Ohio Legislative Service Commission

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Fiscal Note & Local Impact Statement

Bill: Sub. S.B. 345 of the 129th G.A.

Date: September 10, 2012

Status: As Reported by House Health & Aging Pension Subcommittee

Sponsor: Sens. Niehaus and Kearney

Local Impact Statement Procedure Required: No

Contents: To revise the law governing the State Highway Patrol Retirement System

State Fiscal Highlights

- The bill allows the Highway Patrol Retirement System (HPRS) Board to increase employee contribution rates to up to 14% of salary (from 10%). If the Board increases such rate, personal income tax (PIT) receipts will be reduced. An employee's contributions that are withheld from the employee's paycheck and paid to the system are not taxable currently. However, the timing and the magnitude of such revenue loss would be contingent upon the HPRS Board action and the rate increase. The state GRF would bear most of such revenue loss. Any decrease in PIT receipts would also reduce the amount distributed to the Local Government Fund (LGF) and the Public Library Fund (PLF).[1]
- Approximately 2.5% of state employees are members of HPRS (96.0% are members in the Public Employee Retirement System, and the remaining 1.5% are in the State Teachers Retirement System).
- Most provisions would decrease future HPRS 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.
- Under existing law, the board of each of the retirement systems is required to prepare an actuarial analysis of any introduced legislation expected to have a

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[1] 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.

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 bill allows the Highway Patrol Retirement System (HPRS) Board to increase employee contribution rates to up to 14% of salary (from 10%). If the Board increases such rate, personal income tax (PIT) receipts will be reduced. An employee's contributions that are withheld from the employee's paycheck and paid to the system are not taxable currently. However, the timing and the magnitude of such revenue loss would be contingent upon the Board action and the rate increase. Any decrease in PIT receipts would also reduce the amount distributed to the LGF and the PLF, thereby reducing the allocations to various local government entities.
- Provisions that affect future HPRS pension benefit expenditures would have no direct fiscal effect on political subdivisions, and minimal (if any) indirect fiscal effect. Few, if any, members of HPRS are employees of political subdivisions.

[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 Highway Patrol Retirement System (HPRS). Most of the provisions have no significant direct fiscal effect on the state and local governments. At a given point in time, the state contributions to HPRS are based on the size of its payroll, which is multiplied by a contribution rate determined by an actuary; for example, the state employer contribution rate under HPRS is currently 26.5%.

The bill's provisions generally create future savings for HPRS, and it is likely that those savings will reduce future required contribution rates compared with what the contribution rates would be under current law, but any such reduction is contingent on an actuary's determination. Because of the contingent nature of the savings to the state (and possibly to political subdivisions), LSC staff consider such fiscal effects to be indirect.

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 HPRS.

- Allows the HPRS Board to increase member contributions to up to 14% of salary (from 10%), if the Board's actuary determines an increase is necessary to meet the 30-year amortization requirement.
- Increases the number of years used in determining final average salary (FAS) to five (from three) for use in determining benefits, effective January 1, 2015.
- Authorizes, rather than requires, the Board to provide a cost-of-living adjustment (COLA) not to exceed 3%. Provides that no recipient of an HPRS pension that begins to be paid after the bill's effective date (including those receiving a disability or survivor pension) is to receive a COLA before attaining age 60.
- Requires the Board's determination of the COLA amount to be based on the annual actuarial valuation required by current law, except that recipients 65 years of age or older whose benefits are less than 185% of the federal poverty limit for a family of two will continue to receive a 3% COLA.
- Provides that, for deferred retirement option plan (DROP) participants, any contribution exceeding 10% is to be deposited in the HPRS Employer Accumulation Fund and not to accrue to the benefit of the member.
- Specifies that all provisions in the bill will take effect on January 7, 2013, except for the provision authorizing the HPRS Board to increase employee contribution rates (effective 180 days later) and the provision related to the change in FAS calculation (effective January 1, 2015).

- Requires the Ohio Retirement Study Council (ORSC) to study and make recommendations on the HPRS Board's authority to adjust employee contribution rates. Directs ORSC to prepare and submit a report of such study to the Senate President and House Speaker within 90 days after the bill's effective date.

