PUBLIC PENSIONS FOR RETIREMENT SECURITY

LITTLE HOOVER COMMISSION

February 2011

February 24, 2011

The Honorable Edmund G. Brown, Jr.
Governor of California

The Honorable Darrell Steinberg
President pro Tempore of the Senate
and members of the Senate

The Honorable Robert D. Dutton
Senate Minority Leader

The Honorable John A. Pérez
Speaker of the Assembly
and members of the Assembly

The Honorable Connie Conway
Assembly Minority Leader

Dear Governor and Members of the Legislature:

California's pension plans are dangerously underfunded, the result of overly generous benefit promises, wishful thinking and an unwillingness to plan prudently. Unless aggressive reforms are implemented now, the problem will get far worse, forcing counties and cities to severely reduce services and layoff employees to meet pension obligations.

The public agency managers responsible for administering California's dozens of pension plans need the Governor's and Legislature's help to impose the structural discipline they lack and to provide alternatives that can put the system on a path to sustainability.

One need look no further than the actions of some 200 public agencies in the months since the steep decline in the stock market and housing values in 2008: Rather than foreswear risky behaviors, these public agencies in California instead have improved pension benefits for their employees. Up and down the state, cities, counties, and fire and water districts rewarded employees with "golden handshake" agreements that provide extra service credit to retire early; introduced favorable methods to calculate pension benefits based on the single highest year of compensation; and lowered retirement ages that extend the government's obligation to pay lifetime retirement benefits. These actions further burden pension plans that already are unsustainable.

In its study of public pensions, the Commission found that the state's 10 largest pension funds – encompassing 90 percent of all public employees – are overextended in their promises to current workers and retirees. The ability and willingness of leaders to contain growing pension obligations should concern not only taxpayers who are seeing vital services and programs cut to balance budgets, but the public employees who have the most to lose. A pension is worthless without a job to back it.

The Legislature has the tools to put state and local public employee pensions back on a path that can restore stability and public confidence to state and local pension systems. Marginal changes, however, will fall short of the need for serious action. Adding a "second tier" of lower pension benefits for new hires, for example, will not deliver savings for a generation, while pension costs are swelling now as Baby Boomers retire.

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In this report, the Commission confronts the elephant in the room: The legal obstacles that limit the options of state and local pension plans to reduce future, as-yet-unearned pension benefits promised to current workers. These promises, protected by decades of court decisions, were made under the illusion that the stock market returns of the dot-com boom were the new normal. After years of benefit enhancements, pay raises and government hiring sprees, the drop in stock and home values made it clear that the promised benefits are unaffordable and leave taxpayers facing all the risk as the bill becomes due.

While recognizing the legal challenges, this is a path that the state has no choice but to pursue. Public agencies must have the flexibility and authority to freeze accrued pension benefits for current workers, and make changes to pension formulas going forward to protect state and local public employees and the public good.

The Commission further urges the Legislature to pursue structural changes that realign pension costs and expectations of employees, employers and taxpayers.

A hybrid model, which combines a lower defined-benefit pension with an employer-matched defined-contribution plan, is a model that must be made available to public agencies. The state needs to collapse unsustainable pension formulas and create a lower defined-benefit formula to facilitate this approach. A cap also must be put in place on the maximum salary that can be used to determine pension payments, or on the maximum pension that an employee can earn. The cap should protect pensions for lower-wage earners, but it is not the government's burden to exclusively fund the retirement of public employees and executives earning high salaries. Earnings that exceed the threshold should be steered into a portable defined-contribution plan, with the ability of employers to match employees' contributions, to encourage workers to remain employed, and to serve a mobile and professional workforce.

California's pension system – a conglomeration of 85 defined-benefit pension plans – demands more uniformity and oversight. Standard definitions for final compensation must be adopted to prevent the type of mischief that erodes public confidence in public employee pensions. Retroactive benefit increases must be banned. More independent members should be added to retirement boards to add needed perspectives about the public's tolerance for risk when setting aggressive assumptions for investment returns. Voters, too, deserve a say in benefit increases that they ultimately have to pay.

All parties must pay a fair share. Contribution holidays from employers should be allowed only in rare cases of fiscal emergency – not when pension assets appear inflated by temporary market surges. Employees must contribute equally to their pensions. And discussion must continue on the federal government's responsibility to share in retirement costs by extending Social Security to uncovered workers, a controversial idea that may become more advantageous as the retirement burden on state and local governments grows.

Fixing the system will not be easy or be done quickly. Government agencies will have to bear for decades the retirement costs already accrued for public employees. The state can, however, make immediate course corrections. It can do so in a way that remains fair to both the public and the worker.

Sincerely,

Daniel W. Hancock
Chairman

PUBLIC PENSIONS FOR RETIREMENT SECURITY

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Executive Summary

The 2008-09 stock market collapse and housing bust exposed the structural vulnerabilities of California's public pension systems and the risky political behaviors that have led to a growing retirement obligation for state and local governments, the scale of which taxpayers are just beginning to understand.

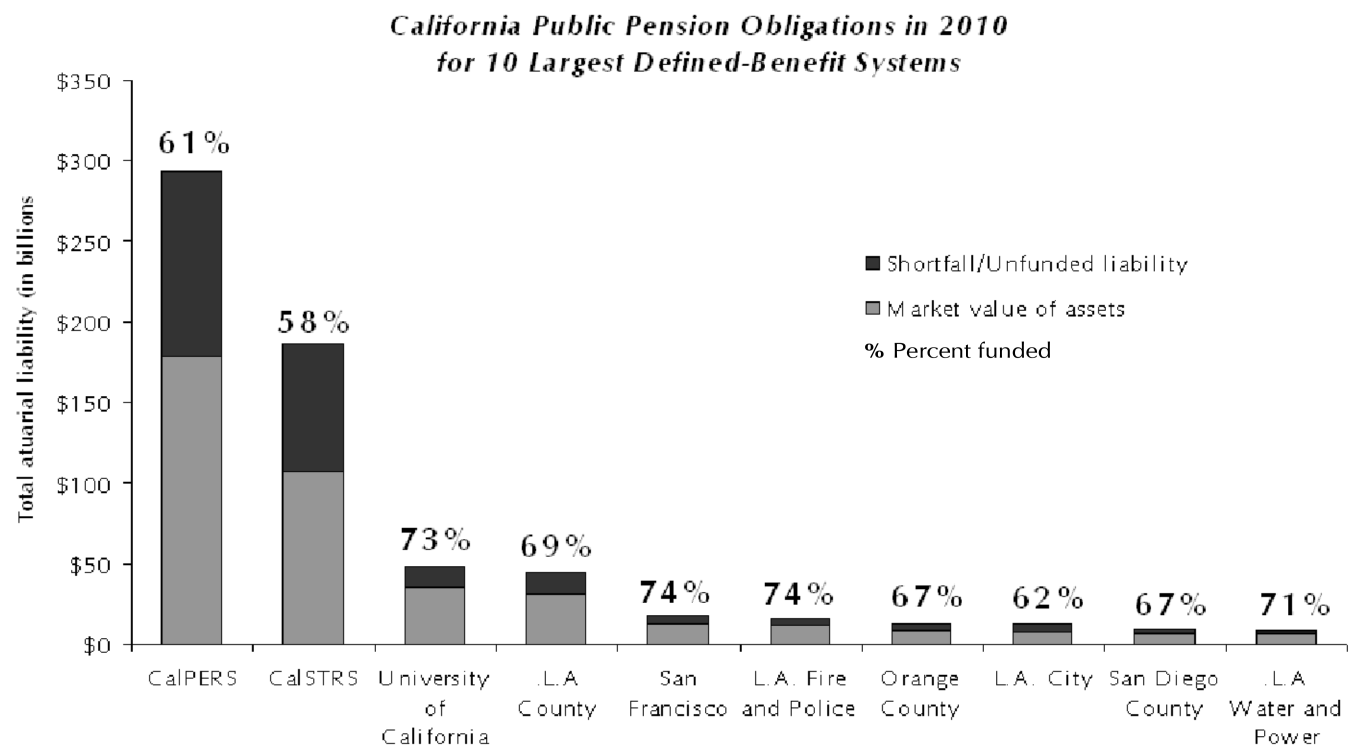
Treated like another speculative house during the boom, the state allowed public agencies and employees to pull equity in the form of increased retirement benefits from the pension funds whose value was inflated by optimistic market return estimates. The retirement promises that elected officials made to public employees over the last decade are not affordable, yet this is a mortgage that taxpayers cannot walk away from easily.

When the economy crashed, another lesson from the housing bubble became just as important. A public pension, like a house, is not a get-quick-rich investment. As a house is for shelter, a pension is for long-term financial security. Even the "teaser rates" reflecting aggressive investment assumptions are re-setting, revealing a higher cost to maintain a level of benefits that have become more generous than reasonable.

Boom and bust cycles are natural, if unpredictable, but political leaders agreed to changes in the pension system at the peak of a boom, and as a major demographic event began unfolding – the start of the retirements of the Baby Boomers.

Pension benefits promised to retirees are irrevocable, as are the promised benefits that current workers have accrued since their employment began. It also remains difficult to alter the theoretical, yet-to-be earned benefits for current workers. This situation, reinforced by decades of legal precedent, leaves little room for state and local governments to control mounting retirement costs, particularly when the only venue for change is the bargaining table.

Taxpayer groups, citizen grand juries and think tanks have sounded the alarm for reform, a call that is beginning to resonate in city councils,



The 10 largest public pension plans in California -- encompassing 90 percent of all assets and members in the state's defined benefit systems – faced a combined shortfall of more than $240 billion in 2010. As a point-in-time measurement to gauge the financial health of these systems, this chart includes the percent of actuarial liabilities that are covered by the market value of assets in each fund. An 80 percent funded status is considered the low threshold for a stable system. Actuarial methodology used by each system to determine liabilities can vary, which can complicate comparisons between systems. This chart was assembled using the unaltered information as reported by the pension systems.

See end notes for sources.

county boards of supervisors, school boards and among trustees of specials districts now that they face the prospect of increasing required contributions into their pension funds by 40 to 80 percent of their payroll costs for decades to come. It is practically enough money to fund a second government, and it will – a retired government workforce.

Public employees might appear to have little incentive to push for reforms, yet they will pay a price for inaction: salary freezes, layoffs, increased payroll deductions and the threat of a city or county bankruptcy. Doing nothing to current pension obligations will cost public employees everything. A pension cannot grow without a job attached to it.

Public employees also share in the prospect of a very different California, as cities such as Los Angeles, San Diego, San Francisco and San Jose prepare to spend one third of their operating budgets on retirement costs in coming years. Pensions are at the center of what will be an intensifying fight for diminishing resources from which government can pay for schools, police officers, libraries and health services. With 86 percent of the retirees and beneficiaries of the California Public Employees' Retirement System remaining in the state, in what sort of communities do they want to live? Without reform, it will be communities with dwindling services and less police and fire protection.

The Little Hoover Commission began its study of California's public pension systems in April 2010 to understand the scale of the problem and develop recommendations to control growing pension costs in state and local governments. Over a six-month period, the Commission held a series of hearings at the State Capitol and conducted several other public meetings with stakeholders to address these issues. Through these hearings and additional research, the Commission found:

> ***Pension costs will crush government.*** Government budgets are being cut while pension costs continue to rise and squeeze other government priorities. As the Commission heard during its hearings, the tension between rising pension costs and lean government budgets is often presented today in a political context, with stakeholders debating the severity of the problem and how long it will last. In another five years, when pension contributions from government are expected to jump and remain at higher levels for decades in order to keep retirement systems solvent, there will be no debate about the magnitude of the problem. Even with the introduction of two-tiered pension plans, barring a miraculous market advance, few government entities – especially at the local level – will be able to absorb the blow without severe cuts to services.

The math doesn't work. Investment losses in 2008-09 certainly shocked the system, but several other factors have contributed to an unsustainable pension environment. Payroll growth – in terms of both compensation for public employees and the number of employees – has ballooned pension liabilities. The minimum retirement age has dropped to 55 – earlier for public safety employees – as people live longer, creating an upside-down scenario where governments potentially will send retirement checks to an employee for more years than they earned paychecks. At the same time, state and local governments have increased what used to be considered a good pension into pensions that are the most generous in the country. Banking on high fund returns and an aggressive investment strategy, employers and employees also have failed to contribute sufficiently – and on occasion, stopped paying into the system at all. Today, the state's largest pension systems are dangerously underfunded.

The system lacks discipline. The purpose of the public pension system has shifted away from providing retirement security to public employees. Today, the pension system is regarded as deferred compensation – the perceived tradeoff of earning a lower salary in the public sector in exchange for a good retirement package. The retirement systems invest aggressively to help workers accumulate wealth, which leaves taxpayers facing all the risk when returns fail to meet system needs. A lesson from history would suggest that, when the market eventually recovers, the pressure from employees will return to ramp up pension formulas and undo any reforms being made today. The ability or willingness of elected officials to hold the line on their own is in serious doubt.

The system lacks oversight and accountability. CalPERS, the largest pension plan in the country, covers state workers and many city, county and school district workers – roughly half of all public employees in California, 1.6 million altogether. Two million other public workers in universities, cities, counties, school districts and special districts receive retirement benefits through dozens of other independently run pension plans. The collective-bargaining environment also allows numerous employee unions within each government entity to negotiate separately for benefits, resulting in thousands of different retirement packages across the state. Since 2008, fewer than 30 of the 1,500 local public agencies in the CalPERS network have adopted a lower level of pension benefits for new hires. As pension portfolios shrunk and tax revenues plunged, nearly 200 public agencies in CalPERS continued to increase retirement benefits for current workers. This lack of uniformity:

- Clouds transparency.
- Invites mischief and abuse, such as pension "spiking."
- Creates a compensation arms race among communities.
- Delegates complicated decisions to often inexperienced, local officials.

With needed reforms, defined-benefit pensions can remain a core component of public employee retirement plans.

The problem, however, cannot be solved without addressing the pension liabilities of current employees. The state and local governments need the authority to restructure future, unearned retirement benefits for their employees. The Legislature should pass legislation giving this explicit authority to state and local government agencies. While this legislation may entail the courts having to revisit prior court decisions, failure to seek this authority will prevent the Legislature from having the tools it needs to address the magnitude of the pension shortfall facing state and local governments.

The situation is dire, and the menu of proposed changes that include increasing contributions and introducing a second tier of benefits for new employees will not be enough to reduce unfunded liabilities to manageable levels, particularly for county and city pension plans. The only way to manage the growing size of California governments' growing liabilities is to address the cost of future, unearned benefits to current employees, which at current levels is unsustainable. Employers in the private sector have the ability and the authority to change future, un-accrued benefits for current employees. California public employers require the ability to do the same, to both protect the integrity of California's public pension systems as well as the broader public good.

Freezing earned pension benefits and re-setting pension formulas at a more realistic level going forward for current employees would allow governments to reduce their overall liabilities – particularly in public safety budgets. Police officers, firefighters and corrections officers have to be involved in the discussion because they, as a group, are younger, retire earlier and often comprise a larger share of personnel costs at both the state and local level. Public safety pensions cannot be exempted from the discussion because of political inconvenience.

Hybrid model. A new "hybrid" model for public employee retirement should be made available to state and local agencies to reinforce the principles of retirement security and shared responsibility. The model, being tested in Orange County for miscellaneous workers, combines a lower defined-benefit pension with an employer-matched 401(k)-style plan. The 401(k) element is risk-managed to protect employee investments from market volatility in order to generate an adequate retirement income.

The idea is not new. The federal government adopted a similar approach more than 25 years ago for federal employees. Federal employees hired after 1987 have joined a three-tiered retirement plan that provides a defined-benefit formula up to 1.1 percent of final compensation for every year of service; a 401(k) plan with an employer match of up to 5 percent of salary (the first 1 percent is automatic); and, Social Security benefits (previously not provided) to augment the workers' retirement income. The newer defined-benefit pension plan requires lower contributions for employees and federal agencies – and it was 100 percent funded as of 2009. Employees hired after July 1, 2010 are automatically enrolled in the 401(k) element, with a 3 percent payroll deduction unless they change the contribution level.

Roughly half of all public employees in California do not participate in or receive Social Security benefits, so many public employees rely more heavily on state and local governments to provide larger retirement benefits. Serious consideration must be given to extending Social Security to non-covered, public-sector workers, toward the goal of building a three-part retirement strategy as has the federal government.

Uniformity. The state also must establish standards for more uniform and reasonable pensions. The public outrage over the "spiking" of benefits to provide a larger retirement income cannot continue to be ignored, nor can the increasing number of six-figure pensions for some managers and high-wage earners. The gaming and abuses of the pension system must end. To restore public confidence in the public pension system, the state must impose a cap in the $80,000 to $90,000 range on the salary used to determine pension benefits, or alternatively, a cap on pensionable income. Under such an arrangement, compensation above the cap would be factored into contributions toward an employee's 401(k)-style plan.

Transparency. The Legislature also must take steps to improve transparency of the state and local government costs of providing retirement benefits to current and future retirees. The debate over discount rates used to determine unfunded pension liabilities has laid bare the volatility of pension assets and raised important questions about the public's exposure to systemic pension obligation risk. A measure of liability is a way for the public to understand and start a fact-based discussion about solutions to the problem. It is reasonable to try to come up with a "bottom line" on how much taxpayers owe, but it is an imperfect process. Numbers that have been used by think tanks and researchers to estimate the unfunded liabilities of California public pension plans can vary by hundreds of billions of dollars. Methodologies across studies are often inconsistent – using different asset bases, investment assumptions, the number of pension plans captured in the estimates, and the inclusion of retiree health benefits – leading to more confusion. There is no one "right" number that the state should mandate to determine actuarial liabilities. But an honest and public assessment of the risks and options about determining obligations can inform decision-makers when setting contribution rates and making investment strategies. Adding more independent, public members to retirement boards can help broaden perspectives to facilitate this conversation.

The Commission offers its recommendations in the spirit of Governor Brown's call in his State of the State address for pension reforms to be "fair to both taxpayers and workers alike." The Commission asks the Governor and the Legislature to take immediate and bold steps to put the state's pension plans on a path to sustainability and to add oversight to protect current employees, retirees and taxpayers. Delay will continue to create concern over California's ability to pay for its promises, distort local government budgets and further erode California governments' standing in the municipal bond market. The stakes are too high to continue making temporary changes at the margin.

Recommendations

Recommendation 1: To reduce growing pension liabilities of current public workers, state and local governments must pursue aggressive strategies on multiple fronts.

- ❑ The Legislature should give state and local governments the authority to alter the future, unaccrued retirement benefits for current public employees.
- ❑ State and local governments must slow down pension costs by controlling payroll growth and staffing levels.

Recommendation 2: To restore the financial health and security in California's public pension systems, California should move to a "hybrid" retirement model.

- ❑ The Legislature must create pension options for state and local governments that would retain the defined-benefit formula – but at a lower level – combined with an employer-matched 401(k)-style defined-contribution plan.

- ✓ The 401(k)-style component must be risk-managed to provide retirement security and minimize investment volatility.

Recommendation 3: To build a sustainable pension model that the public can support, the state must take immediate action to realign pension benefits and expectations.

- ❑ To provide more uniform direction to state and local agencies, the Legislature must:
  - ✓ Cap the salary that can be used to determine pension allowances, or cap the pension, at a level that is reasonable and fair. Once the employee exceeds the threshold, employees and employers could make additional retirement contributions into a risk-managed, 401(k)-type defined-contribution plan.
  - ✓ Set appropriate pension eligibility ages to discourage early retirement of productive and valuable employees.
  - ✓ Set a tight definition of final compensation, computed on base pay only, over a five-year average to prevent and discourage pension "spiking."
  - ✓ Set uniform standards for the maximum hours that retirees can return to work and continue to receive public-sector pensions.
  - ✓ Set uniform standards and definitions for disability benefits.
  - ✓ Restrict pension allowances to exclude service in an elected office.
  - ✓ Eliminate the purchase of "air time."
  - ✓ Strengthen standards for revoking or reducing pensions of public employees and elected officials convicted of certain crimes involving the public trust.
- ❑ To minimize risk to taxpayers, the responsibility for funding a sustainable pension system must be spread more equally among parties.
  - ✓ The Legislature must prohibit employees and employers from taking contribution "holidays," except under rare circumstances.
  - ✓ The Legislature must prohibit retroactive pension increases.
  - ✓ The Legislature must require employees and employers to annually adjust pension contributions based on an equal sharing of the normal costs of the plan.
  - ✓ State and local governments must explore options for coordinating pension benefits with Social Security.

Recommendation 4: To improve transparency and accountability, more information about pension costs must be provided regularly to the public.

- ❑ The Legislature must require government retirement boards to restructure their boards to add a majority or a substantial minority of independent, public members to ensure greater representation of taxpayer interests.
- ❑ All proposed pension increases must be submitted to voters in their respective jurisdictions.
  - ✓ The ballot measures must by accompanied by sound actuarial information, written in a clear and concise format.
- ❑ The Legislature must require all public pension systems to include in their annual financial reports:
  - ✓ The present value of liabilities of individual pension funds, using a sensitivity analysis of high, medium and low discount rates.
  - ✓ The government entity's pension contributions as a portion of the general operating budget and as a portion of personnel costs, trended from the past and projected into the future.
- ❑ The State Controller must expand the *Public Retirement Systems Annual Report* to include the above information. Administrative fees to pension systems should be considered as a funding source to support actuarial expertise and the timely production of the report.
- ❑ The Legislature must require pension fund administrators to improve procedures for detecting and alerting the public about unusually high salary increases of government officials that will push pension costs upward.

