

Department of Legislative Services
Maryland General Assembly
2000 Session

FISCAL NOTE

Senate Bill 583 (Senator Neall)

Budget and Taxation

State Employees - Retirement and Pensions - Postretirement Health Funding System

This pension bill creates a Postretirement Health Funding System to assist in the funding of the State's retiree health insurance subsidy for retired State employees. The bill creates a "sweeping" mechanism so that if there is a decline in pension contributions from one year to the next, the State is required to contribute the difference in pension contributions between the two years to the new system. These contributions would be invested by the State Retirement and Pension System for ten years. Thereafter, a portion of the new system's assets would be used to fund the retiree health insurance subsidy.

Fiscal Summary

State Effect: To the extent that State pension contributions decrease below the baseline forecast, State retiree health care expenditures will increase proportionally from FY 2001 to FY 2010. Based on recent experience, the amount of such an increase could be significant. Beginning in FY 2011, retiree health care expenditures would decrease based on the growth in the fund's assets. Administrative expenditures for the State Retirement Agency will increase by \$33,300 in FY 2001 for an additional accountant, increasing to \$45,100 in FY 2002 on a full-year basis. Revenues would not be affected.

Local Effect: None.

Small Business Effect: None.

Analysis

Bill Summary: The bill creates a Postretirement Health Funding System (PHFS) as an additional subsystem of the State Retirement and Pension System (SRPS), with the purpose of assisting the State in financing the retiree health insurance subsidy. The PHFS is to be created in accordance with Section 401(h) of the Internal Revenue Code.

For fiscal 2001 through fiscal 2010, on behalf of all regular State employees, the State will pay to the PHFS an amount equal to or greater than the lesser of:

- (1) 13% of the aggregate annual earnable compensation of all regular State employees; or
- (2) the difference between the total annual State pension contributions for the current fiscal year and the previous fiscal year, unless those pension contributions increased from the previous year, in which case no contributions to the PHFS is required.

The assets of the PHFS are to be invested in the same manner as those of the other systems of the SRPS. For fiscal 2001 through 2010, no payments may be made from the PHFS. For fiscal 2010 and thereafter, the SRPS will transfer to the State for the sole purpose of assisting in the payment of the State's retiree health insurance subsidy the lesser of:

- (1) one-quarter of the prior year's investment gains of the PHFS to the general fund; or
- (2) the amount necessary to pay the annual health insurance premiums and other costs that constitute the State's retiree health insurance subsidy.

Current Law:

Retiree Health Insurance

The State currently pays 80% of the health insurance premiums (including prescription plans) of State employees who retire with 16 or more years of service. Retirees with less than 16 years receive a subsidy equal to 1/16th of the 80% subsidy for each year of service.

Pensions

Each year the State's pension actuary certifies contribution rates for each of the pension systems that make up the SRSP. The board of trustees of the SRPS adopts these percentage rates, which are applied against the payroll of each of the systems to determine the total State contributions in dollars for that fiscal year. The actuary calculates these contribution rates by totaling the SRPS's liabilities and amortizing them over the period through fiscal 2020, when by law the State must be fully funded, then dividing the amortization payments by the actuary's forecasted payroll. These calculations assume a flat contribution rate over the amortization period (at this time, 19 years) with an assumed 5% per year payroll increase. In other words, the State's actuary and the SRPS project that pension contributions will increase by 5% per year from now to fiscal 2020.

Background:

Retiree Health Insurance

The State currently pays the retiree health insurance subsidy on a “pay-as-you-go” basis. State payments for this subsidy were \$117.1 million in fiscal 1999 and are forecasted by the Segal Company, the State’s health insurance actuary, to increase to \$603.4 million in fiscal 2018, a growth rate of 9% per year.

The State’s pension actuary, Milliman & Robertson, Inc., without performing a full valuation, informally estimates the total liabilities associated with retiree health benefits for current and future retirees to be \$3 billion. (This does not include the costs of the retiree subsidy for future State employees.) Current Government Accounting Standards Board (GASB) rules do not require the State to pre-fund these liabilities; the rules only require that the State note the existence of these liabilities in its annual financial report.

Federal tax laws make it disadvantageous for private sector firms to pre-fund retiree health benefits because employer contributions above those required on a “pay-as-you-go” basis are not deductible (as compared to private sector pre-funding of pension contributions, which is tax deductible).

There is no comparable disincentive for public entities regarding pre-funding health insurance liabilities and it is possible that GASB will require recognition of such liabilities on governments’ balance sheets in the future (which would in turn necessitate pre-funding to mitigate the balance-sheet impact). Among public sector entities, several localities, one multi-locality pension system, and at least one state have implemented various strategies to pre-fund these health insurance liabilities, in anticipation of the retirement of the “baby boom” generation.

Delaware has had a fully funded pension system since 1995 and has chosen to drop its contribution rate below the plan’s normal cost. The rate produced by the 1999 valuation is

1.67% of payroll, versus a normal cost of 6.50%. The state has captured that savings and increased the state contribution for the retiree medical insurance subsidy.

