Department of Legislative Services
Maryland General Assembly
2006 Session

FISCAL AND POLICY NOTE
Revised

House Bill 1737 (Delegate James, *et al.*)
Appropriations Budget and Taxation

State Employees' and Teachers' Retirement Enhancement Benefit Act of 2006

This bill enhances pension benefits for all members of the Teachers' Pension System and the Employees' Pension System, except those employed by participating governmental units (PGUs), which have the option of electing to participate in the enhanced benefits by June 30, 2007. For current members, the benefit multiplier increases from 1.4% to 1.8% for service credit retroactive to 1998. Employee and teacher contribution rate increases are phased in over three years, rising from the current rate of 2% to 5% by July 1, 2008.

The bill takes effect July 1, 2006.

Fiscal Summary

State Effect: State pension liabilities increase by $1.9 billion. Amortizing those liabilities over 25 years results in a first-year cost of $122 million in FY 2008, which is assumed to grow by 4% annually.

($ in millions)	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
Revenues	$0	$0	$0	$0	$0
GF Expenditure	0	106.2	110.5	114.8	119.4
SF Expenditure	.2	7.9	8.2	8.5	8.9
FF Expenditure	0	7.9	8.2	8.5	8.9
Net Effect	($.2)	($122.0)	($126.9)	($131.9)	($137.2)

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: Assuming all participating governmental units (PGUs) elect to participate in the enhanced benefit, pension liabilities could increase by a total of $263 million, resulting in a first-year increase in pension contributions of $24.5 million based on a 25-year amortization schedule. PGUs that elected to participate in the 1998 enhancements will pay a surcharge of 1.76% of the portion of their payroll attributed to members of the

Employees’ Pension System (EPS). PGUs that did not elect to participate in the 1998 enhancements will pay a surcharge of 5.96% of their payroll attributed to members of EPS.

Small Business Effect: None.

Analysis

Bill Summary: The bill creates the Alternate Contributory Pension Selection (ACPS) for members of the Teachers’ Pension System (TPS), the Employees’ Pension System (EPS), and members of the Employees’ Retirement System and Teachers’ Retirement System that opted for Selection C (the bifurcated option). All current and future members of TPS/EPS are subject to ACPS; however, employees of PGUs are subject to ACPS only if their employer elects to participate before July 1, 2007.

The employee contribution rate under ACPS is 3% of annual compensation earned from July 1, 2006 through June 30, 2007, 4% from July 1, 2007 through June 30, 2008, and 5% beginning July 1, 2008 and annually thereafter.

Members subject to ACPS earn a retirement benefit allowance according to the following formula:

Years of Creditable Service Before 1998	x	Average Final Compensation (AFC)	x	1.2%
		Plus		
Years of Creditable Service After 1998	x	AFC	x	1.8%

Current provisions governing eligibility for normal retirement, early retirement, ordinary disability retirement, and special disability retirement for TPS/EPS members remain unchanged.

Joint Committee on Pensions Peer Studies

The Joint Committee on Pensions (JCP) must hire an actuarial consulting firm every five years, beginning September 1, 2008, to conduct a peer study that examines the following issues:

- the funding status of the State Retirement and Pension System (SRPS), including its current unfunded accrued liability;
- the composition of the several retirement plans within SRPS; and

- the benefit levels and contribution rates in each the various plans within SRPS.

Findings from the report must be provided to JCP no later than December 31 of the year of the study.

Current Law: Teachers, State employees, and employees of PGUs are members of one of four pension systems:

- Teacher' Retirement System (TRS)
- Employees' Retirement System (ERS)
- Teachers' Pension System (TPS)
- Employees' Pension System (EPS)

Under Chapter 7 of 1984, TRS and ERS each provide three benefit options to their members, known as Selections A, B, and C.

TPS and EPS both have contributory and noncontributory parts. Teachers and State employees who joined TPS/EPS after January 1, 1980 participate in the contributory parts; TRS and ERS members who transferred to TPS/EPS after June 30, 1998 participate in the noncontributory parts. Most PGU employees in EPS participate in the contributory part, but eight PGUs participate in the noncontributory part. The contribution and benefit structures for the four plans are shown in **Exhibit 1**.

