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Could states save money if raises during a recession were designated as non-pensionable?

How government could reduce pension debt while protecting earned retirement benefits

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Recession's impact

- **Pension funds lose assets in a market downturn.[1]**

- Due to the nature of defined benefit plans, the system still needs to pay full retiree benefits, even when return on assets plummets in an economic downturn.

- School systems have committed to pay raises, even though they are no longer in sync with the labor market.

  - Those raises drive up teacher retirement costs at a time when the broader population sees declines in their retirement assets.

As the US enters an economic downturn, public pension systems will be further stressed, and states will have difficulty making full payments to their funds.[2]

Policymakers seeking ways to regain control of burdensome pension debt

Types of changes typically sought[3]:

• Increases in employee contributions

• Cost of living adjustment (COLA) reductions

• Increase in retirement age and/or vesting periods

• Change to final average salary (cap final salary and/or years averaged in formula)

Policymakers still feel limited by their means to lower pension costs for teachers already in the system without putting a larger share of the burden on younger teachers.

But many are overlooking an important lever still under their control - pensionable pay raises.

A teacher's pension consists of four key components

$$\text{Annual Pension Allowance}^4 = \left(\boxed{\text{Final Avg. Salary}} \times \boxed{\text{Years of Service}} \times \boxed{\text{Multiplier}} \right) + \boxed{\text{COLA}}$$

New raises each year

A growing pensionable salary is a central factor in an individual's pension benefit, yet is often overlooked because <u>local employers</u> control raises.

Imagine if lawmakers passed a law:

1. All raises during near-term shortfalls (recessionary times) are non-pensionable

- **OR** -

2. All raises going forward are non-pensionable until pension debt is fully funded

+ Pensions on current salaries are protected.

+ Teachers still earn years of service.

+ Assumes all teachers made whole in salary with non-pensionable pay.

+ Assumes teachers don't have to pay retirement contributions on non-pensionable pay.

+ Employers can give raises, but not pensionable ones.

+ Employers could offer retirement on non-pensionable salary, but it would be subject to ERISA.

This study examines both the two-year impact and the ten-year impact if such a law were enacted in 2008

- What would this mean for teachers? We explore three different teachers at different longevity levels

- How would such a requirement affect pension debt?

- Is this a viable (legal) policy option?

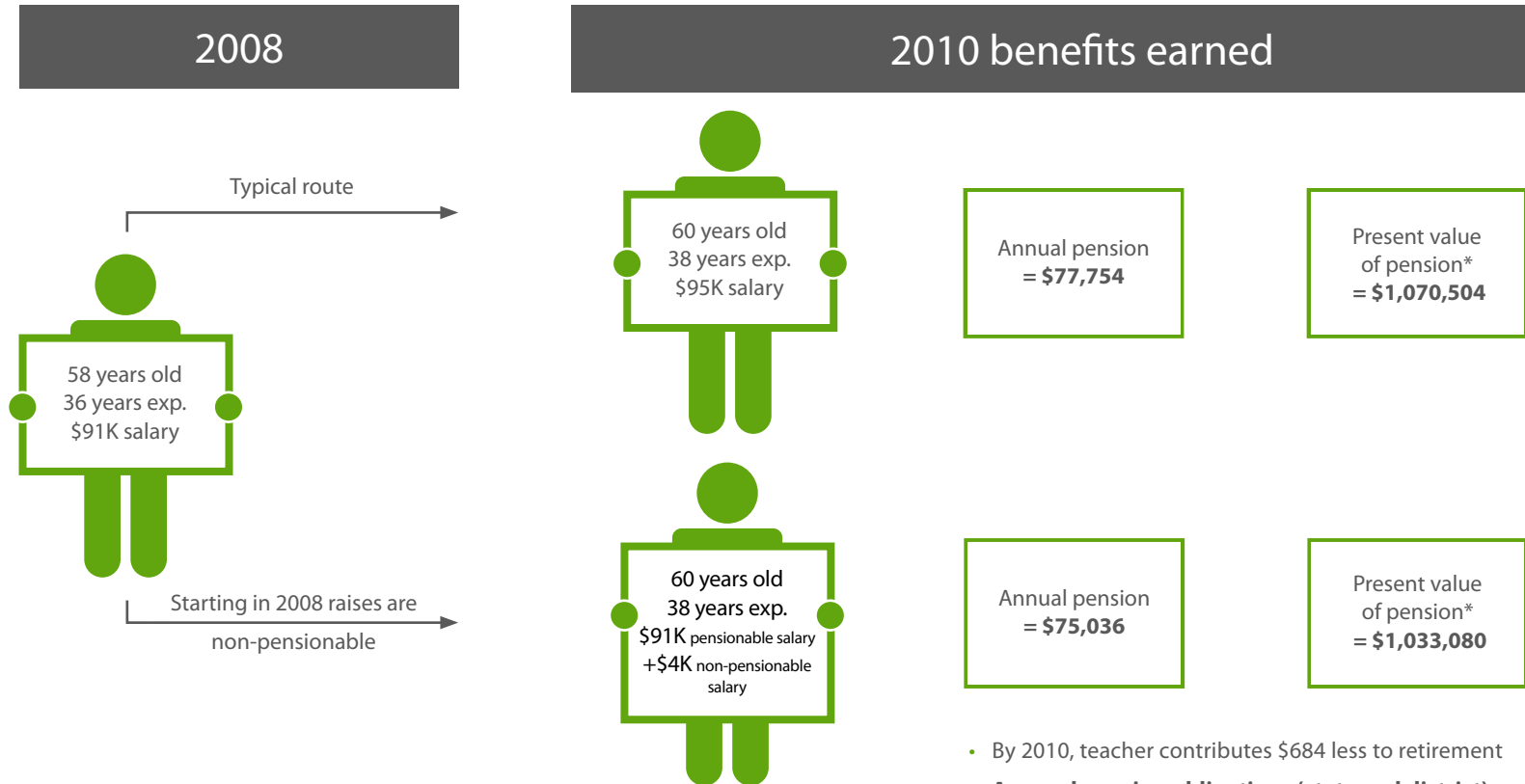*This analysis explores the effect across California, Illinois, Texas, and Vermont.*

2-Year impact if enacted in 2008

How would this work?

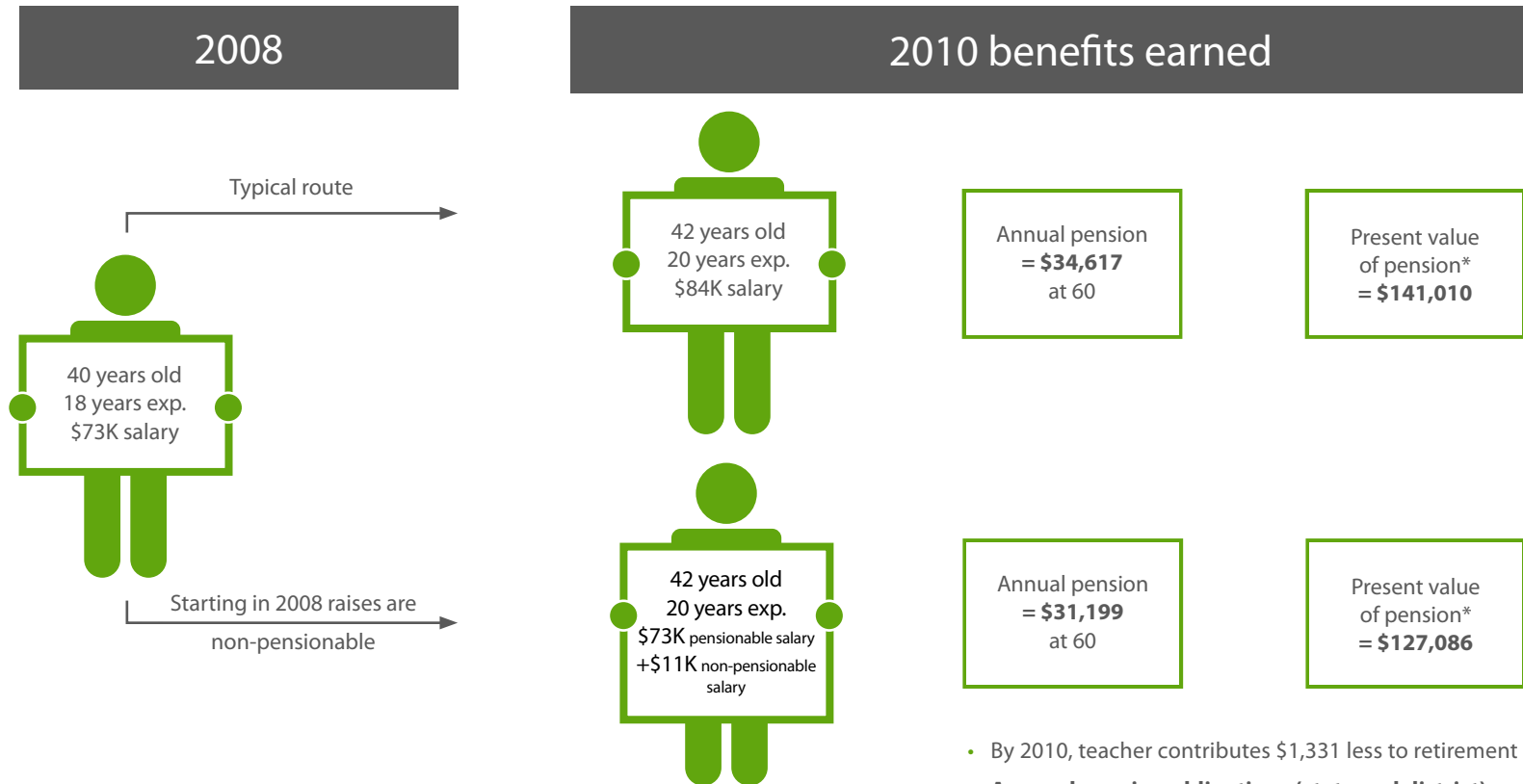Example: Illinois teacher, **58 years old** when law passed in 2008

