December 22, 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 concerning public employee pensions (A.G. File No. 11-0063, Amdt. #1S).

BACKGROUND

Existing Public Employee Pensions. California governments generally offer comprehensive pension benefits to their employees, which are funded from public employer and public employee contributions, as well as investment earnings generated from those contributions. Some governments also contribute to retiree health benefits for their former employees.

Types of Retirement Plans. In general, California public employees are enrolled in defined benefit pension plans, which provide them with a specified benefit—generally based on their salary levels near the end of their career, their number of years of service, and the type of job they had while in public employment. This is called a defined benefit pension plan, and public employees generally are obligated to contribute only a fixed amount—as a percentage of their pay each month—to these plans.

Public employers and employees generally are required to contribute the amount estimated by actuaries as the "normal cost" for plans each year. Normal costs are the amounts estimated to be necessary—combined with future invested returns—to pay for benefits earned by employees in that year. To the extent that the plans do not have enough money over time to pay for benefits, an unfunded liability can result—due, for example, to lower-than-expected investment returns or decisions to give retroactive benefit increases that apply to prior years of service. In general, public employers bear all of the responsibility to pay for such unfunded liabilities. As of 2008-09, the most recent year for which data are available from the State Controller's Office, public employers paid a total of about $14 billion to pension systems to cover benefit costs, including several billion dollars to pay for unfunded liability costs.

Many California governments also provide their employees with options to contribute funds to defined contribution retirement plans, which are common in the private sector. Defined

contribution plans do not promise a defined benefit like those described above. Instead, these plans are able to provide retirees with income generated from prior contributions plus available investment returns. Employers have no obligation to provide additional money to employees' defined contribution accounts to offset lower-than-expected investment returns.

In addition to defined benefit and defined contribution plans, many California public employees also are eligible to receive Social Security benefits. Teachers and many public safety workers, however, generally are not eligible for such Social Security benefits.

Contract Clause. Courts have ruled that public employees in California accrue certain rights to pension benefits on the day that they are hired and, over time, they typically accumulate more pension benefit rights. Contracts related to pensions sometimes are included in collective bargaining agreements or in statutes, but in some cases, they may be "implicit" (or unwritten) commitments based on their employer's past practices. Both the U.S. and California Constitutions contain a clause—known as the Contract Clause—that prohibit the state or its voters from impairing contractual obligations. Interpreting these Contract Clauses, California courts have ruled for many decades that pension benefits for current and past public employees can be reduced only in rare cases—generally, when public employers provide a benefit that is comparable and offsets the pension contract that is being impaired or when employers previously have reserved the right to modify pension arrangements.

PROPOSAL

This measure amends the California Constitution to impose new requirements and limitations concerning public employee retirement benefits and the funding of those benefits by public employers and employees. The measure establishes different retirement benefit requirements for public employees hired before July 1, 2013 (referred to below as "current public employees" or "current employees") and public employees hired on or after July 1, 2013 (referred to below as "future public employees" or "future employees"). Assuming the measure is adopted by voters in November 2012, current employees, therefore, would include public employees hired between the date this measure is adopted and June 30, 2013.

Pensions for Employees Hired On or After July 1, 2013

This section describes this measure's limitations on retirement benefits and the funding of such benefits for future public employees. On or before June 30, 2013, state and local elected leaders would be required to adopt measures providing for benefits consistent with the measure.

Current System of Defined Benefit Pensions Would Be Changed Substantially. For future public employees, this proposal prohibits state and local governments from accumulating pension debt or unfunded liabilities and requires them to retain the exclusive authority to modify the terms of defined benefit and defined contribution retirement plans at any time. Benefits for future employees, therefore, would differ markedly from those currently offered to California's public employees. Under this proposal, for example, future public employees—and not public employers—would have to bear *all* financial risk for unfunded liabilities. For future public employees, this means that their retirement income plans would have to (1) allocate all future unfunded liability costs for defined benefit pensions to the employees themselves or (2) be

structured as defined contribution plans or similar plans, instead of the defined benefit pension plans now offered to current public employees.

