

April 7, 2008

Recent Proposals for CalSTRS Purchasing Power Benefits

LEGISLATIVE ANALYST'S OFFICE

Presented to:

Senate Budget and Fiscal Review

Subcommittee No. 4 on State Administration

Hon. Michael Machado, Chair





The Legislature's Powers in This Area

- ☑ ***Legislative Options Are Limited.*** In general, pension commitments represent contracts between public entities and public employees, such as teachers. The U.S. and State Constitutions generally prohibit impairment of contracts.

- ☑ ***Quid Pro Quo Required to Make Changes.*** Case law holds that when a California government makes changes in pension benefits that disadvantage current and past employees, these disadvantages must be accompanied by “comparable new advantages” for those persons.
 - ***Recent Proposals.*** In general, the recent proposals *disadvantage* California State Teachers' Retirement System (CalSTRS) members by having the state pay less to the Supplemental Benefit Maintenance Account (SBMA) in the future. The proposals provide what *may* be a comparable new advantage, principally by increasing purchasing power benefits for today's retirees and/or guaranteeing the purchasing power benefits for the first time.

- ☑ ***Constitutional Authority for Retirement Boards.*** In 1992, Proposition 162 amended the State Constitution to give retirement boards like the Teachers' Retirement Board (TRB) “sole and exclusive” power over actuarial functions.

- ☑ ***Pension Changes, Once Enacted, Are Difficult to Reverse.*** Actions to increase benefits and shift power to retirement boards are virtually certain to affect state finances for decades, a century, or more.



Purchasing Power Benefits

- ☑ ***Nation's Second-Largest Public Pension Fund.*** Governed by TRB, CalSTRS serves over 800,000 members, including over 200,000 retired teachers and their survivors who currently receive benefits.

- ☑ ***Benefits.*** The main CalSTRS benefits include:
 - A defined benefit allowance based primarily on age, years of service, and final compensation.
 - A purchasing power benefit supported by the SBMA.

- ☑ ***Purchasing Power Benefits.*** Basically, retired teachers' allowances are increased by an annual benefit improvement factor equal to 2 percent of their initial allowance. Over time, inflation often grows faster than this, resulting in the erosion of the purchasing power of the retiree's initial benefit.

- ☑ ***Legislative Actions.*** The Legislature has taken various actions over time to prevent this erosion of benefits' purchasing power. Chapter 115, Statutes of 1989 (SB 1407, C. Green), and Chapter 116, Statutes of 1989 (SB 1513, Campbell), established the SBMA. Chapter 840, Statutes of 2001 (AB 135, Havice), increased the targeted SBMA benefits to those necessary to restore benefits for members and beneficiaries to 80 percent of their original purchasing power, as measured by the California Consumer Price Index, to the extent that funding is available.



Purchasing Power Benefits

(Continued)



State Contributions. The state contributes 2.5 percent of the second prior fiscal year's teacher payroll to SBMA each year under current law. In 2008-09, this required state General Fund contribution would equal \$664 million. In addition, the state, districts, and teachers contribute funds to CalSTRS' defined benefit program accounts each year. In 2008-09, the required state General Fund contribution for this purpose totals \$536 million.

- **2003-04 Budget and Court Case.** In 2003-04, the Legislature withheld a \$500 million state contribution to SBMA on a one-time basis. Courts found this action to be unconstitutional and ordered the state to pay the funds to CalSTRS. The administration exhausted its appeals of this case during 2007.
- **SBMA Reserve Balance.** Estimates indicate that the SBMA reserve balance will be \$4.6 billion as of June 30, 2008.



SBMA Benefit Recipients

- ☑ ***About One-Fourth of Current CalSTRS Benefit Recipients.*** Estimates indicate that nearly 59,000 CalSTRS benefit recipients will receive payments from SBMA in 2008-09 in order to restore the purchasing power of their benefits to 80 percent of the initial benefit. Estimated costs for these payments are \$267 million.

- ☑ ***Recipients Are Elderly Retirees.*** Under current law, recipients of SBMA payments in 2008-09 would generally be persons who retired from teaching in 1989 or earlier. Accordingly, 77 percent of CalSTRS members currently receiving SBMA benefits have an age of 80 or above, and 15 percent have an age of 90 or above.

- ☑ ***Most Recipients Are Women.*** The overall membership of CalSTRS is 70 percent female, and the higher life expectancy for women—as well as historical teacher demographics—suggests that the SBMA population is even more disproportionately female.

- ☑ ***SBMA Recipients Tend to Receive \$2,000 or Less of Benefits Per Month.*** According to CalSTRS, the average SBMA recipient is paid a basic monthly benefit allowance of \$1,606 and a monthly SBMA payment of \$333. Only 1 percent of SBMA benefit recipients have a basic monthly allowance of \$4,000 or more.



Recent Proposals: General Themes

- Objectives of Recent Proposals.*** The Governor, CalSTRS, and the California Retired Teachers Association (CRTA) each have made proposals to change current law concerning SBMA. These proposals have several common themes:
- An increased and/or newly guaranteed purchasing power benefit for retired teachers.
 - Decreased state contributions to SBMA to help the Legislature address the 2008-09 budget problem.
 - Adjustments to state payment dates to SBMA to help alleviate cash flow problems in 2008-09. (The payment date to SBMA was moved to November 2008 in the special session.)
 - A schedule for the state to pay court-ordered interest to CalSTRS of over \$200 million related to the Legislature's action to withhold SBMA payments on a one-time basis in 2003-04.



