HOUSE COMMITTEE ON APPROPRIATIONS

INTERIM CHARGE 7:

Identify structural changes that can be made to the Economic Stabilization Fund (ESF) in order to maximize investments and establish a source of funding for long-term liabilities. Examine the potential of using the fund for long-term infrastructure projects and the impact of the constitutional cap on the ESF balance.

The following constitute responses to a request for information regarding the above interim charge posted on August 5, 2020.

Glenn Hegar Texas Comptroller of Public Accounts

September 30, 2020

The Honorable Giovanni Capriglione, Chair
The Honorable Oscar Longoria, Vice Chair
Committee Members
House Committee on Appropriations
Capitol Building, Room E1.032
Austin, Texas 78701 Via email: appropriations@house.texas.gov

Dear Chair Capriglione, Vice-Chair Longoria and Members of the Appropriations Committee:

The Committee requested information on Interim Charge 7. Specifically, the charge is to identify structural changes that can be made to the Economic Stabilization Fund (ESF) to maximize investments and establish a source of funding for long-term liabilities. The charge also asks the committee to examine the potential of using the fund for long-term infrastructure projects and the impact of the constitutional cap on the ESF balance.

Background

For much of its 30+ year history, the ESF was managed in the same manner as the state's general operating funds, as a strictly cash fund within the state treasury. The only earnings to the fund were in the form of depository interest earned on the balance of the treasury pool and then allocated to the individual funds comprising that balance, including the ESF. This structure failed to recognize the distinguishing feature of the ESF as a *savings* account, in contrast to other operating funds that the state relied upon for daily operating needs.

House Bill 903

In 2015, the 84th Legislature enacted House Bill 903, which authorized the comptroller to invest the portion of the ESF balance exceeding the amount of the sufficient balance in accordance with the prudent investor standard. The sufficient balance of the fund was, at that time, determined on a biennial basis by a select committee of the legislature. This marked the first time in the ESF's history where the fund was being actively managed to earn a higher return in relation to the treasury pool. In investing the eligible portion of the balance, the comptroller identified two primary performance objectives: 1) to maintain purchasing power; and 2) deliver returns in excess of short-term cash equivalents. Maintaining purchasing power means achieving net returns over a full market cycle that exceed inflation as measured by the Consumer Price Index.

Senate Bill 69

In 2019, the 86th Legislature enacted Senate Bill 69, which directed the comptroller to invest up to 75 percent of the ESF for a higher return, ensuring at least 25 percent of the fund remains fully liquid. This change significantly increased the portion of the balance of the fund that is eligible for investment under the original provisions of HB 903.

The enhanced management of the ESF, as provided originally by HB 903 and later amended by SB 69, has been beneficial to the fund.

Building on previous success with the ESF, there may be additional untapped potential resulting from further enhanced management of Texas' severance tax revenues in the form of a sovereign wealth fund.

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Sovereign Wealth Fund

According to Pew Charitable Trusts, many sovereign wealth funds are derived from severance taxes collected on oil, natural gas, coal, and other minerals extracted in the state. By investing a portion of this revenue to generate returns, states can transform a volatile and ultimately finite revenue stream into a permanent asset. Investment returns can also be dedicated to a specific public purpose, such as defraying the cost of a long-term liability to the ongoing benefit of multiple generations of residents.

Sovereign wealth funds are not a new concept. Numerous countries worldwide have sovereign wealth funds, and an increasing number of US states have also established such funds, particularly those states with abundant natural resources. Notably, Texas has already been credited with having two such funds already – the Permanent School Fund (PSF) and the Permanent University Fund (PUF). The PSF and PUF both behave similarly to sovereign wealth funds in that they manage a particular natural resource (in this case, state lands) as an investment portfolio, generating returns that are dedicated to a particular public purpose (in this case, public education).

For illustrative purposes, a sovereign wealth fund in Texas could easily work in conjunction with the existing ESF structure. The ESF itself could continue to be managed under the provisions of HB 903 and SB 69. With SB 69, the Legislature adopted a new standard for determining a sufficient balance for the ESF, setting the amount equal to 7 percent of the certified general revenue-related (GR-R) appropriations made for that biennium. The balance of the ESF, in relation to the sufficient balance as now calculated under SB 69, could determine how annual severance tax is deposited.

