LEAGUE OF CALIFORNIA CITIES

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# Pension Reform Revisited: 2010 White Paper

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A major policy shift occurred in California's public pension systems in 1999 resulting in a substantial increase to the level of public pension benefits. This shift, along with other economic factors, is now producing a public backlash against public pension benefits. Many Californians, as well as residents of other states, seriously question the amount of public resources being dedicated to public pension costs. This growing public pension debate has become amplified by the global recession that has, among other things, decimated federal, state and local tax revenues used to pay for public services, including pension costs. At the same time, private sector workers are experiencing substantial reductions, or in some cases, the complete loss of their pension funds, not to mention their jobs. This stark contrast between the public and private sectors is adding fuel to the public's discontent over public pension costs. How did we get to this point and perhaps more importantly, what do we do to address it?

## Recent Pension History

Rebounding from a significant recession in the early 1990s, the economy expanded rapidly in the early 2000s. Stock market investments soared, producing a tremendous amount of return on the investments of California's public pension systems.

Investment earnings were so high in the late 1990s that employers were given a "rate holiday" for a number of years and did not have to make employer contributions into their respective pension systems.

Public employee organizations quickly recognized the tremendous earnings on pension fund investments systems and concluded that employers should not be the only group receiving a financial advantage. To "even" the investment largesse, they proposed a series of retirement benefit formula increases. The first round of increases was accomplished in 1999 with SB 400 (Ortiz), which established a new set of retirement formulas for public safety officers. In 2001, just two years later, miscellaneous (non-safety) employees were also provided increased benefit level options with AB 616 (Calderon).

The California Highway Patrol was the first to receive the new benefits. Local governments were given the option to adopt the same benefits for their public safety officers. The state of California also increased benefits for its miscellaneous employees through SB 400 by changing the retirement formula from 2% at 60 to 2% at 55. The 2% at age 55 formula was enacted as an option for local government miscellaneous employees many years earlier.

Benefits grew with SB 400 by increasing the "multiplier factor" in existing formulas. Public safety officers were given a 3% multiplier instead of 2%. A public safety employee with 30 years in the system would receive 90% of salary in retirement: 3 X 30 years of service = 90% X $80,000 final salary = $72,000 as a retirement benefit. Under the previous formulas, that same public safety officer would have received the following benefit: 2 X 30 years of service = 60% X $80,000 final salary = $48,000. A substantial increase in the final retirement benefit. It's important to remember that while this example is mathematically correct, for a public safety officer to receive 90% of his/her final salary at age 50 they would have to begin working at 20, which may not be all that common.

AB 616 provided increased benefits

for miscellaneous local government employees only. The increases were accomplished again by increasing the multiplier factor. Previously, the multiplier was set at 2%. AB 616 established the following optional formulas with the increased multipliers:

2.5% at age 55;

2.7% at age 55; and,

3% at age 60.

These new formulas were not mandatory, but they were subject to collective bargaining. The post-1999 formulas for both safety and miscellaneous employees have been very popular among local governments. Most cities in the California Public Employees' Retirement System (CalPERS) have now adopted some form of the increased benefit options placed into law through AB 661 and SB 400.

## Financial Strain on Public Pensions

The new benefit increases, combined with a significant downturn in the economy in the early 2000s—know as the "Good Recession"—brought a brief period of volatility to California's public pension systems.

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## Pension 101—Sidebar

Defined Benefit Plan: Most public pension systems provide defined benefit plans. This means that a retiree's pension is computed through a formula that incorporates: 1) years of service, 2) age, 3) final salary and 4) a retirement multiplier. For example, an employee with a 30 year public sector career who is 55 years old with a final salary calculated at $100,000 and is covered by a retirement formula that has a 2% multiplier, that employee would receive an annual salary of $60,000 (2 [multiplier] X 30 years of service = 60% X $100,000 = $60,000).

Pension System Revenues: A defined benefit plan has three sources of revenue: 1) employee contributions (a fixed percentage); 2) investment earnings on the system's assets (employee and employer contributions); and 3) employer contributions (percentage varies based on revenue needs that are actuarially determined). When investment earnings on the system's assets are high, employer contribution rates (stated as a percentage of payroll) go down; when investment earnings are down, employer contribution rates go up.

Defined Contribution Plan: A small and diminishing number of defined benefit plans are found in the private sector. Most private sector retirement plans, if a corporation or business has a pension system in place at all, are defined contribution plans. In such a plan the employee contributes as much as possible into the plan and there may or may not be an employer contribution. The amount of money going into the plan is the amount of money an individual has to meet his or her retirement planning. If the amount in the defined contribution plan meets the amount needed to retire, then all is well. If not, then the individual has to make adjustments to ensure that sufficient money is present to meet retirement obligations. Unlike the defined benefit plan, there is no guaranteed benefit amount.

Investment earnings in public pension systems took a nosedive along with all other investments. Public employers who had enjoyed years of no or very low contributions to their pension systems experienced a dramatic increase in employer contributions after most pension systems experienced unprecedented negative investment earnings for two consecutive years. Employer contributions climbed sharply. Funds were diverted from other public sector services to meet rising pension obligations. This economic downturn and its direct impact on pension costs was not anticipated or seriously considered when the rush was on in the Legislature to enact new and higher benefit formulas. All of a sudden, pension contributions began to pull heavily on local resources.

