December 28, 2009

Hon. Edmund G. Brown Jr.
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Krystal Paris
Initiative Coordinator

Dear Attorney General Brown:

Pursuant to Elections Code Section 9005, we have reviewed the proposed statutory initiative regarding retirement benefits for state and local employees (A.G. File No. 09-0080). (Below, these employees are referred to as "public employees"—a term that, for the purposes of this analysis, excludes military and civilian employees of the U.S. Government who reside in California.)

Background

Pension Benefits. The State Constitution and statutes authorize the establishment of systems to provide pension and other benefits to retired public employees, as well as public employees retiring with certain disabilities and survivors of some public employees. Currently, 4.1 million Californians—11 percent of the population—are members of one or more of the state's 134 public retirement systems, including around 1 million who currently receive benefit payments. Most public employees—including some part-time employees—are eligible to receive a defined benefit pension after retiring that is based on the employee's age at retirement, years of service, salary, and type of work assignment. For example, a typical state office worker with five or more years of service is eligible for a defined benefit pension at age 55 equal to 2 percent of his or her highest single working year's salary multiplied by the number of years of service upon retirement. (Therefore, after working for 25 years, such a retiree would be eligible to receive a defined benefit equal to 50 percent of his or her highest single year's pay.) Peace officers and other public safety employees often are eligible for larger pensions. The pension plans generally provide annual cost-of-living increases to limit how much the effects of inflation erode the purchasing power of the pension benefits.

Currently, California governments contribute about $13 billion per year to the state's public retirement systems for pension benefits, including several billion dollars per year to retire existing unfunded pension liabilities. This amount probably will increase by several billion dollars per year over the next few years due mainly to unfunded liabilities resulting from the systems' investment losses during 2008.

Public Employee Pensions Over $100,000 Per Year. Under the terms of the defined benefit pensions described above, a small portion of retired public employees receive annual pensions of $100,000 or more. For example, according to the California Public Employees' Retirement System (CalPERS), about 1 percent of its over 490,000 retirees and beneficiaries now receiving pension checks receive an annual total of $100,000 or more. According to CalPERS, many of these are "specialized skilled employees or other high wage earners who worked 30 years or more," and "many served in high-level management positions" working for state or local governmental entities.

Retiree Health Benefits. Many state and local governmental entities in California also provide health benefits to eligible retired employees and/or their spouses, domestic partners, dependents, and survivors of eligible retirees. Generally, public employers offering such benefits contribute a specific amount toward a retiree's health premiums each month. The level of these benefits and the eligibility of groups of retirees to receive the benefits vary considerably among governmental entities. Currently, California governments pay around $4 billion to $5 billion per year for retiree health benefits.

Proposal

This measure limits the defined pension benefits that could be provided to public employees hired after the date when voters approve this measure. (These employees are referred to as "new employees" below.) The measure would have no direct effect on existing retirement benefits of public employees and retirees hired before its effective date.

Limits on Annual Amounts of New Employees' Pensions. This measure limits the pension that any new employee receives during the first year of his or her retirement to $100,000. After this first year, the new employees' annual pension could be adjusted upward to reflect cost-of-living adjustments to offset the effects of inflation. Specifically, new employees' pensions could be adjusted upward in each subsequent year by that year's increase in the California Consumer Price Index (compounded). In no event, however, could a new employee's pension ever exceed $162,500 per year.

Legislature or Voters Could Amend This Measure. The proposal, once approved by voters, would allow the Legislature to amend this measure with a vote of three-fourths of the Members of each house of the Legislature. The measure also could be amended by a law that is subsequently approved by the state's voters.

Fiscal Effects

In the Short Run, Minor Savings for Governments. At first, after this measure's passage, only a small percentage of public employees would be affected by the pension limitations in this measure. Although newly hired employees would generally not retire for many years, pension plans could begin requiring lower government contributions to reflect lower expected future benefits. In the short run, therefore, this measure could produce some savings for state and local governmental entities due to decreases in pension payments for these newly hired employees. In the context of overall pension costs, these savings would likely be minor in the short run.

In the Long Run, Larger Pension Savings for State and Local Governments. A few decades after this measure's passage, its pension limitations would apply to the majority of public employees. At that time, assuming the Legislature and the voters have taken no steps to lift the limits prescribed in this measure, this measure could produce a substantial reduction in overall state and local defined benefit pension contributions. Very few public employees now receive pensions of over $100,000, but the effects of inflation over the next few decades can be expected to greatly increase this number. Accordingly, within a few decades, this measure could result in substantial reductions in state and local defined benefit pension payments, compared to what they might be under current law and policies. Several decades from now, these savings eventually could total in the billions of dollars per year (in today's dollars). Because these limitations in retirement benefits could cause some public employees in the future to work longer before retiring, there might be fewer retirees drawing retiree health benefits at any given time, resulting in additional savings for state and local governments.

Increases in Other Forms of Public Employee Compensation. In order to offset the decline of retirement benefits required under this measure for new employees, some governments likely would increase other forms of compensation for some employees in order to remain competitive in the labor market. These other forms of compensation include salaries and contributions to employee retirement funds other than those limited in this measure (such as "defined contribution" retirement accounts, for which governments make a specific payment, rather than promise a specific future benefit). These increases would offset the long-term reductions in pension and retiree health payments to an unknown extent. The magnitude of these additional costs would be determined by various factors, including labor market conditions and choices made by governmental entities and voters.

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

- Minor reductions in annual public sector pension costs in the short run.
- Major reductions in annual public sector pension and retiree health payments several decades from now.
- Possible increases in other public employee compensation costs, depending on future decisions made by governmental entities and voters.

Sincerely,

Mac Taylor
Legislative Analyst

Michael C. Genest
Director of Finance