Getting Down to Facts on Pensions in California

January 18, 2019
Sacramento, California

Stanford University

PACE
Policy Analysis for California Education

GETTING DOWN TO FACTS II

What is Getting Down to Facts II?

National collaborative research project on California's PreK-12 education system including more than 100 researchers across the country.

- Sequel to the first GDTF released 10 years ago
- Input from multiple stakeholders: the public, teachers, principals, CBOs, superintendents (county and district), policy leaders
- 36 research studies, 19 research briefs and a summary paper

Areas Covered

Student Success

Governance

Personnel

Finance

Key Findings from Getting Down to Facts II

- California schools and students have been moving in the right direction.

- Great need remains for policies to address system weakness and build capacity.

- Specifically, areas for California to focus on:
  - Building on current reforms
  - Increasing funding and fixing systems
  - Addressing achievement gaps

Cory Koedel

Associate Professor of Economics and Public Policy at the University of Missouri

Coeditor, *Economics of Education Review*

Dr. Koedel has recently released two studies that evaluate the interaction between educator pension systems and educator labor markets.

Agenda

- Presentation by Cory Koedel: Pensions and California Public Schools

- Q&A

Pensions and California Public Schools

Cory Koedel
Gabriel E. Gassmann

University of Missouri

Outline

- Background
- What is happening?
- Why is it happening?
- Longer-term outlook
- Policy options

- NOTE: The focus of the GDTFII report and today's talk is primarily CalSTRS, although California schools also employ workers covered by CalPERS. The situation with CalPERS is substantively similar to CalSTRS, but CalSTRS is a much larger cost item for school districts.

Background

- Benefits
  - CalSTRS is a defined-benefit pension plan. The benefit formula is as follows:

Initial Annual Retirement Benefit = *[(formula factor)*(years of service)](final average salary)**

  - Example: a 25-year worker who retires at age-60 with a 2-percent formula factor would receive 50 percent of her final average salary annually in retirement.
    - At 30 years of service, an age-60 retiree would get 66 percent (30*2.2) of her final average salary in retirement.
    - Final average salary is based on either the highest 1 or 3 years of earnings (depending on service years and locally bargained labor contracts).
  - CalSTRS benefits include an annual cost of living adjustment.

Background

- Funding
  - Benefits in a DB plan are not directly linked to contributions at the individual level (they are defined by the formula).
  - The lack of a direct link between contributions and benefits facilitates resource transfers between teachers in a plan.
    - Contrast this with a defined contribution plan (like a 401k) where resource transfers across workers are structurally prevented.
  - Resource transfers occur within cohorts; and although DB plans are designed to be funded at the cohort level, resource transfers across cohorts can occur.
    - It is overwhelmingly the case in DB plans nationally that the direction of cross-cohort resource transfers is from younger cohorts to older cohorts.

What is Happening with CalSTRS?

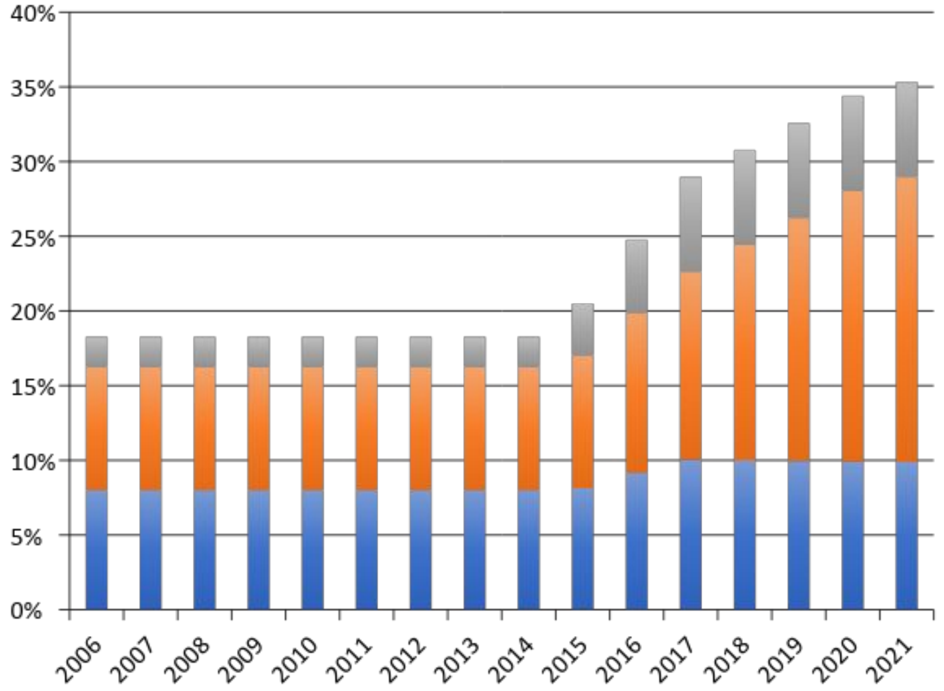
- Contribution rates are going up.

