



How California's Public Pension System Broke (and How to Fix It)

by Adam B. Summers



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Executive Summary

Governments at all levels are struggling to balance their budgets amid falling revenues and rising costs, particularly of government employee pensions. The state of the economy or the stock market is often blamed for poor public pension system health. In reality, pension fund underperformance merely unmasks the volatile—and ultimately unsustainable—nature of the defined-benefit system, particularly at current benefit rates, which are significantly more generous than benefit levels received in the private sector. The defined-benefit structure of the vast majority of government worker retirement plans forces governments (that is, taxpayers) to pay more during recessions to make up for shortfalls in pension fund investments. Not only is the defined-benefit pension system unsustainable, it is unfair to taxpayers in the private sector, who are forced to pay more to recession-proof government workers' pensions even as they are struggling to save for their own retiree health care costs and seeing their own retirement benefits reduced during rough economic times.

Things are markedly different in the private sector. Private sector workers' pay and benefits are determined primarily by economic realities, rather than by special interest influence. Thus, it is no coincidence that private sector businesses began switching to 401(k)-style defined-contribution retirement plans decades ago, and have by now almost entirely abandoned the defined-benefit plan for being too expensive and too unpredictable. Many of the few businesses that have retained defined-benefit plans, largely those in industries characterized by greater labor union strength, have been forced to dump their pension obligations on the Pension Benefit Guarantee Corporation (PBGC), the quasi-governmental agency created in 1974 to insure private sector pensions. During the last decade alone the PBGC was forced to absorb \$1.3 billion in pension claims for National Steel, \$1.9 billion for LTV Steel, \$3.9 billion for Bethlehem Steel, \$3 billion for US Airways, and a whopping \$6.6 billion for United Airlines.¹ Now the auto industry is facing serious pension problems. Last year, the PBGC assumed responsibility for at least a half-dozen auto supplier pensions covering 100,000 workers and retirees, adding more than \$7 billion to the agency's

deficit.² The Big 3 Detroit automakers themselves are also in trouble, with Chrysler facing a \$3.6 billion pension deficit, Ford looking at a \$12 billion deficit, and General Motors confronting an \$18 billion shortfall.³ There is no such “insurer of last resort” like the PBGC for public sector pension plans, but since vested benefits are guaranteed by the California Constitution, taxpayers are the ones who serve this role and are ultimately on the hook for unfunded pension liabilities.

Famous investor Warren Buffett summed up the state of public pension systems in a sobering discussion from the 2007 Shareholder Letter for his Berkshire Hathaway Inc. company:

Whatever pension-cost surprises are in store for shareholders down the road, these jolts will be surpassed many times over by those experienced by taxpayers. Public pension promises are huge and, in many cases, funding is woefully inadequate. Because the fuse on this time bomb is long, politicians flinch from inflicting tax pain, given that problems will only become apparent long after these officials have departed. Promises involving very early retirement—sometimes to those in their low 40s—and generous cost-of-living adjustments are easy for these officials to make. In a world where people are living longer and inflation is certain, those promises will be anything but easy to keep.⁴

While government pension systems across the nation have strained to cope with escalating pension obligations, California is in worse shape than most because of a large increase in pension benefits made a decade ago, raising benefits as much as 50 percent for some state employees and cementing the state’s position as one of the most generous states in the nation in terms of pension and retiree health care benefits.

A recent paper by University of Chicago business professor Robert Novy-Marx and Northwestern University finance professor Joshua D. Rauh calculated California’s unfunded liability at about \$475 billion.⁵ Similarly, an April 2010 Stanford Institute for Economic Policy Research study puts the state’s liabilities at around the half-trillion-dollar mark, estimating them at approximately \$535 billion.⁶ That translates to roughly \$36,000 for each California household.⁷ These newer estimates are much higher than prior reported estimates of about \$63 billion in unfunded pension liabilities.⁸

It is often argued that governments must pay greater benefits to their employees because they cannot pay salaries as high as those in the private sector and they need to offer greater benefits and job security to effectively compete with the private sector for quality workers. While perhaps the argument could be made a generation or two ago, it clearly does not hold true today. Now government employees typically make more, on average, in both wages *and* benefits than their private sector counterparts.

According to the U.S. Department of Labor’s Employer Costs for Employee Compensation report for December 2009, state and local government employees earned total compensation of \$39.60 an hour, compared to \$27.42 an hour for private industry workers—a difference of over 44 percent. This includes 35 percent higher wages and nearly 69 percent greater benefits.⁹ Data from the U.S. Census Bureau similarly show that in 2007 the average annual salary of a California state

government employee was \$53,958, nearly 32 percent greater than the average private sector worker (\$40,991).

Pension Benefit Increases, Benefit Creep and the Growing State Workforce

The adoption of SB 400 in 1999 ushered in an era of dramatic pension increases, including the “3 percent at 50” benefit for the California Highway Patrol, whereby a public employee with 30 years of work experience may retire with 90 percent (3 percent for each year of work) of his or her final salary as young as 50 years old, “3 percent at 55” benefit for peace officers and firefighters, and “2 percent at 55” benefit for other state workers. For police, firefighters and other public safety workers, this represented an increase in benefits of between 20 percent and 50 percent.

California Standard Pension Benefit Formulas Before and After SB 400		
Employee Category	Before SB 400	After SB 400 (Effective January 1, 2000)
Miscellaneous/Industrial	2% at 60	2% at 55
Safety	2% at 55	2.5% at 55
Peace Officer/Firefighter	2.5% at 55	3% at 55
Highway Patrol	2% at 50	3% at 50

Source: California Legislative Analyst’s Office, “State Employee Compensation: The Recently Approved Package,” December 6, 1999, http://www.lao.ca.gov/1999/120699_employee_comp.html.

Moreover, the benefit increases were retroactive, meaning that the aforementioned pension increases of up to 50 percent were, as former *Sacramento Bee* columnist Daniel Weintraub observed, “not only for future employees but for workers whose retirement contributions had been based for decades on the expectation of a lower benefit.”¹⁰ These added benefits now cost the state hundreds of millions of dollars per year. The state will be paying for those benefit increases for decades to come. As a result of these benefit levels, there are 9,111 state and local government retirees in California, such as police officers, firefighters and prison guards, who receive pensions of at least \$100,000 a year (through CalPERS), and an additional 3,065 retired teachers and school administrators who receive pensions over \$100,000 a year (through CalSTRS).¹¹

But the government need not change pension benefit rates to increase benefits. For decades, “benefit creep” has allowed more government employees to move up into higher benefit plans. This is particularly true for “public safety” employees in California. As a *Sacramento Bee* article relates,

Prison cooks, plumbers, groundskeepers, teachers, dentists, business managers, and “audiovisual specialists”—all are among the 70,000 state workers considered police or firefighters, eligible to retire with better benefits than other state workers.

In fact, any worker in a California prison regularly in contact with inmates is considered a police officer, rewarded with a richer public pension for helping safeguard society.

*The same goes for workers in state mental hospitals—from psychiatrists to podiatrists—who supervise patients.*¹²

In the 1960s, roughly one in 20 state employees received public safety pensions. Now it is one in three workers.¹³

Another problem is the sheer number of workers that the state employs (at great cost). Since 1998, the state workforce has grown by over 31 percent, and today the state employs more than 356,000 workers, including the state university systems.¹⁴ Incredibly, the state has added over 13,000 employees since the onset of the economic recession in 2008 and continued hiring even during the worst of the recession.¹⁵

Not only are California government workers getting higher pay than most state workers, but the health care benefits are excessive as well. The state covers approximately 85 percent of health care premiums for active state employees. The benefits are even better for retirees, covering 100 percent of health care costs for retirees and 90 percent of costs for their families. This benefit can cost the state close to \$1,200 a month per retiree, according to CalPERS.¹⁶

The One-Year Final Salary Rule, Pension-Spiking and Double-Dipping

Additionally, California state workers play by different rules than other states. While California uses only an employee's final year salary for the purpose of determining pension benefits, all other states use the average of an employee's final three or five years of salary (or highest three- or five-year period) in order to avoid situations where employees retire soon after receiving their final raise. California once used a three-year average as well, but a provision inserted to SB 2465 in 1990 changed state retirement rules to calculate pension benefits based on an employee's highest salary in a single year. The law was expected to cost an additional \$63 million per year. In reality, it has proven to be 50 percent more costly, totaling more than \$100 million annually.¹⁷

The state and some of its government employee unions have agreed to go back to the three-year average in recent years, albeit through the collective bargaining process rather than the stricter legislative process, though pensions for firefighters, highway patrol officers and peace officers are still based on the one-year final salary rule.

In addition to using the one-year final salary rule to increase retirement benefits, employees may intentionally inflate their final compensation so as to increase their pension benefits, a process known as "pension spiking," by having accrued vacation time, unused sick leave, excessive overtime, shift differentials, education incentives, cashed in auto allowances, uniform allowances, etc., included in their final salaries. The passage of SB 53 in 1993 made it more difficult to spike CalPERS pensions by manipulating final-year pay, although "loopholes in state law make pension spiking easy and legal."¹⁸ State workers can increase their pensions by purchasing up to five years of service, called "air time," which they can count toward their retirement, without paying the full actuarial costs of those benefits.

Workers who have already retired may also “double-dip” to enhance their retirement compensation by returning to work for the state, collecting both a salary and a pension. Some states prohibit the practice or force employees to forfeit their retirement checks when they go back on the state payroll, but it is legal in California so long as employees do not work more than 960 hours in a year, about half-time. According to the *Los Angeles Times*, more than 5,600 state employees are currently “double-dipping” in California, a figure 57 percent higher than a decade ago.¹⁹ “The notion is we have retirement systems so once people stop working they are provided for,” said Alicia H. Munnell, director of the Center for Retirement Research at Boston College. “It seems just not acceptable to taxpayers that people are earning a salary and a retirement check.”²⁰ And former California Assemblyman Keith Richman says that those collecting both a state paycheck and retirement payments are “ripping off the taxpayers.”²¹

California’s liberal workers’ compensation and disability pension rules as to what constitutes a “work-related” injury also invite abuse. State law presumes, for example, that police officers and firefighters suffering from illnesses such as cancer and heart disease were injured on the job, thus automatically qualifying them for disability pensions.²² This has also become a problem for local governments that have adopted this state government policy. Paul Derse, a deputy executive administrator from Ventura County, illustrated the waste that such loose disability retirement rules invite: “We had a four-pack-a-day smoker who was presumed to have cancer from his job.”²³

Unrealistic Actuarial Assumptions

Contributions to defined-benefit plans are based upon actuarial assumptions designed to ensure that the plan is sufficiently funded to cover its benefit payouts. These assumptions include what the average annual pension fund return will be, how much salaries and inflation will increase, how soon employees will retire, how long retirees will live, what disability rates will be, and so on. Complicating matters is the fact that these assumptions must be projected out decades into the future, rendering them little more than educated guesswork. If the actuarial assumptions prove to be wrong and costs are higher than expected, taxpayers are liable for the difference.

