

UNDERSTANDING ARIZONA'S PROPOSITIONS: 2016 SERIES

Prop 124 – Changes to the Public Safety Personnel Retirement System (PSRS)

By Thom Reilly

Director, Morrison Institute for Public Policy
Professor, School of Public Affairs
Arizona State University

Arizona is one of seven states (Alaska, Hawaii, Illinois, Louisiana, Michigan and New York being the others) that have constitutional protections for public pensions. In fact, Arizona, New York and Illinois have the strongest public pension protections in the country.¹

Voters amended the Arizona Constitution in 1998 to state that public retirement programs are a contract and therefore benefits cannot be cut. The courts have determined that these protections include both current and future benefits.

For instance, in April 2011 the Arizona Legislature passed a series of reforms to state retirement systems that included hikes in employee contribution levels and decreases in cost-of-living adjustments. However, due to Arizona's constitutional provision barring any diminishment of pension benefits, the reform plan was found unconstitutional – and local governments were ordered to pay back affected workers with interest.

Proposition 124 would amend the Arizona Constitution to create an exception to the current prohibition against diminishing or impairing public retirement systems benefits by allowing adjustments to the Public Safety Personnel Retirement System (PSPRS).

Proposition 124 would make three major changes to PSPRS:

- 1) Exchanges the current retiree permanent benefit increase (PBI) structure for a compounding annual cost of living adjustment (COLA), based on inflation using the Phoenix-Mesa Consumer Price Index, capped at 2 percent;
- 2) Establishes a voluntary “catch-up” Defined Contribution (DC) provision for non-social security participants hired after Jan. 1, 2012 and before Jan. 1, 2017; and

- 3) Allows the Arizona Legislature the ability to modify public retirement benefits for future or prospective employees.²

A companion bill, Senate Bill 1428, contains other adjustments to the system. This bill, passed by the Arizona Legislature in 2016 and signed into law by Governor Doug Ducey, does not require voter approval but its provisions require passage of Prop 124.³

Background

The soundness of many state and local pension and retiree healthcare plans are of grave concern. Nationwide, unfunded liabilities for state and local pensions and retiree health care range from \$1.4 trillion to over \$4 trillion, depending on what assumptions one uses.⁴

Presently, most public pension plans guarantee retirees a set income for the rest of their lives. Because of this defined benefit, taxpayers are responsible regardless of how much government or the employees contribute to the system, or how well the market performs. In contrast, private-sector workers generally are enrolled in 401(k)-style retirement accounts or defined contribution plans based on what they and their employer contribute, as well as market returns. This means that private-sector employees largely are responsible for their own retirement savings.

The Arizona Legislature created PSPRS as a state pension system for police officers and firefighters. Currently PSPRS has 48 percent of the funds needed to meet current and future retirement payments.⁵ Public pension plans are ideally expected to maintain a minimum funding level of 80 percent. Plans slipping below 60 percent are considered weak.⁶ The \$6.6 billion in unfunded liability accumulated over the past decade has severely impacted local governments' ability to hire police officers and firefighters. Two primary factors have been cited for the weakening of PSPRS: (1) the system's current Permanent Benefit Increase (PBI) mechanism, and (2) underperforming investment returns.⁷

The PBI was designed to adjust benefit levels for retirees upward over time. However, this has contributed significantly to the current financial problems for PSPRS by skimming assets off the top of the fund in years when the market was performing well. PSPRS investment returns over 9 percent are diverted to a separate PBI fund that cannot be used to address the unfunded liability and does not earn interest. Additionally, PBI benefits are not linked to inflation yet retirees have been receiving a PBI benefit for the past 20 years despite the continuing declining of the fund.⁸

Like many public pension systems nationally, Arizona has used an unrealistic expected annual rate of return on investments between 7.5 percent to 8 percent. The annual investment rate nationally for public pensions over the past 10 years has been 5.6 percent.⁹ The actuarially valued returns since 2002 for Arizona PSPRS have been 5 percent or less. This has contributed to the poor financial condition of the fund and has increased its unfunded liabilities.¹⁰