For example, in the event the balance in the ESF is less than 7 percent of GR-R appropriations, annual severance tax deposits would continue to be directed to the ESF until the 7 percent sufficient balance is achieved. However, whenever the balance in the ESF is at 7 percent of GR-R appropriations or greater, annual severance tax deposits could alternatively be deposited to the sovereign wealth fund where they become part of the principal and invested in long-term higher-yield instruments. As a result, the constitutional cap on the ESF balance would no longer serve a purpose and could be eliminated. The sufficient balance at 7 percent of GR-R appropriations would effectively replace the constitutional cap as the primary limiter on excess growth of the fund. Growth beyond the sufficient balance would be redirected to the sovereign wealth fund instead, until such time as the balance of the ESF were to fall below the 7 percent sufficient balance at which point severance tax deposits to the ESF would resume.

Similar to the PSF, annual distributions from the earnings in the sovereign wealth fund can be dedicated to a particular public purpose, such as defraying the cost of long-term liabilities including pensions and infrastructure. It is noteworthy that this concept could provide new revenues to defray these liabilities without creating new taxes or fees. Rather, the new revenue comes from enhanced management of an existing asset.

We appreciate the opportunity to provide the committee with this information. Please do not hesitate to contact my office if you have any questions.

Sincerely,

Glenn Hegar

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Texas Conservative Coalition Research Institute

Comments to the House Committee on Appropriations

September 30, 2020

Interim Charge 7: *Identify structural changes that can be made to the Economic Stabilization Fund (ESF) in order to maximize investments and establish a source of funding for long-term liabilities. Examine the potential of using the fund for long-term infrastructure projects and the impact of the constitutional cap on the ESF balance.*

I. Background

The Economic Stabilization Fund (ESF), often referred to as the state's "rainy day fund," is funded by several streams of revenue.

First, the ESF receives half of any unencumbered balance remaining in the general revenue fund at the end of a biennium.[1] As the House Research Organization noted in 2019, however, this type of transfer to the ESF rarely happens.[2]

Second, and much more importantly, 37.5 percent of severance tax revenue received by the state in a fiscal year which exceeds certain thresholds is deposited to the ESF after the conclusion of that fiscal year.[3] Another 37.5 percent of collected severance tax revenue is deposited in the State Highway Fund (SHF); however, if the ESF lacks a "sufficient balance,"[1] funds that otherwise would have been deposited to the SHF under the above methodology are deposited in the ESF until the ESF reaches that balance. Due to the passage of Senate Bill 69 in the 86h Session, the Comptroller now determines this sufficient balance of the ESF in a given biennium by setting it equal to seven percent of the certified general revenue-related appropriations for that biennium.[4]

An additional source of funding for the ESF is the interest and investment income on the ESF balance. Although at least one-quarter of the ESF balance must be liquid, the Comptroller is authorized to invest the ESF balance in the manner of a prudent investor.[5] This standard should allow the Comptroller to, at minimum, invest the ESF balance in a way that prevents its true value from being eroded by inflation over time.

The balance in the ESF is subject to a constitutional cap. During a given biennium, it may not exceed ten percent of the total amount deposited to the General Revenue Fund (after applying certain

[1] The phrase "sufficient balance" is no longer used in statute, as a result of the enactment of Senate Bill 69 (86R, 2019). However, this testimony uses that phrase because the concept remains in statute.

adjustments) during the previous biennium.[6] The cap for the 2020-21 biennium is approximately $18.8 billion. The state has never reached the cap. The Comptroller estimates that the ESF will have a balance of $8.79 billion at the end of the 2020-21 biennium (excluding any appropriations authorized between now and then).[7]

In 2017, Comptroller Hegar identified the following four long-term obligations as matters which have the potential to significantly limit the amount of revenue the state has for general spending in future legislative sessions and to harm the state's credit rating:

- Pension funding for the Employees Retirement System (ERS);
- Health care coverage for public school teachers and employees (TRS-Care);
- The Texas Tomorrow Fund (a prepaid tuition plan); and
- Deferred maintenance of state buildings and facilities.[8]

A year later, the Comptroller proposed the creation of the Texas Legacy Fund (TLF), a fund which would receive severance tax revenues flowing to the ESF under current law, but only if the ESF has a sufficient balance.[9] The TLF would be operated like an endowment, with the funds generating returns which could be used to help pay for the state's long-term obligations.[10] These earnings would be outside of general revenue and would therefore not be subject to the state's "pay as you go" spending limit.[11]

II. Legislative Proposals During the 86th Session

In the 86th Session, the Legislature considered House Joint Resolution 10 and House Bill 20, which together would have created the TLF and funded it by transferring $500 million from the ESF. Each of HJR 10 and HB 20 passed the House overwhelmingly but failed to receive a vote in the Senate.