One of the major assumptions that has proven to be overly optimistic is the rate at which the pension systems discount their future liabilities. Public pension systems use the average annual rate of return that they expect their pension fund investments to achieve as the discount rate. This tends to encourage riskier investment strategies, which *may* offer higher returns, because this allows pension systems to use a higher discount rate and thus makes liability estimates look lower to the public.

The danger, of course, is that the risk does not pay off and investments underperform, resulting in larger than expected liabilities (as we have now witnessed firsthand). The CalPERS Public Employees’ Retirement Fund, for example, has significantly underperformed its assumed 7.75 percent average rate of return²⁴ for the one-year, three-year, five-year, and 10-year periods.²⁵ CalSTRS has an even more aggressive 8.00 percent assumed rate of return.²⁶ Investor

extraordinaire Warren Buffet has said that such assumptions are much too high, and has set a more reasonable assumption of between 6 percent and 6.9 percent for the pension plan in his own company, Berkshire Hathaway Inc., over the past decade.²⁷ Some financial advisors have suggested that an even lower rate, such as 5 percent, would be more reasonable.²⁸

How Do We Fix It?

Most of the public pension “reform” proposals that have been put forth in California and elsewhere do not go far enough. The entire defined-benefit system is broken, particularly given the cozy relationships between lawmakers and labor union officials, and only a complete overhaul can restore fiscal responsibility to the state’s retirement system. Tinkering with the existing defined-benefit retirement system by implementing a lower tier of benefits or increasing retirement ages does not work because it is too easy to simply increase benefits at a later date. Moreover, preserving the existing defined-benefit pension system would maintain the moral hazard problem that arises from the incentive of policymakers and labor unions to push for benefit increases in the short term when the actual costs of those enhancements will largely not materialize until long after they are out of power.

Switching to a 401(k)-style defined-contribution plan for new employees would afford California lower costs while offering a number of other benefits such as:

- Increasing the stability, transparency and predictability of the annual contribution payments required of the government (i.e., taxpayers)
- Ensuring full funding of the system
- Providing employees greater plan portability and greater freedom to invest their retirement money as they see fit
- Removing political influence from investment decision-making.

While this would have some short-term consequences, requiring the state to effectively deal with significant existing liabilities, it would represent a long-term shift that would ultimately put California on much healthier financial footing.

In devising its new retirement plans, the state should adopt salary and benefit rates that are comparable to those earned in the private sector. Retiree health benefits are much less generous in the private sector, if they are offered at all, so California should reduce its retiree health care benefits, just as private firms have been forced to reduce their health care costs for active workers, and/or require employees to make suitable contributions for their retiree health costs. Several states, including Connecticut, Kentucky and New Hampshire, are now requiring employees to make contributions toward their retiree health care benefits in addition to contributions to their pension plans.

Those who do not work for the government should not be forced to pay for ever-richer benefits for public employees while they are seeing their own retirement funds erode during difficult economic times. In addition, requiring voter approval of future government employee benefit increases—as several local governments, including San Francisco, San Diego, and Orange County, have done—would serve as a final check against unwise, overly generous pension enhancements and excessive labor union influence.

The municipal bankruptcy of the city of Vallejo, due primarily to the city’s inability to meet rising pension costs, served as a wake-up call to governments across the state and the nation. It may already be too late for some others to avoid the same fate, but those that are able, including the state of California, must realize that only significant reform can solve such a significant problem. To that end, they should follow the lead of the private sector and switch to a defined-contribution retirement system with benefits comparable to those received in the private sector for all future government employees, as well as following these recommendations.

Recommendations

1. Perform an evaluation of wages and benefits offered in the private sector and adjust state employee compensation to bring it in line with this standard. Repeat such an evaluation every five years.
2. Close the defined-benefit pension plans for state employees and enroll all new employees in defined-contribution plans for pensions and other post-employment benefits (OPEB) such as retiree health care and dental benefits.
3. Adopt more conservative investment strategies and more conservative discount rate assumptions for current employees’ defined-benefit plans.
4. Begin pre-funding OPEB liabilities for employees already in the current system, with the ultimate goal to achieve full funding.
5. Adopt an amendment to the state constitution requiring all future government employee benefit increases to be ratified by the voters.
6. Adopt an amendment to the state constitution prohibiting retroactive benefit increases.
7. Eliminate “air-time” purchases to reduce pension spiking and discourage early retirement.
8. Require employees who have previously retired to forfeit their retirement checks while they are on the state’s payroll to avoid double-dipping.

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Part 1

Introduction

For a long time now, state and local policymakers and labor unions have looked the other way as growing public pension obligations have increasingly become a fiscal burden, but now the problem can no longer be ignored. Taxpayer advocates and government watchdog groups have been warning for years that state and local governments must address their mounting pension obligations, and now their warnings are proving prescient.

Governments at all levels are struggling to balance their budgets amid rising costs and falling revenues. Unfortunately, it is during times such as this when the nature of the defined-benefit structure of the vast majority of government worker retirement plans requires the government to kick in even more contributions to make up for shortfalls in pension fund investments.

The state of the economy or the stock market is often blamed for poor public pension system health. In reality, pension fund underperformance merely unmasks the volatile—and ultimately unsustainable—nature of the defined-benefit system, particularly at current benefit rates, which are significantly more generous than benefit levels received in the private sector. Even the chief actuary of the California Public Employees' Retirement System was compelled to admit last year that the current system is unsustainable.²⁹

While government pension systems across the nation have strained to cope with escalating pension obligations, California is in worse shape than most because of a large increase in pension benefits made a decade ago, raising benefits as much as 50 percent for some state employees and cementing the state's position as one of the most generous states in the nation in terms of pension benefits. Equally excessive retiree health care benefits exacerbate the state's notoriously chronic budget deficit problems.

The steadily increasing public pension obligations have been described as a “pension tsunami” preparing to swamp government budgets.³⁰ In 2005, Reason Foundation described the situation as a “gathering storm.”³¹ It has now started raining. Unfortunately, California, like many other governments across the country, did not save for a rainy day. In fact, it did quite the opposite: continuing a spending binge without addressing the rapidly increasing costs of state workers' retirement benefits.

Things are markedly different in the private sector. Private sector workers' pay and benefits are determined primarily by economic realities, rather than by special interest influence. Thus, it is no coincidence that private sector businesses began switching to 401(k)-style defined-contribution retirement plans decades ago, and have by now almost entirely abandoned the defined-benefit plan for being too expensive and too unpredictable.

Those businesses in the private sector that have retained defined-benefit plans have suffered in recent years as a result of increasing wages and pension obligations. These are mostly businesses in "legacy" industries characterized by greater labor union strength, and thus higher costs and less flexibility in their wage and benefits levels. First, it was the steel industry, then the airlines, and, more recently, the domestic auto industry. During the last decade, the Pension Benefit Guarantee Corporation (PBGC), the quasi-governmental agency created in 1974 to insure private sector pensions, was forced to absorb \$1.3 billion in pension claims for National Steel, \$1.9 billion for LTV Steel, \$3.9 billion for Bethlehem Steel, \$3 billion for US Airways, and a whopping \$6.6 billion for United Airlines.³² Now the auto industry is facing serious pension problems. Last year, the PBGC assumed responsibility for at least a half-dozen auto supplier pensions covering 100,000 workers and retirees, adding more than \$7 billion to the agency's deficit.³³ The Big 3 Detroit automakers themselves are also in trouble, with Chrysler facing a \$3.6 billion pension deficit, Ford looking at a \$12 billion deficit, and General Motors confronting an \$18 billion shortfall.³⁴

There is no such "insurer of last resort" like the PBGC for public sector pension plans, but since vested benefits are guaranteed by the California Constitution, taxpayers are the ones who serve this role and are ultimately on the hook for unfunded pension liabilities.

It is particularly egregious and unfair to expect taxpayers, the majority of whom are private sector workers struggling to set aside enough money for their own retirement and family's health insurance premiums, to also bear the ever rising costs of retirement and benefits for public sector employees.

California has been spending beyond its means for many years. If it is to right-size its government, it must address the pay and benefits of its over 356,000 employees.³⁵ Efforts to nibble around the edges by slightly altering benefit formulas will prove unsuccessful because they preserve the existing unworkable defined-benefit structure and make it too easy for policymakers to repeat the same mistakes and simply increase benefits again in the future. Moreover, preserving the existing defined-benefit pension system would maintain the moral hazard problem that arises from the incentive of policymakers and labor unions to push for benefit increases in the short term when the actual costs of those enhancements will largely not materialize until long after they are out of power.

Famous investor Warren Buffett summed up the state of public pension systems in a sobering discussion from the 2007 Shareholder Letter for his Berkshire Hathaway Inc. company:

Whatever pension-cost surprises are in store for shareholders down the road, these jolts will be surpassed many times over by those experienced by taxpayers. Public pension promises are

huge and, in many cases, funding is woefully inadequate. Because the fuse on this time bomb is long, politicians flinch from inflicting tax pain, given that problems will only become apparent long after these officials have departed. Promises involving very early retirement—sometimes to those in their low 40s—and generous cost-of-living adjustments are easy for these officials to make. In a world where people are living longer and inflation is certain, those promises will be anything but easy to keep.³⁶

The municipal bankruptcy of the city of Vallejo, due primarily to the city's inability to meet rising pension costs, served as a wake-up call to governments across the state and the nation. It may already be too late for some others to avoid the same fate, but those that are able, including the state of California, must realize that only significant reform can solve such a significant problem. To that end, they should follow the lead of the private sector and switch to a defined-contribution retirement system with benefits comparable to those received in the private sector for all future government employees.

Part 2

How We Got Here

State and local public pension systems across the country are struggling with mounting obligations as a result of overly generous retirement benefits, unrealistic actuarial assumptions and the downturn in pension fund investment performance during the past couple of years as a result of the recession. A recent Pew Center on the States report estimates that states have a combined pension and retiree health care deficit of \$1 trillion over the next 30 years. Even this daunting figure is understated, as it was based on a survey of only about 85 percent of state retirement systems and relied upon midyear 2008 data, missing out on additional pension investment losses incurred during the second half of 2008 and early part of 2009.³⁷

Several other estimates are even higher. A March 2010 *Barron's* cover story pegged the likely pension deficit of the states at about \$2 trillion.³⁸ A Free Enterprise Nation study from earlier this year puts the combined state and local government unfunded liability at \$3.5 trillion.³⁹ And a recent paper by University of Chicago business professor Robert Novy-Marx and Northwestern University finance professor Joshua D. Rauh estimates state pension liabilities alone at between \$3.2 trillion and \$5.2 trillion.⁴⁰

While public pension troubles are widespread, California has got more than its fair share of pension problems. In a separate paper, professors Novy-Marx and Rauh calculated California's unfunded liability at about \$475 billion.⁴¹ Similarly, an April 2010 Stanford Institute for Economic Policy Research study puts the state's liabilities at around the half-trillion-dollar mark, estimating them at approximately \$535 billion.⁴² That translates to roughly \$36,000 for each California household.⁴³ These newer estimates are much higher than prior reported estimates of about \$63 billion in unfunded pension liabilities.⁴⁴ Moreover, the Stanford report estimated that the state would have had to contribute \$200 billion—nearly two and a half times the size of its entire general fund budget—just to have an 80 percent chance of covering at least 80 percent of its pension liabilities in 16 years.⁴⁵ What is worse, this analysis applied to the funds' values as of June 2008—*before* they lost roughly \$100 billion combined during the ensuing fiscal year.