The Reform Proposal

Arizona Senate Bill 1428 was passed by the Legislature and signed by Governor Ducey to address these. The bill contains numerous reforms, chief among them are:

- Linking retirees’ pension-cost-living adjustments to a pre-funded regional (Phoenix-Mesa) Consumer Price Index, with a cap of 2 percent for current employees and retirees. For new employees it restricts or eliminates cost-of-living adjustments when the plan falls below 90 percent funding.
- Creating a retirement plan for new employees hired on or after July 1, 2017. This new plan would give employees the choice of a full 100 percent defined contribution plan, similar to a 401k, or a defined benefit hybrid plan. It would also require new employees to work until age 55 before retiring (up from 52.5 years) and change the pension benefit multiplier from a flat 2.5 percent to a graded multiplier that ranges from 1.5 percent to 2.5 percent depending on years of service.
- Capping pension benefits for new employees based on a maximum salary of \$110,000 (from the current cap of \$265,000) per year thus preventing forms of “pension spiking”.
- Creating a three-tier classification of employees for the purposes of benefits:
 - Those hired before Jan. 1, 2002.
 - Members hired with less than 20 years of credited service before Jan. 1, 2012 employees hired between Jan. 1, 2012 and June 30, 2017.
 - Those hired July 1, 2017 and thereafter.
- Increasing the number of PSPRS governing board members to nine, from seven; adding an advisory council; requiring certain minimum qualifications for board members and prohibiting the removal of a board member without cause.
- Creating a defined contribution disability plan.
- Requiring all new employees to pay 50 percent of retirement costs and unfunded liabilities in the event that investment returns do not meet expected returns.¹¹

The reforms are expected to result in an estimated savings of more than \$1.5 billion to taxpayers over the next 30 years and reduce total PSPRS pension liabilities by at least 36 percent.¹²

A constitutional amendment is required to implement the PBI reform and to allow the legislature to make adjustments to PRPRS. Proposition 124 is on the ballot because constitutional changes require voter approval in Arizona.

Arguments for Proposition 124

There is broad-based support for this proposition. Groups with different perspectives and interests on the type of pension reform needed have worked on this consensus-plan including both Republican and Democratic legislators, local governments, public safety unions, and the League of Arizona Cities and Towns. The business community also has expressed their support. A Libertarian think tank, The Reason foundation, assisted in brokering the plan. The Arizona Senate unanimously approved SB 1428 and the House of Representatives passed the measure 49-10 vote.¹³

Most proponents have cited the long-term cost savings of the measure and the prospect of lowering the financial burden on local governments and taxpayers. Some municipalities have not been able to afford to hire additional public safety personnel because of the increased costs of the unfunded liabilities. Others support the provision that will allow public safety employees for the first time to choose a defined contribution program or a defined benefit hybrid plan. Still others have cited improved PSPRS governance and transparency.¹⁴

Arguments against Proposition 124

The Arizona's special election guide published by the Arizona Secretary of State has no arguments filed against Proposition 124.¹⁵

The main opposition to Proposition 124 is that, except for the new COLA adjustments for current employees and retirees, it does not change or reduce any benefits accruing to current employees nor does it alter for current employees, the Deferred Retirement Option Plan (DROP), which cost the system almost \$105 million last fiscal year.¹⁶

It has been suggested that reducing benefits only for new employees will not result in budget relief for decades.¹⁷

One alternative solution advanced to address pension problems is to consider curbing benefit accruals for current employees. This also could also be accomplished by changing the constitutions in those states with constitutionally protected pensions, or by passing legislation in other states by clearly stating that benefits earned by public employees are protected but benefits going forward can be modified.¹⁸

Impact

Tackling the pension crisis is a complicated affair. Many states and local governments have found that reform legislation is exceedingly difficult. Proposition 124 appears to make important inroads for reforming the PSPRS; however, more comprehensive reform efforts may still need to be considered.