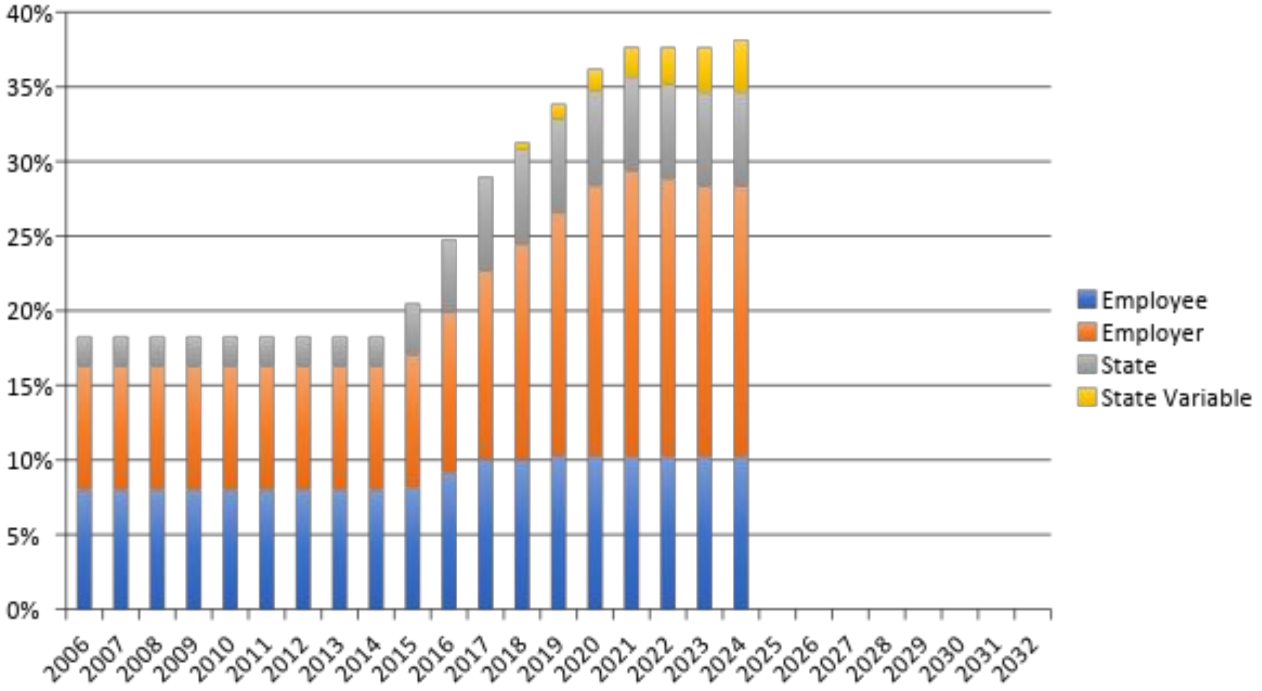
- Contributions are operationalized as a percent of salary on a "per head" basis.
  - Rates are rising for three parties:
    - school districts, the state, and employees.

  - Most of the already-realized and projected rate increases are due to direct legislation: Assembly Bill 1469
    - Sharp rate increases are being phased in between 2014-2021. E.g., AB 1469 stipulates that the district rate will rise from **8.25% of salaries** in 2014 to **19.1% of salaries** by 2021. This is more than a 100 percent increase in district pension costs.
    - The state rate is currently projected to rise significantly above what was directly legislated by AB1469 (due to a variable-rate stipulation in the legislation).

What is Happening?

- Figures 1/A1. District & State Contribution Rates to CalSTRS as Projected by the 2017 CalSTRS' Actuarial Valuation Report (based on Assembly Bill 1469 and corresponding actuarial calculations.



