Alternatives for Administering the Wisconsin Retirement System

Current Policy versus Total Retirement Outsourcing

Prepared for the
Wisconsin Legislative Council

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Foreword

Students enrolled in the Workshop in Public Affairs at the Robert M. La Follette School of Public Affairs, University of Wisconsin–Madison, prepared this report in collaboration with the Wisconsin Legislative Council, one of five nonpartisan legislative service agencies of the Wisconsin Legislature. The workshop provides graduate students in their last semester of the Master of Public Affairs degree program the opportunity to expand their policy analysis skills while working with a government agency and contributing to that agency's understanding of an important public policy issue.

A major responsibility of the Legislative Council is to provide nonpartisan research and legal services to legislative committees and staff on issues that are before the legislature or are likely to be considered. While most studies are requested by legislators or committees, the Legislative Council may initiate a study of an important public policy issue. This report is the result of a such a request made to the La Follette School of Public Affairs. Students enrolled in the Workshop were asked to examine the potential privatization of the Wisconsin Retirement System, with a focus on the privatization of the administrative services. This aspect of privatization is typically neglected in studies of pension systems or public insurance programs. Rather, studies typically simulate changes in contributions or benefits to assess the effect on beneficiaries; less often do these analyses examine how administrative functions could be altered to influence long-term system costs and the quality of program services.

The report describes the somewhat unique structure, operations, and outcomes of the Wisconsin Retirement System—in particular, its distinct departments under separate secretaries and its costs and investment returns relative to other public pension programs. The major focus of the report compares the current system, which already outsources some investments and administrative services to the private sector, with an alternative that would contract with the private sector to fully manage the WRS. The report assesses the potential gains and costs of these two alternatives in terms of the most relevant goals of a public pension system.

I am grateful to Legislative Council director Terry Anderson for his willingness to devote staff time to working with students on this report and to senior analyst Daniel Schmidt who discussed the project with me early in the semester and consulted with the students throughout the semester. In their acknowledgments, the authors thank other individuals who supported their work, and I extend my thanks to them as well.

The report benefited greatly from the support of La Follette School faculty and staff, especially that of Publications Director Karen Faster, who edited and managed production of the report. The conclusions herein are those of the authors alone and do not represent the views of the La Follette School or the client.

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Glossary

Absolute return strategy: A strategy that attempts to always have a positive return regardless of the direction or volatility of the financial markets. This involves risk mitigation strategies that limit return volatility and target consistent (but more conservative) positive returns.

Annuitant: A person who receives an annuity, in the form of monthly payments, from the Wisconsin Retirement System. Generally, to qualify for an annuity, a person must be or have been an employee of an employer that participates in the system or be named by such an employee as a beneficiary of the employee's annuity. Wisconsin state government and almost all local governments and school districts in Wisconsin are participating employers in the Wisconsin Retirement System.

Basis point: A unit equal to 1/100th of 1 percent. It can also be interpreted as the cost in cents to manage the investment of $100, i.e. five basis points indicate a cost of 5 cents for every $100 managed or invested.

Benefits administration: The administration of benefits to current employees, inactive participants, and annuitants. Within the Wisconsin Retirement System, the Department of Employee Trust Funds is responsible for benefits administration.

Core Fund: Managed by the State of Wisconsin Investment Board , this fund is a fully diversified portfolio of bonds, common stocks, mortgages, real estate holdings, and private equity. Approximately 93 percent of the Wisconsin Retirement System's assets are in the Core Fund.

Defined benefit plan: A retirement plan that pays to eligible beneficiaries an annuitized (monthly) benefit that is defined by a predetermined formula.

Defined contribution plan: A retirement plan that pays a benefit determined by the accumulated contributions of the plan sponsor and plan participant and the growth of the investments in the plan.

Department of Employee Trust Funds (ETF): The Wisconsin state agency that administers retirement and other benefits programs for state and local government employees and retirees.

Investment: As performed by the State of Wisconsin Investment Board and contracted private firms, the allocation of contributions and earnings in ways that will potentially yield profitable returns, .

Piecemeal Outsourcing: The partial manner in which the Wisconsin Retirement System is contracted out by the Department of Employee Trust Funds and the State of Wisconsin Investment Board.

Privatization: The transfer of a public sector good or service to a private sector vendor. As used in this report, privatization would have the private vendor primarily responsible for some share (or all) of the provision of the good or service, while the government remains responsible for the financing and oversight of the private operations.

State of Wisconsin Investment Board (SWIB): The Wisconsin state agency responsible for managing and investing the assets of the Wisconsin Retirement System, the State Investment Fund, and other state trust funds.

Total Retirement Outsourcing: The outsourcing of an organization's entire pension system—including, but not limited to, plan administration, investment management, actuarial services, consulting, and payroll—to a single private sector company.

Variable Fund: A fund managed by State of Wisconsin Investment Board. This fund comprises primarily common stock investments. Approximately 7 percent of the Wisconsin Retirement System's assets are in the Variable Fund.

The Wisconsin Retirement System (WRS): The public pension system that provides retirement benefits for employees and retirees of the state of Wisconsin and most local units of government in Wisconsin. The State of Wisconsin Investment Board and the Department of Employee Trust Funds are the state agencies responsible for the administration functions of the system.

Executive Summary

This analysis explores the potential costs and benefits of outsourcing the Wisconsin Retirement System's (WRS) administrative and investment services through contracts with private vendors. We compare two policy alternatives: the current policy and an option that would contract out all WRS investment and benefits administration functions. The report begins by describing the WRS and the impetus for reform. We then lay out the two policy alternatives and describe the policy goals we will use to evaluate the desirability of these two alternatives. After analyzing how the two alternatives fare under each of the policy goals, we conclude that the current policy is the most desirable alternative for the WRS.

In Wisconsin, policy makers are considering reforming the WRS as the legislature seeks to reduce government expenditures. Privatization advocates argue that states should increase the private sector's involvement in the production of services that have been traditionally performed by the government and that this outsourcing can reduce costs. Opponents counter that the WRS has been lauded as an exemplary state retirement system because it is regularly fully funded, its funds receive a higher rate of return than average, and its cost to administer is lower than that of most of its peers.

Two state agencies manage the WRS. The State of Wisconsin Investment Board (SWIB) is responsible for the investment functions of the WRS, and it invests 55 percent of funds internally and contracts out the investment of 45 percent of funds. The Department of Employee Trust Funds (ETF) administers WRS benefits for the approximately 572,000 current and former state and local government employees in Wisconsin.

ETF and SWIB manage and invest WRS funds and benefits while contracting out some specialized services that cannot be as efficiently performed in-house. We term this policy "Piecemeal Outsourcing." We compare this approach to a total privatization of both the ETF and SWIB functions of the WRS through a contract with one private vendor, a policy we term "Total Retirement Outsourcing." We examine impacts around four major goals: minimization of costs, enhanced performance, positive economic impacts, and feasibility. We find that the internal investment that SWIB performs and the administration of benefits that ETF performs is less expensive than equivalent services would be in the private sector. Outsourcing SWIB and ETF's functions would make the state dependent on a private firm and could result in higher prices or increased risk if the firm ceased operations while managing the WRS. Additionally, the risk minimization strategies and the level of accountability and public oversight of SWIB are advantageous in comparison to Total Retirement Outsourcing. Unlike private firms that have a profit motive, both ETF and SWIB function at cost. With the WRS publically managed by ETF and SWIB, any increase in efficiency benefits the WRS's members and the state government. Finally, Piecemeal Outsourcing is the existing policy and therefore is politically feasible, whereas Total Retirement Outsourcing has poor political feasibility.
We recommend the state continue the policy of Piecemeal Outsourcing, of only contracting out specialized services that cannot be performed in house as efficiently.

Introduction

As a result of the recent economic downturn, states are cutting budget expenditures in a number of areas. In Wisconsin, attention has turned toward reforming the Wisconsin Retirement System (WRS) as a means to reduce government expenditures. One proposal would introduce private investment and benefits administration through a defined contribution option for WRS participants. The 2011-2013 biennial budget bill, Wisconsin Act 32, directed the Department of Employee Trust Funds, the Department of Administration, and the Office of State Employment Relations to investigate the structure of the WRS and the potential for establishing a defined contribution plan. That study is underway and will be completed by June 30, 2012. This report focuses on a related potential change to the WRS: maintaining the system's benefits structure, but privatizing the system's benefits administration and investment functions.

Analysis of this change is especially pertinent in light of the defined contribution proposal being examined. Even if the legislature and the governor opt to provide all future public employee retirement benefits as a privately administered defined contribution plan, elements of the existing benefits structure of the WRS will likely remain in place for decades because courts have consistently ruled that benefits already earned by employees are not subject to later amendment. Accordingly, this report contributes to a more complete analysis of proposed reforms to the WRS by considering two options for administering the WRS benefits structure: 1) current policy; and 2) fully contracting out WRS management to a private entity.

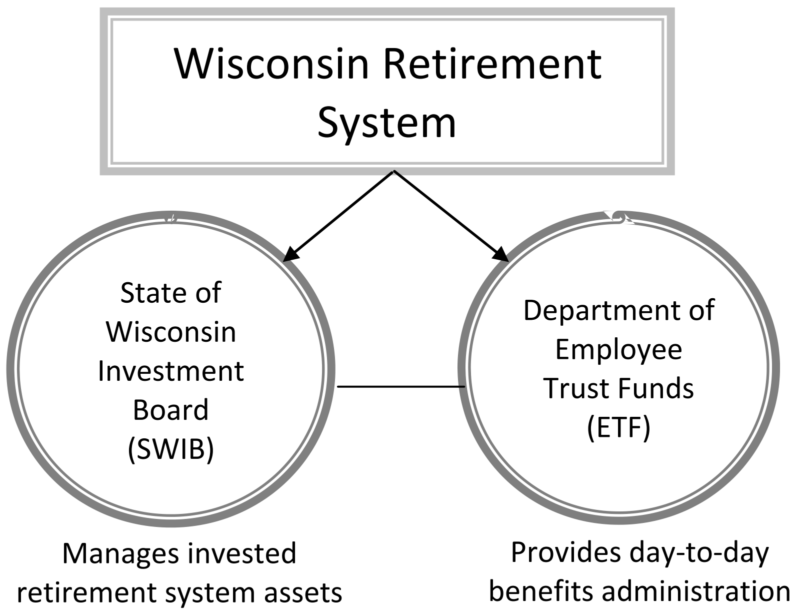
The Department of Employee Trust Funds (ETF) and the State of Wisconsin Investment Board (SWIB) oversee the WRS and contract with several private vendors for services that support this mission. Contracting out the WRS's benefits administration and investment duties in their entirety may have several significant impacts on the state budget and on state and local government employees. First, cost savings or additional expense may result. Second, this reform may cause improvement of or deterioration in service quality. Third, it may result in economic impacts from the loss of jobs for public employees involved in WRS management. Finally, reforming the WRS, or even just its administrative functions, is a potentially contentious political issue.

