

Reprint

FROM *THE ANALYSIS OF THE 1993-94 BUDGET BILL*

THE STATE'S RETIREMENT SYSTEMS: FISCAL ISSUES FOR 1993-94

Elizabeth G. Hill
Legislative Analyst

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THE STATE'S RETIREMENT SYSTEMS: FISCAL ISSUES FOR 1993-94

How Can the Legislature Maintain Oversight of the State's Retirement Systems and Reduce the Major State Costs Associated with the Systems?

Summary

In the November 1992 election, the voters approved Proposition 162—the California Pension Protection Act of 1992. This act may fundamentally alter relationships between retirement boards (at both the state and local levels) and the executive and legislative branches of these levels of government. There are many issues related to implementation of this act that will be of concern to the Legislature. Key issues include (1) how the Legislature can carry out oversight of the budgets of the Public Employees' Retirement System (PERS) and the State Teachers' Retirement System (STRS) if those systems are free to spend funds without appropriations and (2) whether, or to what extent, these and other retirement boards are exempt from a wide range of provisions of state law and the State Constitution.

Additional concerns arise from the fact that retirement-related expenditures account for a significant part of annual state spending. The Governor's Budget for 1993-94 proposes state expenditures approaching \$1.7 billion, including almost \$1.3 billion from the General Fund, for various costs associated with public employee retirement.

In the Analysis of the 1993-94 Budget Bill, we address key retirement-related issues for the 1993-94 fiscal year. This analysis includes recommendations designed to help the Legislature (1) maintain oversight of state retirement systems in the wake of Proposition 162 and (2) reduce the major state costs associated with these systems. This reprint brings together those parts of the Analysis pertaining to retirement issues. It includes, in the following order:

- An overview entitled "The State's Retirement Systems."*
- Analysis of "Contributions to the Judges' Retirement Fund."*
- Analysis of the "Public Employees' Retirement System."*
- Analysis of the "State Teachers' Retirement System."*

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Crosscutting Issues

The State's Retirement Systems

1. **Retirement-Related State Costs Approach \$1.7 Billion.** 7
The budget includes total state expenditures approaching \$1.7 billion, including almost \$1.3 billion from the General Fund, for various costs associated with public employee retirement.
2. **Proposition 162.** Proposition 162—the California Pension Protection Act of 1992—may fundamentally alter relationships between retirement boards (at both state and local levels) and respective executive and legislative branches of government. The act raises important implementation issues, which we discuss in more detail in our analysis of the PERS budget (Item 1900 of this Analysis.) 8

Contributions to the Judges' Retirement Fund

3. **Future Benefits Are Completely Unfunded.** The payments made by current members of the Judges' Retirement System and their employers go directly to pay benefits to current retirees, providing nothing for the retirement of current judges. Moreover, these contributions are not even adequate to cover the benefit payments to current retirees, forcing the General Fund to make up the difference. 12
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of the Legislature's direction in the 1992 Budget Act to bill public agencies for the costs of audits of those agencies.

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| 11. Spending on Outside Investment Advisors Nearly Equals All Other Spending on PERS Operations. We recommend that the PERS report to the fiscal committees prior to budget hearings on its spending on outside investment advisors, including steps the PERS will take to ensure that in the future these expenditures are cost-beneficial, especially in comparison with use of in-house advisors. | 23 |
| 12. Increase PERS Accountability to Employee Members. We recommend that the Legislature enact legislation to require periodic adjustment of employee contribution rates, as one means to increase PERS management accountability to system beneficiaries and to have an equitable share in cost changes between employees and the state. | 27 |

State Teachers Retirement System

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| 13. Major General Fund Costs in the Budget Year. The budget includes General Fund transfers to the Teachers' Retirement Fund totaling \$835 million in 1993-94. | 29 |
| 14. General Fund Transfer to Supplemental Benefit Maintenance Account Overbudgeted. The Governor's Budget overstates the amount of General Fund monies needed for statutory transfers to the Supplemental Benefit Maintenance Account by \$16.6 million. We recommend the Legislature recognize the availability of these funds as part of the Legislature's budget solution (General Fund savings of \$16.6 million). | 31 |
| 15. Redefining the State's Role in Teachers' Retirement. We recommend that the Legislature enact legislation to establish an alternative benefit plan for future entering members of the STRS that is fully funded by member and employer contributions on an actuarially sound basis. (Eventual annual General Fund savings of roughly \$400 million—in today's dollars.) | 32 |
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16. **Option to Reduce General Fund Expenditures in 1993-94.** 34
An option for reducing General Fund expenditures for the STRS in the budget year is to suspend or reduce the purchasing power benefit payments.
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THE STATE'S RETIREMENT SYSTEMS

The budget raises issues concerning legislative oversight of state retirement systems, as well as state costs associated with these systems.

Retirement-related expenditures account for a significant part of state spending for the budget year. The budget includes total state expenditures approaching \$1.7 billion, including almost \$1.3 billion from the General Fund, for various costs associated with public employee retirement. As summarized in Figure 4, the state makes employer contributions and/or various other payments to four public

Figure 4

State Costs for Retirement Systems^a 1993-94 (Projected)

(Dollars in Millions)

System	General Fund	All Funds
Public Employees' Retirement System	\$355	\$780
State Teachers' Retirement System	835	835
Judges' Retirement System	64	64
Legislators' Retirement System	1	1
Totals	\$1,255	\$1,680

^a Includes transfers to retirement trust funds for employer contributions, state mandates, retired judges' benefit payments, and other purposes. Does not include PERS and STRS administrative expenditures from trust funds. General Fund transfer to PERS net of offsets from surplus accounts in the trust fund.

retirement systems: the Public Employees' Retirement System (PERS), the State Teachers' Retirement System (STRS), the Judges' Retirement System, and the Legislators' Retirement System. The latter two systems are administered by the PERS for fees charged to the judges' and legislators' retirement funds and reimbursed by the General Fund.

Continued Legislative Role in Oversight of State Retirement Systems Unclear

Passage of Proposition 162 in November raises questions concerning the ability of the Legislature to perform an effective oversight role of the various state retirement systems.

In the November 1992 election, the voters approved Proposition 162—the California Pension Protection Act of 1992. This act may fundamentally alter relationships between retirement boards (at both state and local levels) and respective executive and legislative branches of government. In addition to the PERS and the STRS, over 100 retirement boards serving counties, cities, special districts, and the University of California are covered by the act. The act includes the following important effects:

- Grants to each public retirement board in the state "plenary" authority for investment of retirement trust monies and administration of retirement systems, notwithstanding any other provisions of law or the State Constitution to the contrary. The act permits the Legislature to continue to prohibit certain investments by boards "...where it is in the public interest to do so, and provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board...."
 - Maintains the requirement that boards provide benefits to system members and their beneficiaries, minimize costs to governments for employer contributions, and provide for reasonable costs of administration, but specifies that the provision of benefits take precedence over the other two mandates.
 - Specifies that the Legislature cannot change terms and conditions of board membership (for boards with elected employee members), unless a majority of the persons registered to vote in the jurisdiction of the system approves the change. Thus, the Legislature cannot change the terms and conditions of membership for the PERS board (which includes elected employee members) without ratification of the changes by a majority of the registered voters in the state. The Legislature, by statute, can continue to change the terms and conditions of membership for
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the STRS board, without ratification by the voters, since the STRS board does not, at present, include elected employee members.

