LAO
65 YEARS OF SERVICE

December 28, 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 initiative regarding retirement benefits for state and local employees (A.G. File No. 09-0075). (Below, these employees are referred to as "public employees"—a term that, for the purposes of this analysis, excludes military and civilian employees of the U.S. Government who reside in California.)

BACKGROUND

Public Employee Retirement Benefits

Pension Benefits. The State Constitution and statutes authorize the establishment of systems to provide pension and other benefits to retired public employees, as well as public employees retiring with certain disabilities and survivors of some public employees. Currently, 4.1 million Californians—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 public employees—including some part-time employees—are eligible to receive a defined benefit pension after retiring that is based on the employee's age at retirement, years of service, salary, and type of work assignment. For example, a typical state office worker with five or more years of service is eligible for a defined benefit pension at age 55 equal to 2 percent of his or her highest single working year's salary multiplied by the number of years of service upon retirement. (Therefore, after working for 25 years, such a retiree would be eligible to receive a defined benefit equal to 50 percent of his or her highest single year's pay.) Peace officers and other public safety employees often are eligible for larger pensions. The pension plans generally provide annual cost-of-living increases to limit how much the effects of inflation erode the purchasing power of the pension benefits.

Typical Retirement Age. In most cases, public employees with several years of service become eligible for a pension benefit at age 50—even though the employee may be able to earn a greater pension benefit if he or she delays retirement until a later age. In the state's three largest public pension systems, the average state or local employee retires at about 60. Figure 1 shows the average retirement ages for several groups of public employees in these three systems. Average retirement ages in other public pension systems in California are about the same as those listed in Figure 1.

Figure 1

Average Retirement Ages for Selected Public Employee Groups

	Age
California Public Employees' Retirement System	
California Highway Patrol Officers	54
Local public safety officers	54
State correctional officers and firefighters	59
Other state and local employees[a]	60
California State Teachers' Retirement System	
School district and community college teachers	61
University of California Retirement Plan	
Professional and support staff members	59
Academic faculty	63

[a] Includes state and local "miscellaneous" employees, such as state office workers.

Retiree Health Benefits. Many state and local governmental entities in California also provide health benefits to eligible retired employees and/or their spouses, domestic partners, dependents, and survivors of eligible retirees. Generally, public employers offering such benefits contribute a specific amount toward a retiree's health premiums each month. The level of these benefits and the eligibility of groups of retirees to receive the benefits vary considerably among governmental entities.

Funding Public Employee Retirement Benefits

Funding Pension Benefits. California governments generally "prefund" the costs of defined pension benefits for their employees. Through prefunding, public employers and/or employees contribute a specific percentage of each employee's pay to a public retirement system each year. In most cases, these contributions are those estimated to be sufficient by the system's actuaries—when combined with future investment returns of the retirement system—to cover the portion of future pension benefits earned by that employee during a given year. This contribution is known as the "normal cost." In making their estimates, public retirement system actuaries make numerous assumptions

about (1) future investment returns, (2) the longevity of public employees, (3) the likelihood that an employee will retire in any given year, (4) the employee's future pay increases, (5) the pension benefits for which the employee eventually will be eligible, and (6) other factors. To the extent that these assumptions prove to be incorrect over time, the eventual costs to provide a given level of benefits will be less or more. In the latter cases, the employers may be required to provide additional contributions to fund a given level of pension benefits and pay down what is called an "unfunded liability." Currently, California governments contribute about $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 over the next few years due mainly to unfunded liabilities resulting from the systems' investment losses during 2008.

For certain California public pension plans, courts have found that public employers have a contractual obligation—protected under both the U.S. and State Constitutions—to current or past employees to contribute funds sufficient to preserve an actuarially sound pension plan. This is one reason why most California public employers and/or their employees contribute funds to pension plans that equal or exceed pension normal costs (as determined by each pension system's actuaries) each year. Such contractual obligations also mean that public retirement systems often specify the manner and number of years over which a government will retire the plan's unfunded liabilities. Currently, governments often have little flexibility to modify or adjust these payments.

Funding Retiree Health Benefits. California governments generally do not prefund retiree health benefits. This means that they pay for the costs of these benefits on a "pay-as-you-go" basis, and there is little money available from investment returns to cover the costs of such benefits. Accordingly, each year, most governments pay for the retiree health benefits consumed during that year by eligible retirees and dependents. Currently, California governments pay around $4 billion to $5 billion per year for retiree health benefits.

PROPOSAL

This measure amends the Constitution to place limits and conditions on defined benefit pensions and retiree health benefits for state and local government employees hired on or after July 1, 2011 (referred to as "new employees"). The measure would have no direct effect on existing retirement benefits of state and local government employees and retirees hired before July 1, 2011.

Pension Benefits and Funding

Retirement Ages. The measure establishes the following minimum "full retirement ages" for new employees:

- Peace officers and firefighters: 58.
- Other public safety employees: 60.
- All other new employees: the full retirement age as defined by the U.S. Congress in the Social Security Act (currently between 66 and 67 for persons born between 1943 and 1959 and age 67 for persons born in 1960 or thereafter).

