70 YEARS OF SERVICE

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INITIATIVE COORDINATOR
ATTORNEY GENERAL'S OFFICE

Hon. Kamala D. Harris
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Ashley Johansson
Initiative Coordinator

Dear Attorney General Harris:

Pursuant to Elections Code Section 9005, we have reviewed a constitutional initiative related to pensions for state and local governmental employees in California (A.G. File No. 13-0043).

BACKGROUND

Government Employee Compensation

Three Main Elements of Compensation. State and local government employers compete with other government and nongovernment employers to attract workers in the labor market. As part of their compensation packages, government employers generally offer full-time employees a salary, retirement benefits (including pension and perhaps retiree health benefits, discussed in more detail below), and health benefits for employees and their dependents.

Compensation for Most Employees Established Through Collective Bargaining. Through the collective bargaining process, government employer and employee representatives negotiate terms and conditions of employment generally culminating in a contract, or "memorandum of understanding." (If an agreement is not reached, state and local collective bargaining laws sometimes provide for mediation and/or a fact-finding process from a neutral third party.) Under certain circumstances, when these efforts have been exhausted after good-faith efforts at negotiating, collective bargaining laws allow employers to declare an impasse and impose terms and conditions of employment for some groups of employees. The process can take several months and is subject to administrative and judicial appeals.

Current law establishes the collective bargaining process for most nonmanagement state and local government employees. These laws establish who is subject to collective bargaining and what elements of compensation are within the scope of collective bargaining. Government employers generally have broad authority to establish compensation for employees who are not subject to collective bargaining. While pension benefits for members of the California State Teachers' Retirement System (CalSTRS) and nonteaching school employees who are members of the California Public Employees' Retirement System (CalPERS) are established by the

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Legislature and generally not subject to collective bargaining, school and community college districts establish other terms and conditions of employment for these employees through the collective bargaining process.

Government Employee Pension Benefits

State and Local Governments Sponsor "Defined Benefit" Retirement Plans for Their Employees. As part of employment, the state provides defined benefit retirement plans for its employees and for those of public schools and community colleges. CalPERS administers the retirement plans for state employees, California State University (CSU) faculty and staff, and nonteaching school and community college employees. The University of California administers its own retirement plan for its faculty and staff. CalSTRS administers plans for school and community college teaching employees. Local governments generally also provide these types of plans for their employees. Some cities, counties, and special districts have their own retirement boards to administer their plans. Most cities, counties, and special districts have CalPERS or their county retirement systems administer their plans.

Pension Benefits Based on Formula. When a government employee retires, he or she receives a pension that is determined using a formula. A typical formula is the number of years of service credited to the employee multiplied by a rate of accrual (determined by the employee's age at the time of retirement) multiplied by the employee's final salary level. Often, retirees receive a cost-of-living adjustment (COLA) each year to at least partially offset erosions in purchasing power resulting from inflation. For example, the rate of accrual for a typical state worker hired before 2007 who retires at the age of 55 years is 2 percent per year. If this employee earns $60,000 in his or her final year of service before retiring after working 18 years for the state, he or she will retire with an annual pension of $21,600 (18 x .02 x 60,000). This pension may increase by up to 2 percent each year, depending on actual inflation. (In the event that the employee's pension allowance falls below 75 percent of its original purchasing power, the state provides additional inflation protection.)

Contractual Benefits. Contracts related to pensions sometimes are included in collective bargaining agreements or in statutes. In other cases, however, they may be "implicit" (or unwritten) commitments based on an employer's past practices. Both the U.S. and California Constitutions contain a clause—known as the Contract Clauses—that prohibit the state or its voters from impairing contractual obligations. Interpreting these Contract Clauses, California courts have ruled for many decades that pension benefits generally vest on the day an employee is hired. As a result, pension benefits for current and past public employees can be reduced only in rare circumstances—generally, when public employers provide a benefit that is comparable and offsets the pension contract that is being impaired or when employers previously have reserved the right to modify pension arrangements. In addition, in some cases, local governments may be able to alter contracts when they seek protection under Chapter 9 of the U.S. Bankruptcy Code.