Exhibit 1
Pension Benefit Structures for Teachers and Employees

	Contribution Rate	Accrual Rate	Cost-of-living Adjustment
TRS/ERS			
--Selection A	7%	1.8%	CPI, unlimited
--Selection B	5%	1.8%	CPI, up to 5%
--Selection C	2%	Bifurcated	Bifurcated
TPS/EPS			
--Contributory	2%	1.4%	CPI, up to 3%
--Noncontributory	5% for income above Social Security Wage Base	*	CPI, up to 3%**

*The greater of 1.2% or the sum of 0.8% of AFC up to the Social Security integration level and 1.5% of AFC over the Social Security integration level.
**This is a simple COLA, calculated only on the amount of the initial benefit payment, whereas all other COLAs are compounded annually.

The bifurcated accrual rates and COLAs for Selection C of TRS/ERS reflect the history of pension enhancements. TRS/ERS members in Selection C chose to retain their TRS/ERS benefits for service credits earned prior to choosing Selection C, but to earn TPS/EPS benefits for service credits earned after choosing Selection C. Therefore, the accrual rates and COLAs applied to their benefit calculations are weighted according to the service credits earned under each plan.

TRS/ERS members are eligible for a normal service retirement after 30 years of eligible service or upon reaching age 60. TPS/EPS members are eligible for a normal service retirement after 30 years of service or upon reaching 62 years of age with 5 years of service.

For TPS/EPS, AFC is the average annual compensation for the three consecutive years of employment that provide the highest average earnable compensation. In most cases, that would be the final three years of employment.

Background: Chapters 23 and 24 of 1979 created TPS and EPS, and closed TRS and ERS to new membership. The creation of the new systems was prompted by concerns over the long-term financial viability of the old systems, so the benefits provided by the new systems were less generous than those available under the old ones. Initially, the new systems were noncontributory and integrated with the Social Security system. Members earning less than the Social Security wage base (generally everyone except those in the upper echelons of the salary schedule) made no employee contributions, while compensation above the wage base was subject to a 5% employee contribution. The benefit accrual rate was 0.8% for the portion of AFC below the Social Security integration level (the 30-year average of wage bases) and 1.5% for the portion of AFC above the integration level.

Chapter 530 of 1998 discontinued the systems' integration with Social Security and transformed TPS/EPS into contributory pension systems, requiring 2% employee contributions on all compensation and raising the benefit accrual rate to 1.4% of AFC. It also changed the COLA from a simple percentage of the initial retirement benefit to an annual compounding COLA. Members of TRS/ERS were given the option of transferring to the new enhanced TPS/EPS by July 1, 1998, and receiving a full refund of their employee contributions. This would have allowed them to take advantage of the lower contribution rates, although the benefits available were also lower than those available under the old systems. TRS/ERS members who transferred after the deadline were only eligible to participate in the old noncontributory plan. Similarly, PGUs were allowed to opt for the enhanced contributory plan or remain in the noncontributory plan; all but 9 out of approximately 112 PGUs opted for the enhanced plan.

Even with the 1998 enhancements, Maryland's pension benefits are viewed as inadequate by some groups representing teachers and employees. There is no question that the

TPS/EPS accrual rate is among the lowest in the country. According to the National Education Association, only Indiana has a lower accrual rate for teacher pensions among the 50 states. In their first year of retirement, TPS/EPS members earn 42% of their AFC, excluding Social Security benefits, compared with 75% for Pennsylvania teachers and 51% for Virginia teachers and state employees.

However, some aspects of Maryland's pension benefits compare favorably with those in other states, and help mitigate the effects of its comparatively low accrual rate. For instance, while many states with higher accrual rates do not participate in Social Security, Maryland teachers and employees receive full Social Security retirement benefits. **Exhibit 2** compares some key aspects of Maryland's pension benefits with those available in neighboring States (all neighboring states participate in Social Security).

