

## POLICY PAPER

# PUBLIC AFFLUENCE, PRIVATE SQUALOR

## California's Dual Pension Crisis

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The financial crisis that has rolled through the economy in recent years has shaken the foundations of retirement security in both the private and public sectors, and nowhere more than in California.

The collapse of housing prices has left 2.4 million California households with negative equity in their homes, wiping out what has normally been the largest form of savings. The decline in stock prices has drained 401(k) plan balances, forcing many to delay retirement. It has also highlighted the vulnerability of the do-it-yourself retirement system created when employers turned from defined benefit pensions to defined contribution plans where workers bear all the financial risk in volatile global financial markets.

The same decline in asset prices has hammered public pension systems in California and around the nation. It has exposed underfunding of pension and retiree health promises from both state and local governments, and at the worst possible time. Facing huge investment losses, pension plans are raising their demands for contributions from public employers. But because their revenue has fallen by 20 percent or more in the recession, those government employers face shortfalls in their own budgets.

The stark contrast between the guaranteed and increasingly expensive pensions and retiree health benefits enjoyed by most public workers in California and the less secure (and

often missing) retirement plans of private-sector workers has touched off pension envy. “[T]axes from people with inferior pensions are funding the fatter monthly checks going to folks who allegedly work for them,” California columnist Tom Elias recently wrote. “Something seems wrong here, and many have come to resent it.”<sup>1</sup>

There is something wrong here – in fact, many things. The three-legged stool that once provided retirement security to many private sector workers – Social Security, workplace pensions, and private saving – is wobbling. The contract between generations has been broken as the underfunding of past retirement promises to public workers sends the bill for today’s government to our children. And California’s decisions in good times to give some public workers pensions that are more generous than needed to provide them with a secure retirement is now cutting into public investments in education, health, and infrastructure needed to underwrite economic growth in the future.

The bumper sticker response to the crisis has been the call to end defined benefit pensions for public employees and substitute 401(k) plans. It’s true that leaving public workers to bear all the risks, financial and actuarial, of retirement,

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as most private workers now do, might reduce pension envy. But it would also increase overall retirement insecurity in the state, hardly a worthy goal for public policy. We suggest a more hopeful approach: to create a fiscally sustainable retirement system in which both public and private workers can put away adequate retirement savings sheltered from the gales of financial markets.

## **Retirement security in California: Public affluence, private squalor**

California's public pensions are complex and multiple. Pension benefits vary between the systems, and often within them. For example, the California Public Employees' Retirement System (CalPERS), which covers state government workers and services the retirement programs of more than two thousand local governments and school districts, administers 13 different benefit formulas with 57 optional contract provisions. Teachers are separately covered by the California State Teachers' Retirement System (CalSTRS). Some counties and cities operate their own pension systems, as does the University of California (University of California Retirement System, or UCRS). But one generalization applies: public retirement benefits in California are, by almost all measures, the highest in the country.<sup>2</sup>

The basic retirement formula for state workers allows them to retire at age 55 with 2 percent of highest final compensation (averaged over one or three years depending on the bargaining unit) for each year worked. State employees are also covered by Social Security. Workers may retire at 50 with a reduced pension, and those who retire after 55 receive a higher percentage of pay, up to 2.5 percent at age 63 and above. An average-wage employee who retires from the state at Social Security retirement age (66) with 30 years of service receives a pension equal to 75 percent of final compensation, along with Social Security benefits that replace about 42 percent of career average earnings. Correctional officers, who make up the largest single piece of the state work force under the control of the governor

and legislature, receive public safety retirement, as do police and firefighters in most localities. They may retire at age 50 with 3 percent for each year of service. Prison guards are also covered by Social Security. State workers with more than 10 years service also receive retiree health benefits. For non-safety and safety workers alike, current pension formulas offer higher benefits than needed to replace 80 percent of pre-retirement income, the target for most retirement systems.<sup>3</sup>

The retirement plan for teachers is less generous. Educators can retire at 60 with 2 percent of highest pay credited for each year worked. They can receive up to an additional 0.4 percent for each year they work past age 60, or for having worked 30 years or more. Teachers do not participate in Social Security.

