

**PENSION REFORM IN CALIFORNIA**  
**League of California Cities**  
**March 1, 2005**

For close to 60 years California state and local governments have offered “defined benefit” retirement plans to their employees which provide a guaranteed annual pension based upon retirement age, years of service, and some period of highest salary (typically the last one or three years of work). These plans generally provide an annual cost-of-living adjustment and additional inflation protection that maintains the purchasing power over time at a specified minimum level. The Public Employee’s Retirement System (PERS), the State Teachers’ Retirement System (STRS), and a variety of individual cities and counties administer these retirement plans.

Over the years local and state government retirement costs have risen and fallen based on two principal factors: (1) the investment returns of the various systems; and (2) the level of benefit payments provided to employees. In the late 1990s the California legislature enacted dramatic benefit enhancements for public employees in the PERS system that were optional for participating local governments. Some local governments adopted these benefit enhancement plans—for a variety of reasons, typically to retain employees and at times at a shared cost with the employees. When the retirement systems suffered serious investment losses in the early part of this decade, these losses combined with the benefit enhancements to cause dramatic increases in employer contribution rates.

**Defined Contribution Mandate Proposed**

In the fall of 2004 a proposed constitutional and statutory initiative (File No. SA2005RF0007) was filed that would close all state and local public sector defined benefit plans (including locally administered plans) to new entrants effective July 1, 2007. Employees hired after that date could only enroll in defined contribution retirement plans. Defined contribution plans provide fixed annual employer contributions to employee accounts that are invested, along with employee contributions. Unlike defined benefit plans, the employee has no guaranteed pension benefit and employers never incur any unfunded liabilities.

The initiative (which has a legislative counterpart by Assembly Member Richman) would establish maximum employer contributions of 9 percent for police officers and firefighters and 6 percent for other employees, assuming participation in federal Social Security (3 percent higher if no Social Security). Local agencies could exceed these limits with a two-thirds vote of their electorate. The state could do so with a three-fourths vote of both houses of the Legislature in two consecutive sessions. Mr. Richman has informed the League in a letter dated February 17 that he is willing to enter into negotiations to avoid the need for the initiative.

In his 2005 State of the State message, Governor Schwarzenegger recommended a defined contribution pension mandate for new state and local employees. In a presentation to the League board of directors on February 25, 2005 Tom Campbell,

Director of Finance, explained the Governor's proposal contains no caps on employer contribution and would not require lower state or local contributions. It would simply remove the risk of increased costs to the taxpayer due to future stock market declines by requiring that all new state and local employees be provided a defined contribution plan in place of the traditional defined benefit plan. Mr. Campbell indicated that in all other respects (e.g., PERS administration, employer contributions, employer contributions, etc.) the plans would be identical.

### **League Pension Reform Task Force**

In late 2004 the Executive Director asked the City Manager's Department's standing task force on PERS to undertake a study of the defined contribution proposal and potential other defined benefit reforms. A group of other appointed and elected officials were subsequently added to the task force to provide broader input, and since early December it has met regularly to study the problems with the existing defined benefit retirement systems and to evaluate the defined contribution proposal. The task force is chaired by Bob LaSala, Lancaster City Manager.

The League also retained the services of a retirement actuary, John Bartel of Bartel Associates, LLC, who worked with the Task Force to ensure its recommendations for reform of the defined benefit system were actuarially sound. He assisted the Board in its discussions. His report to the Pension Reform Task Force, dated February 26, 2005 and entitled *Replacement Ratio Study: Preliminary Results*, is available from the League.

### **Review and Comment on Discussion Draft Sought**

The task force report was reviewed by subcommittee of the Public Employee Relations Policy Committee on Wednesday, February 23, 2005 and forwarded to the League board of directors with a favorable recommendation. On Saturday, February 26, 2005 the board accepted the report, with modifications, and authorized staff to circulate the report as a discussion draft for review and comment. It is important to note the ideas contained in this report represent an initial assessment by the League on pension reform. It is offered for discussion and consideration in the pension reform debate. Comments are requested from League member cities, other local government associations, local government labor organizations, state legislators and the Administration. Comments should be sent to the League of California Cities, c/o Anthony Thomas, Legislative Representative, 1400 K St., Sacramento, CA 95814 [athomas@cacities.org](mailto:athomas@cacities.org).