This legislation would also have created the Texas Legacy Distribution Fund (TLDF), which annually would receive a portion of the earnings of the TLF. The principal of the TLF would be maintained; appropriations would not be made from it. Instead, appropriations would be made from the TLDF.

The engrossed version of HJR 10 provided that appropriations from the TLDF could be made only to pay for the unfunded actuarial liabilities of the ERS or the Teacher Retirement System (TRS). Prior versions of the resolution would have permitted appropriations to be made for the following purposes as well:

- Paying off state debt which depend on general revenue for debt service;
- Projects to repair state infrastructure other than transportation infrastructure or higher education facilities; or
- Other long-term obligations of the state, provided that such appropriations are approved by two-third of each house of the Legislature.

House Bill 20 set the sufficient balance of the ESF at seven percent of the certified general revenue-related appropriations for that biennium. The Legislature would have the ability to change this threshold by general law.

Notably, under HJR 10, appropriations could be made for the pension obligations of ERS and TRS, "notwithstanding the limitation on contributions otherwise provided by Section 67(b), Article XVI, of this constitution." That section of the constitution provides that the state's annual contribution to TRS and ERS pension funding must be at least six percent and no more than ten percent of the aggregate annual compensation paid to each system's members, as applicable. However, the Legislature can appropriate additional money to fund benefits authorized by law if the governor declares an emergency.

III. Analysis and Recommendations

The creation of the TLF is a goal worth pursuing. As the Comptroller noted in 2018:

> Texas' long-term obligations must be addressed at some point, and the longer we wait, the higher their cost will be. Inaction will simply cause these problems to snowball, lowering the state's credit rating, raising our cost of borrowing and putting the state's financial stability at risk.[12]

Having a dedicated stream of funding to address these liabilities ensures that even in "lean" fiscal biennia- in which revenue declines from the previous biennium or is less than anticipated- the state will still be paying down its long-term obligations.

The Legislature in the 87th Session should again consider the concept of the Texas Legacy Fund as set forth in HJR 10 and HB 20; however, it should do so with two qualifications. First, as the introduced version of HJR 10 provided, the state should be able to use the TLF for long-term obligations other than just public employee pensions, such as the early retirement of state debt and the maintenance of state facilities.

Second, funding for TRS and ERS pension obligations out of the TLF should be limited. The state currently contributes 10 percent of the aggregate annual compensation paid to ERS participants and 7.5 percent of the aggregate annual compensation paid to TRS participants[2] (pursuant to Senate Bill 12 (86R, 2019), the latter figure will increase to 8.25 percent by 2024 and subsequent fiscal years). Requiring the state to make even greater contributions detracts from the crucial reform that needs to take place with respect to TRS and ERS pensions: converting defined benefit (DB) pension plans to defined contribution (DC).

Participants in DC plans such as 401(k) plans generally contribute a portion of their salaries to the plan. Employers often provide a matching contribution to a certain extent, but are not required to do so. After these contributions are made, the funds in the plan grow depending on the performance of the investments in the plan. DB plans in the public employee context also (generally) require employees to make contributions, but generally receive a significant contribution from the public employer as well. A retired participant in a DB pension plan typically receives annual pension benefits which are calculated pursuant to a formula- which typically is based on the employee's years of service and salary over those years- and are not based on the performance of the investments in the DB plan. To make projections about its ability to pay promised benefits years into the future, the DB plan must estimate a rate of return on its investments. This creates a significant risk to taxpayers; if the trustee of a DB plan assumes

[2] ERS participants contribute 9.5 percent of their annual compensation. TRS participants contribute 7.7 percent of their annual compensation, but as noted that number will increase in the future. School districts also make separate annual contributions for the benefit of TRS participants.

a 7 percent average annual return over a 30-year period, but the actual average annual return is only 5 percent, then the plan will need additional funds to pay out the promised benefits, or will need to reduce promised benefits. When the employer is a public entity, that additional funding can become the burden of taxpayers.