The Commission's Study Process

The Commission began its study on state and local public pension systems in April 2010 to review the growing obligations and structural issues surrounding public employee retirement.

Over the next six months, the Commission convened three public hearings to solicit input from stakeholders, including pension system administrators, retirement board members, labor union leaders and public employees, national retirement policy experts, industry consultants, actuaries and taxpayer advocates. A list of all public hearing participants is included in Appendix A.

In addition to the hearings, the Commission held a series of public meetings with legal experts about the opportunities and limits of pension reform, with Orange County supervisors and labor leaders about the county's "hybrid" retirement model, and with executives and members of the California State Teachers' Retirement System about the fund's challenges. A list of all public meeting participants is included in Appendix B.

Commission staff received valuable feedback from a number of experts representing all aspects of the pension system and reform debates. The Commission greatly benefited from the contributions of all who shared their expertise, but the findings and recommendations in this report are the Commission's own.

It is important to note that the Commission did not examine retiree health care costs as part of its pension study. The Commission would like to acknowledge the extensive work of the state Public Employee Post-Employment Benefits Commission, which stressed the need of current workers and employers to share in the responsibility of pre-funding retirement health care costs.

All written testimony submitted electronically for each of the hearings, and this report is available online at the Commission Web site, www.lhc.ca.gov.

Background

The boom and bust cycles of the stock market revealed the structural vulnerability of California's retirement systems and the high costs of political choices made over the last decade.

The 2008-09 downturn wiped out hundreds of billions of equity value and fueled a credit crisis that extended the damage, depressing tax revenues and pushing up unemployment to double-digit rates. Revelations of soaring unfunded liabilities competed with an endless parade of grand jury reports and news stories about rich payouts to push the obscure realm of pensions to the forefront of the policy agenda. All of a sudden, taxpayers were enraged, and every aspect was ripe for scrutiny, from the closed-door process of negotiating benefits to the actuarial practices and accounting standards of disclosing and determining retirement costs.

The discussions – and recriminations – about how to address mounting costs and who is responsible for preventing the situation from worsening are just beginning for public agencies, public employees and taxpayers. Their search for policy levers and opportunities for reform will take place within a century-old system shaped and constrained by legislative battles, ballot measures and court decisions.

Public Retirement Systems in California

The state's retirement system is actually a dispersed collection of 85 separately managed "defined-benefit" plans and 46 "defined contribution" plans, serving a total membership of 4.4 million workers and retirees in California.[1]

Current public employees and "inactive" workers (who have moved on to other jobs but have yet to retire and collect earned benefits) make up 77 percent of the membership, or 3.4 million people. Retirees, disabled former workers and surviving beneficiaries make up the other 23 percent, about 1

How Much Do We Owe?

Estimating the shortfall facing California's 85 public pension plans is an imperfect task. Numbers that have been used by think tanks and researchers to determine the unfunded actuarially accrued liability (UAAL) have varied by hundreds of billions of dollars.

Methodologies used across studies often are inconsistent – using different asset bases, investment assumptions, the number of pension plans captured in the estimates and the inclusion of retiree health benefits in the total. Some are based on outdated estimates of fund assets. Using the most recent data available, the state's 10 largest defined-benefit plans for public employees reported an actuarial shortfall in 2010 of $240 billion, based on the pension plan methodologies and the market value of assets as provided to the Commission.

See Appendix E for a glossary of key terms.

million people. The demographics are shifting: Beneficiary membership is increasing at a faster rate than the workforce that pays into the system. From 2003-04 to 2007-08, the number of current and inactive workers has increased by 10.6 percent, while beneficiary membership has increased by nearly 18 percent.[2]

Workers and retirees are covered by plans ranging in size from fewer than 100 members (36 percent of all plans) to more than 10,000 members (19 percent of all plans). The state's 10 largest pension-plan funds encompass 90 percent of all assets and membership in state retirement systems. The remaining pension funds are not insignificant in scale: They represent combined assets of more than $50 billion.[3]

This study focuses on the state's 85 defined-benefit programs, which include:

- Six state plans.
- 21 county plan.
- 32 city plans.
- 26 special district and other plans.[4]

Created in 1932, the California Public Employees' Retirement System (CalPERS) has grown into the nation's largest public pension plan. With a membership of 1.6 million workers and beneficiaries, the $220 billion pension plan covers all state workers, California State University employees, judges and retired legislators (those elected before 1990). Since 1937, the state has allowed local public agencies and school districts to contract with CalPERS to administer retirement benefits. The CalPERS network now includes more than 3,000 such agencies.[5]

Though CalPERS covers only half of all government workers in California, it often leads the conversation on pension policy and benefit changes, and receives the bulk of attention from policy-makers.

The nation's second largest pension system also is based in California. Public-school teachers built their own retirement system in 1913, the California State Teachers' Retirement System (CalSTRS), predating the federal Social Security system by more than 20 years. The state retains strict control over CalSTRS. It sets a uniform pension benefit for all K-12 teachers and administrators and community

Retirement Plan Types

Defined-Benefit Plan: A plan with terms that specify the amount of pension benefits to be provided at a future date or after a certain period of time. The amount specified usually is a function of one or more factors, such as age, years of service and compensation.

Defined-Contribution Plan: A plan with terms that specify how contributions to a plan member's account are to be determined, rather than the amount of retirement income the member is to receive. The amounts a member receives depend on the amount contributed to the member's account and earnings on investments of those contributions.

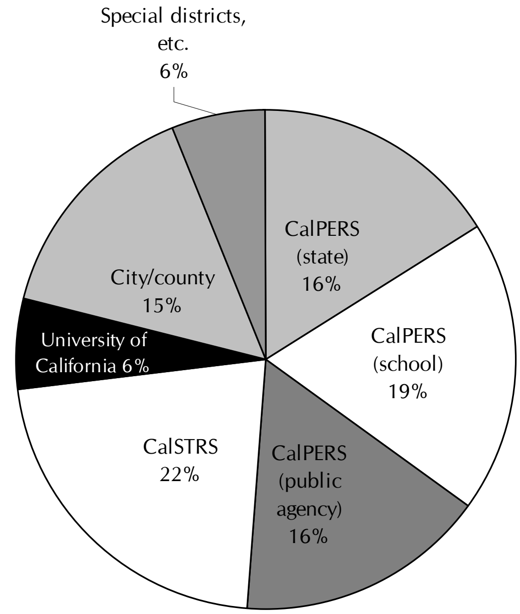
college faculty and sets flat contribution rates for all school districts and all participants to pay into the system. The state provides an annual supplementary payment into CalSTRS.[6]

Under a 1937 law, 20 counties operate retirement plans independently of CalPERS. This group includes the state's largest counties, such as Los Angeles, Orange, San Diego, San Bernardino, Sacramento and Fresno, many of which created retirement plans before the establishment of CalPERS. San Luis Obispo County also administers an independent pension program.[7]

A number of cities, from Los Angeles to San Francisco, also manage their own pension funds, as do several transit, irrigation and other special districts. Many local government entities operate separate pension funds for different classes of employees, such as public safety officers.[8]

The University of California system also maintains its own retirement plan, independent of the parameters set by the state for other pension plans. The state does not contribute directly to the UC pension program. For 20 years, the UC pension plan was funded entirely by investment returns, a tradition that ended in 2010, when employees and the university resumed making contributions into the pension fund to address the plan's swelling unfunded liability.[9]

4.4 Million Public Employees: Retirement System Membership



Source: Grant Boyken. April 2007. "Funding the Golden Years in the Golden State: An Overview of Public Employee Post-Employment Benefits and Recent Concerns About How to Provide and Pay for Them." Page 2. Sacramento, CA. California Research Bureau.

Evolving Roles

Through the state Constitution, each state and local pension board retains exclusive control over its administrative and investment policies. This authority was added by Proposition 162 in 1992, a key turning point in California's public pension storyline.

During a weak economy that cut into state revenues in the early 1990s, Governor Pete Wilson proposed using $1.6 billion from CalPERS' accounts to help balance the state budget. Wilson also called for giving the Governor the authority to appoint a majority of CalPERS board members, as well as to control actuarial projections, which are used to determine liability levels and state payments into the pension fund. The Legislature agreed to the changes in 1991 with AB 702.[10]

Opponents reacted with Proposition 162, overturning the provisions of AB 702, blocking in the future what they considered "raids" on the pension fund and embedding in the state Constitution a new level of authority that insulates CalPERS – and all other retirement boards – from legislative interference. Retirement boards since then have had exclusive jurisdiction over investment, administration and actuarial policies.[11]

The role of the state Legislature, however, remains far from limited. The state still sets parameters for benefits, retirement formulas, eligibility ages and, in some cases, contribution rates. The state has adopted a somewhat permissive approach, devising an extensive menu of retirement options from which state and local government bodies can offer to employees. Under collective bargaining, each employee group at every government entity has negotiated a unique set of benefits, resulting in thousands of different plans, but lacking in controls to ensure that promised benefits are shored up by adequate contributions or realistic investment return expectations.

The process by which public employee labor unions and government officials negotiate and approve retirement benefits faces increasing scrutiny. "Such agreements, which have been under the public's radar in the past, are now coming to light due to the massive budget deficit the state is facing," noted the California Court of Appeals, 3rd District, in a January 2011 ruling. In blocking a retroactive pension increase because the full costs had not been disclosed, the court underscored the duty of elected officials to oversee and manage retirement costs of public employees.[12]

The ruling followed a 2008 disclosure reform. Legislation that came out of the Public Employee Post-Employment Benefits Commission that year prohibited elected officials from approving pension changes on fast-track "consent calendars," forcing elected officials to acknowledge and address pension issues during public meetings.[13]

Attention on transparency continues to dominate the reform debate. In the wake of the compensation scandal in the Los Angeles suburb of Bell, the State Controller's Office has begun posting on its Web site detailed salary and retirement information for local government employees.[14]

Retirement and the Progressive Era

Nearly 100 years ago, retirement systems were designed to get people to leave the workforce, not provide them with leisure income in old age or reward them for a lifetime of hard work. Public pension systems meant government reform. In the early 20th century, a new civil service and merit system began filling the ranks of government with professionals, replacing a workforce of political appointees installed by the spoils system. The problem of the hold-over appointees – growing older and unproductive, yet protected by civil service rules – continued to vex reformers.

"Heartless demands for efficiency would relegate these employees to the scrap heap, but sentiment and justice would deter such action," noted the state's Civil Service Commission in 1926.[15] The public pension system emerged as tool of the Progressive Era, to provide an adequate retirement income as an incentive for older workers to retire, or in the parlance of the day, to be retired. Pension supporters argued that the anticipated turnover would prevent stagnation and provide opportunities for young people – at cheaper salaries – to enter state service. "In the absence of a retirement system, the aged or disabled employee is left in active service as long as he can 'go through the motions,'" according to a 1929 report by the Commission on Pensions of State Employees, which developed a framework for what would become known later as the California Public Employees' Retirement System.[16]

In 1932, the state set the retirement age for government workers at 65 – with mandatory retirement at age 70. Architects of the plan were careful to select a pension eligibility age that would retain productive workers. "No system should be established which would encourage or permit granting of any retirement allowance to an able-bodied person in middle life who through long experience may have just reached the peak of his value to the state," declared the 1929 Pension Commission.[17]

The eligibility age for benefits followed prevailing retirement standards at the time. German Chancellor Otto von Bismark, created the first modern pension program in 1889 with an eligibility age of 70, later reduced to 65. In 1900, the Pennsylvania Railroad adopted an influential corporate plan that reinforced 65 as the target retirement age. By the time Social Security adopted the age 65 standard in 1935, half the states with retirement plans used 70 and the other half used 65.[18]

Today, the situation has reversed. What started as a pension system designed to provide income for the few remaining years of a retired worker's life before death has now stretched into a decades-long obligation. With longer life spans and pension-eligibility ages as low as 55 for rank-and-file workers – and age 50 for public safety – it is conceivable that public employees can receive retirement checks for as many or even more years than they earned public service pay checks.

For example, the average years of service for a state miscellaneous worker who retired in 2010 was 23.2 years; the average California Highway Patrol officer worked for 28 years.[19] Consider that CalPERS projects the average life expectancy for a 60-year-old male to be an additional 23 years; for a 60-year-old woman, it's an additional 25.7 years. CalPERS has determined there is no material difference in the life expectancy of miscellaneous workers versus public safety officers.[20]

This upside-down scenario was not envisioned by architects of the state's pension system. As pension plans – and their government sponsors – have realized, the costs are compounding, the ranks of experienced government managers and staff are thinning due to early retirement, and the balance is shifting between workers putting money into retirement systems and the retirees drawing money from them. "To reward employees for retiring early, as the retirement plans of local governments tend to do, is folly and … it is vicious," predicted management expert Peter Drucker more than 35 years ago.[21]

In response to the earlier retirements driving higher pension liabilities, as well as to public pressure, at least 10 states increased retirement ages for government workers last year – the most dramatic being the age 67 threshold that newly hired public workers in Illinois will need to reach in order to receive full pension benefits, up from age 60.[22] Extending the eligibility age for a public employee to draw benefits – reducing by several years the pension system's retirement obligation – represents the biggest cost-saving tool for pension systems, Keith Brainard of the National Association of State Retirement Administrators told the Commission.[23]

Under agreements reached in 2010, the age in which newly hired state workers in California can receive full benefits increased by five years to age 60, up from 55; new officers for the California Highway Patrol also saw their retirement age increased by five years, to 55 from 50.[24]

During the 2010 gubernatorial campaign, as news reports detailed his potential $78,000 annual public pension, then-candidate Edmund G. "Jerry" Brown, Jr., embraced the adage that time is the friend of the retirement system. "If every state worker worked as long as I did, to the age of 72, the pension funds would have so much money, they could start lending it to China," he said.[25]

"If you elect me Governor, I won't collect until I'm 76," then-candidate Brown said during one of the debates. "If I get a second term, I'll be 80. I'm the best pension buy California has ever seen."[26] He called for raising retirement ages, among other reforms.

The issue has come full circle: Extending retirement ages to increase productivity and save costs. It is a mirror image of the Progressive Era view of retirement as a social tool to rejuvenate the workforce with younger workers, observed historian William Graebner in the seminal History of Retirement. "A new myth," he said, "replaces the old."[27]

Early Design Stressed Moderation

In many ways, today's pension-reform debate is circling back to the principles for sustainability, shared responsibility and moderation laid out nearly a century ago. California cautiously approached the idea of a pension plan for state workers in the 1920s. "An unsound system is worse than none," warned the state's Pension Commission in 1929, in setting the framework for what became CalPERS.[28]

Since the creation of the state retirement system in 1932, benefit levels have changed significantly from those the state designed to allow its government workers to retire in "dignity and comfort," without the need for charity in old age.[29] With the federal Social Security system still years away, the concept of financial security for the elderly provided inspiration when the state's pension system opened during the Great Depression.

Initially, state workers retiring at age 65 could expect retirement income valued at roughly half of their final compensation, based on the average salary earned during their last five years of employment. The retirement formulas and benefits began ratcheting up in the 1940s and never stopped.[30]

Social Security benefits, added for rank-and-file state workers in 1961, also changed the equation, adding additional retirement income.

Today, a 30-year state worker retiring at age 63 can expect to receive 75 percent of the single highest paid year – every year for the rest of his or her life. When drawing full Social Security benefits, the same worker can expect to earn more money in retirement than he or she did on the job. For many, lifetime health benefits also are included after a certain level of service, as are automatic cost-of-living pension increases.

"An unsound system is worse than none."

Commission on Pensions of State Employees. 1929.

California's public pensions went from what was once a good pension to one now considered among the most generous in the country.[31] In a national study, the average formula multiplier for state pension plans that coordinate Social Security benefits for employees is about 1.94 percent per year of service; California's pension formula for miscellaneous state workers tops out at 2.5 percent per year of service.[32]

Local government workers in California can negotiate for pension benefits based on as high as 3 percent per year of service.[33]

In state retirement plans that do not include Social Security, such as CalSTRS, California still leads with a top formula for teachers of 2.4 percent per year of service, compared to the national average of 2.3 percent.[34] Public safety officers – corrections officers, police and firefighters – in California also do not receive Social Security benefits, and can negotiate a higher base pension, using a 3 percent multiplier.[35]

See Appendix C for an expanded timeline.

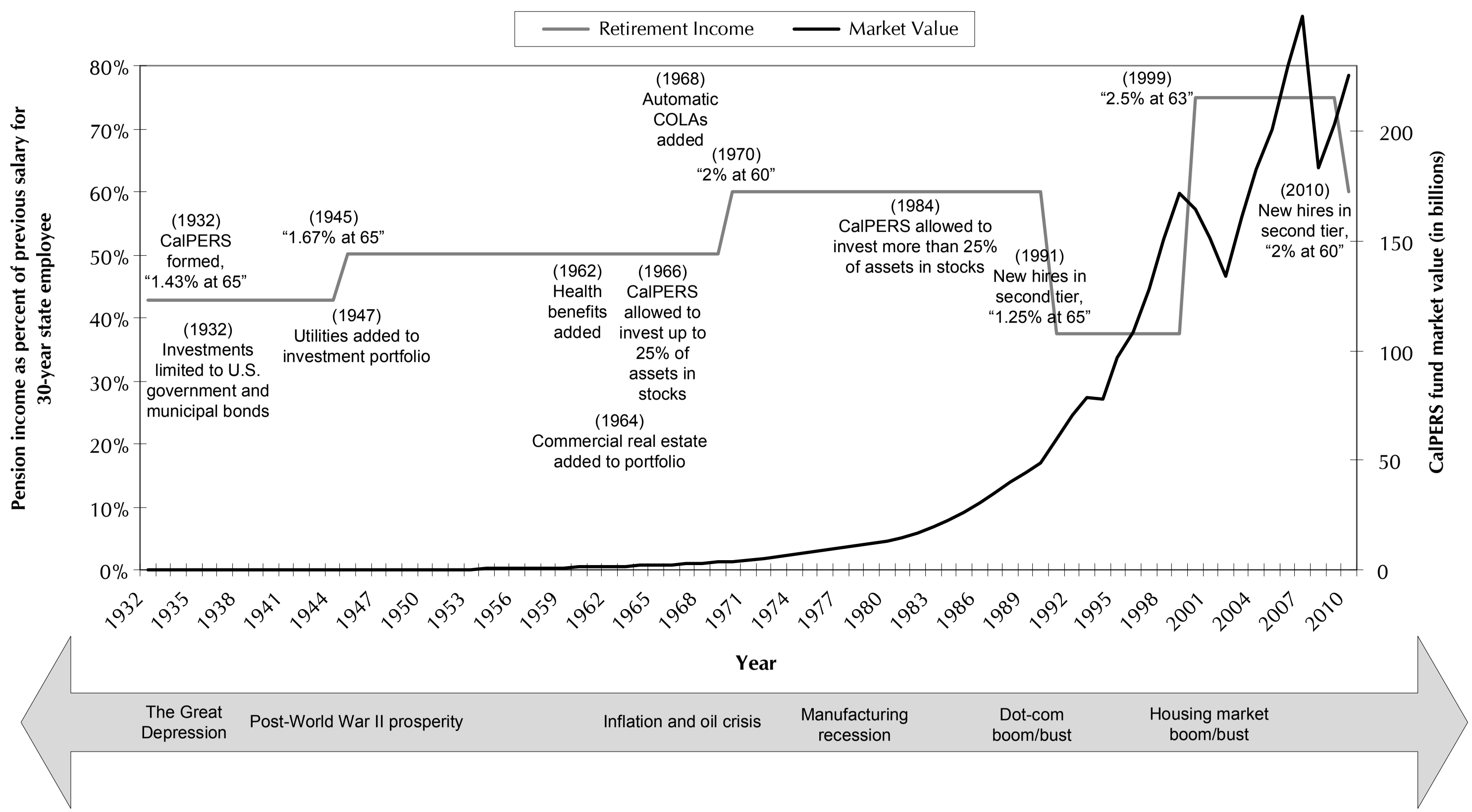
As public workers gained more influence over pension policy, they justified enhanced benefits by pushing plans to adopt more flexible investment strategies with higher risk/reward ratios. Previously, pension funds for public workers had a limited, and conservative, menu of investments from which to choose: government bonds. With voter approval, CalPERS ventured into the real estate market in the 1950s and began playing the stock market in the 1960s. By 1984, voters gave CalPERS permission to invest more than 25 percent of its portfolio into the stock market, allowing the pension fund to swell with the Dow Jones Industrial Index.[36] The advent of new portfolio management strategies and the proliferation of new categories of investment opportunities made a compelling case for change. So too did new tools for managing portfolio risk, which worked, until they did not.

When the state pension plan was limited to government bonds, its expected rate of return started at 4 percent; today, CalPERS, as well as most retirement systems, must deliver investment returns of nearly 8 percent to keep pace with pension obligations. When investment returns fall short, as they did in 2008-09, the government is obligated to make up the difference.

As originally designed, employers and employees were to contribute equally to a capital fund built up during the work years. "Both parties expect to benefit from the retirement system and it seems reasonable that the cost of the benefits to be earned should be divided in approximately equal proportions," noted the 1929 Pension Commission.[37] Investment income historically makes up about 60 percent of pension fund revenue. Payroll contributions from employers and employees cover the remaining 40 percent, though the balance tilts heavily toward the employer.[38] For example, rank-and-file state employees in 2010-11 contribute 8 percent of pay into the CalPERS fund, while the state is contributing twice that rate.[39] In some local agencies, employees often do not pay their share; it is picked up by their employer as part of their compensation. This places even more burden on public agencies and ultimately taxpayers when the time comes to pay the bill.