April 2016 / Established in 1982, Morrison Institute for Public Policy is a leader in examining critical Arizona and regional issues, and is a catalyst for public dialogue. An Arizona State University resource and part of the ASU College of Public Service and Community Solutions, Morrison Institute uses nonpartisan research and communication outreach to help improve the state's quality of life. MorrisonInstitute.asu.edu

End notes

¹ State Constitutions Shouldn't Shield Public Pension Benefits (2013, September 4) Retrieved from: <http://www.economics21.org/commentary/state-constitutions-shouldnt-shield-public-pension-benefits>

² *Ibid.*

³ Arizona Legislature. Proposition 124 [SCR 1019 (2016)] public retirement system benefits. Analysis by legislative council. Retrieved on April 8, 2016 from:

http://azleg.gov/alispdfs/Council/2016BallotMeasures/Adopted_Analysis_for_Prop_124.pdf;

Arizona Secretary of State. Proposition 124 - Sample ballot/ballot format. Retrieved on April 7, 2016 from: https://www.azsos.gov/sites/azsos.gov/files/2016_0216_prop_124_ballot_language.pdf

⁴ Eucalitto, C. (2012) State Budget Solutions' third annual State Debt Report shows total state debt over \$4 trillion. Retrieved April 18, 2016 from State Budget Solutions:

<http://www.statebudgetsolutions.org/publications/detail/state-budget-solutions-third-annual-state-debt-report-shows-total-state-debt-over-4-trillion#ixzz46DRTlw6z>;

Novy-Marx, R. & Rauh, J. (2011) Public pension promises: How big are they and what are they worth?. *The Journal of Finance* 66(4), 1211-1249;

Pew Charitable Trust. (2015). *The state pensions funding gap: Challenges persist* (Issue Brief). Retrieved on April 18, 2016 from Author: <http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2015/07/the-state-pensions-funding-gap-challenges-persist>;

Ring, E. (2015). *Estimating America's*

total unfunded state and local government pension liability (Report). Retrieved April 18, 2016 from California Policy Center: <http://californiapolicycenter.org/estimating-americas-total-unfunded-state-and-local-government-pension-liability/>

⁵ Gilroy, L., Constant, P. & Randazzo, A. (2016). Arizona enacts groundbreaking public safety pension reform. Retrieved April 18, 2016 from Reason Foundation: <http://reason.org/news/show/az-public-safety-pension-reform>

⁶ Stalebrink, O. (2012). Public pension funds and assumed rates of return: An empirical examination of public sector defined benefit pension plans. *The American Review of Public Administration*. 44(1), 92-111.

⁷ Gilroy, Constant & Randazzo

⁸ *Ibid.*

⁹ Kessler, A. (2013, April 9). Andy Kessler: The Pension Rate-of-Return Fantasy. *Wall Street Journal*. Retrieved on April 18, 2016 from:

<http://www.wsj.com/articles/SB10001424127887324100904578403213835796062>

¹⁰ Reilly, T. (2012). *Rethinking Public Sector Compensation: What Ever Happened to the Public Interest?*. New York, NY: Routledge.; Gilroy, Constant & Randazzo

¹¹ Arizona State Senate, 52nd Legis, 2nd Regular Session. Fact Sheet for SB 1428 PSPRS Modifications. (2016). Retrieved on April 18, 2016 from Arizona State Legislature:

<http://www.azleg.gov/legtext/52leg/2r/summary/s.1428fin.pdf>

¹² Gilroy, Constant & Randazzo; Arizona Secretary of State

¹³ Arizona Secretary of State

¹⁴ *Ibid.*

¹⁵ *Ibid.*

¹⁶ Harris, C. (2016, February 2). Modest pension reform proposed to fix public safety retirement system. *Arizona Republic*. Retrieved on April 18, 2016 from:

<http://www.azcentral.com/story/news/arizona/investigations/2016/02/02/modest-pension-reforms-proposed-fix-public-safety-retirement-system/79646588/>

¹⁷ Barro J. (2012, March 10). Without this fix, it's not reform. *The New York Post*. Retrieved on April 18, 2016 from: <https://www.manhattan-institute.org/html/without-fix-its-not-reform-3675.html>; Pew Charitable Trust.

¹⁸ Buck, S. (2012). Legal Obstacles to State Pension Reform. Retrieved on April 18, 2016 from Social Science Research Network: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1917563