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March 4, 2005

Hon. Bill Lockyer
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Tricia Knight
Initiative Coordinator

Dear Attorney General Lockyer:

Pursuant to Elections Code Section 9005, we have reviewed the proposed statutory initiative regarding retirement plans (File No. SA2005RF0061).

BACKGROUND

State and Local Governments, Many Businesses Sponsor "Defined Benefit" Retirement Plans for Their Employees. As part of employment, the state and local governments provide defined benefit retirement plans for employees, including teachers. In addition, many businesses sponsor defined benefit retirement plans for their employees. Defined benefit plans provide a guaranteed annual pension based upon age at retirement, years of service, and some period of highest salary. These plans can provide an annual cost-of-living adjustment and additional inflation protection that maintains purchasing power over time at a specified minimum level.

Defined Benefit Funding. Defined benefit plans have three main sources of funding—employee contributions, employer contributions, and returns on assets invested by the retirement boards that administer the plans. Investment returns are the biggest component of defined benefit funding.

Employee contributions are typically fixed. Employer contributions usually exceed employee contributions and vary annually, depending on returns from assets invested and other factors. Less-than-assumed investment returns require higher future contributions, while returns that exceed expectations result in reduced contributions.

Employer Contribution Consists of Two Parts. The annual employer contribution for retirement is comprised of two parts—the "normal cost" and the "unfunded liability/actuarial surplus." The normal cost is the average annual cost (generally based on a percent of payroll) of a defined benefit plan. Normal cost contributions collected

over the working life of an employee, combined with employee contributions and investment earnings, should be sufficient to pay that employee's future retirement benefits. For various reasons—such as lower-than-expected investment returns—pension fund assets can fall short of benefit liabilities, resulting in an unfunded liability. (An actuarial surplus, by comparison, occurs when investment returns have provided more assets than necessary to pay future retirement benefits.) Unfunded liabilities are typically addressed through "add-on" employer contribution rates. Retirement plans spread out payment of unfunded liabilities, usually over 10 to 30 years, to "smooth" the impact on these rates.

Plans Vary. There is some variation in defined benefit retirement plans. In general, employer contributions for public safety employees are higher than for other employees. For instance, the retirement formula for state correctional officers and firefighters is "3 percent at 55." This means that officers retiring at age 55 receive 3 percent of their highest year's pay for each year of service. Thus, at age 55 a 25-year career officer would earn a pension equal to 75 percent of final salary. (The state formula for highway patrol officers is more generous, offering 3 percent of salary at age 50.) The state formula for most other employees is "2 percent at 55."

KEY PROVISIONS

Defined Benefit Programs for Private Sector Employees

The measure establishes a defined benefit retirement plan for private sector workers not currently covered by a plan with specified benefit and contribution levels. This new plan would apply to all individuals who work at least 40 hours per month for an employer with gross revenues exceeding $2 million annually. (The plan would include many seasonal and part-time workers.) The benefit formula would be 2 percent at 55 for nonsafety employees and 3 percent at 55 for employees who protect the public or have physically demanding work requiring the use of safety equipment (paramedics and heavy construction workers, for example). Pension amounts could not exceed 100 percent of pay earned in the highest year of compensation. For time worked prior to the passage of the measure, individuals would generally receive retirement service credit for one-half of their time in the workforce. These retirement benefits could be reduced by majority voter approval on a statewide ballot.

Funding

The retirement benefits would be funded by employee and employer contributions. Employee contributions would be set at (1) 1 percent for wages up to 200 percent of federal poverty guidelines and (2) 4 percent for wages above that level. Employees could choose to defer or not pay these contributions. Any employee contributions not

made by the time of retirement would result in a correspondingly reduced pension to account for foregone employee contributions and interest.

Employer contributions would vary annually to fund accrued benefits on an actuarial basis. The Employment Development Department would collect these contributions at the same time as unemployment insurance tax collections. The measure prohibits employers making certain employee status changes (for example, moving to independent contractor status or temporary staffing, reducing wages or number of hours, relocating employees, or terminating and rehiring employees) to avoid making retirement contributions.

Existing Defined Benefit Plans Could Be Exempted

Employers with existing defined benefit plans could receive a full credit against contributions if their retirement plans fall into one of several categories. These include:

- Plans administered pursuant to collective bargaining agreements.
- Plans that comply with federal pension law, assuming that (1) assets are held in a trust that is independent of the employer, (2) benefits meet or exceed those established under the measure, and (3) employee contributions are no more than those established under the measure.
- Plans administered by current state and local government retirement programs, as long as benefits are not reduced below their August 1, 2004 levels.