In response to the Stanford study, Governor Arnold Schwarzenegger issued a press release acknowledging the severity of the public pension problem and its consequences for other state programs and priorities:

This study reinforces the immediate need to address our staggering pension debt. According to the study, California taxpayers are on the hook for over a half trillion dollars. That's nearly six times the size of our entire state budget. The consequences are clear: increasingly large portions of state funding for programs Californians hold dear such as schools, parks and health care will be diverted to pay for this debt. That is bad enough, but without reform, pension debt will only grow.⁴⁶

California's pension system is broken and unsustainable. Public pension costs will continue to eat up a large, and growing, portion of state and local budgets. At the state and local levels, governments are increasingly spending more on public employees' retirement costs and less on actual government services like providing police protection, educating our children, or offering health and human services. Schwarzenegger administration Special Advisor on Jobs and Economic Growth David Crane notes that "This year alone, \$3 billion was diverted to (state) pension costs from other programs."⁴⁷ Already, approximately 4.1 million Californians—about 11 percent of the population—are members of one or more of 134 state and local government retirement systems, including around 1 million who currently receive benefit payments.⁴⁸ In a February 2010 *National Review* column, Kent Osband argued:

While wrapped as public-spiritedness, such benefits are actually assaults on future generations. When education bills get padded with extra retirement benefits for teachers, they guarantee that a larger share of future education budgets will be siphoned off to people who no longer teach. That can't possibly help the next generation to learn. Nor can it help the next generation of teachers, who will have to settle for lower pay and worse benefits to keep their states afloat.⁴⁹

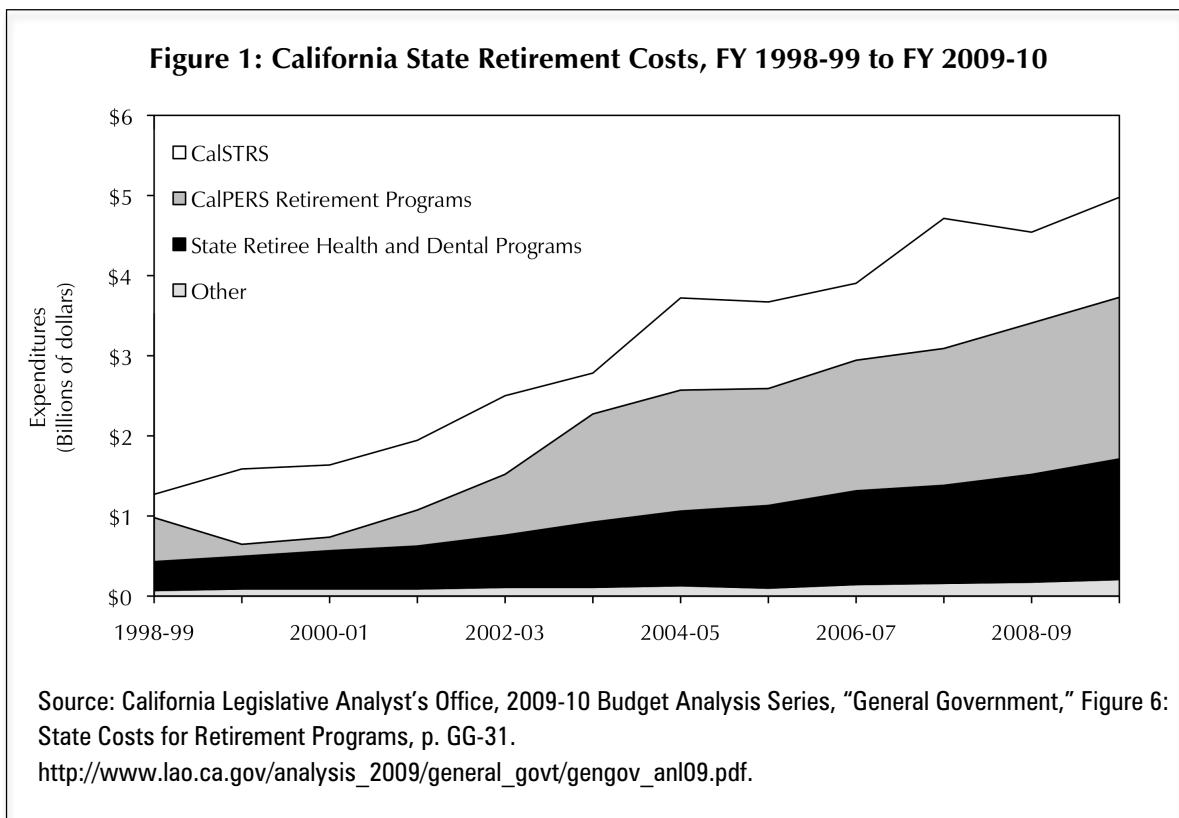
The situation is not going to significantly improve anytime soon. Governor Schwarzenegger's administration has estimated that the official estimates of the state's pension deficit could swell from the aforementioned \$63 billion figure to \$300 billion if pension investments continue to earn less than the anticipated return rates,⁵⁰ and, according to the aforementioned studies, the real costs are likely much higher and will burden the state for decades to come.

Pension funds for the state's two main retirement systems, the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS),⁵¹ have posted staggering losses as the economy dove into recession and investments faltered. Both funds lost roughly one-quarter of their portfolio values, as CalPERS reported a loss of \$56.2 billion for the fiscal year ended June 30, 2009, and CalSTRS posted a drop of \$43.4 billion, for a combined loss of \$100 billion in one year.⁵² CalSTRS reported that it could only cover 77 percent of its future obligations⁵³ (and if pension fund investment losses had not been spread out over a three-year period the system's liabilities would be only 58 percent funded).⁵⁴ This puts it below the 80 percent funding ratio threshold financial experts typically hold up as the mark of a sound government pension system.⁵⁵ This means that the state, as well numerous local governments that have their retirement systems administered by CalPERS, will have to make significantly higher contributions in the near future to offset the pension funds' losses.

These funding troubles led Moody’s Investors Services to downgrade the long-term credit ratings of both CalPERS and CalSTRS by three notches in December 2009. According to Martin Duffy, the company’s vice president and senior credit officer, the action “reflects our expectation that the cumulative back-to-back market value declines in the investment portfolios of both CalPERS and CalSTRS for the fiscal years ended June 2008 and 2009 will exacerbate long-term projected actuarial funding shortfalls, recent market gains notwithstanding.”⁵⁶

Pension costs to the state have skyrocketed over the last decade. In fact, total California pension expenditures have quintupled since FY 1998-99, from about \$1 billion to \$5 billion (see Figure 1), and they are expected to triple again to \$15 billion within the next decade.⁵⁷ Including state and local governments, California taxpayers are already spending \$17 billion to \$18 billion a year for public employee pensions and retiree health care, and costs are increasing at a rate of several billion dollars a year.⁵⁸

Despite a policy of spreading out pension fund investment losses over many years to prevent large, sudden increases in the contributions that must be paid into the system (see “Unrealistic Actuarial Assumptions” below), CalPERS is still requiring the state and local governments that have their pension plans administered by CalPERS to increase their contribution rates by 6 percent to 10 percent.⁵⁹ Unlike CalPERS, CalSTRS does not have the authority to set its own contribution rates, but it plans to petition lawmakers to increase its contribution rates as well sometime next year.⁶⁰



It is an unfortunate characteristic of defined-benefit plans that economic downturns necessitate greater government contributions to the pension system at the very time governments themselves are struggling to cope with falling revenues and can least afford to do so. While the investment losses are often blamed for poor retirement system health, they are merely the symptom, not the disease. Significant swings in the stock market and other investments—particularly to the downside, as we are now experiencing—simply reveal the inherent volatility and unpredictability of the required contributions for defined-benefit plans. The real culprit is the extravagance of government employees' pension benefits.

A. Pension Benefit Increases

The simple answer to how California got into its present pension mess is that it promised more benefits than it could afford. As we shall see, the defined-benefit structure of the state's pension system facilitates this by allowing costs to be hidden or postponed for many years. The final straw, however, was the passage of significant pension benefits increases in 1999. As a result of these benefit levels, there are 9,111 state and local government retirees in California, such as police officers, firefighters and prison guards, who receive pensions of at least \$100,000 a year (through CalPERS), and an additional 3,065 retired teachers and school administrators who receive pensions over \$100,000 a year (through CalSTRS).⁶¹

The adoption of SB 400 in 1999 ushered in an era of dramatic pension increases, including the “3 percent at 50” benefit for the California Highway Patrol, whereby a public employee with 30 years of work experience may retire with 90 percent (3 percent for each year of work) of his or her final salary as young as 50 years old, “3 percent at 55” benefit for peace officers and firefighters, and “2 percent at 55” benefit for other state workers (see the text box below for a more detailed explanation of how benefits are calculated for these formulas). For police, firefighters and other public safety workers, this represented an increase in benefits of between 20 percent and 50 percent (see Table 1).

Table 1: California Standard Pension Benefit Formulas Before and After SB 400		
Employee Category	Before SB 400	After SB 400 (Effective January 1, 2000)
Miscellaneous/Industrial	2% at 60	2% at 55
Safety	2% at 55	2.5% at 55
Peace Officer/Firefighter	2.5% at 55	3% at 55
Highway Patrol	2% at 50	3% at 50

Source: California Legislative Analyst's Office, "State Employee Compensation: The Recently Approved Package," December 6, 1999, http://www.lao.ca.gov/1999/120699_employee_comp.html.

How Defined-Benefit and Defined-Contribution Plans Work

A traditional, or “defined-benefit,” retirement plan spells out the pension amount an employee will draw once he or she retires based on a formula consisting of an agreed-upon multiplier (a fixed percentage rate) and the employee’s final salary and the number of years worked. It also sets a minimum retirement age. The amount of benefits is determined by multiplying the fixed percentage by the number of years worked (usually up to a maximum of 30 years) by the employee’s final salary. Plans are often referred to by their benefit formulas. For example, a “3 percent at 50” plan would allow an employee who had worked for 30 years to retire at age 50 with 90 percent (3 percent times 30) of his or her final salary.

Pension benefits are paid from a combination of employer contributions, employee contributions and investment returns from a pension fund, which is managed by a government pension board. Under a defined-benefit plan, benefit levels are guaranteed by the employer (in this case, the government), and any shortfalls that result after employee and pension fund contributions are made must be covered by the government (i.e., the taxpayers).

By contrast, a defined-contribution plan, such as a 401(k), delineates how much must be contributed to the employee’s retirement plan, rather than what the final benefits will be. Under a defined-contribution plan, the employer contributes an agreed upon amount equal to a certain percentage of the employee’s salary to the employee’s retirement account. This account is controlled by the employee instead of the government, so the employee has greater freedom over his or her retirement portfolio, but also bears the risk of the account’s investment performance. Depending on the plan, the employee may or may not be required to make contributions to the account as well, and sometimes the employer will make additional contributions to match employee contributions up to a certain amount.