Retirement Benefits Chase Assets

The state's largest pension system, CalPERS, initially provided retired state workers with a modest pension equal to half of their previous salary. As CalPERS received authority to expand its investment portfolio, the level of pension benefits has increased as CalPERS assets grew.



Sources: CalPERS. 2007. Dedication. Vision. Heart. The CalPERS Story. Chantilly, VA: The History Factory. Also, CalPERS. February 1, 2011. "Total Fund Monthly EMV July 1, 1998-December 31, 2010." Sacramento, CA. Also, Christopher J. Castaneda, Department of History, California State University, Sacramento. Sacramento, CA. February 7, 2011, and February 8, 2011. Written communication. Also, Department of Personnel Administration. October 18, 2010. "SEIU Local 1000 agrees to new contract with Schwarzenegger Administration." Press release. Sacramento, CA.

The SB 400 Story: Reform Attempt Backfires

Legislation that passed in 1999 expanded retirement formulas available to state and local workers, starting a chain reaction of retroactive pension increases granted to public employees up and down the state. The legislation, Senate Bill 400, is now regarded as a pivotal point that has set the course to the current pension crisis.

What is often lost in the story about SB 400 is that it did more than allow public agencies to increase benefits. The bill was designed to undo the type of pension reform under consideration today, as public agencies try to control long-term costs by providing new hires with a lower level of retirement benefits.

The origins of SB 400 began in 1984, when the state created a substantially lower pension formula for rank-and-file state workers – "1.25 percent at 65" compared to "2 percent at 60."[40] The new plan required no employee contributions and extended the vesting period to 10 years. The more Spartan retirement plan was entirely optional, but it attracted almost an equal number of new employees as the existing plan. CalPERS found that 47 percent of new workers from 1984 to 1988 chose the lower pension tier, which did not require any payroll deductions from employees. By 1990, CalPERS found that Tier II produced a total savings in six years of $66.5 million in annual state pension contribution costs. Though unspecified, the state's long-term savings were estimated to be even greater for employees in Tier II, considering their pension payouts would amount to roughly 40 percent of other retirees.[41]

In 1991, in an effort to further lower the state's long-term pension costs during an economic recession, the Legislature closed the more generous Tier I "2 percent at 60" plan to new state employees, directing all new employees into the Tier II "1.25 percent at 65" plan.[42]

The move was seen as unfair by employee groups, and CalPERS pushed to repeal what it considered an inferior and inadequate Tier II plan for the workers it covered. The effort gained momentum during the dot-com stock market surge of the late 1990s when CalPERS plans experienced superfunded status. Ann Boynton, deputy executive officer for benefits for CalPERS, told the Commission, "From the very beginning, SB 400's real purpose was to bring fairness and equity to retirees and state workers who over many years had seen their benefits fall significantly behind those of many other California public employees."[43] Further, she said, the bill was aimed at attracting and retaining skilled employees at a time when the quickly expanding economy created new competition for workers.

CalPERS pitched the benefits increase to the state Legislature in a 17-page brochure titled, "Addressing Benefit Equity: The CalPERS Proposal." The organization said average benefits were not "keeping pace," and drew a direct comparison between the $1,175 average monthly allowance for a CalPERS service retiree to the poverty level of $922 of monthly income for a family of two (omitting that Social Security benefits can replace an additional 25 percent or more of previous income).[44]

SB 400 brought the Tier II employee pensions back in line with workers hired before 1991. The bill also went further, lowering minimum retirement ages and allowing state and local agencies to enhance pension benefits for safety officers.[45] The changes were allowed to be applied retroactively, putting in motion a bidding war among government agencies, particularly at the local level, to retain and attract talent by boosting retirement benefits.

At the time, CalPERS claimed in its promotional literature the plan could be implemented "without it costing a dime of additional taxpayer money." CalPERS contended that excess assets would keep state payments to the pension fund below 1999 levels for the next decade.[46] CalPERS, in fact, gave the state a "holiday" from making a substantial contribution to the pension fund during that time, though state workers were required to continue paying into the fund.

Legislative analyses of SB 400 for lawmakers did not dispute the optimistic funding scenario.[47] The measure passed with overwhelming support, 70-7 in the Assembly, and 39-0 in the Senate.[48]

Former Governor Gray Davis, who signed SB 400, today says it was a mistake. "The evidence seemed to suggest the state was wealthy enough to afford it," he said in 2010. "It was part ideology and part math, and the point is the math was wrong, big-time."[49]

The math was not necessarily wrong – it was just ignored. "For people who really wanted to take the time, the information was there," pension actuary John Bartel told the Commission.[50] The CalPERS board learned in 1999 that if the fund in the future experienced poor investment returns, then the state would be forced to increase its payments into the pension fund to $3.9 billion by

Tier II Choice

When the Legislature in 1988 gave state employees a one-year window to move from the lower tier into the higher tier, and vice versa, approximately 3,431 workers transferred into the higher pension tier – but 2,782 chose to switch into the lower pension tier. The experience showed that when workers are given a choice, many – but not all – will support a lower pension in exchange for lower payroll deductions, leading to higher take-home pay. As of 2009, there were 8,000 active state employees (hired between 1991 and 2000) who have chosen to remain in the second tier.

Sources: CalPERS. "Tier II Cost Experience Report" for fiscal years 1986-87, 1987-88 and 1989-90. Sacramento, CA. Also, CalPERS. 2010. "Shaping Our Future: Ensuring Performance, Transparency and Accountability. Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2010." Statistical Section, Program Data. Page 149. Sacramento, CA.

2010, an ominous scenario that was realized following the 2008-09 stock market plunge when CalPERS lost nearly a third of the value of its investment portfolio.[51]

Tony Oliveira, president of the California State Association of Counties, a Kings County supervisor and a member of the CalPERS governing board, said the “3 percent at 50” formula authorized by SB 400 for public safety officers “moved across agencies like a grass fire.” Local officials believed the added costs were covered by investment surpluses and agreed to enhance pensions as communities raced to match the level of benefits, he said.[52]

Mr. Oliveira said officials – including him – who supported the pension increases a decade ago did not fully realize the ramifications. In testimony to the Commission, he called SB 400, “one of the worst public policy decisions in the history of California.”[53]

In 2001, the Legislature passed AB 616, allowing local agencies to increase the pension formulas for miscellaneous employees to as high as 3 percent at 60, sparking another competitive bidding war.[54]

Reform Landscape Today

For now, pressure continues to mount on public agencies, employee unions and pension administrators to work within existing confines to address the long-term stability of their retirement systems. Many pension backers contend that the solutions remain at the bargaining table. Public employers and employees often say that bargaining got us into this, and bargaining will get us out of it.[55] They remain optimistic that the bargaining environment can facilitate the conversation that will put pensions on firmer footing.

Based on news reports, it would appear that many bargaining units at all levels of government are assessing pension modifications, including a new tier of lower benefits for new hires. In testimony to the Commission, CalPERS noted it responded to 82 requests in 2010 from cities, counties and special districts to determine cost savings from implementing a second tier of lower benefits for new hires.[56] The extent of the self-correction, however, is spotty at best. In the 2008-09 and 2009-10 fiscal years, only 26 of the 1,500-plus public agency contracts with CalPERS were amended to lower benefits for new workers.[57]

During the same period, however, nearly 200 agencies actually *enhanced* benefits for current workers, calling into question the ability and willingness of local officials and employees to rein in costs. This includes

13 local governments that improved local safety pensions to the "3 percent at 50" formula, 18 amendments to improve local rank-and-file pensions to the "2.7 percent at 55" formula and 22 amendments to compute final compensation based on the highest single year. Fifty-five public agencies also amended contracts to provide two years of additional service credit through "golden handshake" agreements.[58] One city – Citrus Heights – even added a provision for elected officials to receive pensions.[59]

See Appendix D for a list of the agencies that have modified benefits since 2008.

Other Changes Focus on Disclosure

The determination of future pension obligations also is under scrutiny. These actuarial forecasts determine how much money public agency employers need to contribute to keep their pension funds safely funded. Control of the calculator has shaped the pension debate in California since at least the early 1990s, when Governor Pete Wilson tried to shift actuarial duties out of CalPERS.

The issue gained new attention following the 2008-09 market drop. Public retirement systems typically use an aggressive investment-return rate – around 7-8 percent – to "discount" or determine the present-day value of future pension costs. Economists have objected to using such an aggressive investment-return rate as a discount rate, arguing that it artificially lowers the level of actual liabilities.[60] A lower-risk discount rate, tied, for example, to the U.S. Treasury debt market, would reveal higher future liabilities and a wider gap between currently projected investment returns and obligations, requiring current employees and the government to put aside more money now to cover their long-term obligations.

In 2010, the Legislature also passed SB 867, which required CalPERS to report to the Legislature, Governor and treasurer the system's future obligations using a low-risk methodology and other guidelines when contribution rates change.[61]

The Governmental Accounting Standards Board (GASB), which already has forced state and local governments to move retirement liabilities from the footnotes onto the balance sheets, now is considering requiring pension systems to value their future liabilities using more conservative discount rates.[62] The financial impact of changing valuation methods could be massive, both on immediate costs to public employers, as well as to reaction in the bond market.

Getting a Second Opinion

A recommendation for a neutral actuary re-surfaced as part of the Post-Employment Benefits Commission. Based on the commission's recommendation, the Legislature in 2008 created the California Actuarial Advisory Panel, with the intent to provide an independent second opinion of internal actuarial assumptions for state and local pension systems. "Such a panel would allow the public to be better educated by moving the actuarial practice in the public arena," according to the PEBC report. The panel's recommendations, overseen by the state controller, are not binding.

Source: Public Employee Post-Employment Benefits Commission. 2008. "Funding Pension & Retiree Health Care for Public Employees." Sacramento, CA. Also, SB 1123 (Wiggins), Chapter 371, Statutes of 1998.

Voters at the Local Level

With mounting attention and concern about unfunded pension liabilities, local voters have been asked to, or have sought to, weigh in on the problem. In the case of cities where retirement benefits are detailed in their charters, voters are required to give permission to change the benefit structure. Other voters have asked for more say in how the benefit packages are structured. Orange County voters in 2008 and San Diego voters in 2006 approved measures requiring voter approval of any future increase in retiree benefits.[63] In the November 2010 elections, voters in seven cities and counties sent a clear message to lower retirement benefits for public employees and have the workers pay a greater share of the costs.[64] The exception was San Francisco where a measure failed to increase city workers' pension and health care contributions.[65] Several months later, the city was told it will have to pay an additional $20 million to its pension fund than it was previously expected, bringing total retirement costs to $375 million a year, a number that is expected to continue rising.[66] Voters in San Diego also rejected a proposed half-cent sales tax hike to offset pension costs.[67]

What Other States are Doing

The demographic challenge of an aging workforce is not unique to California. As the Baby Boomers begin to retire, pension reform has gripped nearly every state across the country. Because of its sheer size, California faces among the largest unfunded liabilities, but it has

Most Pension Measures Succeed on California Ballots

City/County	Measure	Description	Passed?
Bakersfield	D	Approved lower formula for new hires.	Yes
Carlsbad	G	Required a public vote before pension increases.	Yes
Los Angeles	G	Would lower pension formulas for newly hired police and firefighters.	March 2011
Menlo Park	L	Reinforced lower formula for new hires that was approved by city council; gives voters final say in future changes.	Yes
Pacific Grove	R	Capped city share to CalPERS at 10 percent.	Yes
Riverside County	M	Mandated public vote before pension increases	Yes
Redding	A and B (advisory)	Called for workers to pay their share to CalPERS, rather than force the city to pick up the costs, and called for changes to the plans for retiree health care.	Yes
San Francisco	B	Would have increased workers' pension and health care contributions.	No
San Jose	V and W	Authorized elected officials to give new hires lower pensions; limited action by arbitrators.	Yes

See end notes for sources.

managed its assets for state workers better than others. Illinois and New Jersey, for example, have provided less support for their pension programs over time and are experiencing dangerously underfunded plans that more immediately threaten the retirement security of employees.[68]

Recent changes to state public pension plans generally fall into six categories:

- Increasing employee and employer contributions into the pension fund.
- Reducing benefits for new hires.
- Extending retirement ages for new hires.
- Lowering cost-of-living increases.
- Extending the numbers of years used to determine final compensation for pension calculations (which mitigates end-of-career salary spikes).
- Increasing vesting periods.

"Pension policies have long-term impacts, and relatively minor changes can result in major cost savings in the future," noted NASRA's Keith Brainard in testimony to the Commission.[69]

At the same time, adding 401(k)-style components to retirement systems continue to receive serious consideration in other states. Legislation approved in Utah in March 2010 replaces a pension plan for state workers with a choice for new employees to enter a 401(k)-type plan with employer contributions and no required employee contribution, or a hybrid plan with a lower defined-benefit plan and a defined contribution component.[70] Several states in recent years have extended defined-contribution options for public employees, including Nebraska, Georgia, Oregon, Texas and Washington.[71]

Pension Protections

Putting California's public pension systems on a path to recovery will require careful navigation of the court system. Retirement benefits that have been promised to current workers are locked in tightly, protected by decades of case decisions that treat pensions as contracts.

This stance is a response to the situation a century ago, when public pensions were considered gratuities that could be withdrawn or amended at any time. Courts and state lawmakers rejected this approach and began adding layers of protections to public pensions that followed a contract-based theory. "Courts simply could not tolerate the absurd result of the gratuity approach, which allowed states to retroactively amend or terminate pension benefits at any time and for any reasons," said Amy Monahan, a University of Minnesota law professor.[72]

Congress has viewed the issue as one reserved by the states. With no clear limit set in California law, the concept of "vested rights" has evolved through 60 years court decisions to the point where there now is a judicially sanctioned right bestowed on public employees, grounded in the state Constitution's ban on impairing contracts, that their future pension benefits, as structured on the first day of work and as improved throughout their careers, are guaranteed to them at retirement. This differs from how federal law treats private-sector pensions, in which accrued benefits are protected, but modification can be made prospectively during the course of employment.[73]

Under extreme circumstances, public pensions for current workers can be reduced, at least in theory. For example, the government retains the power to amend contracts temporarily in accordance with the state's "police power." Police power refers to the fundamental ability of a government to make laws necessary to preserve public security, order, health, morality and justice. The power cannot be surrendered by the Legislature or irrevocably transferred away from government, though the argument has yet to be used successfully in court as a means to lower pension benefits.[74]

California courts have indicated that public employees do not have an "absolute right to fixed or specific benefits," but the courts set a high test to prove that altering the pension is reasonable and necessary to serve a public purpose.[75] As Professor Monahan notes: "Saving money is not, by itself, sufficient justification."[76] Additionally, pension reductions for current employees must be offset by "comparable new advantages." In other

Alternative Retirement Program

A little-known pension reform took place in 2004, delaying the state's retirement contributions for new employees for two years. Under the Alternative Retirement Program (ARP), new employees make mandatory 5 percent payroll contributions to a risk-free 401(k) plan for their first two years of employment. Administered by the Department of Personnel Administration, the ARP was created as part of a legal settlement stemming from a dispute over a pension-obligation bond with the Howard Jarvis Taxpayers Association. After two years of employment, the worker and the state begin contributing toward a CalPERS pension, and the employee becomes fully vested in CalPERS after five years.

The Department of Finance has estimated that the state could save $2.5 billion over 20 years by delaying CalPERS contributions for those first two years of a new employee's career. The savings are offset after two years when the employee can make a one-time exchange, transferring the ARP account into CalPERS service credit; the state must play "catch up" and pick up contributions for the initial two years that went unpaid. The Legislative Analyst's Office estimates that any up-front savings from the program eventually will be canceled out.

Only half of all employees, however, are taking advantage of the deal. Some are cashing out their contributions after two years, with tax penalties. But the initial data shows that 44 percent of workers, predominantly younger state employees, are not making the switch within the required time period, let alone responding to the paperwork and mailers about it. Their ARP contributions remain in DPA's conservative 401(k) plan indefinitely.

Sources: CalPERS. May 18, 2010. "Alternative Retirement Program Update." Agenda Item 5A. Benefits and Program Administration Committee. Sacramento, CA. Also, Department of Finance. "ARP Final Stats Through March 2010." Sacramento, CA. Jason Sisney, LAO. September 8, 2010. Personal communication.

words, it requires a fair economic trade, which works against realizing any savings from pension modifications. The Supreme Court explained:

> "An employee's vested contractual pension rights may be modified prior to retirement for the purpose of keeping a pension system flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system. Such modification may be reasonable, and it is for the courts to determine upon the facts of each case what constitutes a permissible change. To be sustained as reasonable, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages."[77]

Ms. Monahan has suggested that legal interpretations are likely to continue evolving in order to reflect the changing economic conditions driving current policy efforts to reform pensions. In particular, she said, a shortcoming of the current approach is that the courts do not explain why the rate of future benefit accruals must be protected, in conflict with how federal law treats private-sector pensions. "This seems to be both an odd expectation to have, and an odd expectation to legally protect, when the economic value of the benefit can vary so drastically," she said.[78]

Legal experts have told the Commission it likely will take a financially distressed county, city or special district to scale back its promised future benefits for current employees, then attempt to defend the action in court before the Supreme Court would have an opportunity to consider a new precedent. Jeffrey Chang, a Folsom-based lawyer who represents local government agencies on pension and employment issues, has suggested that local governments may have more latitude than they realize in this area. Such clarification, he said, may only come through a court challenge.[79]

As public agency budget cuts and layoffs loom over public workers, the "comparable benefits" tradeoff also may need to be sorted out. Workers might prefer to trade current job security and a livable wage for theoretical, yet-to-be-earned pension benefits that were based on an expectation from the first day of work. A promised pension is not worth much if there is no career over which to earn it, notes Harvey Leiderman, an attorney who represents pension funds throughout California. However, the question of whether individual "vested rights" may have been traded off through collective bargaining has yet to be tested in court.[80]

Revising pensions through municipal bankruptcy has yet to be explored. In the state's high-profile bankruptcy, the City of Vallejo stopped short of seeking to reduce its current pension obligations. No bankruptcy court has permitted a public agency to reject its vested pension obligations, though legal experts note that a court might allow a public agency to restructure the payment of its unfunded accrued pension liabilities.[81]

National pension watchers expect to see more states test the limits of their ability and legal authority to change provisions for current employees. In 2010, legislatures in Colorado, Minnesota, and South Dakota reduced automatic cost-of-living adjustments for existing retired members, along with other changes. Lawsuits have been filed in each state by retirees, and these legal challenges in each case are still pending.[82]

Conclusion

Today's benefit structure for public employees is unrecognizable from the design, funding structure and goals of the original 1932 version. Instead of retirement security, the public pension became a wealth generator. The risks of maintaining a more expensive system have been pushed largely onto taxpayers, who are demanding more transparency and accountability as they begin to understand the scale of the state and local government retirement burden.

Pension Costs Will Limit Choices

The fight for diminishing resources is just beginning for public employees and their pension systems. California's state and local government pension plans are overextended in their promise to future retirees.[83] The crisis will take a generation to untangle, at a steep cost to employees and their government employers, and ultimately, taxpayers. As public agencies attempt to manage the retirement obligation – even grasp the magnitude of the shortfall – California governments' standing in the bond market will remain in question, limiting the ability of state and local governments to find stable footing as they exit from recession.[84]

For public workers, the legitimacy and long-term viability of public pension systems will continue to be put under scrutiny. The big questions – what is a fair retirement package for public workers and who should pay for it – have been elevated in the public eye but have gone largely unexplored and unanswered. This lack of discourse only fuels the call for reform, with some critics demanding an end to the defined-benefit pension model for public employees. As Dwight Stenbakken, deputy director of the League of California Cities, said, "We're trying to maintain credibility with the taxpayers, but right now, I'm not sure this is defensible."[85]

In Los Angeles, retirement costs for current public employees, police and firefighters are projected to double by 2015 to nearly $2 billion, consuming one-third of the city's operating budget.[86]

San Diego underpaid into its pension fund for years and now needs to divert an increasing amount of its budget – up to one half of its General Fund by 2025 – to stabilize its retirement system for city workers.[87]

San Francisco's annual pension costs for current employees are approaching $600 million a year – enough to operate San Francisco General Hospital.[88]

Those working within the system are sensitive to the criticism, as well as to the consequences of their actions in eroding public support for a retirement benefit increasingly rare in the private sector. "It takes only a few instances of pension benefit misuse and abuse to tarnish the public's confidence in the integrity of these benefits," said Keith Brainard, research director at the National Association of State Retirement Administrators, in testimony to the Commission.[89]

How Bad Will It Get?

The tension between rising pension costs and lean government budgets is often presented today in a political context, with stakeholders debating the severity of the problem and how long it will last. To weather the market drop and subsequent recession and decline in public revenues, many pension boards gave public agencies a three-year grace period before hiking required payments in the pension fund to make up for investment losses, in effect creating a balloon payment. In another five years, when pension contributions from government are expected to jump 40 to 80 percent and remain at those levels for decades in order to keep retirement plans solvent, there will be no debate about the magnitude of the problem.[90] Barring a miraculous market advance and sustained economic expansion, no government entity – especially at the local level – will be able to absorb the blow without severe cuts to services.

Actuaries estimate that in the next few years, government agencies in the CalPERS system will need to divert increasing amounts of payroll costs toward their employees' retirement, depending on the retirement formula.

