Ohio Legislative Service Commission

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Fiscal Note & Local Impact Statement

Bill: Sub. S.B. 342 of the 129th G.A. **Date**: September 12, 2012

Status: As Enacted **Sponsor**: Sens. Niehaus and Kearney

Local Impact Statement Procedure Required: Yes

Contents: To make changes to the law governing the State Teachers Retirement System

State Fiscal Highlights

- The provision that increases employee contribution rates to up to 14% for members participating in the State Teachers Retirement System (STRS) would reduce personal income tax receipts. An employee's contributions that are withheld from the employee's paycheck and paid to STRS are not taxable currently. Thus, this provision would reduce personal income tax (PIT) receipts for several years, by an amount increasing over four years as the rate increases are phased in beginning with compensation earned on July 1, 2013, to approximately $18.6 million per year starting in the fourth year. The GRF would bear $18.0 million of this revenue loss beginning in FY 2017. The decrease to PIT receipts would also reduce the amount distributed to the Local Government Fund (LGF) and the Public Library Fund (PLF) by approximately $0.6 million.[1]
- Approximately 1.5% of state employees are members of STRS (about 96% are members of the Public Employees Retirement System, and the remaining 2.5% are members in the Highway Patrol Retirement System).
- Most provisions would decrease future STRS pension benefit expenditures, thereby generating savings for the system. The resulting decrease in liabilities is likely to decrease future state spending to provide retirement benefits to employees, contingent on an actuary's determination that the savings are sufficient to reduce contribution rates. Due to this contingency, LSC staff consider any such fiscal effects to be indirect.

[1] Under current law, beginning in FY 2014, transfers to the LGF and PLF will be based on a fixed percentage of GRF tax receipts as determined by the Tax Commissioner not later than July 5, 2013. The percentage will be based on the amount transferred to each fund in FY 2013 as a percentage of total GRF tax revenues in FY 2013. In FY 2014, total distribution to the LGF and the PLF is estimated to be about 3.3% of total GRF tax revenue.

Local Fiscal Highlights

- The provision that increases employee contribution rates for members participating in STRS would reduce state personal income tax receipts. The amount of the reduction would increase over the four-year phase-in period, to approximately $18.6 million per year starting in FY 2017. The state GRF would bear most of the revenue loss, which would begin in FY 2014. Any decrease to the personal income tax would also reduce the amount distributed to the LGF and the PLF, subsequently reducing the allocations to various local government entities. The combined revenue loss to these two funds would grow to about $0.6 million in FY 2017.
- The provision that increases employee contribution rates for STRS would also decrease school district income taxes, for those school districts that impose them and in which STRS members reside. This occurs for the same reason as the reduction in the state personal income tax.
- Most school districts' employees are members of STRS or the School Employees Retirement System (SERS).
- Most provisions would decrease future STRS pension benefit expenditures, thereby generating savings for the system. The resulting decrease in liabilities is likely to decrease local governments' spending to provide retirement benefits to employees, contingent on an actuary's determination that the savings are sufficient to reduce contribution rates. Due to this contingency, LSC staff consider any such fiscal effects to be indirect.

Detailed Fiscal Analysis

The bill makes various changes to the law governing the State Teachers Retirement System (STRS). Most of the provisions have no significant direct fiscal effect on the state and local governments. At a given point in time, state and local contributions to STRS are based on the size of their respective payrolls, which are multiplied by a contribution rate determined by an actuary; for example, the employer contribution rate under STRS is currently 14%.

The bill's provisions generally create savings for STRS, and it is likely that those savings will reduce future required contribution rates compared with what the contribution rates would be under current law,[2] but any such reduction is contingent on an actuary's determination. Because of the contingent nature of the savings to the state and to political subdivisions, LSC staff consider such fiscal effects to be indirect. However, some provisions requiring public employers to comply with certain administrative requirements may minimally increase the state and local governments' administrative costs.

The LSC bill analysis provides a detailed description of the bill. The following are provisions that have a fiscal effect on the state or on political subdivisions, or a major fiscal effect on STRS.

- Increases member contributions by 1% of salary per year beginning with compensation earned on July 1, 2013, to a total increase of 4% on July 1, 2016. Currently, STRS Ohio members pay 10% of their salaries to STRS. Provides that the STRS Board may reduce member contribution rates to less than 14% after July 1, 2017, upon its actuary's determination.
- Revises age and service retirement benefit eligibility criteria for STRS members to retire with unreduced benefits beginning August 1, 2015.[3] Phases in over several years the requirement for an unreduced retirement benefit from 30 to 35 years of service credit and increases the requirement for early retirement with a reduced benefit from 25 to 30 years of service credit at age 55.
- Increases the number of years used to determine final average salary (FAS), used to calculate a member's benefit, from three to five, beginning August 1, 2015.
- Reduces the benefit multiplier to 2.2% of FAS for each year of service credit beyond 30 years, instead of 2.5% plus an amount increasing by 0.1% of FAS for each year beyond 30, beginning August 1, 2015.

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[2] This statement does not necessarily imply an actual decrease in contribution rates. It would also describe, for example, a scenario in which an actuary determined that the rate needed to be increased by one-half percentage point under the bill's provisions, when it would have needed to be increased by a full percentage point under current law.

