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ARIZONA TAX RESEARCH ASSOCIATION

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Salaries and Benefits Dominate State and Local Government Budgets

AZ Public Employees Rank 4th in Adjusted Average Salaries

Over the last two years, the public debate in Arizona has been dominated by the effects that the on-going recession has had on state and local government budgets. The recession has stripped 300,000 jobs out of the Arizona economy and state and local tax revenues have seen precipitous declines. Since FY 2007, state general fund revenues have declined 35%.

As tax revenues declined, state and local policymakers faced difficult choices in making cuts to the "current services" budgets they became accustomed to approving. In the early stages of the recession, policymakers at both the state and local level focused their attention on reducing programs or services that directly impact the general public. From increasing student teacher ratios to reducing the number of police officers and fire fighters, most of the options exercised steered away from across-the-board reductions in the largest budget item; salaries and benefits.

Salaries and benefits of employees have dominated state and local government budgets for years. Salaries and benefits account for roughly 85% of

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Arizona's Pension Plans in Need of Reform

Arizona public pension systems are swimming in red ink and, unless reformed, threaten to break taxpayers with unsustainable costs to fund these mandated benefits. Over the years, there have been many proposals introduced at the Legislature to reform Arizona's pension plans; however, most of those proposals have been directed toward increasing member benefits rather than seeking real reforms to the systems. Although a recent study by the PEW Center on the States ranked ASRS as one of the healthiest pension plans in the country, further reforms to the system need to be made, particularly to Arizona's other three pension plans—the Public Safety Personnel Retirement System (PSPRS), the Correction's Officers Retirement Plan (CORP), and the Elected Officials Retirement Plan (EORP), which closely resemble the pension plans of the other states that ranked poorly in the same study.

According to the PEW study, a one trillion dollar gap existed at the end of fiscal year (FY) 2008 between retirement benefits states promised to their employees and the costs associated with those benefits. The study rated the plans across the country on how well they manage their plans by analyzing the funding ratios of pension plans, health care benefits and other benefits. Based on the 50-state comparison, Arizona (ASRS) was rated among the top-performing plans in the country.

In addition to the loss in assets as a result of the market downturn, the study points to other factors that contributed to the massive decline in public pension assets. Regarded by the authors of the study as a general lack of discipline, the states continued to provide additional benefits, including cost-of-living increases and retiree health care, without adequately funding those additional benefits.

Many states have responded to the losses to their pension plans by adopting reforms to ensure that their systems remain solvent. According to the study, the number of states that have passed legislation to reform some aspect of their systems has been growing over the past few years. The most common reforms made by the states have included reducing benefits, increasing retirement age, increasing employee contributions, and shifting board membership to non-pension recipients. In addition, some states have considered switching to a defined contribution plan, in which retirement benefits would be based on the amount in the retirement account and not on a fixed benefit into perpetuity.

Just like all other states, Arizona's pension plans have been hit hard as a result of the economic downturn. For example, at the end of FY 2009, the ASRS actuarial funding ratio (based on a ten-year smoothing period) had dropped to 79.1%. The one-year market funding ratio of ASRS was much lower at 56.5%. PSPRS, CORP, and EORP experienced even greater losses. At the end of FY 2009, the actuarial funding ratios, based on a seven-year smoothing period, for PSPRS, CORP, and EORP were 68.2%, 86.4%, and 71.3%, respectively. Considering just the one-year market funding ratio at the end of FY 2009 resulted in ratios of 47.9% for PSPRS, 59.7% under CORP, and a 50% ratio for EORP. The significant losses in Arizona's pension plans, particularly PSPRS, CORP, and EORP, makes it clear that major reforms are needed to address the flaws in the systems in order to regain financial stability.

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the maintenance and operation budgets of most school districts. The operating budget of the City of Phoenix dedicates over 90% to salaries and benefits of city employees. Maricopa County, after excluding payments to the state for low income health care, dedicates 76% of its budget to salaries and benefits.