2008	2010 benefits earned

Typical route

58 years old
36 years exp.
$91K salary

Starting in 2008 raises are non-pensionable

60 years old
38 years exp.
$95K salary

Annual pension
= **$77,754**

Present value
of pension*
= **$1,070,504**

60 years old
38 years exp.
$91K pensionable salary
+$4K non-pensionable salary

Annual pension
= **$75,036**

Present value
of pension*
= **$1,033,080**

- By 2010, teacher contributes $684 less to retirement
- **Accrued pension obligations (state and district) lower by $37,425***

* In 2018 dollars

How would this work?

Example: Illinois teacher, **40 years old** when law passed in 2008

2008

Typical route →

**40 years old
18 years exp.
$73K salary**

Starting in 2008 raises are
non-pensionable →

2010 benefits earned

**42 years old
20 years exp.
$84K salary**

| Annual pension = **$34,617** at 60 | Present value of pension* = **$141,010** |

**42 years old
20 years exp.
$73K** pensionable salary
+$11K non-pensionable salary

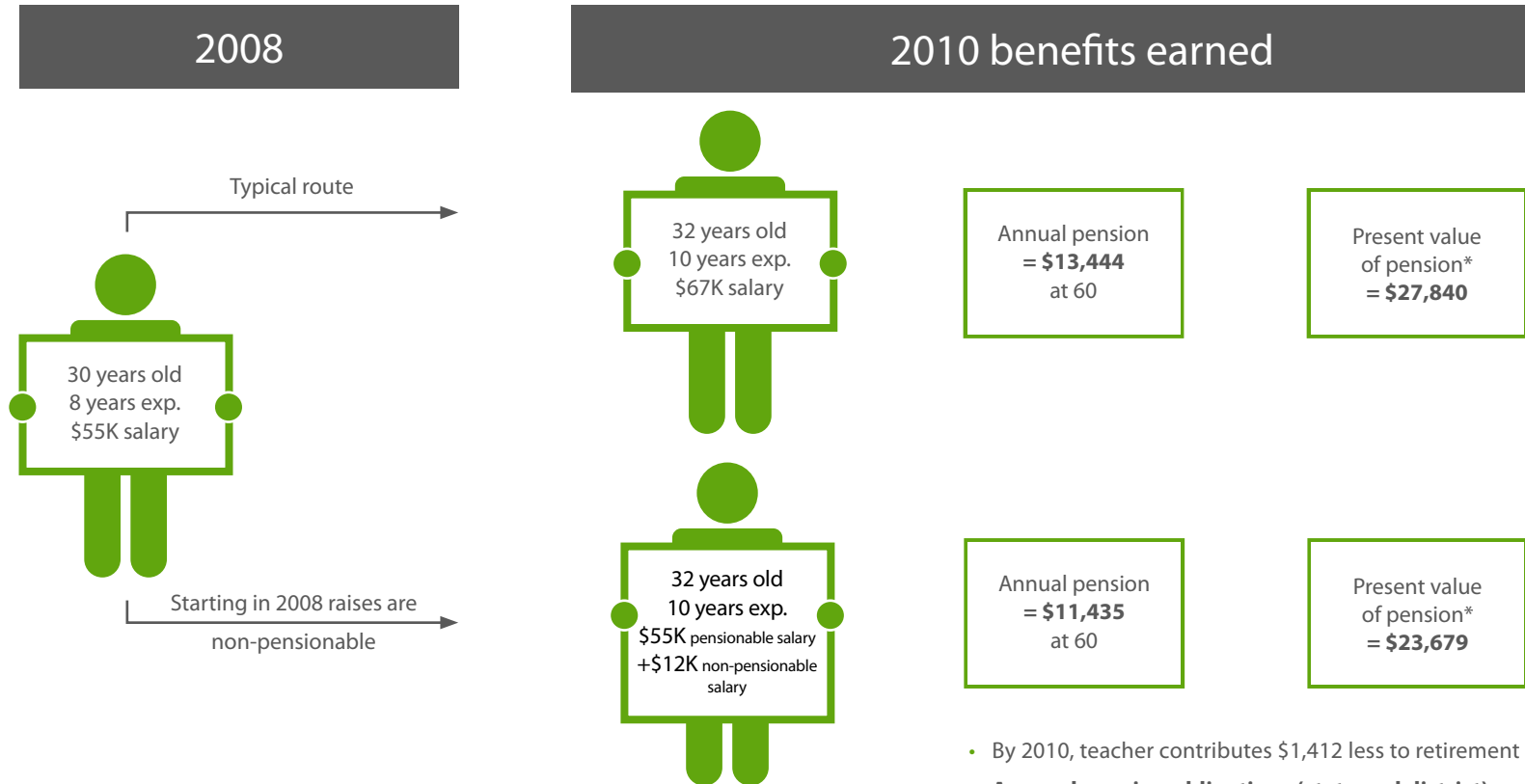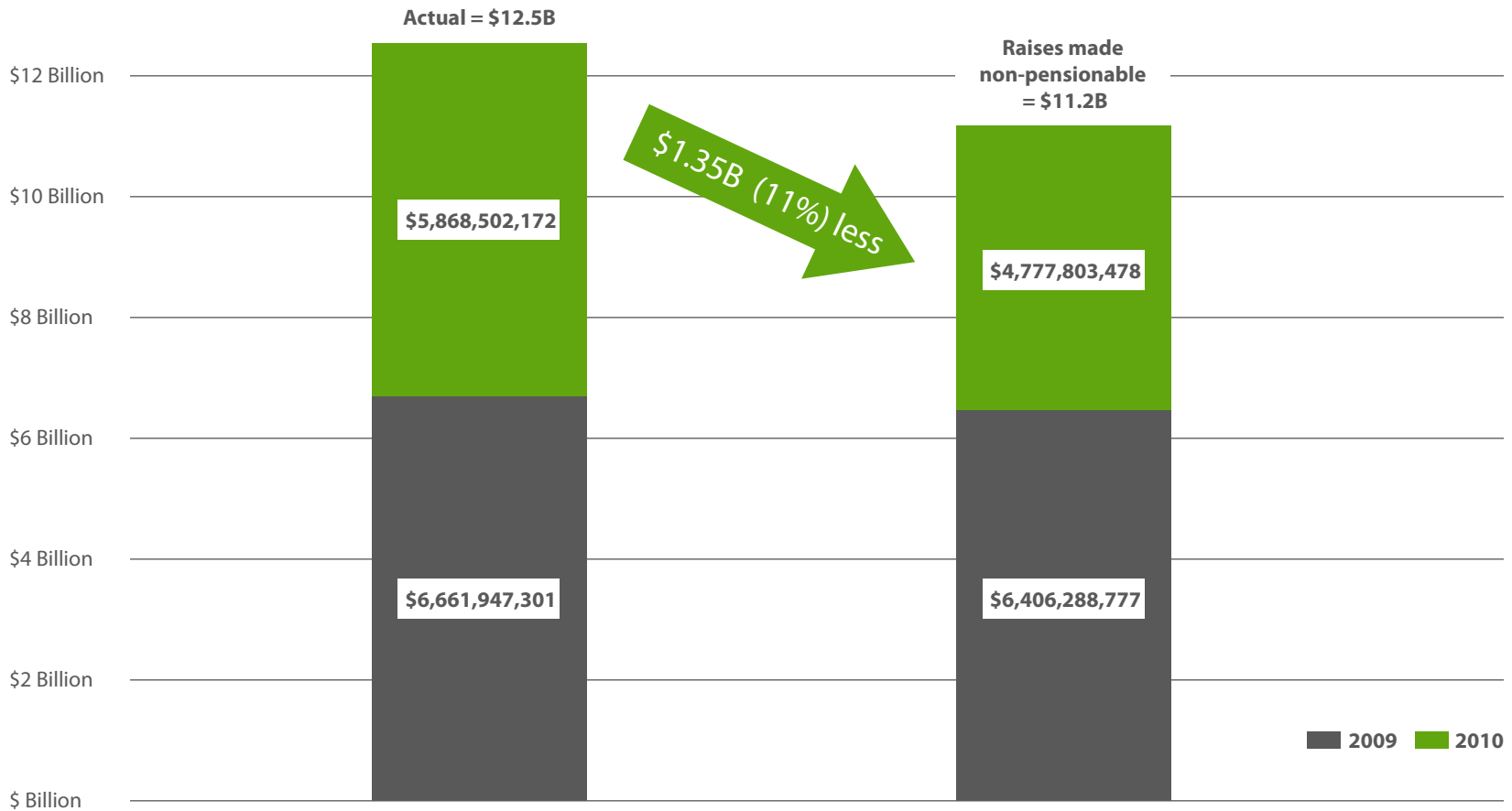| Annual pension = **$31,199** at 60 | Present value of pension* = **$127,086** |

