Department of Legislative Services

Maryland General Assembly
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FISCAL AND POLICY NOTE

Senate Bill 466 (Senator Kasemeyer)
Budget and Taxation

Employees' and Teachers' Pension Benefit Enhancement Act of 2005

This pension bill provides a pension benefit enhancement to members of the Employees' Pension and Retirement Systems (EPS and ERS) and the Teachers' Pension and Retirement Systems (TPS and TRS). The bill increases the benefit multiplier from 1.4% to 1.75% of payroll, and increases the employee contribution rate from 2% to 5% of salary.

The bill is effective July 1, 2005.

Fiscal Summary

State Effect: State pension system liabilities will increase by $1.8 billion. However, the increase in employee contribution will offset these liabilities. Therefore, it is not anticipated that this proposal will affect the employer contribution rate.

Local Effect: Increase in contributions for participating local government units to account for the increase in the employees' systems rates. All teacher pension costs are borne by the State.

Small Business Effect: None.

Analysis

Current Law: Benefits for members of the Employees' and Teachers' Combined Systems are calculated as follows:

(1.4% x Average Final Salary x Years of Creditable Service after July 1, 1998) **plus**:
(1.2% x Average Final Salary x Years of Creditable Service prior to July 1, 1998).

State Fiscal Effect:

Effect on the Individual

Exhibit 1 shows the impact of the multiplier change on two employees. First is an "average employee" in EPS, based on statistics compiled by the State Retirement Agency. The average employee is 46.7 years old with 12.7 years of service and a salary of $41,703. Second is a "new employee," 22 years old with a starting salary of $27,004. This employee will accumulate **all** service credit under the proposed 1.75% multiplier, whereas the average employee has already earned 12.7 years of service credit under the existing benefit structure.

Exhibit 1
Impact of Enhancement on Employees of EPS

	Current Salary	Final Salary	Current Annual Benefit @ 1.4%	Proposed Annual Benefit @ 1.75%	Change in Annual Benefit	Initial Change in Pay with 5% Employee Contribution
Average Employee	$41,703	$75,143	$28,554	$32,762	$4,208	($1,251)
New Employee	$27,004	$84,258	$35,388	$44,235	$8,847	($810)

Source: Department of Legislative Services, Maryland State Retirement and Pension System

As Exhibit 1 indicates, the proposed increase in the benefit multiplier results in a substantial increase in benefits for both sample employees. The average employee will receive an additional $4,208 annually, or $351 per month, and the new employee will receive an annual increase of $8,847, or $737 per month.

The last column in Exhibit 1 illustrates the effect of the increase in the employee contribution rate from 2% to 5% of salary. The average employee will pay $48 per pay period, or $1,251 per year, and the new employee will pay $31 per pay period, or $810 per year.

Effect on the State

The contribution rates for the two largest State pension systems, the employees' and teachers' systems, are fixed from year to year as long as funding for these systems remains in a "corridor" of actuarial funding from 90% to 110%. Should the funding level fall out of this corridor, the rates must be adjusted to account for a percentage of the difference between the prior year's rate and the "true" actuarial rate. The true rate funds both the normal cost (the cost of benefits spread over the span of the employee's career) and a component of any unfunded accrued liability, which is amortized on a 25-year schedule. This method has been in place since fiscal 2003. The annual actuarial valuation (done at the close of each fiscal year) determines the contribution rates for the next following fiscal year (*e.g.,* the fiscal 2004 valuation sets the rates for fiscal 2006). The most recent actuarial valuation (for fiscal 2004) showed that the employees' pension system is 89.2% actuarially funded. Thus, under the corridor method, the contribution rate for fiscal 2006 increased to 5.76% from 4.73% of payroll in fiscal 2005.

An exception to the corridor rule exists for benefit level changes. Changes to benefit levels that impact the normal cost rate must be incorporated into the contribution rate determined by the next valuation, regardless of whether the benefit change would affect the funding status of the system with respect to the corridor.

Looking at the employees' systems only, approximately $650 million in new benefits would be promised to the current active employee population by increasing the benefit multiplier to 1.75%. These benefits carry a first-year cost to the State of $67.7 million, increasing 4% annually for 25 years. Actuarial assumptions about payroll growth, employee population, and investment returns all influence this cost estimate. However, when also increasing the employee contribution rate from 2% to 5% of salary, first-year State contributions fall to $221,000, increasing 4% annually for 25 years. At this point the normal cost of funding benefits will actually be .3% lower than with a 1.4% multiplier and 2% employee contribution, *i.e.,* the 5% employee contribution more than covers any associated normal costs. As mentioned, investment performance, salary growth, and other actuarial assumptions can shift these costs up or down.

Applying the same scenario (*i.e.,* 1.75% multiplier and 5% employee contribution) to TPS and TRS employees promises another $1.25 billion in benefits to the active teacher population and minimally decreases the normal cost rate. This equates to a first-year cost decrease of $900,000.

Exhibit 2 lays out the corresponding effect on State costs for each system.

Exhibit 2
State Costs for Benefit Enhancement

	TPS and TRS	EPS and ERS
Long-term Percentage Change in Employer Normal Cost	(.25%)	(.3%)
Change in Employer Contribution Rate	No Change	
Total Employer Increase in Cost		
FY 2007	($900,000)	$221,000
FY 2008	(1,000,000)	230,000
FY 2009	(1,000,000)	240,000
FY 2010	(1,000,000)	249,000
FY 2011	(1,040,000)	259,000

Although the teachers' systems results show a slight reduction (relative to the current costs of the systems) in long-term costs, any changes in employee demographics between the date of this study (*i.e.,* this analysis uses fiscal 2003 data, the latest available) and the effective date may change the slight reduction in costs to a slight increase in costs.

Total Impact

As shown in Exhibit 2, the implementation of this benefit structure change will decrease the normal cost of benefits by .55%. This creates negative amortization payments of the benefits promised. The first-year (fiscal 2007) savings are $679,000. However, this will not materially impact State pension rates. As mentioned above, this fiscal note is heavily dependant on demographic data. Any change in the demographic makeup could change a slight reduction in costs to a slight increase in costs. Given all these factors, any savings that could be realized by the bill may not materialize, and the employer contribution rates will not be materially affected.

Local Fiscal Effect: Increase in contributions for participating governmental units to account for the increase in the employees' systems rates. All teacher pension costs are borne by the State.

Additional Information

Prior Introductions: None.

Cross File: None.

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

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mp/jr

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