To assess the implications of privatizing the WRS and its management, we evaluate the above impacts qualitatively, gleaning insights from the public administration and management literature and applying them in the context of the WRS. We begin by describing the administrative structure of the WRS, including its investment and administrative functions, followed by a discussion of privatization in government. We then explain our goals and impact categories in detail. Finally, we analyze the current policy in contrast to a potential Total Retirement Outsourcing policy. To conclude, we assess how each policy fares given the policy goals we use and make our policy recommendation.

Overview of the Wisconsin Retirement System

Two state agencies, SWIB and ETF cooperate to administer the WRS (Figure 1). In general, SWIB manages the investment of WRS assets and provides ETF with information on investment gains and losses so that ETF can calculate the impact to WRS participants and communicate this impact to WRS participants. ETF shares information with SWIB about cash flow so that SWIB can maintain sufficient liquidity in its accounts. This section details the roles of these two agencies in the WRS.

Figure 1: Wisconsin Retirement System Structure



Source: Authors

The State of Wisconsin Investment Board

SWIB manages the investment functions of the WRS. WRS assets compose 93 percent of the assets managed and invested by SWIB. The remaining 7 percent of SWIB-invested funds consist of assets of the State Investment Fund[1] (6 percent) and several small miscellaneous accounts (1 percent) (State of Wisconsin Investment Board, 2011b).

SWIB has two parts: 1) the Board of Trustees that oversees the functions and operations of the agency, and 2) the agency that comprises the chief executive officer, the professional investors, and other associated staff.

[1] The State Investment Fund is a pool of cash balances from state and local government units. This pool of cash balances provides the state's general fund and other state agencies liquidity for operating expenses. These assets are invested separately from WRS assets.

SWIB's mission is: "To provide prudent and cost- effective management of funds held in trust by the State. This is achieved with solid investment returns, consistent with the purpose and risk profile of each fund" (State of Wisconsin Investment Board, 2011a).

SWIB's vision is: "to be a premier public investment organization, a place where professional excellence and public service thrive. Superior investment returns, the highest ethical and professional standards, teamwork and a rewarding work environment will make SWIB the investment management organization of choice" (State of Wisconsin Investment Board, 2011a).

The Board of Trustees comprises nine members. Of these nine, five are public members, two are WRS participants, one is the secretary of the Department of Administration (or the secretary's designee), and one is a local government representative. State statutes require four of the public members to possess at least 10 years of professional investment experience. The board appoints an executive director who administers the operations of the agency.[2] The agency is organized into broad investment groups and administrative units. In 2010-11, the agency had 124.25 full-time equivalent positions (Zimmerman, 2011).

Management decisions for the agency's operations are made by the Board of Trustees acting in a fiduciary role (David Stella, former secretary of ETF and current SWIB Board of Trustees member, personal communication, March 12, 2012). Because the WRS's assets are held legally as a trust, Wis. Stat § 25.15 dictates the fiduciaries of the WRS are required to enact management practices that result in the lowest responsible cost (i.e., the lowest cost practices that responsibly serve the agency's mission). In other words, if privatizing or contracting out a function of SWIB would result in a lower responsible cost, the board would be required to contract out that function. If not, the function would continue to be managed by SWIB.

The WRS's assets are divided into two funds, a "Core Fund" and a "Variable Fund." The Core Fund is a diversified portfolio of bonds, stocks, mortgages, real estate holdings and private equity. The Variable Fund is primarily common stock investments. Of all WRS assets, 93.4 percent were in Core Fund accounts and 6.6 percent of assets were in Variable Fund accounts as of June 30, 2010. The default option is that 100 percent of employee and employer contributions made on behalf of the employee are directed to the Core Fund account. However, an employee may elect to have 50 percent of his/her contributions directed to the Variable Fund account. Since the Variable Fund is invested primarily in stocks, the returns are more volatile and offer a chance at a higher rate of return, but also the possibility for lower returns than the Core Fund depending on the performance of the stocks in the stock market (Zimmerman, 2011).[3]

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[2] The executive director and other SWIB positions are all unclassified positions that are filled directly through an advertising, application and interviewing process. SWIB does not go through the Office of State Employee Relations for any hiring.

[3] Losses/gains from Variable Fund investments are immediately attributed to an account, whereas Core Fund losses/gains are allocated over a five-year period.

SWIB's nine-member Board of Trustees establishes an investment policy for the WRS's assets. Once this investment policy is set, investment transactions must be made within the parameters of the policy. The specific day-to-day investment decisions on what to buy and sell are made by SWIB's in-house professional investors or external professional investors investing on behalf of SWIB.

At the time of this report, SWIB internally invested 55 percent of trust funds and external professionals invested the other 45 percent. These professional private investors were contracted to invest in various markets in which SWIB investors did not have sufficient expertise (such as emerging markets, real estate, and hedge funds). SWIB uses external services when it is not efficient to hire investors in-house. The SWIB website states:

> External managers are used to manage investments that involve skills, locations, support systems or intensity of staff attention that make direct management by SWIB staff impractical or less cost effective. SWIB selects external managers based on investment style, performance, experience, company size and fee structure. (State of Wisconsin Investment Board, n.d.)

Fifty-five percent is at or near the limit of funds that can be invested internally while still maintaining an effective level of investment diversification and an "absolute return strategy"[4] policy (Vicki Hearing, Public Information Officer, State of Wisconsin Investment Board, personal communication, March 1, 2012).

Available data suggest that the WRS's investment returns rank favorably with similar funds. CEM Benchmarking, Inc., a private firm, evaluated the performance of SWIB for a five-year period ending December 2010. The report noted the following (Hopkins, 2011):

- The WRS Core Fund five-year total return of 5.0 percent was above the U.S. median of 4.9 percent and the peer median of 4.5 percent.[5]
- The WRS Core Fund had a lower cost than peers by 17 basis points on average, without adjusting for asset mix differences. Basis points are the cost in cents of managing and investing each $100, so the WRS Core Fund spent 17 cents less per $100 managed than did its peers.
- The WRS Core Fund was low cost because it had a lower cost implementation style and paid less for similar mandates, which means the WRS's costs for similar investments were lower relative to other pension funds.

The CEM Benchmarking report noted that in general investments that were externally managed were more expensive that those internally managed. Over the five-year period, SWIB invested, on average, 43 percent of assets internally, while peers invested 29 percent of assets internally (Hopkins, 2011). Therefore, SWIB had lower costs partly due to its greater use of internal investment, or rather, its allocation of investments between external and internal investments based on

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[4] "Absolute return strategy" attempts to always have a positive return regardless of the direction or volatility of the financial markets. It uses risk mitigation strategies that limit return volatility and target consistent (but more conservative) positive returns.
[5] Peer group consisted of 15 U.S. public pension funds from $23 billion to $226 billion. Median size was $64 billion; the WRS was $69 billion at the time of completion of the study.

expected management costs. SWIB's documentation supports these findings: At the end of 2007, SWIB invested 20.7 percent of assets internally. At the end of 2009, SWIB invested 41.2 percent of assets internally. By the end of 2010, SWIB had invested 47.3 percent of assets internally. SWIB reports the increase from 2009 to 2010 resulted in net annual savings to the trust funds of approximately $13 million in 2010 (State of Wisconsin Investment Board, 2011b).

SWIB Board of Trustees member and former ETF secretary David Stella noted SWIB achieves greater cost savings over having private firms invest the WRS's assets for these other reasons:

- The absence of marketing costs.
- Lower Securities and Exchange Commission compliance costs, as the Securities and Exchange Commission does not regulate SWIB as extensively as it does private firms; these costs raise external management costs.

Because of the documented cost savings associated with internal management, SWIB has taken steps to ensure these cost savings are achieved through effective internal management (Vicki Hearing, Public Information Officer, State of Wisconsin Investment Board, personal communication, March 1, 2012). One step in doing this was to improve retention of internal staff responsible for investment decisions. Providing competitive compensation to SWIB staff has increased the retention rate. Salaries are now based on a consultant's estimation of the median salaries of comparable private positions (excluding the east and west coasts). In addition to their salary, SWIB investors can earn incentive compensation based upon the five-year performance of their investments. Private investment firms often award employees with such compensation typically based on one-year returns (Matsunaga, 2001). SWIB's relatively lengthy evaluation period is designed to dissuade risky investment decisions.

In 2008, the enactment of investment modernization legislation,[6] which allowed SWIB greater flexibility and discretion regarding its investment choices, was another important step in improving internal fund management (Vicki Hearing, Public Information Officer, State of Wisconsin Investment Board, personal communication, March 1, 2012). More recently, SWIB has been given authority over hiring decisions that previously had required Department of Administration approval. This legislation has provided further latitude in exploring cost saving investment management options.

The Department of Employee Trust Funds

ETF provides a wide array of benefits to approximately 572,000 current and former state and local government employees in Wisconsin. These benefits include retirement, health, life, income continuation, long-term disability, and long-term

[6] Wis. Stat § 25.182: Management authority for certain funds. In addition to the management authority provided under any other provision of law, and notwithstanding any limitation on the board's management authority provided under any other provision of law, the board shall have authority to manage the money and property of the core retirement investment trust and, subject to s. 25.17 (5), the variable retirement investment trust in any manner that does not violate the standard of responsibility specified in s. 25.15 (2).

care insurance programs as well as an employee reimbursement accounts program, commuter benefits program and a deferred compensation plan (Wisconsin Department of Employee Trust Funds, 2011).