The situation is not self-correcting. Contribution rates for public agencies may have been as high 30 years ago during previous economic downturns – the difference today is, the projected rates are going to remain high for another 30 years. And that assumes pension funds are able to post investment or portfolio returns at nearly 8 percent annually. If stock markets underperform, state and local agencies will need to increase their contributions by 69 to 133 percent of today's rates if they want to stay safely funded, according to an analysis by pension actuary John Bartel.[91]

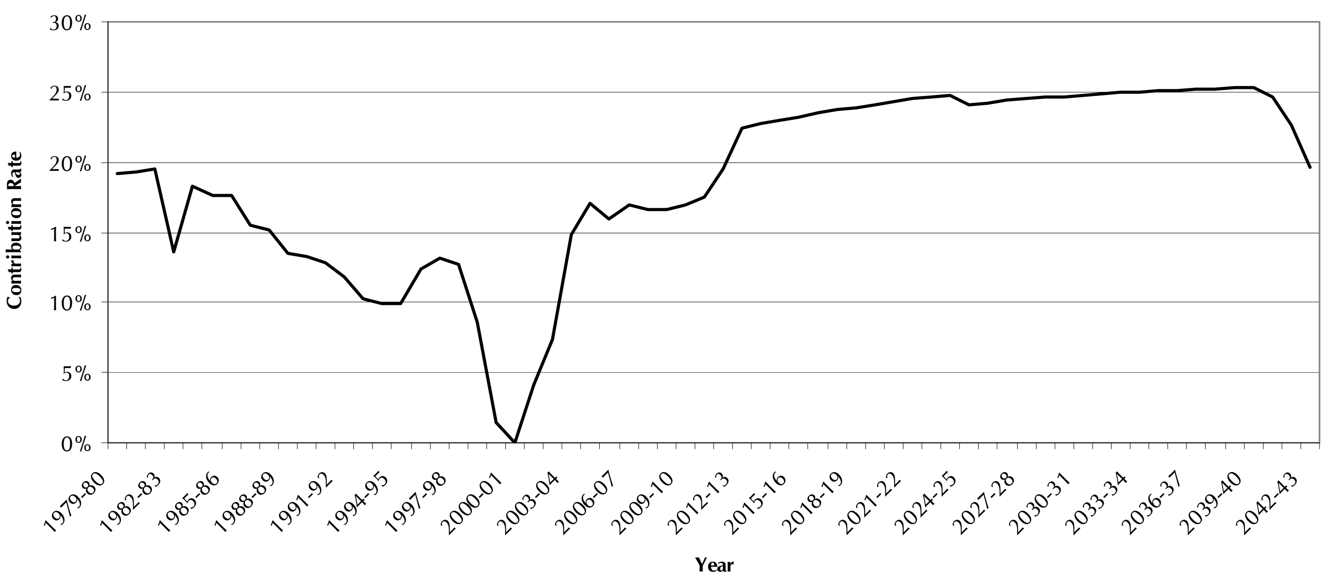
These projections do not reflect a proposal by the Governmental Accounting Standards Board (GASB) for pension funds to recalculate their future obligations on their balance sheets to use more conservative discount rates.[92] Discount rates measure the time value of money, to account for putting aside funds for later that cannot be spent today. The choice of a discount rate sends an important signal about the government's willingness to sacrifice the current use of resources for future needs.[93] Looked at another way, it can indicate who should bear the costs of financing a pension system over the long haul: the current workers who will receive the benefits, or future generations who will pay for pensions received by retirees and current workers.

A lower risk discount rate, for example, of 4 percent, tied to the U.S. Treasury market, would disclose a greater need to put aside more money now. The selection of a lower rate also serves as a precaution against aggressive investment strategies falling short and pushing retirement costs out too far in the future.
Pension funds use a discount rate tied to an optimistic investment strategy, based on annual returns of nearly 8 percent, that has the effect of spreading lower payments into the system over a longer period of time.

CalPERS actuaries estimate that even a one-quarter percentage point decrease in the discount rate would lead to an increase in the employer contribution rate for local public agencies of 1.5 to 3 percentage points, and 3 to 5 percentage points for public safety pension plans.[94]

GASB also might limit the ability of pension systems to amortize their obligations over longer periods, requiring them to estimate the size of their obligations over a fewer number of years.[95] "Mathematically, it doesn't take a genius to figure out what all this means for public employers," pension industry consultant Girard Miller wrote in Governing Magazine. By adopting a more conservative stance to risk and by shortening amortization periods, the unfunded actuarial accrued

Historical and projected contribution rates



The state has seen a wide swing over the past 30 years in its contribution rates to CalPERS for miscellaneous employees. As a percent of payroll, these rates plummeted in the late 1990s and 2000, but have risen steadily in recent years. They are expected to remain high in the coming decades.

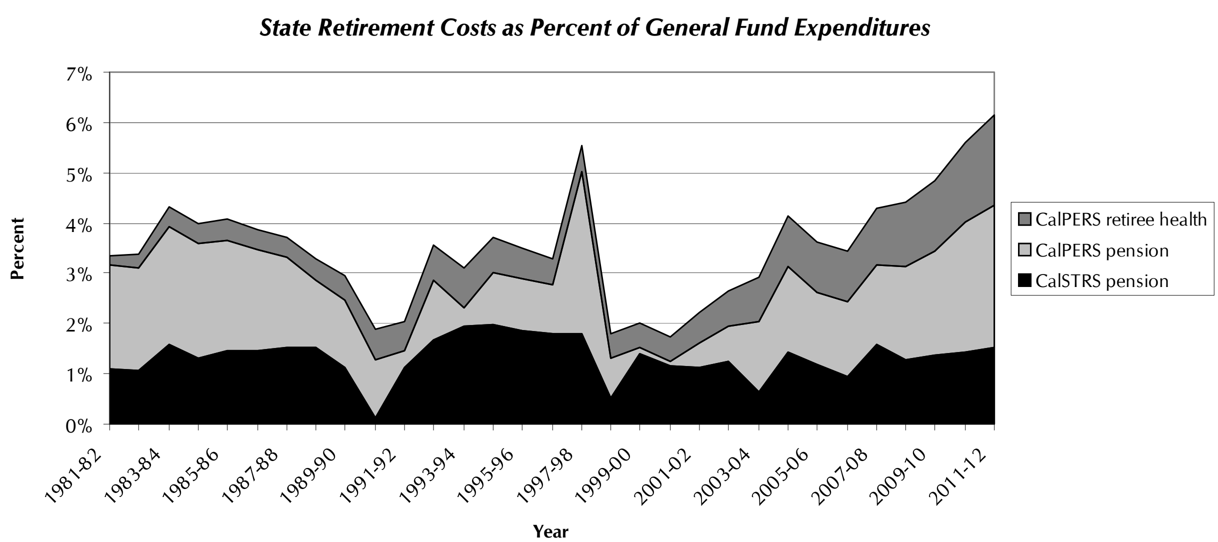
Source: California Public Employees' Retirement System, Actuarial & Employer Services Branch. December 16, 2009. "Estimated Employer Contribution Rate for the State Plans." Presentation to CalPERS Board of Administration. Sacramento, CA.

liabilities could triple at the very least, when compared to current levels, he said.[96] Others have estimated the liabilities could increase as high as tenfold.[97]

The problem is not that the pension funds necessarily will go broke – they just will cost far more money to run, at the expense of other government priorities. The state Constitution permits retirement systems to charge school districts, cities, counties and the state however much money retirement boards determine is needed to pay for the pension promises that government agencies have previously made to workers.[98] Without new revenue or reducing pension obligations, governments will have to pull heavily from other parts of their budgets to afford the bill.

By law, pension payments must be made. In that respect, they are treated much the same way as public debt. Retirement costs (not including health care) for state government account for 4 percent of the General Fund – a proportion still in single digits, but rising and limiting choices in a constrained budget environment. The situation often is worse at the local level, where personnel costs comprise far more of the city or county operating budget than they do at the state level.

In Los Angeles, for example, retirement costs (including health care) for current city workers, police and firefighters already consume 18 percent



Retiree costs are increasing, and as the state's General Fund tightens, the costs can be expected to comprise an even greater portion of the state budget. Note: The figures for the 2011-12 fiscal year are estimates.

Source: California Department of Finance. 2011. "GF Revenues/Expenditures & Historical Retirement Contributions." Sacramento, CA.

of the city budget. By 2015, it will be 37 percent.[99] The state's largest city is looking at increasing annual payments into its police and fire pension fund to more than $700 million in coming years, nearly double the contribution today, amounting to 50 percent or more of police payroll costs.[100] For a police force of 9,900 sworn officers, that is enough money to fund a second police department in a major city.

It is the same story in San Jose, which has seen retirement costs for current police officers and fire fighters quadruple since 2001. The average cost to the city to field a police officer or firefighter is more than $180,000 a year. Retirement and other benefits comprise half of the amount. In testimony the Commission, San Jose Mayor Chuck Reed said:

> "Due to these cost increases, we have whittled away at services and jobs. We now have over 1,000 fewer employees delivering services to our residents and businesses. We have had to cut services to our residents and businesses year after year. These out-of-control costs are why we can't keep all of our libraries, community centers, and swimming pools open."[101]

The Math Doesn't Work

The recent increase in contribution rates reveals a harsh reality: The money coming in is nowhere near enough to keep up with the money that will need to go out for the coming wave of Baby Boomer retirements. Investment losses in 2008-09 certainly shocked the system, but several other factors have contributed to an unsustainable pension environment. While banking on an aggressive investment strategy, employers and employees also have not contributed sufficiently – and on occasion, stopped paying into the system at all, failing to take prudent steps fundamental to pension plan solvency and sustainability. Payroll growth – in terms of both compensation for public employees and the number of employees – has ballooned pension liabilities. At the same time, state and local governments sweetened what was already considered a generous pension package.

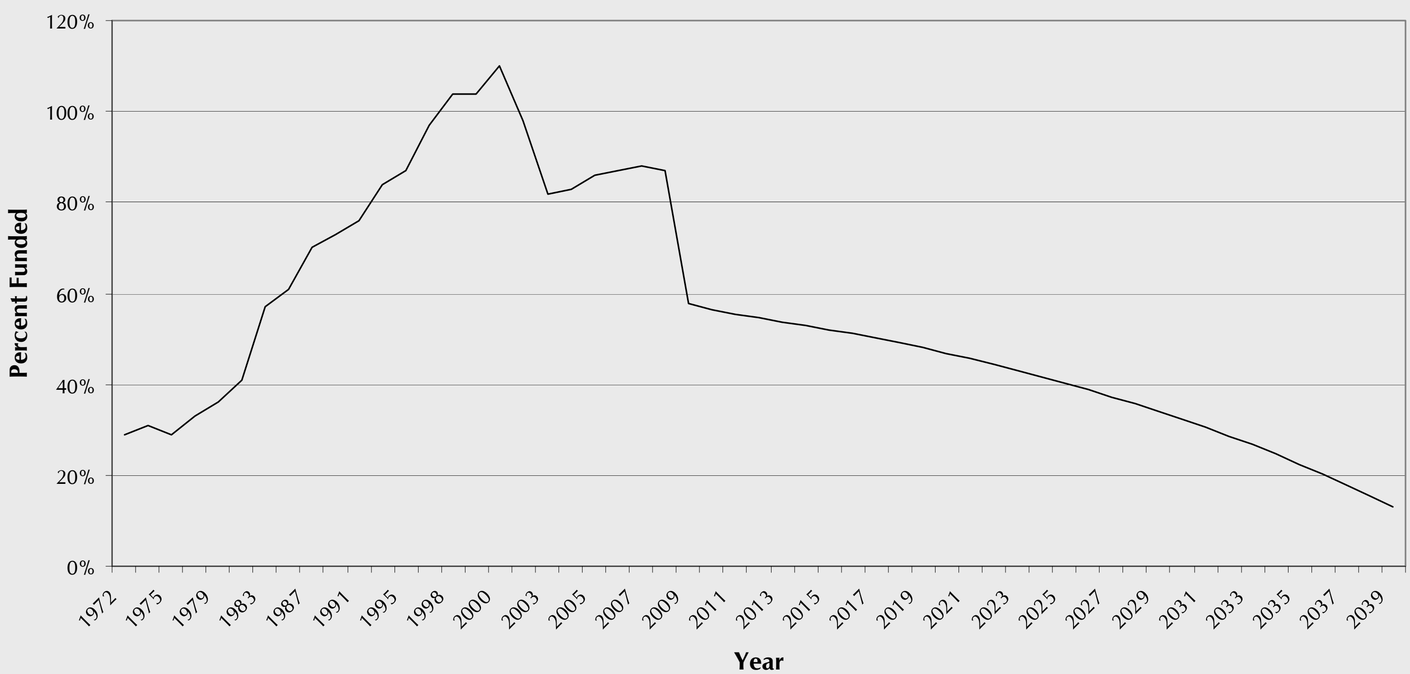
It is a different situation for the private sector. Federal law under the Employment Retirement Income Security Act (ERISA) requires a higher level of responsibility for private companies. To discourage private companies from abandoning troubled pension funds and walking away from retirees, ERISA provides companies with the flexibility to freeze accrued benefits of current employees and restructure the theoretical, yet-to-be-earned pension benefits to prevent the depletion of pension funds.[102] This ensures retirees maintain some level of retirement income and forces companies to acknowledge the size of their liabilities.

The courts have not provided state government with similar flexibility, arguing that government, unlike private companies, always can raise revenue to pay for obligations. Government managers and elected officials have sanctioned pension boosts knowing there is little room to change the deal even if economic conditions demand it.

Aggressive assumptions and "holidays." Pension administrators once could build a portfolio only on the most conservative investment vehicles, government bonds, a stable if low-yielding investment. Only in 1984, for example, did California voters remove a restriction that allowed pension funds to invest more assets in shares of publicly-held companies. Today, pension administrators across the country invest aggressively in not only public companies, but in real estate and foreign markets. While exposing pension portfolios to more risk, these investments also have introduced a string of double-digit returns, often far above the stated

CalSTRS on Path to Exhaust Assets

Absent a bailout by the Legislature, the prospect of insolvency is very real at California State Teachers' Retirement System (CalSTRS), which faces a unique circumstance. The Legislature sets the contribution rates for teachers and school districts, supplemented by a state contribution. The Legislature has relied on moderate, but inadequate payments, into the $146 billion system. Teachers have an 8 percent payroll deduction and school districts contribute 8.25 percent of payroll to CalSTRS. The state provides an additional 2 percent of payroll costs. If the funding formula is not changed, CalSTRS will run out of money around 2040 to send pension checks to retired teachers. Delay only exacerbates the problem.



Source: CalSTRS Board. February 5, 2010. "Executing the Funding Strategy – Revised." Item 7. Sacramento, CA.

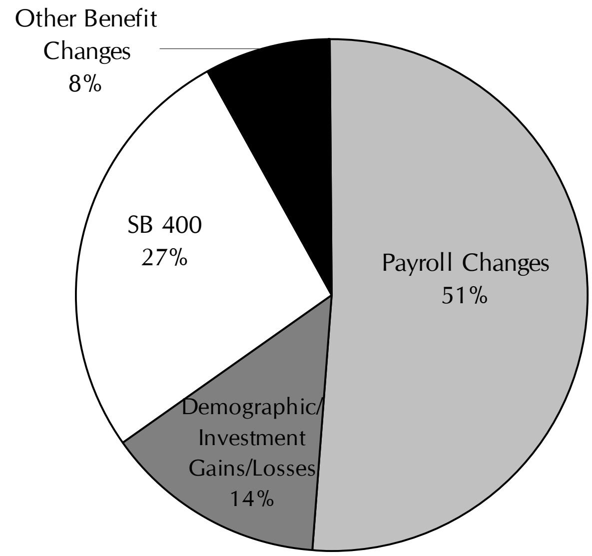
target of a 7.75 percent or higher return. As part of this evolution, the plans hired sophisticated portfolio managers who employed complex strategies to manage or offset risk, an approach that worked well for the state (and other pension plans) until the assumption-devouring stock market crash of 2008-09.

High-risk investment assumptions were attractive to both public employees and employers. With strong market returns, it was easy to justify benefit enhancements. "If there's a lesson in history, the system is always pushed to the max and slightly beyond," said CSU Sacramento professor Chris Castenada, a public pension historian.[103]

Once benefits are increased, rosy if risky investment assumptions can become politically difficult to ratchet back, because public agencies would have to cover more of the costs of the benefits through increased contributions, taking away money that could be spent on other programs. The enhanced benefits put in motion by the Legislature a decade ago placed "extraordinary pressure on the fund managers to consider investment strategies to achieve a rate of return to meet the promised benefits that are riskier than prudent," said Tony Oliveira, a Kings County supervisor and CalPERS board member.[104]

Breakdown of growing state pension costs, 1997-98 to 2009-10

Several factors have contributed to increasing pension costs for government agencies. CalPERS actuaries attribute half the additional costs to growth in salaries and in the number of employees. Benefit enhancements and investment losses make up the other half of new costs.



Source: Alan Milligan. January 7, 2010. "California Retirement Dialogue: Impact of Economic Downturn on Employer Contributions and Changes to the CalPERS Smoothing Methods." PowerPoint slides. Sacramento, CA.

CalPERS predicted – wrongly, it turned out – that surging investment returns would pay for the enhanced benefits set in motion by SB 400 in 1999. This thinking lulled government leaders into believing that investment returns would continue soaring ahead of obligations, and with temporarily overfunded pension funds, they eased off making contributions into the system. Continued payments into the system would have softened the blow from the market drop. Contribution "holidays" have lasted as long as 20 years for the University of California. In 2010, the UC system ended the practice as it saw its once superfunded pension fund slip below 100 percent.[105]

The confidence in the market clearly faded when the housing bubble burst, sparking a market sell-off and credit crisis. CalPERS assets tumbled 30 percent from its high point of $260 billion in October

2007.[106] Even with a double-digit investment return in 2010, far above its target rate of 7.75 percent, CalPERS still has not been able to catch up because it is working off of a substantially reduced asset base. The system is far behind where it needs to be to keep contribution rates at manageable, or tolerable, levels for public agencies. The reality, unspoken then, explicit now, is that if employers cannot get employees to pay more, taxpayers are left facing all the risk when returns fail to meet needs.

The risk is a substantial one, and one being acknowledged more openly. CalPERS began providing a sensitivity analysis to public agencies in 2010 based on the expected return and volatility of its current asset mix. CalPERS predicted a 50 percent chance of hitting the target investment rate of return of 7.75 percent in a given year, within a range of 0 to 16 percent.[107]

"This sensitivity analysis will allow employers to better budget for the future by being more aware of the potential risk to their employer contribution rates," according to a report by CalPERS actuarial staff to the CalPERS board. "This will also be a useful tool for any employer contemplating a benefit improvement by ensuring they are fully aware of potential increases in employer rates in the event of another investment loss."[108]

In the aftermath of the recession and steep 2008-09 market declines, CalPERS, as are many other pension plans, now is considering modifying its posted assumption of a 7.75 percent rate of return to compute future liabilities – though only by a fraction of a percent.[109]

Payroll growth. Another driving force for increased pension costs is payroll growth. The number of employees, as well as their salaries, jumped significantly since the Legislature enhanced pension benefits through SB 400 in 1999 and other measures. Because the pension formula is based on compensation, increasing these variables expanded the total pension obligation. In the 10 years after SB 400 was passed:

- The state added 83,134 new workers to its payrolls, including California State University employees, a 39 percent net increase.
- Average pay for state workers increased to $64,172 from $42,810, a 50 percent jump.
- Average pay for local government workers increased to $61,185 from $38,326, a 60 percent jump.
- Average pay for local safety increased to $89,056 from $52,804, a 69 percent jump. The number of local police and firefighters on the local governments' payrolls also increased by 21 percent.

With increasing number of employees and salary levels, total state payroll costs increased 84 percent in the 10 years after SB 400 passed. Payroll costs have more than doubled for school districts and local governments.[110]

"The deal used to be that civil servants were paid less than private sector workers in exchange for an understanding that they had job security for life. But we politicians, pushed by our friends in labor, gradually expanded pay and benefits to private-sector levels while keeping the job protections and layering on incredibly generous retirement packages that pay ex-workers almost as much as current workers."

Willie Brown, former Speaker of the Assembly, former Mayor of San Francisco, former CalPERS board member. January 3, 2010. San Francisco Chronicle.

Benefit increases for what purpose? In 1999, during the dot-com boom that fattened pension funds, the Legislature passed SB 400, which provided more generous pension options than could be negotiated by state and local employers and employees in the CalPERS system. The new menu at the bargaining table included lower minimum eligibility ages for retirement benefits and higher service-year multipliers to determine retirement allowances, going as high as 3 percent of final compensation for each year of service, up from 2 percent.[111]

Because SB 400 applied only to retirement benefits for workers in CalPERS-covered agencies, employees in separately run, county pension systems sought the same approval to retroactively increase their benefits. At the time, the state prohibited such action, based on a 1981 law designed to prevent a "windfall" when employees retire soon after receiving an enhanced benefit for past service.[112] In 2000, the Legislature overwhelmingly approved SB 1696, permitting county governments to override that law.[113]

Over the next few years, employees in county and local governments pressed at the bargaining table to match the state's munificence for increased benefits. "The Legislature's actions set off a tsunami of pension increases throughout the state," Mayor Chuck Reed of San Jose told the Commission.[114]

With few exceptions, notably in Los Angeles County, government officials across the state ratcheted up retirement benefits. David Janssen, the Los Angeles County chief executive officer, told the Post-Employment Benefits Commission in 2007 that the county did not believe it could afford the enhancements over time, despite pressure from employee groups. "The Board of Supervisors held firm on what they believed was a good existing retirement system," Mr. Janssen said.[115]

For others, the consequence of the decision to make the richer benefit package apply retroactively was to substantially expand the base on which the new benefits were calculated, often with little or no accompanying increase in contributions by employees. At a stroke, the plans veered toward unsustainability.