Moreover, the benefit increases were retroactive, meaning that the aforementioned pension increases of up to 50 percent were, as former *Sacramento Bee* columnist Daniel Weintraub observed, “not only for future employees but for workers whose retirement contributions had been based for decades on the expectation of a lower benefit.”⁶² These added benefits now cost the state hundreds of millions of dollars per year. The state will be paying for those benefit increases for decades to come.

The bill also eliminated California’s two-tier system for non-safety/industrial employees. California had adopted a second, less generous pension benefits formula for new state workers in 1991 in an effort to control pension costs. Under SB 400, the “1.25% at 65” Second Tier was essentially abandoned and Second Tier employees were moved to the more generous First Tier plan.

The measure was advanced on the flawed assumption that the remarkable pension fund investment gains earned during the late 1990s would continue indefinitely, and that these earnings would cover the vast majority of the additional costs of the benefit increases, so the state and taxpayers would not be on the hook. It was estimated, based on CalPERS's assessment of its "superior return on system assets," that by 2009 and 2010 the annual cost of the benefit increases would be approximately \$650 million. The actual costs to the state are \$3.1 billion for this fiscal year, and \$3.5 billion next year.⁶³ SB 400 passed by a 70-7 margin in the Assembly, and unanimously (39-0) in the Senate.

SB 400 additionally allowed local governments to match the state's pension increases for public safety employees. Numerous local governments then followed suit in order to compete with the state and each other to attract workers. Now they are facing the same pension funding dilemmas as the state, as pension contributions eat up an increasingly large share of their budgets. The city of Vallejo, California was forced into municipal bankruptcy due primarily to its pension obligations, and other local governments across the state may be headed for the same fate.

CalPERS bears as much blame as state legislators for the trend to increase benefits. In addition to strongly lobbying for legislation such as SB 400, CalPERS encouraged local governments that participate in CalPERS plans to adopt higher benefits. In exchange for local government approval of pension increases, CalPERS offered to reduce municipalities' required contributions to the system.⁶⁴ Thus, governments were induced to increase benefits while decreasing the amounts they were contributing to their systems, making funding gaps even larger in the longer term.

A study conducted in 2004 by California's non-partisan Legislative Analyst's Office determined that California's retirement benefits are much more generous than those of comparable states. The study found, for example, that an employee who worked 21 years for the state and retired at age 65 with a final salary of \$65,000 would earn a pension of \$46,500 in California. The same employee would realize benefits of \$40,775 in Texas, \$29,606 in Oregon, \$28,913 in Illinois, and \$28,410 in Florida (see Table 2).⁶⁵

Table 2: California Retirement Benefits Compared to Selected Other States					
State	Employee Retiring in 2004*				Employee Contribution
	Benefits at Age 55	Benefits at Age 60	Benefits at Age 62	Benefits at Age 65	
California	\$25,200	\$36,098	\$40,958	\$46,500	5%
Florida	\$11,914	\$20,424	\$24,439	\$28,410	—
Illinois	**	\$24,250	\$26,115	\$28,913	4%
Oregon	\$15,242	\$24,831	\$26,741	\$29,606	6%
Texas	**	\$34,199	\$36,829	\$40,775	6%

* Assumes employee started working for the state at age 34 and has earned \$60,000 in salary in the last year before retirement.

** Not eligible for retirement at this age.

Source: California Legislative Analyst's Office, *Analysis of the 2004-05 Budget Bill*, "General Government," February 18, 2004, p. F-19, http://www.lao.ca.gov/analysis_2004/general_govt/gengov_anl04.pdf.

Soon after the “dot-com” stock market bubble burst in 2000, just a year after SB 400 was passed, it became clear to many that California’s pension increases were untenable. Public officials are finally coming to this conclusion, too. Gov. Schwarzenegger called the state’s pension benefits “unsustainable” in June 2009,⁶⁶ and at a seminar on pension sustainability in August 2009 Dwight Stenbakken, Executive Deputy Director of the California League of Cities, announced that pension benefits are “just unsustainable” in their current form and difficult to defend politically.⁶⁷ At the same seminar, CalPERS chief actuary Ron Seeling, in a startling admission for one in his position, admitted that the state’s pension benefits are, indeed, unsustainable. “I don’t want to sugarcoat anything,” Seeling said. “We are facing decades without significant turnarounds in assets, decades of—what I, my personal words, nobody else’s—unsustainable pension costs of between 25 percent of pay for a miscellaneous plan and 40 to 50 percent of pay for a safety plan (police and firefighters) ... unsustainable pension costs. We’ve got to find some other solutions.”⁶⁸

Even several state Democratic Party leaders, who are traditionally very sympathetic to government employee labor unions’ interests, have recognized the coming financial crisis caused by expensive pension benefits and cautioned against too-cozy relationships with labor unions on the issue. At an October 2009 joint hearing of the Select Committee on Improving Government, state Treasurer Bill Lockyer warned that without significant reform public pensions will “bankrupt the state.” Lockyer scolded legislators for their role in the crisis and offered a pessimistic view on the prospect of reforming the state’s pension system: “It’s impossible for this legislature to reform the pension system, and if we don’t do it we bankrupt the state. And I don’t think anybody can do it here because of who elected you [labor unions].”⁶⁹ And in a January 2010 *San Francisco Chronicle* article, former Assembly Speaker and San Francisco Mayor Willie Brown wrote:

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.

Talking about this is politically unpopular and potentially even career suicide for most officeholders. But at some point, someone is going to have to get honest about the fact that 80 percent of the state, county and city budget deficits are due to employee costs.

Either we do something about it at the ballot box, or a judge will do something about in Bankruptcy Court. And if you think I’m kidding, just look at Vallejo.⁷⁰

B. Benefit Creep

The government need not change pension benefit rates to increase benefits. For decades, “benefit creep” has allowed more government employees to move up into higher benefit plans. This is particularly true for “public safety” employees. As a *Sacramento Bee* article relates,

Prison cooks, plumbers, groundskeepers, teachers, dentists, business managers, and “audiovisual specialists”—all are among the 70,000 state workers considered police or firefighters, eligible to retire with better benefits than other state workers.

In fact, any worker in a California prison regularly in contact with inmates is considered a police officer, rewarded with a richer public pension for helping safeguard society.

The same goes for workers in state mental hospitals—from psychiatrists to podiatrists—who supervise patients.⁷¹

In the 1960s, roughly one in 20 state employees received public safety pensions. Now it is one in three workers.⁷²

The passage of SB 183 in 2002 continued this trend by reclassifying the 3,200 members of the California Union of Safety Employees (CAUSE) as public safety employees, affording them an immediate 25 percent increase in pension benefits. As a result, milk testers, billboard inspectors, DMV driving examiners, forensic pathologists and deputy directors at the Department of Real Estate (among others) are now included among today’s “public safety” workers. The cost of SB 183 is estimated at \$216 million over 20 years.⁷³

C. State Employee Growth

California’s growing pension obligations have not stopped it from adding to the ranks of its state employees. Since 1998, the state workforce has grown by over 31 percent, and today the state employs more than 356,000 workers, including the state university systems.⁷⁴

Even as California has struggled with a severe economic recession, plummeting revenues and record budget deficits, and Gov. Schwarzenegger issued a supposed hiring freeze, the state continued to hire more workers. Incredibly, the state has added over 13,000 employees since the onset of the economic recession in 2008 and continued hiring even during the worst of the recession.⁷⁵ According to a *Sacramento Bee* analysis, “From June 2008 to February 2009, most state agencies either increased or kept the same number of full-time employees,” resulting in a net increase of about 2,000 workers.⁷⁶

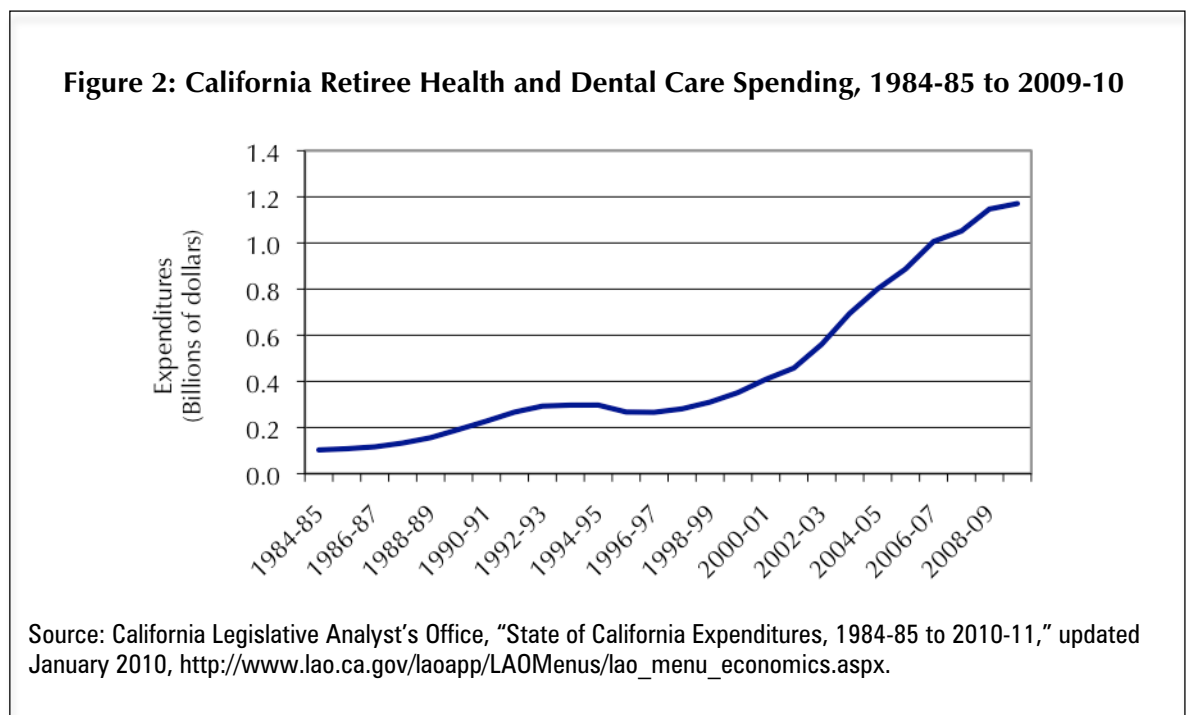
Of course, more workers means more future pension obligations. The state cannot continue to expand at its current rate, particularly during an economic contraction, without plunging itself even further into debt and increasing taxes on a population that is already one of the most heavily taxed in the nation.⁷⁷

Businesses and workers in the private sector have had to adjust to economic realities during the current recession. The government should certainly not be shielded from its effects. To do so would place an increasing and unfair burden on the private sector to prop up government programs

and employees at a time when taxpayers in the private sector are seeing salary and benefit cuts and losing their jobs.