There are many issues related to implementation of this act that will be of concern to the Legislature. Key issues include (1) how the Legislature may carry out oversight of the budgets of the PERS and the STRS if those boards are free to spend funds without appropriations and (2) whether, or to what extent, the retirement boards are exempt from various statutory and constitutional provisions (including open meeting laws, fair political practices laws, civil service laws, and provisions for affirmative action). These issues have been brought to the surface by the 1993-94 budget proposed by the PERS, other actions taken or currently under consideration by the PERS, and a legal analysis of Proposition 162 prepared by the PERS General Counsel. We discuss these issues in more detail and make recommendations for legislative action in our analysis of the PERS budget (Item 1900), which follows this overview.

Other Issues Discussed in Analyses of Specific Retirement Systems

There are a number of other major issues specific to the following retirement systems that we discuss in our analyses of the individual systems.

Judges' Retirement System (Item 0390). In our analysis of the Judges' Retirement System, we discuss options available to the Legislature to place the system on an actuarially sound basis and reduce future General Fund subsidies.

Public Employees' Retirement System (Item 1900). In addition to implementation issues raised by Proposition 162, we review trends in PERS spending on external investment advisors and the Governor's proposal to transfer administration of state employee health benefit programs to the Department of Personnel Administration.

State Teachers' Retirement System (Item 1920). In our analysis of the STRS budget request, we discuss ways the Legislature can minimize General Fund contributions to the STRS in 1993-94 and beyond. These contributions are proposed in the budget at a total of approximately \$835 million.



CONTRIBUTIONS TO THE JUDGES' RETIREMENT FUND (0390)

The Judges' Retirement Fund (JRF) provides benefits for those justice, municipal, superior, appellate and supreme court judges, and their survivors, who are members of the Judges' Retirement System (JRS). This system is administered by the Public Employees' Retirement System (PERS).

The primary revenues deposited in the fund come from the following sources:

- *Active members' contributions*, equal to 8 percent of members' salaries (about \$12 million in 1993-94).
- *Fees on civil suits* filed in municipal and superior courts (about \$3.8 million).
- *General Fund appropriations* (\$64.3 million in 1993-94), equivalent to 8 percent of the salaries of authorized judicial positions (\$11.8 million) *plus any amount necessary to cover JRS benefit payments each year* (an additional \$52.5 million in the budget year).

Members of the JRS earn retirement benefits equal to a percentage (up to 75 percent) of the *current* salary of the judicial office last held. The JRS will pay an estimated \$80 million in benefits to 1,315 annuitants in the budget year. This amount is \$10 million (13 percent) more than estimated payments in the current year.

Funding Problems of the JRS

System Continues to Be Underfunded

The payments made by current members of the Judges' Retirement System and their employers go directly to pay benefits to current retirees, providing nothing for the retirement of current judges. Moreover, these contributions are not even adequate to cover the benefit payments to current retirees, forcing the General Fund to make up the difference.

Active members of the JRS earn retirement benefits over the course of their judicial careers. The annual costs of ensuring that these benefits will be available upon retirement (without resorting to a General Fund subsidy) is called the normal cost. Because the normal cost for the JRS has been historically underfunded, there are insufficient assets in the JRF to pay benefits previously earned by active and retired members, thereby creating an "unfunded liability."

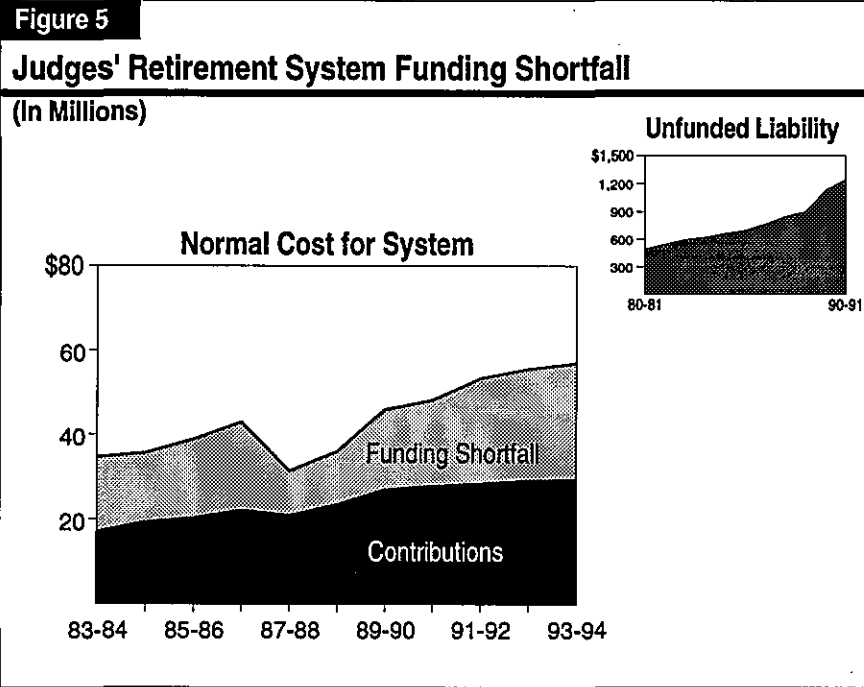
Based on the most recent (1991) actuarial valuation of the JRS, revenues totaling 36.43 percent of the payroll of active members are required in order to meet the normal cost. Current employer and employee contributions combined with other system revenues, however, provide less than 19 percent of payroll. The difference is the system's normal cost deficit. In 1993-94, this shortfall is expected to be approximately \$28 million.

Even if the normal cost were fully funded in the future, the system's current unfunded liability of the JRS would increase due to interest costs. The system's unfunded liability as of June 30, 1991 was \$1.2 billion, which was \$116 million, or 10 percent, higher than the prior year. The problem of a growing unfunded liability is compounded by not fully funding the system's normal costs. If contributions continue at current levels, the unfunded liability of the JRS will grow dramatically.

Figure 5 displays the normal cost requirements of the JRS compared to the employer and employee contributions and other system income over the period 1983-84 to 1993-94. The rapid growth in the unfunded liability is shown in the inset of Figure 5.

General Fund Subsidy Continues to Grow

In order to honor 1993-94 benefit payments to current retirees, the budget includes a subsidy of \$52.5 million from the General Fund—\$6.5 million above the current-year subsidy.



