

Calculating the Cost of Virginia's New Mandatory Retirement Program

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Implementation of a new mandatory hybrid retirement program could cost Virginia millions of dollars during the first two years. These new costs are due to significant systems development and management expenses that will come with implementing a new retirement program. Examining those costs incurred by other states that have implemented mandatory hybrid retirement programs suggests that new costs to the state could run between \$5 million and more than \$25 million.

Legislation to implement a mandatory hybrid program, HB 1130 and SB 498, has been passed by the General Assembly and signed by Governor McDonnell. The potential high costs of a new retirement program are the latest sign that the proposals to cut benefits for public employees bring significant downsides for the state. To date, the debate over Virginia's efforts to cut the state retirement system have not included a thorough examination of the costs of transitioning to a mandatory hybrid program.

Background

HB 1130 and SB 498 authorize the establishment of a "hybrid" retirement plan, which combines a defined benefit portion (pension) with a defined contribution portion (savings account). All new state and local employees, as well as teachers and judges, will have to participate in a mandatory hybrid as of January 1, 2014. Current employees are not required to join, though some can elect into the hybrid. These bills reduce pensions for public employees by cutting the defined benefit formula that goes into calculating an employee's retirement benefit. The bills also require the state to be more consistent in adequately funding the pension system by heading down a pathway to meet 100 percent of the Virginia Retirement System Board of Trustees' certified annual required contribution rates for the state's contributions to the system by 2018.

Table 1: Systems Development Cost Estimates

State	Year	Cost	Active Employees
Virginia	2012	"While this bill does have significant costs associated with systems development, these cannot be ascertained at this time." ¹	339,740 (2011)
Oregon	2003	\$26.3 million in 2003-2005 and \$6.1 million in 2005-2007 estimated for implementing the new mandatory hybrid program (HB 2020). Funding for special items include data processing (86.4%), personnel services (12.2%), and services & supplies and expendable property (1.4%) ²	368,996 (2003)
Michigan	2010	\$4.5 million was appropriated to the Office of Retirement Services to implement the statutory changes of SB 1227. SB 1227 reduces the defined benefit formula and creates a mandatory hybrid for new <i>public</i> school employees. ³	11,617 (2011)
Utah	2010	The Utah Retirement System could not separately identify systems development costs related to the mandatory hybrid. ⁴	104,467 (2011)

Assessing the Costs

Systems Development

The systems development needs for a new mandatory hybrid retirement plan in Virginia will be substantial.

Evidence from other states shows that executing such sweeping changes to the public pension system come with hefty systems development costs, ranging from \$4.5 million in Michigan to \$26.3 million in Oregon (see Table 1). Virginia's costs may lay closer to Oregon's price tag due to the similar number of active employees, as opposed to Michigan whose plan only affected new public school employees, and therefore impacted a much smaller number of public employees than the legislation on its way to enactment here in Virginia.

Unfortunately, the state has failed to articulate even a range of what systems development costs could be incurred from the transition to a mandatory hybrid.

Complicating matters, systems development projects often carry risks that dramatically increase costs, delay the implementation schedule, or change the project's scope.

Virginia's recent experiences with IT systems development and deployment projects provide important evidence for concern in this area.

For example, the Virginia Retirement System (VRS) has had troubling issues when it comes to modernizing systems. According to the Auditor of Public Accounts, a \$42.9 million VRS project "continued to experience vendor project management and communication issues as well as project schedule slippage." The Auditor further noted that "proposed legislative changes to the Commonwealth retirement plans could have a significant impact on the timeline of the Modernization Project" and that VRS "will need to shift resources from this project to implement the new legislative changes, therefore reducing the number of resources available to work on the development and testing of the project." Reduced testing should raise concerns, since it could result in developing an inferior product that potentially increases project costs in the long-term.⁵

In addition, Virginia's costly problems with the information technology modernization projects through its major vendor, Northrop Grumman Corporation, which the state hired to privately manage the state's information technology system, have made headlines for being behind schedule, over budget, and failing to deliver promised performance. Northrop Grumman and the Virginia Information Technologies Agency, the state agency that manages the IT contract, have come under intense scrutiny for these schedule delays, disruptive technical glitches (such as an extensive August 2010 outage), worsening service quality, and cost overruns.⁶ Recently the Virginia School for the Deaf and the Blind decided to separate from VITA/Northrop Grumman and individually manage its own IT needs because "[t]he reduction in costs will be very substantial."⁷

