LAO
70 YEARS OF SERVICE

April 29, 2011

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

Attention: Ms. Krystal Paris
Initiative Coordinator

Dear Attorney General Harris:

Pursuant to Elections Code Section 9005, we have reviewed the proposed constitutional initiative regarding retirement benefits for state and local employees (A.G. File No. 11-0007, Amdt. #1NS). (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

Public Employee Retirement Benefits

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 public employees. Currently, about 4 million Californians—11 percent of the population—are members of one or more of the state's 85 defined benefit public pension systems, including 1 million who currently receive benefit payments. Most California public employees (including some part-time employees) are eligible to earn "defined benefit" pensions—pensions that pay a specific amount after retirement that is generally based on the employee's age at retirement, years of service, salary, and type of work assignment. For example, a typical state office worker who retires this year 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 (known as the "2 percent at 55" benefit formula). Therefore, after working for 25 years, such a retiree would be eligible to receive at age 55 a defined benefit roughly equal to 50 percent of his or her highest single year's pay.

In the last few years, based on negotiations between the Governor and state employee unions, pension benefits for newly hired state employees—who will begin to retire in large numbers several decades from now—have been lowered. Newly hired state office workers today, for instance, typically are eligible for a defined benefit pension at age 60 equal to 2 percent of their

highest average monthly pay rate during any 36 consecutive months of employment. This "2 percent at 60" benefit formula costs less than the 2 percent at 55 formula described above. Like the 2 percent at 55 formula, the benefits in the 2 percent at 60 formula grow with more advanced ages as well, such that waiting to retire until age 63 or later can result in a defined benefit pension equal to about 2.4 percent of the highest three years' pay. Some local government employee groups have agreed to similar reductions in pension benefits.

Local government employees often have different pension formulas than those applicable to state employees—sometimes higher and sometimes lower. Teachers and administrators in California's public schools and community colleges, for example, generally are eligible for a defined benefit pension at age 60 equal to 2 percent of their "final compensation" multiplied by their number of years of service before retirement through the California State Teachers' Retirement System (CalSTRS). For teachers, "final compensation" is the highest single year's pay if they have 25 or more years of service and the highest average annual pay over 36 consecutive months for most others. In general, CalSTRS members are not eligible for Social Security benefits through the federal government.

State and local office workers and teachers sometimes are eligible for somewhat higher pension benefits if they delay their retirement a few years after age 60. In the 2 percent at 55 formula described above, for example, state office workers retiring at age 63 may be eligible for a pension equal to 2.5 percent of their highest single working year's salary multiplied by their years of service. Similarly, the basic CalSTRS benefit formula grows to provide a 2.4 percent benefit multiplied by years of service at age 63.

Peace officers and other public safety employees often are eligible for larger state or local pensions than other public employees. For example, a typical state correctional officer who retires this year with five or more years of service is eligible for a defined benefit pension at age 50 equal to 3 percent of his or her highest single working year's salary multiplied by the number of years of service upon retirement (known as the "3 percent at 50" benefit formula). Therefore, after working for 25 years, such a retiree would be eligible to receive a defined benefit roughly equal to 75 percent of his or her highest single year's pay. As with other state workers, based on union negotiations with the Governor and approval by the Legislature, pension benefits for newly hired state peace officers have been lowered. Newly hired state correctional officers today, for instance, typically are eligible for a defined benefit pension at age 55 equal to 2.5 percent of his or her highest average monthly pay rate during any 36 consecutive months of employment. Many state and local peace officers also do not receive Social Security benefits from the federal government.

Typical Retirement Age. In most cases, public employees with several years of service become eligible for a pension benefit at age 50—even though the employee may be able to earn a greater pension benefit if he or she delays retirement until a later age. In the state's three largest public pension systems, the average state or local employee retires at about age 60 (see Figure 1). Due to recent changes in benefits for newly hired state employees, the average retirement ages of state employees will tend to increase somewhat in the coming decades compared to the data shown in Figure 1.