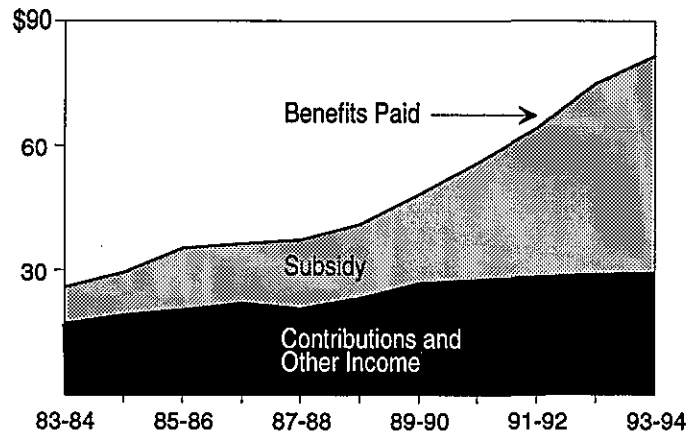
State law requires the Legislature to appropriate in the annual Budget Act enough monies to the JRF to pay all obligations of the system that become due in the ensuing fiscal year. Because no funds are accumulated in the JRF to pay for benefits as members retire, each year the Legislature is forced to provide increasing General Fund subsidies so that benefit payments can be made to retirees in that year. The 1993-94 subsidy is budgeted at \$52.5 million. This amount, when combined with employee/employer contributions and other system revenues, provides the \$80 million needed in 1993-94 to make these payments.

Figure 6 (see next page) shows the growth in the General Fund subsidy from 1983-84 to 1993-94. Unless the Legislature takes steps to address the fundamental problems of the JRS, the General Fund subsidy can be expected to continue growing at the current rate of between 15 to 30 percent per year. Under this scenario, the General Fund *subsidy* in 2001-02 would exceed \$200 million.

Figure 6

Judges' Retirement System Growth in Annual General Fund Subsidy 1983-84 Through 1993-94

(In Millions)



Addressing the JRS' Problems

Recent Legislative Activity

In 1992 the Legislature enacted two bills that would have made fundamental changes to judges' retirement, but the bills were vetoed by the Governor. Assembly Bill 1031 (Bentley) would have increased member contributions from 8 percent of salary to 11 percent. Senate Bill 1563 (McCorquodale) would have created a new, less costly, retirement plan for judges appointed or elected after the effective date of the bill (January 1, 1993). The Governor indicated in his veto messages that, although reform of judges' retirement is necessary, neither bill received the full review through policy and fiscal committees warranted by the issues involved. The Governor also expressed concern about maintaining the state's ability to attract superior talent into the judiciary. He invited the respective authors to re-introduce legislation in the 1993-94 session.

We believe reforms along the lines of the vetoed legislation are long overdue. The Judges' Retirement Fund needs to be put on a sound actuarial basis, with retirement benefits paid for as they accrue. This is

fiscally responsible because it does not conceal the full extent of the obligations created in providing government services, and does not confront future Legislatures with unfunded contractual obligations. In addition, the total costs for judges' services, including retirement costs, are paid by the generation of taxpayers benefiting from their services and are not shifted to future generations that do not benefit from them.

In order to place the fund on a sound footing, it will not be enough to make changes in the existing system for sitting and retired judges. It also will be essential to create a new, less costly, benefit plan for judges appointed in the future. Below, we discuss (1) possible changes in the existing system and (2) considerations for creating a system covering judges appointed in the future.

Changes to the Existing System

We recommend enactment of legislation that reduces the General Fund cost of the existing judges' retirement system, including legislation to increase member contributions (for a potential \$4.7 million General Fund savings in 1993-94). In order to capture these savings, we recommend reducing Item 0390-001-001 by \$350,000 and reducing Item 0390-101-001 by \$4,350,000. The Legislature also should consider options of (1) reducing benefits and (2) increasing the amount of court filing fees transferred to the JRF. Such additional steps could save the General Fund as much as \$10 million in 1993-94 and could produce major additional savings thereafter.

Increase the Judges' Retirement Contribution Rate. Since judges under the current benefit plan enjoy substantially more generous (and costly) retirement benefits than other public employees, there is a strong case to be made that they should contribute more than 8 percent of their salary toward retirement. The average service retirement benefit paid to retired judges exceeds \$66,000 annually. The annual costs of ensuring that these benefits will be available upon retirement (the normal cost) exceeds 36 percent of covered payroll. By contrast, the normal cost for teachers' retirement benefits is 17.5 percent of payroll and for most state employees is approximately 15 percent of payroll. Increasing the judges' contribution rate to 11 percent, as proposed in AB 1031 last year, is reasonable. We recommend reenactment of this proposal as urgency legislation. This would save the General Fund about \$4.7 million in 1993-94, with increasing annual savings thereafter. In recognition of the 1993-94 savings of such a step, we further recommend that the Legislature reduce Item 0390-001-001 by \$350,000 and reduce Item 0390-101-001 by \$4,350,000.

There are two other steps that could be taken to reduce the system's unfunded liability which the Legislature should seriously consider.

Reduce the Level of Benefits. The Legislature has the option, under existing law, to reduce benefits (at least marginally) for sitting judges who took office on or after January 1, 1980. Even marginal benefit reductions, applied to this group, could dramatically reduce the unfunded liability (currently \$1.2 billion and growing) of the existing judges' retirement plan and thereby produce significant savings to the General Fund in future years.

Increase Court Filing Fees and the Fund's Share of These Fees. Estimated annual revenues from fees on civil suits filed in municipal and superior courts for 1992-93 amount to roughly \$275 million. Of this amount, only \$3.8 million (equivalent to 2.4 percent of covered payroll) will be transferred to the JRF. At present, superior court fees are \$182 per filing, of which \$3 are transferred to the JRF. Municipal court fees are \$80, of which \$2 are transferred to the JRF. Although total filing fees were raised substantially in 1992, the fee amounts designated for the JRF have not increased since 1971. Therefore, revenues to the JRF from this source, as a percentage of covered payrolls, have steadily declined over time. If the fees designated for the JRF were to be adjusted for inflation since 1971, superior court fees for the JRF would increase to \$11, while municipal court fees for the JRF would increase to \$7. We estimate these increases would generate an additional \$10 million per year, offsetting annual General Fund transfers to the JRF by an equal amount.

The Legislature could raise the fees designated for the JRF either by (1) raising total fee levels (from \$182 to \$190 at superior courts and from \$80 to \$85 at municipal courts) or (2) redirecting a portion of the existing fee levels. Redirection within the existing fee totals, however, would reduce resources needed for trial court operations.

Create A New System for New Judges

We recommend enactment of legislation to create a less costly retirement benefit plan for new judges that will be fully funded on an actuarially sound basis.