Public Employer Contributions to Pension Plans Limited. Under this proposal, for future employees covered by Social Security, a public employer's total contribution to an employee's defined benefit, defined contribution, and other retirement plans could not exceed 9 percent of pay for safety employees (such as police and firefighters) and 6 percent of pay for non-safety employees. For employees who are not eligible for Social Security, including teachers and many public safety employees, employers and employees also would share equally the cost of an additional defined benefit pension that would "as precisely as possible" match benefits provided by the Social Security program. (The measure specifies that after 30 years of service and attaining the age of 58, future public safety employees would be eligible to receive the full benefit of this pension. The measure does not specify at what age or length of service future non-safety employees would be eligible to receive this full benefit.)

This measure also requires that future employees contribute an amount—presumably in each pay period—to their pension and defined contribution retirement plans that is at least equal to the amount contributed by their public employer, and it prohibits employers from making any contributions to plans on behalf of future employees.

Pensions for Employees Hired Before July 1, 2013

This section describes this measure's limitations of retirement benefits and the funding of such benefits for current public employees.

Pension Modifications for Current Employees Retiring After June 2016. Under this measure, a current employee who retires after June 30, 2016 would be able to receive pension benefits based only on the average of his or her highest three years' average annual base wage.

Annual Review of Plans' Funded Status. This measure requires the administrator of each defined benefit retirement plan for current employees to obtain an independent review of the plan's assets and liabilities and determine the plan's funding status each year. This independent review would have to follow potentially stricter standards than those currently used by California's defined benefit public pension systems—specifically, the accounting standards and assumptions established by federal law for private-sector pension plans, including those established by the federal Employee Retirement Income Security Act (ERISA). If the independent review determines that a plan's assets cover less than 80 percent of its liabilities, based on the standards included in the measure, the plan would be considered "at risk." Once a plan is considered at risk, the public employer would be required to either (1) appropriate the funds necessary to fund the plan above the at-risk level or (2) find and declare that making the appropriation necessary to fund the plan above the at-risk level would impair the public entity's ability to provide essential governmental services. If a public employer makes the latter declaration, the measure (1) requires employees to contribute more to the plan until the plan's funding exceeds the at-risk level, and (2) gives the affected employees the right to withdraw from further participation in the at-risk plan and enter into the retirement plan available to future employees. Moreover, current employee and public employer contributions would change as described below so long as pension plans are deemed at risk.

Contributions to Pay for Normal Costs of At-Risk Pension Funds. Under this measure, if a public employer declares that it cannot fund an at-risk plan for current employees without impairing essential services, the public employer would be required to limit its contributions to the normal cost to 6 percent of a non-safety employee’s pay and 9 percent of a safety employee’s pay. Public employers, however, would contribute some additional amount for employees who do not participate in Social Security. The balance of the normal cost generally would be contributed by current employees, provided, however, that current employees’ share of pension costs could not increase by more than 3 percent of pay per year. (If this 3 percent of pay limit, however, otherwise would result in normal costs not being fully funded in any year, the public employer would be required to make additional contributions above the limits described earlier to ensure that normal costs are fully funded each year.)

Contributions to Pay for Unfunded Liability Costs of At-Risk Pension Funds. If a public employer’s contribution to the normal cost of an at-risk plan under this measure is less than it contributed before the plan was considered at risk, the employer would contribute the difference to the unfunded liability of the fund. The measure states that public employers would be able to require employees to make additional contributions to the unfunded liability determined to be “necessary and equitable,” but the employee’s aggregate contribution to normal costs and unfunded liabilities never could increase by more than 3 percent of pay each year. There is no limit to the total amount of pay current employees contribute to plans as long as their contributions do not increase by more than 3 percent of pay each year.

Other Provisions

The measure makes a number of other changes to the retirement benefits received by public employees and the systems that provide those benefits.

Death and Disability Benefit Administration Changes. Public employers that provide retirement benefits for their employees may also “separately provide” death and disability benefits to their employees, regardless of the employee’s date of hire. The cost of such death and disability benefits is not subject to the cost limitations established by the measure. Death and disability benefits for employees hired on or after July 1, 2013 would have to be provided separately from the system that administers their pension, defined contribution, or similar retirement benefits.

Retroactive Benefits Prohibited. Under this measure, public employers no longer would be able to provide increases in pension plan benefits or formulae applicable to prior years of service—otherwise known as “retroactive increases” in employees’ pension benefits.

Limits on Cost-of-Living Increases for All Current and Future Retirees. For all current and future state and local retirees, this measure states that it would amend existing pension benefit contracts to limit annual percentage cost-of-living increases after December 31, 2012, to no more than the annual Social Security cost-of-living increase.