[3] The bill allows an STRS member who under current law would be eligible to retire on July 1, 2015 to retire on or after August 1, 2015 under current law's eligibility and benefit provisions.

- Eliminates the $86 minimum benefit calculation and the commuted service calculation, which is an alternative to the FAS method of calculating a retirement allowance effective July 1, 2013.
- Reduces the annual cost-of-living adjustment (COLA) from 3% to 2% effective August 1, 2013. Increases to five years, from one year, the time that must pass before the first COLA is granted unless the allowance or benefit was immediately preceded by a disability benefit that was terminated.
- Specifies that no COLAs will be granted from July 1, 2013, through June 30, 2014, to persons retiring prior to July 1, 2013, or until July 1, 2015, to persons retiring on or after July 1, 2013.[4]
- Modifies disability and survivor benefits coverage and eligibility requirements for such benefits.
- Revises a member's eligibility and increases the cost to purchase certain service credit. Generally, requires a member or former member who purchases certain credit to pay an amount equal to 100% of the additional liability resulting from the additional credit.
- Excludes certain amounts paid to a teacher by an employer as a payment from compensation for the purpose of STRS contributions and benefits.
- Creates a health care fund, to which amounts allocated by the STRS Board for health care and any earnings are to be credited. Specifies that, if STRS discontinues health care coverage, any remaining surplus funds are to be distributed to employers who have contributed to the health care fund.
- Permits, rather than requires, the STRS Board to reimburse Medicare Part B premiums to benefit recipients and provides that reimbursement may be made only to recipients who are "enrolled in" Medicare Part B.
- Subjects certain retirees who are re-employed in positions covered by STRS to the two-month forfeiture of benefits.
- Permits, rather than requires, STRS to transfer the "mitigating rate" to the STRS defined benefit plan. Under existing law, a percentage of employer contributions made on behalf of STRS defined contribution plan participants, known as the mitigating rate, will be redirected to the defined benefit plan to compensate for any negative financial impact due to such members' participation under the defined contribution plans.
- Requires the Ohio Retirement Study Council (ORSC) to study and make recommendations on the STRS Board's authority to (1) reduce the employee contribution rate to less than 14% for compensation earned on or after July 1, 2017, (2) adjust retirement eligibility requirements, and (3) adjust the COLA. Directs ORSC to prepare and submit a report of such study to the

[4] The bill includes a statement of the General Assembly's intention related to COLA changes.

Senate President and House Speaker within 90 days after the bill's effective date.

- Specifies that most provisions in the bill will take effect on January 7, 2013.

Fiscal impact

State and local governments

The provision that increases employee contribution rates to up to 14% for members participating in STRS would reduce receipts from the state personal income tax and from school district income taxes. Table 1 shows STRS proposed member contribution rates and the amount of member contributions in FY 2011, the latest data available. Employees' contributions that are withheld from such employees' paychecks and paid to STRS are treated as tax deferred, and thus not taxable income currently. Any increase in employee contribution rates would correspondingly increase total amounts of payroll that are not taxed currently, thereby decreasing state personal income tax receipts. The state GRF would bear most of any such revenue loss. Any reduction in state personal income tax receipts would also decrease the amount distributed to the Local Government Fund (LGF) and Public Library Fund (PLF), subsequently reducing the allocations to various local government entities.

Using member contributions in Table 1 below, the estimated amount of payroll that would effectively shift from taxable to nontaxable would be up to $113.0 million in the first year, increasing each year to up to $452.0 million per year starting in the fourth year. Assuming a marginal tax rate of 4.109%,[5] state personal income tax revenue would decrease by up to $18.6 million per year after four years. The state GRF would bear up to $18.0 million of such revenue loss while the LGF and the PLF (combined) would bear about $0.6 million annually.[6]

Any revenue loss to the LGF and PLF would subsequently reduce the allocations to various local government entities. Because school district income taxes are determined starting with Ohio Taxable Income, the provision would also decrease school districts' income tax receipts.

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[5] According to data from the most recent STRS annual report, the average member's salary was $54,018 annually.

[6] Under existing law, the amounts of total GRF revenue that will be allocated to the LGF and the PLF after the current biennium would be based on the ratio of LGF distributions to total GRF tax revenue in FY 2013 and the ratio of PLF distributions to total GRF tax revenue in FY 2013, respectively. In FY 2014, total distribution to the LGF and the PLF is estimated to be about 3.3% of total GRF tax revenue.