With salaries and benefits dominating budgets, recent reports of salary increases for public employees seem to be inconsistent with the current revenue situation. According to the *Arizona Republic*, the City of Mesa gave merit raises totaling $2.5 million to 1,600 of the cities employees. Similarly, 500 employees of Maricopa County received $1.2 million in raises despite layoffs of other employees.

As always, the greatest controversy surrounding the effects of state budget reductions has been with the K-12 school districts. In most instances, reductions to the formulaic increases that drive K-12 spending result in school districts suggesting that teachers will have to be let go. Union leaders have repeatedly raised the specter of student to teacher ratios being increased dramatically as a result of the relatively modest decreases to school funding over the last two years.

From FY 2007 to FY 2009, school districts increased their total full-time equivalent (FTE) positions by 4.2%, an increase of 4,575 positions. The increase was nearly evenly divided between classified staff and certified employees. In FY 2007, school districts spent an average of $49,098 per FTE. In FY 2009, they spent an average of $51,262, an increase of 4.4%.

While many continue to insist that budget cuts will lead to dramatic increases in class sizes, the state could actually fund school districts at a level $243.7 million lower than the FY 2009 amount and do it without issuing a single reduction in force (RIF) notice. This could be accomplished by rolling back salary schedules to their FY 2007 amounts. The pay reduction would affect each school district employee but no one would lose their job. The dramatic increases in student to teacher ratios would not occur and students' education would not be effected.

The national rankings of public employees indicate that salaries may be a logical place for policy makers to look for budget savings. In 2006, Arizona ranked 21 in the nation for the highest average annualized payroll of public employees. By 2008, the salaries had increased by $4,000 and the state's ranking moved to 19. When each state's average annual payroll is expressed as a percentage of the state's per capita income, Arizona ranked 4th in the nation in both 2006 and 2008. It is not a surprise that Arizona's public employees rank high relative to their peers in other states. Arizona has experienced significant growth in revenues over the last 20 years. The overwhelming majority of this revenue growth went directly to the salaries and benefits of public employees.

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One characteristic of ASRS that other states have moved toward is the equal sharing of pension contributions by the employer and employee. In contrast, the employers of PSPRS, CORP, and EORP bear a disproportionately higher share of the burden. The employee contribution rates of these plans remain fixed, and therefore, the employer contribution rates have been dramatically inflated to compensate for keeping the employee contribution rates artificially low. For instance in FY 2009, the PSPRS employer rate was 21.71% while the employee rate was 7.65%. Similarly under EORP, the employer rate was 28% while the employee rate remained fixed at 7%. In comparison, the ASRS employer and employee contribution rates in FY 2009 were identical at 9.45%.

Shifting the bulk of pension costs onto the employers has resulted in tremendous upward pressure to total employer contributions over the last ten years, placing additional strains on state and local government budgets. Since FY 1999, ASRS employer contributions increased 398% (770% if only considering pension contributions and excluding contributions to health care and long-term disability premiums), PSPRS increased 640%, CORP 227%, and EORP 347%.

Another factor that has contributed to the increased employer contribution rates is the significant drop in total active membership, as a percentage of total membership, for the four plans. For instance, in FY 1999, the relationship that active membership had to total membership was 61% (ASRS), 73% (PSPRS), 92% (CORP), and 51% (EORP). In FY 2009, the percentage of members paying into the systems dropped considerably to 40% (ASRS), 65% (PSPRS), 78% (CORP), and 46% (EORP).

One way to address the decrease in active membership is to increase the number of years that a member is required to remain in the system prior to retirement. Under ASRS, normal retirement is based upon an 80-point methodology, which is calculated by adding the members' total years of service to the members' age. Currently, the average retirement age for a member under ASRS is 61.5 years. Under the other three plans, a member can retire at any age with only 20 years of credited service. Not surprisingly, the average retirement age for a member of PSPRS, for instance, is much lower at 50.8 years and 57.2 years for a member of CORP.

