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COST SHIFTING OF TEACHER PENSION CONTRIBUTIONS IN MARYLAND

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SUMMARY

OVER THE PAST DECADE, the annual cost of funding Maryland's public school teacher pensions has more than doubled, from $403 million in 2001 to $900 million in 2011.[1] Although county governments employ public school teachers, the state pays the full cost of their employer pension contributions. Costs will continue to increase despite several pension benefit reforms passed during the 2011 legislative session, soon exceeding $1 billion annually.

In the past several years, state legislators floated various proposals to shift the cost of funding teacher pensions to Maryland's counties, rather than require the state to continue paying the full amount of such funding. In its final recommendations following a comprehensive review of the state's public employee benefits, the Public Employees' and Retirement Benefits Sustainability Commission (hereafter "the Commission") called such a cost shift "a vital component of a sustainable system."[2]

In light of the state's difficult fiscal situation, the structure of teacher compensation policy, and the state's new Race to the Top-related push for teacher quality evaluation procedures, this policy report supports a partial, phased cost shift of teacher pension contributions to Maryland's counties. Below, we explain the rationale behind cost shifting, discuss the various elements of a feasible cost shifting proposal, and explore the possible consequences of cost shifting for both teachers and students.

INTRODUCTION

The vast majority of public employees in Maryland participate in a defined benefit pension plan administered by the state. State employees are required to participate in the pension system as a condition of employment. Reforms adopted during the 2011 legislative session changed the amount that each employee is required to contribute toward his or her pension benefits, increasing it from 5 percent to 7 percent of wages. The governmental employer (state, county, or city) also makes a contribution for each worker employed. Together, these contributions are credited to the state's pension funds; in turn, the funds invest these assets and pay benefits when employees eventually retire.

A variety of different pension plans are available for different types of employees; for example, law enforcement officers and state judges participate in plans with different requirements and benefit levels. However, the two largest pension plans by far are those provided for general government employees and public school teachers.

Maryland's method of handling teacher pension contributions is unusual. While local governments are required to make contributions for their general employees, the state pays the full cost of teacher pension contributions, even though local school systems employ teachers. The state also pays the full cost of pension contributions for local library and community college employees, but as the number of public school teachers vastly outnumbers these employees, scrutiny has been focused on the cost of contributions the state makes for teachers.

The state has been paying the costs associated with various retirement programs for public school teachers since 1927, but while the financing structure has a long history in Maryland, it is an outlier when compared with the rest of the country. Texas and Kansas are the only other states to pay the full cost of teacher pension contributions.[3] On the other hand, Maryland's local school boards also lack independent taxing authority, and so are financially dependent on annual appropriations from county governments. Aside from Maryland, only eight other states do not grant local school boards independent taxing authority.[4]

THE LOGIC OF COST SHIFTING

The primary motivation driving the state-level push for cost shifting has been the rapid increase in required contributions over the past several years, combined with a large and persistent structural deficit in the state budget. Prior to the 2011 legislative session, the state's Spending Affordability Committee recommended that the fiscal year 2012 budget attempt to reduce the state's structural deficit by one-third, with an eye to completely eliminating the deficit over three years. Through a variety of cost-containment actions, the fiscal year 2012 budget met and exceeded the deficit reduction target. However, future year targets will be increasingly difficult to meet. Intense attention is thus focused on those portions of the budget that are growing faster than average. Further complicating the issue, during the past two fiscal years the state has used federal stimulus funds to help pay for the costs associated with teacher pensions, but those funds are no longer available.[5]

There are several reasons why annual pension contributions have ballooned in recent years. The primary factor has been poor investment performance due to the broad economic downturn, resulting in much lower average returns on pension fund assets than expected. Salary increases and teacher workforce growth are also responsible for increasing costs. Finally, an unfunded, retroactive benefit increase adopted in 2006 significantly increased both pension liabilities and annual costs.[6] While the so-called "corridor funding" method has indeed contributed to the declining funding status of the pension system, it has had a lesser effect on annual pension contributions than these other factors.[7]

Local school boards do not internalize the full cost of their decisions to increase salaries or hire additional employees. Cost shifting would ensure that local school boards consider these costs in their salary and workforce decisions.