The economic challenges and the effect these new benefit formulas would have on local budgets for years to come compelled the League to take a closer look at the issue. The organization created a task force to examine the genesis of the new pension problems and make recommendations for local governments to consider. These recommendations appeared in the League's 2005 White Paper on the subject and have subsequently served as the basis of League policy in this area.

## Development of the 2005 White Paper

The Pension Reform Task Force used professional actuaries to provide needed technical resources and expertise.

The task force began by asking fundamental questions about the purpose behind public pension benefits in local government compensation packages before addressing the merits of the multiple pension benefit plan options. It concluded that public pension systems have served as a successful tool to recruit and retain a quality workforce. The task force also concluded that a key factor in that success has been the defined benefit plan (please see Pension 101 sidebar on page 3 for information on the defined benefit and defined contribution).

The task force requested that the actuaries make comparisons of the benefit options in California (both pre-and-post 1999) against two models developed to help determine the appropriate level of retirement benefits for public sector employees. One model was developed by CalPERS and another by Georgia State University, known for its Actuarial Science program. These two models contained three primary principles for determining an "appropriate level of retirement benefit" and include:

1. Retirement benefits should be "fair" and recognize the contribution of public employees to the mission of the organization;
2. The retirement system should be established with the goal of providing this benefit to a career employee (defined as 30 years of service); and,
3. The retirement benefit should provide the means to maintain an employee's standard of living in retirement (with the model including an array of factors such as changes in taxation in retirement, personal savings, expenses and other factors).

Using the CalPERS and Georgia State University models, the task force concluded the post-1999 formulas produced retirement benefits that were well above what these models considered as appropriate levels of retirement benefits. Based on this analysis, the task force finished its work by making the following recommendations:

- Defined benefit plans have been a great recruitment/retention tool for local government workforces and should be retained;
- Because retirement benefits under the post-1999 formulas substantially exceeds the amount necessary to meet the three principles in the comparative models, local governments should return to pre-1999 formulas for all new hires coming into public employment;
- All post-1999 benefit options adopted by the California Legislature should be repealed and no longer be options for local governments; and,
- The "highest single year" standard for determining "final salary" in computing retirement benefits has produced far too many, highly-visible and publicly embarrassing incidents of pension spiking and should be eliminated as an option and replaced with a "three highest years average" standard.

In addition to these key elements, the 2005 White Paper recommended that retirement formula options be rolled back to their pre-1999 levels for newly hired public safety and miscellaneous employees and that one single formula be made available for all public safety employees and one single formula be made available for miscellaneous employees. The 2005 White Paper contained a number of other related recommendations.

The 2005 White Paper was approved by the League's Employee Relations Committee as well as the League's board of directors.

## Public Pensions and the Great Recession

A recovery that pushed investment earnings back into the black followed the recession of the early 2000s. For CalPERS, the stock market recovery produced investment returns close to a high of 20% in one fiscal year. However, the apparent return to more robust market conditions did not last.

The stock market rapidly declined in the late summer, early fall 2008. This was partially fueled by the implosion of questionable real estate investments and aggressive investment practices by key financial institutions. A worldwide recession of a magnitude not witnessed since the Great Depression ensued.

California's public retirement systems experienced a huge drop in investment earnings followed by rapidly escalating employer contributions. The volatility of employer contributions has been somewhat eased through actuarial "smoothing" techniques. Unfortunately, retirement system administrators predict that employer contributions will continue to rise to historically high levels and perhaps remain for decades. Public pension systems will need an extraordinary revenue infusion to simply meet normal retirement obligations. Additional revenues will be needed to mitigate the large losses these systems suffered in this recession.

Comments from pension administrators about this financial problem are very telling. The scope and breadth of the financial challenge to sustain current pension levels are formidable, some say impossible. Paraphrased observations from pension administrators include:

*"We will not be able to invest our way out of this financial condition – it is a reality that we will live with for years to come, regardless of market turnarounds."*

*"The employer contribution levels for these pension benefits are simply unsustainable."*

These are the warnings that seriously concern those who are responsible for balancing city, county and special district budgets. The question is where will this revenue infusion come from? If the answer is primarily local governments, administrators at the local level have doubts that these pension benefits can be sustained.

# Pension Reform Revisited

This most recent financial crisis prompted the League to reexamine the 2005 White Paper on pension reform with the League's City Managers' Department taking the lead in this process. As managers of our public institutions, there is widespread concern about the financial ability of local governments, and state government for that matter, to meet predicted pension obligations in the future.

The League's Employee Relations Policy Committee scheduled a meeting in the fall 2009 to begin reexamining the organization's pension reform policy. The committee members heard from representatives of local government labor organizations, including both the Peace Officers Research Association of California (PORAC) and the California Professional Firefighters (CPF).