Figure 1

Average Retirement Ages for Selected Public Employee Groups in 2009-10

	Age
California Public Employees' Retirement System[a]	
California Highway Patrol Officers	53
Local public safety officers	55
State correctional officers and firefighters	60
Other state and local employees[b]	60-61
California State Teachers' Retirement System[a]	
School district and community college teachers	62
University of California Retirement Plan	
Professional and support staff members	59
Academic faculty	63

[a] Includes service retirments only. Disability retirements, on average, occur 8 to 11 years earlier for CalPERS members and about 6 years earlier for CalSTRS members.
[b] Includes state and local "miscellaneous" employees, such as government office workers.

CalPERS = California Public Employees' Retirement System; CalSTRS = California State Teachers' Retirement System.

Other Ways to Earn Benefits. For the most part, public employees earn pension benefits based on their base salary—that is, as a certain percentage of their base salary during a specified number of years in their career. Overtime earnings provided as a supplement to base pay generally do not affect the pension benefits of public employees. There are, however, a few other ways that some groups of public employees earn pension benefits. In some systems, for example, additional credits for years of service can be claimed based on an employee's unused sick leave at retirement. In recent years, many governments in California also have granted employees "retroactive benefits"—that is, increased pension benefits for *prior* years of service. In a retroactive benefit situation, an employee might have worked most of his or her career for a governmental entity under one pension formula, only to benefit from a significantly larger pension formula put into effect and applied to all *prior* years of service just a few years before retirement.

Retiree Health Benefits. Many state and local governmental entities in California also provide health benefits to eligible retired employees and/or their spouses, registered 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.

Funding Public Employee Retirement Benefits

Funding Pension Benefits. California governments generally "prefund" the costs of defined pension benefits for their employees. Through prefunding, public employers and/or employees contribute a specific percentage of each employee's pay to a public retirement system each year. In many cases, the percentage paid by the employer and that paid by the employee is determined

through negotiation between governments and unions representing rank-and-file public employees.

In most cases, the combined employer and employee contributions are those estimated to be sufficient by the system's actuaries—when combined with future investment returns of the retirement system—to cover the portion of future pension benefits earned by that employee during a given year. This contribution is known as the "normal cost." In making their estimates, public retirement system actuaries make numerous assumptions about (1) future investment returns, (2) the longevity of public employees, (3) the likelihood that an employee will retire in any given year, (4) the employee's future pay increases, (5) the pension benefits for which the employee eventually will be eligible, and (6) other factors. To the extent that these assumptions prove to be incorrect over time, the eventual costs to provide a given level of benefits will be less or more. In the latter cases, public employers in California generally are required to provide additional contributions to fund a given level of pension benefits and pay down what is called an "unfunded liability."

As of 2007-08 (the most recent fiscal year for which this data is available), public employers, on average, made pension contributions equal to 14.6 percent of employee payroll for non-safety employees and 20.7 percent of employee payroll for safety employees, according to estimates of the State Controller's Office (SCO). This resulted in $14 billion of employer contributions to California's public pension systems, including several billion dollars per year to retire existing unfunded pension liabilities. This amount probably will increase by billions of dollars per year in the relatively near future due to new unfunded liabilities resulting mainly from the systems' large investment losses during 2008.

In addition to contributions made by public employers, public employees also make contributions to the state's pension systems. The percentage of payroll contributed by public employees varies. The typical state employee, for instance, currently make pension contributions equal to somewhere between about 5 percent and 11 percent of his or her pay. For many state employees, these employee contributions have increased by several percentage points of their pay from a few years ago, due mainly to negotiated agreements between public employee unions and the state.

Funding Retiree Health Benefits. California governments generally have not prefunded retiree health benefits. This means that they still generally pay for the costs of these benefits on a "pay-as-you-go" basis, and there has been relatively little money available from investment returns to cover the costs of such benefits. Accordingly, each year, most governments pay for the retiree health benefits consumed during that year by eligible retirees, dependents, and others. Currently, California governments are estimated to pay somewhere around $4 billion per year for retiree health benefits.

Contract Clauses of the U.S. and State Constitutions

Background. Article I, Section 10 of the U.S. Constitution prohibits any state from passing a "law impairing the obligation of contracts." As with the constitutions of some other states, the California Constitution also prohibits the legislative branch of California's government from

passing any law impairing the obligation of contracts. These clauses are known as the "Contract Clauses" of the U.S. and State Constitutions, respectively.