Defined Benefit Funding. Defined benefit plans have three main sources of funding.

- ***Investment Returns.*** Investment returns are the biggest component of defined benefit funding. In the case of CalPERS, the system reports that most pension benefits paid to

retirees are paid from investment returns. Revenues from investment returns vary significantly year to year depending on market performance. In 2010-11, we estimate that pension systems expected to receive at least $40 billion from investment returns.

- ***Employee and Employer Contributions for Normal Costs.*** The normal cost is the amount estimated to be necessary—combined with future investment returns—to pay for benefits earned by employees in that year. These costs typically are split between the employer and employee, with the employer paying about half (or somewhat more) of the total cost. Statewide in 2010-11, employers' contributions to normal costs totaled over $8 billion. Total employee contributions to normal costs were in the range of several billion dollars.
- ***Employer Contributions for Unfunded Liabilities.*** To the extent that a pension plan does not have enough money over time to pay for benefits, an unfunded liability results. Employers generally bear all of the responsibility to pay for unfunded liabilities. Pension boards typically set employer rates to pay off any unfunded liabilities over a specified number of years—known as an amortization period. The longer an amortization period, the lower an employer's annual costs to pay off any unfunded liabilities but the higher the employer's total costs over the entire amortization period. Because a fund can incur losses or gains in any given year, the unfunded liability—and consequently, the employer's contributions—can vary year to year depending on investment returns. A plan is considered fully funded when actuaries determine that the plan—based on an assumed rate of future investment returns and other assumptions—has sufficient assets to pay for all future benefit payments earned to date. Statewide, public employer contributions for unfunded liabilities in 2010-11 exceeded $8 billion.

In most cases, the amount of resources from each of these three sources fluctuates based on market conditions, actuarial assumptions, and other factors. In the case of funding for CalSTRS pension and related benefits, however, (1) state contributions provide a fourth source of funding (around $1.2 billion in 2010-11) and (2) all contributions (from the state, school or community college district employer, and employees) are fixed in statute.

Large Pension and Retiree Health Unfunded Liabilities. The total unfunded liabilities associated with pension and retiree health plans offered by California government employers is in the range of hundreds of billions of dollars. To close this funding gap, most pension systems have required employers to make additional payments toward pensions. With regard to retiree health plans, most employers do not prefund their plans, but pay benefits to retirees on a pay-as-you-go basis. These health care costs are significant and have generally been rising for most government employers as health premiums and the number of retirees increase.

Efforts to Reduce Pension Costs. Many government employers have made efforts in recent years to reduce their annual pension costs by shifting some of the costs onto employees and/or reducing benefits for future employees. In some cases, these changes were negotiated with employee representatives. In 2012, the Legislature passed legislation making these types of changes for most government pension plans in California. In addition, some local government

employers—including the cities of San Diego and San Jose—have attempted to change benefits for *current* employees. These cities' pension changes are the subject of ongoing legal challenges.

Pension Boards as Fiduciary. In 1992, voters approved Proposition 162. This proposition amended the California Constitution to give the board of each public pension system plenary authority and fiduciary responsibility for investment of moneys and administration of the pension system. As a result of this proposition, the California Constitution makes a pension board the exclusive authority over the investment decisions and administration of its respective pension system. In managing the pension system, pension boards determine how much risk the pension fund should be exposed to by determining the fund's investment asset allocation. The pension board also adopts all actuarial assumptions used to calculate normal cost and unfunded liabilities—including the amortization period of the unfunded liabilities and discount rate. In the case of the discount rate, the board's decision is largely based on its investment strategy and assumed rate of return.