The Ohio Teachers' System administers a system for retiree health benefits under Internal Revenue Code § 401(h). The Ohio Retirement System has 15 employees with an administrative budget of \$3.5 to \$4.0 million to administer health benefits. As required by the Internal Revenue Code, their board of trustees "establishes" the provisions of the various plans to be offered and the benefits are negotiated with the insurers by the system staff. During active employment, employees pay a contribution rate (currently 2%) for retiree health benefits. There are currently 300,000 retirees from school systems and universities throughout the state.

Pensions

By comparison, the State's unfunded actuarial liabilities for the pension system total \$828.8 million, reflecting total actuarial liabilities of \$28.5 billion less assets of \$27.6 billion. The system is therefore 97% funded and will likely achieve full funding next year, absent a market downturn. As the system becomes fully funded (and overfunded) the system's contribution rate will continue to decline.

Presently, the SRPS consists of the following systems and plans: the Correctional Officers Retirement System; the Employees' Pension System; the Employees' Retirement System; the Judicial Retirement System; the Legislative Pension Plan; the Local Fire and Police System; the Law Enforcement Officers' Pension System; the State Police Retirement System; the Teachers' Pension System; the Teachers' Retirement System; and any other systems that the board of trustee administers.

To date the "other" system reference only applies to the administration of the funds of a pension system established under Sections §7-206 & §7-603 of the Transportation Article for the Mass Transit Administration (MTA). The board invests the monies received from the MTA and pays from those assets as requested by the MTA for pension benefits. In addition, the State Retirement Agency keeps a separate set of accounts for the "municipal pool" of the governmental units that participate in the Employees' Pension System and the Local Fire and Police System.

State Fiscal Effect:

Impact on Postretirement Health Subsidy Liabilities

Under the bill, contributions will be made to the PHFS only when pension contributions decline. Because the State’s actuary does not project State pension contributions to decline, there is no fiscal impact from the bill, versus baseline. To the extent that pension contributions continue their recent pattern of decline, however, these savings would not be available for other purposes and instead would be spent on retiree health insurance.

Historically, annual State pension contributions have declined at times, particularly so over the past several years. These declines are due to investment performance of the SRPS that has exceeded the actuarially-assumed investment return. As the SRPS's assets grow faster than the actuary has projected, the amount of annual contributions required to fully fund the system by 2020 has declined. The change in contributions from year to year over the past ten years is illustrated below:

Change in State Pension Contributions FY 1991 to 2000 (\$ in Millions)			
Fiscal Year	Estimated State Contributions*	Change versus Prior Year	SB 583 Contribution to PHFS (Hypothetical)
2001 (est.)	552.6	-43.7	\$43.7
2000 (est.)	596.3	-51.4	51.4
1999	647.7	-35.8	35.8
1998	683.4	-1.3	1.3
1997	684.8	19.2	
1996	665.6	26.2	
1995	639.4	34.1	
1994	605.3	-11.8	11.8
1993	617.1	5.1	
1992	612.0	22.0	
		Total	\$144.0

* The State Retirement Agency does not officially report State contributions separately from other employer contributions including participating local governments and non-budgeted State agencies. These figures reflect total employer contributions less local employer contributions.

Under the bill, if there is a decrease from year to year in State pension contributions, the amount of the decrease would be transferred to the PHFS and the State's total contributions (including pensions and the PHFS) for that year would remain constant. (Based on historical

contributions, the State's contributions to the PHFS over the past ten years would have been \$144 million.)

The contributions to the PHFS would be invested on the same basis as the other assets of the SRPS. The SRPS's annual investment performance has averaged 13.2% over the past 20 years; however, the State's actuary assumes an investment return of 8%, which is probably more realistic over the long term. The value of assets in the PHFS in fiscal 2010 cannot be reliably estimated at this time, but for illustrative purposes could range between \$145 million and \$725 million, assuming an 8% investment return and annual contributions ranging between \$10 million and \$50 million.

Administrative Expenses

Special fund administrative expenditures could increase by an estimated \$33,291 in fiscal 2001, which accounts for a 90-day start-up delay. This estimate reflects the cost of hiring one additional accountant (Grade 15) to handle the additional accounting work associated with the PHFS. It includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses. Future year expenditures reflect (1) full salaries with 3.5% annual increases and 3% employee turnover; and (2) 1% annual increases in ongoing operating expenses.

It is not assumed that the retirement agency would take over the administration of the health benefit programs for retirees, but if that were the case, the additional staffing needs would be similar to the Ohio system.

Additional Comments: Legal counsel at the State Retirement Agency advises that the proposed provisions of the bill are not in compliance with Section 401(h) of the Internal Revenue Code because the bill does not provide for a dedicated, consistent source of revenue to fund the benefits. (In some years, there could be no contributions to the PHFS.) Legislative Services concurs with this legal analysis and notes that the PHFS may be better constructed as a “special purpose trust” under Section 115 of the Internal Revenue Code. The retirement agency counsel notes that in that instance the assets of the PHFS could not be comingled with those of the pension system, which is a tax-qualified plan. Legislative Services notes that a Section 115 trust is also tax-exempt and that so long as separate accounts are kept (as is the case with the “municipal pool” and the Mass Transit funds) there would be no threat to the SRPS’s tax-qualified status.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): State Retirement Agency; Milliman & Robertson, Inc.; Department of Legislative Services

Fiscal Note History: First Reader - February 16, 2000
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