Provides Certain Protections Concerning Public Employee Retirement Benefits. In various instances over the past century, California governments have made attempts to alter or reduce pension benefits for current and past employees and to reduce payments to pension systems. In a number of cases, California courts have held that such actions violated the Contract Clauses of the U.S. and/or State Constitutions. In a number of cases, California courts have held that a public employee's pension constitutes "an element of compensation," that a "vested contractual right to pension benefits accrues upon acceptance of employment," and that such a pension right "may not be destroyed, once vested, without impairing a contractual obligation of the employing public entity." California courts have ruled that allowable modifications to pension systems for current and past employees, when they result in a "disadvantage to employees," generally must be accompanied by "comparable new advantages." For example, a reduction of one part of the benefit must be accompanied by some other "advantage" to the employee or retiree. The contractual protections apply to various aspects of the pension benefit and also have applied to certain commitments of governments to contribute to pension systems each year. In general, this means that California courts have declared that it is difficult to modify or alter public employee pension benefits to reduce governmental costs unless that change is accompanied by comparable new advantages for affected public employees and retirees.

Municipal Bankruptcy. The U.S. Constitution also reserves for the U.S. Congress the power to pass uniform laws on the subject of bankruptcies, which sometimes involve modifications to contracts. Consistent with this provision of the Constitution, the U.S. Congress has established one method—bankruptcy—whereby *local* governmental entities (but not *state* governmental entities) can seek to reorganize (restructure) their contractual obligations. Local governments, however, rarely seek such bankruptcy protection, and the experience of local governments in seeking to modify their retirement contracts has been even rarer.

PROPOSAL

Proposed Change to Existing Public Employees' Retirement Benefits

This measure provides that public employee defined pension benefits in California can only allow for "full retirement ages" of 62 years of age or older. This provision of the measure states that it would apply to public employees who are employed on the day after this measure is approved by the state's voters, notwithstanding the Contract Clause of the State Constitution.

It is unclear to us exactly what "full retirement age" would be construed to mean in practice. There are at least two possible interpretations of this provision. One interpretation would prevent "service retirements" (retirements not related to disability) by current public employees prior to age 62. (As described above, public employees currently can retire beginning at age 50, and many groups of public safety employees currently retire in their early 50s.) A second interpretation would prevent the pension benefits described earlier from reaching their maximum level until at least age 62. For example, most state correctional officers currently work under the 3 percent at 50 pension benefit formula. This provision of the measure could be interpreted as

preventing the state from providing a pension benefit to current employees that reaches this full 3 percent level until at least age 62. In other words, a smaller benefit factor than the one in the 3 percent at 50 formula might be allowable for retiring officers between ages 50 and 61. These types of changes—delaying receipt of pension benefits until later ages—would also affect the date at which employees would begin to draw any retiree health benefits for which they are eligible.

Likely to Be Challenged in the Courts. This measure does not appear to provide a comparable new advantage for existing employees to offset the possible changes to the retirement age described above. Accordingly, it is likely that this part of this measure—reducing retirement benefits for existing public employees—would be challenged in the courts. This measure states that its various provisions are "severable," meaning that if one part of the measure is held invalid by the courts, this would not affect the other parts of the measure that can still be put into effect.

Changes to Future Public Employees' Retirement Benefits

This measure would take effect on the day after it is approved by a vote of the people. It includes various limitations to retirement benefits for public employees first hired on and after that date, as follows.

Various Changes to Pension Benefits. For these future public employees, defined pension benefits would be required to be limited in the following ways:

- ***No "Full Retirement Age" Prior to 62.*** For future public employees (as with public employees working on the effective date of this measure), full retirement ages of less than 62 would not be permitted. (As noted above, we are unsure how this provision would be construed in practice.)
- ***No Pension Greater Than 60 Percent of Highest Three Years' Compensation.*** Defined benefit pensions for future public employees could be no more than 60 percent of the highest annual average base wage of the employee over a period of three consecutive years of employment by a public agency. For future public employees, only base wages could be included in the calculation of wages used in determining the pension benefits. Payments received for unused sick leave, for example, would be excluded from calculations of the annual average base wage.
- ***No Pensions for Part-Time Employees and Others.*** Future public employees would be prohibited from receiving a defined benefit pension unless they had been "a full time employee of one or more public agencies for at least five consecutive years." In the future, certain public employees who worked on a part-time basis for part or all of their careers—who may be eligible for defined pension benefits under existing laws and contracts—might not be eligible under this provision.
- ***Future Employee Pension Contributions Must at Least Equal Employer's.*** As described above, many public employees make smaller pension contributions each year than their employers. Under this measure, future public employees' contributions to pension systems would be required to be at least equal to those of their employers.