A critical aspect of DB plans relative to DC plans, then, is the shifting of investment risk from employee to employer (or taxpayers). This fact is a key reason why DB plans are increasingly rare in the private sector. According to a BLS survey, in 2019, 64 percent of workers had access to a DC plan through their employer, but only 16 percent had access to a DB plan through their employer.[13] The corresponding figures for state and local government employees, however, were 37 percent and 86 percent.[14] Moreover, of the private sector employees who actually participated in a DB plan, 38 percent participated in a plan that was "frozen."[15] Frozen DB plans are those in which (a) newly-hired employees may not participate, or (b) only some participants still accrue benefits. The above numbers accord with an observation the BLS made back in 2012: "Beginning in the 1980s, a dramatic shift occurred in employer-sponsored retirement plans. This shift was away from traditional defined benefit plans and towards portable defined contribution plans, such as the popular 401(k)."[16] Despite this shift in the private sector, public employees in general continue to enjoy the advantages of DB plans.

TRS and ERS are DB pension plans which promise members future benefits which are calculated pursuant to a formula. For example, TRS's formula for calculating a standard annual pension is: 0.023 x (years of service credit) x (average annual salary based on five highest-earning years).[17] For example, assume a person retires at age 65 after working as a public educator in Texas for 40 years. The average of her five highest annual salaries is $70,000. She will receive an annuity payment of $64,400 each remaining year of her life.

Because DB participants are promised benefits irrespective of pension funds' investment performance, investment performance that is worse than anticipated can result in dramatic changes to the financial health of a pension fund. For example, in July 2018, the TRS board of trustees changed its projected long-term annual rate of return on investments from 8 percent to 7.25 percent. This seemingly slight change caused the then-32 year amortization period of TRS to soar to 86 years.[18]

Conclusion

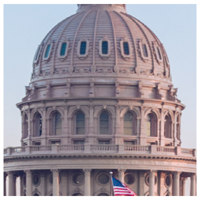
While employees with DB pensions can be expected to strongly oppose a switch to DC pensions, the question for policymakers is whether the state can afford to grant public employees the benefit of a DB plan when the vast majority of private sector employers cannot afford to do so while remaining economically competitive. If public employers (and thus, taxpayers) are paying public employees retirement benefits which are outsized compared to those which private sector employees receive, then taxpayers are not receiving the best value for their dollars; rather, they are subsidizing the retirement of public employees.

It should be emphasized that the current amortization period for ERS is infinite, meaning that its unfunded liabilities will never be paid down under current contribution rates and investment assumptions. TRS's amortization period is superior at 29 years, although that is still longer than ideal.

In creating the TLF, the Legislature should provide that the revenue from the TLF may be used to provide the state's share of funding for TRS and ERS pensions; however, the existing 10 percent cap on the state's contribution should still apply. In addition, any legislation creating the TLF should be considered in conjunction with measures to convert ERS and TRS pensions to DC plans.

ENDNOTES

[1] Article 3, Section 49-g(b), Texas Constitution.
[2] House Research Organization, "House Joint Resolution 10," (April 23, 2019), available at https://hro.house.texas.gov/pdf/ba86r/hjr0010.pdf#navpanes=0
[3] Article 3, Section 49-g(c) though (e), Texas Constitution.
[4] Section 316.092(a), Government Code.
[5] Section 404.0241, Government Code.
[6] Article 3, Section 49-g(g), Texas constitution.
[7] Comptroller, "Press Release: Texas Comptroller Glenn Hegar Projects a Fiscal 2021 Ending Shortfall of $4.6 Billion in Revised Revenue Estimate," (July 20, 2020), available at https://comptroller.texas.gov/about/media-center/news/2020/200720-cre.php?utm_source=tw&utm_medium=en-social&utm_campaign=cre-0720&utm_content=gr1
[8] Comptroller, "Fiscal Notes: Texas State Government and Long-Term Obligations," (March 2017), available at https://comptroller.texas.gov/economy/fiscal-notes/2017/special-edition/index.php
[9] Comptroller, "Long-Term Obligations and the Texas Legacy Fund," (October 2018), available at https://comptroller.texas.gov/economy/fiscal-notes/2018/sep-oct/legacy.php
[10] Ibid.
[11] Ibid.
[12] Ibid.
[13] Bureau of Labor Statistics, "2019 Employee Benefits Survey," available at https://www.bls.gov/ncs/ebs/#bulletin_details_retirement
[14] Ibid.
[15] Bureau of Labor Statistics, "Employee Benefits Survey (Frozen Plans)", available at https://www.bls.gov/ncs/ebs/factsheet/defined-benefit-frozen-plans.htm
[16] Bureau of Labor Statistics: "Beyond the Numbers: Retirement costs for Defined Benefit Plans Higher than for Defined Contribution Plans," available at https://www.bls.gov/opub/btn/volume-1/retirement-costs-for-defined-benefit-plans-higher-than-for-defined-contribution-plans.htm
[17] Section 824.203, Government Code.
[18] See Erald Kolasi, "The Cost and Adequacy of Teacher Pensions in Texas," *The Urban Institute,* (September 2019), available at https://files.eric.ed.gov/fulltext/ED601790.pdf