Governance

The measure establishes the California Employee Retirement Board to administer the new retirement plan. Like other retirement boards, the board created by the measure would have independent authority largely outside of the state's oversight.

The board would initially consist of seven nonsalaried members:

- Three gubernatorial appointees who would represent small business, organized labor, and retirees.
- The Senate Rules Committee and Speaker of the Assembly would appoint one member each.
- The State Controller and State Treasurer.

Once the retirement fund balance reached $8 billion, the board would expand to 15 members, who would begin receiving salaries (except for the Controller and Treasurer). The eight additional members would be elected—four by Board of Equalization districts and four statewide. The measure requires the board to contract

with the Public Employees Retirement System to administer the program until the fund balance reached $10 billion. After that, the board could assume any administrative duties at its discretion and hire an administrator and chief actuary. The board could obtain a General Fund loan for start-up costs until employer contributions were collected.

FISCAL EFFECT

Impact on Private Sector Retirement Costs

Of California's private sector workers, about one-half—7 million individuals—do not participate in a work-related pension plan. In addition, another one-quarter—3.5 million individuals—participate in defined contribution retirement programs. In most cases, the costs of the retirement plan under the measure would be more expensive than these current defined contribution programs. Consequently, businesses employing at least three-quarters of private sector workers would face higher retirement costs under the proposal. In addition, it is not clear how many existing defined benefit plans in the private sector comply with the exemption conditions specified in the measure. As a result, it is possible that some businesses with defined benefit retirement programs would be required either to enhance their pension plans to meet exemption criteria and/or transition to the proposed program.

Based on the above information regarding the number of employees potentially affected by the measure, salaries of private sector employees, and the estimated normal cost of the new plans, we estimate that this measure would result in added private sector retirement costs in the range of $30 billion to $40 billion annually.

Impact on State and Local Revenues

How businesses and individuals responded to the requirements of this measure would determine the impact on governmental revenues. Businesses facing these higher retirement costs would first look to ways to offset these costs through reductions in other forms of compensation. This could be achieved through reductions in the costs of other benefits and slower growth in wages. If much of the new retirement cost was offset in these ways, there would be a major impact on state personal income tax payments. This is because a large portion of compensation would shift from a taxable form (wages) to a tax-deferred form (retirement). Under this scenario, the state could experience revenue reductions for the foreseeable future in the range of $1 billion annually. (In the longer run, such losses would be offset somewhat by increased tax payments on higher retirement income.)

Alternatively, if businesses could not offset much of these added costs, they would attempt to recoup costs through higher product prices. This would be difficult, however, for those businesses operating in national or international markets. As a

result, they would face a reduction in profits and some could reduce operations in California. Under this scenario, the measure would likely result in a decline in employment and business activity in the state relative to what would otherwise have occurred. If much of the added retirement cost was absorbed by businesses, this would result in reduced corporate tax payments. The magnitude of this revenue loss also could be in the range of $1 billion annually.

The actual impact on state income tax revenues—as well as other state and local revenues—would depend on how businesses and individuals actually responded to these added retirement costs. While there would be both increases and decreases in tax revenues, we believe there would likely be a net major reduction in annual state revenues.

Impact on Public Sector Expenditures

The measure could have numerous impacts on state and local government spending:

- State and local governments provide various services through private sector providers—primarily in the health and social services areas—that could experience increased retirement costs as a result of the measure. These include community-based service providers paid through the Department of Developmental Services, in-home supportive services, and contracted work such as janitorial services. There may also be some state and local government temporary or seasonal staff who currently do not participate in public sector defined benefit programs but would be subject to the measure's provisions.
- By prohibiting public sector retirement programs from reducing benefits below August 1, 2004 levels, the measure would also "lock in" current benefit levels for all future employees. This would preclude any cost-saving retirement changes for future employees—an option that the state and local governments currently have.
- To the extent the number of job opportunities, and therefore employment, decline as a result of the measure, state and local governments could incur additional costs to provide various health and social services to the unemployed. These services include the Medi-Cal program, the California Work Opportunity and Responsibility to Kids (CalWORKs) program, and indigent health care services. The additional costs of these services are unknown.
- These additional costs from the above factors would be offset to some extent by savings that result from reduced Supplemental Security Income/State

Supplementary Program benefits provided to those who receive more retirement income from the proposed defined benefit plans. This is because the increased income would lower the benefit levels for which they are eligible.

Summary of Fiscal Effects

This measure would result in the following major fiscal effects on state and local governments:

- Net reduction in state revenues, potentially in the range of $1 billion annually.
- Unknown annual state and local governmental costs as a result of the measure.

Sincerely,

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Elizabeth G. Hill
Legislative Analyst

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Tom Campbell
Director of Finance