One of the other areas of public pension plans that the PEW study questioned was how realistic an assumed actuarial rate of return of 8% was, which is the average rate used by most state pension plans. The PEW study pointed out that "the top 100 private pensions had an average assumed return of

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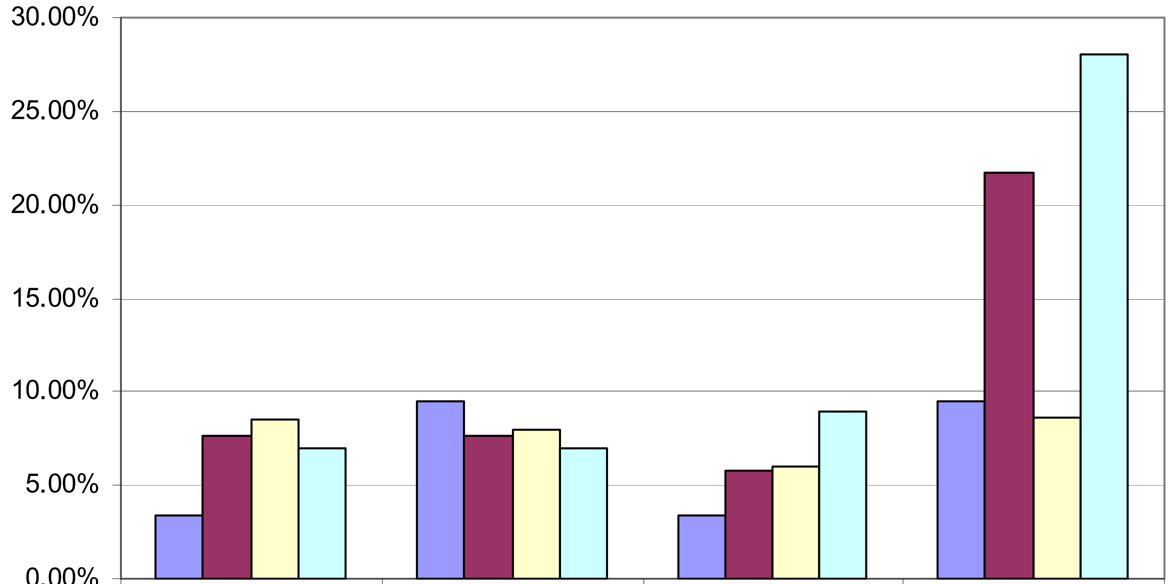
Average Salaries of Public Employees

