the defined contribution plan, the Senate proposal will reduce the number of new employees who enter the defined benefit plan but then work too few years to become eligible for a pension (i.e., to "vest"). Since members of this non-vesting group do not receive pensions, the employer—and taxpayer—costs of their pensions equal zero. The zero employer cost of non-vesting employees' pensions currently holds down the overall cost of the defined benefit plan. Removing these employees from the defined benefit plan increases its costs. [4] Thirty-year projections by the FRS actuary, Milliman, for the state's status quo pension arrangements confirm that aging the new entrants to the defined benefit pension—and shifting more young, less-likely-to-vest employees into the defined contribution plan—can increase defined benefit plan costs substantially.[5] This aging—and the resulting increase in costs—would be

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[1] Milliman, *Study Reflecting the Impact to the Florida Retirement System of Members Initially Enrolled on or after January 1, 2014 Defaulting Into Investment Plan*, March 13, 2013.

[2] Professional Staff of the Committee on Community Affairs, Florida Senate, *Bill Analysis and Fiscal Impact Statement*, p. 7; online at http://www.flsenate.gov/Session/Bill/2013/1392/Analyses/0ITEJSU3jpuKvCJe/KUmeUIagQM=|14/Public/Bills/1300-1399/1392/Analysis/2013s1392.pre.ca.PDF

[3] In 2011-12, the total payroll of employees in the Florida defined contribution plan (or "investment plan") equaled $4.27 billion. One percent of this amount equals $42.7 million. Florida Department of Management Services/Division of Retirement (FDOMS/DORS), *The Florida Retirement System Annual Report: July 1, 2011 – June 30, 2012*, p. 22, online at https://www.rol.frs.state.fl.us/forms/2011-12_Annual_Report.pdf.

[4] Since this group of employees that would have been in the defined plan but not vested will now participate in the defined contribution plan, with an employer cost of 4% of salaries, the stand-alone cost increase of the Senate plan for this group is 4% of salaries. As noted in the text, however, removing this group from the defined benefit plan means that this increase also shows up as a rise in the cost of the defined benefit plan.

[5] See Milliman, *Study Reflecting 30-Year Projection of Open Defined Benefit Plan and Revised Study Reflecting the Impact of Closing the Defined Benefit Plan to New Members Effective January 1, 2014 Including Projected Blended Rates for the next 30 Fiscal Years*, online at http://miamiherald.typepad.com/files/close-db-prospectively-with-baseline.pdf. In these Milliman projections, the aging of new entrants to the defined benefit plan under the status quo appears to be exaggerated, as do the impacts of this on the cost of the pension plan. (See Stephen Herzenberg and Sarabeth Snuggs, *A Misguided "Solution to a Nonexistent Problem*, Keystone Research Center, online at

more pronounced with the Senate proposal, as younger new hires default into the defined contribution plan and respond to the financial incentive to choose that plan.

The Senate pension proposal will also increase the costs of the state's defined benefit pension plan by lowering the investment returns on the accumulated assets of the plan. It will do this because the reduction by nearly 40% in the number of new (mostly young) entrants into the defined-benefit plan will significantly age the profile of the retired and active employees left in the plan.[6] Once a higher proportion of its members are retired or become senior employees, the pension fund would invest in a somewhat more conservative and liquid portfolio, lowering investment returns and increasing taxpayer costs. The impact on investment returns with the Senate proposal would be an attenuated version of the larger erosion of investment returns that would result from the House proposal to close the defined benefit plan entirely.[7]

The taxpayer costs that result because investment returns on plan assets fall when a defined benefit pension plan closes (or, in the case of the Senate proposal, takes in significantly fewer young members) are a central reason that a dozen states which considered closing their defined benefit plan chose not to do so. An earlier policy brief contains an annotated bibliography and online links to studies conducted in these dozen other states. [8] That brief also summarizes the increases in pension unfunded liabilities (in Alaska and Michigan) and the erosion of retirement income for public workers (in West Virginia) that resulted in the three states that have actually closed their defined benefit plans.