Plan Termination. From time to time, government employers terminate their relationship with a pension board. While the procedures pension boards follow vary, some pension boards require the terminating agency to pay any unfunded liabilities in a lump sum and calculate the unfunded liability using a discount rate that is lower than the discount rate used for active plans. The lower discount rate, which increases the unfunded liability amount, reflects the pension board's assessment that it must invest this portion of the plan's assets to minimize risk.

Government Retiree Health Benefits

State and Many Local Governments Provide Retiree Health Benefits. The state and many local governments provide health benefits to retired employees. In some cases, these benefits expire when an employee becomes eligible to enroll in Medicare; in other cases, the employer-sponsored retiree health benefit becomes a supplemental insurance to the coverage provided by Medicare. Some government employers—including the state—require employees to work for the employer for a specified number of years before the employee is eligible to receive employer-sponsored retiree health benefits.

Few Government Employers Prefund Retiree Health Benefits. Unlike pension plans, few government employers prefund retiree health benefits. That is, most government employers and employees do not make annual contributions to either the normal cost or unfunded liabilities associated with the benefit. Instead, employers pay premium costs for retiree health benefits as they incur after employees have retired—a method of payment referred to as "pay-as-you-go." Some government employers recently have started prefunding these benefits. In 2010-11, the state paid about $1.4 billion towards these benefits for retired state and CSU employees. We estimate that local employers paid an equal or greater sum for these benefits for their employees and retirees.

PROPOSAL

This measure amends the California Constitution to expand the authority of state and local government employers to change public employee pension and retiree health benefits for work performed in the future. Under the measure, the Legislature is considered the government

employer for members of CalSTRS for purposes of pension benefits and school and community college districts are the government employer for purposes of retiree health benefits.

Alters Automatic Vesting for Pension and Retiree Health Benefits for Future Service. Under the measure, pension and retiree health benefits for future government employees would be earned and vested as the employee performs work and only in proportion to the work performed. With regard to current government employees, the measure specifies that their pension or retiree health benefits generally would be considered vested contractual rights only for work the employees have already performed.

Allows Employers to Reduce Pension and Health Benefits for Future Service. A government employer could reduce future pension and retiree health benefits for current and future employees if the government employer (1) finds its pension or retiree health care plan is substantially underfunded and at risk of not having sufficient funds to pay benefits to retirees or future retirees or (2) declares a fiscal emergency. With regard to pension and retiree health benefits, a government employer could (1) reduce the rate of accrual for benefits to be earned in the future, (2) reduce the rate of COLAs to be made in the future, (3) increase the retirement age for benefits earned in the future, (4) require employees to pay a larger share of the cost, or (5) make any other reductions or modifications agreed upon during collective bargaining. If any of the benefit changes are within the scope of collective bargaining, the measure requires the government employer to submit the changes to collective bargaining. If good-faith efforts at negotiating, mediation, and/or fact-finding have been exhausted, the measure appears to permit employers to impose—to the extent permissible under collective bargaining laws for some groups of employees—the benefit changes summarized above under numbers one through four. In cases where these changes are not within the scope of collective bargaining, the government employer could implement the changes directly.

Requires Most Employers to Develop Pension and/or Retiree Health Care Funding Status Reports. The measure requires government employers to prepare a funding status report for any pension or retiree health plan with assets equaling less than 80 percent of its liabilities. The report must specify actions designed to fully fund the benefit plan within 15 years—including any changes in benefits or employer and employee annual costs. The government employer would be required to hold a public hearing on the funding status report (or reports) each year until the benefit plan's actuary finds that it is fully funded.

Restricts Pension Plan Administrator Authority in Certain Cases. The measure requires retirement plan administrators to use the same discount rate in their management of plans that have been modified, frozen, or terminated as they use for active plans. Pension boards could not use different discount rates to account for different asset allocations between plans.

Requires Employers With Terminated Plans to Make Annual Payments. The measure requires retirement plan administrators to establish contributions for employers with terminated plans using the same amortization schedule and other methodologies that govern the retirement plan administrator's other plans. This means that—instead of current practice where some terminating employers make a one-time payment of the unfunded liability calculated with a lower discount rate—terminating employers would make annual payments to the unfunded liability calculated with the same discount rate as other plans.