- By 2010, teacher contributes $1,331 less to retirement
- **Accrued pension obligations (state and district) lower by $13,924***

* In 2018 dollars

How would this work?

Ex: Illinois teacher, **30 years old** when law passed in 2008

2008

Typical route →

30 years old
8 years exp.
$55K salary

Starting in 2008 raises are
non-pensionable →

2010 benefits earned

32 years old
10 years exp.
$67K salary

Annual pension
= $13,444
at 60

Present value
of pension*
= $27,840

32 years old
10 years exp.
$55K pensionable salary
+$12K non-pensionable salary

Annual pension
= $11,435
at 60

Present value
of pension*
= $23,679

- By 2010, teacher contributes $1,412 less to retirement
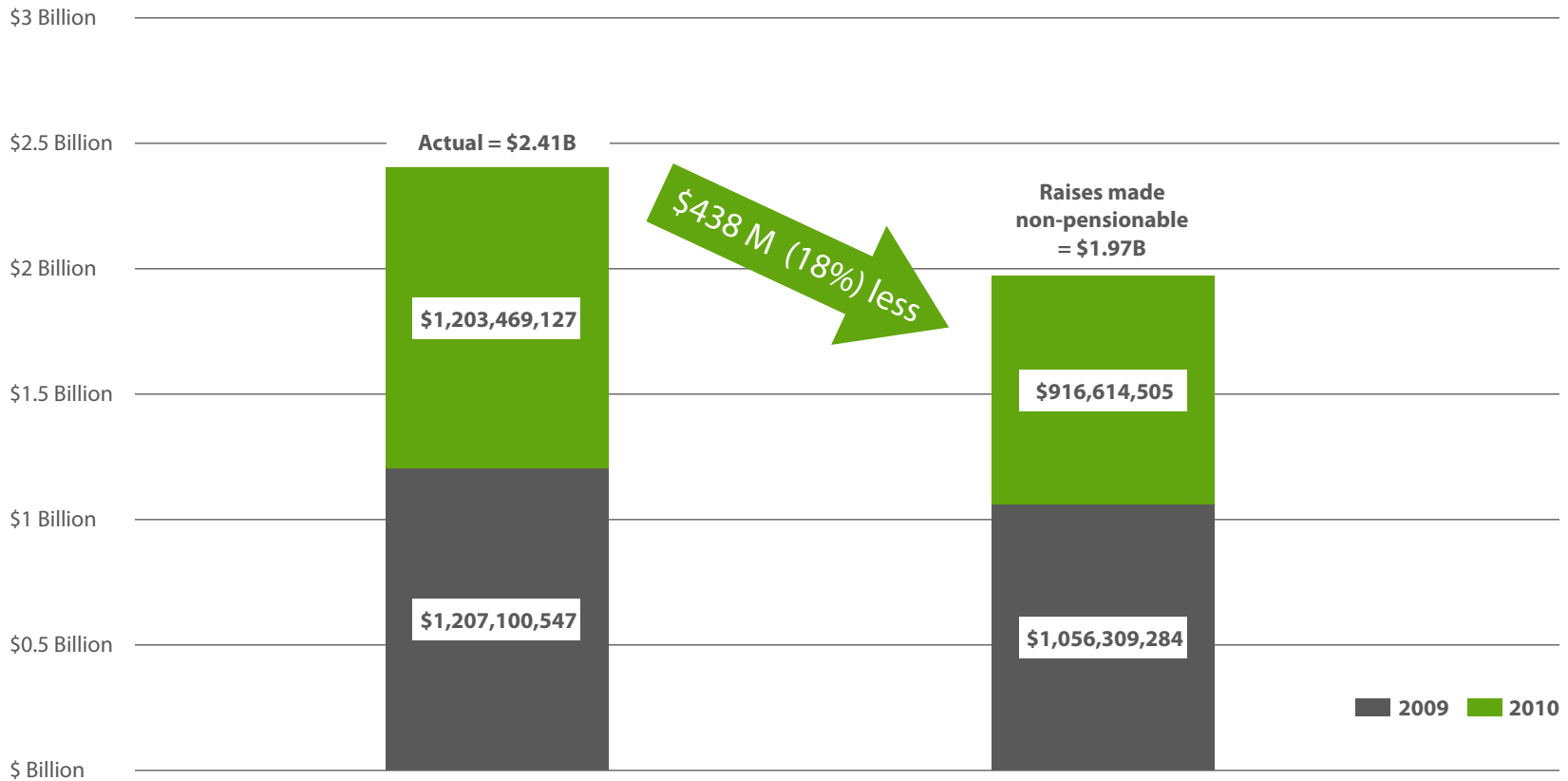- **Accrued pension obligations (state and district) lower by $4,160***