Less Cost-Effective Pensions

In favoring the defined contribution plan, the Senate proposal contradicts research evidence that shows defined benefit pensions to be more "efficient" or cost-effective. The research literature suggests that

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http://keystoneresearch.org/publications/research/florida-pensions, Appendix A.) Even so, the point in the text is that this aging (and the removal of younger employees from the defined benefit plan) will be greater under the Senate plan than the status quo and will increase costs compared to the status quo. In 30-year projects for the Senate proposal, Milliman appears to make assumptions inconsistent with its earlier (3/1/13) modeling of the status quo (i.e., in the "base case" projection). (See *Study Reflecting 30-Year Projection Effective January 1, 2014 of…2% Employee IP Contributions…and Changing the Default Option for Regular and Special Risk Class Members to be IP rather than DB…*, April 11. 2013.) In particular, the Senate proposal study says on page 6: "This study assumes no adverse selection on which members elect the DB plan versus the DC plan. If DB plan elections are concentrated to older participants, average DB normal cost rates will increase at a quicker pace than shown in this analysis." By contrast, the 3/1/13 actuarial study of the "base case" (status quo) says (p. 3): "When the DB plan is kept open [i.e., in the status quo base case], the composite normal cost rates are also expected to increase during the projection period. The primary reason for this is a change in the demographics over time. In recent years, the members who have entered FRS have been older than in prior years. DB plan members are worth more to older members, which in turn results in higher costs. These higher costs slowly and steadily are expected to increase the overall cost of the DB plan during the projection period, if the members entering FRS are consistent the members hired in recent years." In a similar vein, P. 8 of the Milliman study of the Senate proposal says "Age and salary distributions for new members entering the DB plan on July 1, 2013 and after are based on members (DB plus DC plan members) hired between June 30, 2011 and June 30, 2012"—i.e., there would be no change compared to the last year of data under the status quo.

[6] If 46% instead of 75% of new employees enter the defined benefit pension plan, this is a decline of 46/75 or 39%.

[7] For more detail on how changing the age profile of defined benefit pension plan participants impacts investment returns, see Herzenberg and Snuggs, *A Misguided "Solution to a Nonexistent Problem*, pages 3-6. After roughly 60 years under the Senate plan, assuming that the share of new employees choosing the defined benefit plan remains stable at a little below half, the balance between retired, older active, and younger employees would be restored and projected investment returns should rebound.

[8] See Herzenberg and Snuggs, *A Misguided "Solution to a Nonexistent Problem*, Appendix B.

defined benefit pension plans deliver about twice as much retirement income for any given level of employer and employee contributions, according to the National Institute on Retirement Security.[9] This is a BIG difference.

Defined contribution plans are less cost-effective for a number of reasons:[10]

- They have higher administrative costs because of the need to manage individual accounts and higher marketing (or educational) costs incurred to educate plan participants about their investment options;
- They deliver lower investment returns because individuals making investment choices do not match the returns of investment experts who manage defined benefit pooled funds;[11]
- They have higher financial management and trading fees; and
- They do not pool "longevity risk." When individuals convert their accumulated savings into an "annuity"—a fixed payment until they die—their annuity payment is lower because the provider of the annuity knows there is a reasonable chance that the individual may live much longer than average. Since defined benefit plans do pool longevity risk—across hundreds of thousands of plan members in the case of FRS—they know that plan participants, *on average*, will live exactly the expected number of years. Thus, annual benefit payments don't need to be pared back to insure against a longer drawdown of benefits.

Under Florida's Natural Experiment, Defined Contribution Plans Yield Lower Returns

In weighing future retirement options, Florida need not simply rely on the research literature comparing defined contribution and defined benefit outcomes. Florida has the unique advantage of a decade-long natural experiment operating two retirement options side by side. Table 1 on the next page presents information on the actual rate of return from 2004 to 2012 for the Florida defined benefit and defined contribution pension plans.

The table shows that over a nine-year period, the annualized rate of return for the defined benefit plan exceeds that for the defined contribution plan, 6.84% to 6.08%. Table 2 considers two other factors that impact the growth of retirement income in a retirement plan: pension plan cost and the rate of inflation. The table also projects out 15 years and 30 years to see how the differences between Florida's pension plan outcomes add up over time. Table 2 shows that over 30 years, based on 2004-12 experiences and taking into account plan costs, the defined benefit plan's assets would grow 184% in real (inflation-adjusted)

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[9] Beth Almeida and William B. Fornia, *A Better Bang for the Buck*, National Institute on Retirement Security, August 2008, online at http://www.nirsonline.org/index.php?option=com_content&task=view&id=121&Itemid=48. See also Mark Olleman, "Public Plan DB/DC Choices," *PERiSCOPE,* January 2009, Milliman, online at http://publications.milliman.com/periodicals/peri/pdfs/PERi-01-01-09.pdf.