FISCAL EFFECTS

There is significant uncertainty as to the measure's fiscal effects on state and local governments. The measure gives government employers authority to reduce current and future government employee retirement benefits for work not yet performed. Many of these provisions could be subject to a variety of legal challenges, including suits alleging that the measure impairs contract obligations under the U.S. and/or California Constitutions. Our analysis discusses the possible fiscal effects for state and local governments assuming the measure's provisions are fully implemented.

Report Development and Plan Administrator Costs

Developing Funding Status Reports. Based on the current funding status of government employee pension and retiree health plans, most government employers would be required to develop funding status reports for their pension and retiree health plans. Because California has several thousand public agencies and most employers have multiple pension and retiree health plans, the measure could require government employers statewide to prepare over 8,000 reports. The cost to government employers to develop these reports and update them annually until fully funded (possibly 15 years or longer) would depend on many factors, including the extent to which they relied upon actuarial and legal specialists to develop them or used standard cost estimating models developed by plan administrators. If the average cost to develop a report was in the range of $5,000 to $20,000, the total statewide costs to develop the reports would be in the range of tens of millions to hundreds of millions of dollars. The annual costs to government employers to update these reports likely would be less.

Plan Administrator Costs. Pension and health plan administrators likely would experience some administrative costs to comply with the terms of the measure. These costs—which would be passed on to government employers—could include costs to (1) modify information technology systems to reflect reductions in benefits provided to employees for future work and (2) provide each agency in a "pooled" pension plan with agency-specific information regarding its funding status. (Plan administrators frequently pool the pension assets and liabilities of smaller government employers to achieve economies of scale.) Overall, these administrative costs to state and local governments are not known, but could total tens of millions of dollars initially and likely lesser sums annually thereafter.

Potential Net Decrease in Annual Personnel Costs

Potential Reduced Personnel Costs… The measure gives government employers the authority to reduce pension and/or retiree health benefits earned for future work performed by (1) employees hired after the date this measure is approved, (2) managers and supervisors not subject to collective bargaining, and (3) teachers and other employees whose pension and/or retiree health benefits generally are outside the scope of collective bargaining. In addition, the measure increases government employers' authority to negotiate changes in benefits for other government employees through the collective bargaining process up to and including—when applicable—imposing such changes after negotiating efforts have been exhausted. Government employers could use this authority to reduce their costs for pensions and retiree health care by decreasing benefits and/or shifting a share of these costs to employees. Because government

employers currently pay over $20 billion each year for pensions and retiree health care, even small changes (such as reducing future benefits or shifting a share of the normal costs to employees) could result in major near-term savings by government employers, potentially in the range of hundreds of millions of dollars each year or more. Over the longer term, benefit reductions could result in savings in the billions of dollars annually.

... Offset by Increases in Other Elements of Compensation. The potential savings discussed above would be at least partially offset by increases in salary and/or other elements of employee compensation. The magnitude of these potential offsetting costs relative to the savings from government actions discussed above would likely vary significantly by employer. In some cases, for example, a government's annual savings from reducing its costs for retiree benefits could be fully offset by pressure to increase wages or other benefits paid to employees. In other cases, however, governments would only agree to compensation changes that resulted in net savings over time.