Adequacy Debate

There is a school of thought that it does not matter how "rich" a public employee's pension is as long as retirement costs are appropriately funded. The problem could be solved, for example, by increasing contributions from employees and employers, or raising tax revenue to pay for the benefits, an approach San Diego voters rejected in November 2010.[116]

This distinction is critical, because some reform advocates cite generous pension benefits as the problem, if not a source of outrage. Initially designed as a retirement safety net for older workers, pensions now follow a wealth accumulation model, providing retirement income that can top 100 percent of previous earnings and unconnected to the level of income needed to provide an adequate retirement. Now considered part of the overall compensation package, pension improvements were made, at times, in lieu of pay increases.

The rising levels of individual pensions has been fodder for reform groups such as the Californians for Fiscal Responsibility, a driving force for reform through ballot initiative, which has published on its Web site the names of government retirees in the CalPERs and CalSTRS systems earning pensions valued at more than $100,000 annually.[117]

The $100,000 public employee pension has clearly hit a squeal point with the public. Though the average pension in CalPERS, for example, is less than $30,000, the number reflects all retirees from all prior years. Examining recent retiree cohorts reveals a trend toward higher-income pensions. For state workers retiring in 2008-09 with more than 30 years of service, the average pension was more than $66,000.[118]

Data from CalPERS shows an increase in the number of high-income pensions is eclipsing the rate of growth of other pension levels. In a five-year comparison of public pension distributions from 2006 to 2010, the Commission found that the number of CalPERS retirees receiving pensions in the $100,000 and above range increased by more

The Orange County Lawsuit

The retroactive pension increases of the last decade would be a decision that many local government leaders would come to regret. In 2008, the Orange County Board of Supervisors tried to roll back a pension increase it adopted in 2001 for sheriff's deputies. In December 2001 – less than three months after the September 11 attacks – the county agreed to provide sheriff's deputies with a new pension based on a "3 percent at 50" formula, up from the "2 percent at 50" formula. The county awarded the pension enhancement retroactively, so that it applied to all years of prior service for deputies.

As investment returns soured and the cost of maintaining the enhanced benefit increased, the county decided it needed to act. It offered a novel legal argument. In court proceedings, the county argued that the pension boost violated the California Constitution's municipal debt limitation provision that requires voter approval for acquiring debt over $100 million. The county also argued that rewarding employees with extra compensation for work that already has been provided violates the California Constitution's prohibition against gifts for public employees. In 2011, the court rejected the arguments.

Despite the county's current frustration with paying the pension bill, an appellate court noted that "imprudence … is not unconstitutional."

The county is appealing to the state Supreme Court.

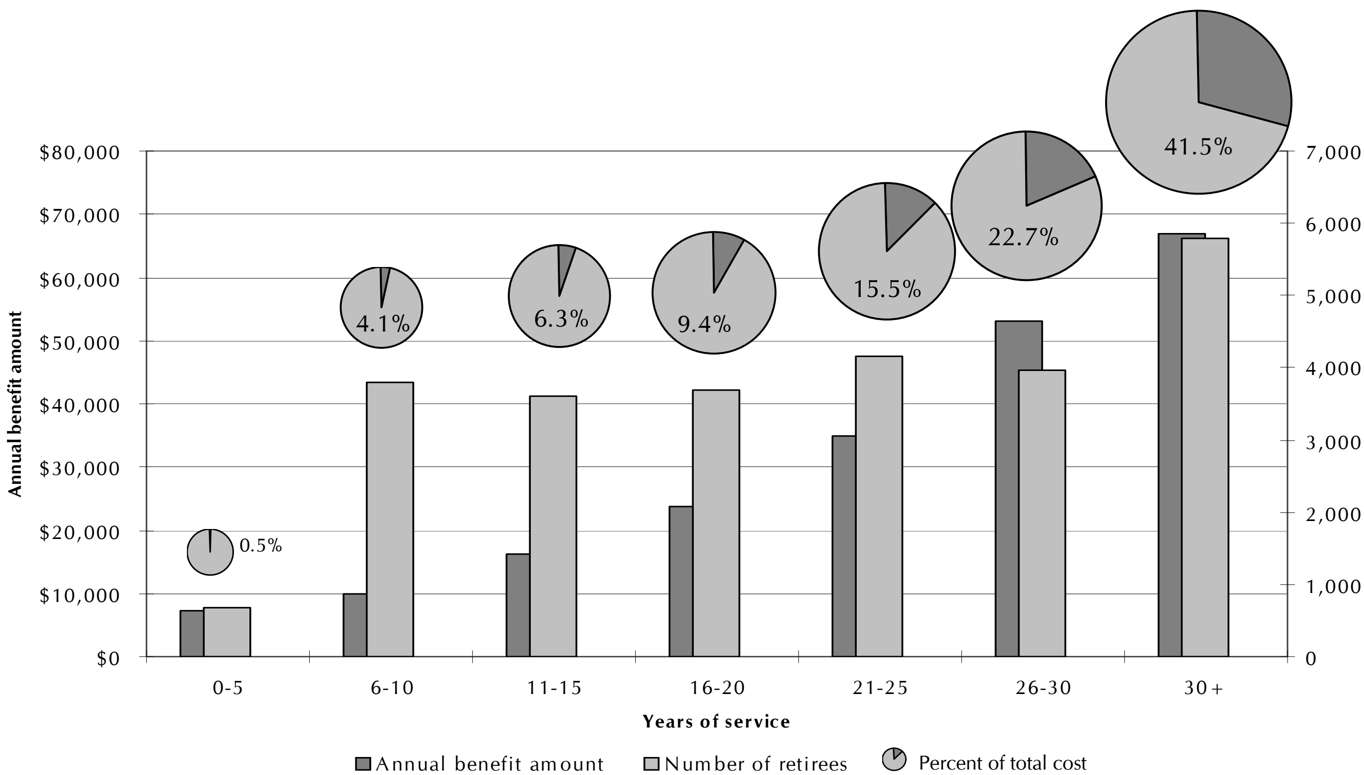
Source: County of Orange v. Association of Orange County Deputy Sheriffs, et. al. Court of Appeal of the State of California, 2nd Appellate District, Division One. 2011.

than 230 percent, while the overall number of retirees increased by 17 percent.[119] See Appendix G for more information.

The math is inexorable. More people are retiring, and more of them are retiring at higher pension levels, and the number of those who are retiring with pensions above $100,000 is increasing by the fastest amount.

Pension Payments by Years of Service

More than 25,000 members of the CalPERS system retired in 2008-09. Workers with more than 25 years of service make up one-third of the number of total retirees but two-thirds of the total cost of providing benefits.



Source: CalPERS. 2010. "Shaping Our Future: Ensuring Performance, Transparency and Accountability. Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2010." Statistical Section. Sacramento, CA.

Retirement Boost: Social Security

Social Security benefits for state workers, added in 1961, have boosted retirement income by an additional 24 percent or more. It wasn't supposed to work that way.

The decision to require state workers to join the Social Security system was a controversial one, and still is: Nearly half of all public employees in California, including teachers, police and firefighters, remain outside of the federal supplemental program.

Congress designed the Social Security system in 1935 to provide income security for retired, private sector workers – public employees who already received government pensions initially could not participate. In an effort to increase the number of workers paying into the system, Congress in 1954 extended Social Security benefits to state and local public employees.

The advantages of joining the system – increased old age, survivor and disability benefits – also meant higher payroll taxes for both employees and employers (then 3 percent, now 6.2 percent each).*

Alan Post, the state's Legislative Analyst, noted in 1954 that "there has been considerable employee agitation ... to obtain new and expensive benefits." He encouraged a cost-neutral merger of the state's pension plan with Social Security as a way to improve benefits. He recommended that the state pension be reduced and supplemented by Social Security to provide the same level of retirement income for the employee. The goal was to minimize the impact of Social Security payroll taxes because a reduced state pension would incur lower payroll contributions from both employees and employers. Mr. Post warned that adding the Social Security benefit without reducing the state pension "would make the cost of the retirement program unduly burdensome."

State workers fought against integrating the systems, rejecting two referenda in the 1950s. Legislation signed by Governor Edmund G. "Pat" Brown in 1961 settled the debate and brought state workers into Social Security under a compromise. The state pension would be partially reduced, but not fully offset by Social Security, so workers would come out ahead in terms of overall benefits.

The formula reduced the final compensation used to determine an employee's pension by one third of the maximum earnings taxed by Congress for Social Security. At the time, this amounted to a reduction in final monthly compensation of $133.33 to compute the worker's retirement allowance. What remained in law, however, was the dollar amount, not the formula.

Whether it is was intentional or an oversight, the $133.33 figure never changed, and the Social Security benefit has gradually expanded the retirement income of state workers. In 1961, the $133.33 offset in 1961 translated into a 24 percent pension reduction for a 30-year "high-income" state worker earning 160 percent of the Average Wage Index (AWI), roughly $67,000 today. Today, the $133.33 reduction represents a 2 percent offset in the worker's state pension, leading to a retirement income that, when combined with Social Security benefits, exceeds 100 percent of the worker's previous salary during employment.

See **Appendix G** for diagrams depicting Social Security coordination under different scenarios.

*Congress enacted a temporary tax reduction in 2011, lowering Social Security payroll taxes for employees to 4.2 percent.

Sources: Legislative Auditor. December 1954. "Survey of Retirement Systems, State of California, Part II: Integration with Old Age and Survivor's Insurance." Report to the Joint Legislative Budget Committee. Sacramento, CA. Also, CalPERS. 2007. Dedication. Vision. Heart. The CalPERS Story. Chantilly, VA. Also, Government Code §21353(b). Also, Social Security Administration. Undated. "National Average Wage Index." http://www.ssa.gov/oact/cola/AWI.html. Accessed January 24, 2011. Also, Social Security Administration. Undated. "Annual Scheduled Benefit Amounts for Retired Workers With Various Pre-Retirement Earnings Patterns Based on Intermediate Assumptions." Washington, D.C. http://www.ssa.gov/OACT/TR/2010/lr6f10.html. Accessed January 24, 2011. Also, Social Security Administration. Undated. "Social Security and Medicare Tax Rates." Washington, D.C. http://www.ssa.gov/oact/progdata/taxRates.html. Accessed January 24, 2011.

Fragmented System Lacks Oversight

Though often described as a "system," California actually has a collection of 85 different defined-benefit plans with very little standardization or required structural standards. Since the 1970s, the collective-bargaining environment has allowed numerous employee unions within each government entity to negotiate separately for pension benefits, resulting in thousands of different retirement packages across the state. Depending on the government entity, contribution rates for employers and employees are set in statute, or by city charter, or through labor negotiations. Participation in Social Security also varies across the state.

This lack of uniformity:

- Clouds transparency and accountability.
- Invites mischief and abuse, such as pension "spiking."
- Creates a compensation "arms race" among communities.
- Delegates complicated decisions to often inexperienced local officials.

Role of retirement boards. With diffused authority, there are few independent and consistent checks on the system. The governance structures of retirement boards build in a heavy representation of employee representatives, who have a fiduciary duty to keep the funds solvent but also have an inherent interest in their own personal retirement. "In California, the control of many public pension and retirement boards of trustees has become dominated by the interests of the beneficiaries, to the detriment of the general public," pension industry consultant Girard Miller told the Commission.[120]

Among the key decisions of retirement boards: Projecting long-term obligations and setting required contributions from public agencies. Retirement plans typically use more optimistic assumptions to estimate contribution rates, which can undervalue and push costs onto future generations of taxpayers.

The interests of taxpayers are secondary, as Article XVI, Section 17(b) of the California Constitution provides that a "Retirement Board's duty to its participants and their beneficiaries shall take precedence over any other duty."[121] In the past, the CalPERS board used this Constitutional authority to advocate for benefit increases. CalPERS now takes a neutral position on legislation concerning changes in retirement benefits. "Retirement benefit design is a matter between employers and employees through collective bargaining," CalPERS executive Ann Boynton told the Commission.[122]

Role of elected officials. In approving an expanded menu of retirement benefits a decade ago, the Legislature provided the blessing needed for public agencies to enhance pensions for their employees. The delegated task of granting retroactive benefit increases fell on local elected officials who may have been unaware of the long-term financial ramifications of their actions. Unlike salaries, with the immediate impact on current budgets, the costs of pensions are more abstract in concept, paid out over decades in the future. Political pressure from employee groups to improve retirement pay certainly played a part as well.

"Most of the elected officials at the time, including myself, were not trained in or familiar about the whole concept of the volatility index or the risks associated with it," Kings County Supervisor Tony Oliveira said in testimony to the Commission. "This radical shift of retroactive enhancements came with a silent but potentially devastating volatility risk not previously understood or considered by most."[123]

At the time, government bodies could quietly and quickly vote through pension increases at public meetings without discussion, putting contract changes with pension enhancements on fast-track "consent" calendars, avoiding a public discussion.

A new state law passed in 2008 requires agencies to discuss proposed pension changes at public meetings and enlist the services of outside actuaries to study the impact of the financial risk to the agency.[124] Requiring local officials to understand such risks and take them into account is harder to mandate.

Role of agency managers. In 2001, the Legislature passed the local government version of SB 400. The bill, AB 616, allowed local agencies to increase the pension formula for miscellaneous employees to as high as 3 percent at 60.[125] In doing so, the Legislature created a conflict of interest for negotiators on the government side: They would benefit from the same pension enhancements that the employees sought.[126]

"Many of those in leadership at the time in the state and local agencies were boomers in their early- and mid-50s who by human nature had a built-in inclination for self preservation," Mr. Oliveira said in testimony to the Commission. A manager could negotiate the terms of the pension as part of the bargaining process, work a few more months then

UC Executive Pensions

Highly paid executives and faculty leaders in the University of California systems are demanding to earn pension benefits on their full salaries above a $245,000 cap set by the federal Internal Revenue Service.

The IRS granted the university system a waiver in 2007 to exceed the cap for 200 top earners in the UC, but university officials have yet to implement the richer pension formula. A group of 36 executives wrote an open letter in December 2010 threatening to sue if administration officials do not follow through on its "legal, moral and ethical obligation" to provide them with better pensions.

Systemwide leaders, who are facing challenges to stabilize the UC pension system while reducing budgets, are preparing to fight back in court.

Source: Nanette Asimov. December 29, 2010. "Highest-paid UC execs demand millions in benefits." San Francisco Chronicle. Also, University of California Office of the President. January 4, 2011. "UC Newsroom: Statement on executive pension benefits." Oakland, CA.

see their own personal retirement plan expand from a 2 percent formula to 3 percent at 60.[127]

Even when agency managers want try to control retirement costs, the decision to increase pensions may not be their own. More than 20 charter cities turn to binding arbitration when contract negotiations fail. Arbitrators do not renegotiate, but consider each party's position, then choose a side. "Historically, arbitrators come into town, spend our money and leave," said San Jose Mayor Chuck Reed, who led a successful ballot effort in November 2010 to limit binding arbitration in his city's pension matters.[128]

In testimony to the Commission, Mayor Reed noted that an outside arbitrator in 2007 increased San Jose firefighters' pension maximum from 85 to 90 percent of final compensation and made the change retroactive to the day the firefighter began working for the city. On a going forward basis, this benefit increase would have cost San Jose $5 million a year, he said. By making it retroactive, the City of San Jose, and ultimately the taxpayers, was faced with a $30 million unfunded liability for the prior service cost.[129]

Role of pension administrators. The press loves a good pension "spiking" story when a public employee retires with an annual pension higher than the salary he or she made on the job, which can occur when cashed-out vacation and other pay is added onto a final-year salary to calculate retirement income. And there has been no shortage of news reports about public employees boosting their pensions.

In one of the more extreme cases, a 50-year-old Moraga-Orinda Fire District chief retired in 2009 with a final salary of $185,000 and

Pensions for Elected Officials

State legislators, school board members and fire district trustees cannot get them. County supervisors and city council members can. Public pensions for elected officials operate under an increasing patchwork of laws and exemptions.

Proposition 140, the term-limit initiative approved by voters in 1990, blocked state legislators elected after November 1990 from receiving public pensions. Assemblymembers and State Senators elected before 1990 still are eligible for benefits, as are current constitutional office holders and legislative statutory officers (Senate and Assembly clerks). The number of participants in the Legislators' Retirement System (LRS) is shrinking – down from 345 in 2000 to 255 as of June 30, 2010. The pool includes 36 current participants who are still serving in office or have yet to retire and begin collecting benefits.

The state spent $11 million on benefits to LRS retirees and beneficiaries in 2009-10 – a sliver of the $12 billion in benefits paid out during that year. With rounding, the LRS amounts to 0 percent of the state's retirement costs. The LRS, administered by the California Public Employees' Retirement System, is actuarially overfunded – it has more assets than is needed to pay for the present value of all future obligations. Neither the state nor employees have made contributions to the fund since 1998.

Though the costs are relatively minimal, the concept of providing pensions for any elected official remains controversial. In 1993, the state Legislature banned from participating in CalPERS any elected or appointed officers of a county office of education, school district, community college district, or special district commission or board. Board members and trustees elected or appointed before July 1, 1994 were grandfathered in. At the time, locally elected board members who earned, for example, $100 for attending a meeting could receive a full service-credit pension based on their total years on the board, even though they may have met only a few hours each month.

City and county government elected officials, however are still eligible for pensions if the jurisdiction permits it, as are board members of special districts that administer pension programs outside of CalPERS.

SourceS: CalPERS. 2010. "Shaping Our Future: Ensuring Performance, Transparency and Accountability. Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2010." Statistical Section. Pages 24,172-173. Sacramento, CA. Also, SB 53 (Russell), Chapter 1297, Statutes of 1993.

Management Unions

To protect their pay and benefits, public sector managers are taking a lesson from more organized, rank-and-file union workers in their agencies. Managers in the private sector are generally barred from joining unions under federal law, but public-sector managers at the state and local level are allowed to unionize, and more are pursuing that option. Government managers formed collective bargaining units in Sacramento County and in the Bay Area city of Emeryville in 2010. Managers in Alameda and Orange counties also negotiate for pay and benefits.

California's collective bargaining law for local government dates to 1968, though forming unions does not guarantee better compensation. Unions can, however, add pressure during budget talks, with a seat at the table to negotiate sacrifices or tradeoffs.

Sources: Conor Dougherty and Kris Maher. January 22-23, 2011. "New Faces Appear at Bargaining Table." The Wall Street Journal. Also, Eraina Ortega, Legislative Analyst, California State Association of Counties. September 27, 2010. Sacramento, CA. Personal communication. Also, Richard Stensrud, Chief Executive Officer, Sacramento County Employees Retirement System. September 27, 2010. Personal communication.

a pension of $241,000. He went back to work at the fire department as a consultant at an annual salary of $176,000.[130] "People point to me as a poster child for pension spiking, but I did not make these rules," the fire chief told *The Wall Street Journal*. The Contra Costa County Employees Retirement Association later voted to prevent such spiking – but only for new hires.[131]

A San Ramon Valley fire chief, for example, was able to have his pension increased by 46 percent to $284,000 annually by adding in credit for management pay, standby pay, auto allowance and payments for unused sick and vacation time.[132]

Such cases may seem like outliers, but the practice of "spiking" a pension by transferring unused leave time into service credit – as well as cashing it out to boost final-year compensation – and other methods to add to base pay is widespread throughout local government. It is often part of the required calculation of benefits based on contractual agreements. The Fresno Bee, for example, determined that half of the retirees earning more than $100,000 in the Fresno County retirement system had credit for unused leave added to their pension calculations.[133] The Modesto Bee found that nearly all of Stanislaus County's management employees and more than 75 percent of rank-and-file workers cashed out unused vacation time to boost retirement pay, accounting for the largest increase in costs to the county to maintain its pension system.[134]

The Legislature has yet to eliminate spiking, as local government officials argue they need the flexibility to design competitive retirement packages for recruitment and retention purposes. [135]

In 1993, after a media scandal, the Legislature prohibited vacation cash-outs from entering into the retirement calculation for workers in the CalPERS system.[136] The ability to transfer a portion of unused sick leave into service credit, however, is still permitted. CalPERS gives retiring workers .004 years of service credit for each day of unused sick leave. Workers can transfer up to 250 days of sick leave, amounting to one year of service credit that can enhance lifetime retirement payments.[137] CalPERS adds an additional 1 percent to its liability column to account for the sick-leave transfer into service credit.[138]

In 1992, CalPERS established a Compensation Review Unit to check pensions for mistakes and spiking abuses. CalPERS set undisclosed parameters to automatically detect unusual compensation surges. In 2009, the 14-person unit flagged 7,000 pending retirements, and determined that 5,000 needed readjustment, mostly to correct reporting errors. Some 50 retirees appealed the readjustment to administrative law judges, though the final outcome of those cases was unclear.[139]

CalPERS also conducts routine audits of public agencies for payroll compliance. Unusually large pay raises, which ultimately balloon pension costs, can trigger red flags. CalPERS, however, deferred to the judgment of city officials in one-high profile case when Bell City Manager Robert Rizzo received a 47 percent salary increase in 2006. As the news first broke in 2010 about a series of pay raises that lifted Rizzo's salary to $800,000, CalPERS told the Los Angeles Times that the pension fund was not part of the chain of command for stopping the automatic pay raises. "It was the elected officials who negotiated, saw and signed the salaries and who are accountable," a CalPERS spokesman told the newspaper.[140]

CalPERS has since frozen Mr. Rizzo's retirement account, pending the outcome of his criminal trial and other investigations.[141] In testimony to the Commission, CalPERS acknowledged that it has the ability and authority to take additional steps to increase accountability and oversight over compensation. "We're establishing stronger guidelines for CalPERS employees to follow to enable them to flag and report up unusually high compensation and salary increases," CalPERS executive Ann Boynton told the Commission. The organization also is scrutinizing salaries paid to CalPERS members above $245,000 a year – an Internal Revenue Service pension threshold. In 2010, CalPERS also created a task force of major public employer organizations, labor groups and legislative staff to develop guidelines for reforms in three key areas:

- Greater disclosure of public compensation and benefit information.
- Options available to limit the amount of compensation used as the basis for retirement calculations.
- Mitigating the impact that excessive salaries have on the retirement costs of agencies in the same liability pool.[142]

These are important steps. Though without more uniform oversight of California's 85 pension plans, these tools are limited to the state government and the 3,000 school districts and local agencies within the CalPERS network. The reach does not extend to pension funds covering the other half of California's public employees – nearly 2 million public employees.

