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Analysis

H.B. 1 – Rep. Sykes
Proposed Reduction in PERS Employer Contribution Rate

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ORSC Position

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The Governor recently proposed, as part of the 2010-2011 biennium budget, to reduce the state's employer contribution to PERS from 14% to 8% for the next biennium.

No language has been drafted that we are aware of; therefore, this analysis will cover the general concept of reducing the employer contribution rate.

Staff Comments - Ohio law currently gives the PERS board the authority to set this rate at no more than 14% for general division employees and 18.1% for public safety and law enforcement officers (R.C. §§145.48, 145.49). It is unclear if the Governor's proposal would include a reduction in the employer contribution rate paid for state employees who are public safety and law enforcement officers. This reduction directly contradicts the recent increase in employer contributions the state will be paying for state troopers who are members of the Highway Patrol Retirement System (HPRS). Pursuant to R.C. §5505.15, the HPRS board certified to the director of budget and management a 1.0% increase in the employer contribution rate from 25.5% to 26.5% of payroll (eff. 7-1-09 to 6-30-11).

The Governor's office has indicated the intent to repay this money to PERS over the next decade. This is akin to what has been happening to Social Security. Congress has repeatedly borrowed from Social Security to pay non-pension related expenses and instead has given the fund IOU's to be paid at a later date. According to "*The 2009 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds*," Social Security's combined trust funds are projected to become exhausted in 2037. A major reason Ohio has consistently opposed Social Security coverage for its public employees is because of the financial instability of Social Security. PERS provides comprehensive retirement, disability, survivor and health care coverage in lieu of Social Security for Ohio public employees and retirees. 90% of PERS retirees remain in Ohio and in 2008 they received over $3.1 billion in pension benefits and $1.3 billion in health care benefits. Economic studies have supported that every $1 of contributions to PERS returns $2.58 back into the Ohio economy.

If the Legislature enacts the Governor's proposal to reduce the current employer contributions to PERS, there would be a number of negative impacts as follows:

- Set a dangerous precedent. The Governor's proposal would affect only state employees, however, local governments and school districts also contribute to statewide retirement systems. If the state refuses to pay their full share of employer contributions, it is highly likely that cities and school districts, most of whom are also facing budget crises, would seek a reduction in their contributions as well. This would harm the other systems as well. It sets the precedent for diverting retirement contributions for other purposes. Once this precedent is set, it is only a matter of time before other interest groups attempt to borrow from the remaining four public pension systems.

- Jeopardize discretionary retiree healthcare benefits, which are funded by statute through a portion of employer contributions on a pay-as-you-go basis with limited reserves. PERS currently allocates 5.5% of employer contributions to fund healthcare. Under federal tax law, assets held in trust for the payment of pensions may not be transferred or otherwise used for the payment of retiree healthcare benefits. According to PERS, healthcare benefits would need to be reduced and retiree healthcare funding could be completely eliminated within ten years. Under this proposal, local governments would be subsidizing healthcare for state retirees because there would be no state employer contributions available for funding healthcare.

- Create significant unfunded actuarial liabilities and further exacerbate the current actuarial funding deficiency in PERS to amortize such liabilities over a maximum 30-year funding period as required by S.B. 82 (eff. 3-7-97). This would gradually disfund the retirement systems as the funded ratio (assets divided by actuarial accrued liabilities) would decrease over time and the funding period would increase indefinitely. In order to avoid this, even greater increases in contribution rates and/or greater reductions in benefits in the near future would be needed to bring the retirement systems into actuarial balance. According to PERS, it is estimated that the funding period would increase to 50 years by the end of 2012 under this proposal. The PERS board acted prudently as fiduciaries in March to reduce the employer contribution allocation to discretionary retiree health care from 7% to 5.5% of payroll and to increase the employer contribution allocation to the mandated pension benefits from 7% to 8.5% in order to achieve a 30-year funding period. The Governor's proposal would leave the system 0.5% short to fund state employees' pensions because it would total only 8.0%, leaving no contributions available for healthcare. Further modifications to contributions and/or benefits are expected to be necessary in order to maintain a 30-year funding period as PERS will be unable to invest itself out of the actuarial funding deficiency created as a result of the steep decline in investment market values.