Potential Long-Term Net Savings to Pay Unfunded Liabilities

Potential Increased Costs to Implement Funding Status Reports. The total unfunded liabilities associated with pension and retiree health plans offered by California government employers is in the range of hundreds of billions of dollars. In the case of government pension plans, most employers are making payments towards these liabilities based on an approximately 30-year amortization period. With regards to retiree health plans, most employers do not prefund their plans, but pay benefits to retirees on a pay-as-you-go basis. Under the measure, most employers would be required to create detailed funding status reports specifying actions designed to fully fund their pension and retiree health plans within 15 years. Using a 15-year amortization period to pay pension and retiree health unfunded liabilities would greatly increase government employer costs relative to what is paid today—possibly by tens of billions of dollars annually for at least the next 15 years. While the measure does not require government employers to implement the provisions in their reports, some government employers might take some actions to do so in response to the measure's provisions enhancing public visibility of these unfunded liabilities. While the amount of these potential increased contributions by state and local government cannot be predicted with precision, the sum could be major—potentially hundreds of millions or billions annually over the next few decades if government employers choose to change their funding practices.

Accelerating Payment of Liabilities Reduces Future Costs. To the extent that some government employers increase employer and/or employee contributions in the near term to accelerate payment of pension and retiree health liabilities, those government employers could increase their retirement funds' assets and investment returns and dramatically reduce the amount of employer contributions needed over the long term. These state and local government savings would depend on the extent to which these government employers contribute additional resources to accelerate payment of their unfunded liabilities. These government employers would experience major savings, beginning in a few decades. Over time, this future savings generally would more than offset the higher near-term costs associated with accelerating payment of the liabilities.

Other Effects

Savings and Long-Term Costs for Terminated Plans. The measure changes how pension plan administrators calculate unfunded liabilities for government employers that terminate pension plans in the future. Under the measure, pension plan administrators no longer could require these government employers to pay unfunded liabilities in a lump sum calculated using a lower discount rate. Instead, the plan administrator must establish employer contributions for unfunded liabilities using the same amortization schedule and other methodologies that they use for other plans. This change would have different fiscal effects on employers, depending in part on whether they were planning to terminate their pension plans under current law. Specifically, employers that would have terminated their plans under current law could experience short-term savings and higher long-term costs under the measure. It is not possible to determine the magnitude of these fiscal effects on these employers. In other cases, however, employers may decide to terminate their pension plans due to the measure's provisions that reduce the up front costs associated with a plan termination. Over the long term, these employers terminating their pension plans could realize significant savings—particularly if the employers do not replace their terminated pension plans with other defined benefit pension plans. The amount of these savings would depend, in part, on other actions the employer takes to increase salary or other benefits to employees.

Potential Broader Economic Effects. The potential reduction in government spending for pensions and retiree healthcare also could have broad effects on the economy that are difficult to predict. For example, some public employees might spend less of their salaries during their years of active employment and invest these funds in private retirement savings plans. This could affect the level of state and local tax revenues and the level of resources available for capital investment. Alternatively, some public employees might not increase their savings and find that they have insufficient funds to support themselves in retirement. This could increase the likelihood that some government retirees eventually rely on health or social services funded in part by state and local governments. The magnitude of these indirect economic effects would in all likelihood be smaller than the direct effects on employer costs and employee wages.

Summary of Fiscal Effects

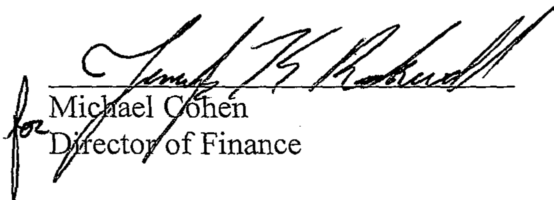
This measure would result in the following major fiscal effects for state and local governments.

- Potential net reduction of hundreds of millions to billions of dollars per year in state and local government costs. Net savings—emerging over time—would depend on how much governments reduce retirement benefits and increase salary and other benefits.
- Increased annual costs—potentially in the hundreds of millions to billions of dollars—over the next two decades for those state and local governments choosing to increase contributions for unfunded liabilities, more than offset by retirement cost savings in future decades.

- Increased annual costs to state and local governments to develop retirement system funding reports and to modify procedures and information technology. Costs could exceed tens of millions of dollars initially, but would decline in future years.

Sincerely,

Mac Taylor
Legislative Analyst



Michael Cohen
Director of Finance