Last year, SB 1534 created a new retirement benefit plan for judges elected or appointed after the effective date of the bill. Clearly, a new and less costly retirement plan is needed. In considering such legislation, however, the Legislature may wish to make specific provisions that depart from those of SB 1534. For example, rather than create a separate retirement plan for new judges, the Legislature could

specify that new judges become members of the PERS under one of the existing classifications for state employees. Such a step would dramatically reduce the future General Fund costs of judges' retirement.

As an alternative or as a supplemental benefit for new judges, the Legislature could create a defined *contribution* plan. Under this approach, each new judge would be free to choose an amount of salary to be deferred and invested until retirement (or separation from service). These amounts also could be matched on some basis by the state. The ultimate benefits would depend on the amounts so invested and the investment returns experienced.

The important point is, in providing for retirement benefits for new judges, the Legislature needs to create a system that will be fully funded on an actuarially sound basis. To accomplish this, a system that is less costly for the state is essential. Otherwise, the new system almost certainly would turn into the same type of pay-as-you-go system as the current system, with the same ever-growing unfunded liability and rapidly escalating General Fund costs. The state's costs, both near-term and long-run, can be kept at reasonable levels through one or more of the following:

- Reduced benefits,
- Increased member contributions,
- Increased use of defined contribution plans, and/or
- Increased use of alternative revenue sources (such as court filing fees).

Select Committee on Judicial Retirement

After the Governor vetoed AB 1031 and SB 1563, the Judicial Council established a select committee to develop recommendations to the Governor and Legislature regarding changes in judges' retirement provisions. Judicial Council staff expect the committee to complete its work in March 1993. We will advise the Legislature on the committee's findings after reviewing the its report.

PUBLIC EMPLOYEES' RETIREMENT SYSTEM (1900)

The Public Employees' Retirement System (PERS) administers retirement, health and related benefit programs that serve almost one million active and retired employees. The participants in these programs include state employees, most nonteaching school employees and employees of the 1,255 public agencies within California that have elected to contract for benefits available through the system. The proportion of members is approximately one-third each for state employees, nonteaching school employees and employees of other local agencies.

The system administers a number of alternative retirement plans through which the state and contracting agencies provide their employees with a variety of benefits. The costs of these benefits are paid from employer and employee contributions equal to specified percentages of each participating employee's salary. These contributions are designed to finance the long-term, actuarial cost of the various benefits provided.

The PERS health benefits program offers state and other public employees a number of basic and major medical plans, on a premium basis.

Overview of the PERS Budget

The Budget Bill does not include items of appropriation for the PERS (other than one item for health benefits administration) because the PERS contends that Proposition 162 grants it authority to spend funds without appropriations by the Legislature.

The Governor's Budget displays "for informational purposes only" expenditures totaling \$130.3 million for administration of the PERS in the budget year. Only \$5.8 million proposed from the Public Employees' Contingency Reserve Fund is specifically appropriated in the Budget Bill (Item 1900-001-950).

This unusual situation arises from an interpretation of Proposition 162 by the PERS Board of Administration. As discussed in the preceding crosscutting issues (*The State's Retirement Systems*), in the November election the voters approved Proposition 162—the California Pension Protection Act of 1992. Regarding Proposition 162 and the PERS, the budget includes the following statement:

"As the Board of Administration interprets Proposition 162 to give them sole and exclusive authority over the investment and administration of the System pursuant to the California Constitution, Article XVI, Section 17, no budget appropriation is required. The budget data presented is for informational purposes only and is not included in the Budget Bill as part of the appropriation process. This budget is included for informational display only and does not necessarily reflect the views of the Administration."

As mentioned above, however, the Budget Bill does include one item of appropriation for the PERS—\$5.8 million from the Public Employees' Contingency Reserve Fund for administration of the PERS Health Benefits program. This is included in the Budget Bill because, according to staff of the Department of Finance, the Administration disagrees with the PERS' position that the autonomy under Proposition 162 extends to the administration of nonretirement benefits.

PERS Implementation of Proposition 162

Proposition 162 grants public retirement boards, including the PERS, "plenary" authority for administration of retirement systems. Implementation of this change raises a variety of important issues.

Proposition 162 amended Article XVI, Section 17, of the state constitution to grant public retirement boards in the state "plenary" authority for administration of retirement systems. The PERS board interprets this to mean, among other things, that it is free to spend funds for administration of the system without appropriations by the Legislature. At this point the board of the State Teachers' Retirement System (STRS) has refrained from such an assertion. Thus, the Budget Bill includes an appropriation request for the STRS along the lines of requests in prior Budget Bills.

In addition to the budget autonomy claimed by the PERS, the General Counsel of the PERS has prepared a legal analysis of Proposition 162 (dated November 2, 1992) that asserts general independence for the PERS from state laws and the State Constitution. Among many points, the legal analysis contends the following:

- "...the Legislature cannot interfere with or prevent the Board from fully exercising its plenary authority to administer the System. For example, any attempt by the Legislature to repeal Government Code Section 20202 (providing for continuous appropriation of PERS funds) arguably would be an unconstitutional attempt to control the administration of PERS."

- The PERS is no longer required by the constitution to deposit its funds in the State Treasury (where expenditures are subject to appropriation and warrants drawn by the State Controller).
- Even if funds are retained in the State Treasury, the State Controller's authority to draw warrants for PERS funds is "ministerial" in nature only. The Controller would have no authority to "second-guess" any claims presented to him by the PERS.
- "A strong argument exists..." that the PERS no longer is subject to State Personnel Board or Department of Personnel Administration (DPA) authorities under the civil service system and may independently establish job classifications and pay scales.
- The PERS is not subject to DPA or any other authority in the setting of salaries and bonuses for executives and other staff.
- Gift limitation/prohibition under the Fair Political Practices Act should no longer prevent travel (including foreign travel) by members of the PERS board since Proposition 162 strengthens the argument that the PERS has sole discretion to determine when travel is reasonably necessary, and the sole power to authorize payment for this travel.

In most of the above areas the PERS has not yet taken specific actions. The important exception is its secession from the budget process, which we have noted already. Also, at its December 1992 meeting, the board made several revisions to the current-year PERS budget, including a revision that overturned a specific decision made by the Legislature in enacting the 1992 Budget Act. We discuss this board action in detail later in this analysis.

Finally, according to the legal analysis, it is uncertain whether the PERS is still subject to the following laws:

- Open Meeting and Public Records Acts.
 - Minority/Women Business Enterprise Participation Goals.
 - Fair Political Practices Act.
 - Civil Service Act.
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Implementing Legislation Needed to Clarify PERS Role in State Government

We recommend the enactment of legislation defining terms contained in Proposition 162 in order to clarify the extent to which public retirement systems, including the PERS, still are subject to state laws and the state constitution.