* In 2018 dollars

California

If enacted in 2008, California government (state and districts) would have accrued $1.35 billion less in CalSTRS retirement obligations by 2010
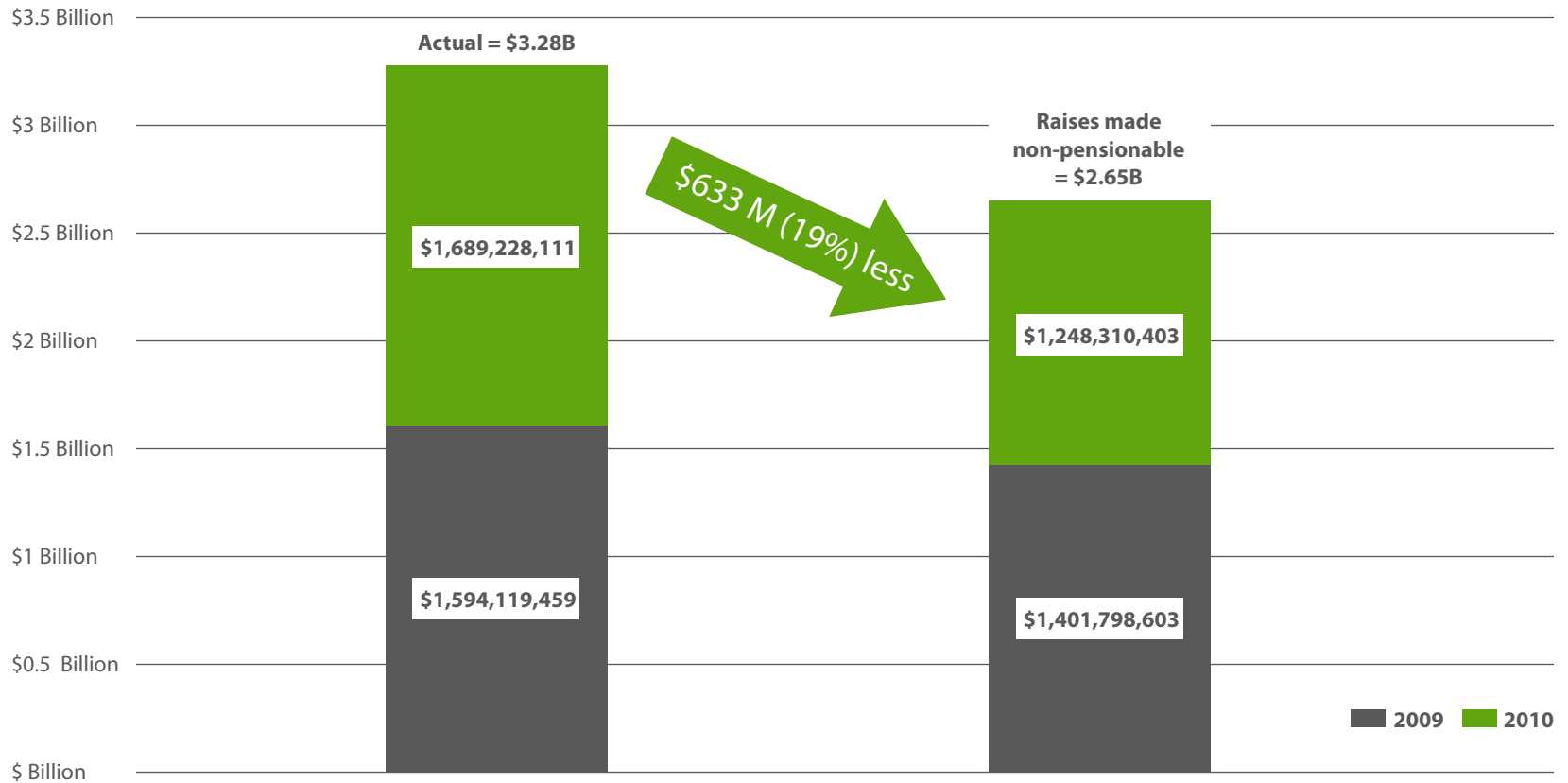
Actual = $12.5B

Raises made non-pensionable = $11.2B

$1.35B (11%) less

$5,868,502,172

$4,777,803,478

$6,661,947,301

$6,406,288,777

$12 Billion
$10 Billion
$8 Billion
$6 Billion
$4 Billion
$2 Billion
$ Billion

2009   2010

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Illinois

If enacted in 2008, Illinois governments (state and districts) would have accrued $438 million less in TRS retirement obligations by 2010
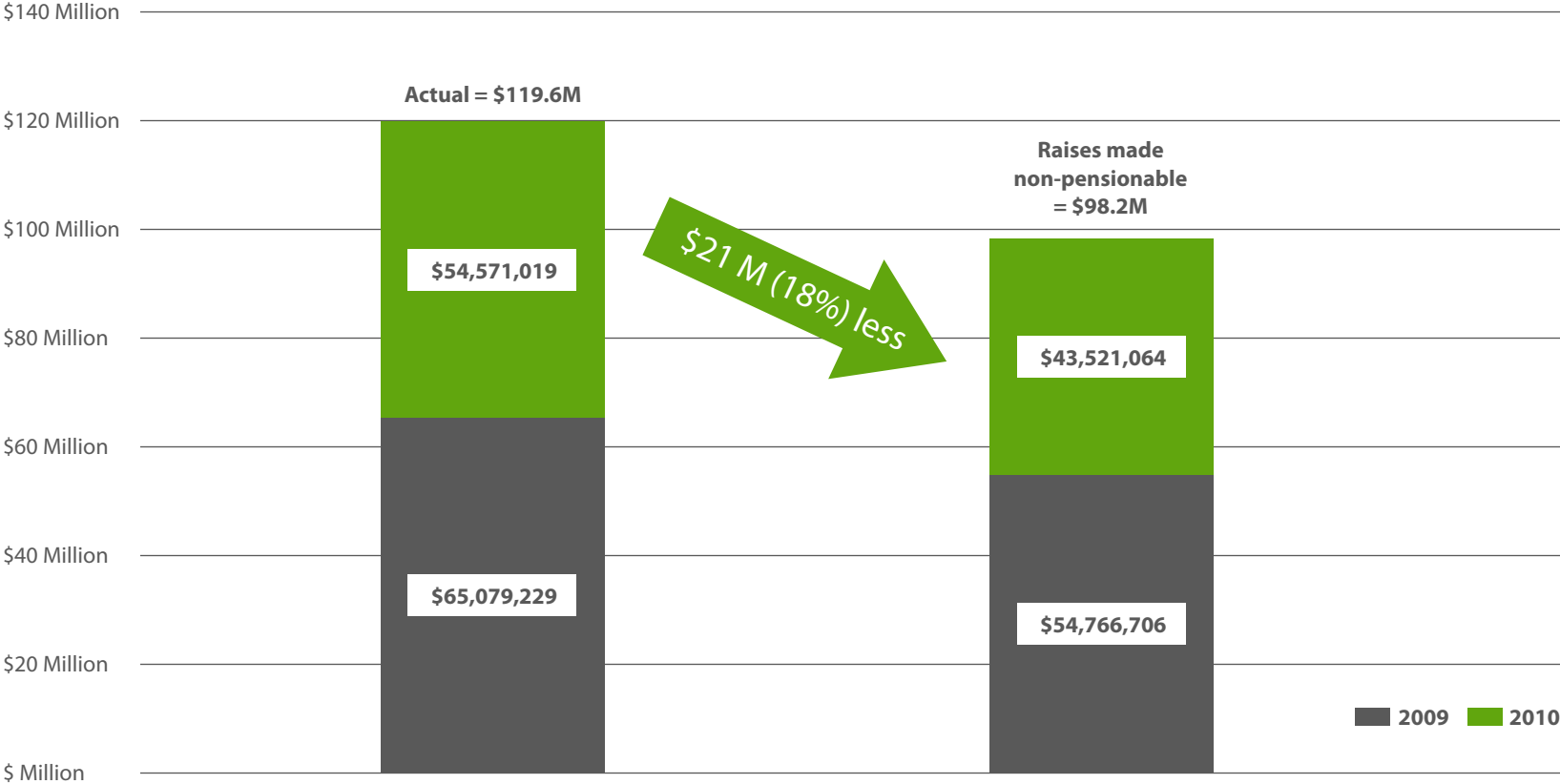
Actual = $2.41B

Raises made non-pensionable = $1.97B

$438 M (18%) less

$1,203,469,127

$916,614,505

$1,207,100,547

$1,056,309,284

$3 Billion

$2.5 Billion

$2 Billion

$1.5 Billion

$1 Billion

$0.5 Billion

$ Billion

2009   2010

Texas

If enacted in 2008, Texas governments (state and districts) would have accrued
$633 million less in TRS retirement obligations by 2010

Actual = $3.28B

$1,689,228,111

$633 M (19%) less

Raises made
non-pensionable
= $2.65B

$1,248,310,403

$1,594,119,459

$1,401,798,603

$3.5 Billion
$3 Billion
$2.5 Billion
$2 Billion
$1.5 Billion
$1 Billion
$0.5 Billion
$ Billion