Employees could retire at an earlier age and receive benefits, although at an actuarially reduced level. Such actuarially reduced benefits could be provided to new employees beginning five or fewer years prior to the full retirement ages listed above.

Limits on Benefits. New employees under this measure generally would be eligible for smaller defined benefit pensions than those currently provided to state and local government employees. The measure specifies the following limits on defined benefit pensions for new employees:

- Peace officers and firefighters: 2.3 percent or the employee's annual average wage base (wage base) multiplied by his or her number of years of employment (years of service credit).
- Other public safety employees: 1.8 percent of wage base multiplied by years of service credit.
- Nonpublic safety employees for which contributions to the Social Security program are not required: 1.65 percent of wage base multiplied by years of service credit.
- All other new employees: 1.25 percent of wage base multiplied by years of service credit.

Under the proposal, pension benefits may be provided to new employees only after they have worked for one or more public agencies for at least five consecutive years. Generally, the pension benefits for new employees could never exceed 75 percent of their annual average wage base. The annual average wage base to be used in calculating defined benefit pensions could be no more than the highest average annual base salary of the employee over a period of three consecutive years of government service.

Higher Benefits Allowed With Voter or Legislative Approval. Except for benefits of state and University of California (UC) employees, benefit payments higher than the limitations described above can be approved by voters in a local jurisdiction. For state

and UC employees, such changes in the benefit limitations could be approved in a bill passed with the votes of two-thirds of the Members of each house of the Legislature.

Limitations on Benefit Adjustments That Offset Inflation. Under the measure, public employers would be limited in the amounts of increased benefits that could be promised to new employees to offset the effects of inflation on the purchasing power of their pension payments. Specifically, the measure contains no allowance for inflation-protection benefits during the first five years of a new employee's retirement. After five years of retirement, public employers may provide annual benefit increases to offset the effects of inflation, not to exceed the increase in the California Consumer Price Index or 3 percent (whichever is less).

Retroactive Increases Prohibited. Effective after its approval by voters, this measure would prohibit retroactive increases of defined benefit pensions. For example, if during a firefighter's first year with a public employer, he or she was provided with a 2 percent benefit, the public entity could not later enhance it to a 2.3 percent benefit *applied to that first year of employment.* This prohibition would apply to pensions of new employees, as well as those for current public employees hired prior to the measure's passage.

Minimum Contributions to Retirement Systems Specified. Under the measure, public employers and/or employees would have to contribute funds annually to a retirement system equal to at least the normal cost of pension benefits, as estimated by the system's actuaries. A new employee who must contribute to Social Security and who is in a defined benefit pension plan would be required to contribute at least 2 percent of his or her base salary as an employee contribution to the pension plan. A new employee who is not required to contribute to Social Security would be required to contribute at least 4 percent of base salary as an employee contribution to the pension plan.

More Flexible Annual Pension Contributions for Public Employers. Subject to the specified minimum contributions to retirement systems described above, this measure would require state and local governmental entities to reserve for themselves the right to adjust the amount and rate of *both* employer and employee pension contributions related to new employees. This means that state and local governmental entities could not enter into a binding collective bargaining or other agreement with public employee groups that would prevent future increases to new employees' contributions to their pension plans. In addition, state and local governing bodies (such as the Legislature, county boards of supervisors, and city councils)—not public retirement systems—would determine the manner and number of years over which any future unfunded liabilities related to new employees would be paid off.

Retiree Health Benefits and Funding

Retirement Ages and Eligibility. Under the measure, retiree health benefits could be provided to new employees only upon their attaining the full retirement ages described above with certain limited exceptions. Retiree health benefits could be provided to a new employee only if he or she has been (1) a full-time employee of one or more public agencies for at least five consecutive years immediately preceding retirement and (2) a full-time employee of one or more public agencies for an aggregate of at least ten years. The measure specifies no limits on the types of retiree health benefits that may be provided to these eligible new employees.

Retiree Health Prefunding Required. The measure requires public employers to prefund retiree health benefits for both new employees and current employees. Under the measure, public employers and/or employees would have to contribute funds annually to a retirement system or similar fund equal to at least the normal cost of retiree health benefits, as estimated by the system or fund's actuaries. As with the normal cost of pension benefits, these normal costs are those amounts estimated to be sufficient—when combined with future investment returns—to cover the portion of future retiree health benefits earned by a group of public employees during a given year. As with employers' pension benefit contributions, employers would have the right to adjust their contributions for retiree health benefits for new employees, subject to the requirement that the governmental entity and/or its new and current employees contribute at least the normal cost of such benefits each year.

New Employees' Pension Funds May Not Be Used for Health Benefits. Currently, some retired public employees receive health benefits funded from a portion of their pension funds' assets. This measure would prohibit the use of this type of funding mechanism for new employees' pension fund assets.