Most recently, the Department of Motor Vehicles decided to cancel a massive systems development project to modernize its customer data system because of cost overruns. DMV originally estimated costs at \$32.5 million, but by early 2011, the budget had grown to over \$90 million. By the time DMV cancelled the project, \$28 million had been spent on the effort.⁸

Administrative and Management Costs

There are also potential administrative and management costs related to this kind of significant change in the Virginia Retirement System. The official fiscal impact statement did include an estimate of \$877,795 for "revising and reprinting all VRS publications and the website, legal and compliance costs, additional positions for the customer contact center due to increased call volume, training and design personnel, third party administrator costs, and RFP costs."⁹

However, this figure does not appear to take into account the ongoing day-to-day total management and administrative costs moving forward of the mandatory hybrid. For example, the Center for Retirement Research found that the administrative and investment expenses as a percent of assets of defined contribution plans are twice that of defined benefit plans in 2009.¹⁰ Generally those costs are higher for defined contribution plans than traditional defined benefit plans because defined benefit plans

enjoy an economy of scale advantage with no individual account reporting unlike defined contribution plans that require the maintenance of individual accounts with daily updates.¹¹

Conclusion

The creation of a mandatory hybrid program will radically change how public employees participate in the retirement system in Virginia. Rushing through this legislation with little public disclosure of the systems development and ongoing administrative and management costs could prove to be a costly mistake for Virginia.

This brief estimates that systems development costs alone could cost an additional \$5.38 million to \$27.18 million during the first two years. The state's own spotty record of systems development, including projects within the Virginia Retirement System, however, should be a cautionary tale of how quickly these costs can skyrocket. In addition, the state is likely to incur higher administrative and management costs because of the expansion of the defined contribution plans, which generally tend to have higher costs than defined benefit plans.

Endnotes

- 1 Fiscal Impact Statement for HB 1130ER: <http://lis.virginia.gov/cgi-bin/legp604.exe?121+oth+HB1130FER158+PDF>
- 2 Fiscal Analysis for HB 2020: <http://www.leg.state.or.us/comm/sms/fis03/fhb2020b-conf08-25-2003.pdf>
- 3 Bill Analysis for SB 1227: <http://www.legislature.mi.gov/documents/2009-2010/billanalysis/Senate/pdf/2009-SFA-1227-E.pdf>
- 4 Phone conversation with Robert Newman, Utah Retirement System, April 6, 2012.
- 5 "Progress Report on Selected Systems Development Projects in the Commonwealth," Auditor of Public Accounts. March 2012: http://www.apa.virginia.gov/reports/SystemDevelopment_March2012.pdf
- 9 Fiscal Impact Statement for HB 1130ER: <http://lis.virginia.gov/cgi-bin/legp604.exe?121+oth+HB1130FER158+PDF>
- 6 For more information, see "Northrup Grumman's extended contract no bargain," Richmond Times Dispatch, April 11, 2010: http://www2.timesdispatch.com/news/2010/apr/11/jeff11_20100410-221611-ar-163134/; "Computer outage extended unnecessarily, report says," Richmond Times Dispatch, February 16, 2011. <http://www2.timesdispatch.com/news/2011/feb/16/tdmain01-outage-response-hit-ar-846091/>; "Virginia Statewide Information Technology System," In the Public Interest: http://www.inthepublicinterest.org/case/virginia-statewide-information-technology-system#field_case_history. Despite these numerous problems and repeated failures to meet agencies' information technology needs, the state extended its relationship with Northrop Grumman another three years and agreed to pay the company over \$100 million more than the original contract.
- 7 "School for deaf and blind close to computer fix," Richmond Times-Dispatch, March 22, 2012: <http://www2.wsls.com/news/2012/mar/22/tdmain01-school-for-deaf-and-blind-close-to-comput-ar-1784542/>
- 8 "Progress Report on Selected Systems Development Projects in the Commonwealth," Auditor of Public Accounts. March 2012: http://www.apa.virginia.gov/reports/SystemDevelopment_March2012.pdf
- 9 Fiscal Impact Statement for HB 1130ER: <http://lis.virginia.gov/cgi-bin/legp604.exe?121+oth+HB1130FER158+PDF>
- 10 "A Role for Defined Contribution Plans in the Public Sector," Center for Retirement Research at Boston College: http://crr.bc.edu/wp-content/uploads/2011/04/slp_16-508.pdf
- 11 "Myths and Misperceptions of Defined Benefit and Defined Contribution Plans," National Association of State Retirement Administrators (Updated February 2005): <http://nasra.org/resources/myths%20and%20misperceptions.pdf>

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