D. The Rising Costs of Retiree Health Care Benefits and Other Post-Employment Benefits

In addition to pension benefits, California offers other post-employment benefits (OPEB),⁷⁸ such as health care and dental benefits, that are extremely generous as well. After remaining fairly stable during the 1980s and 1990s, retiree health care costs started shooting up after 2000, and have more than tripled in the last decade (see Figure 2). These rising costs have led to an unfunded OPEB liability of nearly \$52 billion,⁷⁹ and unless the state starts paying more than the bare minimum needed to fund retiree health care costs each year (this is akin to making the minimum payments on a credit card bill) that total is expected to rise to \$71 billion in 10 years.⁸⁰



As health care costs continue to increase rapidly, they are consuming an ever-larger portion of employee retirement costs. After posting double-digit year-over-year cost increases for most of the last decade, medical cost increases have not slowed down much even during the recession. They rose another 9.9 percent in 2008 and 9.2 percent in 2009, and are expected to rise 9.0 percent in 2010, according to a June 2009 PricewaterhouseCoopers Health Research Institute report.⁸¹

Unlike pension benefits, OPEB are on a pay-as-you-go system, so the liability is not even partially funded. This is an even more expensive way to fund benefits, and the state could save on costs in the long term by making greater contributions in the near term and establishing a trust fund to accumulate assets, referred to as "pre-funding."

The state covers approximately 85 percent of health care premiums for active state employees. The benefits are even better for retirees, covering 100 percent of health care costs for retirees and 90 percent of costs for their families. This benefit can cost the state close to \$1,200 a month per retiree, according to CalPERS.⁸² Retiree health benefits are generally not offered in the private sector, so California should reduce its retiree health care benefits, just as private firms have been forced to reduce their health care costs for active workers, and/or require employees to make suitable contributions for their retiree health costs. Several states, including Connecticut, Kentucky and New Hampshire, are now requiring employees to make contributions toward their retiree health care benefits in addition to contributions to their pension plans. Kentucky requires new employees to allocate 1 percent of their salaries for post-retirement health care and other non-pension benefits, and Connecticut demands that new employees, and current employees with fewer than five years of work experience with the state, contribute 3 percent of their salaries.⁸³

Since the determination of appropriate contribution and benefit levels would still involve a great deal of guesswork concerning future medical cost inflation, mortality rates, Medicare availability and other actuarial assumptions, an even better solution would be to shift to a defined-contribution OPEB plan, medical savings accounts or health savings accounts for state employees.

E. Other Contributing Factors

1. Unrealistic Actuarial Assumptions

Contributions to defined-benefit plans are based upon actuarial assumptions designed to ensure that the plan is sufficiently funded to cover its benefit payouts. These assumptions include what the average annual pension fund return will be, how much salaries and inflation will increase, how soon employees will retire, how long retirees will live, what disability rates will be, and so on. Complicating matters is the fact that these assumptions must be projected out decades into the future, rendering them little more than educated guesswork. If the actuarial assumptions prove to be wrong and costs are higher than expected, taxpayers are liable for the difference.

One of the major assumptions that has proven to be overly optimistic is the rate at which the pension systems discount their future liabilities. Public pension systems use the average annual rate of return that they expect their pension fund investments to achieve as the discount rate. This tends to encourage riskier investment strategies, which *may* offer higher returns, because this allows pension systems to use a higher discount rate and thus makes liability estimates look lower to the public.

The danger, of course, is that the risk does not pay off and investments underperform, resulting in larger than expected liabilities (as we have now witnessed firsthand). The CalPERS Public Employees' Retirement Fund, for example, has significantly underperformed its assumed 7.75 percent average rate of return⁸⁴ for the one-year, three-year, five-year and 10-year periods (see Table 3).⁸⁵ CalSTRS has an even more aggressive 8.00 percent assumed rate of return.⁸⁶ Investor

extraordinaire Warren Buffet has said that such assumptions are much too high, and has set a more reasonable assumption of between 6 percent and 6.9 percent for the pension plan in his own company, Berkshire Hathaway Inc., over the past decade.⁸⁷ Some financial advisors have suggested that an even lower rate, such as 5 percent, would be more reasonable.⁸⁸ Unlike the public sector, private sector pension plans are required by the Financial Accounting Standards Board to base investment return assumptions on corporate bond rates. As of December 2008, the top 100 private pension plans had an average assumed rate of return of 6.36 percent.⁸⁹

Because vested employee benefits are constitutionally protected in California and many other states, the mismatch in the risk of pension plans' investment portfolios and benefit obligations is greater in the public sector. The risk of the state defaulting on pension benefits is virtually zero, yet the state's pension funds utilize aggressive discount rates to reflect the risky investments they must make to achieve their 7.75 percent or 8 percent assumed average annual returns. For this reason, many researchers and financial experts have recommended using more conservative discount rates such as municipal bond or U.S. Treasury interest rates to better match the risk of public pension funds' assets and liabilities.⁹⁰

Criticism of overly aggressive pension fund actuarial assumptions and the significant investment declines experienced by pension funds have prompted several public pension funds around the country to lower their earnings expectations, and now CalPERS and CalSTRS are considering reducing their return assumptions as well, although no decisions are expected before this fall for CalSTRS, and likely not until February 2011 for CalPERS.⁹¹ This would be a prudent move, considering the mounting financial expert consensus that investments will earn less than the pension funds' assumed earnings rates for a prolonged period of time. Even one of CalPERS's own outside investment managers, the chief executive of BlackRock Inc., warned CalPERS officials last summer that investment returns will be "subpar for many years."⁹²

Table 3: CalPERS Historic Investment Returns	
Period	Return
Fiscal year to date ended 7/31/09	-18.15%
3 years for period ended 7/31/09	-2.58%
5 years for period ended 7/31/09	3.50%
10 years for period ended 7/31/09	3.25%

Source: California Public Employees' Retirement System, "Facts at a Glance: Investment," October 2009, p. 2, <http://www.calpers.ca.gov/eip-docs/about/facts/investme.pdf>.

Other accounting tricks can make public pension funds appear to be in better financial shape than they really are. CalPERS, for example, has employed a strategy of "smoothing" pension fund gains and losses over a period of years. While this can be a reasonable strategy to reduce the volatility of government employer contributions to the pension system, as severe investment losses are spread over a number of years so that the local governments that use CalPERS as their pension plan administrator do not have to jolt their budgets to make up shortfalls at once, CalPERS has taken

this strategy to the extreme, allowing losses to be spread over 30 years. By comparison, the most common smoothing period used by other states is five years.⁹³

In 2005, CalPERS changed its policy of spreading gains and losses out over three years to spreading them out over 15 years. In 2009, it adopted a new policy to allow local governments to isolate the extraordinary investment losses of the past two years, phase in the higher extra payments that are required to make up for them over the next three years, and then pay them off over the next 30 years. According to an LAO analysis, this will delay big increases in local government pension contributions (for CalPERS participants) that would otherwise occur in FY 2011-12, but is likely to result in even higher contribution rates by FY 2013-14, “which may persist for the next three decades.”⁹⁴

In adopting the 30-year smoothing policy, allowing governments to underfund the system and postpone higher contribution rates while engaging in riskier investments and wishful thinking that extraordinary market gains in the future will bail them out, CalPERS has repeated the same mistakes that have gotten state and local governments into their dire pension straits in the first place. When the CalPERS plan was unveiled, Gov. Schwarzenegger strongly criticized it, saying, “By deferring pension contributions, CalPERS would not only be gambling that its investment earnings in this economy will grow faster than its pension obligations but would also be using our kids’ money to do so because they are the ones stuck footing the bill.”⁹⁵ Added Schwarzenegger economic advisor David Crane, the plan is “at best imprudent and at worst dangerous to future generations.”⁹⁶ Even CalPERS’s own analysis of its plan contained a cautionary note: “It is important to note that unless the investment markets recover, delaying increases in contribution rates only means that more money will have to be collected in the future.”⁹⁷ Accounting for losses may cause some short-term budgetary pain, but this would be more financially responsible than deferring or hiding the true costs until future generations realize they have been saddled with a much bigger than expected bill.

The trouble with defined-benefit plans is that the true costs of pension benefits may easily be hidden, and pension funding ratios overstated, by overly optimistic actuarial assumptions. These errors may be intentional—to make pension systems appear to be better funded than they really are—or unintentional and simply inaccurate, but, as Edward Siedle, a former Securities and Exchange Commission attorney who now owns a business that investigates government pension fund abuses, observes, “In my experience, every pension fund I’ve ever seen has an actuarial assumption that is more akin to wishful thinking than what is reasonably foreseeable.”⁹⁸ Texas Pension Review Board member Frederick “Shad” Rowe echoes this sentiment: “My experience has been that pension funds misfire from every direction. They overstate expected returns and understate future costs. The combination is debilitating over time.”⁹⁹

2. Demographics

Demographic trends are working against the affordability of defined-benefit plans. People are spending more time in retirement as life spans continue to increase and people retire younger than in the past. Moreover, the Baby Boomer generation is starting to retire, which will only add to pension costs.

According to the Centers for Disease Control, during the 20th century, the average American life span rose by more than 30 years.¹⁰⁰ Of course, the more time spent in retirement, the greater the costs are to employers. Consider the trend in the length of retirement over the second half of the twentieth century:

*When Social Security was invented, life expectancy at age 65 for a man was about 12 years. By 1950, life expectancy had risen to almost 13 years and the average age at which a man applied for Social Security was 68.7. Paradoxically, the average age for applying for Social Security benefits fell to less than 64 in 2000 while expected life at age 65 rose to 15.7 years. **That suggests that the time a typical man spends in retirement has nearly doubled since 1950. This is despite the fact that people are healthier at every age and the physical demands associated with work have fallen as mechanization has increased and the economy has shifted more toward services.***¹⁰¹ (Emphasis added)

Continuing advances in medical technology make it likely that this trend will continue into the future. Thus, it will be more and more expensive to retire in the years ahead. Employers must consider this when establishing or revising their retirement benefit levels.

3. The One-Year Final Salary Rule

One expensive defined-benefit plan unique to California involves the way an employee's final salary is calculated for the purpose of determining pension benefits. All other states use the average of an employee's final three or five years of salary (or highest three- or five-year period) in order to avoid situations where employees retire soon after receiving their final raise, but a provision inserted to SB 2465 in 1990 changed state retirement rules to calculate pension benefits based on an employee's highest salary in a single year. (California had previously used a three-year average.)

As Wisconsin legislative counsel William Ford points out, "Other states have not adopted the one-year formula because they are concerned about the type of problem you have in California. It makes the system easier to manipulate to increase pensions."¹⁰² The law was expected to cost an additional \$63 million per year. In reality, it has proven to be 50 percent more costly, totaling more than \$100 million annually.¹⁰³

The state and some of its government employee unions have agreed to go back to the three-year average in recent years, albeit through the collective bargaining process rather than the stricter legislative process, though pensions for firefighters, highway patrol officers and peace officers are still based on the one-year final salary rule.

4. Pension Spiking

In addition to using the one-year final salary rule to increase retirement benefits, employees may intentionally inflate their final compensation so as to increase their pension benefits, a process known as “pension spiking,” by having accrued vacation time, unused sick leave, excessive overtime, shift differentials, education incentives, cashed in auto allowances, uniform allowances, etc. included in their final salaries. The passage of SB 53 in 1993 made it more difficult to spike CalPERS pensions by manipulating final-year pay, although “loopholes in state law make pension spiking easy and legal.”¹⁰⁴

There are other ways state employees can game the system, too. State workers can increase their pensions by purchasing up to five years of service, called “air time,” which they can count toward their retirement, without paying the full actuarial costs of those benefits.