2009 2010

Vermont

If enacted in 2008, Vermont governments (state and districts) would have accrued $21 million less in VSTRS retirement obligations by 2010
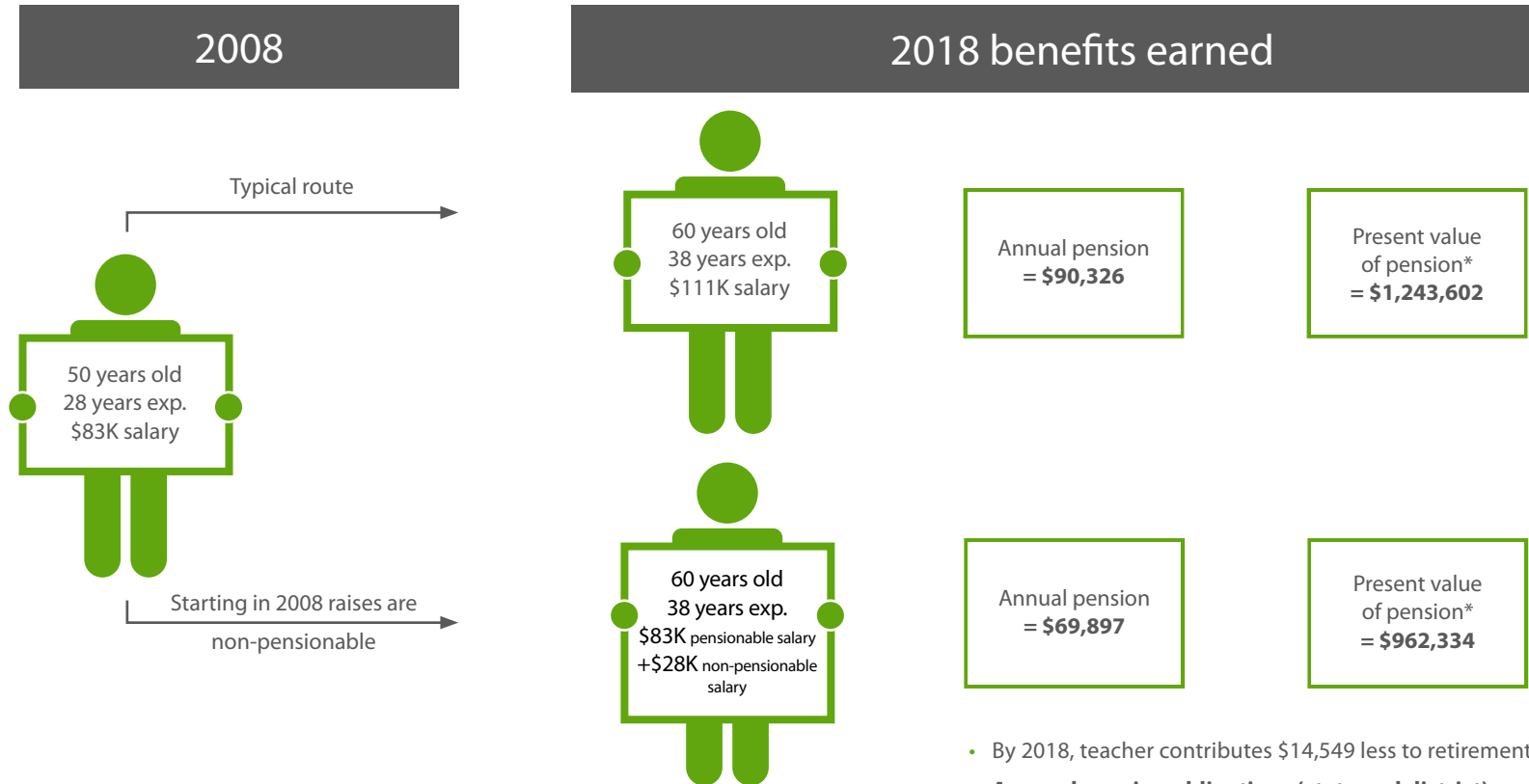
Actual = $119.6M

Raises made
non-pensionable
= $98.2M

$54,571,019

$43,521,064

$21 M (18%) less

$65,079,229

$54,766,706

$140 Million

$120 Million

$100 Million

$80 Million

$60 Million

$40 Million

$20 Million

$ Million

■ 2009   ■ 2010

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10-Year impact if enacted in 2008

How would this work?

Example: Illinois teacher, **50 years old** when law passed in 2008

2008
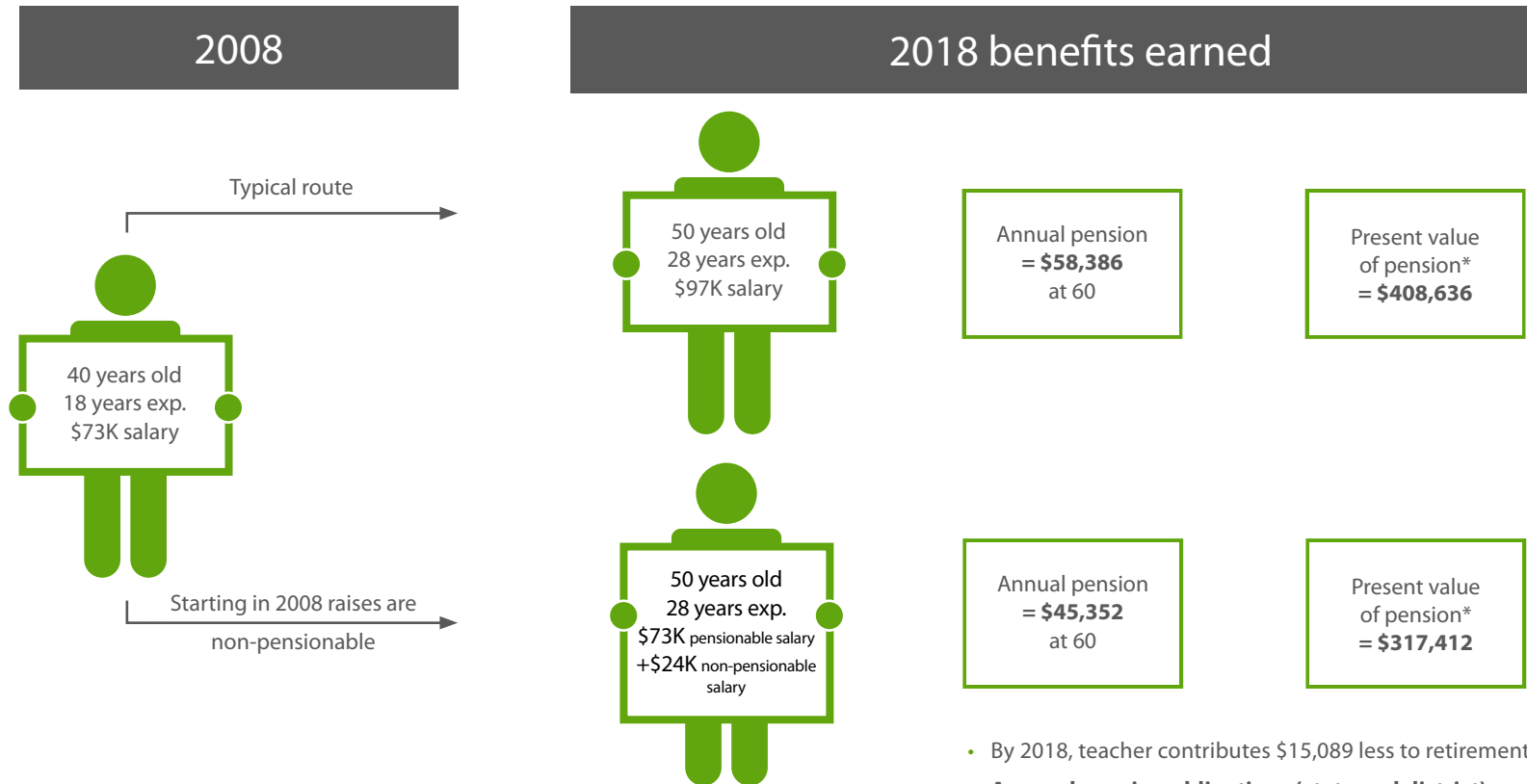
50 years old
28 years exp.
$83K salary

Typical route →

Starting in 2008 raises are
non-pensionable →

2018 benefits earned

60 years old
38 years exp.
$111K salary

| Annual pension = **$90,326** | Present value of pension* = **$1,243,602** |

60 years old
38 years exp.
$83K pensionable salary
+**$28K** non-pensionable salary

