Ohio Legislative Service Commission

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# Fiscal Note & Local Impact Statement

**Bill**: S.B. 342 of the 129th G.A. **Date**: May 9, 2012

**Status**: As Introduced **Sponsors**: 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 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 the Public Employees Retirement System (PERS) members, and the remaining 2.5% are members in the Highway Patrol Retirement System (HPRS)).
- Most provisions would decrease 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, the Legislative Service Commission (LSC) staff consider any such fiscal effects to be indirect. Under existing law, the STRS Board is required to prepare an actuarial analysis of any introduced legislation

[1] Under current law, beginning in FY 2014, transfers to the LGF and PLF will be based on a fixed percentage 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.

expected to have a measurable financial impact on the system by not later than 60 days from the date of introduction of the legislation.[2]

## 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 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.

[2] A copy of the actuarial analysis must be submitted to the Legislative Service Commission (LSC), the Ohio Retirement Study Council (ORSC), and the standing committees of the House of Representatives and the Senate with primary responsibility for retirement legislation.

# Detailed Fiscal Analysis

The bill makes various changes to 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, 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.
- 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.
- 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 and receive the greater of the benefit determined under the current benefit formula or the new benefit formula established under the bill.
- 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.

[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.
- 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" the 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.

## Fiscal impact

### State and local governments

The provision that increases employee contribution rates 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 revenue loss to 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%,[4] 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.[5]

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.

**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[6] | 14.0% (increases phased in by 1% per fiscal year, over four years, beginning July 1, 2013) |

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

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

[5] 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.

[6] 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.

investment earnings on those contributions. 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%[7] 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.

### Retirement systems

The majority of the bill's provisions, when they begin to take effect, would decrease 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. The magnitude of the impacts on STRS liabilities and UAAL would need to be determined by an actuary, and is undetermined at this time.

Under current law, STRS is required to amortize its UAAL over a period not to exceed 30 years.[8] Based on the latest 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,[9] 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.

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

[8] 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. UAAL is calculated by an actuary based on various economic and actuarial assumptions.

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

In the future, if STRS maintained a 30-year amortization and its funding status remained stable, it would lessen the chances of further increase in contribution rates or reductions in benefits.[10] Thus, the bill may indirectly affect employer (state and school districts) and employee contributions in the future, as described above.

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[10] 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.