	Average Annualized Payroll of Public Employees				Average Payroll as a % of Per Capita Income			
State	**2006**	**Rank**	**2008**	**Rank**	**2006**	**Rank**	**2008**	**Rank**
Alabama	$36,945	38	$40,064	39	117.3%	25	118.6%	21
Alaska	$50,037	11	$53,761	10	128.6%	6	122.1%	13
Arizona	$44,132	21	$48,271	19	131.7%	4	140.6%	4
Arkansas	$33,729	51	$36,343	50	114.1%	30	112.2%	36
California	$59,267	1	$65,100	1	143.1%	1	149.2%	1
Colorado	$46,217	17	$49,164	18	113.0%	34	114.4%	34
Connecticut	$54,523	4	$58,153	4	103.5%	45	103.3%	44
Delaware	$46,423	15	$49,675	16	118.5%	19	122.6%	12
District of Columbia	$58,260	2	$63,700	2	97.0%	50	96.3%	50
Florida	$41,822	24	$46,384	22	109.2%	39	118.1%	24
Georgia	$38,553	33	$40,943	35	115.2%	28	117.3%	28
Hawaii	$46,322	16	$49,895	15	120.3%	16	118.6%	22
Idaho	$35,638	45	$40,338	36	112.5%	35	122.0%	14
Illinois	$46,846	13	$50,098	14	118.5%	22	118.3%	23
Indiana	$39,422	29	$41,311	33	119.9%	17	119.4%	17
Iowa	$40,552	26	$45,006	25	119.8%	18	120.3%	15
Kansas	$36,794	39	$39,347	44	102.9%	46	101.4%	48
Kentucky	$35,634	46	$38,560	46	118.3%	23	120.2%	16
Louisiana	$35,340	47	$39,769	42	104.7%	44	109.2%	39
Maine	$37,809	36	$40,337	37	112.1%	37	110.6%	38
Maryland	$50,982	7	$55,623	7	113.0%	33	115.0%	32
Massachusetts	$50,406	10	$53,535	11	106.5%	41	104.5%	42
Michigan	$46,564	14	$50,531	13	140.3%	2	144.6%	2
Minnesota	$47,242	12	$50,821	12	118.1%	24	118.1%	25
Mississippi	$33,972	50	$35,701	51	121.3%	14	117.4%	26
Missouri	$36,054	43	$38,583	45	105.8%	43	105.3%	41
Montana	$36,466	41	$39,353	43	113.2%	32	113.6%	35
Nebraska	$39,598	28	$42,248	31	110.8%	38	107.9%	40
Nevada	$50,621	8	$55,657	6	128.6%	7	135.1%	6
New Hampshire	$40,302	27	$44,820	27	98.3%	49	102.7%	47
New Jersey	$55,721	3	$61,298	3	116.9%	26	119.4%	18
New Mexico	$36,249	42	$39,791	41	118.5%	21	119.0%	20
New York	$54,503	5	$57,246	5	123.9%	12	117.4%	27
North Carolina	$38,715	32	$42,135	32	115.1%	29	119.2%	19
North Dakota	$38,845	31	$41,130	34	115.6%	27	103.2%	45
Ohio	$42,818	22	$46,372	23	125.6%	11	128.7%	9
Oklahoma	$34,027	49	$37,316	48	102.2%	47	103.7%	43
Oregon	$45,099	20	$49,604	17	130.3%	5	136.7%	5
Pennsylvania	$45,829	18	$46,998	21	122.8%	13	117.1%	29
Rhode Island	$53,102	6	$54,769	9	138.3%	3	132.4%	7
South Carolina	$36,778	40	$40,227	38	118.5%	20	123.1%	11
South Dakota	$35,770	44	$37,848	47	105.9%	42	97.9%	49
Tennessee	$37,110	37	$40,040	40	112.5%	36	114.5%	33
Texas	$38,259	35	$42,290	30	108.5%	40	112.0%	37
Utah	$38,901	30	$44,967	26	128.3%	8	140.8%	3
Vermont	$40,852	25	$44,747	28	113.4%	31	115.7%	30
Virginia	$42,221	23	$45,456	24	102.1%	48	102.8%	46
Washington	$50,608	9	$55,439	8	127.7%	10	129.4%	8
West Virginia	$34,624	48	$36,477	49	120.5%	15	115.3%	31
Wisconsin	$45,689	19	$47,514	20	128.1%	9	125.8%	10
Wyoming	$38,273	34	$43,296	29	85.6%	51	89.1%	51
United States	**$45,173**		**$48,805**		**119.7%**		**121.4%**	