This would tend to increase employees' contributions, thereby reducing employers' contributions.

All of these limitations would tend to result in later retirement ages for future public employees. This also would delay the date at which they begin to draw retiree health benefits for which they are eligible.

Retroactive Pension Increases Prohibited

This measure provides that public agencies may not provide retroactive pension benefit increases to "any public agency employee under any plan."

Retirement Provisions Unaffected by This Measure

This measure states explicitly that it does not affect the following.

- ***Existing Retirees' Benefits.*** This measure would not affect benefits of persons who retired from public agency employment prior to the date this measure takes effect.
- ***Death and Disability Benefits.*** This constitutional initiative would not limit death or disability benefits for public employees.
- ***Legislators' Retirement Benefits.*** Under Proposition 140 (1990), Members of the Legislature elected or serving after November 1, 1990, are prohibited from receiving pension and retirement benefits for their legislative service through a state or local retirement system. (Legislators do, however, participate in the federal Social Security program.) This constitutional initiative would not alter the limits on legislative pensions put in place by Proposition 140.

Two-Thirds Legislative Vote Required for Certain Pension Measures

This constitutional initiative allows the Legislature to enact laws implementing this measure's provisions through bills passed by two-thirds of the Members of the Assembly and the Senate. Under current law, some such enactments could be passed with a majority vote of the Assembly and the Senate.

FISCAL EFFECTS

This measure would result in major changes to how the state and local governments compensate their employees. The fiscal effects of these changes would depend in part on how the measure is interpreted by the courts and the Legislature and implemented by both state and local governmental entities. Most of the measure's changes would apply only to those public employees hired after the date it is approved by voters. Accordingly, the full fiscal effects of this proposal may not emerge until several decades after the measure's passage—particularly if the courts invalidate the parts of the measure limiting benefits for existing employees. Below, we discuss how the measure could affect state and local government costs in the short run (the next few years) and over the long run (perhaps 20 or more years in the future), respectively.

Short-Run Fiscal Effects

Possible Significant Reductions if Applied to Existing Employees. If the measure is allowed by the courts to be applied to existing employees, it could result in substantial reductions in state and local government pension contributions beginning almost immediately. The most substantial decreases could result from lowered state and local pension contributions related to public safety employees. That is because delaying these employees' "full retirement age" to 62 or later could result in more savings than a similar change for teachers and other public employees, who, as shown in Figure 1, tend to retire fairly close to age 62 already. To the extent that this measure delayed the retirement date of current employees, governmental payments for retiree health benefits also would be reduced in the short run.

Because this measure would not affect pension benefits of those who retire on or before the date it is approved by voters, it could result in current public employees making choices to retire on or before the Election Day on which it appears on the ballot in order to avoid having their benefits reduced. It is impossible to predict exactly how this factor would increase or decrease governmental costs in the short run.

In Near Future, Relatively Little Savings Related to Future Employees. The measure would tend to reduce significantly—as a percentage of payroll—the required employer pension contributions related to *future* public employees. This is because the defined benefit pensions for these employees would be reduced substantially under this measure. In the near future, however, future public employees subject to all of this measure's pension limitations would be a relatively small portion of the workforce for most public agencies. Accordingly, in the short run, savings from reducing pension benefits for future employees would reduce state and local government costs by a relatively modest percentage.

Increases in Other Forms of Compensation. In order to offset the decreased retirement benefits resulting from this measure, governmental entities 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 the defined benefit pension plans addressed by this measure. (These other retirement funds include "defined contribution" retirement accounts, for which employers make a specific payment, rather than promise a specific future benefit.) For some part-time, temporary, and seasonal employees, this measure's prohibition on enrollment in state or local defined benefit pension systems would result in new requirements for public employers to make payments either to the federal Social Security program or an alternative retirement program, as allowed by federal tax laws and regulations. These various cost increases would offset the short-term reductions in pension contributions described above to an unknown extent. The overall magnitude of these additional costs would be determined by various factors, including labor market conditions and choices made by governmental entities.