Since pension contributions are linked to salary levels, and local school boards determine salary levels, the current funding structure requires the state to make pension contributions without control over the factors determining the size of the contributions. The result is that local school boards do not internalize the full cost of their decisions to increase salaries or hire additional employees. Furthermore, since the state bears the entire cost of deferred compensation, local school boards and counties face a perverse incentive to heavily tilt the total compensation package offered to teachers towards deferred compensation, and to support increases in pension benefits, versus higher salaries. Given the fiscal externalities of this funding structure, the Commission also recommended a cost shift to ensure that local school boards consider the effects of deferred compensation costs in their salary and workforce decisions.

While the Maryland State Education Association (MSEA, the state's teachers' union) denies the link between salary and workforce increases and increased pension contributions, claiming, "Salary growth has been flat," the increase in average education payroll has in fact significantly outpaced inflation over the past decade.[8] In a letter responding to the Commission's final report, the MSEA attempts to justify this claim by noting that average state employees' payroll has grown by a comparable amount over the same time period. It is hard to understand how 3.7 percent annual increases in average payroll over 10 years constitute "flat" salary growth.

Furthermore, comparing average payroll growth for teachers to average payroll growth for state employees is not the proper approach. Better and more revealing is to compare average payroll growth for teachers—and state employees—to growth in overall household median income. Accounting for inflation, teachers' and state employees' payrolls have both increased by 15 percent over 10 years, while household median income in Maryland has increased by only 5 percent. Maryland has fared better than the rest of the country: over the same time period, household median income for the entire United States has actually declined.[9]

COST SHIFTING PROPOSALS

A number of bills proposing various types of cost shifts were introduced in prior year legislative sessions. Several of these bills include features that, when combined, offer a reasonable and equitable path to sharing the responsibility of funding public school teacher pensions.

1. Social Security Contributions Recognizing the Social Security contributions made by school boards and teachers as part of total retirement costs shifts a significantly smaller and more feasible amount to the counties. For example, the Commission recommends sharing the total retirement cost, including Social Security contributions, equally between counties and the state. As a result, counties are responsible for 25 percent of the pension costs associated with public school teachers.

2. Phase-In If total retirement costs are shared equally between the counties and the state, the county governments and Baltimore City combined will face $233 million in pension costs during the first year of implementation. This is a significant amount, and it is unrealistic to expect county governments to be able to fund the entire amount immediately, especially while the state's economy remains on shaky ground. While state tax revenues have recently shown signs of recovery, a prudent cost shift policy will phase-in such costs over several years, allowing counties time to adjust their budgets incrementally, and potentially take other policy actions, such as implementing teacher quality evaluation systems.

3. Wealth Equalization A critical component of any cost shift proposal is its wealth equalization policy. Given widely differing levels of wealth and tax capacity throughout the state, it would be infeasible to uniformly distribute the effects of the cost shift across all counties. Instead, just as state education aid accounts for local wealth levels, the portion of increased costs associated with teacher pension contributions will be higher for wealthier counties, and lower for poorer counties. Including a wealth equalization component addresses concerns about the equity of cost shifting raised by Governor Martin O'Malley in media appearances.[10]

CONSEQUENCES

1. Workforce In its response to the Commission's report, MSEA asserts "Shifting 50 percent [of total retirement costs] from the state to locals costs the equivalent of 2,803 education jobs statewide."[11] This claim is based on the improbable assumption that all increased costs associated with the shift will result in layoffs. In reality, cost increases will likely produce a variety of responses, such as increased budget appropriations, shifts in budget resources from other areas to human resources, increased tax revenues, slow or frozen workforce growth, and finally, some potential layoffs. The assumption that the only response will be layoffs is unrealistic and overstates the negative impact of any cost shift.

