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March 21, 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 constitutional and statutory initiative regarding public employee retirement contributions (File No. SA2005RF0070).

BACKGROUND

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. The Public Employees' Retirement System (PERS) administers the retirement plans for state employees, California State University faculty and staff, and nonteaching school employees. The University of California (UC) administers its own retirement plan for its faculty and staff. The State Teachers' Retirement System (STRS) administers plans for teachers.

Local governments also provide these types of plans for their employees. Some cities and counties have their own retirement boards to administer their plans. Other cities, counties, and special districts contract with PERS or their county retirement systems to administer their plans.

Guaranteed Benefit. Defined benefit plans provide a guaranteed annual pension based upon age at retirement, years of service, and some period of highest salary (typically the last one or three years of work). These plans generally provide an annual cost-of-living adjustment and additional inflation protection that maintains 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. (School district and state contributions to STRS, however, are fixed in statute.) 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.

Plan Contribution Rates Vary. There is a great deal of variation in retirement contribution rates among state and local government plans. In general, employer contributions for police officers and firefighters are higher than for other employees. Over the last 25 years, the state has paid between 12 percent and 21 percent annually on average for most of its employees. In total, the state and local governments have paid, on average, in the low billions of dollars annually for retirement contributions.

PROPOSAL

This measure makes major changes to state and local government employee retirement plans.

Closes Defined Benefit Plans, Allows "Defined Contribution" Plans. This measure closes public sector defined benefit plans, except for UC, to new entrants effective July 1, 2007. Employees hired after that date could only enroll in defined contribution retirement plans. Defined contribution plans provide fixed annual employer contributions (typically as a percent of pay) to employee accounts. These assets, along with employee contributions, are invested and the employee has whatever these assets have generated for retirement income. Unlike defined benefit plans, the employee has no guaranteed pension benefit and employers never incur any unfunded liabilities.

Maximum Employer Contributions. The measure establishes maximum employer contributions (with specified employee contributions) of 9 percent for police officers and firefighters and 6 percent for other employees, assuming participation in federal Social Security. These maximums could be up to 3 percent higher for employees who do not participate in Social Security. In order to receive these maximum employer contributions, employees would have to contribute to their accounts as well. Without employee contributions, the maximums would be 3 percent for nonsafety employees and 4.5 percent for safety employees.

Authority to Exceed Maximums. Local agencies could exceed the specified maximum contributions with a two-thirds vote of their electorate. The state could amend these limits with three-quarters approval of both houses of the Legislature in two consecutive sessions.

Current Employees Could Opt Out of Defined Benefit Retirement. The measure also provides a six-month window from July 1, 2007 through January 1, 2008 for current public sector employees to opt out of defined benefit programs in favor of the new defined contribution accounts. These employees would be able to transfer the "net present value" (not defined by the measure) of their retirement benefits earned to date to a defined contribution plan.

FISCAL EFFECT

The measure would have two main fiscal impacts for state and local governments, pertaining to:

- Retirement costs for future employees.
- The closing out of existing defined benefit plans.

Retirement Costs for Future Employees

Plan Funding. Under the measure, public agencies would begin contributing some level of payroll to individual defined contribution accounts for new employees, instead of contributing toward defined benefit pensions. (This would also be the case for current employees who opt out of defined benefit plans.) The maximum employer contributions to the individual accounts would be between 6 percent and 12 percent. These maximum rates are generally lower than the employer normal cost contributions the state and local governments are currently paying for their defined benefit plans. Consequently, the measure would result in a net reduction statewide in retirement contributions for new employees. The amount of savings would depend on the extent to which public agencies choose employer contributions that are less than the maximums allowed. Once fully phased in for all public sector employees after several decades,

these savings in annual retirement costs could potentially be in the hundreds of millions of dollars to over $1 billion annually.

Offsetting Employee Compensation in Other Areas. Reductions in retirement compensation for employees could lead to increases in other types of employee compensation. For instance, in order to attract and retain employees, some governments might need to increase salaries to compensate for lower retirement benefits. Over time, these types of increased public employer costs could offset a significant portion of the retirement savings.

Administrative Costs. Some administrative costs associated with defined contribution plans could include the following:

- Start-up costs to set up defined contribution retirement plans for new employees and to inform them of their investment options.
- Ongoing costs of investing funds and managing individual retirement accounts.

These types of administrative costs would likely be higher than those for existing defined benefit programs. This is because of more contacts with customers to direct investments and report account activity and results. There may or may not be added costs to the state and local governments, however, depending on whether the costs were borne by public agencies or employees. Any government costs would be relatively minor compared to the magnitude of the contribution changes under the measure.

Closing Out Defined Benefit Plans

Public agencies would still be responsible for funding the now "closed" defined benefit plans for several decades, until the last plan retiree or beneficiary dies. The change in status of these plans could have fiscal impacts on the state and local governments. The net fiscal effect is unknown and would depend on a number of factors and on future decisions by retirement boards and existing government employees. For instance, the closing of plans could change how quickly retirement boards require governments to pay off their unfunded liabilities. To the extent that boards required unfunded liabilities to be paid off more quickly, governments would experience increased near-term costs with comparable longer-term savings.

Fiscal Summary

The measure would have the following major fiscal effects on the state and local governments:

- Over the long term, major reduction in state and local government retirement costs for employees hired after July 1, 2007, offset to an unknown extent by increased costs for other types of employee compensation.
- In the shorter term, unknown net impact on public employer costs related to the closing out of existing defined benefit plans. The fiscal effect would depend on the decisions of both retirement boards and existing government employees.

Sincerely,

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Elizabeth G. Hill
Legislative Analyst

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Tom Campbell
Director of Finance