Workers who have already retired may even enhance their retirement compensation by returning to work for the state and collecting both a salary and a pension. Some states prohibit the practice or force employees to forfeit their retirement checks when they go back on the state payroll, but it is legal in California so long as employees do not work more than 960 hours in a year, about half-time. According to the *Los Angeles Times*, more than 5,600 state employees are currently “double-dipping” in California, a figure 57 percent higher than a decade ago.¹⁰⁵ “The notion is we have retirement systems so once people stop working they are provided for,” said Alicia H. Munnell, director of the Center for Retirement Research at Boston College. “It seems just not acceptable to taxpayers that people are earning a salary and a retirement check.”¹⁰⁶ And former California Assemblyman Keith Richman says that those collecting both a state paycheck and retirement payments are “ripping off the taxpayers.”¹⁰⁷

While air-time purchases and limited double-dipping are legal forms of compensation enhancements, other pension-spiking schemes are simply fraudulent, or encouraged by loopholes in workers’ compensation and disability pension laws. Take the example of “chief’s disease,” for instance. Chief’s disease is the practice of claiming a questionable work-related injury during one’s final year of employment in order to receive greater retirement benefits, and is particularly common among police and firefighter employees (hence, the name). According to the *Sacramento Bee*, over 80 percent of California Highway Patrol chiefs who retired between 2000 and 2004 filed disability claims just before they retired, “though many of the alleged medical problems had been building for years and were common for those in any field who are nearing retirement age.”¹⁰⁸

A successful injury claim allows the employee to take a one-year leave of absence while collecting his or her full salary tax-free. The lack of tax withholding allows the employee to realize a higher salary than he or she would if he or she were working. Thus, the employee benefits from claiming an additional year of service without actually working that full year and also gets to claim a higher salary (one or both of which will increase his pension benefits upon retirement). The filing of the workers’ compensation claim, moreover, opens the door to a disability pension, which grants full

medical benefits and greater benefits to the retiree's spouse upon the retiree's death. On top of that, half of the amount of the disability pension is tax-free.¹⁰⁹

Apart from the obvious fraud problem, liberal workers' compensation and disability pension rules as to what constitutes a "work-related" injury contribute to abuses of the system. State law presumes, for example, that police officers and firefighters suffering from illnesses such as cancer and heart disease were injured on the job, thus automatically qualifying them for disability pensions.¹¹⁰ This has also become a problem for local governments that have adopted this state government policy. Paul Derse, a deputy executive administrator from Ventura County, illustrated the waste that such loose disability retirement rules invite: "We had a four-pack-a-day smoker who was presumed to have cancer from his job."¹¹¹

5. Poor Fiscal Planning and "Contribution Holidays"

Pension systems often get into trouble when the government employer neglects to make contributions as a result of strong pension fund performance. When investment returns are so high that the employer is not required to make any contributions to the system that year, the employer is said to enjoy a "contribution holiday."

As noted above, however, taking a holiday can lead to serious consequences when portfolio performance falters, contribution requirements rise, and the government is left unprepared to adjust its budget accordingly. Governments tend to follow a pattern, however, of spending rather than saving during the good years. Then they are unwilling to cut back, even as revenues (from pension fund investments or taxes in general) do not rise fast enough to support the spending. The correction typically takes years longer than in the private sector.

This is essentially what happened with California during the stock market run-up of the dot-com bubble of the late 1990s. Pension fund performance was so great that the state contributed virtually nothing to the pension system in fiscal years 1999-00 and 2000-01.¹¹² But, as California's coffers were overflowing, largely as a result of capital gains taxes paid on taxpayers' soaring investments, this is precisely the time the state should have been socking away some pension contributions for a rainy day. When the stock market inevitably reversed course, the state was caught unaware and had to make significantly higher contributions for which it had not budgeted.

Part 3

Pension Reform Proposals

It became clear after only a few years that California's enhanced pension benefits were unsustainable. There have been a couple of efforts to fix the system, although no significant reforms have yet been implemented.

In December 2004, then-Assemblyman Richman offered a plan, Assembly Constitutional Amendment 5, that would have switched the state's pension system to a defined-contribution model. (See the following section for more discussion of defined-contribution plans and their advantages over defined-benefit plans.) Under the proposal, all state employees hired after July 1, 2007, would have been enrolled in a 401(k)-style plan. Those that were already in the existing defined-benefit plan would have stayed in this system.

Gov. Schwarzenegger supported a plan like Richman's and prepared to place a proposition before the voters to switch to a defined-contribution system for future employees. However, public safety unions utilized a controversial ruling by Attorney General Bill Lockyer that suggested the proposal did not explicitly protect death and disability benefits and thus would result in their elimination. Gov. Schwarzenegger claimed that this was not his intention and the initiative did not have this effect. In spite of the fact that his proposal had already garnered 400,000 signatures, he pulled the measure and the reform effort died in 2005.

Schwarzenegger revived the idea of pension reform in 2009, although instead of switching to a defined-contribution plan his proposal would scale back the existing defined-benefit plan and create a lower tier of benefits for new state employees. The plan would essentially return benefit levels to those offered prior to the 1999 pension increase, meaning that new workers would receive a smaller portion of their final salaries as pensions and most would have to work five years longer before being eligible to retire. In addition, retiree health care benefits would be reduced and the final salary used to determine pension benefits for firefighters and Highway Patrol officers would be based on a three-year average of their highest earnings, instead of the highest single year of earnings (see Table 4). The governor's office estimated that such changes would save the state \$95 billion over 30 years.¹¹³ "Everyone understands we are running out of money," Schwarzenegger told reporters in July 2009. "We cannot continue promising people things we cannot deliver on."¹¹⁴

Table 4: Schwarzenegger 2009 Pension Reform Proposal		
	Current Pension System	Schwarzenegger Proposal
Pension Formulas		
Firefighters and Highway Patrol Officers	3% at 50	3% at 55
Peace Officers	3% at 50	2.5% at 55
Other State Safety Employees	2.5% at 55	2% at 55
Miscellaneous Employees	2.5% at 63 2% at 55	2.418% at 63 2% at 60
Final Salary Calculation – Firefighters and Highway Patrol Officers		
	Highest single year	Highest 3-year average
Retiree Health Care		
Vesting	State pays 50% of insurance costs after 10 years worked; Portion rises 5% annually thereafter (100% after 20 years worked)	Lifetime benefits only for retirees who have worked for 25 years
State Contribution	100% of premiums	An amount that matches the contribution for active state employees (generally about 85% of premiums)

Source: State of California, Office of the Governor, "Fact Sheet: Reforming State Employee Retirement Compensation," July 1, 2009, <http://gov.ca.gov/index.php?/fact-sheet/12836/>.

Schwarzenegger tried to include the pension reform proposal in the July 2009 state budget deal, but lawmakers balked at addressing the issue and the governor abandoned the effort.

While the Schwarzenegger proposal would be an improvement over the current, overly generous pension system, it would still be just nibbling at the edges when the system needs comprehensive reform. The dozen or so other states, including Nebraska, Nevada, New Jersey, New York and Rhode Island, that are attempting similar pension reforms such as raising retirement ages, reducing benefit formulas, increasing employee contribution rates and cracking down on pension spiking practices¹¹⁵ are likely to come to the same conclusion. Moreover, it would be too easy for the legislature to simply raise benefits again in the future and get the state right back into the same mess it is in now. In order to truly reform the system and return fiscal responsibility to the system, California and other state and local governments must follow the lead of the private sector and switch to a defined-contribution system in line with private sector compensation levels for all new employees.

Part 4

A Way Out: Switch to Defined-Contribution Retirement Plans

A. The Rise of Defined-Contribution Plans

Private sector pension plans have had to face the same demographic pressures and rising pension and health care costs as have government plans. The difference has been in how they have reacted to these rising costs. While private sector firms must compete with each other and offer attractive compensation packages—including pension benefits—to entice the best-qualified workers to work for them, they are also constrained by the need to control costs and maintain profitability. Government does not face this efficiency/profitability constraint since government is the ultimate monopolist and can simply raise taxes, issue bonds or sacrifice service quality to maintain its growth. Hence, governments have been much slower than the private sector to react to rising pension costs.

That said, defined-contribution plans have been growing in popularity within both the private sector and the government. While they first caught on with the private sector, soaring pension and health care costs, combined with the unpredictability of contribution levels associated with defined-benefit plans, have caused the government to take a closer look at them as well in recent years.

The trend toward defined-contribution plans has been substantial. The popularity of defined-contribution retirement plans has boomed since the Employee Retirement Income Security Act of 1974 (ERISA) became effective in 1975. In 1975, approximately 28 percent of all private sector, tax-qualified retirement plan assets were held in defined-contribution plans. This rate remained fairly unchanged until the early 1980s when the emergence of 401(k) plans began a dramatic increase in defined-contribution assets.¹¹⁶ This percentage rose steadily and consistently until 1998, when more than 52 percent of all private plan assets were held in defined-contribution plans, before leveling off somewhat.¹¹⁷

According to the U.S. Bureau of Labor Statistics March 2009 National Compensation Survey, 84 percent of state and local government workers had access to a defined-benefit retirement plan,

including 96 percent of government union workers, while only 30 percent had access to a defined-contribution plan.¹¹⁸ By contrast, a mere 21 percent of private sector workers had access to a defined-benefit plan (although 68 percent of private industry union workers had access to such a plan), compared to 61 percent who had access to a defined-contribution plan.¹¹⁹

The PBGC: Insurer of Last Resort for Private Pension Plans

The Pension Benefit Guarantee Corporation (PBGC) was established by the Employee Retirement Income Security Act of 1974 (ERISA) in response to the high-profile bankruptcy of the Studebaker Corporation and other firms during the 1960s. The PBGC receives no tax revenues, but is funded instead through mandatory insurance premiums paid by pension plan sponsors (employers), as well as investment returns and assets from pension plans taken over by the agency.

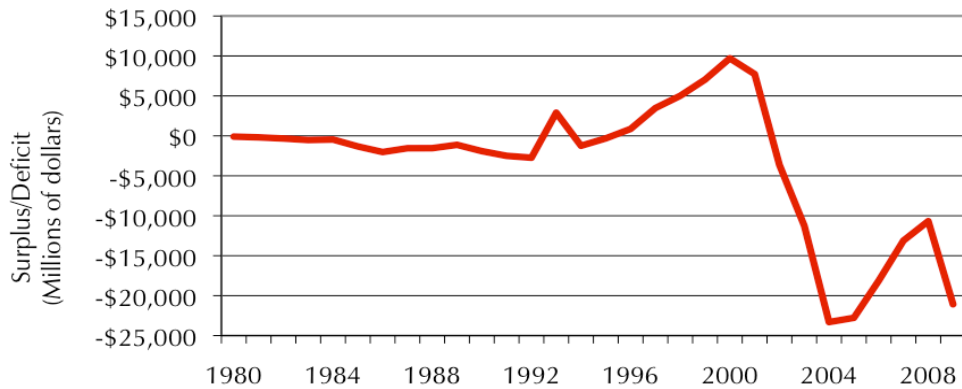
When a company's financial situation becomes so dire that it cannot afford to pay its pension obligations, the PBGC may end, or "terminate" the plan and take over the liabilities, paying out benefits up to a maximum level that is established by law and adjusted annually. For plans ended in 2009 and 2010, workers who retire at age 65 may receive a maximum pension payment of \$4,500 per month, or \$54,000 a year. Once a plan is terminated, employees can no longer continue to earn additional benefits. The PBGC is currently responsible for paying the pensions of nearly 1.5 million people (including about 744,000 who have already retired) in roughly 4,000 plans that have been terminated.¹²⁰

In addition to the "distress terminations" noted above, a healthy company may opt to discontinue its defined-benefit pension plan through a "standard termination" upon payment of all accrued benefits to covered employees and retirees. (Note that in this scenario, the company's pension obligations must be fully funded before the plan can be terminated.)