ETF has several key duties within the WRS. It collects all moneys for the Core Fund and the Variable Fund. Half of these moneys come from employee-required contributions and the other half from employer-required contributions. These moneys are then pooled and remitted to SWIB for investment and to beneficiaries in the form of annuity payments. ETF also calculates and ensures the appropriate disbursement of benefits payments from the trust funds, "establishes the controls, systems, and procedures necessary to ensure the appropriate administration and security of the trust," and provides information to participating employees and employers (Wisconsin Department of Employee Trust Funds, 2011).

The governance structure of ETF includes the Employee Trust Funds Board, which sets policy for the department and appoints the ETF secretary. Two other boards relevant to the WRS are the Wisconsin Retirement Board and the Teachers Retirement Board. These boards are advisory only and are vestiges of the 1982 merger that formed the WRS (Zimmerman, 2011). Stella indicated that these latter two boards could be eliminated with some gain in efficiency, though the costs associated with these boards are minimal because its members are part time and receive only travel reimbursement and a modest $25 daily per diem for their services.

Complexity

The WRS's benefits administered by ETF reflect decades of extensive legislative changes to benefits formulas. A summary of Wisconsin public employee retirement provisions prepared by ETF spans nearly 39 pages (Wisconsin Department of Employee Trust Funds, n.d.). Because many of these changes are complex, a great deal of work goes into ensuring that ETF's information technology systems correctly calculate benefits for each individual employee. This information technology system is an ongoing investment by ETF that is specific to its needs and cannot be easily adapted for another purpose.

Both Stella and Jon Kranz, director of the Office of Budget and Trust Finance at ETF, indicated that the Wisconsin Deferred Compensation Program, in contrast, is much better suited to management by a private contractor. This program does not involve a complicated benefits structure, meaning that it can be managed much like deferred compensation plans offered by other employers. The simple structure gives private companies advantages in terms of large economies of scale. Accordingly, ETF contracts with Great-West Retirement Services to administer this program (Wisconsin Department of Employee Trust Funds, 2011).

Privatization

In the context of pension accounts, "privatization" commonly refers to the process of allowing employees to invest pension contributions in individual accounts that incorporate personalized investment portfolios. However in public administration generally, "privatization" has several relevant definitions and applications.

Privatization Definitions

Most broadly, privatization refers to "the transfer of the production of goods or services from the public to the private sector…[while]…the financing and oversight of the function or activity continues to be the responsibility of government" (Berrios, 2006). This transfer can occur in several ways. Jacob Hacker (2006) highlights four prevalent privatization strategies:

(1) Reduced direct governmental action to encourage self-reliance and privately provided services
(2) Increased subsidies for private insurance, savings, and charitable activities
(3) More government contracts with non-profit and for-profit service providers
(4) Tools to encourage or require recipients to tap the private sector instead of government benefits.

Hacker notes that all of these strategies maintain a role, albeit smaller, for government, focusing on government management and oversight within a new regulatory framework as opposed to direct service delivery (Hacker, 2006).

For this analysis, Hacker's third privatization strategy, outsourcing through contracts, is most relevant. Privatization by scaling back services or providing vouchers would require not only legislation, but also a different compensation structure that we do not explore in this report.

Many departments in the Wisconsin state government contract for services with private vendors. There are two broad types of contracts: fixed price and cost reimbursement. Fixed price contracts are based on a predetermined price for the goods or service delivered. Cost reimbursement requires that the government pay the contractor back after the service has been completed. Governments tend to prefer fixed price contracts because they can ensure that vendors do not exceed budgeted amounts (Berrios, 2006). Wisconsin's Medical Assistance Program has struggled with vendors completing projects late and over budget, causing an increase in cost, a problem consistent with cost reimbursement contracts (Appendix A). Though the two types of contracts are distinct, both can cause an increase in costs if the terms of the contract are not followed carefully.

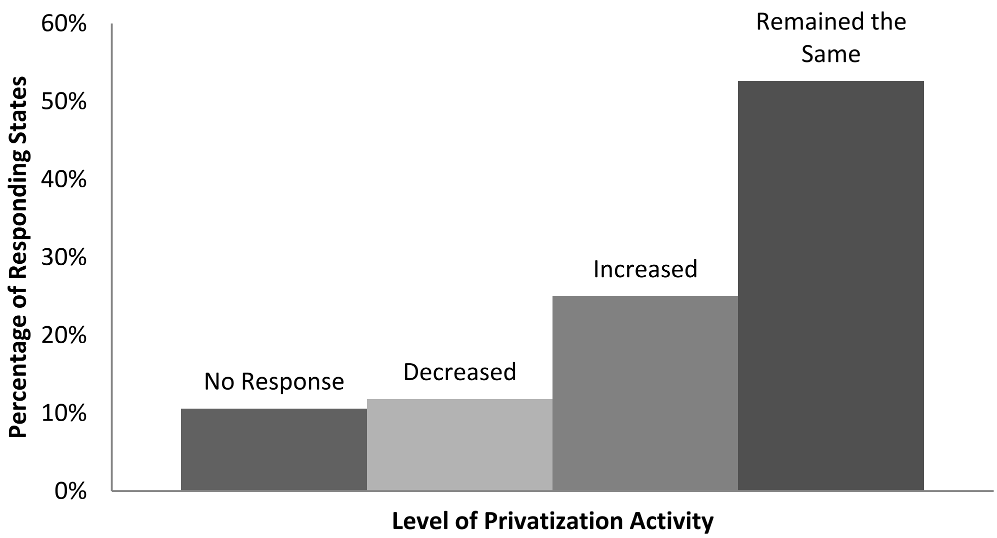
Criteria for Making Privatization Decisions

Privatization of public services has been growing for several decades. Ronald Moe (1987) found privatization to be the most influential concept of public administration in the 1980s. After exploring the limits of privatization and predicting that the "Privatization Movement" was unlikely to slow, he identified a need for a set of criteria to help governments assign the functions best suited for the private sector.

Moe's predictions proved correct. In the 1990s states showed increasing attention to privatization as a method of increasing productivity and sparking innovation in efforts to cut costs. A survey performed by the Council of State Governments[7] showed that the level or amount of privatization among more than 75 percent of state agencies had remained the same (compared to their pre-1998 levels) or increased from 1998-2002 (Figure 2).

Figure 2: Levels of Privatization among States (1998-2002)

The survey asked state budget and legislative service agency directors: "Which of the following best describes the amount of privatization activity in the past five years?"



Source: Chi, Arnold, & Perkins, 2004

Some states that had implemented privatization in the 1990s contributed best-practice models in the form of feasibility checklists and privatization workbooks. For example, in 1993, Massachusetts created a set of review criteria (Table 1) that includes items states should consider when making the decision to privatize (Auger, 1999). This checklist provides a framework with which agencies can assess the appropriateness of privatizing the provision of a particular service. We used this checklist as the foundation for our analysis of the state of the WRS and the potential effects of further privatization.

[7] The council sent the survey to 450 state budget and legislative service agency directors and the heads of five executive branch agencies: personnel, education, health and human services, corrections and transportation. The survey yielded an overall response rate of nearly 77 percent (Chi, Arnold, & Perkins, 2004).

Table 1: Criteria for Making Privatization Decisions for State Governments

Criterion	Considerations
Competition	• Availability of service in private market • Multiple providers ensures competition
Potential for Savings	• Privatization impact on costs to state
Promise of Enhanced Quality or Responsiveness	• Time constraints on privatization • Technicality or specialized characteristics of the process better suited to private sector
Government Accountability and Control	• Measurability of service (quantity, quality, and desired performance) • Capacity of government to maintain oversight
Minimal Risk	• Failure of private firm to provide service • Consequences if services are interrupted or discontinued
Legal, Political, or Practical Barriers	• Resistance to change by service users, interest groups, and elected officials • Compatibility of privatization with law and legislative intent
Adverse Employment (and Other Social) Impacts	• Compatibility with collective bargaining agreements

Source: Auger, 1999

Policy Analysis: Rationale, Alternatives, and Goals

The following section discusses the rationale for conducting this analysis, describes policy alternatives, and outlines policy goals that we will use to judge the desirability of these policy alternatives (see *Comparison of Policy Alternatives*).

Rationale

With its high funding levels, high investment returns, and low administrative costs relative to its peers, the WRS has been praised as one of the best state retirement systems in the nation. Factors that have promoted its sustainability include the distribution of risk among all plan participants by making annual post-retirement adjustments based on the market returns (Stella & Bozarth, 2010), an independent governance structure, and a legislative mandate to remain cognizant of funding sustainability (Wirtz, 2011). Another strength of the WRS is its inclusion of all public employees, including school teachers. This integration across all public employees increases the size of the WRS and prevents it from becoming beholden to the interests of any group of public employees.

Furthermore, management of a public employee pension system is not generally thought to be the sort of task best suited to privatization. Support services that relate more to ancillary activities rather than core government functions are particularly appropriate for privatization (Auger, 1999).[8] Previously, the expansion of privatization has affected a broad spectrum of services, including transportation, parks and recreation, social services, and corrections agencies; for example, food services, medical services, custodial services, and architecture and engineering services are areas that often involve more extensive private sector contracts (Auger, 1999).

However, given the success of privatization in some areas of public administration and private companies' use of private firms to manage defined benefits plans, it is worthwhile to examine whether private management could reduce the WRS's management costs while maintaining an acceptable level of service. This consideration is particularly important in light of Governor Scott Walker's administration's effort to find new strategies to reduce state expenditures.

Policy Alternatives

The following section describes our two policy alternatives: the current policy, Piecemeal Outsourcing[9]; and the other policy alternative, Total Retirement Outsourcing. We also describe a third alternative, to expand piecemeal contracting out until every internal duty other than management and contract oversight would be contracted out to private firms. After consideration, we removed this option from

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[8] Auger defines administrative services as those that are ancillary or support-related, rather than those activities that are part of an agency's core mission. As it applies to the WRS, investment services can be thought of as core mission activities.

[9] We use "piecemeal" in this context to indicate the partial or fragmented way in which the WRS is outsourced. For a detailed discussion of this approach, see the *Policy Alternatives* section.

our list of alternatives because of the cost and management challenges that such a system would present. Additionally, this option is already available to ETF and SWIB if they find it to be cost-effective, so increasing piecemeal outsourcing is not a distinct policy alternative.