TEXAS PUBLIC POLICY FOUNDATION
Testimony

September 30, 2020

Simplify Texas's Rainy Day Fund

Testimony submitted to the Texas House Committee on Appropriations

by Vance Ginn, PhD, Senior Economist

Chairman Capriglione and Members of the Committee:

My name is Dr. Vance Ginn, and I am chief economist at the Texas Public Policy Foundation. I am submitting this written testimony in response to Charge 7 of the interim charges considered by this committee. I provide background on the state's Economic Stabilization Fund, also known as the "rainy day fund," and highlight the need for structural reforms to simplify its use so that money is there to cover tax receipt shortfalls while upholding a high credit rating by external agencies.

Background on Texas's Rainy Day Fund

Production of crude oil and natural gas has historically fluctuated based on many market-driven and geopolitical factors. Because the Texas Legislature collects severance taxes from this volatile production to primarily fund the state's rainy day fund, the purpose for and use of the ESF must be worthy.

Texas voters approved the ESF with passage of a constitutional amendment in 1988 after an uncertain state tax receipts period when oil and gas comprised a large share of economic output and was highly volatile in the 1970s and 1980s. The ballot language that Texans approved was "The constitutional amendment establishing an economic stabilization fund in the state treasury to be used to offset unforeseen shortfalls in revenue." The Texas Constitution requires a three-fifths vote in each house to close a revenue shortfall and a two-thirds vote in each house to use it for other reasons.

Since its inception, deposits to the fund have totaled $21.8 billion. While there have been many proposed uses for the money in the rainy day fund, the ballot language sold to Texas is clear that this money is to fill unexpected tax receipt declines. All told, only 27.4%, or $3.2 billion, of the $11.6 billion spent from the fund since its inception has been for general deficit reduction. In 2019, the Legislature appropriated $4.9 billion from the ESF for the 2019 fiscal year supplemental budget to help pay for expenditures such as ongoing Hurricane Harvey related relief and an additional $1.2 billion for the 2020-21 biennium. Clearly, a more stringent use of these funds outside of the intended purpose is warranted. In addition, the current economic slowdown as a result of the COVID-19 pandemic and a significant drop in the demand for oil and subsequently a decline in its price will likely reduce expected deposits into the rainy day fund.

Despite these uses of severance taxes for one-time and ongoing expenditures and the anticipated drop in deposits, the rainy day fund's balance is expected to be $8.9 billion at the end of the 2020-21 budget cycle. Given the fund's constitutional limit of 10% of general revenue (GR)-related funds excluding interest and investment income in the previous budget cycle, the cap this period is $16.9 billion.

Simplifying the Uses of the Fund

The cap of 10% on biennial GR-related funds is a 20% annual cap. Every dollar not in the private sector without a clear purpose is wasting potential productivity that could help Texans prosper, so these dollars should be used wisely and not be excessively collected. Moreover, the state's economy, and therefore tax revenue, is much less reliant on oil and gas activity as previously experienced. Research shows that Texas could have a biennial cap closer to 7%, or annually 14%, to cover the most severe fiscal downturns, which should primarily be solved with spending restraint. Alternatively, if this money is spent each session, the fund will quickly dwindle, and the state's credit rating could be at risk.

