July 27, 2015

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

Attention: Ms. Ashley Johansson
Initiative Coordinator

Dear Attorney General Harris

Pursuant to Elections Code Section 9005, we have reviewed a constitutional initiative related to compensation and retirement benefits for state and local governmental employees in California (A.G. File No. 15-0033).

BACKGROUND

Governmental Employee Compensation

Many People Employed by State and Local Governments. The State of California and its more than 3,000 local governments—including special districts, school and community college districts, cities, and counties—employ more than 1.7 million full-time equivalent employees. According to the United States Census Bureau, these governmental employees earned more than $10 billion in March 2013. While these governmental employees perform a variety of functions, more than 60 percent of them are identified by the Census as working in K-12 schools, higher education, hospitals, and police protection.

Three Main Elements of Compensation. State and local governmental employers compete with other governmental and nongovernmental employers to attract workers in the labor market. As part of their compensation packages, governmental employers generally offer full-time employees a salary, various benefits (such as health benefits for employees and their dependents), and retirement benefits (including pension and perhaps retiree health benefits, both discussed in more detail below).

Collective Bargaining

Establishes Compensation for Most Governmental Employees. In most cases, governmental employer and employee representatives negotiate terms and conditions of employment. This negotiation process is known as collective bargaining and generally culminates in a contract, or "memorandum of understanding." Current law establishes the collective bargaining process for most non-management state and local governmental employees. These laws establish who is subject to collective bargaining and what elements of compensation are within the scope of collective bargaining. Governmental employers generally have broad authority to establish compensation for employees who are not subject to collective bargaining, generally managerial and supervisorial employees. Pension benefits for members of the California State Teachers' Retirement System (CalSTRS) and nonteaching school employees who are members of the California Public Employees' Retirement System (CalPERS) are established by the Legislature and Governor and not subject to collective bargaining.

Collective Bargaining Statutes Administered by Public Employment Relations Board (PERB). The board is a quasi-judicial agency tasked with overseeing public-sector collective bargaining established in eight collective bargaining statutes. (In some cases, local government collective bargaining is overseen by local employment relations boards.) In this role, PERB (1) ensures these laws are implemented and applied consistently and (2) adjudicates disputes between governmental employers and employees.

Governmental Employee Pension Benefits

State and Local Governments Sponsor "Defined Benefit" Retirement Plans for Their Employees. As part of employment, the state provides defined benefit retirement plans for its employees and for those of public schools and community colleges. CalSTRS administers plans for school and community college teaching employees. CalPERS administers the retirement plans for state employees, California State University faculty and staff, and nonteaching school and community college employees. The University of California (UC) administers its own retirement system for its faculty and staff—known as the University of California Retirement System, or UCRS. Local governments generally also provide these types of plans for their employees. While some local governments have their own retirement boards to administer their plans, most cities, counties, and special districts have CalPERS or their county retirement system administer their plans.

Defined Benefit Based on Formula. When a governmental employee retires, he or she receives a pension that is determined using a mathematical formula. A typical formula is the number of years of service credited to the employee multiplied by a rate of accrual (determined by the employee's age at the time of retirement) multiplied by the employee's final salary level. Retirees typically receive a cost-of-living adjustment each year to at least partially offset erosions in purchasing power resulting from inflation.

Pension Boards as Fiduciary. In 1992, voters approved Proposition 162. This proposition amended the California Constitution to give the board of each public pension system authority and fiduciary responsibility for investment of moneys and the administration of the pension system. As a result of this proposition, the California Constitution makes a pension board the exclusive authority over the investment decisions and administration of its pension system. In managing the pension system, boards determine how much risk the pension fund should be exposed to by determining the fund's investment asset allocation. The pension board also adopts all actuarial assumptions used to calculate costs associated with the pension system. These assumptions include the "discount rate," which largely is based on a pension system's investment strategy and asset allocation. The discount rate has a strong effect on actuarial calculations of costs to fund a pension plan.