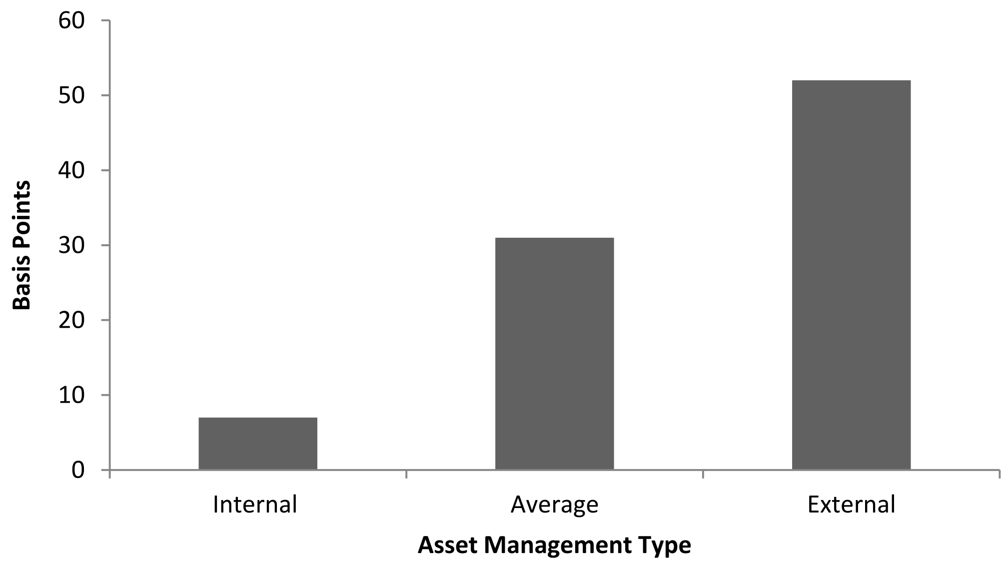
Current Policy: Piecemeal Outsourcing

ETF and SWIB oversee the WRS and contract with several private vendors for services that support this mission. This section describes the extent of contracting in both agencies.

State of Wisconsin Investment Board. As of 2012, SWIB internally invested 55 percent of trust funds while private professional investors managed the remaining 45 percent. The external managers increased SWIB efficiency by providing expertise at a lower cost than hiring internal investors. According to Vicki Hearing of SWIB, 55 percent is at or near the limit of funds that can be managed internally while still maintaining an effective level of investment diversification and an absolute return strategy policy.

In 2010, the average monthly assets SWIB managed were $79.3 billion (State of Wisconsin Investment Board, 2011b). Total management costs were $245.3 million, resulting in a cost of 3.1 cents for every $100 (31 basis points) (Figure 3).

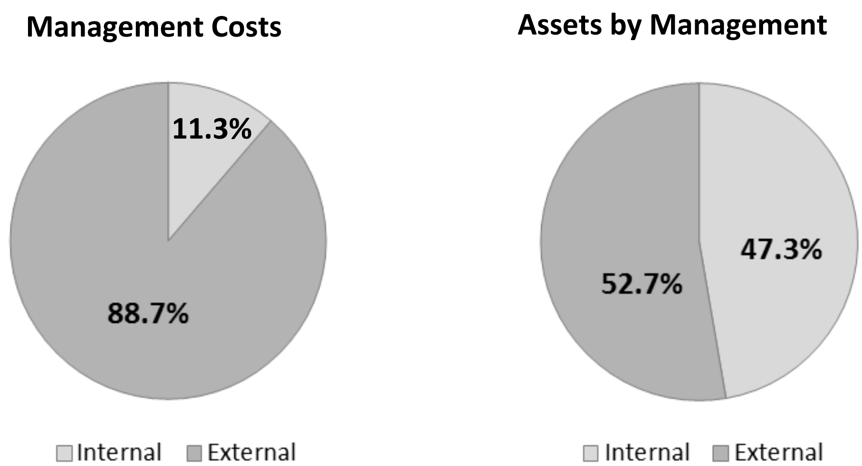
Figure 3: Management Costs by Type of Management



Source: State of Wisconsin Investment Board, 2011b

About 47 percent of assets were managed internally. The cost to manage these funds was $27.7 million, resulting in a cost of 0.7 cents for every $100. The remaining 52.7 percent of assets were managed externally. The cost to manage these funds was $217.6 million, resulting in a cost of 5.2 cents for every $100. Overall, 89 percent of the operating budget went to external managers to manage 52.7 percent of the funds (Figure 4).

Figure 4: Distribution of Management Costs and Assets of the Wisconsin Retirement System

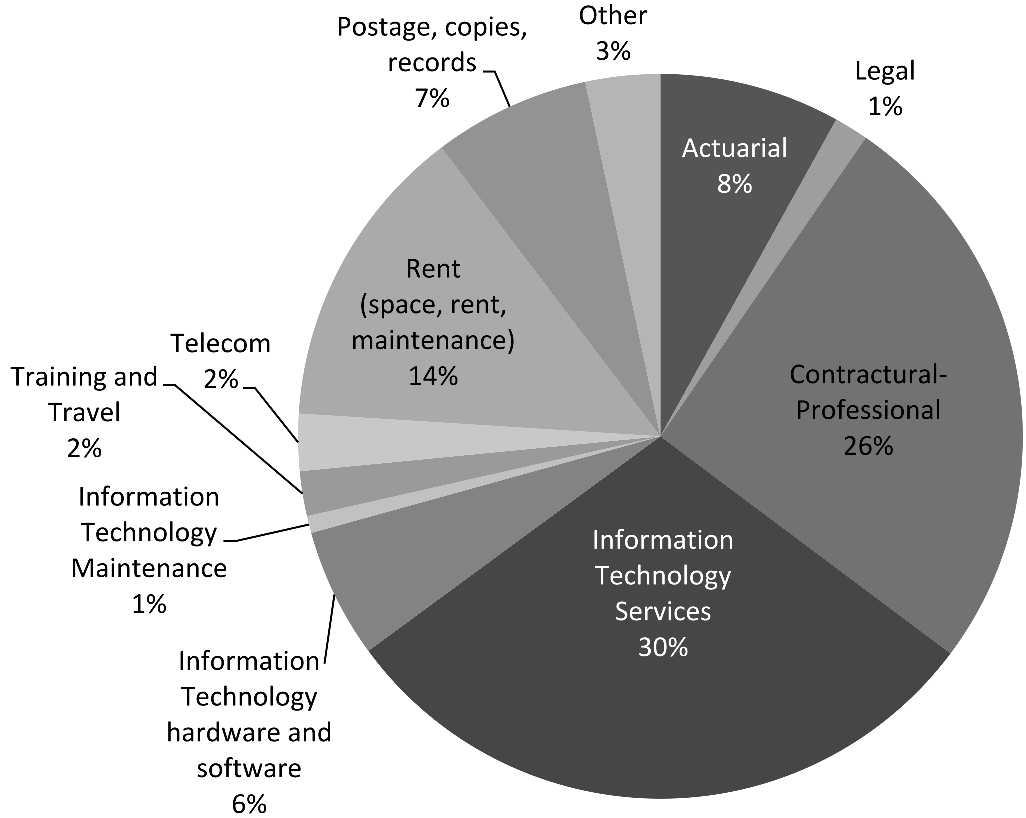


Source: State of Wisconsin Investment Board, 2011b

The Department of Employee Trust Funds. ETF contracts with private-sector information technology firms and a private actuarial firm, Gabriel Roeder Smith, which has developed a thorough understanding of the WRS by working with ETF since 1978, according to Stella. He also noted that actuarial services are appropriate for contracting out for two reasons. First, they require substantial expertise and investment in information technology that would be expensive for the state to acquire on its own. Second, while actuarial services are crucial to the continuing health of the WRS, such services are required only three times per year and thus are better provided by actuarial firms.

Additionally, ETF contracts with companies to administer the various insurance programs available to employees. Between actuarial and other professional contractual services, 34 percent of ETF's fiscal year 2011-12 expenses were paid through contracts with private-sector firms (Figure 5). We were not able to determine what percentage of information technology costs consisted of contracts with private-sector firms.

Figure 5: Department of Employee Trust Fund Fiscal Year 2011-12 Expenses



Source: Wisconsin Department of Employee Trust Funds, 2012

Policy Alternative: Total Retirement Outsourcing

Total Retirement Outsourcing, a term commonly used by investment firms, involves outsourcing all retirement system services to one private firm. These services include investment management, plan administration, actuarial services, consulting, and payroll. Employers choose Total Retirement Outsourcing in an effort to improve service quality and reduce costs, complexity, and risk by utilizing the expertise and capacity of professional managers at third-party firms (Ward & Moore, 2010).

Total Retirement Outsourcing became a popular option for employers in the early 2000s; those who chose to implement Total Retirement Outsourcing then were called “first generation bundlers.” In general, Total Retirement Outsourcing has had mixed results. In 2010, the periodical *PlanSponsor* reported that many employers utilizing Total Retirement Outsourcing for defined benefit plans have not seen reductions in costs because of the complexity of these systems. Indeed, the outsourcing of defined benefit plans often results in improved technology and service, but at a higher cost to the client compared to its in-house systems. The tightened economy has further limited the spending of money on Total Retirement Outsourcing in order to streamline pension systems; in fact, some first-generation bundlers have looked to “in-sourcing” defined benefit services that they had previously outsourced (Ward & Moore, 2010).

Total Retirement Outsourcing differs greatly from the current policy that contracts out selective service functions of SWIB and ETF to private vendors while these agencies maintain their internal structure, management, and oversight. Although the theoretical Total Retirement Outsourcing vendor might maintain structure and management similar to what ETF and SWIB have in place, the vendor would be more likely to incorporate all WRS functions into its own benefits management structure. Some government entities contracted with private firms that promised integrated services to match their needs, but they found that the private firms actually provided "clunky," disjointed services (Ward & Moore, 2010). Thus experience suggests that the resulting management structure could look dramatically different as the WRS became managed entirely by a private entity. Oversight could stay the same in theory: SWIB's appointed boards could remain, although predicting the effectiveness of oversight would be difficult. Access to proprietary information would change and the structure and goals of the organization would shift away from those of a public agency toward those of a private firm (e.g., budgets would look different and efficiency measures would change).