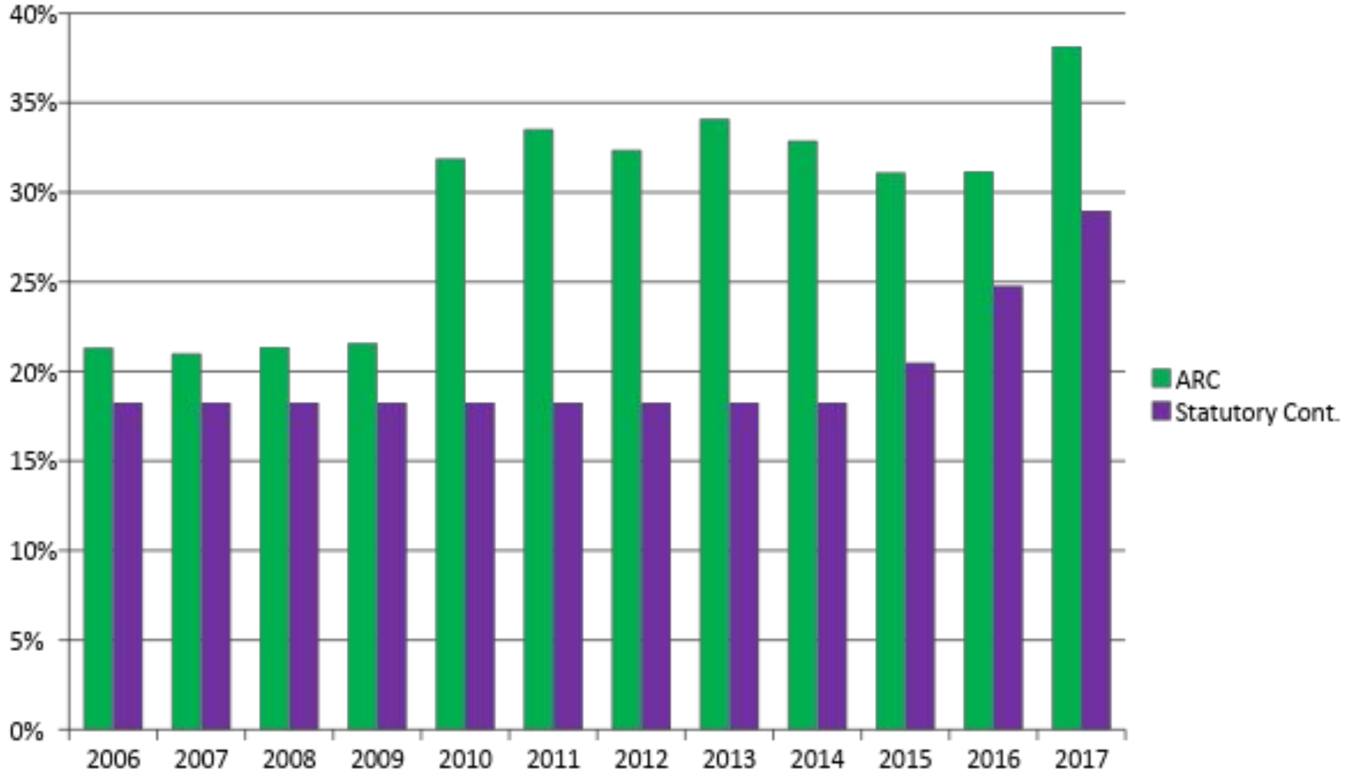


Why is it Happening?

- Pension debt.
- Pension accounting is really complicated and there are many factors we could discuss. But if you're not a pension wonk (and even if you are!), only two key factors really matter:
  1. School districts, the state, and CalSTRS employees have been underpaying the actuarially-calculated ARC for a very long time.
     - This is like receiving a credit card bill every month and not paying it off in full. The balance builds up over time.
     - **Implication: California has not been paying the full price of the pension benefits promised to employees.**

Why is it Happening?

- Figure 2. Realized ARC and Statutory Contribution Rate, 2006-2017, in Percentage Points of Salaries



Why is it Happening?

2. The ARC is what actuaries say is needed to fund promised future benefits. In addition to underpaying the CalSTRS ARC for many years, there is consensus among financial economists that the ARC itself is too low.

- The issue: Actuarial calculations assume a high rate of return on assets. This allows them to collect less now to pay out benefits far into the future.

- The Federal Reserve recently changed how it calculates pension liabilities, lowering the assumed rate to 4 percent.
  - CalSTRS' current rate is 7 percent (while this is good compared to most other public DB plans, it is still too high)

- **Implication: Pension debt will likely continue to accrue even if the ARC is paid in full.**

Longer-Term Outlook

- How long will the higher pension contribution rates be required?
  - Under current law and assuming all actuarial assumptions hold, through **2046**

  - If actuarial projections are too optimistic, one of two things will happen:
    - Even higher contribution rates will be required (under Assembly Bill 1469, most but not all of this risk falls on the state)