Table 1: Proposed STRS Employee Contribution Rates			
System	**2012 Member Contribution Rate**	**Member Contributions as of July 1, 2011 ($ in millions)**	**Proposed Contribution Rates**
STRS	10.0%	$1,129.9[7]	14.0% (increases phased in by 1% per fiscal year, over four years, beginning July 1, 2013)

Table 2: Estimated Revenue Loss, by Fiscal Year				
	FY 2014 ($ in millions)	**FY 2015 ($ in millions)**	**FY 2016 ($ in millions)**	**FY 2017 ($ in millions)**
PIT revenue loss	$4.64	$9.28	$13.92	$18.56
GRF revenue loss	$4.49	$8.98	$13.47	$17.96
LGF and PLF revenue loss	$0.15	$0.30	$0.45	$0.60

Most of the provisions would have no direct fiscal impact on the state, local governments, and school districts because the bill does not make any changes to employers' contribution rates. Thus, the bill would not directly affect the state's, local governments', and school districts' retirement costs. Retirement benefits for a public employee are funded by a combination of employees' and employers' contributions and investment earnings on those contributions.[8] Employee and employer contribution rates are based on a set percentage of employees' payroll. The rates are determined by an actuary as the percentage necessary to fully fund benefit amounts over time, but limited to the maximum rates specified in the Revised Code. In 2012, an employee pays 10% while the employer contributes 14%[9] of payroll into STRS.

Many of the bill's provisions would decrease STRS liabilities. By doing so, those provisions would likely permit an actuary to determine, at some point, that employer contribution rates could be reduced, thereby decreasing future costs for the state and political subdivisions. LSC does not employ an actuary, and does not have access to employee-level data with which to estimate the likely magnitude and timing of any such reduction in contribution rates. Also, due to the fact that such reductions are contingent on an actuary's analysis and determination, LSC would consider such reductions to be indirect fiscal effects.

According to an ORSC staff member, the provision requiring ORSC to study, make recommendations, and prepare a report related to certain authority that the bill grants to the STRS Board would have no significant fiscal impact on the ORSC. The

[7] In FY 2011, defined benefit (DB) members contributed a total of $1,081.96 million while defined contribution (DC) members contributed a total of $47.9 million.

[8] In general, investment earnings account for about two-thirds of total revenues to pay for retirement benefits. Thus, investment returns have a significant and direct impact on future contribution rates.

[9] A portion of the employer's contributions is used to pay for optional health benefits provided by STRS.

ORSC is funded by a portion of investment earnings made on the assets of the five state retirement systems.

STRS liabilities

The majority of the bill's provisions, when they begin to take effect, would decrease future STRS pension benefit expenditures. This in turn would decrease STRS pension liabilities and the number of years to amortize their unfunded actuarial accrued liabilities (UAAL). A UAAL occurs when the value of the actuarial accrued liabilities exceeds the value of assets. UAAL is calculated by an actuary based on various economic and actuarial assumptions. The bill would require increased employee contributions. Thus, the bill would improve the long-term funding status of STRS. Under current law, STRS is required to amortize its UAAL over a period not to exceed 30 years.[10]

Based on the STRS actuarial valuation as of July 1, 2011, the actuarial value of net assets set aside to pay its defined benefit (DB) plan benefits (excluding health care assets) was $58.1 billion. STRS's UAAL for its DB plan was $40.6 billion, which corresponded to a 58.8% funded ratio. A funded ratio is the ratio of a retirement system's assets to its actuarial accrued liabilities, and is a measure of its financial health (i.e., its ability to pay benefits when due). The valuation results indicated that the STRS DB plan had an infinite funding period,[11] which means that STRS total contributions of 24% of payroll will not be able to amortize its UAAL, unless changes are made. The bill may also increase STRS's administrative costs, however, any potential cost due to the bill would be offset by savings realized by the system.

According to an actuarial analysis dated May 10, 2012 and prepared by an STRS actuary, PricewaterhouseCoopers, the proposed changes under S.B. 342 (As Introduced) would decrease the STRS funding period to 36 years (from infinity). The analysis is calculated based on July 1, 2011 valuation results and data. The assumptions and methods used in the analysis are based on the results of a three-year experience study ending June 30, 2011, with some modifications to retirement patterns and interest rate assumption of 7.75% per year compounded annually and net of expenses. PricewaterhouseCoopers estimated that the STRS funding period would decrease to 21 years by July 1, 2014 if assets earn a compounded 7.75% annual rate of return and all other assumptions are met as expected.

A study prepared by Pension Trustee Advisors (PTA) dated July 2012 found the bill's provisions would reduce total employer normal cost by 10.84 percentage points (including a 4.31 percentage point decline in the employer normal cost rate and a 6.53 percentage point decline in the UAAL amortization rate), compared to the amount

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[10] The Revised Code specifies that in any year a system's funding period exceeds the 30-year requirement, the system is required to submit a report to the Ohio Retirement Study Council outlining its plans to comply with the 30-year funding requirement.

[11] Funding period represents the number of years needed to fully amortize a plan's pension liabilities.

needed to accomplish a 30-year amortization under current law.[12] The 10.84 percentage point decline is not from the current 14.0% employer contribution rate, which would not amortize the UAAL within 30 years; it is from the 30.10% rate that would be needed to amortize the UAAL within 30 years under the current program. The PTA study concluded that, while the 30-year funding requirement would not be met initially under the bill's provisions, it would be met by 2016. In order to meet the 30-year funding requirement immediately, the employer contribution would have to be 19.26% (which equals 30.10% minus 10.84%) instead of the current 14.0%.

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[12] Normal cost expresses pension costs as a percentage of payroll, so the estimate implies that an employer's pension costs would be reduced by 10.84% of its payroll.