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70 YEARS OF SERVICE

August 19, 2011

Hon. Kamala D. Harris
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Dawn McFarland
Initiative Coordinator

Dear Attorney General Harris:

Pursuant to Elections Code Section 9005, we have reviewed the proposed constitutional initiative regarding taxation of certain public sector pensions above $100,000 per year (A.G. File No. 11-0021).

BACKGROUND

Public Employee Pensions in California

California Has Both Statewide and Local Public Pension Plans. The two largest entities managing state or local pension systems in California are the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS). Combined, CalPERS and CalSTRS serve 3.1 million members (about 8 percent of California's population), including around 750,000 members and beneficiaries who currently receive benefit payments. Members of CalPERS include current and past employees of state government and the California State University, as well as judges and classified public school employees. In addition, hundreds of local governmental entities (including some cities, counties, special districts, and county offices of education) choose to contract with CalPERS to provide pension benefits for their employees. Members of CalSTRS include current and past teachers and administrators of California's public school and community college districts. Members of CalPERS and CalSTRS receive differing levels of pension benefits. Many CalPERS members also participate in the federal Social Security program; in general, CalSTRS members do not.

In addition to CalPERS and CalSTRS, about 80 other defined benefit state and local pension systems (such as the University of California Retirement System, the Los Angeles County Employees' Retirement Association, and the Los Angeles City Employees' Retirement System) serve about 1 million other Californians, including about 300,000 who currently receive benefit payments.

Defined Benefit Pensions. CalPERS and CalSTRS both provide "defined benefit" pensions, to their members. Defined benefit pensions provide a specific monthly benefit after retirement that is generally based on the employee's age at retirement, years of service, salary at or near the end of his or her career, and type of work assignment. In general, both public employees and their employers (and, in the case of CalSTRS, the state government as well) contribute to public retirement systems to finance future pension benefits during the employees' working years. Public pension systems invest these contributions to generate returns that, over time, pay for a significant portion of these pension benefits.

Pension Benefits Over $100,000 Per Year. A small percentage of CalPERS and CalSTRS retirees and beneficiaries currently receive pension benefits totaling over $100,000 per year. About 2 percent of CalPERS and CalSTRS retirees currently receive such payments. Payments to the retirees receiving over $100,000 of pension benefits per year now equal around 7 percent to 9 percent of total pension payments from the two systems. During their working lives, these retirees generally were among the longest-serving and highest-paid public employees—for example, senior executives and managers of some state and local agencies, school districts, and community colleges. The percentage of CalPERS and CalSTRS retirees that receive over $100,000 in annual pension benefits—as well as the percentage of the systems' pension payments going to these retirees—likely will grow in the future for several reasons. These reasons include the effects of inflation (which will tend to increase all employees' pay and pension benefits over time) and the effects of increased pension benefit provisions put in place about one decade ago for many current public employees.

Other Programs Administered by CalPERS and CalSTRS. In addition to their defined benefit pension programs, CalPERS and CalSTRS offer a number of other benefit programs for eligible public employees. CalPERS, for example, administers health plan benefits for the state and many other public agencies and offers tax-deferred retirement savings plans, including the Supplemental Income 457 Plan that employees of participating public agencies and schools can use to save money for retirement. The CalSTRS Pension2 program provides 403(b), 457, and Roth 403(b) savings plan services to school employees.

Taxation of Pension Income

California Residents Are Taxed by the State. In general, recipients of public employee pension benefits pay federal income taxes on those benefits. California residents also generally are subject to state income taxes on most income, including pension income received from California and out-of-state sources.