State Controller's role. An invaluable source of information about California's pension funds comes in the form of the *Public Retirement Systems Annual Report,* compiled and published by the State Controller's Office since the 1970s. The report contains detailed information about the benefit structure and financial health of each pension system in California. Production of the document, however, has lagged by as much as four years from the reporting period. Recent state legislation mandated the Controller's Office to issue the report within 18 months from year-end.[143] It has been an increasingly difficult task. The Controller's Office uses software that is nearly 15 years old – Microsoft Access 97 – to compile information sent in by retirement systems. The software is growing outdated and incompatible with modern systems, leading an increasing number of retirement systems to send the Controller's Office the required information on paper, which needs to be re-entered manually. For the most recent report capturing the 2008-09 fiscal year, 17 percent of agencies filed paper reports. The reporting requirements also have not been reviewed or updated since the 1980s, which can result in omitted but useful information – regarding unfunded health care obligations, for example.[144]

The information is reviewed by the Controller's Office for compliancy, but not analyzed for actuarial accuracy.[145] The Controller's Office does not employ actuaries. The information, therefore, must be viewed cautiously. Because actuarial projections of liabilities can vary by the methodology – using high or low-risk assumptions and extended amortization periods – comparisons across retirement systems to determine a pension fund's health can be difficult if not misleading.

Conclusion

Pension costs to state and local governments are rising at a pace that has grown unmanageable for public agencies to maintain services, and unacceptable for taxpayers. A fragmented collection of 85 pension plans, combined with a legal landscape that limits options for reform, has given government employees incredible leverage to push for benefit increases, often out of the public eye and with little risk to bear. Elected officials have enabled these behaviors that put pensions on a path toward unsustainability. Containing these behaviors will require a new but old understanding of the purpose of the public pension system.

Pension Revocation

The ability of state and local retirement systems to revoke the pensions of convicted felons also has gained attention following recent news articles revealing that convicted officeholders continue to receive pension benefits. The issue does not center as much on the law protecting vested pension rights, but has more to do with fairness – for outraged taxpayers as well as the pension recipient and his or her family.

The U.S. Supreme Court has determined that private employee pensions are protected under Employee Retirement Income Security Act (ERISA) from forfeiture for misconduct. The federal ERISA law does not cover state and local public pension funds, which have more latitude to revoke pensions of public employees for misconduct. Pension forfeiture laws across states, including California, have actually expanded in recent years.

California has had laws on the books since 1959 to expel corrupt judges and legislators from CalPERS. Retirement allowances also can be suspended by court order for any public employee under indictment for on-the-job corruption (embezzlement, bribery, etc.) and who flees the jurisdiction where he or she is facing charges. However, a legislative effort in 2008 failed in committee to revoke the pension of any public employee convicted of such crimes. Public employee unions protested that the bill would have unfairly imposed a lifetime sentence on the children and spouses of the employees.

A narrowly drawn measure signed by the Governor in 2005 cancels pension benefits accrued during the term of office of any elected official convicted of felony bribery, embezzlement of public money, extortion or theft of public money, perjury or conspiracy to commit those crimes. The law, proposed after the criminal conviction in 2005 of San Joaquin Sheriff Baxter Dunn, was made prospective for officeholders elected or re-elected after January 1, 2006. But there is a loophole: The governing body of the officeholder's jurisdiction can grant clemency for the forfeiture.

It is unclear if this law has been used in California. The law came too late to modify Sheriff Dunn's $140,000 annual pension, nor does it apply to Orange County Coroner-Sheriff Mike Carona, who was convicted in 2009 of witness tampering in a public corruption case. Witness tampering is not one of the crimes that can reduce a public pension. Mr. Carona, who now is serving a 5½-year federal prison sentence, is receiving a $217,000 annual pension from the Orange County Employees' Retirement System.

More recently, the Legislature strengthened an anti-fraud law in 2008 as part of a series of reforms that came out of the Governor's Public Employee Post-Employment Benefits Commission. Public employees, retirees and their beneficiaries now face up to one year in county jail and a $5,000 fine – and may be required to pay restitution – for making false claims to boost benefits, such as claiming disability eligibility or continuing to cash pension checks after the retiree has died.

In the current 2011 legislation session, Senator Tony Strickland introduced SB 115,which would expand the scope of the state's pension revocation law to apply to non-elected city, county and school officials who are convicted of felonies involving their public duties.

Source: See end notes for references.

A Framework for Reform

Looking back through the history – and expansion – of the state's public pension system, it becomes obvious that today's crisis was both avoidable and predictable. Decades of pension enhancement for public employees left taxpayers defenseless against billions of dollars in liabilities when investment returns failed to meet expectations.

A defined-benefit pension can and should remain an important component of public employee retirement, but reforms must be adopted to control the escalating costs and put the system on a path to sustainability.

In its recommendations, the Commission focused on structural improvements that can reduce current and long-term costs, as well as instill more discipline and increased accountability for state and local defined-benefit retirement plans.

Unearned, Future Benefits Must be Rolled Back

Every month, local governments announce steps to fix their pension systems. Much of the attention centers on imposing a lower tier of retirement benefits for new workers. These fixes, while important, are not adequate to meet the size and urgency of the problem. The real consequence – still unaddressed – is the growing overhang of liabilities caused by unfunded pension obligations for current employees.

Actuaries estimate that in the next few years, government agencies in the CalPERS system will need to increase contributions into their pension funds by 40 to 80 percent from 2010-11 levels.[146] Required government payments into pension funds will remain at heightened levels for decades, assuming that investments continue producing returns of nearly 8 percent annually, an optimistic scenario.

Government agencies already are taking steps to control payroll growth – the basis for computing pensions – by slowing wage increases and hiring. Many communities have joined the city of Chula Vista in San Diego County, which froze cost-of-living increases and other pay hikes for employees to save $7 million in pension costs in 2011 and 2012.[147] These are important tools to manage short-term costs and budget deficits, but they are temporary fixes to a generational problem. Hiring freezes can hardly last 30 years.

It would be reckless to follow the denial – and, according to the Securities and Exchange Commission, fraudulent – tactics of New Jersey, where officials have refused to pay more into the state's overextended pension system.[148] It does not mean, however, that state and local governments face no other options except to swallow the future costs.

Let the Commission be clear: State and local governments have made a promise to workers they can no longer afford. Yet the issue of rolling back future pension benefits is, for now, off the table. As San Jose Mayor Chuck Reed told the Commission, there's an attitude of "we don't talk about that. They're vested. No conversation."[149]

Courts have held that public employees have a "vested right" to their future pension benefits as structured on their first day of work, guaranteed through the course of employment, even though there is no guarantee that the employee will hold that job to accrue those benefits. This differs from the law over private-sector pensions, in which accrued benefits are protected, but modification can be made prospectively during the course of employment.[150]

The legal standards in California were derived from case law but not explicitly articulated in statute or in the state Constitution. Many consider this issue settled by the courts, though the courts have provided openings to modify pensions for current public employees. The extent of these options remains unclear, making this is an area of law that must be clarified.

Government agencies cannot generate the needed large-scale savings by reducing benefits only for new hires. It will take years if not decades to turn over the workforce, and the government is hardly in hiring mode today.

State Pension Reforms in 2010

- General Fund pension costs for state employees in 2010-11 and 2011-12: **$4.5 billion.**
- Savings from rolling back pension formulas for new hires: **Zero.**
- Two-year savings from higher employee contributions: **$223 million.**

Source: Department of Finance. 2011. Sacramento, CA.

To provide immediate savings of the scope needed, state and local governments must have the flexibility to alter future, unaccrued retirement benefits for current workers. This notion is unpopular but must be pursued. And it must be pursued for public safety pensions as well.

Public safety personnel costs generally comprise a larger portion of government budgets than other job classifications. With higher salaries, a younger workforce and earlier retirement ages, changes made prospectively to safety pensions for current workers help put these plans on a sustainable footing more quickly.

In state government, for example, employees in the California Department of Corrections and Rehabilitation comprise two-thirds of state General Fund salary costs, outside of public universities.[151] Of the 31,000 uniformed corrections officers, roughly half are under age 40. Among the state's other 49,000 rank-and-file workers, only one-third are under age 40.[152]

Cutting a promised benefit raises fundamental issues of fairness for workers. As the scale of the pension problem becomes starker in coming years, the issue of fairness will extend beyond the public worker. California is facing a situation where cities like Los Angeles will spend one of every three taxpayer dollars on retirement costs for current city workers by 2015. Across the state, governments will be forced to sacrifice schools, public safety, libraries, parks, roads and social services – core functions of government – and the public jobs that go with them, to pay the benefits that have been overpromised to current workers and retirees. That scenario is unrealistic and unfair to present and future Californians. It also is unfair to younger workers, who will have limited opportunities to pursue public service careers.

Hybrid Model Emerges

Public support is waning for the traditional pension. A January 2010 poll by the Public Policy Institute of California (PPIC) found that 67 percent of Californians favor changing pensions for new public employees from monthly pensions to 401(k)-style individual investment plans – a 6-percentage-point increase in support since 2005. According to the PPIC: "Strong majorities across parties, regions and demographic groups favor this proposal."[153]

The debate between a defined-benefit and a defined-contribution system, however, does not need to be an either-or choice. Twenty-five years ago, the federal government developed a breakthrough model for pension reform that is gaining renewed attention as states struggle to address rapidly increasing pension costs. In 1985, as part of a cost-saving pension reform plan for newly hired federal employees, the federal government reduced its defined-benefit pension, supplemented it with a 401(k)-type plan that includes a matching contribution by the federal government, and

LAO's Bottom Line

- State should encourage retirement savings by public employees.
- Current system is too expensive and too inflexible.
- Goal should be to preserve robust public retirement systems that more closely resemble those of other Californians.

Source: Legislative Analyst's Office. February 10, 2011. "Public Retirement Benefits: Options for the Future." Sacramento, CA.

added Social Security benefits, which previously had been unavailable to federal employees.[154]

Today, retirement for federal employees is based on a three-tiered system of Social Security, a modest pension formula (up to 1.1 percent of final salary times years of service, down from the previous 2 percent multiplier) and supplemented with a 401(k) plan that includes up to a 5-percent-of-salary match from the federal employer. As of 2009, the pension system for federal workers had an actuarially funded status of 100 percent. The original pension plan, which remains in place for employees hired before 1987, is only able to meet 39 percent of future obligations.[155]

Many public agencies, including California state and local governments, have long offered 401(k) and other tax-advantaged investment vehicles to employees, but those programs are run largely in isolation from their public pension plans. The federal system is different in that it restructured its retirement program based on three roughly equal sources of income for retirees: a modest pension, an employer-matched 401(k) and Social Security.

Seeking solutions to its pension problems, Orange County took this concept further in 2010 for its rank-and-file public employees, by ensuring that the 401(k)-style component of its retirement package will deliver investment income at a level that will provide retirees with adequate retirement security. Under the plan, newly hired workers have the option of choosing a lower fixed pension with a government-matched 401(k)-type component.[156] The county is seeking permission from the Internal Revenue Service to allow current workers also to opt into the hybrid retirement plan, which requires lower employee contributions.

Part of the appeal for employees: a 7 percent increase in their take-home pay due to the smaller deduction for their share of pension contributions. In Orange County, the third leg of the federal plan's stool is not available: County workers do not pay into or receive Social Security benefits.

After the 2008-09 market drop depleted private retirement accounts, the notion of public pension systems going entirely the defined-contribution route is receiving less attention. Working with TIAA-CREF, Orange County added the defined-contribution element with a plan designed to limit risk and market volatility in order to provide retirement security for employees, not encourage them to accumulate wealth. This approach gives employees the upside of a 401(k)-style plan – the ability to roll over the retirement savings when the worker changes jobs – without the downside of potential, steep investment losses.

Another unique feature of the Orange County hybrid model is that the decision to try it was made with support from organized labor. Workers earlier agreed to take on the additional costs of retroactively enhancing their pensions, which exposed them to significantly higher payroll deductions when the market tumbled. As the costs of a 2004 retroactive pension increase became uncomfortably expensive – for the both the county as well as employees – county officials and employee representatives worked on a compromise solution.

The Commission learned that building support for the hybrid plan meant that stakeholders needed to get past ideology to focus on their goals: to save the county money and provide retirement security for workers. The parties realized their goals were not mutually exclusive, and the hybrid model emerged as a middle ground. The key, said Nick Berardino, president of the Orange County Employees Association, was to accept the reality of the situation. "The unions are here. They're not going away," he said. "The pension problem is here. It's not going away. Accept it."[157]

A bigger challenge was acquiring the necessary legislative approval, because of strong labor opposition at the state level against defined-contribution elements in the broader pension reform debate. In the end,

Hybrid Models

Name of Fund	Federal Employees Retirement System	Washington State Public Employees' Retirement System	Utah Retirement Systems	Orange County Employees Retirement System
Year created	1986	2000	2010	2010
Participation	Mandatory	Voluntary choice of hybrid or defined-benefit plan	Voluntary choice of hybrid or defined-contribution plan	Voluntary choice of hybrid or defined-benefit plan
Defined-benefit (DB) formula	1.1% at age 62	1% at age 65	1.5% at age 65	1.62% at age 65
Employer share, as percent of payroll	11.5%	5.3%	10%	19.2%
Employee share of DB component, as percent of payroll	0.8%	0%	Some percent of salary, if the employer's 10% does not fund the defined-benefit	7.7%
Defined-contribution employer match, as percent of payroll	Up to 5%	None	Some percent, if any, left after funding the defined-benefit	Up to 2%
Social Security coverage	Yes	Yes	Yes	No

See end notes for sources.

Mr. Berardino said, the Legislature recognized that the Orange County solution was the result of bargaining and compromise.

Because of its voluntary nature, the numbers of employees opting for the hybrid plan, as opposed to a more generous defined-benefit pension, have been low: Only 7 out of 24 new hires, as of August 2010. The state can do more to enable and encourage government entities to pursue more affordable hybrid models, which combine a lower defined-benefit pension with a 401(k)-type plan, with regular contributions made by both the employee and the employer. The defined-contribution component should be risk-managed to allow for a more dependable investment stream.

Realigning expectations

Public discomfort has taken aim at the six-figure pensions, as well as pensions that match – or even exceed – the salaries when the retiree was still working. Defined-benefit pensions have all but disappeared in the private sector, so it is understandable that taxpayers employed by the private sector wonder why they should be relied upon to pay for a richer pension system than they could possible receive. Sometimes dismissed by public employee unions as "pension envy," the outrage is real and growing, according to pension-reform ballot organizer Marcia Fritz, in testimony to the Commission.[158] The level of retirement benefits that top-earning public employees and managers receive has caused considerable anger in the public. Examples of pension spiking, together with retirees who return to work part-time and still receive pension payments, and convicted former public employees who receive pensions also have eroded taxpayer support for the system.

The spiking games must end. Pensions must be based only on actual base salary over a five-year average – not padded with other pay for clothing, equipment or vehicle use, or enhanced by adding service credit for unused sick time, vacation time or other leave time. Provisions can be expanded to reduce pension allowances for public corruption convictions. Awarding pensions to elected officials does not appear to serve any genuine public policy purpose.

Retirement expert Teresa Ghilarducci of the New School told the Commission that public perception that overly generous public employee pensions could kill what used to be considered an efficient, effective and sustainable retirement model, at a time when retirement security nationwide is in jeopardy. "When there's a big mismatch there's revolt," she said. Changes in the public-sector pension model will be necessary, she said, to restore stability and confidence to the defined-benefit systems.[159]

It begins with a new, but old, understanding of what taxpayers, employers and employees are paying for. Over the years, as government budgets tightened, elected officials and employees turned to less visible pension systems as a way to increase overall compensation, which had the obvious political benefit of not being immediately obvious.[160] By design, public pensions no longer bear any resemblance to an appropriate or adequate amount of income needed in retirement. To put the systems right, it is critical to restore the purpose of a public pension as a vehicle for retirement security – not a platform for wealth accumulation for someone who retires in their 50s.

The level of income that a person needs or desires in retirement is clearly subjective. Whichever level is appropriate, the key point is that the burden of providing an adequate retirement for public employees is not the exclusive burden of government. Public employees, like their counterparts in the private sector, should expect, and be expected to, make supplemental savings arrangements on their own for their retirement years.

The government certainly plays a role in establishing a floor for a reasonable and fair pension to government employees. It also must set the ceiling, to ensure that benefit levels remain sustainable and, in the eyes of the taxpayer, legitimate and fair.

A hard cap on total benefits could backfire and encourage more workers into early retirement once they reach the maximum, leaving the state and local governments without needed expertise and increase liabilities by further extending the future stream of retirement benefits. Instead, the state could cap the amount of salary – in the $80,000 to $90,000 range to include supervisors and managers – that could be used toward an employee's pension, and then direct a percentage of additional earnings into a tax-advantaged 401(k)-type account. The cap should be designed to screen out top earners, not lower-earning rank-and-file workers.

As government employers direct additional dollars into defined-benefit pension funds, having the second, defined-contribution component would

Criteria for a Public Pension System

Common elements for an efficient, effective, sustainable and fair retirement system for public employers and employees:

- Employers and employees share the pension costs.
- The pension is designed to provide adequate retirement income.
- Money management is pooled so that fees are low and the funds can afford professional management.
- The payout is in the form of annuities, not a lump sum.
- Every worker is covered.
- A person's pension savings are not lost when changing jobs.

Source: Teresa Ghilarducci, Director, Schwartz Center for Economic Policy Analysis, Department of Economics, The New School for Social Research. June 24, 2010. Written testimony to the Commission.

provide substantial savings for state and local governments – even if the government matched employee contributions. This hybrid approach would encourage top-earning employees to remain on the job and continue investing in, and growing, their retirement funds, keeping in mind that extending an employee's working years buttresses the pension system. The approach also provides an innovative recruitment and retention tool for a mobile and professional workforce, consistent with the Commission's call for competitive compensation in its June 2005 report, *Managing the State Workforce to Improve Outcomes*.

Alternatively, the state could designate a universal pension threshold that would provide reasonable retirement security for public employees. When workers earn a salary and accrue enough years of service to exceed that threshold, a portion of additional earnings could be directed into the employer-matched 401(k) plan as part of a hybrid model. Capping the pension, as opposed to the salary used to determine the pension, could offer an additional layer of comfort for taxpayers, in providing the public with the knowledge that a public pension can never exceed a certain amount of money, regardless of the employee's salary. Doing so would further mitigate the urge for employees and managers to "spike" their pensions in an effort to increase their retirement income to as close to or even exceeding their pre-retirement salary. It also would even the playing field across local jurisdictions, preventing public agencies from using sweetened – and often obscured – pension packages as recruitment tools.

When they were established, public pension systems were designed to be funded with equal contributions from the employer and the employee, supported by investment income.[161] This principle eroded during the dot-com boom, when many government entities briefly enjoyed overfunded pension plans and stopped making contributions, while raising benefits, often retroactively. It still is common for many public agencies to "pick up" the employee portion of pension contributions, often in the public safety arena.

The lessons became painfully obvious with the 2008-09 market downturn, and a solution will require stronger structural changes to prohibit practices, such as contribution "holidays" and retroactive increases. The concept of requiring employers and employees to contribute equally and consistently to pension funds must be restored. The Commission learned that employees respond to pension reform differently when they are required to bear the cost of increased benefits through higher payroll deductions, as Orange County workers experienced.[162] When given the option of lower paycheck deductions for pension contributions, alternative retirement options, such as the hybrid model, become more attractive to employees.

Additionally, about 40 to 50 percent of public workers in California do not participate in Social Security (teachers, public safety, and several local government employee groups, including Los Angeles County employees), which means that state or local employees rely more heavily on their public sector pensions for retirement security.[163] Enrolling more workers into the Social Security system – and simultaneously lowering state or local pension benefits – theoretically could alleviate pressure on state and local pension systems, though the concept is controversial and complicated, and could be costly at the outset.[164] While adding Social Security benefits requires additional costs (a 6.2 percent tax each for employees and employers), it should allow governments to lower future pension contributions, which are expected to increase sharply to cover liabilities. Integrating Social Security may become more advantageous as employee and employer contribution rates continue to increase at levels higher than Social Security taxes.

For federal employees, Social Security is described in their retirement planning literature as a foundational source of post-employment income.[165] In California, the inclusion of Social Security often is omitted from policy discussions about state worker retirement. State miscellaneous workers have participated in the Social Security system since 1961. During the debate in 1999 to pass a retroactive pension increase for state workers, CalPERS claimed that the pension formula – reduced in 1991 to 1.25 percent of final salary times years of service (higher than the defined-benefit component of the federal employee plan) – provided some retirees with income near the poverty-level. CalPERS did not mention that those workers receive Social Security benefits that replace an additional 25 percent or more of pre-retirement income.[166]

The state may have required Social Security for new rank-and-file state workers in 1961, but participation in Social Security remains inconsistent across state government divisions, cities and counties in California. The decision to coordinate the federal old age security program with a state or local pension has often been left to the discretion of employee groups, who have opposed the move. The Legislature retains the ability to extend Social Security coverage to other public employees and modify pension formulas to provide appropriate retirement income for workers – an important policy lever.