MSEA's letter continues by claiming, "In education terms, a loss of 2,803 jobs means larger class sizes, an overriding concern for parents and a proven detriment to student achievement."[12] While again assuming that all costs will result in layoffs, this claim also implies that any layoffs will be confined to teachers, not including any of the other 15 education-related jobs that also require state pension contributions.[13]

Finally, while class size is a sensitive political issue, the scientific evidence regarding the effects of class size is complex. As one well-known meta-evaluation of class size research studies concluded, "The econometric evidence is clear. There is little reason to believe that smaller class size systematically yields higher student achievement. While some studies point in that direction, an almost equal number point in the opposite direction."[14]

2. Teacher Quality While MSEA's response to cost shifting overstates the negative effects, cost shifting may in fact prompt some counties to lay off small numbers of employees, including teachers, as one response to increased costs. As a result, average class sizes in some counties may increase slightly. While increased class size alone does not necessarily have a uniformly detrimental effect on student achievement, increased class size paired with ineffective teaching does yield uniformly detrimental results. In fact, educational research reveals that teacher quality plays a more important role in student achievement than class size: "Variations in teacher quality have been shown to be extraordinarily important for student achievement, and econometric studies indicate that these variations completely dominate any effects of altered class size."[15]

Similar studies have found that high-quality teachers perform well in both larger and smaller class size settings:

By retaining high-quality teachers, encouraging the development of struggling teachers, and dismissing ineffective teachers, counties can meet the demands of cost shifting while ensuring student achievement does not suffer.

"The results suggest that relatively capable teachers do as well when teaching large classes as when teaching small classes…the pattern of international effect heterogeneity suggests that class-size effects occur only when the quality of the teaching force is relatively low."[16] Such research suggests that more attention should be paid to teacher quality than potentially misleading statistics such as average class size.

Fortunately, legislation passed during the 2010 session and Maryland's successful application and subsequent receipt of federal Race to the Top funding provides a way forward that could allow counties to identify and reward high-quality teachers while also reducing the number of ineffective teachers. By retaining high-quality teachers, encouraging the professional development of struggling teachers, and dismissing ineffective teachers, counties will be better able to meet the demands associated with cost shifting while ensuring that student achievement does not suffer.

Having won a competitive $250 million federal Race to the Top grant, Maryland is currently moving ahead with a performance evaluation system for public school teachers and principals. This system is designed to measure the quality of instruction and management through both quantitative and qualitative factors. Fifty percent of the evaluation depends on student growth, measured by both state and local assessments; the other half depends on measures of professional practice, such as lesson planning and classroom instruction.

The Maryland Council for Educator Effectiveness developed the evaluation standards. This group was convened by executive order and consists of educational administrators, teachers, and other professionals, as well legislators and union and business representatives. Implementation has been delayed, however, with full implementation targeted for the 2013-2014 school year, at which time the system would affect employment decisions.

The current system is unsustainable. Shifting a portion of pension costs to the counties will rationalize the compensation incentives that local school boards face, and complements the state's push for teacher evaluation processes.

Even when the evaluation system is fully implemented, dismissing tenured teachers who receive poor evaluations may prove exceedingly difficult: in 2010, the National Council on Teacher Quality gave Maryland a failing grade on its procedures for dismissing ineffective teachers, suggesting that Maryland should take steps to ensure "that districts do not feel they lack the legal basis for terminating consistently poor performers."[17] During the 2011 legislative session, a former teacher introduced a bill that would have explicitly added ineffectiveness to the list of valid reasons for which local school boards can dismiss teachers; facing union opposition, however, the legislation stalled.[18]

CONCLUSION

Maryland faces a variety of fiscal and economic challenges, in part due to decisions made in the past, and in part due to new realities of the present. During the next decade, the state must place a greater emphasis on efficiency, sustainability, and responsibility. Regarding public school teacher pensions, the current system is unsustainable. However, shifting a portion of pension costs to the counties, if done properly, will rationalize the compensation incentives that local school boards face, and complements the state's push for teacher evaluation processes. Maryland's legislators should follow the recommendations of the Public Employees' and Retirement Benefits Sustainability Commission and implement a phased-in, wealth-equalized cost-shift of teacher pension contributions to the counties.

In addition, legislators can best support the work of the Maryland Council for Educator Effectiveness by ensuring there are no additional delays in the implementation of teacher evaluation processes. Such evaluation processes will play a major role in improving teacher quality and ensuring that Maryland's public school system continues to produce a well-trained, well-educated, and competitive workforce for the state's economy.

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