August 19, 2011

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

Attention: Ms. Dawn McFarland
Initiative Coordinator

Dear Attorney General Harris:

Pursuant to Elections Code Section 9005, we have reviewed the proposed constitutional initiative regarding changes to pension benefit retirement ages for certain public sector pension systems (A.G. File No. 11-0022).

BACKGROUND

California Has Both Statewide and Local Public Pension Plans. The two largest entities managing state or local pension systems in California are the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS). Combined, CalPERS and CalSTRS serve 3.1 million members (about 8 percent of California's population), including around 750,000 members and beneficiaries who currently receive benefit payments. Members of CalPERS include current and past employees of state government and the California State University (CSU), as well as judges and classified public school employees. In addition, hundreds of local governmental entities (including cities, counties, special districts, and county offices of education) choose to contract with CalPERS to provide pension benefits for their employees. Members of CalSTRS include current and past teachers and administrators of California's public school and community college districts. Members of CalPERS and CalSTRS receive differing levels of pension benefits. Many CalPERS members also participate in the federal Social Security program; in general, CalSTRS members do not.

In addition to CalPERS and CalSTRS, about 80 other defined benefit state and local pension systems (such as the University of California [UC] Retirement System, the Los Angeles County Employees' Retirement Association, and the Los Angeles City Employees' Retirement System) serve about one million other Californians, including about 300,000 who currently receive benefit payments.

Defined Benefit Pensions. CalPERS and CalSTRS both provide "defined benefit" pensions to their members. Defined benefit pensions provide a specific monthly benefit after retirement that is generally based on the employee's age at retirement, years of service, salary at or near the end of his or her career, and type of work assignment. Defined benefit pensions are one part of public employees' total compensation, along with salaries, health benefits, and other employment benefits. In general, both public employees and their employers (and, in the case of CalSTRS, the state government as well) contribute to public retirement systems to finance future pension benefits during the employees' working years. Public pension systems invest these contributions to generate returns that, over time, pay for a significant portion of these pension benefits. The pensions of CalSTRS members are established in state law—specifically, in the state's Education Code—and generally are not the subject of local negotiations between districts and teachers' unions. The pensions of CalPERS members also are established in state law—generally, in the state's Government Code—with some aspects of state or local employee pensions delineated in memoranda of understanding (MOUs) or labor contracts with unionized public employees' bargaining units.

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 CalPERS and CalSTRS, the average state or local employee retires at about age 60 (see Figure 1). Due in part to recent changes in benefits for newly hired state employees and some local employees in CalPERS (generally the result of negotiations between governments and public employee unions), average retirement ages 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

[a] Includes service retirements 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.

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. In January 2008, a state commission estimated that public entities in California—including those with employees in CalPERS and CalSTRS, as well as other governments—spent about $3.5 billion per year, as of that time, on retiree health benefits. (About 55 percent of those costs were attributable to the state government, CSU, school districts, and community college districts, with the rest attributable to other local governments and UC.) State costs for retiree health benefits have since increased about 50 percent above the level cited in the January 2008 commission report. Accordingly, we estimate that current statewide retiree health benefits expenses total around $5 billion annually for California governments, most of which is attributable to entities with employees in CalPERS and CalSTRS.

Legal Protections for Public Employee Pension Benefits. Article I, Section 10 of the U.S. Constitution prohibits any state from passing a "law impairing the obligation of contracts." The State Constitution also prohibits the state 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.

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. Courts have held that a public employee's pension constitutes an element of their compensation, that a vested contractual rights 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 public employer. In general, 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.

PROPOSAL

This measure provides that "no new memorandum of understanding or other contract or agreement" between any public agency and employees in CalPERS or CalSTRS may allow their retirement with "full retirement benefits" at an age younger than 65, except for sworn public safety officers, who would be able to receive full retirement benefits starting at age 58.

Significant Uncertainty About What This Measure Means. This measure raises several significant legal and implementation issues that make it uncertain as to how its provisions would be implemented. For example, 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 65 (or age 58 for sworn public safety officers). A second interpretation would prevent pension benefits from reaching their maximum level until at least age 65 (or 58 for public safety officers). For example, many public safety officers now work under the 3 percent at 50 pension benefit formula, where they are able to retire at or after age 50 with an annual benefit equal to 3 percent of their "final compensation" multiplied by their number of years of service. (Therefore, an officer who worked for 30 years and retired at 50 could be eligible for a retirement benefit equal to 90 percent of his or her highest annual salary—3 percent of the highest year's pay multiplied by 30.) Under this second interpretation of the measure, a government might be able to comply by reducing this pension benefit to 2.99 percent at 50, while allowing the retiree to work for eight more years and retire with a 3 percent at 58 benefit formula. If this second interpretation were adopted, the measure could result in only *de minimis* benefit changes for affected CalPERS and CalSTRS members.

The measure would be applied only to "new" MOUs negotiated with employee bargaining units. As described above, however, many pension contracts are not included in MOUs, but rather are derived from statutes, such as those in the Government Code or the Education Code. Moreover, managerial and supervisorial employees generally are not members of bargaining units and thus are not subject to any MOUs at all related to their current period of service. It is unclear to us whether the word "new" in this measure applies only to MOUs or whether it also applies to other pension contracts or agreements, such as those delineated in statute or those applicable to managers and supervisors. Courts could determine that this measure applies only to new MOUs or new pension contracts. For CalSTRS members, for example, this interpretation might mean that this measure has no substantive effect to the extent that current Education Code provisions related to the pension system are never changed in the future. There might, in other words, *never* be a new contract or agreement for CalSTRS members and some or all CalPERS members.