Pension Benefit Funding. Defined benefit plans have three main sources of funding:

- ***Investment Returns.*** Investment returns are the biggest component of a defined benefit funding model. In the case of CalPERS, the system reports that about two-thirds of every dollar paid to retirees is paid from investment returns. Revenues from investment returns vary significantly year to year depending on market performance; however, pension boards adopt actuarial assumptions that assume average investment returns over an extended time horizon. For example, CalPERS, CalSTRS, and UCRS each assume its investments will, on average, annually yield a 7.5 percent return.
- ***Employee and Employer Contributions to "Normal Cost."*** The normal cost is the amount estimated to be necessary—combined with future investment returns—to pay for benefits earned by employees in a given year. These costs typically are shared between the employer and employee, with the employer paying half—or somewhat more—of the normal cost.
- ***Employer Contributions for "Unfunded Liabilities."*** To the extent that a pension plan does not have enough money to pay for all future benefit payments earned to date, an unfunded liability results. Employers generally are considered the guarantors of pension benefits—meaning they usually bear all of the responsibility to pay for unfunded liabilities. Pension boards typically set employer rates to pay off any unfunded liabilities over a specified number of years—known as an amortization period. The longer an amortization period, the lower an employer's near-term annual costs to pay off any unfunded liabilities but the higher the employer's total costs over the entire amortization period. Because a fund can incur losses or gains in any given year, the unfunded liability—and consequently, the employer's contributions—can vary year to year depending on investment returns. A plan is considered fully funded when actuaries determine that the plan—based on an assumed rate of future investment returns and other assumptions—has sufficient assets to pay for all future benefit payments earned to date.

In most cases, the amount of resources from each of these three sources fluctuates based on market conditions, actuarial assumptions, and other factors. As we discuss in more detail later, in the case of funding for CalSTRS pension benefits, (1) state contributions provide a fourth source of funding and (2) all contributions—from the state, school or community college district employer, and employees—are fixed in statute established by the Legislature and Governor.

Large Pension Unfunded Liabilities. The total unfunded liabilities associated with pension plans offered by California governmental employers is in the range of hundreds of billions of dollars. To close this funding gap, most pension systems have required employers to make additional payments towards pensions over the next few decades. Later in this analysis, we discuss two recent laws designed to address pension benefit costs, including unfunded liabilities—the Public Employees' Pension Reform Act of 2013 (PEPRA) and the CalSTRS funding plan of 2014.

Plan Closure. A plan is considered closed if (1) new members are prohibited from enrolling in the plan but (2) existing members continue to accrue benefits under the plan. Because members continue to accrue benefits under a closed plan, both employees and employers continue to make contributions to the plan.

Plan Termination. On occasion, a governmental employer chooses to terminate its relationship with a pension system. For example, a city might choose to close its fire department and instead contract fire protection services with the county. In such a case, the city would terminate its pension plan associated with its firefighters. When an employer terminates a pension plan (1) new members are prohibited from enrolling in the plan, (2) existing members of the plan no longer accrue benefits under the plan, and (3) neither the employer nor members make regular contributions to the terminated plan in the future. While the procedures pension boards follow vary, some pension boards require the terminating agency to pay any unfunded liabilities in a lump sum and calculate the unfunded liability using a discount rate that is lower than the discount rate used for active plans, which increases the estimate of a plan's unfunded liability. The lower discount rate reflects the pension board's assessment that a less risky investment strategy is appropriate for a terminated plan. This is because—without the possibility of future contributions from employers or employees—a terminated plan is less capable of recovering from a large investment loss.

Governmental Retiree Health Benefits

State and Many Local Governments Provide Retiree Health Benefits. The state and many local governments provide health benefits to retired employees. In some cases, these benefits expire when an employee becomes eligible to enroll in Medicare; in other cases, the employer-sponsored retiree health benefit becomes a supplemental insurance to the coverage provided by Medicare. Some governmental employers—including the state and UC—require employees to work for the employer for a specified number of years before the employee is eligible to receive employer-sponsored retiree health benefits.

Few Governmental Employers Prefund Retiree Health Benefits. That is, most governmental employers and employees do not make annual contributions to either the normal cost or unfunded liabilities associated with the benefit. Instead, these employers pay premium costs for retiree health benefits after employees have retired—a method of payment referred to as "pay-as-you-go." There have been some efforts by governmental employers to begin prefunding some or all retiree health benefits.

Governmental Employee Death and Disability Benefits

Benefits Provided by Pension Systems. When a governmental employee or retiree dies, his or her beneficiaries or survivors are generally eligible to receive a benefit provided by a pension system. In addition, employees who have a disabling injury or illness that prevents them from performing their usual jobs with their governmental employer may be eligible to receive a disability retirement provided by the pension system. Death and disability benefits provide payments to recipients that generally are based on factors like the member's occupation, length of service, and employer. The costs to prefund these benefits typically are included in a pension plan's normal cost.

Benefits Provided Through Other Means. In some cases, governmental employers provide employees additional death and disability benefits outside of a pension system. For example, a governmental employer might provide certain employees life insurance.

