CSBA

The Public Employee Benefits Reform Act

Analysis from CSBA's Governmental Relations Department

The Public Employee Benefits Reform Act, an initiative to amend the California constitution, was filed with the Attorney General's Office for an official title and summary on June 21. The initiative would retain the current defined benefit plan for state and local public employees and retain current benefit levels for current employees, but would reduce the size of the pensions that new public employees could receive. It was filed for possible inclusion on the ballot by the California Foundation for Fiscal Responsibility, whose president is former Assembly member Keith Richman.

Modification of defined benefits

Defined benefits are calculated using three factors: (1) years of service (employment), (2) a benefit factor (expressed as a percentage), and (3) salary. Currently, school employees who are members of the Public Employee Retirement System may retire and receive a pension as early as age 50. The benefit factor is 1.1 percent at age 50 and gradually increases to 2.5 percent for those who retire at age 63 or older. The pension is based on the highest 12 months of pay.

PEBRA would change this for most public employees[1] by:

1. Raising the minimum retirement age to 60
2. Establishing a flat benefit factor of 1.5 percent for all ages of retirement, and
3. Basing the pension on the average annual pay of the highest five years of pay

These new provisions would substantially reduce the size of a retiree's pension. For example, consider an employee who retires at age 60 after 30 years of service. Assume the employee earned $50,000 per year five years prior to retirement and received a 5 percent pay raise in each of the subsequent 4 years, ending in a final year's pay of $60,775. The following table compares the pensions that would be received under current law and PEBRA.

	Service Credit	x	Benefit Factor	x	Compensation	=	Pension
Current law	30	x	2.314 percent	x	$60,775	=	$42,190
PEBRA	30	x	1.5 percent	x	$55,256	=	$24,865

Under this example, two employees working the same number of years, earning the same wages and retiring at the same age would receive vastly different pensions. Under current law, the pension would be equal to nearly 70 percent of this employee's final annual earnings. Under the initiative, it would drop to 41 percent.

For teachers, the situation is a little more complicated. The "normal" retirement age for the California State Teachers Retirement System is 60. Members may retire as early as age 50 if they have 30 or more years of service credit and as early as age 55 with at least five years of service credit. The benefit factor for those who retire at 60 is 2.0 percent. It is reduced for each month under 60 at age of retirement. It is increased to 2.4 percent at age 63 or older. CalSTRS also offers an early retirement incentive program for eligible members that provides for an additional two years of service credit.

Final compensation for teachers is defined as the highest three consecutive years of creditable earnings for teachers with less than 25 years of service credit, and as the highest 12 consecutive months of creditable earnings for teachers with more than 25 years of service credit. However,

[1] Slightly higher benefits would be provided for firefighters, peace officers, and public safety employees.

teachers with less than 25 years of service credit may have their pension based on the highest 12 months of earnings if (1) it is provided for in a collective bargaining contract and (2) all costs are paid for by the employee and/or employer.

The following table compares the pension for a teacher who retires at age 60 with 30 years of service credit and a final salary of $85,085 (based on a salary of $70,000 at age 55 with four years of 5 percent increases).

	Service Credit	x	Benefit Factor	x	Compensation	=	Pension
Current law	30	x	2.0 percent	x	$85,085	=	$51,051
PEBRA	30	x	1.5 percent	x	$77,359	=	$34,812

Similar to the example of the classified employee, the value of the pension as a percentage of the final year's earnings drops precipitously, from 60 percent to 41 percent.

Impact on local education agencies

Under current law, the state sets the contribution rates for schools and school employees. PEBRA does not change these rates. Because the pension obligations of both PERS and STRS would be reduced by PEBRA, maintaining these current rates would certainly result in excess revenues to both retirement systems. However, absent any other change in law, PEBRA would not affect the current cost of LEAs for employee retirement. In other words, PEBRA, by itself, would not result in LEA employer savings. The amount of LEA savings would be determined by the contribution rates established by the state.