Maximum Contracting within Current System

A third privatization option is to maintain SWIB's contracts for various investment functions and ETF's information technology and actuarial functions and, *in addition*, bid out remaining internal services. In this scenario of maximum contracting, the structure, the management, and the oversight would remain the same as under the current policy of Piecemeal Outsourcing because the two agencies would have the power to draw up contracts along existing departmental lines (information technology, database management, front-office staff, etc.). This scenario differs from Total Retirement Outsourcing, where the vendor would have the ability to restructure the WRS to fit into its existing structure while taking over internal management functions. Oversight in maximum contracting with internal management would be similar, as the agencies would be divided up into contract areas that reflect the terms of the contract. Under this scenario, the larger number of contracts could add a degree of complexity, causing oversight to become a serious challenge. As a result of the potential cost of maintaining these separate contracts, the degree of oversight necessary, and the additional transaction costs implied through the creation of the myriad additional contracts, we do not examine this alternative. We do note SWIB could take this path now, but only if additional contracts met the goal of cost savings (thus far this is not the case). Though we initially considered such an option as a viable alternative, we exclude it from our policy analysis for the reasons stated above.

Policy Goals

This section outlines the goals we use for our analysis and the impact categories considered within each goal. Our goals are to reduce cost, enhance performance, have a positive economic impacts, and be feasible. Using our goals and impact categories, we create a framework through which we evaluate the two policy alternatives. Refer to Appendix B for a visual representation of the policy alternatives and goals.

Reduce cost. A goal of any program, public or private, is to reduce costs while maintaining the expected levels of performance. The following factors are relevant in considering Total Retirement Outsourcing costs:

- **Expertise**. Privatization may offer cost savings by accessing expertise in the private sector that may be far more expensive for the state to provide in house.
- **Competition**. Contracts with vendors are entered into via a bidding process that incorporates an element of competition that was not in place within ETF and SWIB. This competition may lead to lower costs for services.
- **Economies of scale**. Because private firms serve many clients, the private firms may be able to take advantage of economies of scale that would reduce costs.

Enhance Performance. Effective management of a pension fund is vitally important for the public employees and retirees whose retirement income and other benefits come from participation in the system, and for public employers whose wage offers to prospective employees includes participation in the system. As performance of the pension fund improves, annuitants will be better off. This analysis considers three impact categories within the goal of enhancing performance:

- **Level of service**. For SWIB, level of service is determined by a combination of investment returns and costs of management (indicated by basis points). ETF performance is primarily determined by customer service functions and associated costs.
- **Level of accountability and control**. Because of the importance of the WRS, it is essential to have appropriate levels of accountability and control to avoid negative impacts.
- **Risk minimization**. To ensure the long-term health of the WRS, stability and assurance of avoiding drastic swings in the performance of pension investments is imperative.

Have positive economic impacts. Changing the administration of the WRS could have statewide economic impacts beyond potential cost savings. These include:

- **Employment effects.** Public sector employees would lose their jobs as a result of a privatization.
- **Distributional effects**. Cost savings from efficiency gains would be distributed differently under private and public management of the WRS.

Be feasible. Even a brilliant policy is irrelevant without the requisite political willingness for reform. Accordingly, we assess the following impact categories:

- **Political Feasibility**. In this impact category, we assess the likelihood that the policy would enjoy sufficient political support to be maintained, in the case of Piecemeal Outsourcing, or implemented, in the case of Total Retirement Outsourcing.
- **Legal Feasibility**. Privatization would have to work within or change existing statutes.

Comparison of the Policy Alternatives

The following is an analysis of the policy alternatives in terms of the policy goals. Refer to Appendix B for a summarized visual representation of this analysis.

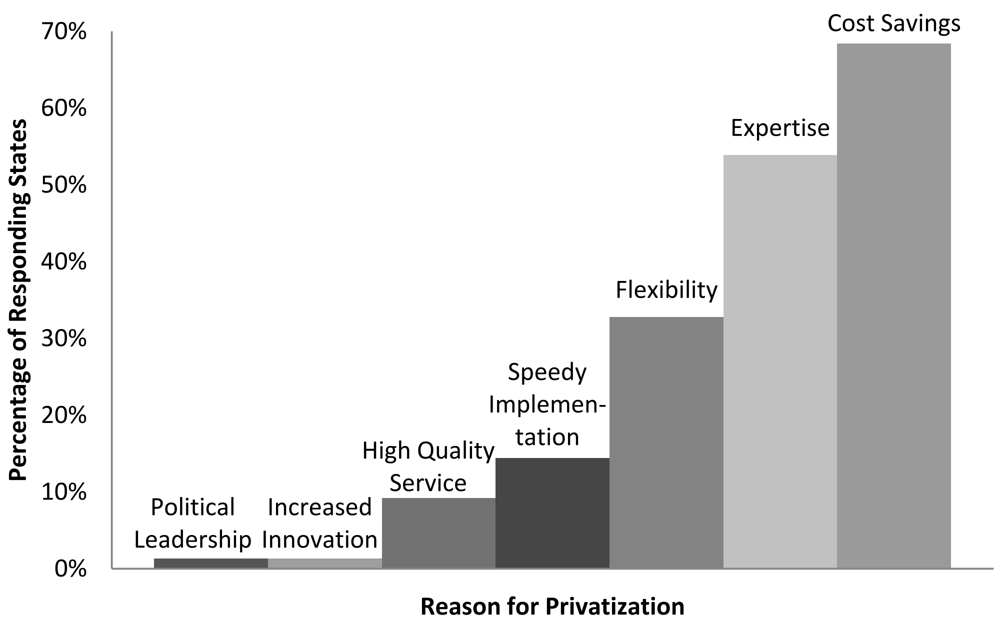
Our analysis faces several limitations. First, no state retirement systems that provide a defined benefit plan have undergone Total Retirement Outsourcing (Ron Snell, senior fellow at the National Conference of State Legislatures, personal communication, February 12, 2012). Without any case studies of this policy, we had to rely heavily on the academic literature about privatization and had to make many assumptions in our analysis. Additionally, comparing different types of retirement systems is challenging, so all of our quantitative comparisons using state data compare the WRS to its state retirement system peers. We considered looking at private firms' pension systems, but information about these systems is unavailable to the public. We also considered looking at states that have privatized individual retirement accounts in defined contribution plans, but the differences in managing individual defined contribution retirement accounts and one large defined benefits retirement system were too great to allow us to compare the two.

Reduce Costs

One of the most common reasons for contracting out public services is the potential for cost savings to the government and citizens. The Council of State Governments survey shows that cost savings were the leading impetus for privatization of state government services (Figure 6).

Figure 6: Reasons for States' Privatization Efforts (2002)

The survey asked state budget and legislative service agency directors: "What are the primary reasons for privatizing services in your state?"



Source: Chi, Arnold, & Perkins, 2004

Additionally, a 1998 report prepared by the U.S. General Accounting Office (now the Government Accountability Office) looked at the questions and issues faced by state and local decision makers when considering privatization options. The report emphasized the importance of reliable cost data for government activities to fully evaluate the activities targeted for privatization. In particular, the report stressed the need to assess privatization's effect on local and state economies and on the national economy, efficiency, and effectiveness of providing the service. To perform this assessment, the report recommends cost-benefit and cost-effectiveness analyses, as well as providing potential private contractors with draft "request for proposals" to obtain cost estimates (GAO, 1998).

We were unable to obtain quantitative data that would enable us to directly compare management costs under our two policy alternatives. The large size of the WRS is a significant hurdle. Few private investment and retirement planning firms could manage services that must be provided to the WRS's more than 572,000 active and inactive employees and annuitants,[10] so it is difficult to estimate how much a private firm would charge if it took on management of the WRS.[11] In addition, because costing methodologies can differ significantly between states and localities and between public agencies and private firms, the estimated costs of services can vary considerably. For example, the way in which indirect costs, such as agency overhead, are included or excluded in the analysis can result in sizable differences or biases in the cost calculations (Auger, 1999).

In the absence of quantitative data, we chose to examine the literature for broad indications that Total Retirement Outsourcing might be more cost effective than Piecemeal Outsourcing. There is considerable speculation that contracts do not always result in cost savings. In his 2006 article, Ruben Berrios argues: "What has happened as the government has turned toward more and more contracting is that it has created a system in which the bidding process and type of contract are increasingly those that are the least favorable to the government." Berrios argues that the genuine bidding process has been neglected for "negotiated deals that tend to cost more,", resulting in greater expenditure for the state. Additionally, privatization often means a brand new delivery system for a service or function, a change accompanied by a large degree of risk and uncertainty (Barnekov & Raffel, 1990). Unless contracts are made with great care, costs may not be reduced for the state.

The Council of State Governments survey also asked about cost savings as a result of privatization.[12] Because of the difficulty of obtaining accurate cost comparisons, this question resulted in a significant portion of Unknown (or "no response") answers. For those who had measured the savings, however, the cost savings from state

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[10] For example, an administrator at a mid- to large-sized national investment and employee benefits firm quoted its largest Total Retirement Outsourcing client as less than 200,000 employees and annuitants.