Fiscal impact

State and local governments

The provision that authorizes the HPRS Board to increase employee contribution rates for its members would potentially reduce receipts from the state personal income tax (PIT). Because any such increase depends on decisions made by the Board, rather than being required by the bill, LSC staff classify any such reduction as an indirect effect. Employees' contributions that are withheld from such employees' paychecks and paid to the system are treated as tax deferred, and thus not taxable income currently. Because school district income taxes are determined starting with Ohio Taxable Income, the provision would also potentially decrease school districts' income tax receipts. Any increase in employee contribution rates would correspondingly increase total amounts of payroll that are not taxed currently, thereby decreasing state PIT receipts.

Using member contributions in Table 1 below, the estimated amount of payroll that would effectively shift from taxable to nontaxable at the 14% contribution rate may be up to $3.8 million per year. Assuming a marginal tax rate of 4.109%,[3] state personal income tax revenue would decrease by up to $0.16 million per year, if the Board increased the rates to the maximum amount allowed under the bill. The state GRF would bear up to $0.15 million of such revenue loss while the LGF and the PLF (combined) would bear about $0.01 million annually. Any revenue loss to the LGF and PLF would subsequently reduce the allocations to various local government entities. Because school district income taxes are generally determined starting with Ohio Taxable Income, the provision would also decrease school districts' income tax receipts.[4] The timing and the magnitude of the fiscal impact is undetermined at this time, as it is dependent on the Board's action.

Table 1: Proposed HPRS Employee Contribution Rates			
System	**2012 Member Contribution Rate**	**Member Contributions as of July 1, 2011 ($ in millions)**	**Proposed Contribution Rates**
HPRS	10.0%	$9.5	Allows the HPRS Board to increase to up to 14%

[3] According to data from the most recent HPRS annual report, the average member's salary was $61,658 annually.

[4] A number of school districts use wages and compensation as a starting point for income tax purposes; for those, an increase in member contribution would also result in decreased income tax receipts.

Most of the provisions would have no direct fiscal impact on the state, local governments, or school districts. The bill does not make any changes to employers' contribution rates, thus the bill would not directly affect the state's retirement costs. Retirement benefits for a public employee are funded by a combination of employees' and employers' contributions and investment earnings on those contributions.[5] 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 26.5%[6] of payroll into HPRS.

Many of the bill's provisions would decrease HPRS liabilities. An actuarial analysis prepared by Gabriel Roeder Smith & Company shows that, if for example, the member contribution rate were increased by 3.8% of salary for all members (and the additional rate increased for DROP members allocated to the DROP account), and the bill's proposed changes related to COLA are implemented, employer contribution costs would decrease by about $11.6 million annually, and the changes reduce the HPRS unfunded actuarial accrued liabilities (UAAL) by about $87.2 million. The changes in this scenario would additionally lower the amortization period of the system's UAAL to 29.94 years if employer contribution rates remain unchanged, which is within the 30-year funding requirement.

The estimates are subject to change each year if actual experience differs from actuarial assumptions. The actuarial analysis was made based on the current member and employer contribution rates, the allocation of contribution rates between the pension program and the retiree health program, and the UAAL of the pension program as of December 31, 2011.

At some point in the future (assuming the 30-year funding requirement is met), employer contribution rates could be reduced, thereby decreasing future costs for the state and possibly for political subdivisions. Because an actuary's determination is needed for the percentages to be reduced, however, LSC staff 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 HPRS Board would have no significant fiscal impact on the ORSC. ORSC is funded by a portion of investment earnings made on the assets of the five state retirement systems.

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[5] 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.

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

HPRS liabilities

The majority of the bill's provisions, when they begin to take effect, would decrease future HPRS pension benefit expenditures. This in turn would decrease HPRS 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 allows the HPRS Board to increase employee contributions. Thus, the bill may improve the long-term funding status of HPRS, as illustrated by the scenario above.

Under current law, HPRS is required to amortize its UAAL over a period not to exceed 30 years.[7] Based on the HPRS actuarial valuation as of December 31, 2010, the actuarial value of net assets set aside to pay its defined benefit (DB) plan benefits (excluding health care assets) was $631.0 million. HPRS's UAAL for its DB plan was $386.8 million, which corresponded to a 62.0% 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 HPRS DB plan had an infinite funding period,[8] which means that HPRS total contributions of 36.5% of payroll will not be able to amortize its UAAL, unless changes are made. The bill may also increase HPRS' administrative costs, however, any potential cost due to the bill would be offset by savings realized by the system.

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[7] 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.

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