The measure does not address specifically how it would be applied to disability retirement benefits of the two pension systems. It also does not address specifically how or if it would be applied to current CalPERS and CalSTRS retirees.

Finally, as described above, a long history of case law makes clear that it is difficult to change pension benefits for current and past public employees without offering comparable new advantages. There are no apparent comparable new advantages provided to current and past public employees in CalPERS or CalSTRS who otherwise would be affected by this measure. Accordingly, litigation is likely that would seek to invalidate this measure's provisions with regard to current and past public employees.

FISCAL EFFECTS

This measure could result in major changes to how the state and some local governments compensate their employees. The fiscal effects of these changes would depend on how the measure is interpreted by the courts and the Legislature and implemented by both state and local governmental entities. In particular, if the courts determine that the measure's increase in retirement ages would apply only to public employees hired after the date it is approved by voters, the full fiscal effects of the measure would not emerge until several decades after its passage. Below, we discuss the potential effects of this measure on 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

Significant Potential Cost Reductions if Applied to Existing and/or Past Employees. If the measure is allowed by the courts to be applied to existing and/or past public employees, it could result in substantial reductions in state and local government pension contributions beginning almost immediately—potentially amounting to billions of dollars per year. The most substantial decreases could result from lowered state and local pension contributions. This is because delaying public employees' retirements by several years—assuming the measure prevents all service retirements until age 65 (or 58, for sworn public safety officers)—could perhaps result in substantially lowered costs for California governments. To the extent this measure delayed the retirement date of current employees, governmental payments for retiree health benefits also could be reduced in the short run. If, on the other hand, this measure is interpreted in a way that requires only *de minimis* changes of public employees' pension benefits, it might result in minimal short-term savings.

Little Short-Run Savings if Applied Only to Future Public Employees. If courts do not allow this measure to be applied to existing and past public employees at all, it might result in little savings in the short run. While the measure might, in this case, tend to reduce significantly the required employer pension contributions for future public employees, such employees would be a relatively small portion of the workforce for most public agencies in the short run.

Increases in Other Compensation Costs. In order to offset the decreased retirement benefits resulting from this measure, governmental entities with employees enrolled in CalPERS and CalSTRS 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 cost increases would offset any short-term reductions in pension contributions described above to an unknown extent. The overall magnitude of these added costs would be determined by various factors, including labor market conditions and choices made by governmental entities.

Some Local Agencies Might Terminate Their Contracts With CalPERS. To avoid the limitations of this measure, local governments—following negotiations with public employee unions, in some cases—could choose to terminate their pension benefit contracts with CalPERS and instead provide pension benefits through another existing or newly established public retirement system. To the extent that local governments choose this option, the savings described above could be diminished, and in certain cases, taxpayer costs to service CalPERS' unfunded liabilities might increase.

Bottom Line. In the short run, public employer defined benefit pension contributions and retiree health contributions could decline by billions of dollars per year if this measure's limitations are interpreted to apply to current and/or past public employees in CalPERS and CalSTRS *and* to require significant reductions in benefits. These cost reductions, however, would be offset to an unknown extent by increases in other compensation costs for some public employees. If, on the other hand, this measure's limitations on retirement ages are applied only to future employees and/or require only small changes in benefits, then there would be little short-term savings for public employers.

Long-Run Fiscal Effects

Significant Potential Cost Reductions in the Long Run. If the measure is interpreted to require significant benefit changes for future public employees, it could result in substantial reductions in state and local government pension contributions in the long run, potentially amounting to billions of dollars per year (in current dollars). As described above, the most substantial decreases could result from lowered state and local pension contributions. Governmental payments for retiree health benefits also could be reduced by billions of dollars per year (in current dollars). If, on other hand, this measure is interpreted in a way that requires only *de minimis* reductions of public employees' benefits, it could result in minimal savings over the long run.

Increases in Other Compensation Costs. In order to offset the decreased retirement benefits resulting from this measure, governmental entities with employees enrolled in CalPERS and CalSTRS likely would increase other forms of compensation for some employees in order to remain competitive in the labor market, as described above. These cost increases would offset reductions in pension contributions described above to an unknown extent. Some local agencies still might terminate their contracts with CalPERS, as described above.

Bottom Line. In the long run, public employer defined benefit pension contributions and retiree health contributions could decline by billions of dollars per year if this measure's limitations are interpreted to require significant reductions in benefits. These cost reductions, however, would be offset to an unknown extent by increases in other compensation costs for some public employees. If, on the other hand, this measure's limitations on retirement ages are interpreted to require only small changes in benefits, then there might be little savings for public employers.

Fiscal Summary

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

- In the long run, possible reductions in state and local pension and retiree health costs. The magnitude of the savings would depend on a variety of legal, implementation, and behavioral uncertainties and would be offset to an unknown extent by increases in other state and local employee compensation costs.

Sincerely,

Mac Taylor
Legislative Analyst

Ana J. Matosantos
Director of Finance