[10] See Almeida and Fornia, *A Better Bang for the Buck*. See also, Robert Hiltonsmith, *The Retirement Savings Drain: The Hidden and Excessive Costs of 401(k)*, Demos, New York, New York; online at http://www.demos.org/sites/default/files/publications/TheRetirementSavingsDrain-Final.pdf.

[11] The Florida defined contribution plan currently includes 20 investment options, which are described online at http://www.myfrs.com/portal/server.pt/community/investment_funds/221. Spend a few minutes on this web site and you gain a feel for how the range of investment options can bewilder non-expert individual participants in defined contribution retirement plans.

terms versus 122% for the defined benefit plan. Thus, the growth of the defined benefit plan's assets for the same initial contribution would be 51% higher than the growth of the defined contribution plan assets.

Table 1. Rate of Return, Florida Retirement System Defined Pension Plan and Defined Contribution Plans, 2004-12

	Defined Contribution ("Investment Plan") Rate of Return, 2004-2012	Defined Contribution Plan Cumulative Growth, 2004-12 (%)	Defined Benefit ("Pension Plan") Return, 2004-12	Pension Plan Cumulative Growth, 2004-12 (%)	Pension Plan Rate of Return Minus Investment Plan Rate of Return
2004	14.4	14.4	16.6	16.6	2.2
2005	8.5	24.1	10.2	28.5	1.7
2006	10.2	36.8	10.6	42.1	0.4
2007	16	58.7	18.1	67.8	2.1
2008	-4.7	51.2	-4.4	60.5	0.3
2009	-15.2	28.2	-19	30.0	-3.8
2010	11.1	42.5	14	48.2	2.9
2011	18.1	68.2	22.1	80.9	4
2012	1.1	70.1	0.3	81.4	-0.8
Arithmetic annual average rate of return	6.61		7.61		1.00
Annualized 2004-12 rate of return	6.08		6.84		0.76

Source. State Board of Administration of Florida, *Investment Report 2012*, Chart 6, p. 30 and Chart 12, p. 51

Table 2. Projected Cumulative 15-Year and 30-Year Rates of Return for Florida Retirement System Defined Contribution and Defined Benefit Plans Based on Actual Experience, 2004-2012

Projection	Defined Contribution Asset Growth	Defined Benefit Plan Asset Growth	Defined Benefit Plan Growth Advantage (%)
15-year cumulative growth at annualized rate	142%	170%	20%
30-year cumulative growth at annualized rate	487%	628%	29%
15-year inflation-adjusted cumulative growth at annualized rate (assumes 3% inflation)	58%	76%	31%
30-year inflation-adjusted cumulative growth at annualized rate (assumes 3% inflation)	148%	210%	42%
15-year inflation-adjusted cumulative growth at annualized rate minus plan cost 2012	49%	69%	41%
30-year inflation-adjusted cumulative growth at annualized rate (assumes 3% inflation) minus plan cost 2012	122%	184%	51%

Source. Table 1 and Chart 8, p. 33 for defined benefit plan cost (0.3%) and p. 53 for defined contribution plan cost (0.38%)

It is worth noting, in addition, that the period 2004-12 was a difficult period for financial markets. The Florida defined benefit plan significantly underperformed its historic investment return averages in this period. Thus, the estimates in Table 2 may well be conservative estimates of the long-term gap likely to result in the increase in inflation-adjusted plan assets under Florida's defined benefit vs. defined contribution plan. Consistent with this interpretation, the Florida actuary assumes in its projections that the defined contribution plan will generate returns of 6.5% whereas the defined benefit plan (under the status quo) would generate returns of 7.75%. With this gap, and the same assumptions for inflation and plan costs as above, the 30-year growth of defined-benefit plan assets would exceed the same figure for defined-contribution plan assets by 78%. Moreover, neither the 51% nor 78% estimates of the defined benefit pension advantage take into account that retirees with individual accounts pay a premium if they want to convert their pool of savings into an annuity that provides a monthly check until the end of life.