Retirement experts predict that Congress is likely to mandate Social Security coverage for more workers as part of a future effort to shore up the federal system.[167] State or local retirement systems can begin planning for that eventuality and discussing how to appropriately integrate the two systems.

Opening the Books

Pensions for public workers are structured as part of closed-door negotiations during contract talks, with managers and executives at the bargaining table in line to receive the same pension benefits being haggled over with unions. A new law in 2008 that came out of the Governor's Post-Employment Benefits Commission is a good step to help ensure that government bodies cannot approve pension changes on a fast-tracked "consent" agenda.[168] Issues remain, however, about the public's ability to understand the nature and cost of these arrangements.

Several civil grand juries have been tracking pension costs and should be encouraged to continue their efforts to spotlight retirement liabilities in their communities to help inform policy-makers. Charter cities that operate independent pension systems in California – for example, Los Angeles, San Francisco and Fresno – already require voter approval to make pension changes, another guardrail against runaway costs. Outside of California, Florida's constitution has required since 1976 that "sound actuarial" studies demonstrate that proposed benefit increases are funded appropriately.[169]

"Accountability is the cornerstone of all financial reporting in government. … Accountability requires governments to answer to the citizenry – to justify the raising of public resources and the purposes for which they are used. Governmental accountability is based on the belief that the citizenry has a 'right to know,' a right to receive openly declared facts that may lead to public debate by the citizens and their elected representatives."

Governmental Accounting Standards Board. Concept Statement No. 1.

The scandal that erupted in 2010 over the compensation of city officials in the Los Angeles suburb of Bell underscores the responsibility of public retirement systems to improve mechanisms and procedures to detect and alert the public to unusually high salary increases, which drive up retirement costs. The same level of scrutiny that CalPERS has given the corporate sector about excessive executive compensation must be matched in the public sector. The State Controller's Office recently began posting individual salary and pension information for city and county workers on a new Web site, which is a good start to improve transparency.[170]

The Controller also compiles substantive data on all state and local pension systems into an annual report; the scope of information should be expanded to include long-term cost projections and be issued more regularly. Tools for reviewing the actuarial accuracy of the plan information also will be required. A model can be found in the state Department of Insurance, which employs a small staff of actuaries to review the financial security and liabilities of health, life and property insurance companies. The department actuaries fill a needed consumer oversight role, as shown by their 2010 discovery of math errors in health insurers' proposals for rate increases.[171] The actuaries also are self-funded: the department charges service fees to insurance companies for investigative work conducted by the department actuaries.[172] A rigorous and routine analysis of California's public pension systems would be a sound investment, leading to potential money savings. To provide the State Controller's Office with resources for these tasks, a small administrative fee should be charged to pension systems.

The issue of an appropriate "discount rate," once the province of accountants and actuaries, also is increasingly the subject of public debate, despite its complexity and vulnerability to misinterpretation. Public pension funds typically use a long-term investment-return rate – roughly 8 percent – to "discount" or determine the present-day value of future pension costs. The "discount" debate is far more than a technical distraction. It has laid bare:

- The volatility of public employee pension liabilities.
- The labor-heavy composition of retirement boards, which control the actuarial process, forming the basis for setting employer and employee contributions.
- The consequence for future generations of setting a high or low discount rate.
- The importance of translating actuarial data into clear and concise information for elected officials, public employees and the public.

Minimizing the potential size of long-term obligations, through accounting methods or disclosure practices, limits information essential to decision-makers, employees and the public. The habit of making short-term pension decisions influenced by self-interest has only led to volatility in California's public pension systems that ultimately benefits no one. Taxpayers still bear all the risk, with little say in the outcome. Greater transparency promotes stability and protects all parties from making uninformed decisions and will help in future discussions of how to spend limited resources.

The issues can be addressed by restructuring the composition of retirement boards to include more independent trustees, a best practice cited by the Government Finance Officers Association.[173] Additional taxpayer voices would provide balance to the interested parties already represented on the board, and a needed perspective when determining the cost burden of financing long term obligations. San Jose made such a governance change to its city retirement system in 2010, adding independent financial experts to the board and requiring that board members representing city workers have financial expertise.[174]

Under Proposition 162, voters limited the ability of the Legislature and Governor to change the structure of retirement boards – requiring legislative amendments to be ratified by the general public.[175] The Legislature can still pursue a more accountable governance structure for retirement boards and make the case for reform.

Requiring a public vote on pension increases also would provide an additional safeguard for taxpayers. Public votes do not necessarily block pension increases; they put a higher burden on employees to make the case for the enhancement. Cities with pension formulas etched into charters, such as San Francisco, already put proposed public pension increases before voters, who over time, have agreed to improve the benefits. A rash of local initiatives in November 2010 that supported the process for voter-approved pension increases speaks to the public demand for this level of oversight.

Leading the Way

Despite the spotlight on pension reform today, nearly 200 public agencies have continued to boost retirement benefits since 2008. In the event of sustained stock market buoyancy, it is not hard to imagine that the pressure from employees will mount to un-reform any reforms being considered today, in order to boost pension benefits. Instilling discipline into the pension system requires realignment not only of expectations, but of authority and accountability.

Public pensions for government workers in California are administered by more than 85 separate defined-benefit retirement systems, though the Legislature plays a key role in establishing retirement formulas and minimum retirement ages that can be negotiated by workers in state and local governments. The state has established a broad menu of choices, resulting in thousands of different pension plans, even deferring to local authorities the basic definition of "compensation" used to determine retirement pay, creating opportunities for spiking and other abuses to boost final-year salaries and trigger a higher pension. The collective bargaining environment that allowed workers to negotiate for pension benefits also set off a bidding war for benefits among jurisdictions. Union officials who testified before the Commission spoke candidly that public employees always will seek higher compensation.[176] But it is the job of elected officials to manage their governments' budgets responsibly. Elected officials have failed on this front.

Removing authority from local officials – and centralizing the system by collapsing and creating more uniform formulas, retirement ages and contribution rates – would provide a measure of consistency and accountability as well as help immensely California's governments to create a sustainable system.

Taking pensions entirely off the negotiating table entirely would require significant changes to California's collective bargaining law, an issue that falls outside of the scope of the Commission's study. The Commission recognizes the pressure public agencies face to continually ratchet up compensation, and with binding arbitration, that decisions sometimes are outside of the control of employers.

The Legislature has the power to set the menu – it must use this power to help the state and local governments by structuring clear standards that provide bulwarks against political temptation, to establish plans that protect employees and taxpayers.

Conclusion

The state must exercise its authority – and establish the legal authority – to reset overly generous and unsustainable pension formulas for both current and future workers. The state must set guardrails for pensions benefits that create consistency across the state, establish an even playing field for government employers and eliminate the pension gaming that can occur at the bargaining table. The importance of stability and fairness that can be gained by a more uniform and cost-effective system outweighs concerns about changing the theoretical, yet-to-be-earned pension benefits of current employers. Greater standardization of benefits would help, not hinder, local government executives concerned about being competitive with neighboring jurisdictions and ensure that adequate security for future retirees can be sustained.

Recovery is possible, though it will take decisive action through the Legislature, and potentially the courts, to make it happen. Moving forward, the state must rebuild a public employee retirement system to withstand unavoidable economic swings and natural, political temptation, in order to protect employees, public agencies, taxpayers and future generations.

Recommendations

Recommendation 1: To reduce growing pension liabilities of current public workers, state and local governments must pursue aggressive strategies on multiple fronts.

- The Legislature should give state and local governments the authority to alter the future, unaccrued retirement benefits for current public employees.

- ❑ State and local governments must slow down pension costs by controlling payroll growth and staffing levels.

Recommendation 2: To restore the financial health and security in California's public pension systems, California should move to a "hybrid" retirement model.

- ❑ The Legislature must create pension options for state and local governments that would retain the defined-benefit formula – but at a lower level – combined with an employer-matched 401(k)-style defined-contribution plan.
  - ✓ The 401(k)-style component must be risk-managed to provide retirement security and minimize investment volatility.

Recommendation 3: To build a sustainable pension model that the public can support, the state must take immediate action to realign pension benefits and expectations.

- ❑ To provide more uniform direction to state and local agencies, the Legislature must:
  - ✓ Cap the salary that can be used to determine pension allowances, or cap the pension, at a level that is reasonable and fair. Once the employee exceeds the threshold, employees and employers could make additional retirement contributions into a risk-managed, 401(k)-type defined-contribution plan.
  - ✓ Set appropriate pension eligibility ages to discourage early retirement of productive and valuable employees.
  - ✓ Set a tight definition of final compensation, computed on base pay only, over a five-year average to prevent and discourage pension "spiking."
  - ✓ Set uniform standards for the maximum hours that retirees can return to work and continue to receive public-sector pensions.
  - ✓ Set uniform standards and definitions for disability benefits.
  - ✓ Restrict pension allowances to exclude service in an elected office.
  - ✓ Eliminate the purchase of "air time."
  - ✓ Strengthen standards for revoking or reducing pensions of public employees and elected officials convicted of certain crimes involving the public trust.
- ❑ To minimize risk to taxpayers, the responsibility for funding a sustainable pension system must be spread more equally among parties.
  - ✓ The Legislature must prohibit employees and employers from taking contribution "holidays," except under rare circumstances.
  - ✓ The Legislature must prohibit retroactive pension increases.

- ✓ The Legislature must require employees and employers to annually adjust pension contributions based on an equal sharing of the normal costs of the plan.
- ✓ State and local governments must explore options for coordinating pension benefits with Social Security.

Recommendation 4: To improve transparency and accountability, more information about pension costs must be provided regularly to the public.

- ❑ The Legislature must require government retirement boards to restructure their boards to add a majority or a substantial minority of independent, public members to ensure greater representation of taxpayer interests.
- ❑ All proposed pension increases must be submitted to voters in their respective jurisdictions.
  - ✓ The ballot measures must by accompanied by sound actuarial information, written in a clear and concise format.
- ❑ The Legislature must require all public pension systems to include in their annual financial reports:
  - ✓ The present value of liabilities of individual pension funds, using a sensitivity analysis of high, medium and low discount rates.
  - ✓ The government entity's pension contributions as a portion of the general operating budget and as a portion of personnel costs, trended from the past and projected into the future.
- ❑ The State Controller must expand the *Public Retirement Systems Annual Report* to include the above information. Administrative fees to pension systems should be considered as a funding source to support actuarial expertise and the timely production of the report.
- ❑ The Legislature must require pension fund administrators to improve procedures for detecting and alerting the public about unusually high salary increases of government officials that will push pension costs upward.

Appendices & Notes

- ***Public Hearing Witnesses***
- ***Public Meeting Participants***
- ***Pension Timeline***
- ***CalPERS Agencies That Changed Benefits in 2008-09 and 2009-10***
- ***Glossary***
- ***Distribution of Pension Benefits***
- ***Social Security Coordination***
- ***Notes***

Appendix A

Public Hearing Witnesses

Public Hearing on Public Pensions
April 22, 2010

Ron Cottingham, President, Peace Officers Research Association of California

David Crane, Special Advisor to the Governor for Jobs and Economic Growth, Governor's Office

Girard Miller, Retirement Plan Consultant

Tony Oliveira, Member, CalPERS Board of Administration; President, California State Association of Counties

Richard Stensrud, Chief Executive Officer, Sacramento County Employees' Retirement System

Public Hearing on Public Pensions
June 24, 2010

Keith Brainard, Research Director, National Association of State Retirement Administrators

Marcia Fritz, President, California Foundation for Fiscal Responsibility

Teresa Ghilarducci, Author and Professor of Economic Policy Analysis, The New School for Social Research

Dave Low, Director, Governmental Relations, California School Employees Association

Public Hearing on Public Pensions
September 23, 2010

John E. Bartel, President, Bartel Associates, LLC, and member, California Actuarial Advisory Panel

Ann Boynton, Deputy Executive Officer, Benefits Administration, California Public Employees' Retirement System

Jon Hamm, Chief Executive Officer, California Association of Highway Patrolmen

Chuck Reed, Mayor, City of San Jose

Appendix B

Public Meeting Participants

Public Pensions Subcommittee Meeting – June 23, 2010
Sacramento, California

Robert J. Bezemek, Attorney, Law Offices of Robert J. Bezemek

Jeffrey Chang, Shareholder, Chang, Ruthenberg & Long PC

Harvey L. Leiderman, Partner, Reed Smith LLP

Jeffrey Lewis, Shareholder and Founding Partner, Lewis, Feinberg, Lee, Renaker & Jackson PC

Amy B. Monahan, Associate Professor, University of Minnesota Law School

Chris Platten, Shareholder, Wylie, McBride, Platten & Renner

Charles Sakai, Managing Partner, Renne, Sloan, Holtzman, Sakai LLP

Public Pensions Subcommittee Meeting – August 20, 2010
Santa Ana, California

Nick Berardino, General Manager, Orange County Employees Association

Bill Campbell, Supervisor, Orange County

Roderick Crane, Director, Institutional Business Development, TIAA-CREF

Steve Delaney, Chief Executive Officer, Orange County Employees Retirement System

Tom Mauk, County Executive Officer, Orange County

Brian McAndrews, Regional Vice President, TIAA-CREF

John M.W. Moorlach, Supervisor, Orange County

Chriss Street, Treasurer-Tax Collector, Orange County

Public Pensions Subcommittee Meeting – September 22, 2010
Sacramento, California

Ed Derman, Deputy Chief Executive Officer,
Plan Design and Communication, California
State Teachers' Retirement System

Appendix C

Public Pension Timeline

1930s

1932: CalPERS forms. Original retirement formula sets normal retirement age at 65, based on 1/70th (1.43%) of five year average salary with 20 years of service. Compulsory retirement at age 75. Investments limited to U.S. government and municipal bond.

1935: Highway Patrol normal retirement age lowered to 60. Compulsory retirement at age 65.

1937: State sets guidelines for county retirement systems.

1939: Local agencies and school district staff are allowed to join CalPERS.

1940s

1945: State retirement formula increases to 1/60th (1.67%) at age 60.

1947: CalPERS begins investing in telephone, electric and gas utilities.

1950s

1954: Compensation used in benefit calculations based on a three-year average salary instead of a five-year average.

1955: Legislature authorizes CalPERS to invest in building certificates.

1959: Survivor benefits added.

1960s

1961: Miscellaneous state employees begin participating in federal Social Security.

1962: Health benefits added.

1964: CalPERS creates mortgage loan department to invest in commercial real estate.

1966: Proposition 1 allows CalPERS to invest up to 25% of portfolio in stocks.

1968: Automatic COLAs added.

1968: Meyers-Milias-Brown Act permits collective bargaining for local government employees.

1970s

1970: State formula increased to 2% at 60.

1973: Credit is allowed for unused sick time at retirement, subject to certain conditions.

1977: Ralph C. Dills Act authorizes collective bargaining for state workers.

1980s

1983: State peace officers' and firefighters' retirement allowances based on 2.5% at 55; local safety offered the same.

1984: Proposition 21 allows CalPERS to invest more than 25% of portfolio in stocks.

1985: Legislature provides voluntary Second Tier retirement plan: 1.25% at 65.

1990s

1990: Proposition 140 closes retirement system to state legislators. Retirement formulas for local miscellaneous workers increased to 2% at 55.

1991: AB 702 requires all new state employees to be placed in Second Tier plan; transfers actuarial functions out of CalPERS, into governor's office; transfers CalPERS funds to balance state budget.

1992: Proposition 162 gives retirement boards exclusive administration and investment authority.

1993: SB 53 curbs pension spiking in CalPERS; bans elected school board members and special district trustees from state pension system.

1999: SB 400 eliminates Second Tier; extends public safety retirement formulas to as high as 3% at 50; 2% at 55 for miscellaneous state workers.

2000s

2000: SB 1696 allows county governments to make benefit changes retroactively.

2001: AB 616 extends local miscellaneous retirement formulas to as high as 3% at 60.

2002: SB 183 extends 3% at 50 formula to more state public safety officials, including livestock inspectors, criminologists.

2004: Legislation requires new state hires to contribute to the Alternate Retirement Program, rather than CalPERS, for two years.

2008: AB 1844 strengthens anti-fraud laws.

2008: SB 1123 establishes California Actuarial Advisory Panel; prohibits local agencies from adopting pension changes on "consent calendar."

2010s

2010: SBx6 22 and SB 867 roll back benefit formulas for new employees to pre-1999 levels; require more disclosure of investment return assumptions, discount rates and amortization periods.

Appendix D

CalPERS Agencies That Changed Benefits in 2008-09 and 2009-10

Public agencies in CalPERS adding new tiers of lower benefits for new hires

Agency	Employee group
American Canyon Fire District	Safety
Associated Students Inc., CSU Long Beach	Miscellaneous
Bakersfield	Miscellaneous
Bishop	Miscellaneous and safety
Conejo Recreation and Park District	Miscellaneous
El Dorado Irrigation District	Miscellaneous
Fairfax	Safety
Garden Valley Fire Protection District	Miscellaneous
Marinwood Community Services District	Safety
Midway City Sanitary District	Miscellaneous
Montclair	Miscellaneous
Moulton-Niguel Water District	Miscellaneous
Napa Sanitation District	Miscellaneous
National City	Police
Nevada City	Miscellaneous and safety
Padre Dam Muni Water District	Miscellaneous
Rancho Simi Recreation and Park District	Miscellaneous
Rohnert Park	Miscellaneous and safety
San Carlos	Miscellaneous and safety
San Juan Water District	Miscellaneous
San Leandro	Miscellaneous
Sanger	Fire
Signal Hill	Miscellaneous
Solano Irrigation District	Miscellaneous
South San Francisco	Miscellaneous and safety
Susanville	Miscellaneous and safety
Weaverville Sanitary District	Miscellaneous

Public agencies in CalPERS making changes to pensions in 2008-09 and 2009-10

Agency	Formula improvement	One-year final compensation	Additional service credit	Enhanced death and survivor benefits	Other
Alameda County Water District				x	
Alturas	x				
Amador Water Agency				x	
Anderson	x				
Arcadia	x				
Arcata	x	x			
Arroyo Grande			x		
Associated Students Inc., CSU Long Beach	x				
Atwater	x	x			x
Avalon			x		
Bakersfield				x	
Banning			x		
Barstow		x			
Bell Gardens				x	
Bellflower					x
Beverly Hills			x		
Borrego Water District	x				
Branciforte Fire Protection District	x				
Brea safety		x			
Brisbane			x	x	x
Cal Poly Pomona Foundations Inc.	x			x	
California Joint Power Risk Management Authority	x				
California Pines Community Services District	x				
Campbell			x		
Carmel Regional Fire Ambulance	x				
Carmel Valley Fire Protection District					x
Cayucos Sanitary District	x				
Chico			x		
Chino Basin WaterMaster	x				
Chino Valley Independent Fire District				x	
Chowchilla	x				
Citrus Heights					x
Claremont			x		
Clovis				x	
Coachella City			x		
Coachella Valley Association of Governments			x		
Coachella Valley Water District			x		
Colusa		x			x
Compton Unified School District	x				
Consolidated Area Housing Authority of Sutter County		x			
Corona					x
Costa Mesa	x		x		
Cottonwood Fire Protection District	x				
Covina	x				
Cudahy	x				
Del Mar					x
Del Norte County			x		
Dinuba			x		
Dixon			x		
Dixon Public Library District			x		
Downey				x	

Agency	Formula improvement	One-year final compensation	Additional service credit	Enhanced death and survivor benefits	Other
Duarte			x		
East Kern Airport District		x		x	x
Eastern Sierra Transit Authority			x		
El Segundo			x	x	
Elk Grove			x		
Eureka		x			
Felton Fire Protection District	x				
Folsom			x		
Fontana			x		
Fountain Valley			x		
Galt			x		
Garden Grove			x		
Garden Valley Fire Protection District		x			
Glen Ellen Fire Protection District		x			
Glendale Community College District				x	
Gridley			x		
Hanford			x	x	
Hercules	x				
Hollister	x				
Hub Cities Consortium	x				
Humboldt County				x	
Indian Wells	x				
Irvine Ranch Water District	x		x	x	
Isla Vista Recreation & Park District		x			
Jackson			x		
Jamestown Sanitary District	x				
Kelseyville Fire Protection District	x				
Kern-Tulare Water District	x				
L.A. to Pasadena Metro Blue Line Construction Authority	x				
La Verne			x		
Laguna Beach	x				
Lake Arrowhead Community Services District	x				x
Lake Elsinore			x		
Lake Valley Fire Protection District	x				
Lakeport			x		
Larkspur	x			x	
Lodi			x		
Los Angeles Memorial Coliseum Commission	x				
Los Osos Community Services District			x		
Madera Housing Authority	x	x			
Mammoth Lakes			x		
Marina Coast Water District		x			
Menlo Park	x				
Mesa Consolidated Water District				x	x
Modesto					x
Monrovia			x		
Montebello	x				
Monterey Park	x			x	
Monterey Peninsula Regional Park District					x
Monterey Peninsula Water Management District		x			
Montezuma Fire Protection District	x				
Moreno Valley			x		
Mountain View				x	
Napa County				x	
Nevada City					x
Nevada Irrigation District	x				
Newport Beach	x				

Agency	Formula improvement	One-year final compensation	Additional service credit	Enhanced death and survivor benefits	Other
North County Fire Protection District of San Diego County	x				
Northern California Power Agency	x				
Northern Salinas Valley Mosquito Abatement District		x			
Norwalk			x		
Oakland			x		
Oakland City Housing Authority	x	x			
Oceanside	x				x
Palm Desert			x		
Palmdale Water District			x		
Pasadena				x	
Patterson	x				
Perris			x		
Petaluma			x		
Pico Rivera			x	x	
Pinole			x		
Pismo Beach		x			
Placerville			x		
Plumas Local Agency Formation Commission	X				
Porterville				x	
Redlands			x		
Redwood Empire Municipal Insurance Fund	x				
Rialto			x		
Richmond					x
Rincon Valley Fire Protection District	x				
Riverside County			x		
Riverside County Flood Control & Water Conservation District			x		
Riverside County Regional Park and Open Space District			x		
Riverside County Transportation Commission			x		
Riverside County Waste Management Department			x		
Riverside Transit Agency			x		
Rolling Hills Estates		x			
Rosemead					x
Roseville Public Cemetery District					x
Running Springs Water District		x			
Russian River Fire Protection District		x			
Sacramento				x	
Sacramento Metropolitan Air Quality Management District				x	
Salinas					x
San Benito County	x				
San Bernardino	x				
San Diego Pooled Insurance Program Authority	x				
San Jacinto	x				
San Marino			x		
San Miguel Consolidated Fire Protection District					x
San Pablo					x
Sanger	x				
Santa Ana	x				
Santa Clara County Central Fire				x	
Santa Cruz					x
Santa Cruz County Regional Transportation Commission	x				

Agency	Formula improvement	One-year final compensation	Additional service credit	Enhanced death and survivor benefits	Other
Santa Maria	x				
Santa Nella County Water District	x				
Seaside			x		
Sebastopol	x				
San Francisco Bay Area Rapid Transit District			x	x	
Shasta Area Safety Communications Agency		x			
South Bay Regional Public Communications Authority		x			
South Gate			x		
South San Joaquin Irrigation District	x				
Special District Risk Management Authority			x		
State Water Contractors		x			
Stege Sanitary District		x			
Stockton East Water District					x
Stockton Unified School District	x				
Suisun Fairfield Rockville Cemetery District					x
Sutter County				x	
Temecula	x		x		
Tri-County Schools Insurance Group	x				
Tri-Dam Housing and Personnel Agency	x				
Truckee Fire Protection District		x			
Tulare			x		
Tuolumne					x
Ukiah	x		x		
Union City			x		
Vacaville	x			x	
Valley Center Muni Water District	x				
Victorville					x
Wasco			x		
Water Employee Services Authority				x	
Water Facilities Authority	x				
Waterford	x				
Weaverville Sanitary District					x
West Contra Costa Integrated Waste Management Authority	x				
Westminster			x		
Yolo County	x			x	

Source: California Public Employees' Retirement System. Employer Services Division. February 1, 2011. "Benefit Changes by Contracting Agency 2008-09." Also, California Public Employees' Retirement System. Employer Services Division. February 1, 2011. "Benefit Changes by Contracting Agency 2009-10."

