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January 6, 2009

Hon. Edmund G. Brown Jr.
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Krystal Paris
Initiative Coordinator

Dear Attorney General Brown:

Pursuant to Elections Code Section 9005, we have reviewed the proposed constitutional measure related to public employee pensions (A.G. File No. 08-0018, Amdt. #1-S).

Background

Public Employee Pension Benefits. The State Constitution and statutes authorize the establishment of systems to provide pension benefits to retired public (government) employees, as well as public employees retiring with certain disabilities and survivors of some public employees. Currently, about 4.1 million Californians—about 11 percent of the population—are members of one or more of the state's 134 public retirement systems, including around one million who currently receive benefit payments. Most state and local government employees are eligible to receive a pension after retiring that is based on the employee's age at retirement, years of service, salary, and type of work assignment. Public employee pension plans also generally provide annual cost-of-living increases to limit how much the effects of inflation erode the purchasing power of these pension benefits.

Government Contributions to Pension Systems. Governments typically contribute funds to pension systems each year during an employee's working years. These funds—along with contributions from employees—are invested by pension systems so that all or most of the costs of paying for a person's pension benefits are paid for by the time of his or her retirement. In California, public employee pensions typically involve a defined benefit—that is, a benefit amount that must be paid regardless of whether the government sets aside enough funds to pay the benefit during an employee's career. If pension systems do not have enough funds to cover the costs of an employee's pension benefits, governments typically must contribute more to the pension system to address what is known as an "unfunded liability." Currently, California governments contribute around $13 billion per year to the state's public retirement systems for pension benefits, including several billion dollars per year to retire existing unfunded pension liabilities. This amount probably will increase by several billion dollars per year in the near future due to unfunded liabilities resulting from investment losses for public pension systems during 2008.

Pension Contracts. In many cases, pension benefits for current or former employees or a government's promised contributions to cover the costs of these benefits constitute a contract with these employees. In particular, California courts have ruled that public employee pensions constitute an element of an employee's compensation, and a contractual right to these pensions accrues upon acceptance of employment. The U.S. Constitution and the State Constitution each contain a "contract clause." The contract clauses limit the power of the state to modify its own contracts with other parties, as well as contracts between other parties. Accordingly, the ability of public entities to modify pension benefits for current or past employees is limited.

Collective Bargaining for Public Employees. Currently, state and local governmental entities in California spend around $100 billion per year on salaries and wages for their employees, not including the cost of pension, health, and other benefits. Under California law, most current public employees are represented by unions or employee organizations, which negotiate with public entities concerning wages, as well as other terms and conditions of employment. (Retirees generally are not formally represented in such negotiations.) In some cases, retirement benefits are discussed in connection with these negotiations. Negotiated reductions in retirement benefits, however, are uncommon.

Proposal

Amend State Constitution's Contract Clause. This proposal would amend the State Constitution's contract clause to allow certain measures that impair public employee pension contracts. Specifically, the proposal would *allow* governments to negotiate with employees, retirees, and/or their representatives to reduce vested pension benefits for existing and future public-sector retirees. Savings resulting from such renegotiations would have to be applied to the provision of education, fire, police, prison, public health, transportation, energy, and climate change mitigation services. This proposal would not *require* governmental entities to negotiate such changes.

Fiscal Effects

Uncertainties Concerning State and Local Savings. We are uncertain whether state and local governmental entities would achieve substantial reductions in pension costs under this measure. First, there is uncertainty about whether many additional governments would choose to seek pension savings through negotiations (compared to the number of governmental entities that already could be expected to seek such savings through negotiations or other means under existing law). Second, legal challenges to such changes could result, given the protections that would remain for pension contracts under the U.S. Constitution.

Pension Savings Probably Would Be Offset by Other Cost Increases. If governments achieve significant savings in pension costs under this measure, employees, retirees, and/or their representatives probably would seek to negotiate offsetting increases in other governmental expenditures, such as employee salaries and wages. These increases would likely offset all or most of the pension cost savings achieved under this measure.

Fiscal Summary

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

- Possible reduction in pension costs for state and local governments, depending on future actions by state and local governments and courts. Any such reduction likely would be largely or entirely offset by negotiated increases in other costs, such as employee salaries and wages.

Sincerely,

Mac Taylor
Legislative Analyst

Michael C. Genest
Director of Finance