As the above discussion indicates, Proposition 162 raises serious questions about the continued applicability of state laws and constitutional provisions to the PERS, and the basic relationship of the PERS to state government. In particular, uncertainties have arisen in important areas that were not addressed either in the text of the proposition nor in the public debate surrounding it. These areas include, but are not limited to, whether, or to what extent, public retirement systems remain governed by open meeting and public records acts, minority/women enterprise participation goals, the Fair Political Practices Act, and civil service acts. These issues need to be addressed by implementing legislation. This legislation should define terms of the proposition and clarify how administration of public retirement systems should proceed, in a manner consistent with the voters' intent in passing the proposition as well as consistent with the Legislature's constitutional responsibilities.

Legislature Should Continue an Oversight Role Through the Budget Process

We recommend that the Legislature enact legislation to (1) rescind the continuous appropriations of the state's employer contributions to the PERS and (2) require that the employer contribution amounts be reviewed and approved through the annual Budget Act.

The budget autonomy claimed by the PERS raises serious questions about the Legislature's future oversight role regarding budgets and operations of state retirement systems. These systems include not only the PERS, but the State Teachers' Retirement System, the Judges' Retirement System and the Legislators' Retirement System. The PERS may be correct in interpreting Proposition 162 as granting it authority to spend monies *from its various trust funds* without appropriations by the Legislature. The state's employer contributions to the PERS, however, are another matter. These contributions are appropriated from the General Fund and other state funds, and are still within the purview of the Legislature.

Under current law, employer contributions from the General Fund are *continuously* appropriated for transfer to the PERS pursuant to

Government Code Section 20751. These transfers, based on percentages of covered payrolls set by the PERS, are transferred semi-annually, six months in arrears, on July 1 and January 1 of each fiscal year. We estimate these General Fund transfers will be approximately \$340 million in 1993-94. The employer contributions from other state funds are continuously appropriated pursuant to Government Code Section 20752 for transfer on a quarterly basis. We estimate these transfers from other state funds will total about \$425 million, *for total employer contributions from the state of \$765 million in the budget year.*

There is no programmatic need for the employer contributions to be continuously appropriated. More importantly, the Legislature has an interest in reviewing these transfers each year since the contribution amounts are affected by (1) the level of PERS administrative expenditures (which now may be beyond the Legislature's *direct* control because of Proposition 162) and (2) actuarial assumptions set by the PERS. By appropriating funds for employer contributions through the annual Budget Act and requesting the PERS to report at annual budget hearings on the basis for the contribution amounts, the Legislature could continue an oversight role regarding PERS operations. We believe continued oversight is important for the interests of the Legislature and the public given the magnitude of annual state spending affected by the PERS. Moreover, legislative oversight is especially needed given the independence in other budget matters that the PERS has received from Proposition 162.

Accordingly, we recommend that the Legislature enact legislation to (1) rescind the continuous appropriations of the state's employer contributions and (2) require that the employer contribution amounts be reviewed and approved through the annual Budget Act.

Pension Abuse Audits: PERS Action Goes Against Expressed Intent of Legislature

We recommend that the PERS report prior to budget hearings on the basis for its reversal of the Legislature's direction in the 1992 Budget Act to bill public agencies for the costs of audits of those agencies.

In the 1992 Budget Act the Legislature approved \$1,803,000 from reimbursements to the Public Employees' Retirement Fund (PERF) for audits of public agencies that contract with the PERS for administration/provision of employee retirement benefits. The Legislature authorized these funds to investigate problems of noncompliance with state retirement laws, including pension abuses such as "spiking" (deliberate over-reporting of individuals' compensation in order to inflate retirement benefit payments). Selection of agencies to be audited

was to be done on the basis of information indicating potential compliance problems, rather than on a random basis. Accordingly, through Budget Act language (Item 1900-001-830) the Legislature specified that audited agencies reimburse the PERF for the full costs of audits.

At its December 1992 meeting the PERS board made several unilateral revisions to the current-year PERS budget, claiming new authority from Proposition 162. Among these revisions, the board appropriated the \$1.8 million directly from the PERF for the audit costs that the Legislature had expressly required be reimbursed by the audited agencies. The fiscal effect of this action is to spread the costs of the audits among *all* public entities in the PERS, *including the state*. (The General Fund ultimately would bear about \$450,000 of the cost since roughly 25 cents of every dollar spent by the PERS is reimbursed to the PERF by the General Fund through employer contributions.) The jurisdictional effect of the action is to directly contravene a specific action of the Legislature.

In view of the above, we recommend that the PERS report to the fiscal committees prior to budget hearings on the basis for the reversal of the Legislature's direction that audited agencies bear the full cost of these audits.

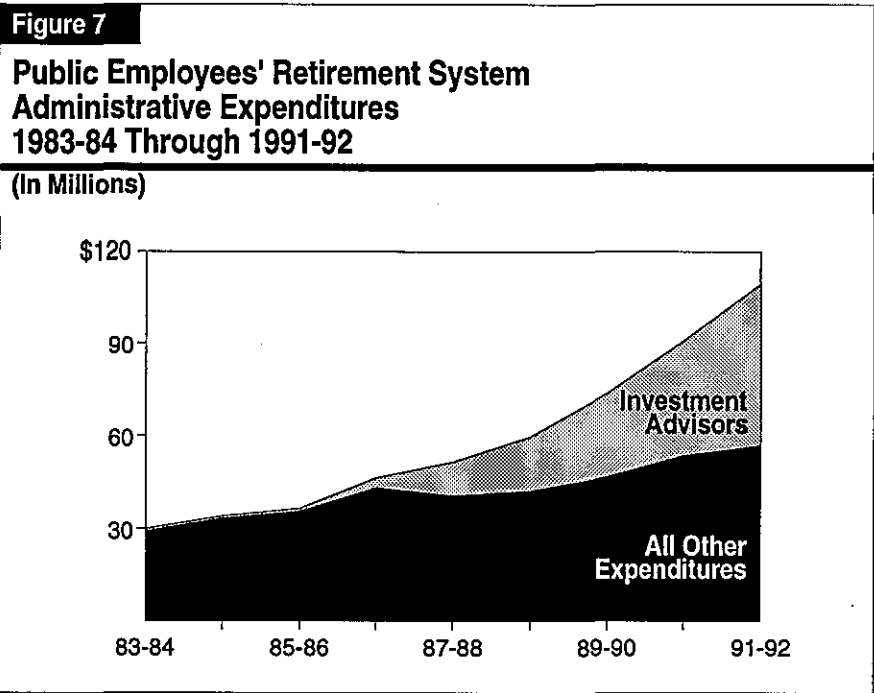
Spending on Outside Investment Advisors

The PERS' spending for outside investment advisors in 1993-94 is estimated at \$56 million—almost equal to PERS' spending on all other administrative costs (\$62 million). We recommend that the PERS report to the fiscal committees prior to budget hearings on its spending on outside investment advisors, including steps the PERS will take to ensure that in the future these expenditures are cost/beneficial, especially in comparison with in-house advisors.