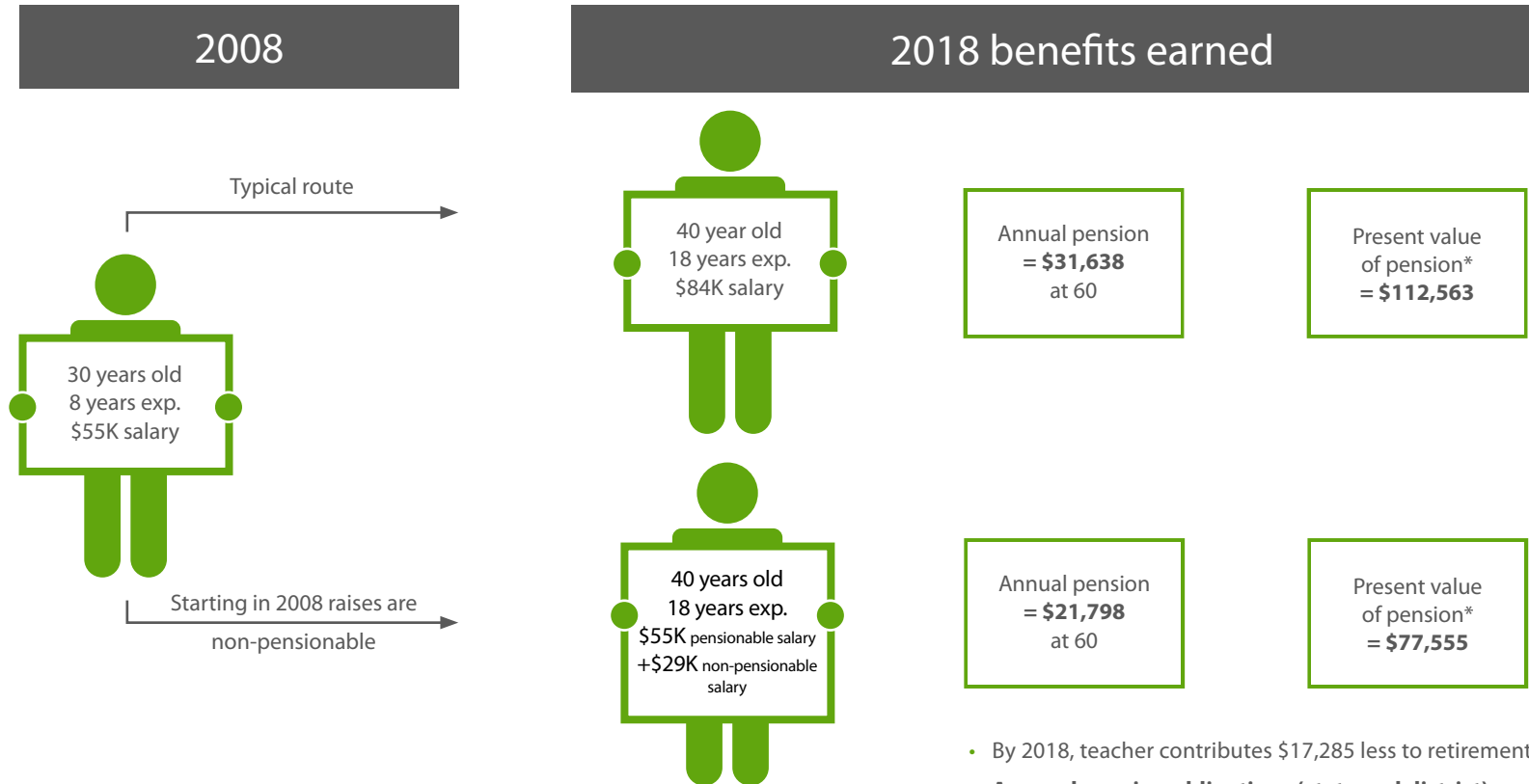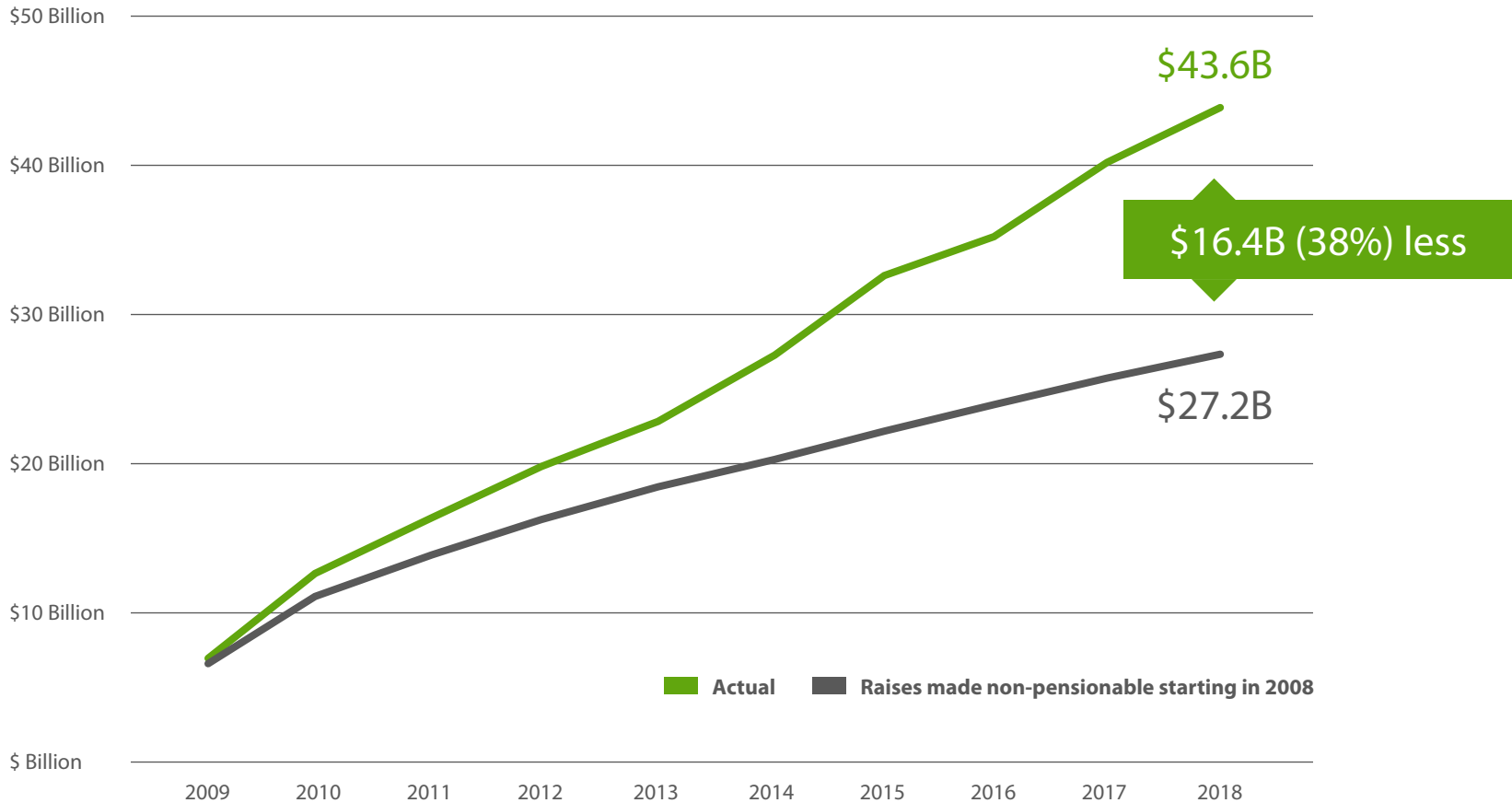| Annual pension = **$69,897** | Present value of pension* = **$962,334** |

- By 2018, teacher contributes $14,549 less to retirement
- **Accrued pension obligations (state and district) lower by $266,719***

* In 2018 dollars

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How would this work?

Example: Illinois teacher, **30 years old** when law passed in 2008

2008

Typical route →

Starting in 2008 raises are non-pensionable →

30 years old
8 years exp.
$55K salary

* In 2018 dollars

2018 benefits earned

40 year old
18 years exp.
$84K salary

| Annual pension = **$31,638** at 60 | Present value of pension* = **$112,563** |