The increasing number of distress terminations in recent years has put a large strain on the PBGC's finances. After about a quarter-century of stability, the agency's coffers began to take a turn for the worse about a decade ago. The PBGC went from a \$9.7 billion *surplus* in 2000 to a \$23.3 billion *deficit* in 2004, a swing of \$33 billion in just four years (see figure below).¹²¹ It recovered somewhat during the ensuing few years, shaving the deficit roughly in half to \$10.7 billion in 2008 before plunging back down to a \$21.1 billion deficit in 2009.¹²²

The magnitude of the deficits is alarming, especially considering that the PBGC's implicit backing by the federal government means that taxpayers could be on the hook for a bailout similar to that of the savings and loan crisis of the 1980s.

Figure 3: PBGC Surplus/Deficit Single-Employer Program, 1980-2009



Sources: Pension Benefit Guarantee Corporation, *Pension Insurance Data Book 2002*, p.29, <http://www.pbgc.gov/docs/2002databook.pdf>; *Pension Insurance Data Book 2008*, p. 40, <http://www.pbgc.gov/docs/2008databook.pdf>; and *2009 Annual Management Report*, November 13, 2009, p. 6, <http://www.pbgc.gov/docs/2009amr.pdf>.

B. Public Sector vs. Private Sector Pay and Benefits

It is often argued that governments must pay greater benefits to their employees because they cannot pay salaries as high as those in the private sector and they need to offer greater benefits and job security to effectively compete with the private sector for quality workers. While perhaps the argument could be made a generation or two ago, it clearly does not hold true today. Now government employees typically make more, on average, in both wages *and* benefits than their private sector counterparts.

According to the U.S. Department of Labor’s Employer Costs for Employee Compensation report for December 2009, state and local government employees earned total compensation of \$39.60 an hour, compared to \$27.42 an hour for private industry workers—a difference of over 44 percent. This includes 35 percent higher wages and nearly 69 percent greater benefits (see Table 5).¹²³ Data from the U.S. Census Bureau similarly show that in 2007 the average annual salary of a California state government employee was \$53,958, nearly 32 percent greater than the average private sector worker (\$40,991).

Table 5: Average Hourly Public Sector and Private Sector Compensation Cost Comparison, June 2009		
	Private Industry	State and Local Government
Wages and Salaries	\$19.41	\$26.11
Benefits	\$8.00	\$13.49
Total	\$27.42	\$39.60

Source: U.S. Department of Labor, Bureau of Labor Statistics, “Employer Costs for Employee Compensation—December 2009,” March 10, 2010, pp. 8, 10, <http://www.bls.gov/news.release/pdf/ecec.pdf>.

Clearly, the greater benefits of government workers are not justified on any salary discrepancy basis. Quite the contrary, it would seem that government employees are overcompensated in terms of both salaries and wages.

C. Advantages of Defined-Contribution Plans

1. Stability and Predictability of Contribution Levels

One of the greatest benefits of a defined-contribution plan, from an employer's perspective, is that it provides a great deal of stability since contribution levels (i.e., costs) are known in advance and do not change much from year to year. This is a sharp contrast to the volatility in contribution levels experienced under defined-benefit plans. For the government, this is particularly helpful in the budgeting process, as legislators—and the taxpayers on the hook for any funding shortfalls—do not have to worry about being surprised by greater-than-expected contribution requirements when the stock market sours and the pension fund's investment returns plummet. Under a defined-contribution plan, since the employer's contribution is simply the agreed upon portion of payroll, there is no such thing as an unfunded liability. Moreover, if lawmakers decide to increase benefits to government employees (which they still can do) it is transparent and cannot create overnight actuarial liabilities, as happened in California in 1999.

2. Choice for Workers

Defined-contribution plans allow employees the freedom to manage their own retirement accounts and invest their own money as they see fit. People have differing retirement needs and investment goals. They also have different levels of risk aversion. Moreover, risk tolerances and investment strategies change with age. Defined-contribution plans allow employees to choose growth-oriented investments when they are young and then switch to more conservative investments as they approach retirement. Defined-contribution plans offer individuals the freedom and the flexibility to tailor their investment strategies (aggressive, conservative, or some combination of the two) to best satisfy their unique requirements for themselves and their families, rather than forcing participants into a one-size-fits-all investment pool as under a defined-benefit plan.

3. Portability

Since employer retirement contributions are paid directly into individual accounts under a defined-contribution plan, it is easy for workers to take their accumulated funds with them when they change jobs. Upon the employee's departure, both employer and employee contributions can be cashed out and "rolled over" to a future employer's plan. Under a defined-benefit plan, by contrast, only employee contributions may be cashed out.

This portability is particularly appealing to employees in an age where the average worker switches jobs numerous times during his or her career. According to the Bureau of Labor Statistics, the median job tenure in 2008 was 4.1 years, and merely 2.7 years for employees aged 25 to 34.¹²⁴

In addition, the vesting period for defined-contribution plans is typically only a few years, whereas the vesting period for defined-benefit plans is often 10 years or more. Thus, government employees that might have otherwise been vested under a defined-contribution plan may leave their jobs before they are vested in their defined-benefit plans, thereby foregoing any retirement benefits and receiving only their own contributions plus interest. Indeed, this has been a widespread problem in California, where 70 percent of state and local government employees lose all employer contributions because they leave their jobs before satisfying the 10-year vesting requirement.¹²⁵ In Michigan, 45 percent of state workers and 65 percent of public education employees effectively receive no benefits for this reason.¹²⁶ Furthermore, the portability of defined-contribution plans may be especially attractive to women who decide to leave their jobs in order to have children and cannot wait 10 years until they are vested before starting or expanding their families.

4. Younger Worker Appeal

As a TIAA-CREF publication notes, shifting to a defined-contribution plan provides particular benefits to younger workers—a demographic government recruiters are desperately pursuing across the nation:

In a defined contribution plan, contributions made at younger ages will have a longer investment horizon, potentially growing over many years. This is true even if employees terminate service after a few years, since accumulations continue to participate in the accounts' investment experience. In a traditional defined benefit plan, an employee's accrued benefit is generally frozen at the time he or she terminates employment. Even with moderate inflation, these benefits lose a great deal of their purchasing power by the time the employee begins retirement income.¹²⁷

These arguments are supported by various studies that demonstrate potential benefits in defined-contribution plans for younger workers, including higher long-term value of returns.¹²⁸

5. Rational and Individual Investment Choices

No one has a greater interest in the proper investment of retirement funds than the future retiree himself. Government pension boards, by contrast, are inherently political bodies whose investment decisions are often colored by political influence or ideology (as evidenced by the current federal criminal investigation into possible influence-peddling related to CalPERS investment decisions, not to mention a pay-to-play scandal involving New York state pension fund managers that led to six people pleading guilty and a U.S. Securities and Exchange Commission inquiry¹²⁹). Under a defined-contribution plan, depending upon the investment choices offered by the employer, the individual is free to invest in companies for the purpose of furthering a political ideology or

cause—even if it means sacrificing greater returns—but others are not forced to suffer the consequences if such investments offend their values or post sub-par returns.

6. Accountability and Transparency

Since defined-contribution retirement accounts are managed by the participants themselves, and not a government pension board, there is complete accountability and transparency with regard to investment decisions; these decisions are simply the responsibility of the individual participant. Thus, there are no backroom deals, no conflicts of interest, and no need to worry about the lack of financial disclosure—all problems that have plagued the pension boards of government defined-benefit plans.

D. Government Defined-Contribution Plans

While once considered an unthinkable impossibility, growing public awareness of and anger over the scope of public pension problems and the growing gap between public and private sector compensation have led to momentum for a switch from defined-benefit plans to defined-contribution plans for new government workers. A January 2010 Public Policy Institute of California poll, for instance, revealed that 76 percent of Californians view the amount of money being spent on the public employee pension systems as a problem, a significant increase from the response to a similar question in January 2005. In addition, 67 percent (and 70 percent of likely voters) favored changing from a defined-benefit plan to a defined-contribution plan for new public employees. Such a measure was favored by strong majorities across political parties, regions and demographic groups.¹³⁰

All three major candidates for governor have capitalized on the public sentiment by calling for public pension reform. Both Republican contenders, former eBay president and CEO Meg Whitman and State Insurance Commissioner Steve Poizner, have called for moving new state employees to defined-contribution plans, while Democratic candidate Jerry Brown, former California governor and the state's current attorney general, has said that although he supports reform, particularly of retiree health benefits, he does not favor switching to a defined-contribution system.¹³¹

Numerous states—including Colorado, Florida, Indiana, Louisiana, Maine, Michigan, Montana, North Dakota, Ohio, Oregon, South Carolina, Vermont, Virginia and Washington—already offer defined-contribution plans to at least some of their state employees.¹³² Alaska and Michigan have switched completely from their traditional plans to defined-contribution plans, Indiana and Oregon require their employees to participate in both a defined-benefit and a defined-contribution plan, and several others—including Colorado, Florida, Montana, North Dakota, Ohio, South Carolina, Washington and Vermont—offer defined-contribution plans as an option in addition to existing defined-benefit plans. Consider the following examples of government defined-contribution plans:

1. Michigan. All employees hired after March 3, 1997, have belonged to a defined-contribution plan in Michigan. The government employers (departments, agencies, etc.) contribute 4 percent of the employee's salary to the plan and will match employee contributions of an additional 3 percent.

2. Alaska. Alaska became the second state to switch completely to a defined-contribution retirement plan in 2005. Suffering from an estimated unfunded liability of \$5.6 billion and plagued by double-digit increases in medical costs and poor investment returns, Alaska changed its system in an attempt to stem the tide of rising costs and instill a measure of predictability to the state's contribution requirements.

3. Florida. Florida began offering a defined-contribution plan in addition to its traditional plan in 2002. Employees were given the option of remaining in the existing defined-benefit plan, transferring accumulated benefits to the defined-contribution plan, or keeping their accrued balance in the old plan but directing all future contributions to the defined-contribution plan. Employees do not contribute anything to either plan. For 2004, state employers contributed 6.2 percent to the defined-benefit plan and 9 percent to the defined-contribution plan for regular employees.