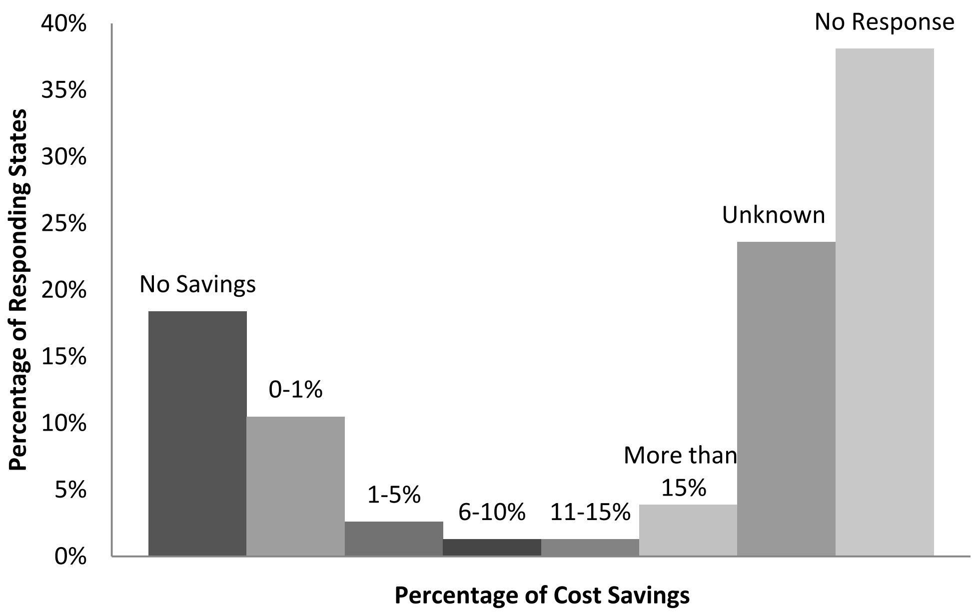
[11] The WRS has 266,629 active employees, 155,775 annuitants (retirees, disabilitants, and beneficiaries), and 149, 815 inactive employees with deferred benefit payable (Wisconsin Department of Employee Trust Funds, 2011).

[12] Survey question (for state budget directors and legislative service agency directors): "What is your state's current cost savings percent due to privatization?"

privatization resulted in zero to 1 percent savings for nearly 30 percent of the survey responders. In fact, most agencies reported the savings from privatization to be less than 5 percent (Figure 7). However, the survey did not incorporate budget figures. As such, although many of the states responded that privatization efforts resulted in less than 5 percent cost savings, the actual dollar figures of these savings could be large.

Figure 7: Cost Savings from States' Privatization Efforts (2002)

The survey asked state budget and legislative service agency directors: "What is your state's current cost savings percent due to privatization?"

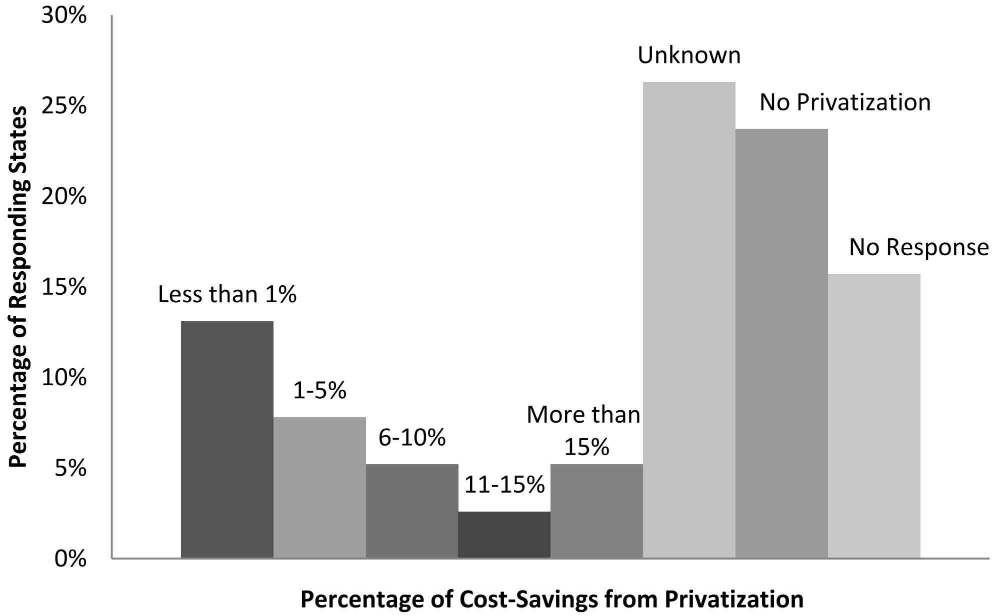


Source: Chi, Arnold, & Perkins, 2004

Answers to questions about cost savings from personnel privatization specifically, which would include administrative tasks such as for workers' compensation claim processing and flexible spending benefits (most closely related to the WRS's duties that would be privatized), were similar to questions about general state privatization. Fewer of the survey responders, however, had implemented personnel privatization (Figure 8).

Figure 8: Cost Savings from States' Privatization of Personnel (2002)

The survey asked state personnel directors: "What is your state's current cost savings percent due to privatization?"



Source: Chi, Arnold, & Perkins, 2004

Compared to similar public pension systems, the WRS's administrative costs are low. In a 2012 report, CEM Benchmarking created a custom peer group for the WRS that comprises public pension systems that are similar to the WRS in terms of total membership; membership mix of active, inactive, and annuitant members; total assets; average assets per active member and annuitant; and number of full-time equivalent positions. The WRS's costs are estimated at $51 per current employee and beneficiary, which is $27 below the cost for the WRS's peer pension funds. CEM Benchmarking computed the amounts by which various factors contribute to this cost savings. The report estimates that, compared to the peer state retirement systems, the WRS pays less for both back-office activities, like information technology and actuarial, legal, audit and other support services (many of which are currently outsourced); and for front-office activities, like member transactions and member communication. The WRS also has lower costs due to economies of scale advantages and higher productivity for employees than comparable state retirement systems. These factors and how much they contribute toward the WRS's advantage over peer systems are summarized in Table 2.

Table 2: Factors in Wisconsin Retirement System Cost Savings

Factor	Impact
Paying more or less for back-office activities	
• Governance and financial control	$1.05
• Major projects	-$2.15
• Information technology strategy, database, applications	-$5.50
• Actuarial, legal, audit, other support services	-$7.68
Lower third-party and other costs in front-office activities	-$7.41
Higher transactions per full-time equivalent position	-$7.52
Higher costs per full-time equivalent position for: salaries and benefits, building and utilities, human resources and information technology	$2.52
Lower transactions per member	-$0.36
Economies of scale advantage	-$0.35

Source: CEM Benchmarking, Inc., 2012

Because the peer group used by CEM Benchmarking's analysis contains no pension plans where Total Retirement Outsourcing has been implemented, this benchmarking information tells us only that the WRS is doing well compared to other systems in which public employees lead the management of the system. Although this information does not allow us to directly compare how the system would compare to a private firm, it does show that the management of the WRS is relatively efficient.

Under the WRS, expenditures and administrators salary data are publicly available and routinely audited. The loss of transparency that would accompany Total Retirement Outsourcing could result in higher costs due to increased employee compensation, waste of resources, and inefficient management practices. Finally, because private firms seek to maximize profits, state expenditures under Total Retirement Outsourcing would need to cover service costs and provide a return on shareholder or owner investment. Privatization could substantially increase the costs of managing the WRS.

Expertise

One of the most common arguments used to advance privatization is that private-sector firm employees have more expertise in their field than government agency employees. Through contracts, public agencies can benefit from a vendor's specialized knowledge or training without the cost of taking on additional full-time employees. SWIB takes advantage of contracted vendors to invest in markets in which SWIB investors do not have sufficient expertise and it is not efficient to hire in-house investors. However, according to the 2012 CEM Benchmarking analysis, SWIB also has low costs because of its high-quality internal staff. This finding suggests that SWIB already captures this advantage of privatization through its hiring practices.

Piecemeal Outsourcing allows the WRS to be administered more efficiently than it would be under Total Retirement Outsourcing. Under Wis. Stat § 16.705 (2), state agencies must conduct a cost-benefit analysis of contractual service agreements that involve estimated expenditures of more than $25,000. In these cost-benefit analyses, agencies must describe the rationale for contracting out and the availability of vendors capable of performing the contracted services, discuss whether the services are a "core service of state government" and whether state employees possess the technical expertise needed to complete the task, and detail risk factors, alternatives to contracting out, legal barriers, and timelines (Wisconsin Department of Administration, 2007). This method allows the WRS to take advantage of private sector expertise when ETF or SWIB finds that doing so is cost-effective. Total Retirement Outsourcing would not allow the state to do such thorough analysis of each contracting decision because one private firm would be managing the entire WRS.

Competition

Advocates of privatization argue that competition among private sector firms can promote efficiency and thus is able to provide the goods and services "better, faster, and cheaper" than government (Kosar, 2006). Renowned economist Milton Friedman linked the idea of a free society with economic and political freedom, suggesting that economic freedom protects individual freedom by limiting the degree of political power. More recently, free market economic theory has been used to criticize "big government," which similarly is said to limit individual freedom through the concentration of power in the hands of government officials. Proponents of privatization also believe that it can promote entrepreneurship in the private sector—and thus economic growth—and as a result, allows the government to focus more on its "core activities," rather than duplicating those that can be performed by private firms (Kosar, 2006). Advocates of privatization believe that moving government service provision away from government agencies and into private firms creates competition among firms and pushes firms to reduce costs and improve service.

The benefit of a competitive market may not be applicable to the privatization of all government services. Elliot Sclar (2000) argues that the majority of public contracting takes place with firms in monopolistic or oligopolistic industries that are characterized by little or no competition, so privatization does not often yield the higher service and reduced costs that would be expected in a competitive market. Because of the size of the WRS, privatizing management of the WRS may not successfully increase competition among firms. The WRS is the ninth largest retirement system in the United States, and it has more than 572,000 active and inactive employees and annuitants. Few private investment and retirement planning firms could manage the number of WRS employees and annuitants.[13] Large investment firms that could accommodate this system would be national firms such as Fidelity, Mercer, or Millman. Rather than spurring competition, giving one firm control over the ninth largest retirement system in the U.S. could actually stifle competition by significantly increasing the proportion of the pension market and its investments controlled by an individual private firm.

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[13] For example, a representative from a mid- to large-sized national investment and employee benefits firm quoted its largest Total Retirement Outsourcing client as less than 200,000 employees and annuitants.

Converting the system to management by a private firm would require significant transition costs as the firm developed expertise in the system and hired the necessary staff. If these start-up costs were sufficiently high, some firms might be dissuaded from pursuing the contract with the state, further reducing the level of competition.

ETF has a statutorily imposed fiduciary duty to the beneficiaries of the trust funds it oversees to provide services in the most cost-effective manner possible. This obligation includes contracting out for services when it makes sense to do so. However, Stella emphasized the importance that ETF not become beholden to a private contractor for providing services. If ETF allows a private company to become too essential to its functions, it runs the risk of that private firm extracting additional fees above required revenue (known as "rents") from ETF in exchange for the firm's continued work. If there are few other private firms willing or able to manage the WRS and ETF and SWIB lose capacity, the WRS would be susceptible to rent-seeking.