# A Framework for Public Pension Reform<sup>1</sup>

## March 1, 2005

### General Pension Reform Principles

Any serious discussion of public pension reform must begin with a set of principles/goals to guide any following recommendations. Until questions about the appropriate role and purpose of public pension benefits in local government compensation packages are answered, it would be at least premature and perhaps self-defeating to make any specific benefit recommendations. In keeping with this philosophy, it is recommended that the following principles precede any benefit recommendations:

- The primary goal of a public pension program should be to provide a full-career employee with pension benefits that maintain the employees' standard of living in retirement.
- The proper level of public pension benefits should be set with the goal of providing a fair and adequate benefit for employees and fiscally sustainable contributions for employers and the taxpayers.
- Public pension benefits should be supported with proper actuarial work to justify pension levels. The Legislature should reject any and all attempts to establish pension benefits that bear no relation to proper actuarial assumptions and work.
- Pension benefits should be viewed in the context of an overall compensation structure whose goal is the recruitment and retention of employees in public sector jobs. In recognition of competitive market forces, any change in the structure of retirement benefits must be evaluated in concert with other adjustments in compensation necessary to continue to attract and retain an experienced and qualified workforce.
- The reciprocity of pension benefits within the public sector should be maintained to ensure recruitment and retention of skilled public employees - particularly in light of the retirement of the post World War II "Baby Boom" generation which will result in unprecedented demand for public sector employees.
- Perceived abuses of the current defined benefit retirement programs need to be addressed. Benefit plans which result in retirement benefits which exceed the levels established as appropriate to maintain employees' standard of living should be reformed. It is in the interest of all public employees, employers and taxpayers that retirement programs are fair, economically sustainable and provide for adequate benefits for all career public employees, *without providing excessive benefits for a select few.*

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<sup>1</sup> This report constitutes the recommendations of the League Pension Reform Task Force that was accepted by the League of California Cities Board of Directors for distribution as a discussion draft.

- The obligation to properly manage public pension systems is a fiduciary responsibility that is shared by PERS, employers and employees. This joint responsibility is necessary to provide quality services while ensuring long-term fiscal stability. These parties need to be held responsible to ensure a high level of protection against mismanagement of public resources that could jeopardize a community's ability to maintain services and provide fair compensation for its workforce.
- Charter cities with independent pension systems should retain the constitutional discretion to manage and fund such pension plans.

### **Reform Recommendations**

Public employee defined benefit programs have been appropriately criticized in a number of areas. The following reform recommendations address short-comings within some defined benefit retirement programs, while preserving the aspects of the program that have served the employees, employers and taxpayers of California well for over 60 years.

### **Pension Benefit Levels**

*Principles:* Public pension benefit plans should:

- Allow career-employees to maintain standard of living post-retirement.
- Be designed with consideration of age at retirement, length of service, compensation level and applicability of Social Security.
- Be supported with proper actuarial work to justify pension levels. The Legislature should reject any and all attempts to establish pension benefits that bear no relation to proper actuarial assumptions and work.
- Promote career public service without creating incentives to work past retirement age, nor disincentive to early retirement. Employees who voluntarily choose to either work beyond retirement age or retire early should not be penalized or rewarded.

### *Recommendations*

- Maintain the defined benefit plan as the central pension plan for public employees in California.
- Rollback/repeal public retirement plans that provide benefits in excess of levels required to maintain a fair, standard of living<sup>2</sup> that are not financially sustainable and may have no actuarial justification. The new and exclusive benefit formulas to achieve these goals should be:

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<sup>2</sup> This should be determined in accordance with a Cal PERS 2001 target replacement benefit study and/or the Aon Georgia State Replacement Ration Study (6<sup>th</sup> update since 1988).

1. **Safety Employees:** 3% @ 55 formula, offset by 50% of anticipated social security benefit for safety employees with social security coverage. Safety employees retain the current cap on retirement at 90% of final compensation.
  2. **Miscellaneous Employees(Non-safety):** 2% @ 55 formula, offset by 50% of anticipated social security benefit for miscellaneous employees with social security coverage. A cap of 100% of final compensation is placed on newly-hired, miscellaneous(non-safety) employees.
- The above formulas would incorporate “Three-Year-Average” for “final compensation” calculation. All “Highest Final Year” compensation calculations would be repealed for newly-hired employees.
  - Provide alternatives to a defined benefit plan for job classifications not intended for career public service employment.
  - Give employers greater flexibility to determine when a part-time employee is entitled to public pension benefits. The current hourly threshold in PERS is too low.