Comparing the Proposals

	Current Law	Proposals		
		Governor's (As of January 2008)	CalSTRS	California Retired Teachers Association
Targeted Purchasing Power Benefit	<ul style="list-style-type: none"> 80 percent of value of initial benefit 	<ul style="list-style-type: none"> 80 percent 	<ul style="list-style-type: none"> 82.5 percent 	<ul style="list-style-type: none"> 85 percent
Constitutional Status of the Benefit	<ul style="list-style-type: none"> Paid to the extent that funds on hand are sufficient 	<ul style="list-style-type: none"> Guaranteed by the state 	<ul style="list-style-type: none"> Guaranteed by the state 	<ul style="list-style-type: none"> Paid to the extent that funds on hand are sufficient
Effect on State Unfunded Liabilities (Teachers' Purchasing Power Benefits Only)	<ul style="list-style-type: none"> No unfunded liability ever 	<ul style="list-style-type: none"> Large new unfunded liability—estimated at \$4.7 billion 	<ul style="list-style-type: none"> Very large new unfunded liability—estimated at \$6.9 billion 	<ul style="list-style-type: none"> No unfunded liability ever
State Contribution (As Percent of Teacher Payroll)	<ul style="list-style-type: none"> Fixed at 2.5 percent 	<ul style="list-style-type: none"> 2.2 percent in 2008-09, with unconditional power for CalSTRS to set future rates 	<ul style="list-style-type: none"> 2.2 percent in 2008-09, with unconditional power for CalSTRS to set future rates 	<ul style="list-style-type: none"> Fixed at 2.25 percent
Constitutional Status of State Contributions	<ul style="list-style-type: none"> Guaranteed 	<ul style="list-style-type: none"> Guaranteed 	<ul style="list-style-type: none"> Guaranteed 	<ul style="list-style-type: none"> Guaranteed
Schedule for Paying Over \$200 Million of Interest Under Recent Court Order	<ul style="list-style-type: none"> No schedule established 	<ul style="list-style-type: none"> Pay over three years beginning in 2008-09 	<ul style="list-style-type: none"> Unknown 	<ul style="list-style-type: none"> Pay over four years beginning in 2009-10
Payment Dates for Annual State Contributions	<ul style="list-style-type: none"> November 1 in 2008-09; unspecified thereafter 	<ul style="list-style-type: none"> Split between November 1 and April 1 each year beginning in 2008-09 	<ul style="list-style-type: none"> Split between November 1 and April 1 each year beginning in 2008-09 	<ul style="list-style-type: none"> Split between November 1 and April 1 each year beginning in 2008-09



Comparing the Proposals: General Fund Costs



The CalSTRS Proposal and the Governor's January Proposal

- **2008-09.** Lower state contributions to SBMA of \$80 million, compared to current law.
- **Each Year Thereafter.** Sole and exclusive power of TRB to set rates. State contributions could be higher than under current law and may vary based on inflation and other actuarial factors. Under an extreme inflation scenario (like that of the 1970s and early 1980s), state contributions could climb above 7.5 percent of payroll annually—three times the payments under current law.
- **Court-Ordered Interest Payments.** Over \$200 million spread out over three years beginning in 2008-09.



The CRTA Proposal

- **2008-09.** Lower state contributions to SBMA of \$66 million, compared to current law and \$80 million less than the Governor's budget proposal for court-ordered interest payments.
- **Each Year Thereafter.** The \$66 million of savings would be ongoing, growing over time.
- **Court-Ordered Interest Payments.** Over \$200 million spread out over four years beginning in 2009-10.



LAO Comments

- All Proposals to Change Pensions Involve Risks for the State.*** Changing pension policies for the primary purpose of achieving near-term budget savings almost always involves significant financial and legal risks for the state over the long term. Reducing state contributions to SBMA over the long term also involves risks for the state and/or for currently employed teachers near the beginning or middle of their careers.
- All Enacted Changes Should Be Part of a Comprehensive Legislative Package.*** The proposed changes to the SBMA funding, as well as the Legislature's decisions on how to appropriate interest payments in response to the recent court order, need to be considered together. To be legally viable, any enacted changes need to offer comparable new advantages to CalSTRS members in exchange for decreases in state contributions.
- Large New Unfunded Pension Liabilities?*** Because the state would guarantee SBMA benefits for the first time under the Governor's January proposal and the CalSTRS proposal, these actions would create new unfunded pension liabilities for the state. Over time, required contributions would amortize these liabilities. Nevertheless, the creation of billions of dollars of new unfunded pension liabilities in order to achieve tens of millions of dollars of near-term budgetary savings would be a questionable fiscal policy.
- LAO Bottom Line.*** The Governor's January proposal and the CalSTRS proposal shift too much of the Legislature's power to CalSTRS in exchange for far too little of a benefit for the state. We, therefore, recommend rejecting both of these proposals. While the CRTA proposal involves long-term financial risks for future retirees and the state, we believe that it is less risky than the other SBMA savings proposals.