Background

Chapter 1431, Statutes of 1982, stated legislative intent that the PERS secure investment advisors with the expertise necessary for the investment of the retirement fund portfolio. The act authorized the PERS to retain "not less than two separate individual investment advisers" and provided a continuous appropriation, without regard to fiscal year, for that purpose.

Figure 7 shows historical trends for PERS spending on investment advisors and on all other administrative purposes. It indicates that spending on investment advisors grew dramatically during the nine-year period 1983-84 through 1991-92. In 1983-84 the PERS spent \$779,000 for investment advisors under the continuous appropriation authority granted by Ch 1431/82. This amount was 2.6 percent of total administrative expenditures (\$30 million) by the PERS that year. By 1988-89 investment advisor spending had become a major part (29 percent) of administrative expenditures. From that significant base, however, spending continued to grow, tripling over the next four years. By 1991-92 spending on outside investment advisors (\$53 million) nearly equaled spending for all other aspects of PERS operations (\$57 million).



It should be noted that the \$57 million for other administrative expenditures in 1991-92 included \$6 million for PERS' in-house investment office. That office has general responsibility for PERS investments, directly managing major portions of the portfolio and retaining responsibility for all aspects of portfolio management not delegated to the outside investment advisors.

Prior to 1993-94, spending on state operations for the PERS did not include expenditures on external advisors. For the first time, the 1993-94 Governor's Budget appropriately includes investment advisor spending as part of state operations. The incomplete display in past budget documents, combined with the fact that expenditures for investment advisors were continuously appropriated under the Government Code, meant that:

- The dramatic growth in spending on investment advisors proceeded without the Legislature's review; and
- The consequent rapid growth in *total* administrative spending by the PERS was masked by the more moderate growth rates presented in the budget documents.

Based on the past budget displays, PERS administrative costs rose at an apparent pace of 8.7 percent per year (average) from 1983-84 to 1991-92. Based on a full accounting, including investment advisor costs, administrative costs actually increased by an average 18 percent per year during the period.

Increased PERS Spending Translates Into Higher General Fund Costs

The recent passage of Proposition 162 appears to take away the Legislature's authority to approve or disapprove proposed levels of PERS administrative spending. However, this record of administrative expenditures, as well as PERS spending plans for the future, remain a legitimate concern of the Legislature. This is primarily because every additional dollar of PERS administrative spending ultimately is paid by the state and public agencies that contract with the PERS through adjustments in employer contribution rates. Based on the state's share of employer contributions, the state reimburses roughly 50 cents of each additional dollar of PERS spending, with the General Fund paying roughly 25 cents of each dollar.

Increased Spending on Investment Advisors Has Not Clearly Resulted in Higher Returns

What appears on the surface to be a run-away spending situation might be justified if the PERS could demonstrate that the significant expenditures for investment advisors were resulting in higher returns on investments than reasonably could have been achieved without such spending. The record, however, does not demonstrate this case. For example, for the 12 months ending September 30, 1992, PERS total

investments gained 9.5 percent in value. This is below the median 10.67 percent gain for a comparison index of large public pension funds, according to PERS' consultant Wilshire Associates. It is even further below the total fund return for the STRS for this period, which was 11.76 percent. (The STRS spends substantially smaller portions of administrative expenditures on investment advisors than does the PERS.) Measured on a three-year basis, the PERS performance also falls behind that of its peers.

This below-average performance is due in part to PERS decisions over the past several years to invest heavily in real estate. The most recent valuation of the PERS portfolio (October 1992) shows that the market value of PERS' real estate equities has declined by \$470 million (8.8 percent) from the book value (original cost) of \$5.4 billion. These investments were made upon the advice of real estate investment advisors, whose advice cost the PERS \$25.7 million in fees in 1991-92 alone.

The strongest part of the PERS portfolio, based on the ratio of market to book values, is a part of the portfolio that is directly managed by PERS' own staff—internally managed domestic equities (stocks). This portion of the portfolio has a current market value of \$18.6 billion, which exceeds book value by \$7.2 billion (63 percent). (To some extent, this reflects the longer average period of time over which these investments have been held. By any measure, however, performance in this area has been far better than that of real estate.) Moreover, during 1990-91 and 1991-92 the internally managed stock portfolio outperformed the stock portfolios that are managed by outside advisors (14.8 percent return versus 14.0 percent return in 1991-92).

This is not to say that outside advisors never add value to a portfolio in a cost-effective way. The return on investment from such spending can vary significantly depending on various factors (such as the point in the business cycle). The above information, however, suggests that such contracts need to be chosen carefully.

Legislative Review of Spending on Investment Advisors Is Needed

We believe legislative review of PERS spending on investment advisors is needed. Over the last decade, this spending has grown dramatically without any review through the budget process, to the point where such spending almost equals spending on all other aspects of PERS operations. Moreover, this spending has not produced clear results in the form of higher returns on investments.

Therefore, we recommend that the PERS report to the fiscal committees prior to budget hearings on its spending on outside investment advisors, including:

- An explanation of what factors are considered in determining (1) the types of investment advisors to use and (2) the level of expenditures for each.
- Bases for spending the amounts proposed for 1993-94.
- Expected return on expenditures for investment advisors compared to cost and expected return if in-house advisors were used.
- Steps the PERS will take to ensure that any future expenditures for outside investment advisors will result in more return on investments (including costs for these advisors) than if in-house advisors were used.

Increase PERS Accountability to Employee Members

We recommend that the Legislature enact legislation to require periodic adjustment of employee contribution rates to the PERS, on the same basis used for employer contribution rates, as one means to increase PERS management accountability to current employees and to have an equitable share in cost changes between employees and the state.

Under current law, employer contribution rates paid by the state and contracting public agencies rise or fall each year in response to changes in an array of factors, including assumptions and actual experience regarding inflation, rates of return on PERS investments, and spending levels for PERS administration. For example, the actual rate of return falling short of the assumed rate would be considered an actuarial loss, and would cause a compensating increase in employer contribution rates in order to maintain the actuarial soundness of PERS trust funds. On the other hand, employer contribution rates would decrease if investments performed above expectations. (To smooth out annual fluctuations, the actuarial loss is amortized over timeframes ranging from 5 to 40 years).

The net effect of changes in so many factors is difficult to predict from year to year. It is clear, however, that important factors affecting the employer contribution rates include factors that are, more or less, under the control of the PERS and for which the PERS board should be accountable (such as administrative expenditures and investment

performance). Under the current funding mechanism, however, it is the state and public agencies alone that either reap the financial rewards or suffer the financial consequences of positive or negative performance by the PERS.

This is because employer contribution rates fluctuate in response to PERS performance while employee contribution rates are fixed. As one means to increase the board's accountability to employees under the PERS, it would be appropriate for employee contribution rates to be adjusted annually on the same basis as employer contribution rates. Increasing the board's accountability in this way is particularly appropriate now that Proposition 162 has made the board, in many respects, autonomous from the Legislature.