## **Rate Volatility**

### *Principles*

- Responsible fiscal planning suggests the need to “manage” volatility in defined benefit plan contribution rates.
- Rates have historically been relatively constant and comparable to rates currently paid by most public agency employers.
- Recent rate volatility is primarily due to large fluctuations in annual investment returns for the retirement plan investment portfolios, causing significant changes in plan funding status.
- Normal Costs for defined benefit plans have remained relatively constant over time.

### *Recommendations*

- Public Agency retirement contribution rates, over time, should be constructed to stay within reasonable ranges around the historical “normal cost” of public pension plans in California. Sound actuarial methods should be adopted to limit contribution volatility while maintaining a sound funding policy.
- Establish “reserve” funding for public pension systems that will help smooth the volatility of pension benefit costs. Plan surpluses are to be retained within plan

assets, but should be reserved for amortization of future unfunded liabilities, and should not be used to offset plans' normal cost contribution rates.

## **Shared Risk**

### *Principles*

- Currently, in most local jurisdictions, employers shoulder the burden of rate volatility risk – both positive and negative. This principle should be carefully examined with the intent of better spreading the risk of rate volatility among both employers and employees.
- Negotiated labor agreements containing language whereby employers “pick-up” employees’ retirement contributions are assumed to be part and parcel of a “total compensation” package; this implies that agencies with Employer Paid Member Contributions would also typically reflect correspondingly lower base salaries.

### *Recommendations*

- When employer contribution rates exceed the “normal costs” threshold, employees should be expected to take some of the financial responsibility for those excessive increases.

## **Disability Retirement**

### *Principles*

- Retirement-eligible employees who are injured in the workplace should be entitled to full disability retirement benefits; disability retirement benefits should, however, be tied to individual’s employability and be structured so as to encourage return to work, where applicable.
- Larger disability reform measures should be considered outside of the scope of general pension reform.

### *Recommendations*

- Full tax-exempt disability retirement should be retained for employees who are injured and can not work in any capacity
- Reform the disability pension provisions of public retirement systems to restrict benefits when a public employee can continue to work at the same or similar job after sustaining a work-related injury.

- Employees eligible for disability retirement should be first afforded applicable service retirement benefits, and THEN provided disability retirement benefits up to applicable “cap” on total retirement benefits.

## **Portability of Plan Benefits**

### *Principles*

- Reciprocity of public agency retirement benefits is critical to recruitment of qualified, experienced public sector employees.
- Limiting portability of retirement plan benefits to non-public sector employment helps in the retention of senior and management level employees.

### *Recommendation*

- Any pension reform package should retain transferability of retirement benefits across public sector employers. No employee currently in a defined benefit plan should be required to involuntarily give up a defined benefit formula before retirement.

## **Tiered Plans**

### *Principles*

- Agencies should strive to avoid multi-tiered compensation structures where there are large discrepancies in benefits accruing to employees. In addition to having adverse impacts on recruitment and employee morale, multi-tiered approaches can raise issues of comparable worth and equity.

### *Recommendations*

- Any pension reform measures should seek to minimize disparity between current and prospective public agency employees.
- Any reduction(s) or change(s) to current Defined Benefit plans should be considered in context of other compensation issues that will tend, over time, to “equate” compensation plans within and across public agency employers.

## **Management Oversight**

### *Principles*

- The obligation to properly manage public pension systems is a fiduciary responsibility that is shared by PERS, employers and employees. This joint responsibility is necessary to provide quality services while ensuring long-term fiscal stability. These parties need to be held responsible to ensure a high level of protection

against mismanagement of public resources that could jeopardize a community's ability to maintain services and provide fair compensation for its workforce.

### *Recommendations*

- Public agencies that do not make the Annual Required Contribution under GASB 27 should be made subject to appropriate oversight.
- The membership of the Public Employees and Retirement System Board should be changed to achieve both a better balance of employer and employee representatives as well as a better balance of public agency representatives.

### **Conclusion**

Defined benefit retirement plans have been the traditional approach for close to 60 years in California and have produced fair and sustainable retirement benefits that have been central to recruiting and retaining quality public employees. Defined benefit plans should be retained as the central component of public pension systems in California.