The response to pension reform from these labor organizations was both pointed and simple: modifications or reforms to public pension systems in order to cope with rising pension costs belong in the local collective bargaining process and should not be addressed from a statewide perspective, whether by legislation or by ballot measure. These labor groups recognize the financial problems facing local governments in California, but ultimately thought this could be best solved locally between employers and employee organizations.

A number of committee members raised concerns at the meeting about the 2005 White Paper's specific recommendation that defined benefit plans should be retained as the primary retirement benefit for recruiting and retaining a quality workforce. They argued that a policy of this nature presupposes the "right" or "best" pension plan for local governments. The committee expressed a preference for a recommendation that was more consistent with the long established League principle of local control; a recommendation that recognized greater latitude for local governments to determine appropriate pension benefit options in local compensation plans.

The League's City Managers' Department also briefed the committee on local government officials' efforts to have regional policy discussions about proper public pension levels. A number of regions have started these conversations that include managers, elected officials and labor organizations. Some areas have already adopted regional policy principles to help guide the inevitable discussion about the sustainability of current pension costs.

The committee went on to make a number of recommendations.

## Employee Relations Policy Committee Recommendations

**1.** *Actuarial Models/Principles Remain Valid.* The assumptions in the actuarial models used to assess CalPERS retirement benefit plans are still valid and should be the basis of any new recommendations on pension reform. Those models were developed by CalPERS and Georgia State University and contained the following principles:

- Public pensions should be fair and sustainable in recognizing the contribution of an employee to the mission of the organization.
- Public pensions should be constructed in such a manner that career employees (defined as 30 years) are incentivized, recognized and rewarded for their contributions to public service.
- Public pension benefits should be set at levels designed to maintain a career employee's standard of living in retirement.

**2.** *1999/2001 Benefit Changes Excessive.* The actuarial analysis done in 2005 clearly suggests that the benefit increases enacted by SB 400 (1999) and AB 616 (2001) produced pension benefits that were in excess of the CalPERS and Georgia State University models. Any local collective bargaining process should consider these principles or conduct a similar actuarial analysis before adopting new benefit policies.

**3.** *Locally Determined Pension Benefits.* The appropriate public pension benefits for any local jurisdiction should be determined through the collective bargaining process. Current benefit levels were set through local collective bargaining and any modifications to those benefits should be determined in the same process. When considering modifications to public pension systems for new employees, defined benefit plans, defined contribution plans, or any combination of the two, along with incentives to increase personal savings for retirement purposes should be fully explored in any analysis.

**4.** *Regional Pension Discussions Endorsed.* The League endorses the regional efforts of city officials to bring about a meaningful public dialogue about the appropriate levels of public pension benefits in any particular region. These regional efforts should also include public employee organizations.

**5**. *Increased Employee Responsibility for Pension Costs.* Employee financial responsibility for public pension costs should be increased above current levels. Employers and ultimately the taxpayers bear far too much of the financial risk in current pension systems.

**6**. *Elected Officials Guide to Public Pensions.* The League should undertake the development of a publication to serve as a guide for elected officials when considering the adoption of and any modifications to public pension benefits.

**7.** *Public Pension Spiking.* The practice of "spiking" pension benefits excessively in the final year(s) of employment is a practice that can and should be eliminated by taking appropriate actions, both at the state and local level. This practice takes a heavy toll on the credibility of public agencies when very visible, highly-paid local employees substantially increase pension benefits in the final years of employment through loopholes in pension laws.

## California Public Policy

The backdrop to this discussion of pension reform cannot be complete without recognition of the realities of public policy development in California. The state of California is solidly deadlocked as a policy-making body. Placing some kind of reasonable control on public pension costs is a growing problem that from all indications cannot be resolved by the current state institutions. The Legislature and the Governor's Office don't appear capable to muster the consensus needed in California to tackle any of the major public problems, including pension reform.

To fill the public policy vacuum left by the state, organizations, special interests, and citizens are increasingly using the initiative process to end-run the state's governing institutions. Public pension reform is an issue that is ripe for this type of public policy end-run.

With the growing sentiment of private sector workers that public pension benefits are too generous, it's likely that the sponsor of a pension reform measure will be an individual or organization who wants to radically alter public institutions. An astute sponsor can easily tap into the growing "pension envy" among private sector workers who have lost their pension plans, perhaps their jobs and are being asked to pay higher taxes for public services during these difficult economic times.

The initiative is the greatest unknown and biggest threat to reasoned public pension reform and needs to be recognized by anyone or any organization that wants to engage in this debate. A measure was submitted to the Attorney General for the November 2010 statewide ballot. It would have seriously altered public sector pension plans. This poorly financed effort will not move ahead to the ballot, but it certainly won't be the last proposal on the subject.

## Conclusion

The League couldn't be more serious about the need to address this public pension problem before it is placed in the hands of the voters by interests who do not have a favorable opinion of public employees, public employment or public service. The League strongly urges employee organizations to join employers in offering a constructive alternative for the public pension reform discussions. The local collective bargaining process is a good place to start these reform discussions, but there is definitely room to talk about reasonable statewide alterations to our public pension systems and this discussion should be framed by a need to ultimately develop public pension systems that are clearly defensible in a public debate.