Allowing the employee rates to fluctuate would also provide a more equitable sharing of changes in cost for the PERS benefit program. If the PERS administration properly manages the retirement system, the cost to the state as well as the employees would be reduced. On the other hand, increased costs would also be shared. As mentioned earlier, these fluctuations in costs affect only employer costs under current practice.

Although employee contribution rates are fixed at present, the Legislature has reserved the right (Government Code Section 20613) to adjust employee contribution rates "...in such amounts and in such manner as it may from time to time find appropriate." The effective date of this section was December 1, 1968. Therefore, the Legislature legally may increase or decrease contribution rates for employees who joined PERS on or after that date. For employees who joined PERS before December 1, 1968, the Legislature may let contribution rates fluctuate in response to actuarial calculations, provided rates do not exceed those specified under current law.

We believe that the benefits of increasing the PERS accountability to current employees, coupled with equitable sharing of fluctuations in costs, justify changing the current state employee/employer PERS rate setting structure. Consequently, we recommend that the Legislature enact legislation to require annual adjustment of employee contribution rates to the PERS, on the same basis used to adjust employer contribution rates, in order to increase the accountability of PERS management to system beneficiaries.

STATE TEACHERS' RETIREMENT SYSTEM (1920)

The State Teachers' Retirement System (STRS) was established in 1913 as a statewide system for providing retirement benefits to public school teachers. Currently, the STRS serves over 445,000 active and retired teachers and community college instructors. Retirement and ancillary benefits totaling \$2.3 billion are expected to be paid from the Teachers' Retirement Fund (TRF) in 1993-94.

Overview of the 1993-94 Budget. The budget includes \$30.4 million from the TRF for support of STRS operations in 1993-94. This is a decrease of \$1.0 million (3.2 percent) from estimated current-year expenditures, and is due mainly to one-time expenditures in the current year for implementation of an alternative disability and survivor benefits program required by federal law. In addition, under a continuous appropriation authority, the STRS will spend a projected \$24.7 million for outside investment advisors. This is \$2.2 million (10 percent) more than estimated current-year expenditures for this purpose.

Implementation of Proposition 162. As discussed in the Crosscutting Issues portion of this section, passage of the California Pension Protection Act of 1992 (Proposition 162) at the November 1992 election grants to public retirement boards in the state "plenary" authority for administration of retirement systems. Unlike the PERS, the STRS at this point has not asserted that this new constitutional authority removes STRS administrative spending from legislative review and approval through the budget process. As discussed in detail in our analysis of the PERS (Item 1900), there are various issues raised by Proposition 162, including issues surrounding the budget process, that need to be addressed by implementing legislation. This legislation should clarify how administration of the STRS and its interaction with the rest of state government proceed in the wake of the proposition.

State Contributions to Teachers' Retirement Fund

State General Fund contributions to the State Teachers' Retirement System will reach \$835 million in the budget year—nearly \$90 million more than in the current year.

The STRS receives contributions from teachers and their employers totaling 16.25 percent of active teachers' payrolls. This contribution rate is not sufficient to provide for the cost of teachers' basic retirement benefits (the so-called "normal" cost of the system, which is 17.46 percent of payroll), nor does it provide for the protection of retirees'

purchasing power (a nonvested benefit). In addition, the STRS has an unfunded liability of \$11.1 billion (based on the most recent actuarial valuation in 1991) that is amortized over the next 37 years. All of these shortfalls are covered through annual transfers from the General Fund.

In total, the budget projects General Fund transfers of \$835 million to the TRF in 1993-94. These transfers are for three purposes:

- The STRS normal cost deficit and unfunded liability, as required by the Elder Full Funding Act (\$519.6 million).
- Maintenance of retirees' purchasing power at 68.2 percent of original allowances (\$257.8 million).
- Costs of retirement benefit enhancements (an adjustment for inflation and an increase in minimum retirement allowances) mandated by the state in 1979 and 1980, respectively (\$57.6 million).

Figure 8 summarizes estimated, budgeted and projected transfers, by purpose, for 1992-93 through 1994-95. The mandated cost reimbursements are included in Item 8885 of the Budget Bill (state mandates) and are counted toward the state's Proposition 98 funding guarantee for K-14 schools. The other two categories of General Fund spending, more than \$777 million in the budget year, are in addition to the amounts provided to K-14 schools under Proposition 98. We discuss these two categories in more detail below.

Figure 8

**State Teachers' Retirement System
General Fund Contributions to Teachers' Retirement Fund
1992-93 Through 1994-95**

(In Millions)

Program	1992-93 Estimated	1993-94 Budgeted	1994-95 Projected ^a
Elder Full Funding Act	\$510.8	\$519.6	\$521.7
Purchasing power protection	180.2	257.8	302.8
Mandates	56.2	57.6	57.8
Totals	\$747.2	\$835.0	\$882.3

^a Legislative Analyst's Office projections for 1994-95, assuming an average growth in covered payroll of approximately 0.4 percent.

Elder Full Funding Act. Education Code Section 23402, added by Ch 460/90 (SB 1370, Cecil Green)—the Elder State Teachers' Retirement System Full Funding Act—requires the state each year to transfer from

the General Fund to the TRF an amount equal to 4.3 percent of covered teachers' payroll for the prior calendar year. This amount is projected to be \$519.6 million in 1993-94—an \$8.8 million increase over estimated current-year transfers. Roughly \$165 million of this amount will cover the system's normal cost deficit—the shortfall between the system's normal cost of 17.46 percent of payroll and the combined employee/employer contribution rate of 16.25 percent of payroll. The remaining \$355 million is to reduce the system's \$11.1 billion unfunded liability.

Purchasing Power Protection. Chapter 115, Statutes of 1989 (SB 1407, Cecil Green), and Ch 116/89 (SB 1513, Campbell) established a statutory funding mechanism that provides purchasing power protection benefits to retired teachers. Prior to these acts, the Legislature provided purchasing power benefits primarily through General Fund appropriations in the annual Budget Act. These benefits are *nonvested* and, therefore, can be modified by the Legislature.

In the 1989 Budget Act, the Legislature appropriated \$167 million for these benefit payments from the TRF, in order to save General Fund monies in the 1989-90 fiscal year without reducing the benefit payments. The Legislature made a "contractually enforceable" promise to repay the TRF, with interest, through the funding mechanism established by Chapters 115 and 116. Under that mechanism, the Controller transfers each fiscal year from the General Fund to the Supplemental Benefit Maintenance Account (SBMA) in the TRF an amount based on specified percentages of teachers' payroll of the prior fiscal year. For fiscal year 1990-91 the transfer was based on 0.5 percent of payroll. The percentage grows by increments of 0.5 percent each year so that it stands at 1.5 percent for the current year and will be 2.0 percent in the budget year. In 1994-95 the percentage will reach a cap of 2.5 percent. It is this incremental growth in the applicable percentage that largely accounts for the significant increases in General Fund transfers that are evident in Figure 8.