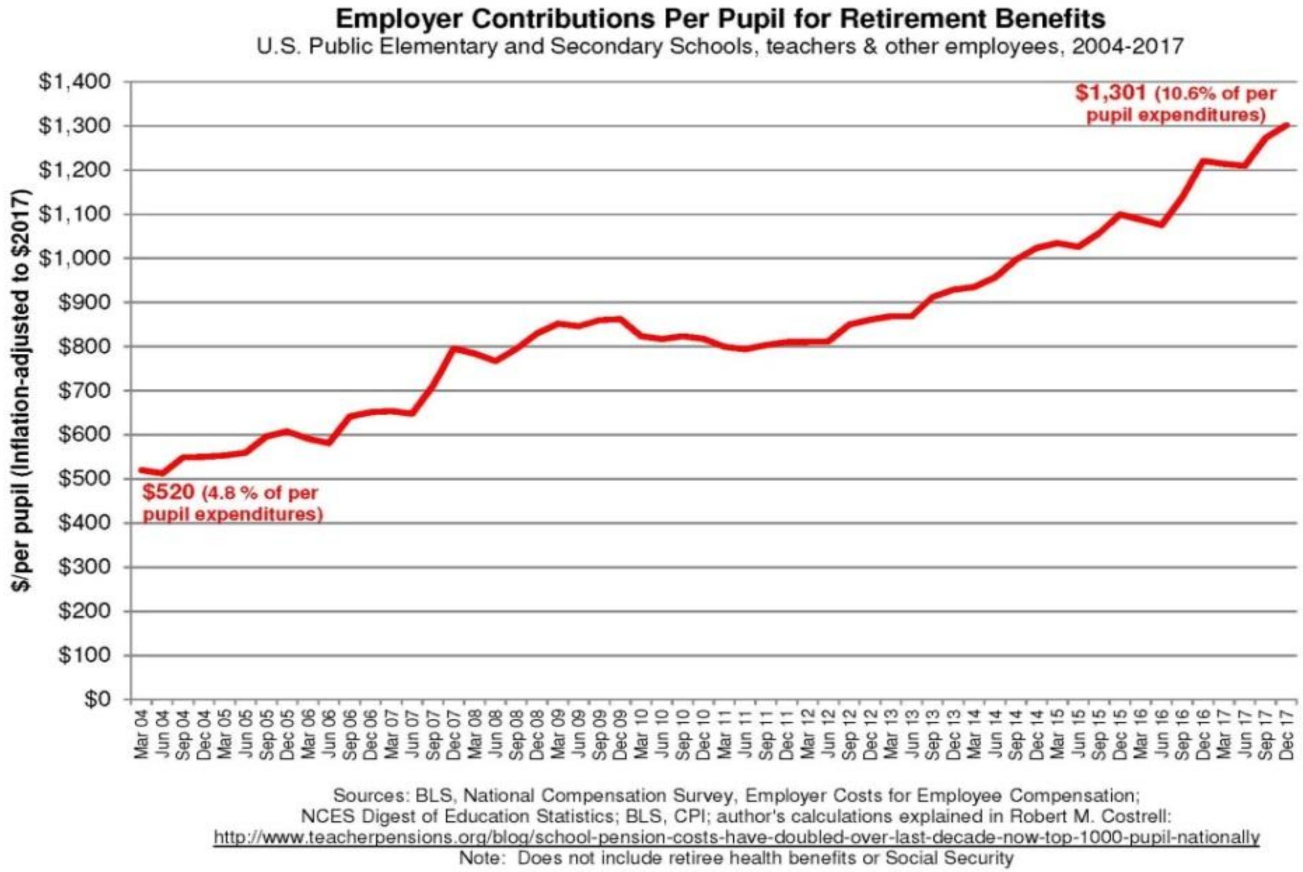
    and/or

    - The 2046 endpoint will be extended

This is a National Problem

- Most states are in a similar position with regard to the financial condition of their teacher pension plans.
  - Backes et al., 2016: On average across state teacher plans in the U.S. as of 2013, roughly 11 percent of teacher salaries were used to service pension debt.
    - CalSTRS is at about 18 percent.

This is a National Problem



Policy Options to Reduce/Halt the Growth of Unfunded Liabilities (not recommendations)

- Growth in unfunded liabilities is the primary threat to school system finances from the pension plan(s).
    - Within the current pension structure, some combination of further benefit reductions, and/or even higher contribution rates, will be required.
        - Contribution rates are already rising but it will not be enough.
            - The recently approved one-time payment reduces short-term pain, but does not address the structural issues that generated the current problems in the first place.
        - New teachers in California, hired after 2012, are already enrolled in a less generous plan but pay essentially the same price for benefits (with more risk).
    - Teachers in many states are covered by Social Security (but not in California).
    - Some states have made structural reforms to their plans. The specific reforms vary, but all reduce the emphasis on “defined benefit” (DB) pensions and shift toward “defined contribution” (DC) pensions.
        - Few states have made a full shift away from traditional DB plans, but some have.
        - Partial shifts either (1) offer a hybrid plan with DB/DC components, or (2) give teachers a choice between DB & DC plans.

Questions?

Upcoming PACE Events

February 1, 2019

PACE 2019 Annual Conference

Kimpton Sawyer Hotel

9am-4pm

GETTING DOWN
TO FACTS II

Putting Evidence into Action to Advance Equity in California

March 8, 2019

PACE Seminar on ***English Learner Policy for California***

Crocker Art Museum 11:30-1:00pm

Ilana Umansky

Lucrecia Santibañez

Christine Snyder