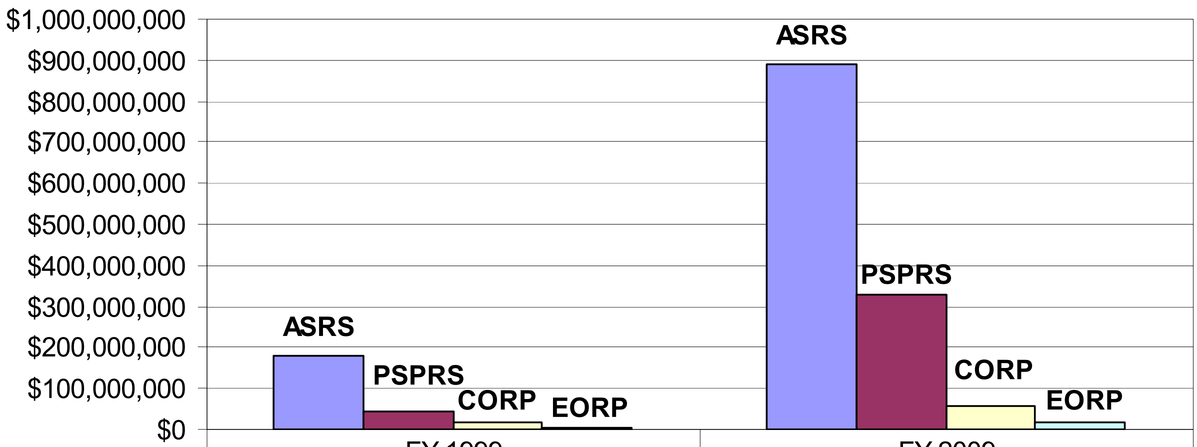
Source: U.S. Census Bureau, Census of Governments, Annual Surveys of State and Local Government Employment and Payroll, 2006 and 2008.

Change in Contribution Rates (FY 1999 - FY 2009)



	Member Rate FY 1999	Member Rate FY 2009	Employer Rate FY 1999	Employer Rate FY 2009
ASRS	3.34%	9.45%	3.34%	9.45%
PSPRS	7.65%	7.65%	5.82%	21.71%
CORP	8.50%	7.96%	5.98%	8.65%
EORP	7.00%	7.00%	8.90%	28.00%

Change in Total Employer Contributions (FY 1999 - FY 2009)



	FY 1999	FY 2009
ASRS	$179,086,635	$891,747,000
PSPRS	$44,384,344	$328,436,309
CORP	$17,109,704	$56,015,138
EORP	$4,126,694	$18,446,377

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6.36%" as of December 2008. And according to some experts "it will take consistently higher levels of investment returns over a number of years for states to make up their losses from 2008 and 2009." Currently under ASRS, the assumed rate of return is set at 8%. The assumed rate of return under PSPRS, CORP, and EORP is even higher at 8.5%.

Lastly, the ASRS plan provides up to a 4% permanent benefit increase (PBI) to its retired members, which is determined annually on a rolling 10-year period and granted only if the actuarial rate of return exceeds 8% (the difference between the return on investment and the assumed rate of return). As a result of the fund losing money over the last several years, retirees of ASRS have not received a COLA since FY 2005. Conversely, under PSPRS, CORP, and EORP, half of the excess returns exceeding 9% on a rolling 7-year period are deposited into an excess investment earnings fund. So even if the plan loses money in one year, retired members can still receive a PBI as long as there is a balance in the fund. That is why on July 1, 2009, even though the plans actual rate of return was -17.72%, members still received a PBI. What is even more problematic is that the PBI reserve is not counted for under the plans funding ratio or in the calculation of the contribution requirements.

The benefits provided under Arizona's four retirement systems have been crafted mostly on an ad hoc basis without much consideration as to the impact of those benefits in the future. Those benefits come at a price, however, and must be funded adequately to maintain solvency in the systems. In addition to continuing to make reforms to ASRS, it is vital to the future health of the pension plans of PSPRS, CORP, EORP that responsible reforms are made to these systems as well. Some of the reforms that should be considered include increasing the normal retirement age so that active members pay into the system for a longer period of time, reducing the actuarial assumed rate of return to reflect a more realistic return, requiring employees to share equally with employers in funding the systems, adopting a more responsible formula in funding PBI's, in addition to considering switching from a defined benefit plan to a defined contribution plan. These recommendations to reform Arizona's pension plans are crucial especially now as state and local governments struggle to balance their budgets.

Jennifer Schuldt