Pensions for Certain Felons Prohibited. This measure provides that a public employee convicted of a felony arising out of his or her service to a government agency cannot receive public pension benefits for his or her service to “such government agency.” (It is not entirely

clear whether this would prohibit the felon from receiving pension benefits related to their service for *another* government agency, for which there was no related felony conviction.)

"Air Time" Purchases Generally Prohibited. This measure prohibits government employees from purchasing additional retirement service credit—often called air time—for any period that does not qualify as government service or military service.

Pension Contribution Holidays Generally Prohibited. Both public employers and employees would be required to contribute to the normal cost of defined benefit pension plans each year unless the plan is more than 120 percent funded under the various private-sector, ERISA, and other funding standards described in this measure for evaluating the at-risk status of current employees' pension plans.

Alterations to Future Pension Benefit Accruals. This measure requires public employers to reserve the right to make prospective changes to pension, defined contribution, and similar retirement benefits at their sole discretion. (It appears that this change would apply to current—as well as future—employees under this measure.)

Changes to Composition of Public Retirement Boards. This measure amends existing constitutional provisions related to the composition of California's public retirement system boards. Under this measure, beginning on July 1, 2013, at least a majority of the members of the governing board of every public retirement system would be required to (1) have demonstrated expertise in a specified area and (2) not be members or beneficiaries of any California government pension plan or retirement system or have immediate family members who are members or beneficiaries of such a plan or system. In addition, the state's Director of Finance—an official appointed by the Governor with the advice and consent of the State Senate—would serve as a voting member of any state or local pension system with total liabilities that exceed $5 billion. (Because this $5 billion figure is not adjusted for inflation, over time, the Director of Finance probably would join each public pension board in the state.)

Judges Excluded From the Pension Limits. This measure applies its various pension plan changes to current and future public employees, which the measure specifically defines to exclude California's judges. Accordingly, the judges' retirements plans—administered by California Public Employees' Retirement System—would be unaffected by this measure.

State Contract Clause Would Not Apply. The measure contains provisions that override existing sections of the California Constitution and other laws to the extent that they are in conflict with this measure's requirements. For example, changes to current employee and related public employer pension contributions are required to be put in place notwithstanding provisions of existing contracts or the California Constitution's Contract Clause.

FISCAL EFFECTS

This complex measure would make changes to hundreds of different public employee pension plans throughout the state. It would almost certainly be subject to a wide array of legal challenges pertaining to its changes to benefit plans that enroll current and retired public employees, including, but not limited to, suits alleging that the measure would impair public contract obligations under the U.S. and/or California Constitutions. Moreover, the provisions of

this measure would be subject to considerable and potentially varying interpretations by public employers and pension systems. In some cases, provisions of the federal Internal Revenue Code—which governs the tax status of public pension plans—may limit the flexibility of pension systems to implement certain provisions of this measure. Given all of these factors, there is large uncertainty about this measure's possible fiscal effects, which we attempt to describe below. There is also large uncertainty about how this measure—applying broadly to nearly every type of government worker—would apply to the variety of public employees in California, which include teachers, public safety workers, office workers, professors, and many others.

Impacts Related to Future Employees

Potentially Large Retirement Benefit Savings Over the Long Term. Under the U.S. and California Constitutions, public employers generally are free to alter existing contractual obligations, such as those for pension benefits, as applied to employees hired after the date of that alteration. This measure's limitations on future employees' retirement benefits would reduce governmental costs for those benefits substantially. Accordingly, California public employers likely would be able to reduce their retirement benefit costs by billions of dollars per year (in current dollars) once public employees hired on or after July 1, 2013 constitute the bulk of their workforces. This likely would not occur until several decades from now.

Included in such cost savings are likely reductions in public employers' costs to provide health benefits to retired future employees. While not affected specifically by this measure, these retiree health benefits generally would cost less for governments over the long term because future employees would likely retire at later ages than current employees. Thus, governments would pay for these benefits for fewer years, and under current federal law, the Medicare program of the U.S. government would pay a greater share of these benefits for future employees.

Offsetting Increases in Other Compensation Costs. To ensure that total compensation for future employees is competitive with that offered by other employers, many public employers likely would increase pay, health benefits, or other non-retirement benefits for future employees. This would partially offset the retirement cost savings described above.