There will likely be interest in tapping the rainy day fund in 2021 if the expected drop in revenue materializes and more demands are put on the budget. Any use of these one-time funds to pay for ongoing expenditures only delays needed

continued

difficult decisions that should be made with general revenue funds and depletes one-time funds available for tax receipt shortfalls, future emergencies, or tax relief. In addition, using money from the fund for investment purposes that could support a higher rate of return to support unfunded state liabilities without considering major structural reforms to pensions and reductions to debt first is not warranted.

The Facts

- The rainy day fund is expected to increase to $8.9 billion by the end of FY 2021.
- Using one-time funds to pay for ongoing expenses is poor public policy.

Recommendations

- Increase the threshold to use money in the fund "at any time and for any purpose" from the current two-thirds of members present to four-fifths of all members in each chamber.
- Lower the constitutional cap from 10% to 7% of biennial GR-related funds in the previous biennium.
- Use excess state tax receipts above the fund's cap or from budget reductions to cut taxes instead of spending or investing them in riskier assets and growing the budget without reforms.

Thank you for your time in considering these key reforms to simplify the rainy day fund so that taxpayer dollars are used sparingly and wisely while keeping a high credit rating by external agencies. Thank you for the work you do, and I look forward to continuing the discussion on this topic.

Resources

Don't Grow Government with the Texas Rainy Day Fund, by Vance Ginn, Texas Public Policy Foundation (April 2019).

Fiscal Size Up 2020-2021 Biennium, Legislative Budget Board (May 2020).

Economic Stabilization Fund Overview, Legislative Budget Board (Jan. 2019).

Leaky Umbrella: The Need to Reform Texas' Rainy Day Fund by Vance Ginn, Talmadge Heflin, and Owen Smitherman, Texas Public Policy Foundation (Oct. 2016).

ABOUT THE AUTHOR

Vance Ginn, PhD, is chief economist at the Texas Public Policy Foundation, a 501(c)(3) non-profit, non-partisan free market think tank based in Austin. He is the former associate director of economic policy for the Office of Management and Budget at the Executive Office of the President, former college lecturer, and an expert on economic and fiscal issues with research that seeks opportunities to let people prosper in Texas, D.C., and beyond. He earned his doctorate in economics at Texas Tech University.

About Texas Public Policy Foundation

The Texas Public Policy Foundation is a 501(c)3 non-profit, non-partisan research institute. The Foundation promotes and defends liberty, personal responsibility, and free enterprise in Texas and the nation by educating and affecting policymakers and the Texas public policy debate with academically sound research and outreach.

Funded by thousands of individuals, foundations, and corporations, the Foundation does not accept government funds or contributions to influence the outcomes of its research.

The public is demanding a different direction for their government, and the Texas Public Policy Foundation is providing the ideas that enable policymakers to chart that new course.

30 September, 2020

To the Members of the Committee:

The Texas Pension Coalition is writing with regards to Interim Charges 2 and 7 for the Texas House Appropriation Committee.

Interim Charge 2

As stated in Interim Charge 2, the committee is charged with the following task:

> Review and evaluate the actuarial soundness of the Employees Retirement System and TRS pension funds. Examine the cost of and potential strategies for achieving and maintaining the actuarial soundness of the funds. Examine the effect the unfunded liabilities could have on the state's credit. Examine the state's investment policies and practices, including investment objectives, targets, disclosure policies, and transparency.

It is the shared belief among the members of the coalition that your committee and the entire legislature has a constitutional obligation to do whatever is necessary to maintain the actuarial health of our two statewide public pension systems.

The Employees Retirement System is in dire need of funding. Based on changes made following the system's most recent experience study, ERS now has a funding ratio below 70 percent. The complete unfunded liability for ERS now stands at $13.6 billion. Further, its depletion date––the point at which ERS Trust can no longer pay annuities and the system reverts to an astronomically expensive PAYGO model––has moved up from 2075 to 2061. While this still seems decades away, every year in which legislators don't tackle the depletion date adds hundreds of millions, and eventually billions, more in costs.

Make no mistake, however, in assuming this is solely because of COVID-19. For years, ERS has been underfunded by the legislature. In the past fifteen years, total contributions have only matched the actuarially sound contribution once. Currently, the actuarial sound contribution rate is just over 25%. The contributions by the state, employing agencies, and workers, however, only total 19.5%, and that gap consistently prevents the system from performing as well as it could.