40 years old
18 years exp.
$55K pensionable salary
+**$29K** non-pensionable salary

| Annual pension = **$21,798** at 60 | Present value of pension* = **$77,555** |

- By 2018, teacher contributes $17,285 less to retirement
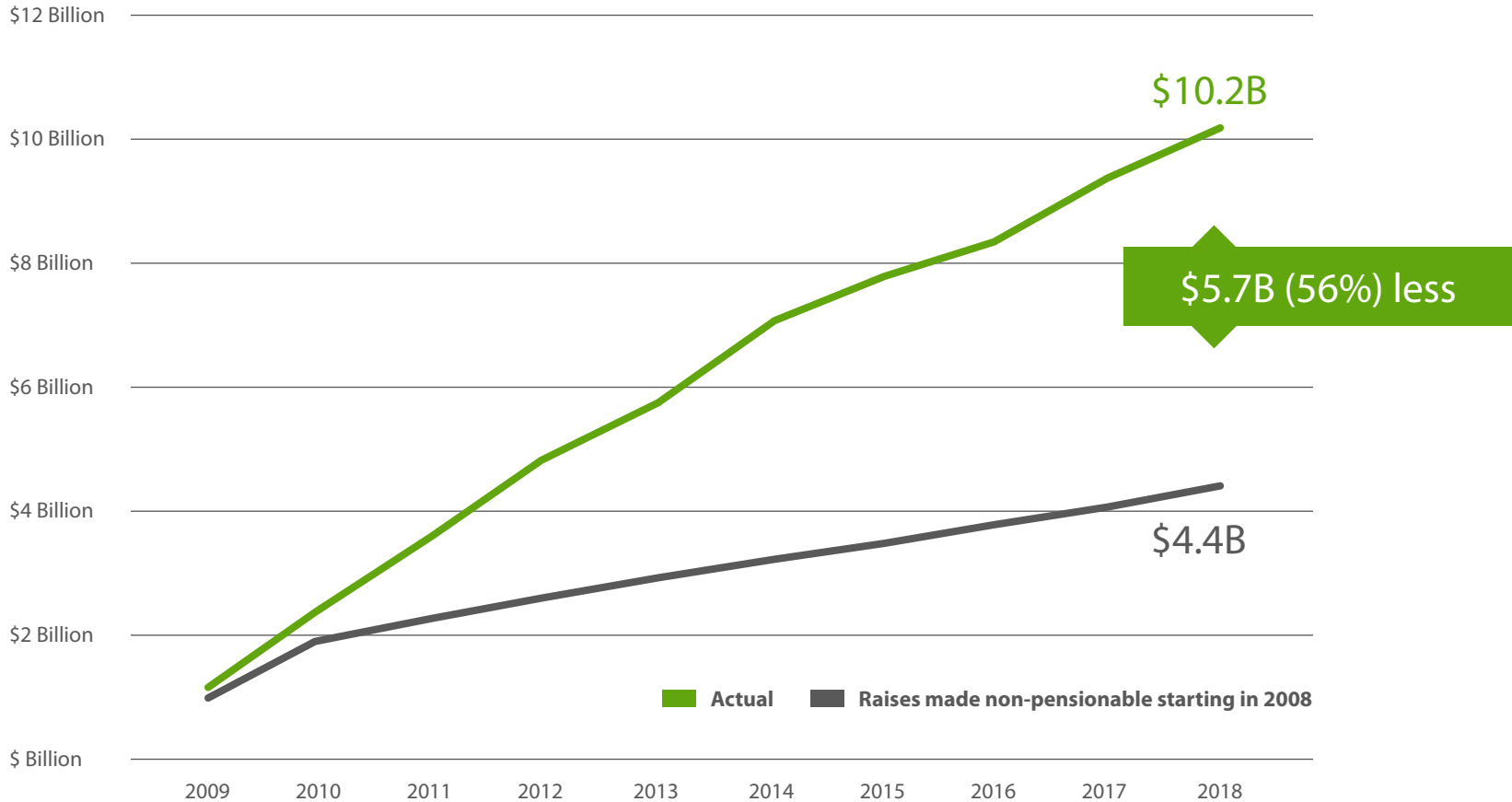- **Accrued pension obligations (state and district) lowerby $17,723***

California

If enacted in 2008, California governments (state and districts) would have accrued 16.4 billion less in CalSTRS retirement obligations over 10 years
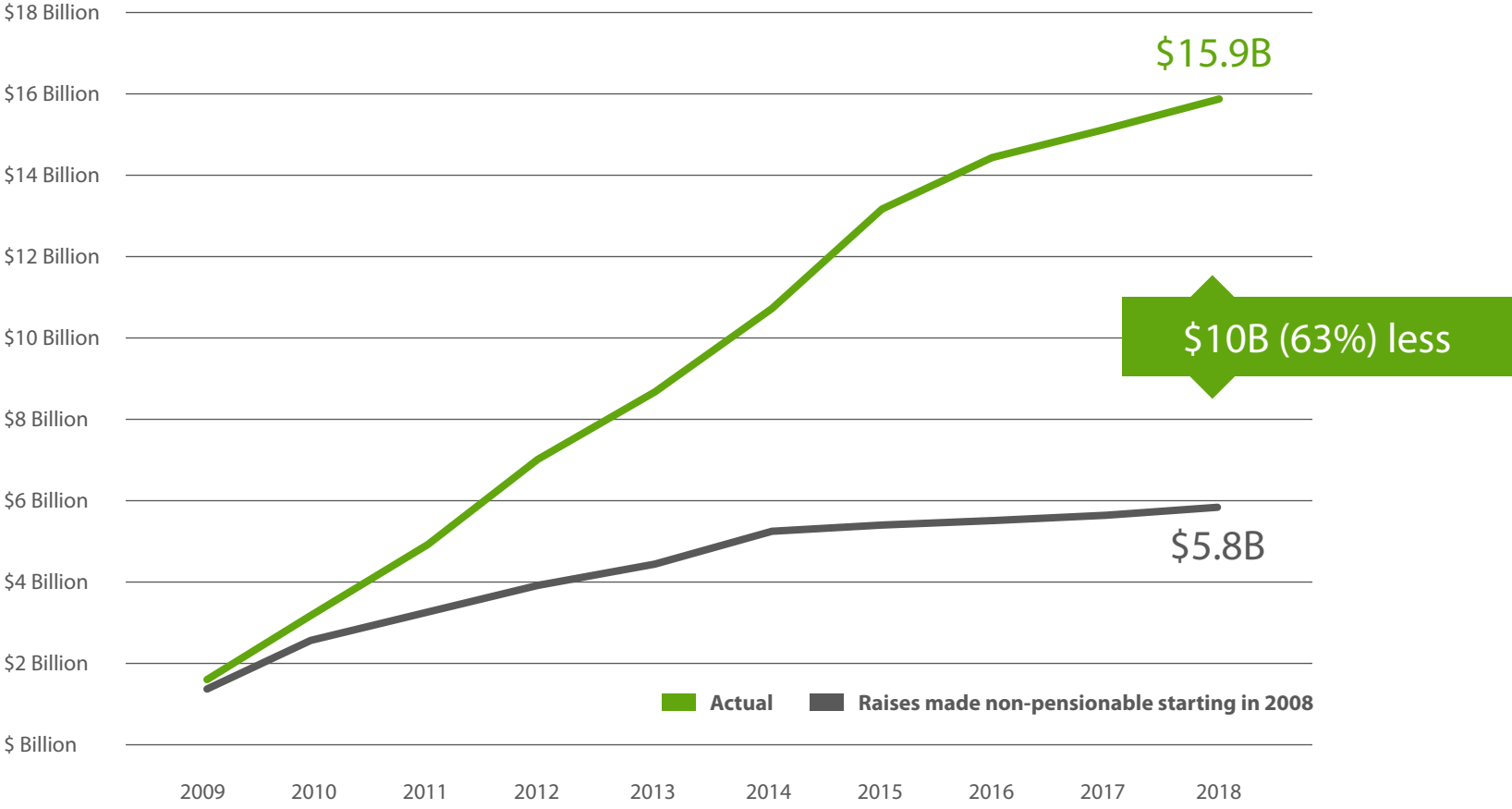
$43.6B