Impacts Related to Current Employees

It is unclear how exactly this measure's at-risk funding status evaluations would have to be conducted. We assume for purposes of this analysis that most—perhaps all—California public pension plans (which have significant unfunded liabilities under existing accounting methods) would initially be at risk under the definitions of this measure. Furthermore, we assume few public entities would be able to appropriate enough money to immediately change their plans' status. As noted above, this could result in substantial changes to employer and current employee contributions to pension plans so long as the at-risk status persists.

Possible Significant Decrease in Pension System Investment Returns. This measure would require that certain pension system accounting calculations be based on private-sector or ERISA standards, which may require systems to use lower assumptions for future investment returns

than they use today. In general, when pension systems use such lower assumptions, their estimated normal costs increase, as do estimates of their unfunded liabilities.

This measure may not be construed to require that pension systems use such private-sector accounting standards when setting required employer and employee contribution rates for current employees. Nevertheless, because this measure would require *future* employees to earn pension benefits that are substantially different from those now offered to current employees, this could result in substantial changes to how California's pension systems invest or "pool" their pension funds. If, for example, pension funds "close" their existing pension plans for current and past public employees and deposit contributions related to future public employees in separate pension funding pools, this could result in lowered investment returns for the plans for a variety of reasons and concomitant higher estimates of normal costs and unfunded liabilities.

Even if funds do not close existing plans, changes in their asset allocation to ensure they can meet existing benefit obligations to current and past public employees also may result in lowered investment returns. Public employers may, in some cases, be able to shift some such higher costs, over time, to current employees under this measure. This measure, however, would not require them to shift *all* such higher costs to their employees (nor, perhaps, would such a shift be found by courts to be constitutional). Accordingly, in the short and medium term (perhaps over the next two or three decades), these changes could result in public employers having to contribute up to several billion dollars more per year (in current dollars) to cover pension costs of current and past employees.

Effects of Shift of Costs to Current Employees. This measure contains provisions that seek to shift pension costs from public employers to current employees over time. For example, the measure contains limits on employer contributions for normal costs related to current employees and allows shifts of unfunded liability costs to employees in some cases. If able to be implemented fully, these provisions could help reduce some public employers' annual pension costs during some periods in the coming few decades. By shifting costs to current employees in this manner, some public employers could encourage or induce employees to "opt out" of existing pension plans and shift to the plans authorized for future employees under this measure.

Other Potential Public Employer Savings. For some current employees, this measure would provide for lower pension benefit costs by requiring benefits to be based on the highest three years' average base pay—rather than existing benefit provisions (often based on the highest single year's pay). This measure also would limit future cost-of-living increases for all current and future retirees. If able to be implemented, these could reduce public employers' costs for current employee benefits during the next few decades. The amount of this savings is unknown, but likely of a lower magnitude than the other savings and cost issues described above.

Potential Public Employer Costs. As with their costs to compensate future employees, public employers likely would increase pay, health benefits, or other non-retirement benefits for current employees to ensure their competitiveness in the labor market.

It is unclear exactly how the measure's provisions for death and disability benefits would affect current employees and their beneficiaries. To the extent that the measure requires these benefits to be provided outside of existing retirement systems and governments provide death

and disability benefits similar to those now in place, increased costs could result for some public employers.

Conclusion

In the short and medium term (perhaps the next two or three decades), the various financial effects of this measure make its net fiscal effects for state and local employers difficult to determine. During these decades, public employers may face significant increased costs or some savings related principally to current and past employees' pension and other retirement benefits.

Over time, a greater portion of public employers' personnel costs would be related to future employees—those hired on or after July 1, 2013, and, therefore, subject to the most significant benefit limitations under this measure. For these future employees, governments would experience substantial savings in retirement costs. These savings would be partially offset by higher costs for employee salaries and non-retirement benefits in order to keep public-sector compensation levels competitive in the labor market. Accordingly, when costs for these future employees constitute the bulk of public employers' personnel costs—several decades from now—governments could experience significant net savings.

Summary of Fiscal Effects

This measure would result in the following major fiscal effects for state and local governments:

- Over the next two or three decades, potentially significant increased annual costs or some savings in state and local government personnel costs, depending on how this measure is interpreted and administered.
- In the long run (several decades from now), annual savings in state and local government personnel costs of billions of dollars per year (in current dollars), offset to some extent by increases in other employee compensation costs.

Sincerely,

Mac Taylor
Legislative Analyst

Ana J. Matosantos
Director of Finance