This gap between what our systems need and what the state puts in is having considerable impact on the well-being of our retirees. By law, neither of our two state pension systems can provide retirees a Cost of Living Adjustment (COLA) unless they are in actuarially sound condition––defined by statute as having an amortization period under 31 years. Because the state has consistently underfunded both systems, anything resembling a true COLA has felt like a pipe dream for most retired public employees.

Pensions are based on a worker's final salary range, and because most public employees earn less than what they would in the private sector, their pensions are also going to ultimately be modest, even if they put in a full career in public service. As a result, the average ERS pension is a bit over $1,700 a month. TRS recipients receive a bit more per month––around $2,000––but the overwhelming majority of teachers in Texas do not receive Social Security: their pension has to do everything. When coupled with inflation, a pension that makes ends meet at the beginning of someone's retirement can quickly fall short unless periodic adjustments are made to account for the rising cost of living in the state. Rent, medications, insurance, and food costs all continue to inch upwards, to say nothing of unexpected expenses. Without legislative action, retired public employees are left waiting every few years for a sporadic "13th check": a welcome bit of relief, but nothing resembling the sustained change people really need.

The need for a legislative solution is compounded by recent changes to our statewide pension systems' expected rate of return. A rate of return is a studied estimation of a system's long-term growth. While the year-to-year growth of a pension system may be volatile––up greatly some years, stagnant in other years––a smoothed long-term estimate, particularly the 30-year outlook, gives us the best sense of the overall needs and health of the system.

Recently, the investment team from ERS downgraded their expected rate of return to from 7.5% to 7%. It had previously lowered its rate from 8% to 7.5%. This move is highly similar to those made by many other pension investment teams over the past couple years. This includes TRS, which lowered its expected rate of return from 8% to 7.25% in 2018.

While the 8% expected rate of return was a standard across pension systems in the United States, it no longer reflects our current economic reality, one in which several years of spotty growth have now been severely compounded by the ongoing pandemic. Keep in mind: pensions are still faring better than individualized investments, and will weather this storm better than any 401(k)-type plan ever can. However, the 8% standard is no longer a reality for the immediate future, at least.

The prudent choice––one which both TRS and ERS have done––is to reset expectations to earthbound levels. Investors want to make as much money as possible: it is in the best interest of the financial teams for ERS and TRS to get as high returns as they can while still responsibly managing billions of dollars. Lowering the rate of return is, by extension, a wise choice because it offers a clear signal to lawmakers: fulfilling our promises has to come from other methods. The state has to find the money in order to make the pieces whole again.

We all know there are several reasons compounding ERS's problems. The public employee workforce has remained relatively static over the past two decades, all while the number of retired state workers has continued to grow; this artificially tight workforce makes it difficult to grow the pension system's contribution base to meet its growing demands. We also know that there is a constitutional cap on pension contribution rates by the state; even if one separates state contributions from agency contributions, we are near that 10 percent threshold. In many ways, we are made to believe that there is nothing that can be done.

But we do know that plenty of things can be done, however. The constitutional cap is not as hard and fast as it seems––indeed, the phrasing leaves a lot to interpret over what, exactly, ten percent means. The governor can always declare an emergency for the fund and override contribution caps. We can actually create a Legacy Fund from excess rainy day funds, in order to have a second set of investments that can ensure the resilience of the system. We can stop offering excessive tax breaks to massive corporations that can already afford to move here––and which dearly need our state for their growth. And we can look into the surplus we still have available in order to fill unfunded pension liability gaps.

We are now at a crucial junction with ERS: either step up and maintain the system's financial health, or be responsible for ill effects that will pop up down the line. We don't have to be in the same scenario as other states with infamous pensions. Texas is, thank goodness, not Illinois or New Jersey––and we don't have to have mismanaged pensions like the ones that plague their states.

Even though TRS is in a much healthier position that ERS, we also have to keep one eye on it as well. To be frank, having one of the largest pension systems in the world should necessitate making TRS a priority every session. We really want to stress that the welcome and necessary changes done during the last legislative session cannot be the final care TRS receives for the next few sessions. Ignoring TRS's needs in maintaining actuarial soundness risks putting this system in financial disarray.

We are well aware that the state has other tremendous needs it must address during the next legislative session. The COVID-19 pandemic has altered every aspect of our state's economy and day-to-day operations. Simply put: We don't see funding ERS and TRS as being in conflict with immediate pandemic and economic recovery responses. On the contrary, we see funding ERS and TRS as part of the complete set of choices the legislature must make in order to ensure the long-term economic health of the State and, more importantly, the wellbeing of its people.