General Fund Transfer to SBMA Overbudgeted

The Governor's Budget overstates the amount of General Fund monies needed for statutory transfers to the SBMA by \$16.6 million. We recommend the Legislature recognize the availability of these funds as part of the Legislature's budget solution (General Fund savings of \$16.6 million).

The budget projects General Fund transfers to the SBMA of \$257.8 million in 1993-94—a \$77.6 million increase (43 percent) over estimated current-year transfers. This increase is due to the interaction

of two factors in the transfer formula specified in statute: (1) the estimated growth in teachers' payroll from 1991-92 to 1992-93 and (2) an increase in the percentage that is applied to that payroll from 1.5 percent to 2.0 percent (as discussed above).

Our analysis indicates that the budget overstates the amount of General Fund monies that need to be transferred in 1993-94, by overestimating growth in teachers' payroll. The budgeted transfer amount is based on an assumption that teachers' payroll will grow by 7.3 percent from *fiscal year* 1991-92 to 1992-93. (Under law, 1992-93 payroll is used for the 1993-94 transfer calculation.) This projection is inconsistent with recent statewide trends in teachers' payroll. For example, actual payroll growth from 1990-91 to 1991-92 was only 1.7 percent (compared to growth the previous year of 7.7 percent). Data for calendar year 1992 indicates that payroll growth rates have decelerated further. For instance, the budget estimates that payroll growth from *calendar year* 1991 to *calendar year* 1992 was only 0.4 percent. (Calendar-year, rather than fiscal-year, payroll is used for calculating General Fund transfers required by the Elder Full Funding Act.) These low growth rates are not surprising, given the current fiscal problems of school districts across the state.

There is no evidence to support the 7.3 percent payroll growth used to determine the General Fund transfer to the SBMA. This assumption needlessly sets aside General Fund resources that the Legislature could use to help address the state's budget problem. Consequently, for purposes of projecting statutory transfers to the SBMA, we recommend that the Legislature assume that growth in teachers' payroll from 1991-92 to 1992-93 will not be greater than the 0.4 percent rate of growth from calendar year 1991 to calendar year 1992. Revising this assumption would free up approximately \$16.6 million for other state purposes in 1993-94. We recommend the Legislature recognize the availability of these funds as part of the Legislature's budget solution.

Redefining the State's Role in Teachers' Retirement

We recommend that the Legislature enact legislation to establish a benefit plan for future entering members of the STRS that is funded fully by member and employer contributions on an actuarially sound basis. The state would experience major General Fund savings in future years by eliminating the state's financial liability for new teachers. These savings would grow each year, as current teachers retire, to an eventual annual level of roughly \$400 million (in today's dollars).

Teacher and school district contribution rates are fixed by law at levels that fall short of what is required to provide for ongoing

retirement benefits. These provisions for teachers' retirement impose major costs on the state's General Fund. In fact, through the funding mechanisms established by current law, the state actually underwrites a large share of the costs of teachers' retirement. In no other instance is the state responsible for retirement costs for nonstate employees/retirees.

Given that the member beneficiaries of the STRS are local, rather than state, employees, as well as the independence accorded to the STRS board by Proposition 162, it is not clear, as a matter of public policy, why the state should continue to be responsible for the normal cost deficit of the system. The normal cost deficit is the difference between the combined employee/employer contribution rate (16.25 percent of payroll) and the rate required to provide for ongoing retirement benefits on an actuarially sound basis (currently 17.46 percent of payroll). This deficit accounts for annual General Fund costs of roughly \$165 million.

With respect to *current* members of the system, there is virtually nothing the state can do about the normal cost deficit. Under case law regarding contracts, the state can neither increase the member contribution rate above 8 percent nor reduce retirement benefits. In addition, any increase in the school district contribution rate would not relieve the General Fund, since it would probably create a mandated local cost that is reimbursable by the state.

The Legislature does, however, have the option of changing contribution rates and benefits for *new* teachers who enter the retirement system in the future, and it is here that efforts for fundamental changes in the financing of the system must be focused.

With respect to future members of the STRS, we recommend that the Legislature enact legislation to establish a benefit plan that is fully funded by member and employer contributions on an actuarially sound basis. This objective may be achieved by one or more measures, including:

- Voluntary—or bargained—increases in employer contributions.
 - Increases in member contribution rates.
 - Reductions in benefits.
 - Teacher participation in social security as a partial substitute for STRS benefits.
 - Participation in defined contribution plans as a partial substitute for STRS benefits. Defined contribution plans—under which
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employees choose amounts of salary to be deferred and invested on a tax-deferred basis—offer not only a means of reducing state costs but also offer a flexible means of accommodating varying financial goals among individuals.

The Legislature could even establish a variety of plans—with different benefit levels, contribution rates, and cost-of-living provisions—from which districts and teachers could choose. Under any plan, however, the state would have *no* liability for school district retirement costs. This would be solely a local decision, as are all other compensation issues.

The state would experience major General Fund savings in future years by eliminating the state's financial liability for new teachers. These savings would grow each year, as current teachers retire, to an eventual annual level of roughly \$400 million (in today's dollars). This estimated amount includes about \$165 million for elimination of state responsibility for normal cost deficit and about \$235 million for eliminating state costs for purchasing power payments.

Options to Reduce General Fund Expenditures in 1993-94

Although there is little the Legislature can do to reduce state costs related to vested benefits of current STRS members, the Legislature could reduce STRS-related General Fund expenditures in the budget year by suspending or reducing the purchasing power benefit payments.

As discussed above, Chapters 115 and 116 of 1989 established a statutory funding mechanism that provides purchasing power protection benefits to retired teachers. A portion of the General Fund amount for this program is part of a legislative promise to repay the TRF for purchasing power benefit payments in prior years, and a portion is for current purchasing power protection benefits. The enacted legislation expressly states that these supplemental benefits are *nonvested* and reserves the right of the Legislature to reduce or terminate the benefit program at any time.

Approximately 55,000 teachers who retired before 1980 receive purchasing power benefit payments. These payments range from an average of \$8 per month for teachers who retired just before 1980 to an average of about \$470 per month for teachers who retired between 1959 and 1973. These supplemental benefits come on top of the vested retirement benefit amounts for these groups, which average \$733 and \$460 per month, respectively. In total, purchasing power benefit payments are expected to cost the General Fund \$226 million in 1993-94.

The Legislature could save significant General Fund amounts by reducing, on a one-time basis, the benefit levels for 1993-94. For example, we estimate that roughly \$75 million could be saved if benefit payments for 1993-94 were set at maintaining allowances at 60 percent of original purchasing power instead of the current target of 68.2 percent.

This report was prepared by Robert Turnage and Gerald Beavers. For information concerning this analysis, please contact the authors at (916) 322-8402.

Legislative Analyst's Office



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