Federal Law Prevents California From Taxing Pension Income of Non-Residents. California requires nonresidents to pay income taxes on many types of income they received from California sources. Prior to 1996, for example, California taxed non-residents on pension income received from California sources. This became a source of controversy for some individuals who had earned pensions from employers in California and subsequently retired and moved out of state. (At the time, 15 other states had pension tax policies similar to California's.) In response to requests from such retirees, Congress passed and President Clinton signed Public Law 104-95, which prohibited, beginning in 1996, any state from imposing income taxes on pension income of a non-resident. In September 1996, Governor Wilson signed Chapter 506, Statutes of 1996 (AB 850, Morrissey), which inserted a similar provision in state law prohibiting

California from taxing non-residents for pension income received from California sources. The prohibition of Chapter 506 (codified as Section 17952.5 of the Revenue and Taxation Code) is in effect only so long as the federal prohibition in Public Law 104-95 remains operative.

Limited or No Case Law on Taxes Focused on Select Groups of Public Sector Retirees. Decades of case law place substantial limits on the ability of California governments—and of voters through the initiative process—to reduce pension benefits of current and past public employees. Because public pension benefits generally represent contracts between governmental entities and the employees or retirees, the U.S. Constitution's "contract clause" also limits the ability of governments and voters to alter pension benefits for current and past public employees. We are not aware, however, of any substantial case law on (1) whether California may institute taxes on public employee pension benefits specifically or (2) if so, whether pensions of only a few public pension systems (but not those of other pension systems) may be taxed.

PROPOSAL

New State Tax on Certain CalPERS and CalSTRS Pension Income. This measure amends the State Constitution to institute a new state tax on pension benefits paid to an individual by CalPERS and/or CalSTRS that exceed $100,000 per year. Because the language is somewhat ambiguous and relies on undefined terms, it is not clear how this change would be implemented. Our best interpretation, however, is that this tax would be in addition to existing state income taxes and would be levied as follows:

- For individuals receiving CalPERS and/or CalSTRS benefit payments between $100,000 and $149,999 per year: an additional tax equal to 15 percent of the benefit payments over $100,000.
- For individuals receiving CalPERS and/or CalSTRS benefit payments above $150,000 per year: an additional tax equal to $7,500 plus an amount equal to 25 percent of the benefit payments over $150,000.

The measure specifies that the tax would apply to "all" public sector pensions paid by CalPERS and CalSTRS. Pensions paid to current and past public employees, therefore, are not excluded from the proposed new tax. The application of the tax to current and past public employees—and to members of just two pension systems, but not other pension systems—almost certainly would be subject to litigation.

Proposed Tax Not Indexed to Inflation. Unlike many other income taxes in existing law, the taxes established under this measure would not be indexed to inflation. In other words, the $100,000 constitutional threshold to begin paying the proposed tax would never be adjusted upward for inflation.

Uncertainties and Possible Litigation Concerning the Proposal. There are various uncertainties concerning this proposal. As noted above, the measure's language is unclear as to exactly how the new tax would be implemented.

The measure does not exclude from its proposed tax the CalPERS and CalSTRS income received by residents of other states. It, therefore, would create a new state law that may be interpreted as applying a state income tax to non-residents. This provision almost certainly would be subject to litigation seeking to invalidate such a non-resident tax as prohibited by current federal law.

In addition, the measure specifies that the new tax would not be applied to benefits received from CalPERS and CalSTRS health benefit programs. It does not, however, specify whether the new tax would be applied to payments from the systems' supplemental savings programs, including, but not limited to, CalPERS' Supplemental Income 457 Plan and CalSTRS' Pension2 program. For purposes of the fiscal analysis below, we assume that the measure does not apply a new tax to payments from these supplemental savings plans.

FISCAL EFFECTS

Revenues

Initially, Potentially Higher Annual State Revenues of About $60 Million. As described above, there are various uncertainties concerning implementation of this proposal. Our best guess, however, is that if the proposed tax is able to be applied to all current and past public employees now receiving pension benefits from CalPERS and CalSTRS, it could generate about $60 million of additional annual state revenue in the short run. (Total estimated General Fund revenues are projected to be $88 billion in 2011-12.)

No Revenues in the Short Run if Tax Cannot Apply to Current Employees and Retirees. We assume that there would be a court challenge to this tax by current and past public employees. If courts ruled that the tax cannot be applied to these employees and retirees, this measure would produce no additional state revenues initially. In this case, a minor amount of state revenue related to *future* employees' pensions would begin to be paid to the state about five years after passage, growing to the tens of millions of dollars per year during the first decades after passage.

