Fiscal Note

BILL # HB 2028

TITLE: PSPRS; contribution rates

SPONSOR: Livingston

STATUS: As Amended by Senate FIN

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Description

The bill would reduce the employee contribution rate for certain PSPRS employees. Under current law, PSPRS members hired during a specific timeframe (on or after 7/20/11 through 6/30/17) generally pay an employee contribution of 11.65%, although this rate may be reduced to 7.65% depending on the actuarial valuation of their employer group. The bill would instead establish a fixed 7.65% employee contribution rate for these employees beginning in FY 2024. The bill is retroactive to June 30, 2023 and contains an emergency clause.

Estimated Impact

The bill is expected to have a minimal fiscal impact for both state government and local governments.

Analysis

A.R.S. § 38-843 specifies that PSPRS members are required to make employee contributions based on the lower of the following 2 amounts: 1) 11.65%; or 2) 33.3% of the sum of the employee contribution rate from the preceding fiscal year and the actuarially determined employer contribution rate for the current fiscal year, except that the calculated employee rate may not be less than 7.65%.

Based on litigation of the enactment of Law 2011, Chapter 357 (SB 1609), the above test to determine the PSPRS employee contribution rate only applies to PSPRS members hired during a specific timeframe (on or after 7/20/11 through 6/30/17), generally known as "Tier 2" members. Members hired before then ("Tier 1" members) are subject to a fixed 7.65% employee contribution rate, while members hired after that ("Tier 3" members) are subject to a different calculation which is dependent on their selection of a defined benefit or defined contribution plan.

Instead of the above test, the bill would establish a fixed 7.65% employee contribution rate for these Tier 2 employees beginning in FY 2024.

Fiscal Impact – 100% Funded PSPRS Employer Groups

In general, once an employer group has eliminated its unfunded actuarial pension liability, the statutory test for employee contribution rates results in Tier 2 employees paying a contribution rate of 7.65%. For these fully funded employer groups, the bill's establishment of a fixed 7.65% employee contribution rate for Tier 2 members would have no fiscal impact. As of the latest PSPRS actuarial valuation (data from June 30, 2022), there are 4 state government employer groups and 48 local government employer groups that have a funded ratio of at least 100%.

Fiscal Impact – PSPRS Employer Groups With Unfunded Liability

For employer groups that currently have an unfunded actuarial pension liability, the statutory test for employee contributions generally results in Tier 2 employees paying the maximum contribution rate of 11.65%. However, as the employer's PSPRS group trends towards becoming fully funded (usually when assets are above 95% of liabilities), the employee contribution rate is typically gradually reduced from 11.65% to 7.65% with each succeeding annual valuation until the group becomes fully funded.

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As of the latest PSPRS actuarial valuation (data from June 30, 2022), there are 5 state government employer groups that have a funded ratio of less than 100% – however, each of these state groups does have a funded ratio of at least 95%. For local government employer groups, the funded ratio can vary significantly by employer.

Therefore, the bill establishing a fixed 7.65% employee contribution rate would reduce the employee contribution rate for the Tier 2 members of these groups. The level of employee rate reduction, however, would depend on the funded status of the individual employer group.

Even though the bill would reduce the Tier 2 employee contribution rates for these groups with unfunded liability, this is not expected to have a fiscal impact due to the statutory maintenance of effort (MOE) provisions. Under the MOE process, the annual PSPRS actuarial valuation disregards any Tier 2 employee contributions made above 7.65% – in the example of a standard employer with unfunded liability where the Tier 2 employee contribution rate is 11.65%, this means that 7.65% is accounted for and 4% is excluded from the valuation. Instead, these "excess" 4% contributions are collected and invested by PSPRS, and the accumulated amounts becomes available for use in the actuarial valuation process once the employer group has reached fully funded status (when assets are 100% or more of liabilities). At that time, these newly-accounted for assets are used to offset the employer's calculated contribution rate.

Given that "excess" contributions above 7.65% are initially disregarded in the actuarial valuation process, the bill replacing the calculated Tier 2 employee rate with a fixed 7.65% rate would have no immediate fiscal impact on the employer contribution rate for groups with unfunded liability.

Over the longer term, the bill's implementation of a fixed 7.65% employee contribution rate would mean that currently underfunded employers would no longer accumulate "excess" Tier 2 employee contributions for use once their account was fully funded.

Under current law, the future use of any "excess" contributions is expected to have a minimal impact on an employer's contribution rate once they reach a 100% funding ratio. The state's largest PSPRS employer group, the Phoenix Police Department, currently implements the maximum 11.65% Tier 2 employee rate due to their status as a group with unfunded liability. At this time, the Phoenix Police group has accumulated $25 million from the excess MOE contributions since 2011. Given that the Phoenix Police group's current total pension liability is approximately $4.0 billion, those relative magnitudes suggest the use of the MOE balance once the Phoenix Police group is fully funded is likely to be minimal compared to the impact of other actuarial changes (such as investment performance).

Therefore we estimate the bill's impact of ending any future "excess" Tier 2 employee contributions will have a minimal impact on PSPRS employer contribution rates as various groups reach 100% funded status.

<u>Disposition of Current MOE Contribution Balances</u>
As noted above, the bill's impact would result in underfunded PSPRS employers no longer collecting any future "excess" contributions for Tier 2 members. As part of that policy change, the bill also authorizes underfunded PSPRS employers to immediately account for their current MOE balances, rather than having to wait until reaching 100% funded status.

The immediate usage of the MOE account balance would provide one-time contribution rate savings to the employers in various underfunded PSPRS groups. To provide a sense of magnitude for these savings, in the example of the Phoenix Police group, the FY 2024 PSPRS actuarial valuation assumes the City of Phoenix will pay total employer contributions of $195.3 million for all PSPRS members. Given the bill's effective date, the City of Phoenix would be able to use their current MOE balance to supplant $25 million of FY 2024 contributions, resulting in one-time savings for the City. At this time, we do not have a statewide estimate of available MOE balances that could be used for one-time employer savings in FY 2024.

<u>Individual Income Tax Impact</u>
As a tax-exempt qualified pension plan under federal tax law, PSPRS employee contributions are made on a pre-tax basis and are not included in the member's annual taxable income. By lowering the amount of pre-tax PSPRS employee contributions made by Tier 2 employees, those employees would report higher annual taxable income, all else being equal. This impact is expected to be minimal, both for individual employees and on a statewide basis.

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