While the actuarial needs of STRS and PERS would be identified at the state level, the initiative gives public agencies the authority to "adjust the amount and rate of employee and agency contributions for pension and retiree health care benefits in any manner the agency may from time to time find appropriate, subject to the limitations provided in this Section" and prohibits collective bargaining agreements from limiting or restricting that authority. Presumably, this would mean that, in practice, the state would establish the amount needed from LEAs on behalf of eligible employees, and the LEAs could determine unilaterally (i.e., outside of collective bargaining) how much would come from the employer and how much from the employee.

Over time, the savings to LEAs could be significant; however, the full impact of the change would not be felt right away. This is because the cost of providing all current school employees who are members of STRS and PERS with their existing benefits must still be met.

On the other hand, since the pensions that would be available under PEBRA would not constitute a livable income, there would be pressure to supplement them with an additional plan, such as an employer- and employee-funded defined contribution plan. This would be especially true for teachers, who do not qualify for Social Security. Such pressure could come from unions, or it could come from the need to successfully compete in the labor market for teachers and other school employees—offering supplemental retirement plans could become a tool for recruiting and retaining employees.

Alternatively, employees could demand higher pay either to compensate for a smaller pension or to claim their "fair share" of the savings. In any event, the savings that would accrue from enactment of PEBRA eventually could be offset by the cost of supplemental retirement plans and/or higher pay.

Cost-of-living increases

Public agencies would be authorized to provide a one-time cost-of-living adjustment to a pension after five years of retirement. The increase would be equal to the increase in the California Consumer Price Index for the preceding year, but it could not exceed 3 percent. In addition, if the actuarially determined value of a plan's assets exceeds 110 percent of its liabilities, then a public agency may increase pensions by up to 3 percent as long as the increase does not reduce the assets to less than 110 percent of liabilities.

For LEAs, the contribution rates established by the state would be a major factor in determining whether assets are more than 110 percent of liabilities. Unions would have an incentive to advocate for higher-than-needed employer rates in order to ensure the 3 percent adjustments.

Post-retirement health care benefits

The initiative also restricts the ability of public agencies to provide retiree health benefits to all new employees[2]. Such benefits can only be made available to employees who have reached full retirement age (but earlier if it would result in a cost savings to the public agency). To be eligible, a new employee must have been a full time employee of one or more public agencies for at least five consecutive years immediately preceding retirement and a full time employee of one or more public agencies for an aggregate of 10 years.

Beginning with the 2009-10 fiscal year, a public agency offering such benefits "shall make payments to one or more retiree health care plans for all current and new public agency employees of that public agency in amounts that each plan's actuary determines will equal or exceed the normal cost for that fiscal year of any retiree health care plan benefits projected to be paid by the public agency to such current and new employees." In other words, the agency (i.e., employer) would bear the full cost of post-retirement benefits (costs could not be shared with employees) for both current and new employees and actuarially determined annual costs must be fully funded (instead of simply "booked" as required by GASB-45, the General Accounting Standards Board's standard requiring public agencies to report benefit costs and obligations.

Apparent conflict

Paragraph 1(F) of the initiative requires each public agency to "make payments to each defined benefit plan for all current and new employees of that public agency in amounts that each plan's actuary determines will equal or exceed the normal cost for that fiscal year of the defined benefits under that plan for all current and new employees of that public agency." This appears to require public agencies, including LEAs, to bear the full cost of employee retirement plans. In other words, employees would not contribute.

However, Paragraph 4 contains the provision, already described, that gives public agencies the authority to adjust the "rate of employee and agency contributions," thus implying that employee contributions would be permissible. But that authority would be "subject to the limitations provided in this Section." It is uncertain whether the language in Paragraph 1(F) would constitute such a "limitation." If it does, then Paragraph 4 would be rendered meaningless.

This initiative has not yet been cleared for circulation. Depending on when it is cleared, the deadline for submission of signatures will be sometime in mid- to late December. If it qualifies, it will appear on 2008's June 3 primary ballot.

[2] Disability and death benefits are specifically exempted from these limitations.