In Longer Run, Could Grow to Be a Somewhat Larger Percentage of State Revenues. Over time, a growing percentage of CalPERS and CalSTRS members would become subject to the proposed new tax. This is because, over time, due to inflation and other factors, there will be a greater proportion of CalPERS and CalSTRS retirees receiving benefits of over $100,000 per year. Accordingly, the revenue from this new tax likely would grow to be a somewhat larger percentage of state General Fund revenues than initially. Many decades from now, assuming the continuation of current pension benefit provisions, it is likely that most CalPERS and CalSTRS beneficiaries will receive benefits of $100,000 or more as inflation expands their salaries.

Behavioral Changes by Retirees Could Reduce Revenue Gains. We are not aware of any other state that imposes a tax specifically targeted to public pensions, as envisioned by this measure. If courts determined that federal law bars California from taxing non-residents' pension income, this measure would result in retirees receiving more than $100,000 in annual CalPERS and/or CalSTRS pension benefits having an incentive to leave the state. This incentive would increase as their income increases. Over time, as a greater percentage of CalPERS and CalSTRS retirees receive more than $100,000 in annual pension benefits, more and more retirees would have a financial incentive to leave California. The departure of some of these retirees from the state would diminish the revenue generated by the proposed tax and result in a loss of economic activity in California (and other state and local tax revenue associated with that activity). These factors could offset a substantial portion of the state revenue gain that otherwise would occur under this measure.

In Long Run, Behavioral Changes by Employers Could Reduce Gains. The effect of this measure would be that public employee pensions administered through CalPERS and CalSTRS would be less valuable to retired public employees. Over the long run, this would affect public employers' compensation decisions in a variety of ways. Public employers—sometimes through negotiations with public employee unions—may make decisions to change the current mix of public employee total compensation, by devoting more compensation to non-pension items and less to pensions. Local agencies also could choose to terminate their existing pension benefit programs with CalPERS and instead ask other pension systems, such as the state's county retirement systems, to administer pensions for them. The Legislature and/or local agencies also could establish new public pension systems, such as new pension systems for employees of state agencies and school districts that would not be subject to the proposed tax. These potential behavioral changes would tend to diminish or offset the revenue that otherwise would be generated by the proposed tax.

Other Fiscal Effects

Potentially Higher State Spending for Schools and Community Colleges. Proposition 98 was approved by voters in 1988. It establishes a minimum amount of annual state funding for K-12 schools and community colleges. The funding formulae of Proposition 98 are complex, but, in some cases, when state General Fund revenues increase, the state's minimum funding guarantee for schools also increases. Because this measure would increase General Fund revenues, it also could result in higher guaranteed state funding of school and community college districts under Proposition 98.

Higher State and Local Employee Compensation Costs. Public employers compete with each other and with private employers to hire qualified employees in the labor market. Because CalPERS and CalSTRS pension benefits would be less valuable to employees under this measure, public employers providing pension benefits through those two systems likely would need to increase other forms of compensation—including salaries, benefits, or contributions to other retirement funding plans—for some of their employees in order to continue to hire and retain a sufficient number of qualified personnel. These increased compensation costs are impossible to predict and would be determined in part through negotiations with public employee unions. In addition, the decisions of some public employers to exit CalPERS could result in some additional unfunded liabilities that may have to be funded in some way by future taxpayers. Combined, all of these higher public employee compensation costs eventually could offset a substantial portion of the revenue gain generated by the proposed new pension tax.

Fiscal Summary

This measure would have the following major fiscal effects on the state and local governments:

- Possible increase in state revenues from a new tax on certain public employee pensions. Over the long run, these revenue gains would be offset by decreases in other state and local revenues and increases in some state and local costs.

Sincerely,

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Mac Taylor
Legislative Analyst

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Ana J. Matosantos
Director of Finance