- Lower the state's bond rating, which would make it more expensive for the state to borrow money. Illinois, for example, has underfunded its pension plans, which led to a lower bond rating for the state.

- Require each retirement system to liquidate assets in depressed investment markets, thereby incurring significant investment losses, to meet their annual benefit payouts. The annual benefit payouts exceed the annual contributions in PERS, with investment earnings being used to pay the balance. This is to be expected for mature retirement systems like PERS that have been funded on an actuarial basis. Investment income funds approximately 70% of the benefit payments.

- Require the PERS board in exercising its fiduciary duty to take legal action against the state for failure to pay required contributions. Similar legal action was successfully taken by public pension funds in California and North Carolina.

- Violate the exclusive benefit rule under PERS law and federal tax law by diverting retirement contributions to pay for general operating expenses of the state. Under the exclusive benefit rule retirement contributions must be used for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan, and may not be used for the purpose of balancing the state's biennial budget.

- Raises the legal issue of whether the current legislature can bind future legislatures by a promise to repay the funds.

- To the extent PERS cannot provide the current level of benefits to future retirees, there will likely be an increase in cost to the State as retirees turn to other government programs for public assistance.

Given the severe decline in investment market values since the end of fiscal year 2008 and the need to begin evaluating options to address this situation proactively, PERS, in consultation with the ORSC, has begun work to develop a legislative proposal that would reduce its funding period to no more than thirty (30) years as required under S.B. 82. Under the current contribution and benefit levels, PERS as a whole is expected to exceed the 30-year funding period as PERS begins recognizing its investment losses in each of the next four years. (As of the last actuarial valuation, the PERS law enforcement division had a funding period of infinity; the PERS state and local government divisions were within a 30-year funding period.) Council staff has been working with all five systems to develop a proposal that would reduce each system's funding period to the maximum 30 years. The Council approved a motion to have staff work with OP&F on December 10, 2008; on March 11, 2009 with STRS, and on April 8, 2009 with PERS, SERS, and HPRS.

The 30-year funding period for amortizing each system's unfunded actuarial accrued pension liabilities was established as part of S.B. 82 in 1997. It was modeled after the national standard adopted by the Governmental Accounting Standards Board for all governmental pension plans. The change was intended to maintain inter-generational equity among taxpayers and system members by limiting the ability to fund benefit costs by extending the funding period beyond 30 years. Unlike Social Security, which essentially has been financed on a pay-as-you-go basis, Ohio's public pension plans are actuarially funded. Any system that does not meet the 30-year maximum must submit to the ORSC a board-approved plan to reduce the amortization period to not more than 30 years.

At the request of the ORSC, each retirement system and its actuary are currently conducting a comprehensive review of various changes in contributions and/or benefits and the actuarial impact thereof upon the funding period and funded ratio of the retirement system. The systems will present their proposed plans to the Council at the September 9, 2009 ORSC meeting. The proposed reduction circumvents this process. The potential changes under review that could be incorporated into a plan are generally as follows:

- Increase in contributions;
- Increase in retirement age;
- Change in benefit calculations;
- Adjustments to COLA's.

Fiscal Impact - PERS estimates this reduction would cost the system $256 million over the next biennium. It is estimated that even if the state were to repay the lost funds with interest there would be a shortfall of $183 million in investment opportunity costs after the loan was repaid. However, PERS has not had the opportunity to perform a complete actuarial analysis of the proposal to determine the long-term cost. Current law requires PERS to complete an actuarial analysis of all proposed legislation expected to have a measurable financial impact on the system. The analysis must be completed and sent to the ORSC within 60 days of introduction of the proposed legislation. The ORSC has an independent actuary who can review these analyses. No legislation has been introduced to date nor have details of the plan been released so PERS' actuary could complete a detailed analysis.

ORSC Position– The Ohio Retirement Study Council voted at its July 8, 2009 meeting to recommend that the 128th Ohio General Assembly disapprove any reduction in the employer contribution rate.