Possible Effects of Pension Fund Cash Flow. If, as normal costs for public employees decline, policymakers decide to reduce the combined employer and employee contributions to pension systems, some public pension systems may receive less cash than they otherwise might on a monthly and annual basis. Accordingly, these systems may have fewer liquid assets on hand at any given time to meet their preexisting pension payment obligations. This could lead some of

the systems to reduce the average amount of time that they invest their assets in the stock, bond, real estate, and other investment markets. In turn, this may reduce the average annual investment returns that the systems are able to assume when calculating required normal cost and other pension payments. If this were to occur, annual pension payments by governments could increase in the near future. It is impossible to estimate the magnitude of these costs, particularly since they could vary substantially from one public pension system to another.

Bottom Line. In the short run, public employer defined benefit pension contributions would decline by a relatively modest percentage due to this measure's limitations on pension benefits for future public employees or perhaps substantially if this measure is allowed by the courts to limit pensions of existing public employees. These savings would be offset to an unknown extent by increases in compensation costs for some public employees, depending on the labor market and future decisions made by pension systems and other governmental entities.

Long-Run Fiscal Effects

Major Reductions in Government Pension Costs in the Long Run. Currently, normal cost pension contributions by California governments to public retirement systems total around $10 billion per year. State and local governments in California would have substantially smaller required normal cost contributions for new employees hired after this measure takes effect. Accordingly, in the long run (after most current governmental employees retire and most of the state and local government workforce consists of persons hired after the effective date of this measure), normal cost pension contributions by California governments would be reduced by billions of dollars per year (as measured in today's dollars).

Increases in Other Forms of Compensation. As described above, in order to offset the decreased retirement benefits resulting from this measure, governmental entities likely would increase other forms of compensation for some employees in order to remain competitive in the labor market. These increases would offset the reduced pension contributions described above to an unknown extent.

Some Additional Flexibility in State and Local Budgeting Possible. Public employee retirement benefits have a substantial degree of protection under court decisions and the Contract Clauses of the U.S. and State Constitutions. Accordingly, state and local government pension contributions are one of the more inflexible components of public budgets in California. This measure would reduce pension contributions substantially over the long run and reduce the possibility that unfunded liabilities related to pension benefits would consume a significant portion of future public budgets. For these reasons, the changes included in this measure could increase budgeting flexibility for state and local governments over the long run, and this could result in policymakers making different budgetary decisions, particularly in times of economic and fiscal distress.

Bottom Line. In the long run, public employer defined benefit pension contributions would decline substantially—likely by billions of dollars per year (as measured in today's dollars)—due to this measure's limitations on pension benefits for future public employees. These savings would be offset to an unknown extent by increases in compensation costs for some public employees, depending on the labor market and future decisions made by governmental entities.

Other Fiscal Effects

Variety of Other Fiscal Effects Are Possible. Particularly over the long run, the measure could result in numerous other effects on governments. For example:

- Changes in the types and amounts of public employee compensation could change the demographics of state and local government workforces. In particular, public safety employees might be older, on average. The proportion of public employees who are young (and typically lower-paid) could be reduced, and the number of retirees drawing retiree health benefits could be reduced at any given time.
- Because future governmental workers would be guaranteed lower annual incomes in retirement, an increased number could enroll in public social services and health programs and increase those programs' costs.

These and other factors could affect state and local government costs and revenues. The net effect of these factors is unknown, but probably would be less significant than the other fiscal effects discussed in this analysis.

Fiscal Summary

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

- Major reductions in state and local defined benefit pension contributions—potentially totaling billions of dollars per year (as measured in today's dollars)—over the long run. These reductions would be offset to an unknown extent by increases in other compensation costs for some public employees, depending on labor market conditions and future decisions made by governmental entities.

Sincerely,

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Mac Taylor
Legislative Analyst

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Ana J. Matosantos
Director of Finance