Appendix E

Glossary

This glossary provides a basic definition of terms used throughout the Little Hoover Commission report on public pensions. These definitions are drawn primarily from the California Public Employees' Retirement System and the Public Employee Post-Employment Benefits Commission.

1937 Act Counties: The 20 California counties authorized by the 1937 Act to establish independent county retirement systems.

Active Employee or Active Member: A member of a pension system who is accruing benefits through current employment.

Actuarial Assumptions: Assumptions made about certain events that will affect pension costs. Assumptions generally can be broken down into two categories: demographic and economic. Demographic assumptions include such things as mortality, disability and retirement rates. Economic assumptions include investment return, salary growth and inflation.

Actuarial Valuation: The determination of the normal cost, actuarial accrued liability, actuarial value of assets and actuarial present values for a pension plan. These valuations are performed annually or when an employer is contemplating a benefit change. The valuations compare the assets to the accrued liability for each plan, and determine the employer contribution rate for the coming year. Actuaries use each employer's schedule of benefits, membership data and a set of actuarial assumptions (for example, life expectancy, inflation rates, etc.) to estimate the cost of benefits. Additional actuarial valuations are made throughout the year to determine the impact of benefit improvements, mergers and reclassifications and legislated changes.

Actuarial Value of Assets: The actuarial value of assets used for funding purposes is obtained through an asset smoothing technique where investment gains and losses are partially recognized in the year they are incurred, with the remainder recognized in subsequent years. This method helps to dampen large fluctuations in the employer contribution rate.

Actuary: A person professionally trained in the technical and mathematical aspects of insurance, pensions and related fields. An actuary estimates how much money must be contributed to a pension fund each year in order to support the benefits that will become payable in the future.

Allowance: A monthly benefit payment issued to a retiree, beneficiary or survivor.

Annual Required Contributions (ARC): The employer's periodic required annual contributions to a defined-benefit pension plan, calculated in accordance with the plan assumptions.

Annuity: A payment of a fixed sum of money issued to a benefit recipient.

Assumed Rate of Return: An estimate of the annual rate of investment returns to be generated by the fund. This amount is approved by the governing body of the retirement system and has a significant impact on the actuary's estimate of the cost of funding a defined benefit pension plan.

Benefit Factor: A percentage (determined by retirement formula and age) that is applied to final compensation to determine a retirement benefit.

Beneficiary: A person eligible to receive a benefit after the death of a member or other benefit recipient.

California Actuarial Advisory Panel (CAAP): An advisory panel established in 2008 to provide public agencies with impartial and independent information on pensions, other post-employment benefits and best practices. The CAAP consists of eight actuaries, appointed by various public officeholders and agencies.

California Public Employees' Retirement System (CalPERS): The retirement system established in 1932 for state employees, classified (non-teaching) school employees and employees of California public agencies that contract with CalPERS for retirement coverage.

California State Teachers' Retirement System (CalSTRS): The retirement system established in 1912 to provide post-employment benefits for K-12 and community college teachers and school administrators in California.

Charter City: A city whose form of government is defined by a charter.

Contribution Holiday: In years when a retirement system meets or exceeds funding requirements, public employers may not be required to make contributions to the retirement system (for example, to enjoy a "holiday" from contributions).

Contributions: Monies contributed to the retirement fund by the employer and employees.

Defined-Benefit Plan: A plan designed to provide eligible participants with a specified lifetime benefit at retirement. The benefit is based upon three factors: a percentage rate based on the member's age at retirement and benefit formula applicable to the member, the member's length of credited service and the member's final compensation. The plans are funded by member contributions, employer contributions and income earned from investment of accumulated contributions.

Defined-Contribution Plan: A type of savings plan that allows participants to make pre-tax contributions that accumulate tax-free. Contributions, plus any earnings, are not subject to state or federal taxes until withdrawn, in most cases after retirement. The amount paid is determined by the amount of contributions made and the rate of return on the investments chosen.

Discounting: The method of valuing future assets and liabilities to determine their present value, for the purpose of setting employer contribution rates. The discount rate used in the calculations reflects a pension system's risk tolerance and is traditionally tied to the assumed investment rate of return.

Department of Personnel Administration (DPA): The department represents the Governor's administration in collective bargaining negotiations with state employees.

Employee Retirement Income Security Act (ERISA): The Employee Retirement Income Security Act of 1974 is a federal law that sets minimum standards for pension plans in private industry. Most of the provisions of ERISA are effective for plan years beginning or after January 1, 1975.

Final Compensation: The average salary for a specific period of time which is used as part of the formula used to calculate retirement benefits. The time period generally ranges from one to five years, depending on the contract or statute.

Funded Ratio or Status: A ratio of the value of benefits members have earned compared to the value of the retirement system's assets. The funded ratio or status provides a measure of how well funded or "on track" a plan is with respect to assets vs. accrued liabilities. The funded ratio can be calculated by dividing the actuarial value of assets by the accrued liabilities, or by dividing the market vale of assets by the accrued liabilities.

Golden Handshake: An early retirement incentive program that provides an employee with additional age or years of service credit enabling him or her to receive a higher retirement benefit than otherwise possible.

Governmental Accounting Standards Board (GASB): The independent, non-government organization that establishes the accounting standards for state and local government entities. The standards of financial accounting and reporting are intended to provide concise, transparent and understandable financial information.

Inactive Member: A member not currently working for a covered employer, but has member contributions on account.

Legislators' Retirement System (LRS): The retirement system for legislators, constitutional officers and statutory officers.

Matching Contributions: A contribution made by an employer to a plan on an employee's behalf in an amount equal to an employee's elective or non-elective contributions.

Member: An employee who qualifies for membership in a pension system and whose employer has become obligated to pay contributions into the pension fund. Also describes retirees, survivors, beneficiaries or anyone receiving a benefit.

Miscellaneous Member: Any of the vast majority of occupations not designated as a "safety member." Often referred to in this report as "rank-and-file."

Normal Cost: The annual cost of service accrual for the upcoming fiscal year for active employees.

Normal Retirement Age: The age established in a plan's provisions when members become eligible for full benefits.

Pension Spiking: The practice of increasing a member's retirement allowance by increasing final compensation or including various non-salary items (such as unused vacation pay) in the final compensation figure used in the member's retirement benefit calculations, and which has not been considered in prefunding of the benefits.

Public Agency: Public agencies are cities, counties, special districts and other local government entities that contract with CalPERS to provide retirement or health benefits to their active employees and retirees.

Portfolio: The mix and composition of an investor's holdings among different classes of assets, such as bonds, mortgages and common stocks.

Present Value of Benefits: The total dollars needed as of the valuation date to fund all benefits earned in the past or expected to be earned in the future for current members.

Retired Member: A member currently receiving a benefit. Also known as an annuitant, which can be a retiree, beneficiary or survivor who is receiving a benefit.

Safety Member: A safety member is defined by statute or by plan provisions, and generally refers to an employee working in a job related to preserving the public's safety, such as a firefighter or law enforcement officer.

State Controller's Office (SCO): The State Controller's Office oversees production of the *Public Retirement Systems Annual Report* and provides staff support for the California Actuarial Advisory Panel.

Service Credit: The length of time, counted in pay periods, months or other measurements, that an employee performs service. The amount of service is used as part of the formula to determine retirement benefits.

Superfunded: A condition existing when the actuarial value of assets exceeds the present value of benefits.

Survivor: A dependent eligible to receive a benefit upon a member's death.

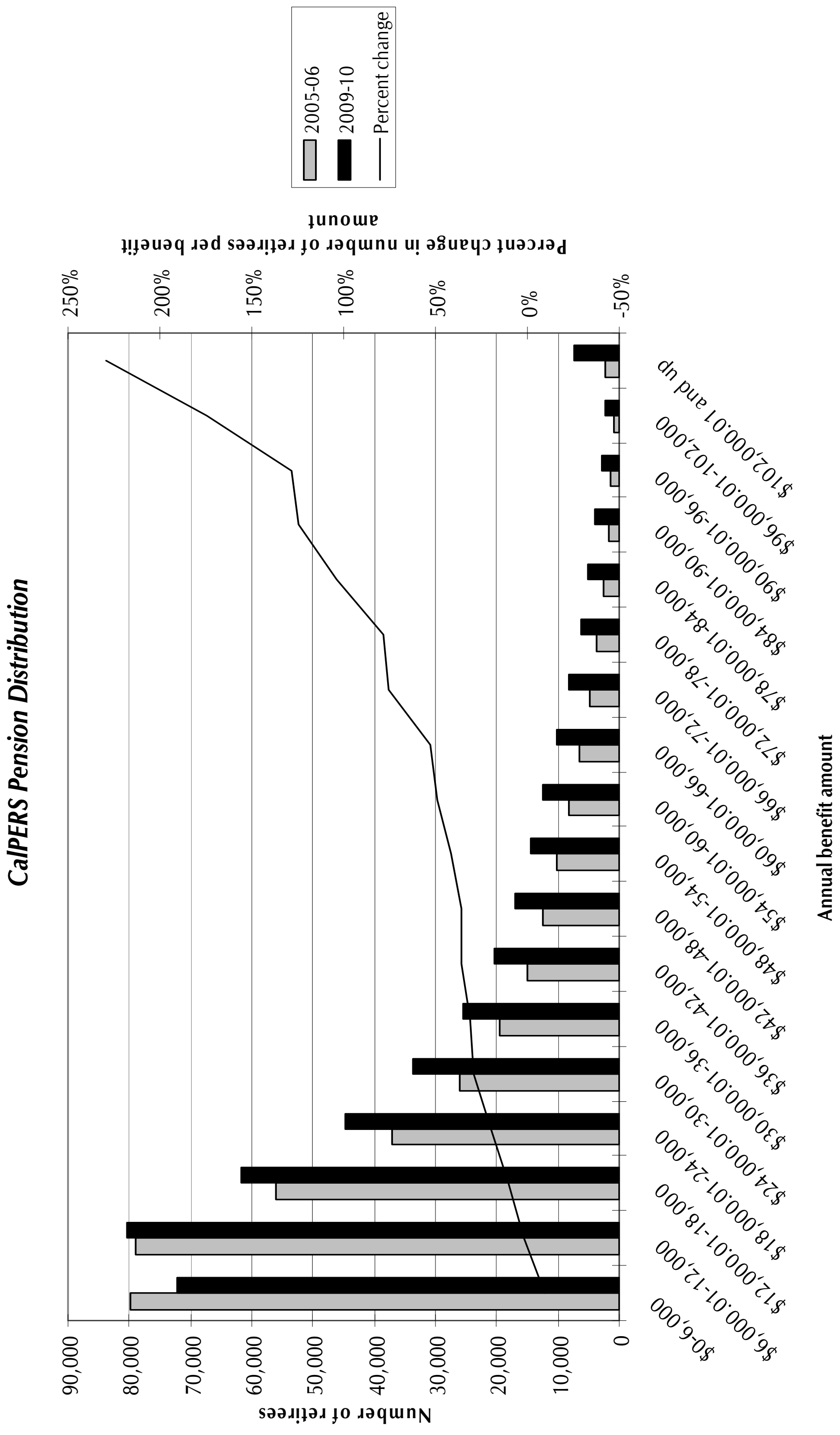
Three-Legged Stool: Theory that a combination of an individual's personal savings, Social Security benefits and pension should be considered when planning for income security in retirement.

Unfunded Actuarial Accrued Liability (UAAL): The amount by which the actuarial accrued liability exceed the actuarial value of assets; or, in other words, the present value of benefits earned to date that are not covered by the value of assets. A plan with an actuarial value of assets below the accrued liability is said to have an unfunded liability and must increase contributions to get back on schedule.

Vested or Vesting: The right to specified benefits granted to eligible employees after a fixed period of employment and membership.

Appendix F

Distribution of Pension Benefits



In the 2009 fiscal year, the California Public Employees' Retirement System added 61,794 service retirees, a 17 percent increase from five years earlier. The number of retirees earning higher benefits grew at faster rates.

Sources: California Public Employees' Retirement System Office of Policy and Program Development. January 2011. "CalPERS Number of Service Retirement Payees by Monthly Benefit Amount, Fiscal Year Ending June 2006." Also, California Public Employees' Retirement System Office of Policy and Program Development. July 2010. "Monthly Benefit Amount by Number of All Servie Retirement Payees Through June 30, 2010."

Appendix G

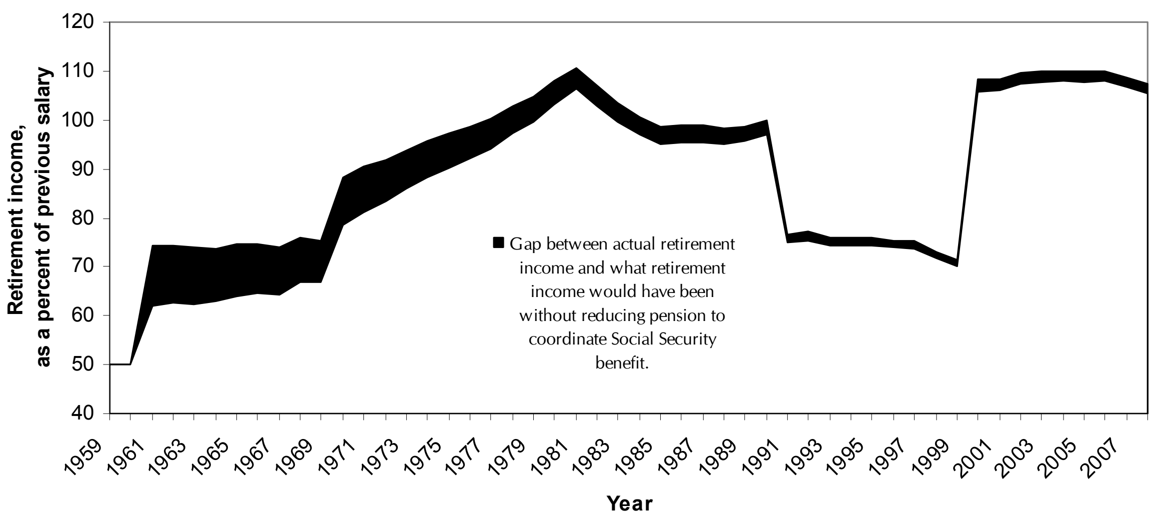
Social Security Coordination

In 1961, legislation signed by Governor Edmund G. "Pat" Brown linked the pension system for state miscellaneous workers with the federal Social Security system. To facilitate the merger, the state sought to avoid the cost of stacking Social Security benefits on top of the state pension, which would have created a windfall of retirement income. The state put in place a formula that partially reduced the state pension, but still provided workers with more retirement income when adding in the new Social Security benefit than the base state pension would have allowed.

The formula reduced the final compensation used to determine an employee's pension by one third of the maximum earnings taxed by Congress for Social Security. In 1961, this amounted to a reduction in final monthly compensation of $133.33 to compute the employee's retirement allowance. What remained in law, however, was the dollar amount of the offset, not the formula. The offset in 1961 translated into a 24 percent reduction in the state pension for a 30-year, "high-income" state worker. Today, trimming $133.33 off the final monthly compensation for the same 30-year worker amounts to a 2 percent cut in the state pension.

Diagram 1 illustrates the impact of Social Security coordination over time as a result of the flat $133.33 offset. As benefit levels fluctuated, the shaded area represents the shrinking gap over time between the actual retirement income (as a portion of previous income, when adding Social Security) and how much higher the retirement income level would have been had the Legislature never enacted the offset.

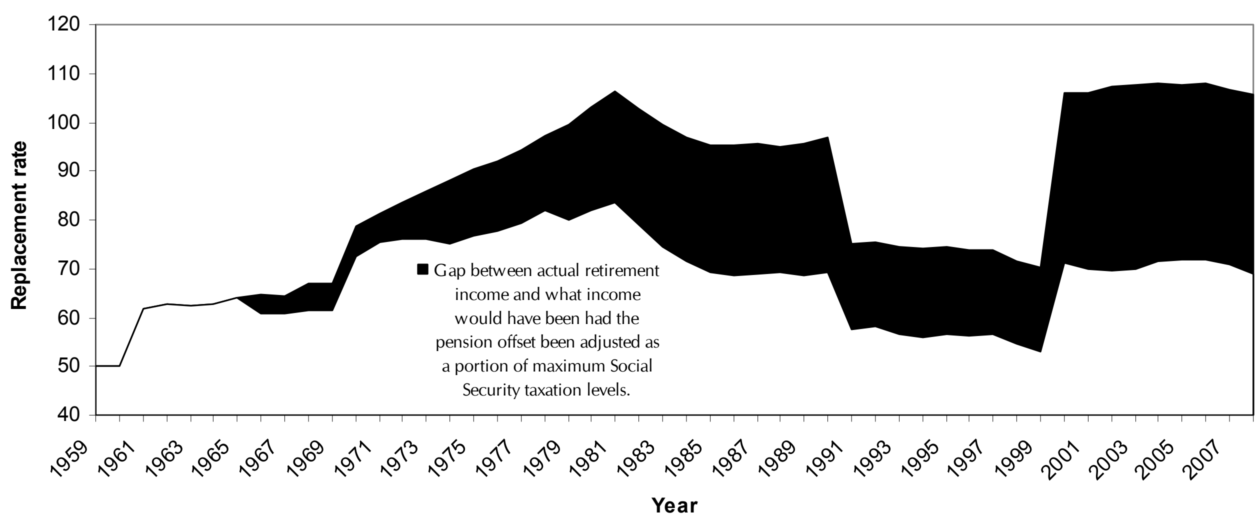
Diagram 1
Social Security coordination: Small impact today from fixed-dollar offset



In the years before the state coordinated Social Security benefits, miscellaneous state workers received a pension equivalent to roughly 50 percent of their previous pay. With rising benefit levels, a rank-and-file state worker who retires at age 63 with 30 years of service now can expect to receive 107 percent of pre-retirement income, when adding in full Social Security benefits (available at age 67). Without the $133.33 reduction in the benefit calculation, the worker's pension would equal almost the same pay, about 109 percent of pre-retirement salary. The calculation used the salary and average Social Security replacement rate of a "high-income" worker earning 160 percent of the Average Wage Index (AWI), roughly $67,000 today.

Diagram 2 considers how the same worker's pension would have changed had the original Social Security coordination formula been adopted, to reflect a reduction in monthly compensation equal to one third of the maximum Social Security earnings. Based on that formula, the $133.33 reduction in 1961 would have meant a $2,833.33 reduction today in the monthly pay used to determine the retirement allowance. Adjusting the offset annually with federal earnings guidelines would have substantially reduced the state worker's pension by 50 percent today, resulting in total retirement income, including Social Security of roughly 70 percent of previous earnings. The shaded area represents the growing gap between actual retirement income and how much lower it would have been over time, as benefits levels changed, under a sliding formula.

Diagram 2
Social Security coordination: Adjusting offset reduces total retirement income



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