Economies of Scale

Total Retirement Outsourcing could reduce costs through economies of scale. By providing all its contracts to one firm and contracting with a large firm with multiple clients, the cost of managing the WRS might fall due to economies of scale. The vendor could be more efficient due to existing infrastructure, tools, employees, or services used to work with other clients. As a result, economies of scale could be one of the Total Retirement Outsourcing policy's major advantages. However, because the WRS is so large, has fashioned its management systems for the particular functions required of WRS, and because SWIB already contracts out investments in specialized markets, it is unclear how much additional cost savings could result from Total Retirement Outsourcing. Because the WRS has a unique benefits structure, many resources, such as software, have been specifically designed for the WRS. The benefits of economies of scale might already be realized under the existing Piecemeal Outsourcing system.

Enhance Performance

The following section examines the effectiveness of enhancing system performance by Piecemeal Outsourcing as compared to the policy alternative of Total Retirement Outsourcing.

Level of Service

Overall, WRS management under Piecemeal Outsourcing is fairly strong. In 2010, SWIB's Core Fund five-year total return of 5.0 percent was above the public pension fund U.S. median of 4.9 percent and the peer median of 4.5 percent. Additionally, SWIB had a lower cost than its peers by 17 cents per $100 managed, on average (Hopkins, 2011).

ETF has a service goal that aims for a cost at 90 percent of the peer median and a delivery of services above the peer median. This demand would be difficult to make of the private sector, as it tends to align its service outcomes with its costs. In 2011, ETF had a total service score of 69/100, while the peer median was 77. However, it should be noted that this score was achieved with significantly below-average administrative costs, and that a higher score is not always better, since increasing it may not be cost-effective (CEM Benchmarking, Inc., 2012).

A central issue when services are contracted out is that fulfillment of the agency's mission becomes dependent on private organizations also embracing that mission. The state depends upon the interests of these organizations fitting into the public interest. Once the agency reduces capacity and loses personnel with expertise to fulfill the role contracted out, the state depends upon the contracting company or other competing companies to provide the service (Goodsell, 2006).

Some attributes of good service, such as responsiveness to consumer voice, are especially difficult to specify in a contract (Hefetz & Warner, 2004). Quality administration of benefits depends upon consumer voice. Private firms may be less responsive to consumer voice than public agencies, especially agencies that have oversight boards with public membership. A survey found that private contractors who provided public transit identified less with the interests of the riders than did public transit agencies. Because they did not contract directly with the rider, responsiveness to the consumer was lower for contracted services (Sclar, Shaeffer, & Brandwein, 1989). As a result, we can infer Total Retirement Outsourcing would not necessarily improve WRS service delivery.

In fact, findings are mixed as to the differences between organizational and individual performance between public and private sector management. Some research indicates that public employees are not as innovative as private sector employees. However, government employees self-report high levels of effort, motivation, and innovation. Additionally, authors observe highly varying levels of efficiency in public organizations as compared to their private counterparts, citing various studies and evidence (Rainey & Chun, 2011). In short, it is difficult to know how the WRS compares in terms of quality of customer services to private firms offering similar services.

Changes in Accountability and Control

Under Piecemeal Outsourcing, state government exercises oversight over ETF and SWIB through a number of mechanisms that have historically been successful. The Board of Trustees oversees the operations of SWIB. Additionally, SWIB and ETF send a variety of reports to the legislature and are audited annually by the state's Legislative Audit Bureau.

A 13-member Employee Trust Funds Board oversees the general direction of the ETF. Specifically, this board ensures that the WRS complies as a qualified retirement plan for tax purposes and the accounts are administered according to federal Internal Revenue Code regulations; appoints the ETF secretary; employs actuarial services; approves tables of benefits, contribution rates, and actuarial assumptions; authorizes payment of all WRS annuities; approves or rejects pension plan administrative rules; and hears appeals of ETF determinations.

The Joint Survey Committee on Retirement Systems is a 10-member committee that serves as the legislature's oversight committee for all proposed statutory changes to the public pension plan.

Because contracting out creates another layer of management, privatization can limit the government's ability to control the service (Sclar, 1997). Indirect management inherently reduces control over the service (Goodsell, 2006). It is important to create a thorough contract and performance accountability system, but the monitoring and transaction costs can be so high that the privatization does not result in cost savings. The cost of monitoring averages nearly 20 percent of contract costs, according to case studies (Hefetz & Warner, 2004).

For this reason, the efficiency of contracting out services depends heavily on the monitoring costs. The necessary level of oversight is proportional to the risk of the private firm not adhering to the contract, so the state would have to assess how likely it would be that a private firm would fail to meet the contract's stipulations.

The monitoring costs also depend on the importance of the task to the agency's mission. The greater the consequences of the private firm failing to perform the tasks satisfactorily, the stronger the state's interest in oversight, with consequent higher monitoring costs (Auger, 1999). Sclar (1997) suggests that contracting is less appropriate when the task is central to the mission of the agency. In these cases, the agency is unlikely to be able to provide oversight that is adequate for the importance of the service.

In addition to monitoring costs, aligning the goals of the contractor and the state is vital for successful contracting that would provide quality services and responsiveness to customer needs. Principal-agent problems arise when the goals of the contractor (the agent) are not perfectly aligned with the goals of the institution which is contracting out services (the principal). Organizations may try to structure contracts and incentives in order to align the goals of the agent with the principal, but contract enforcement involves transaction and monitoring costs, which can be very high (Hefetz & Warner, 2004). Goodsell (2006) writes that "the more precisely a task or result can be specified in advance," the more successful contracting out will be and that the best candidates for privatization are those for which "performance can be evaluated after the fact." Therefore, the more clearly the WRS would be able to specify tasks or results to a private firm, the less risk of principal-agent problems they would have.

Minimize Risk

SWIB has an investment strategy that incorporates a high level of diversification and an absolute return strategy. According to CEM Benchmarking, the WRS's investment strategy is less risky than most of its peer pension funds (Hopkins, 2011). Under Total Retirement Outsourcing, some degree of control over the investment strategy would likely be ceded to the private firm, which could result in an overly risky strategy.

The performance of the WRS's management duties by ETF and SWIB prevents potentially large problems that could arise if the functions were performed by a private firm. If the duties were privatized and the private firm ceased operations, significant consequences and costs would result; for example, the state would need to quickly find a substitute firm, from a limited number of options, to perform these functions.

Privatization often entails a new delivery system for a service or function, a change that introduces substantial risk (Barnekov & Raffel, 1990). While internal investment is less expensive than external investment, SWIB still employs use of external investment for certain types of investments in order to appropriately diversify to a level that effectively minimizes risk.

In cases where there is a greater likelihood the private firm will fail to provide satisfactory service, the state will have to engage in more oversight and will likely have higher monitoring costs (Auger, 1999).

Have Positive Economic Impacts

The following section examines the economic impacts of Piecemeal Outsourcing as compared to the policy alternative of Total Retirement Outsourcing.

Employment Effects

SWIB and ETF employ state residents, whose positions would likely no longer exist in-state under Total Retirement Outsourcing. SWIB had 125.25 full-time equivalent positions as of June 2011 (State of Wisconsin Investment Board, 2011a), and ETF had 243.2 full-time equivalent positions at the end of 2010 (Wisconsin Department of Employee Trust Funds, 2011). Having Wisconsin-based employees benefits Wisconsin because these employees pay state and local taxes and spend money in the state economy.

Due to the size of the WRS, Total Retirement Outsourcing would likely require a national firm. If a national firm were to take over the duties of ETF and SWIB, the jobs performed by state workers could be moved to another state. The loss of these jobs would have a negative effect on Wisconsin's economy and tax revenue.

Any cost savings that could result from privatization would likely arise from reduced personnel costs in the form of reduced employment or reduced wages and benefits (Birdsall & Nellis, 2003). Assuming that the affected employees found other employment, the loss of employment would have no net impact on the state. It is possible that these employees would be unable to find employment at equivalent salaries in Wisconsin and would move out of state (as might the investor staff) or suffer a decrease in income.

The WRS's funds are central to the continued operation of SWIB and ETF. SWIB also manages the state investment fund and the injured patients and families compensation fund, among others, but the WRS's funds make up 93 percent of its investments (State of Wisconsin Investment Board, 2011a). If SWIB's WRS functions were privatized, policy makers would have to decide between privatizing the investment of the remaining funds and eliminating SWIB or maintaining a much smaller SWIB workforce to invest these funds. In either scenario, if services were contracted back in after the state had lost capacity, the state would have to pay high start-up costs and redevelop its infrastructure.

As noted, ETF administers several employee benefits programs in addition to the WRS. These other benefits are largely administered by private contractors, so it is unlikely that a robust ETF agency would remain if the WRS's functions were privatized. The state would therefore face high start-up costs if it decided to contract back in the ETF functions after privatizing them.

Distributional Impacts

The state would need to consider how the benefits would be distributed if there are efficiency gains from privatizing SWIB or ETF functions. The WRS strives to maintain efficient management that fulfills the agency's mission at the lowest cost. Unlike private firms, the WRS does not have a profit motive. When the WRS achieves cost savings, all of the benefit is passed on to the participating employees and employers. Private firms require a profit to operate, unlike SWIB and ETF, so it is possible that any efficiency gains from privatization would not fully benefit the state and taxpayers. After the electricity sector in the United Kingdom was privatized, for example, the private sector captured the financial gains at the expense of the government and taxpayers (Birdsall & Nellis, 2003). If the efficiency gains are large enough, however, it is possible that the state will still experience some share of those cost savings.

Be Feasible

The following section examines the political and legal feasibility of Piecemeal Outsourcing as compared to the policy alternative of Total Retirement Outsourcing.