Social Security Benefits

Federal Retirement Plan. Most employed individuals in the United States are required to participate in the federal social security program. Social security provides monthly payments to retired individuals based on how old they are when they retire and how much money they earned during their career. During an employee's career, both the employer and employee pay taxes on earnings. In 2015, both the employee and the employer pay 6.2 percent of the employee's pay—up to a limit of $118,500—towards social security.

Many Public Employees Not Covered by Social Security. Under federal law, state and local governmental employees may be excluded from social security if they are members of either a (1) defined benefit retirement system that provides a benefit generally comparable to that provided by social security or (2) defined contribution retirement system to which a minimum of 7.5 percent of his or her pay is credited to a retirement plan account from a combination of employer and employee contributions. Any governmental employees who are not covered by one of these two types of retirement systems must be covered by social security. In California, many public employees—including virtually all teachers, peace officers, and firefighters—are excluded from the social security program.

Contractual Obligations

Limited Ability to Change Retirement Benefits for Current Employees and Retirees. Contracts related to pensions, retiree health benefits, and other retirement benefits often are included in collective bargaining agreements or in statutes. In other cases, however, they may be "implicit" (or unwritten) commitments based on an 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. In the context of pension benefits, California courts have ruled for many decades that the Contract Clause generally prohibits reductions to pension benefits accrued by governmental employees for work already performed. In addition, the courts have determined that these benefits generally are promised to an employee on the day he or she is hired and so, under what is referred to as the "California Rule," employees have a right to pension benefits accrued in the future for work yet to be performed. In the case of both past and future pension benefit accruals, pension benefits for current governmental employees can be reduced only in rare circumstances—generally, when governmental 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. In addition, in some cases local governments may be able to alter contracts when they go through bankruptcy proceedings established under Chapter 9 of the U.S. Bankruptcy Code. While some governmental employers are contractually obligated to provide a certain level of health benefits to retirees, others—including the UC—specify that the employer has no contractual obligation and reserves the right to change or discontinue the benefit.

Public Employees' Pension Reform Act of 2013

Affects Most—but Not All—Governmental Employers. Chapter 296, Statutes of 2012 (AB 340, Furutani), referred to as PEPRA, made significant changes to governmental employee pension benefits. The law applies to employees of most governmental employers but does not apply to some, notably the UC and retirement systems established under city or county charters. PEPRA affects "classic members"—generally, those hired before 2013—differently than "PEPRA members"—generally, those hired after January 1, 2013.

Standard for Classic Members to Pay Half of Normal Cost. The law establishes a standard that classic members pay at least half of normal cost. Although the law does not require employers to implement the standard, it does give employers the authority to impose the standard in 2018 after reaching impasse in collective bargaining. Many classic employees—including teachers and most state employees—paid at least half of normal cost prior to PEPRA.

No Retroactive Benefit Enhancements. In the late 1990s and early 2000s, many governmental employers enhanced pension benefits provided to governmental employees and applied these benefit enhancements to benefits that were earned in the past without contributing additional money to pension funds. These retroactive enhancements contributed to today's unfunded liabilities. PEPRA specifies that any increase in the value of a governmental employee's pension benefit resulting from changes to an existing formula or for other specified reasons cannot be applied to service credit already earned by the employee.

Significant Changes to Pension Benefits for PEPRA Members. Most of the major provisions of the law apply to PEPRA members. Under the law, a PEPRA member is someone who either has (1) never been a member of any public retirement system prior to January 1, 2013 or (2) moved between retirement systems or governmental employers with more than a six month break in service. The law provides PEPRA members less generous pension plans from what was provided to employees hired before the law. We describe the major elements of these plans below.

- ***Pension Formulas Modified to Produce Less Generous Benefit.*** Pension formulas that existed prior to the law are closed to PEPRA members. This means that while PEPRA members may not earn benefits based on one of the old pension formulas, classic members continue to accrue pension benefits based on the more generous benefit design of the prior formula. Accordingly, a PEPRA member must work a few more years to earn a pension comparable to that provided to a classic member.
- ***Employees Required to Pay Half of Normal Cost.*** Contrary to classic members, PEPRA members are *required* to pay at least half of the amount of money that actuaries estimate as the normal cost to prefund the pension plan.
- ***Cap on Pensionable Compensation.*** The law limits the amount of a new member's salary that applies to his or her pension benefit. In 2015, this limit is $117,020 for

employees who participate in social security or 120 percent of that limit if they do not participate in social security.