Exhibit 2
Pension Plan Characteristics in Mid-Atlantic States

	Employee Contribution	Accrual Rate	Annual COLAs
Maryland	2.0%	1.4%	CPI up to 3%
Pennsylvania			
–Teachers	7.5%	2.5%	None**
–Employees	6.5%	2.0%	
Delaware	3.0% on income above $6,000	1.85%	None**
Virginia	5.0%	1.7%	CPI up to 3%, then 0.5% for each CPI point
West Virginia*			
–Teachers (closed)	6.0%	2.0%	None**
– Employees	4.5%	2.0%	

*West Virginia's defined benefit pension plan for teachers was closed to new members in 1991; until 2005, it operated a defined contribution plan for teachers, but then decided to re-open the defined benefit plan.

**Considered on an annual basis.

As Exhibit 2 shows, while Maryland has the lowest accrual rate in the region, it also has the lowest employee contribution rate, so teachers and employees are taking home a larger portion of their income. That enables them to invest their extra take-home pay in other retirement savings vehicles such as Individual Retirement Accounts or the

Maryland Supplemental Retirement Plan, if they choose. Also, while three states in the region have no automatic annual COLAs, Maryland's annual COLA allows retirees to "catch up" with their counterparts in other States that retired with larger initial benefits. Without COLAs, those benefits lose value over time due to inflation, while the buying power of Maryland's retirement allowances keeps up with inflation. Many other states require local school boards to share the cost of teacher pensions, whereas Maryland pays the full employer contributions for all teachers. Pennsylvania, by comparison, pays only half.

An analysis performed for the Joint Committee on Pensions by Cheiron, an actuarial consulting firm, found that, when all factors are considered, retired teachers and employees in Maryland earn just over 80% of their final salary after 10 years of retirement. This places Maryland solidly in the middle of its peer group, which includes all neighboring states and other States with AAA bond ratings. Cheiron also found that Maryland bears a substantially higher share of the cost of pension benefits paid to teachers and employees than other neighboring States. While Maryland pays 84% of benefits, Pennsylvania pays just 55%, Virginia pays 66%, and Delaware pays 79%.

As of June 30, 2005, there were 91,535 members of TPS and 76,787 members of EPS, of whom 23,403 are employed by approximately 112 active PGUs. There were 896 members of the TRS/ERS Selection C; these individuals will benefit from ACPS, but other members of TRS/ERS are not affected by the bill.

State Expenditures: The bill provides a 28.6% benefit increase for TPS/EPS members. According to the State's actuary, State pension liabilities could increase by $1.9 billion. Amortizing that liability over 25 years results in State pension contributions increasing by $122 million beginning in fiscal 2008; of that, $82.5 million is for TPS and $39.5 million is for EPS. TPS contributions are paid entirely out of general funds, while EPS contributions are estimated to be 60% general funds, with 20% coming from each of special and federal funds. As enacted, the fiscal 2007 budget sets aside $51.5 million ($37.6 million in general funds) toward the costs of future retirement benefits.

The ratio of system assets to system liabilities would drop from 89.3% to 85.0% for TPS and from 84.9% to 80.6% for EPS, a 4.3 percentage point drop for both systems. This indicates that not only would State pension contributions be higher in the future to pay for the enhanced benefit, but they would need to grow at a faster rate than currently forecast in order to achieve full actuarial funding (a 100% funding ratio) in 30 years.

As shown in **Exhibit 3**, two factors account for most of the increased State expenditures under this bill: retroactivity and the contribution phase-in. Retroactivity increases pension liability by providing a benefit that has not been paid for. From fiscal 1998 through 2006, the State and employees have made contributions to pay for a 1.4% accrual rate. By increasing the accrual rate to 1.8% for that period without requiring members to pay the difference between the 2% they have been paying and the 5% they will be paying, the bill increases the system's liabilities and ultimately requires the State to pay \$77.5 million to begin making up that difference. By contrast, ERS/TRS members have been paying the higher 5% or 7% contributions all along to get the higher 1.8% benefit, but retroactivity gives that same benefit to TPS/EPS members (for eight years) who have been paying just 2% during that time.