FISCAL EFFECTS

The measure would result in major changes to how the state and local governments compensate their employees. The fiscal effects of these changes would depend in part on how the measure is interpreted by the courts and implemented by governmental entities and voters. The requirements for changes in retirement benefits would apply only to those public employees hired on or after July 1, 2011. Accordingly, the full fiscal effects of the proposal would not emerge until several decades after the measure's passage. Below, we discuss how the measure would affect state and local government costs for defined benefit pension and retiree health benefits, respectively. In some cases, the fiscal effects of this measure are described both over the long run (perhaps 20 or more years in the future) and over the short and medium term (less than 20 years in the future).

Pension Benefits

Major Reductions in Government Pension Payments in the Long Run. Currently, normal cost pension contributions by California governments to public retirement systems total around $10 billion per year. State and local governments in California would have smaller required normal cost contributions for new employees hired on or after July 1, 2011. Measured as a percentage of payroll, these required normal cost pension contributions for new employees often would be about one-half—and in some cases, less than one-half—of the contributions now paid by governments for current employees. Accordingly, in the long run (after most current governmental employees retire and most of the state and local governmental workforce consists of persons hired on or after July 1, 2011), normal cost pension contributions by California governments could be less than $5 billion per year (as measured in today's dollars). This assumes that, in most cases, governmental entities offer the maximum pension benefits specified in the measure (but not the higher benefits which could be authorized by the Legislature or the voters of a local jurisdiction). This also assumes that governmental entities do not choose to increase new employees' required pension contributions as allowed under the measure.

Increases in Other Forms of Compensation. In order to offset the decline of retirement benefits required under this measure for new employees, some governments likely would increase other forms of compensation above current levels for some employees in order to remain competitive in the labor market. These other forms of compensation include salaries and contributions to employee retirement funds other than those defined pension plans limited under this measure (such as "defined contribution" retirement accounts, for which employers make a specific payment, rather than promise a specific future benefit). These increases would offset the long-term reductions in pension contributions to an unknown extent. The magnitude of these additional costs would be determined by various factors, including labor market conditions and choices made by governmental entities and voters.

Possible Effects of Pension Fund Cash Flow. If, as normal costs for new employees decline, policymakers decide to reduce the combined employer and employee contribution, some public retirement systems may receive less cash than they otherwise might on a monthly and annual basis. Accordingly, these systems may have fewer liquid assets on hand at any given time to meet their pre-existing pension payment obligations. This could lead some of the systems to reduce the average amount of time that they invest their assets in the stock, bond, real estate, and other markets. In turn, this may reduce the average annual investment returns that the systems are able to assume when calculating required normal cost and other pension payments. If this were to occur, annual pension payments by governments could increase. Conversely, if policymakers chose not to reduce existing levels of employer and employee contributions, then the

amount of funding received by the retirement systems would exceed the amount necessary to pay normal cost for new employees. This would result in the systems having more money than is currently the case to fund any pre-existing unfunded liability. As a result, the systems would become actuarially fully funded sooner than would otherwise be the case. It is particularly difficult to estimate these effects, as they could vary substantially from one public pension system to another.

Retiree Health Benefits

Requirement to Prefund Costs of Retiree Health Benefits. Under the measure, governments and/or public employees would be required to start prefunding retiree health benefits that governments commit to provide to both current and new employees. Most governments do not currently prefund these benefit costs. In the short term, therefore, the measure would result in annual governmental payments above those that otherwise would be made in order to fund normal cost retiree health benefit contributions. (We assume that actuaries would determine that these normal cost payments are in addition to existing pay-as-you-go costs that governments make for current retirees' health benefits.) The increased payments are likely to be several billion dollars per year in the short and medium term. In the long run, however, reductions in annual governmental costs for retiree health benefits would more than offset the shorter-term increases in payments. This is because investment returns would fund a significant amount of future retiree health benefit costs and cover costs that otherwise would have to be paid by governments, employees, and/or retirees.

Other Fiscal Effects

Variety of Other Fiscal Effects Are Possible. Particularly over the long run, the measure could result in numerous other effects on governments. For example:

- Changes in the types and amounts of public employee compensation could change the demographics of state and local government workforces.
- Because future governmental workers would be guaranteed lower annual incomes in retirement, an increased number could enroll in public social services and health programs and increase those programs' costs.

These and other factors could affect state and local government costs and revenues. The net effect of these factors is unknown, but would be much less significant than the other fiscal effects discussed in this analysis.

Fiscal Summary

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

- Major reductions in annual public sector pension costs—potentially in the range of 50 percent or more—over the long run.
- Possible increases in other public employee compensation costs, depending on future decisions made by governmental entities and voters.
- Major near-term increase in annual governmental payments to prefund retiree health benefits, more than offset in the long run by annual reductions in these costs.

Sincerely,

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Mac Taylor
Legislative Analyst

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Michael C. Genest
Director of Finance