Our public pension systems are giant economic engines in themselves. The overwhelming majority of money paid out in pension annuities stays in Texas––circulating funds all across the state. This circulation also multiplies the money: a pension check puts out much more

in economic value than its original cost. At a time where many communities are having difficulty keeping businesses afloat––and when many Texans are having difficulty making ends meet––pensions are serving as vital boosters for local and household economies alike.
We also believe that a healthy pension system is also connected to the overall health of our workers as they weather this crisis.

Further, healthy pensions will ensure the long-term health of our public sector, so that it can continue to provide essential services during the future, in both "normal" times and amid unforeseen circumstances. When coupled with livable wages, reliable pensions ensure that public employees stay for the long haul; it is one of the key ways to ensure people will make a full career out of their jobs. Pensions are also a key way to ensure that workers retire with security, and aren't left working several extra years to pad out meager savings. This enables new generations of workers to come in at a healthy pace, ensuring the public mission and public service remains strong.

What we cannot do at this moment is kick the can down the road another two years. Wishful thinking that the economy will bounce right back into peak performance––that we will experience the mythical V-shaped recovery––will not only make the system even more expensive to solve, but may risk putting ERS in a very precarious situation. Again: we are not there yet, but every year without a true funding solution brings the pension closer to an unresolvable crisis.

Our pension systems are massive, and they are one of the key economic forces in our state. Having them fail is going to be much, much, much more expensive than maintaining their health.

Interim Charge 7:

The House Appropriations Committee has also been given the following task:

> Interim Charge 7: Identify structural changes that can be made to the Economic Stabilization Fund (ESF) in order to maximize investments and establish a source of funding for long-term liabilities. Examine the potential of using the fund for long-term infrastructure projects and the impact of the constitutional cap on the ESF balance.

First, as an aside, we realize that the committee itself is not in charge of whether or not it gets to convene a special session. That said, we find it rather dispiriting that the governor would choose to wait until January––when economic issues will either be more expensive to fix or will become unfixable altogether––to consider how to tap into the ESF.

That said, the issues with finding a best use for ESF funds run a bit deeper, particularly when it comes to ongoing issues related to pensions. We believe an opportunity was missed by not establishing a Legacy Fund out of the surplus money above what is necessary to maintain the Rainy Day Fund at a healthy level.

We know that challenges will always exist. There will always be unforeseen circumstances––whether a public health pandemic, a recession, or natural disaster. But this is why the Rainy Day Fund is already in place. Further, this is why nearly all members of the legislature agree that the Rainy Day fund should be stocked at a level to weather a considerable set of challenges: the jar should ideally be filled with several billion dollars.

But we were well beyond that point in 2019. What Representative Capriglione initially suggested for stocking the Legacy Fund––an idea echoed by the state comptroller's office––would not have put the integrity of the Rainy Day Fund at risk. In fact, by reinvesting that money separately and allocating it for legislatively-mandated purposes (including our two statewide pension systems), it would have quickly freed up the remaining Rainy Day Fund money for other purposes.

We know that whatever the shape of the economic recovery, it isn't going to be overnight. We also know that this recovery is bound to public health and the development of a consistent working vaccine for COVID. Both of these are going to take time, but they impact every element of our state's economic well-being. That includes our state pension systems. In fact, we cannot have an economic recovery from COVID without devoting some of our reserve funds to our pension systems.

For the long-term health of both our pensions and the state's economy, we maintain that a certain amount of Rainy Day Fund money should be reallocated in a separate investment corpus, the returns from which can be used to pay off any ongoing or future unfunded liabilities for ERS and TRS. The larger this initial investment corpus can be, the sooner its investment returns will have considerable results for maintaining the health of our statewide pension systems. By maintaining this separate investment corpus, our state can also ultimately use Rainy Day Funds for their intended purpose: addressing emergencies and unexpected circumstances.

If ESF money cannot be set aside for a separate Legacy Fund, then we recommend committing some of that money to tackling the unfunded liability for ERS and TRS caused by the COVID pandemic. Neglecting our pensions as part of the recovery will only make it harder for the Texas economy to return to full form.

Sincerely,

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