The contribution phase-in accounts for another portion of the increased State contribution. If the contribution rate was increased to 5% in the first year instead of phased in over three years, State pension contributions would increase by \$109 million in fiscal 2008 instead of \$122 million. The reason for this is that during the first two years of implementation, benefits grow faster than contributions; members are getting a full benefit enhancement for which they are not paying the full employee cost. State contributions have to make up the difference.

Exhibit 3
First-year Cost Breakdown
(\$ in Millions)

Enhanced Future Benefits	\$30.2
Retroactive Benefits	78.0
Contribution Phase-in	13.8
Total First-year Cost	**\$122.0**

Under the provisions of this bill, pension benefits for all TPS/EPS members would increase and be more competitive with regional pension systems, but newer members would benefit to a greater extent than veteran members. **Exhibit 4** shows the current and enhanced replacement ratios for different members based on when they first joined TPS/EPS. Replacement ratios measure the proportion of AFC that a member can expect to receive in pension payments during the first year of retirement, not including Social Security or private savings.

Exhibit 4
TPS/EPS Replacement Ratios*

Year Hired	Current	Enhanced Benefit
1980	38.4%	43.2%
1985	39.4%	46.2%
1990	40.0%	49.2%
1998	42.0%	54.0%

*Assumes normal service retirement with 30 years of service credit.

The State Retirement Agency advises that this bill will require it to reprogram its legacy computer system to reflect the new benefit and contribution rates. By making benefit enhancements retroactive to 1998, the last time the State enacted benefit enhancements, the bill minimizes the cost of reprogramming the computer system because it is already set up to provide a specific level of benefits beginning in that year. Nevertheless, the computer system's age and complexity will require additional programming resources, estimated to total $150,000 in fiscal 2007.

Exhibit 5 shows the effects of this bill on employee contributions for employees at three different salary levels. The higher employee contribution will cover about 67% of the increased cost of the benefit enhancement.

Exhibit 5
Annual Employee Pension Contributions Under HB 1737

Annual Salary	Current	FY 2007	FY 2008	FY 2009 and Beyond
$25,000	$500	$750	$1000	$1,250
40,000	800	1,200	1,600	2,000
75,000	1,500	2,250	3,000	3,750

Local Expenditures: This bill allows all PGUs, including those in the contributory and noncontributory portions of EPS, to elect to participate in the enhanced benefits under ACPS. This analysis assumes that all PGUs will elect to participate in ACPS, based on the fact that most elected the enhanced benefits in 1998.

All PGUs participating in EPS currently contribute 4.8% of payroll; PGUs that opted for the contributory benefit system in 1998 pay an additional 2.42% of payroll for the enhanced benefit.

Under ACPS, pension liabilities for all PGUs could increase by $263 million, of which $122 million would be for the 112 PGUs in the contributory portion and $141 million would be for the eight PGUs in the noncontributory portion. Employer contributions by PGUs in the contributory portion would have a first-year increase of $24.5 million in fiscal 2008. As a result, PGUs in the contributory portion of EPS would be assessed a surcharge of 1.76% of their EPS and Selection C payroll; the surcharge would not be applied to the portion of their payroll that pays for employees in Selections A or B of ERS. PGUs in the noncontributory portion would be assessed a surcharge of 5.96%, which includes the 2.42% that PGUs in the contributory portion already pay and the 1.76% surcharge for the new enhanced benefit. The remaining difference (1.78%)

reflects the fact that average salaries in the noncontributory PGUs are substantially higher than those in the contributory PGUs.

Employees of noncontributory PGUs that opt for the new enhanced benefit would go from paying nothing toward their pension to paying 3% of their salary in the first year.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Milliman USA, Maryland State Retirement Agency, Department of Legislative Services

Fiscal Note History: First Reader - March 20, 2006
mll/jr Revised - House Third Reader - April 7, 2006
Revised - Enrolled Bill - May 10, 2006

Analysis by: Michael C. Rubenstein

Direct Inquiries to:
(410) 946-5510
(301) 970-5510