In sum, while FRS appears to have done well to reduce the increased costs of 401(k)-type retirement plans through economies of scale, there is no escaping the reality that defined contribution retirement plans are much less efficient. With these plans, Florida pays more for less, hurting all FRS stakeholders: taxpayers, employees, and public-sector employers seeking to retain high-quality employees.

A final point, widely understood but not always adequately considered: the switch to defined contribution plans means that employees bear the risk associated with financial market volatility. While a well-managed defined benefit plan, such as Florida's, can mitigate this risk for taxpayers, individual employees who happen to retire at the wrong time—such as the 2009-2011 period—can find their retirement income falls far below their expectations.

Challenge Retaining High-Quality Teachers and Other Public Employees

Defined benefit plans are a well-established human resource management tool for employers at which staffing levels tend to be relatively stable—such as in the public sector. By making this human resource management tool applicable to less than half the workforce, shifting more new employees to the defined contribution plan could make it more difficult for Florida's public employers to retain high-quality employees. This problem could be particularly acute in Florida's schools.

Across the country, K-12 teachers earn an estimated 12% less in salaries than comparable private-sector workers, which makes secure defined benefit pensions important to retaining good teachers nationwide.[12] Florida's challenges are even greater because Florida public school teachers earn salaries nearly $10,000 below the national teacher average.[13] To be sure, young employees who know that they want to enter teaching partly to gain access to a defined benefit pension can still do so under the Senate plan. Many other young teachers, however, will default into the defined contribution plan or choose that plan because the required employee contribution is lower. Five or seven years later, after they have gained the experience to become effective in the classroom, nothing will hold them back from taking higher-paid private-sector jobs.

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[12] Lawrence Mishel, Sylvia A. Allegretto, and Sean P. Corcoran, *The Teaching Penalty: An Update Through 2010*, March 30, 2011; online at http://www.epi.org/publication/the_teaching_penalty_an_update_through_2010/.

[13] National Education Association (NEA) Research, *Rankings & Estimates: Rankings of the States 2012 and Estimates of School Statistics 2013*, December 2012; online at http://www.nea.org/assets/img/content/NEA_Rankings_And_Estimates-2013_(2).pdf, p. 18. Florida has the 7th lowest teacher salaries in the nation.

If It Ain't Broke, Don't Fix It

FRS has one of the most well-funded defined-benefit pensions in the nation. According to the most recent FRS annual report, the system has 87% of the funds needed to pay current pension obligations, not far from the 100% fully funded level and above the 80% funded ratio that pension experts regard as financially healthy.[14] The Pew Center on the States rates Florida's pension system as one of only 11 "solid performers" in the country—Pew's highest ranking.[15] Two other developments should further improve the health of Florida's defined benefit pensions: the recent stock market gains, which have not been factored into estimates of the FRS funded ratio, and the cost-saving pension changes implemented in 2011.

The 2011 changes included an increase in the retirement age, the phase-out of automatic 3% annual cost-of-living increases in retiree benefits, an increase to eight years in the vesting period (the years of service required before employees become eligible to receive a pension), an increase to eight years in the period over which final average salaries are determined (employees, based on years of service, receive a pension equal to a share of "final average salary"), and a sharp reduction in the interest rate earned on deferred benefits received through the Deferred Retirement Option Program, or DROP.[16]

In sum, Florida does not need further changes to its pension system beyond those implemented in 2011. Moreover, the Senate proposal to shift more employees towards a defined-contribution plan would represent a step in the wrong direction—for taxpayers, for employees, and for public employers seeking to retain high-quality teachers and other public servants.

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[14] FDOMS/DORS, *The Florida Retirement System Annual Report: July 1, 2011 – June 30, 2012*, p. 51.
[15] Pew Center on the States, *The Widening Gap Update*, June 2012, p. 3, online at http://www.pewstates.org/research/reports/the-widening-gap-update-85899398241.
[16] Under Florida's Deferred Retirement Option Program, or DROP, employees who already qualify for retirement benefits can defer receipt of their benefits while they continue to work for up to five years for an FRS employer. The deferred benefits are held in the pension trust fund and then paid out upon the employee's actual retirement. Under the 2011 changes, the interest rate earned on deferred benefits while held in the trust fund was reduced dramatically, from 6.5% to 1.3%.