Political Feasibility

The WRS has been lauded as one of the stronger systems in the nation. In The Pew Center's report on state pension system reform, it ranked as a "solid performer" and was only one of four states to be fully funded in 2008. The report underscores the ways in which the WRS has developed ways to mitigate the fiscal effects of the recession, such as the use of a dividend process in place of standard cost-of-living increases (Pew Center on the States, 2010).[14]

Citizen perspectives in general are an important consideration of privatization efforts. Although the topic of privatization of government services is complex, public opinion about any policy issue can constrain or enable policy makers and their proposals. In their study on patterns of support for privatization, Thompson and Elling (2000) used survey data from Michigan to demonstrate how the public reacts to the privatization of various state and local government services. Their study focuses on the public opinion and attitudes about contracting government services to for-profit and non-profit firms. Interestingly, public attitudes about for-profit privatization were largely positive; however, the majority of the respondents preferred that government services are delivered publicly.

[14] Under this system, retirees are paid a share of the dividend if investment returns are positive, and benefits may be reduced when returns are negative.

The effort to privatize government services can be a contentious political issue. Disapproval of "big government," as mentioned above, traditionally aligns with conservative opinion that gained popularity when the federal government expanded during the New Deal era (Kosar, 2006). As such, the issue of privatization often divides along party lines. The Michigan study additionally attempted to determine which personal or political characteristics predict the support of privatization through for-profit firms. The authors found that the strongest predictors for the number of services privatized are Republican identification, income, and white race (Thompson & Elling, 2000). This finding may reflect that privatization can be part of a larger partisan policy agenda that does not place enough emphasis on the *need* for privatization.

Cutting costs is consistently the principal motivation for privatization, according to state managers (Auger 1999). This fiscal decision – in particular, to cut spending on government expenditures—is another partisan issue recently under much debate in Wisconsin. Given the tension surrounding 2011 legislation addressing the Wisconsin state budget, one might anticipate that an attempt to privatize the WRS would result in significant partisan conflict and public attention.

Legal Feasibility

The WRS is the result of dozens of legislative acts and mergers beginning with the 1891 creation of the Milwaukee police and fire pension plans. State statutes define the WRS's functions and structure. Section 15.16 of the Wisconsin Statutes creates ETF and its related boards; Section 25.17 of the Wisconsin Statutes sets forth the powers and duties of SWIB; and Chapter 40, Subchapter II of the Wisconsin Statutes governs participation in and the benefits structure of the WRS. Statutes also mandate annual ceilings for contributions and payouts, as well as specifications related to the WRS's funding and federal Internal Revenue Code compliance. Statutes would need to be modified to accommodate privatization or the private firms or contractors would need to follow the existing regulations (such as the annual ceilings, for example) to ensure that a privatized WRS operates within Wisconsin law.

Additionally, contracts may constrain the legislature and governor in making changes to the WRS's benefits structure. While changes impose transition costs under the publicly administered system, the costs of renegotiating a contract with a private firm in the middle of a contract term would be far higher.

Assessment and Recommendation

Based on the above analysis, Piecemeal Outsourcing is clearly the superior alternative (refer to Appendix B for a visual summary of the policy alternatives in terms of the policy goals). Although whether cost savings could be achieved through Total Retirement Outsourcing is unclear, Piecemeal Outsourcing provides higher levels of performance and more positive economic impacts than the Total Retirement Outsourcing alternative. It is also more politically feasible and requires no statutory changes.

The WRS costs less to manage than similar retirement systems due to ETF's and SWIB's high levels of productivity and low costs for front-office and back-office activities. Outsourcing allows the state to take advantage of expertise in the private sector, but Piecemeal Outsourcing already employs contracts with private firms when doing so is cost-effective. Total Retirement Outsourcing might decrease costs because of economies of scale; however, because of the large size of the WRS, it is likely that further economy of scale advantages are small.

Compared to other state retirement systems, the level of service achieved by ETF and SWIB is relatively high given their low costs. Total Retirement Outsourcing could reduce the level of service if the private firm did not have effective communication between the branch investing WRS funds and the branch administering WRS benefits. Piecemeal Outsourcing has a high level of accountability; Total Retirement Outsourcing could introduce principal-agent problems and would be expensive to monitor. In Piecemeal Outsourcing, SWIB is attentive to risk minimization and the WRS has a history of following an investment strategy that maintains its full funding status. Total Retirement Outsourcing would mean a brand new delivery system, which could cause a large degree of risk and uncertainty and impose significant transition costs. Total Retirement Outsourcing could also make the state dependent on a private firm in a way that is inconsistent with the WRS's mission.

The economic impacts of Total Retirement Outsourcing would be negative compared to Piecemeal Outsourcing. Total Retirement Outsourcing would reduce employment by more than 300 full-time equivalent positions, and these jobs would likely move out of state. Under the Piecemeal Outsourcing policy, any efficiency gains achieved by ETF or SWIB benefit the state, local governments, and WRS members, but under Total Retirement Outsourcing, these benefits would largely accrue to a private firm in the form of profits.

Feasibility is higher for Piecemeal Outsourcing than for Total Retirement Outsourcing. Piecemeal Outsourcing is the current policy, and the WRS is praised as a low-cost, high-performance retirement system. Total Retirement Outsourcing would require extensive statutory changes, and these changes would impose transition costs on the state.

We recommend the state continue its policy of Piecemeal Outsourcing, of only contracting out specialized services that cannot be performed in house as efficiently.

Appendix A: Privatization of Wisconsin's Medical Assistance Program

In Wisconsin, the Medical Assistance Program (Medicaid) provides medical services to low and moderate-income individuals, using state and federal funds. Though there are many programs that receive funding, there are three main subgroupings: acute and primary care, long-term care, and limited benefit. Recently the overall program has grown from serving 870,201 people in January 2007 to 1.2 million in January 2011. Largely due to this increase in program recipients, the overall program cost increased from $5 billion in fiscal year 2006-07 to $7 billion in fiscal year 2010-11 (Wisconsin Legislative Audit Bureau, 2011).

Current State of Contracting

The Medical Assistance Program is administered by the Wisconsin Department of Health Services. The agency contracts out many of the administrative duties to vendors through a bidding process. Outsourcing is not new for the department: it has been working with an external fiscal agent since the 1970s. In fiscal year 2010-11 vendor payments were $114.8 million, a noticeable 73.4 percent increase from the $66.2 million spent on contracts in fiscal year 2006-07. Two vendors represent three-fourths of the overall contract expenditures: HP Enterprise Service (the fiscal agent) and Deloitte Consulting (administrators of the electronic eligibility system).These resources translate into private-sector jobs. In June 2011, the largest administrative service vendor had 1,127.5 full-time equivalent positions working on the Medical Assistance Program whereas the Department of Health Services had 364.6 full-time equivalent positions working on the Medical Assistance Program . Overall, the Medical Assistance Program's largest administrative expenditure is the aggregate amount for contract services (Wisconsin Legislative Audit Bureau, 2011).

Medical Assistance Contracting Considerations

Privatization in Wisconsin's Medical Assistance Program provides some lessons that policy makers should consider when making decisions about privatization. When deciding whether to privatize administrative duties, policy makers should consider that vendors may have greater costs than anticipated and that they might go over budget. They must ensure that an appropriate accountability system is in place to monitor the contracts. The lack of an appropriate bidding process for Medical Assistance shows that privatization does not always ensure that the state will purchase services in a competitive market. However, privatization may be the only option if state rules prevent the hiring of additional state employees.

Potential to exceed budget. In December 2011, the Legislative Audit Bureau reported on multiple examples of Medical Assistance Program vendors that finished projects late and over budget with no repercussions from the state. One example is the development of the ForwardHealth interchange that was slated to be completed in January 2007 for a cost of $27.5 million and was not finished until November 2008 with costs totaling $55.4 million (federal funds covered 90 percent of the projected increase). Similarly, the state contract with Deloitte Consulting increased from 75,500 hours in fiscal year 2006-07 to 126,800 in fiscal year 2010-11. Rather than opening a bidding process to see if other firms could provide the services at a lower cost, the state expanded its existing contract with Deloitte Consulting (Wisconsin Legislative Audit Bureau, 2011). This example illustrates that privatization does not guarantee that the state will seek services in a competitive market.

Necessary oversight. The Legislative Audit Bureau noted that the Department of Health Services has an insufficient accounting codes system, making it difficult for state staff to correlate expenditures with correct subprograms and specific contracted activities. In this case, the agency needed to add infrastructure to properly track expenditures and hold its vendors accountable. Given that vendors have ignored the terms of their contracts, better oversight by the Department of Health Services seems especially pressing (Wisconsin Legislative Audit Bureau, 2011).

Appropriate bidding processes. According to the Legislative Audit Bureau, the Medical Assistance Program had made the decision upon multiple occasions to expand the existing contracts with its largest vendors without an open bidding process that would have allowed for other vendors (or the existing vendors) to propose more competitive prices, which could have potentially cut state expenditures. Also, additional services were reportedly added to existing contracts without a bidding process in an effort to provide the new services in a timely manner (Wisconsin Legislative Audit Bureau, 2011).

Employee impact. The Department of Health Services indicated that contracting was the best option given the workload demand and the inability of the Department of Health Services to augment existing staff at the time because of a January 2008–December 2010 hiring freeze. Additionally, they cited furlough days in 2009-2010 and 2010-11 as causing staff shortages. Standard billing rates were established for 180 different positions, ranging from $21.96 per hour for customer service staff to $323.15 per hour for an actuarial services employee. Contracts are set to conclude (unless extended) in 2013 (Wisconsin Legislative Audit Bureau, 2011).

Appendix B: Privatization Alternatives in Terms of Policy Goals

Table B1 summarizes our assessment of the two policy alternatives—the current policy of Piecemeal Outsourcing and Total Retirement Outsourcing—in terms of the policy goals.

Table B 1: Wisconsin Retirement System Privatization Alternatives Assessment

Goals	Impact Category	Current Policy: Piecemeal Outsourcing	Alternative Policy: Total Retirement Outsourcing
Reduce Costs	**Profit Motive**	Excellent	Poor
	Competition	Fair	Poor
	Economies of Scale	Excellent	Good
	Transition	Excellent	Poor
Enhance Performance	**Level of Service**	Good	Poor to Fair
	Level of Accountability and Control	Excellent	Poor
	Risk Minimization	Excellent	Fair
Have Positive Economic Impact	**Employment Effects**	Good	Poor
	Distributional Effects	Good	Fair
Be Feasible	**Political Feasibility**	Excellent	Poor
	Legal Feasibility	Excellent	Fair

Source: Authors

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