CalSTRS Funding Plan

Contribution Rates Set in Statute. CalSTRS is a statewide pension system that provides pension benefits to school and community college teachers. As discussed earlier, in addition to the three typical funding sources for pensions systems (investment returns, employer contributions, and employee contributions), the state contributes money to CalSTRS. Unlike CalPERS—which has the authority to set employer contribution rates—contribution levels to CalSTRS from teachers, school and community college districts, and the state are set in statutes adopted by the Legislature and Governor.

Recent Law Established Funding Plan. CalSTRS faces significant unfunded liabilities—totaling $74 billion as of the end of 2013-14. In 2014, the Legislature and Governor approved a funding plan through Chapter 47, Statutes of 2014 (AB 1469, Bonta) that aims to eliminate CalSTRS' unfunded liabilities over about 30 years by increasing contributions from districts, teachers, and the state. Under the funding plan, the CalSTRS board can make limited changes to state and district contribution rates in the fufure.

Initiative and Referendum

Tools for Direct Democracy. Government in California—both at the state and local level—generally is a representative democracy, whereby voters elect representatives to legislative bodies and executive positions who, in turn, make decisions related to the laws and administration of government in a particular jurisdiction. In addition to this system of representative democracy, California voters can change state laws and county and city ordinances through the powers of initiative and referendum. These powers are established in the State Constitution. Under statutory law, the Legislature establishes the procedures used by voters in counties and cities to exercise these powers. Current law does not provide these powers to voters in all local government jurisdictions—for example, school districts.

- ***Initiative.*** The initiative is the power of the electors to propose new laws. At the state level, these proposals may change either statutory or constitutional law.
- ***Referendum.*** The referendum is the power of the electors to approve or reject legislation enacted into law through the representative legislative process. Some state laws—for example (1) laws intended to take effect immediately, referred to as "urgency statutes," or (2) appropriations for usual and current expenses of the state—are not subject to referendum. Typically, state employee compensation is ratified by the Legislature using legislative vehicles that are not subject to referendum.

PROPOSAL

Provisions Affecting Current and Future Governmental Employees

The proposed measure includes a number of provisions that affect both current and future people employed by state and local governments. These provisions would go into effect immediately if voters approve the measure.

Makes Employee Compensation Subject to Initiative and Referendum. Under the measure, voters would have the right to use the powers of initiative or referendum "to determine the amount of and manner in which compensation and retirement benefits are provided to employees of a government employer." This power extends to voters of every type of jurisdiction in state and local government. Voters could use these powers to determine elements of compensation. Pursuant to the measure, any challenges to the legality or application of an initiative or referendum affecting governmental employee compensation currently within the scope of collective bargaining would not be heard by PERB or local employment relations boards but would instead be heard in either state or federal courts.

Requires Future Pension Benefit Enhancements Be Approved by Voters. The measure would require voter approval whenever a governmental employer increases the value of a governmental employee's defined benefit pension.

Limits Elements of Pension Board Plenary Authority to Set Employer Costs for Closed Plans. The measure limits pension boards' existing plenary authority to impose financial conditions on government employers proposing to close a defined pension plan to new members. Specifically, the measure prohibits pension boards from imposing termination fees, accelerating payments on existing debt, or imposing other financial conditions against a government employer unless such actions are approved by the government employer or the voters of the affected jurisdiction. The full extent to which this provision limits this power is not clear.

Death and Disability Benefits. The measure specifies that nothing in the measure "shall be interpreted to modify or limit" these benefits "even if those benefits are provided as part of a retirement benefits system."

Provisions Affecting "New Government Employees"

The measure includes a number of provisions that affect only new government employees. This term is defined by the measure to include individuals hired by a governmental employer on or after January 1, 2019 "regardless of any prior employment status with that or any other government employer." In addition, a governmental employee hired *before* January 1, 2019 who changes jobs and works for a different governmental employer after January 1, 2019 would be considered a new government employee for purposes of the measure. This is different from how governmental employees are treated when changing governmental employers under PEPRA.

Requires Voter Approval to Establish Pension Plans. People hired by a governmental employer after January 1, 2019 would not be allowed to enroll in a new or existing defined benefit pension plan unless the voters of that jurisdiction approve their enrollment in such a plan. In other words—in the absence of voters approving the continuation of existing pension plans in a ballot measure—the measure closes existing governmental defined benefit pension plans on January 1, 2019.

Limits Governmental Funding of Retirement Benefits. The measure requires voter approval for governmental employers to pay more than one-half of the total cost of pension plans, defined contribution plans, retiree health plans, or any other form of deferred compensation provided to new government employees. In the case of pension benefits, this means that new employees would be required to pay one-half of total costs—both normal cost *and* unfunded liabilities—associated with their benefits. In the case of retiree health benefits, new governmental employees likely would be required to pay (1) at least one half of the normal cost and unfunded liabilities, in cases where governmental employers prefund these benefits or (2) at least half of premium costs after they have retired, in cases where governmental employers pay for these benefits on a pay-as-you-go basis.

