Department of Legislative Services
Maryland General Assembly
2006 Session

FISCAL AND POLICY NOTE

Senate Bill 1055 (Senator McFadden, *et al.*)
Budget and Taxation

Teachers' and Local Employees' Retirement Enhancement Act of 2006

This bill enhances pension benefits for all members of the Teachers' Pension System, Teachers' Retirement System, Employees' Retirement System, and certain members of the Employees' Pension System. The benefit multiplier increases to 2.0% for all service credit. The contribution rate for teachers and employees affected by the bill is 5%.

The bill takes effect July 1, 2006.

Fiscal Summary

State Effect: State pension liabilities increase by $4.5 billion, which amortized over 25 years yields a first-year increase in State pension contributions of $386.4 million in FY 2008, almost all of which is general funds. State costs increase annually according to actuarial assumptions. Special fund expenditures by the State Retirement Agency increase by $300,000 on a one-time basis to fund re-programming costs.

($ in millions)	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
Revenues	$0	$0	$0	$0	$0
GF Expenditure	0	386.4	401.9	417.9	434.6
SF Expenditure	.3	0	0	0	0
Net Effect	($.3)	($386.4)	($401.9)	($417.9)	($434.6)

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

Local Effect: Potentially significant increases for local school boards that are participating governmental units (PGUs) and opt to participate in the enhanced benefit system. Actual cost increases for PGUs cannot be determined at this time because it is not known which PGUs will opt for the enhanced benefit.

Small Business Effect: None.

Analysis

Bill Summary: The bill applies to all members of the Teachers' Retirement System (TRS) and Employees' Retirement System (ERS). It creates a third level of pension benefits within the Teachers' Pension System and the Employees' Pension System called the Alternate Contributory Pension Selection (ACPS) that applies to two additional sets of individuals:

- all current and future members of the Teachers' Pension System (TPS);
- all current and future members of the Employees' Pension System (EPS) who are employed by a local board of education that participates in the contributory portion of the EPS as a PGU.

The employee contribution rate under ACPS is 5%. Members subject to ACPS earn a retirement benefit allowance according to the following formula:

Years of creditable service	x	Average final compensation (AFC)	x	2.0%

For members subject to ACPS, current provisions governing eligibility for early retirement, ordinary disability retirement, and special disability retirement remain unchanged.

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

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

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. For TRS/ERS, AFC is the average annual compensation for the three years of employment during which the member's compensation was highest; those three years need not be consecutive.

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 about 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 nine out of 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 Supplement 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, 12,312 members of EPS who are employed by local boards of education who participate in the contributory portion of EPS, 6,255 members of TRS, and 2,591 members of ERS.

State Expenditures: The bill provides a 42.9% benefit enhancement for TPS/EPS members and an 11.1% benefit enhancement for TRS/ERS members. According to the State's actuary, State pension liabilities could increase by $4.5 billion, of which $4.0 billion is for TPS members, $404 million is for TRS members, and $76 million is for ERS members. Amortizing that liability over 25 years results in State pension contributions increasing by $386.4 million beginning in fiscal 2008. All but a fraction of that amount would be general funds. For TPS, the ratio of system assets to system liabilities would drop from 89.3% to 76.1%, a 13.2 percentage point drop. 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.

The retroactive benefit in this bill accounts for the large State price tag because it provides a benefit that has not been paid for. Most TPS members made no employee contribution toward their pension from January 1, 1980 until July 1, 1998, when TPS was noncontributory, and the State made contributions to pay for a lower accrual rate. From 1998 until the present, TPS members have paid 2% for a 1.4% accrual rate, and the State also made contributions toward that accrual rate. By increasing the accrual rate to 2.0% for all their years of service without requiring members to pay the difference between the contribution rates in effect during those years, the bill increases the system's liabilities and ultimately requires the State to pay that difference over time.

ERS/TRS members have been paying the higher 5% or 7% contributions all along to get the higher 1.8% benefit, but retroactivity gives those who paid nothing for 18 years and 2% for the past eight years a higher benefit than those who have been paying 5% or 7% all along. Even though ERS/TRS members will benefit from this enhancement by increasing their accrual rate from 1.8% to 2.0%, TPS members will be benefiting to a far greater extent.

With the new accrual rate in place, teachers and employees hired since 1980 will retire with 60% of their AFC, up from the current rate of 38.4% under TPS and 54% under TRS/ERS.

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 the benefit enhancement retroactive and creating a single tier of benefits, the bill minimizes the cost of reprogramming the computer system. At the same time, making participation for PGUs optional could increase the cost because the system will have to be reprogrammed to accommodate each PGUs choice. Also, the computer system's age and complexity will require additional programming resources, estimated to total $300,000 in fiscal 2007.

Local Expenditures: The bill gives local school boards that are PGUs the option of joining ACPS or remaining in the contributory portion of EPS in which they currently participate. PGUs that remain in their current systems will not experience additional costs, but their employees will not receive the enhanced benefits, either. Actual cost increases for PGUs that opt for the enhanced benefit cannot be calculated at this time because it is not known which of them will opt for the enhanced benefit system. Once that is known, employer calculations for those PGUs will be determined by an actuarial valuation that will be based on the employee profiles of the participating local school boards.

Additional Information

Prior Introductions: None.

Cross File: None.

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