4. Oregon. While Florida began offering its defined-contribution plan mostly to provide its employees a greater choice in their retirement plans, Oregon chose to revamp its pension system to save money. State employees hired after August 29, 2003, participate in both a defined-contribution *and* a new defined-benefit plan. Now all employee contributions go into the defined-contribution plans and all employer contributions are made to a scaled-down defined-benefit plan. Legislative analysts estimated that the new pension plan would save an estimated \$7 billion over 30 years, although court rulings invalidated portions of the reform, reducing the savings potential.¹³³

5. Nebraska. Nebraska became the first state to shift to defined-contribution benefit plans when the State Employees' Retirement Plan was initiated as a defined-contribution plan in 1964. (Teachers, judges and highway patrol officers remained on defined-benefit plans.) The state then switched from its defined-contribution plan to a hybrid, cash-balance plan (a defined-benefit plan with some defined-contribution plan features) in 2002 (effective January 1, 2003) after a study conducted in 2000 revealed that those in the defined-contribution plan achieved a 6 to 7 percent average annual return versus 11 percent for the defined-benefit (state-managed) plans over a 30-year period.¹³⁴ It would appear that three bad years in the stock market from 2000 to 2002 were the final straw. Under the cash-balance plan, beneficiaries are guaranteed a minimum return of the greater of 5 percent or the federal mid-term rate plus 1.5 percent.¹³⁵

Tellingly, however, there has not been an exodus from the defined-contribution plan. In fact, approximately 70 percent of the members of the defined-contribution plan chose to remain under that plan when the cash-balance plan went into effect.¹³⁶ If the defined-contribution plan was so disastrous, as critics claimed, many more people would have switched out of the plan. Apparently, people value the freedom to make their own retirement investment decisions.

Closer to home, in Pacific Grove, California, voters in November 2008 approved Measure Y, an advisory vote on whether the city should shift out of the CalPERS defined-benefit pension system and establish its own 401(k)-style defined-contribution retirement plan, with over 56% of the vote. According to Mayor Dan Cort, “It’s [the state retirement system is] a burden, expensive, an unfunded liability.” Added Cort, “Cities all across California are being crushed by pensions.”¹³⁷ Pension fund losses have made a switch prohibitively expensive in the immediate term, since the city would have to return to full funding before being allowed to exit the CalPERS system, although the city still plans to leave the system when the pension fund’s investments recover a bit and the transition is not so costly.

In addition, a June 2009 Ventura County Grand Jury report entitled, “Ventura County Pension: ‘An Uncontrollable Cost,’” recommended that the county study switching from its existing defined-benefit system to a combination of reduced defined benefits and a defined-contribution plan.¹³⁸ Unfortunately, the recommendation to move toward at least a partial defined-contribution system has thus far fallen on deaf ears. At the city level, Ventura Mayor Christy Weir even went so far as to write in an August 2009 column for the *Ventura County Star*, “The statewide pension system for state, county, school district and local governments is not financially sustainable. I believe Ventura can be a leader in pension reform. That likely means moving from ‘defined benefit’ plans (which guarantee a certain retirement income and are increasingly costly to taxpayers) to ‘defined contribution’ plans (which are more fiscally feasible) for new employees.”¹³⁹

The TIAA-CREF Institute conducted a best practice benchmark analysis of existing defined-contribution pension plans in the public sector in an April 2008 report. Among the study’s recommended features for a public sector defined-contribution plan were the following:

- Mandatory enrollment of employees in the defined-contribution plan
- A one-year vesting requirement
- A range of investment options, but not too many (no more than 15 to 20)
- A target wage replacement (how much of one’s final earnings are replaced by pension benefits, 401(k) earnings, Social Security benefits, etc.) of 75-85 percent [This seems very high—in fact, it is almost as high as the most generous public safety employees’ pensions currently offered in California—but for the sake of argument, this would translate to a total contribution (including both the employer’s and the employee’s share) of approximately 10-12 percent for employees eligible for Social Security, and 18-20 percent for those who are not.]
- Basic retirement investment information, such as investment advisory services, made available to employees¹⁴⁰

The mere act of switching to a defined-contribution plan will not cure all pension system ills, however. Court decisions have found that government employee pension benefits are protected and cannot be reduced for current employees, so any reduction in benefits would only apply to new hires.¹⁴¹ This means that cost savings from a new, less generous plan would start out rather small,

but would eventually grow and become significant over time as more employees are enrolled in the new system.

Moreover, depending upon the government contribution level, and any additional matching contribution amounts, defined-contribution plans could be just as lavish as defined-benefit plans. A government switching to a defined-contribution plan should, therefore, study private sector defined-contribution plans in order to determine equitable levels of compensation.

Part 5

Voter Approval Requirements

In addition to switching new government employees to a defined-contribution retirement system, the implementation of a requirement that voters ratify any increases in public employees' benefits could serve as a final check against unreasonable or unsustainable public pension benefits.

This has long been the policy in San Francisco. As a result, despite the city's liberal and labor-friendly reputation, it has fared relatively well in terms of its pension funding. By contrast, local governments that have traditionally had more conservative reputations, such as the city of San Diego and Orange County, have experienced serious problems due to rising pension costs.

Although the pension costs racked up by both governments cannot be rolled back and will have to be paid one way or another (with the possible exception of the bankruptcy option), both acted to try to prevent future such problems by adopting voter approval requirements.

San Diego passed its voter approval measure, Proposition B, by an overwhelming 70-30 margin in November 2006. Orange County followed suit in November 2008 when its citizens passed Measure J by an even greater 75-25 margin. County Supervisors' Chairman John Moorlach labeled Measure J "an insurance policy for the taxpayer," because it would prevent the kind of private labor negotiations that led to significant benefits increases in 2001 and 2004, and which were largely rubber-stamped by county supervisors.¹⁴²

Voter approval requirements should likewise be employed at the state level. Voters should have the opportunity to vote on a constitutional amendment to require that future government employee benefit increases be approved by a vote of the people. The labor unions will certainly resist such an effort to put in place an additional check on excessive employee benefits increases, but they must remember that state workers are paid with taxpayers' money, and taxpayers should have a say in how their hard-earned money is spent. History has proven California's political leadership, with the urging and influence of state employees' labor unions, to be imprudent stewards of taxpayers' funds when it comes to government employee compensation. It is time citizens were empowered to put a stop to such abuses of their trust and livelihoods.

Part 6

Conclusions

California's retirement system is broken and in desperate need of reform. Recent poor performance by pension fund investments will put a strain on state and local governments for years to come, as they struggle to make greater contributions to the pension system to compensate while simultaneously trying to balance ever-tighter budgets. But the state's pension system is afflicted by more than just bad luck in the stock market, and these investment losses only exposed the shortcomings of a system that was always prone to volatility.

At the heart of the pension crisis is a set of incentives that encourages policymakers to make decisions for which they do not have to bear the consequences. Since, under a defined-benefit retirement system, lawmakers, pension board members and union officials do not bear the costs of the benefit increases they preside over, there is no incentive for them to show fiscal restraint. Policy leaders get to reap the political rewards of creating lucrative new benefits for employees or underfunding a system and freeing those monies for other purposes in the short term, and in the long term the bills for increased costs they impose on the system will not come due until they are long gone from their positions of power. The predictable result is promises to pay extravagant benefits that the state cannot afford. Even the governor, the state treasurer and the chief actuary of CalPERS now admit that California's pension benefits are unsustainable.

Most of the public pension "reform" proposals that have been put forth in California and elsewhere do not go far enough. The entire defined-benefit system is broken, particularly given the cozy relationships between lawmakers and labor union officials, and only a complete overhaul can restore fiscal responsibility to the state's retirement system. Tinkering with the existing defined-benefit retirement system by implementing a lower tier of benefits or increasing retirement ages does not work because it is too easy to simply increase benefits at a later date—and make those increases retroactive to boot! California witnessed this first-hand merely a decade ago, when pensions were increased in 1999 and the lower benefit tier that had been established in 1991 to address escalating pension costs at the time was eliminated, and those who had been in the lower tier were awarded the higher benefits as well.

Over the past several decades, the private sector has rapidly shifted away from defined-benefit plans for good reason: they are expensive, unpredictable and unsustainable in the long run.

California should follow the private sector's lead in transitioning to defined-contribution retirement for all new employees.

Switching to a 401(k)-style defined-contribution plan would afford California lower costs while offering more stability, transparency and predictability of contribution payments; ensure full funding of the system; provide employees greater plan portability and greater freedom to invest their retirement money as they see fit; and remove political influence from investment decision-making. While this would have some short-term consequences, requiring the state to effectively deal with significant exiting liabilities, it would represent a long-term shift that would ultimately put California on much healthier financial footing. In devising its new retirement plans, the state should adopt salary and benefit rates that are comparable to those earned in the private sector. Those who do not work for the government should not be forced to pay for ever-richer benefits for public employees while they are seeing their own retirement funds erode during difficult economic times. Requiring voter approval of future government employee benefit increases would serve as a final check against unwise, overly generous pension enhancements and excessive labor union influence.

The gap between public and private sector compensation is widening, and taxpayers who are not on government payrolls are getting increasingly sick of working longer, watching their wages and benefits decline with the sagging economy, and paying more of their hard-earned—and dwindling—dollars so that state employees can retire sooner with larger pension checks and better health benefits. It is only a matter of time before a tipping point is reached and taxpayers clamor in sufficient numbers for true reform. Let us hope that day comes soon, for the longer reform is postponed, the greater the unfunded liabilities will become, and the more painful the transition will be in the long run.

Part 7

Recommendations

1. Perform an evaluation of wages and benefits offered in the private sector and adjust state employee compensation to bring it in line with this standard. Repeat such an evaluation every five years.
2. Close the defined-benefit pension plans for state employees and enroll all new employees in defined-contribution plans for pensions and other post-employment benefits (OPEB) such as retiree health care and dental benefits.
3. Adopt more conservative investment strategies and more conservative discount rate assumptions for current employees' defined benefit plans.
4. Begin pre-funding OPEB liabilities for employees already in the current system, with the ultimate goal to achieve full funding.
5. Adopt an amendment to the state constitution requiring all future government employee benefit increases to be ratified by the voters.
6. Adopt an amendment to the state constitution prohibiting retroactive benefit increases.
7. Eliminate "air-time" purchases to reduce pension spiking and discourage early retirement.
8. Require employees who have previously retired to forfeit their retirement checks while they are on the state's payroll to avoid double-dipping.

About the Author

Adam B. Summers is a policy analyst at Reason Foundation. He is also the Managing Editor of Reason's *Privatization Watch* publication. He has written extensively on privatization, government reform, individual liberty, law and economics, public pension reform, occupational licensing and various other political and economic topics.

Mr. Summers's articles have been published by *The Wall Street Journal*, *Los Angeles Times*, *San Francisco Chronicle*, *San Diego Union-Tribune*, *Atlanta Journal-Constitution*, *Orange County Register*, *Los Angeles Daily News*, *Baltimore Sun*, *Los Angeles Business Journal* and many others.

Summers holds an M.A. in Economics from George Mason University and earned his Bachelor of Arts degree in Economics and Political Science from the University of California, Los Angeles.

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Reason Foundation
3415 S. Sepulveda Blvd., Suite 400
Los Angeles, CA 90034
310/391-2245
310/391-4395 (fax)
www.reason.org