FISCAL EFFECTS

Fiscal Effect Depends Heavily on Future Actions. There is significant uncertainty as to the magnitude, timing, and direction of the fiscal effects of this measure and its effects on current and future governmental employees' compensation. For instance, the fiscal effects of the measure would depend on:

- ***Voter Actions.*** The fiscal effect of this measure would depend heavily on how voters exercise their powers of initiative and referendum to change employee compensation. Granting voters these powers could result in compensation packages that are very different than what would have been created through existing processes to establish employee compensation. These alternate compensation packages could increase or decrease governmental employer costs.
- ***Court Interpretation of Provisions.*** Many of the measure's provisions could be subject to a variety of legal challenges. For instance, it is not clear to what extent allowing voters to use the power of initiative or referendum to determine elements of compensation for existing employees would change governmental employers' contractual obligations under the California Rule.
- ***Effects on Collective Bargaining.*** Allowing memoranda of understanding and other labor agreements to be subject to the voters' power of referenda could affect the dynamics at the collective bargaining table. This new dynamic likely would result in different outcomes at the bargaining table.
- ***Structure of Death and Disability Benefits in the Future.*** While the measure specifies that it does not modify or limit any death or disability benefits provided to governmental employees and their families, the measure does not preclude governmental employers or voters from taking future actions to modify these benefits. Future decisions by voters and governmental employers related to these benefits could produce costs or savings.

Likely Large Savings Related to Retirement Benefits

Lower Costs for Defined Benefit Pensions. Under this measure, defined benefit pension plans would not be available to new employees unless specifically authorized by voters. As such, it is likely that such benefits would be reduced or eliminated in many jurisdictions. (This mainly would affect new hires beginning in 2019, but also would affect current employees as they move between government employers in the future.) In addition, even if voters establish defined benefit pension benefits for new employees, these pension plans likely would be less costly to governmental employers than current plans because employees would be expected to pay half of any costs associated with the plan—including unfunded liabilities that might materialize in the future. These changes would reduce governmental employer costs significantly in the future.

Offsetting Costs Related to Closed Plans. While many governments would realize the savings noted above, there are costs related to the closure of defined benefit plans. As these plans "wind down" over the decades, their pension boards likely would change investments to those with lower risk and lower expected returns. This would result in higher costs for these closed plans. In addition, PEPRA employees would pay more towards normal cost, creating pressure to increase other elements of their compensation.

Lower Costs for Retiree Health Care. By requiring governmental employers to pay no more than 50 percent of the cost of retirement benefits for new employees, the measure would result in significant savings to provide retiree health benefits.

Offsetting Costs Related to Other Compensation

Compensation Packages Much Different in Future. Due to the less generous retirement benefits and cost-sharing requirements described above, governmental employers likely would face pressure to increase other elements of compensation to attract and retain employees. This likely would produce compensation packages that look very different from those offered to current governmental employees. To offset lower compensation in defined benefit pensions and retiree health benefits, governmental employers likely would increase compensation in some or all of the following areas:

- ***Defined Contribution Retirement Plans.*** The most likely retirement benefit to replace a defined benefit pension plan is a defined contribution retirement plan like a 401(k) offered by many nongovernmental employers. Governmental employers would be able to provide matching contribution to these types of accounts; however, such matches could not exceed the contributions made by employees (unless approved by voters).
- ***Increased Wages.*** Employers also could offset decreases in retirement benefits by increasing employees' wages. Increasing wages would increase other salary-driven benefit costs like social security and Medicare.
- ***Social Security.*** It is possible that employees in some jurisdictions who currently are excluded from social security no longer would be excluded. To the extent this occurs, employers and employees would then be required to each contribute 6.2 percent of pay (up to the social security wage limit) to the social security program.

- ***Disability Benefits.*** Governments likely would continue to provide such benefits for new employees—particularly for police and fire personnel. The costs to do this would depend on many factors. For example, costs could go up if employees worked later into life, increasing the rate of disability retirement.

Summary of Fiscal Effects

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

- Significant effects—savings and costs—on state and local governments relating to compensation for governmental employees. The magnitude and timing of these effects would depend heavily on future decisions made by voters, governmental employers, and the courts.

Sincerely,

Mac Taylor
Legislative Analyst

Michael Cohen
Director of Finance