$16.4B (38%) less

$27.2B

Actual **Raises made non-pensionable starting in 2008**

$50 Billion
$40 Billion
$30 Billion
$20 Billion
$10 Billion
$ Billion

2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

Illinois

If enacted in 2008, Illinois governments (state and districts) would have accrued $5.7 billion less in TRS retirement obligations over 10 years
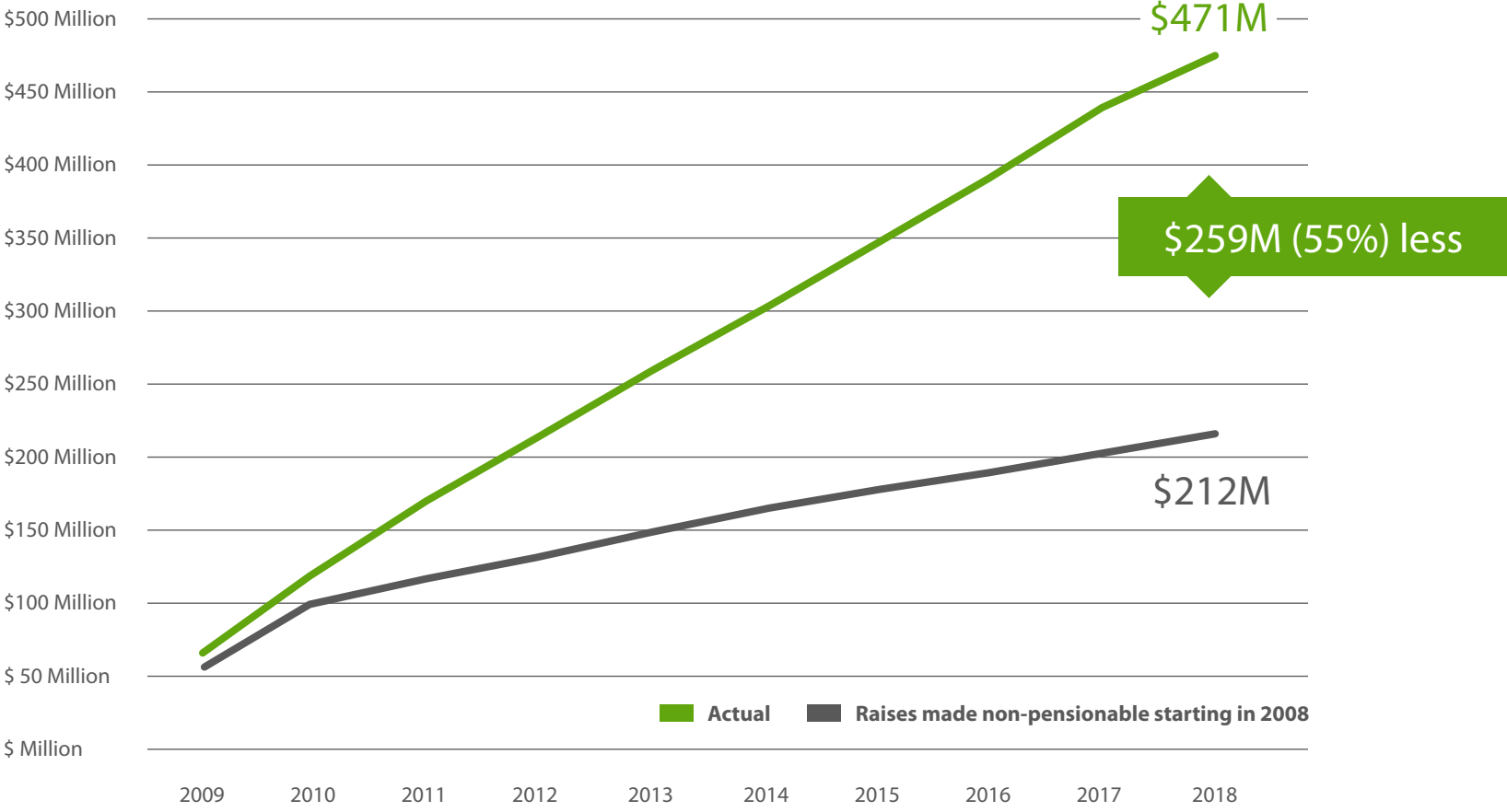

$10.2B

$5.7B (56%) less

$4.4B

Actual   **Raises made non-pensionable starting in 2008**

2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

$12 Billion
$10 Billion
$8 Billion
$6 Billion
$4 Billion
$2 Billion
$ Billion

Texas

If enacted in 2008, Texas governments (state and districts) would have accrued $10 billion less in TRS retirement obligations over 10 years

$18 Billion

$15.9B

$16 Billion

$14 Billion

$12 Billion

$10 Billion

$10B (63%) less

$8 Billion

$6 Billion

$5.8B

$4 Billion

$2 Billion

$ Billion

Actual — **Raises made non-pensionable starting in 2008**

2009   2010   2011   2012   2013   2014   2015   2016   2017   2018

Vermont

If enacted in 2008, Vermont governments (state and districts) would have accrued $259 million less in VSTRS retirement obligations over 10 years

$471M

$259M (55%) less

$212M

■ Actual   ■ Raises made non-pensionable starting in 2008

$500 Million
$450 Million
$400 Million
$350 Million
$300 Million
$250 Million
$200 Million
$150 Million
$100 Million
$ 50 Million
$ Million

2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

Implications for teachers:

- All teacher salaries are protected, and no earned pension benefits are jeopardized.

- All teachers still accrue pension that is substantially more than social security (maximum social security = $27,180/year[5]).

- Teachers/employers could establish separate retirement systems for their non-pensionable pay, which would benefit many junior teachers who do not qualify for state defined benefit plans. (For junior teachers, financial effect is negligible unless planning to stay entire career.)

Biggest change is in accrued pension liability for teachers nearing retirement:

- If enacted 2 years before retirement, a teacher would retire with $75K/year vs $78K/year

- If enacted 10 years before retirement, a teacher would retire with $70K/year vs $90K/year

Implications for states and districts:

- Substantial effect on accrued pension obligations, which could relieve some financial pressure on states during recession, or until the pension debt is fully funded.

- Could be imposed federally as a condition of receiving stimulus funding.

- Some savings could be applied to raise salaries or create sustainable alternative retirement plans.

- States will have more money to spend on educating today's students, instead of on retirement benefits.

- Would likely face legal challenge if done at the state level (but likely could survive).

Is this a viable (legal) policy option?

In 2013, IL State Senator Cullerton proposed a bundled set of pension reforms that included a pensionable pay cap. Courts rejected the entire bundle, but didn't rule specifically on the cap.[6]

Substantial precedent exists:

- Newark Public Schools (and NJ) regularly awards non-pensionable raises (sometimes called "bonuses" but not always).

- New York City Dept. of Education deemed 2014 retroactive step/column raises non-pensionable.[7]

- Chicago Public Schools awarded $25M in veteran teacher pay that is thus far non-pensionable.[8]

Some likely complications/unknowns:

- Districts might not be able to award raises as step/column pay.

- What can be done about step/column raises for the remaining term of the labor contract?

Notes on the analysis

- 2008-2018 data from California's CalSTRS, Texas' TRS, Vermont's VSTRS and Illinois' TRS used to model effect on accumulated pension obligations if pensionable salaries frozen in 2008.

- Applies the state's discount rate to explore effects in 2018 dollars.

- For each year, model compares incrementally accrued value of pension with accrued value if each teacher's pensionable salary had been frozen in 2008. So for 2010:

$$PV_{2010} - PV_{2009}$$ compared to $$PV_{2010} - PV_{2009}$$

Using a 2008 salary, but 2010 yrs. experience

Using a 2008 salary, but 2009 yrs. experience

For each state, we used the plan's formula and included COLA when applicable.[9]

	California	Illinois	Texas	Vermont
RETIREMENT AGE	60*	60*	65	62
FINAL AVERAGE SALARY (FAS)	Highest 3 years in one position	4 last years	5 highest years	Highest 3 consecutive year
MULTIPLIER	2.0% accrual rate (but increases by 0.333% for each quarter year after the age of 60)	2.2% accrual rate	2.3% accrual rate	1.66% accrual rate
DISCOUNT RATE[10]	Discount rate: 7.1%	Discount rate: 7.0%	Discount rate: 7.25%	Discount rate: 7.5%
COLA	2%	3%	N/A	1.30%
GROUP/TIER USED	2% at 60 Members	Tier 1	Tier 2	Group C

- This model subtracts off employee contributions to determine implications for government pension obligations

- Assumes a typical mortality rate of 81 years old

- Assumes no effect on teacher attrition (!)

*Illinois & California differ because it changes among different years of service and the retirement plan. But we agreed to choose one age, 60.

Endnotes

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   https://www.bloomberg.com/opinion/articles/2020-01-31/pension-funds-may-not-survive-a-recession

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6. Schuster, A. (2019, September 9). Tax hikes vs. reform: Why Illinois must amend its constitution to fix the pension crisis. Retrieved from:
   https://www.illinoispolicy.org/reports/tax-hikes-vs-reform-why-illinois-must-amend-its-constitution-to-fix-the-pension-crisis/

7. Eterno, J. (2016, June 7). Pension Recalculation Email. Retrieved from:
   http://iceuftblog.blogspot.com/2016/06/pension-recalculation-email.html

8. Milkowski, G. (2020, January 12). $25 million for veteran teachers not addressed at January Chicago Teachers Union House of Delegates. Retrieved from:
   http://www.substancenews.net/articles.php?page=7157

9. NASRA Issue Brief: Cost-of-Living Adjustments. (2019, November). Retrieved from:
   https://www.nasra.org/files/Issue Briefs/NASRACOLA Brief.pdf

10. Downloadable Data. (n.d.). Retrieved from:
    https://publicplansdata.org/public-plans-database/download-full-data-set/

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