By contrast, retirement security is a fading dream for the majority of private-sector workers in California. The percentage of private workers with defined benefit plans has plummeted. In 1980, nearly two-thirds of workers in private industry had access to a defined benefit plan. By 2008, the Bureau of Labor Statistics (BLS) estimates, only 23 percent of private workers in the Pacific region, which is dominated by California, had access to a defined benefit plan.<sup>4</sup> Only 57 percent of workers in the region had access to any type of retirement plan at their job. One study estimated that as many as 8 million Californian private workers lack access to an employer-based retirement plan.<sup>5</sup>

The economic downturn has depleted other pots of retirement savings. Typical 401(k) account balances, the most common form of retirement savings for private workers, are paltry even for those people with access to an employer-sponsored plan. The median value for these defined contribution plans at the end of 2008 was \$12,655, down 33 percent from a peak of \$18,942 in December 2007. Though account balances have rebounded somewhat since then, even this higher number will not cover the normal expenses of a single year of retirement. And although account balances in retirement plans grow with

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age and tenure, nearly half (48 percent) of participants with account balances less than \$10,000 were in their 40s, 50s, and 60s.<sup>6</sup> According to the most recent Retirement Confidence Survey by the Retirement Research Center at the University of Michigan, 27 percent of workers report having less than \$1,000 in savings outside of defined benefit pensions and home equity, a 35 percent increase from the previous year.<sup>7</sup>

In the past, Californian families counted on the equity in their homes as a key source of retirement saving. As home prices have collapsed, this dynamic has reversed and markedly so in California, which has the fifth highest rate of negative-equity mortgages. In the first quarter of 2010, 34 percent of all mortgage holders in the state had near zero or negative equity. Two California communities were ranked in the top five cities for the number of “underwater” mortgages, with 406,000 in Los Angeles and 463,000 in Riverside.<sup>8</sup> Sixty-five percent of the mortgages in Stockton were in a negative or near-negative position, 62 percent in Modesto, and 60 percent in Vallejo-Fairfield.

Without belaboring the point, it is fair to say that the state of retirement security in the private sector in California does not represent a standard to emulate.

## Toward a pension funding crisis

The gap between the retirement security enjoyed by public-sector and private-sector workers is by no means unique to California. But the gap is larger in California, where a broken government system and a boom-and-bust economy make elected officials and citizens alike more prone to pushing today’s obligations into the future.

Although it is not widely recognized, much of this is due to the inadvertent effects of Proposition 13, the famous 1978 property tax limitation measure. Prop 13 created a new operating system for California government. By giving the legislature more control and responsibility over financing services, it shifted power to the state capital. At the same

time it made legislative action more difficult by requiring a two-thirds vote to raise tax revenues. Piled on top of the existing supermajority rule for passing budgets, Prop 13 gave California the dubious distinction of being the only state to require a supermajority vote for all of the normal processes of fiscal management. The result has been frequent budget gridlock and equally frequent resort to fiscal gimmicks, such as handing out improved pensions in lieu of pay increases. In a favorite phrase at the state Capitol, this is “kicking the can down the road.” Similarly, local governments, barred by Prop 13 from raising property taxes to accommodate the public’s demand for services and their employees’ demands for pay, often used promises of higher pensions and retiree health benefits as the currency to get through labor negotiations and win the political support of public unions.<sup>9</sup>

Consider the case of San Diego, now teetering on the edge of bankruptcy, in large part because of pension obligations. The San Diego crisis has its early roots in the decisions three decades ago by then-Mayor Pete Wilson to hand out bonuses from the pension fund, defer contributions to the city-run pension fund, and give higher pensions to employees for agreeing to leave the Social Security system. In the wake of Prop 13, such evasions put off the need to ask hard things of either taxpayers or public unions.<sup>10</sup>

Later, as governor, Wilson would similarly put off pension contributions during California’s early 1990s budget crisis. But he was not the first. Even before he arrived in Sacramento, the legislature in 1990 passed the law basing pensions on the highest single year of compensation was passed, a deal made to let the state to help balance its budget by making less frequent pension contributions. The cost of the change, estimated in 1990 at \$63 million a year, would balloon to over \$100 million by 2006.<sup>11</sup>

The most damaging act of loading yesterday’s bills onto tomorrow’s taxpayers came in 1999 when Governor Gray Davis and the legislature made up for a long freeze on state worker pay by approving SB 400. On a vote of 39-0 in the

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state Senate and 70-7 in the Assembly, lawmakers raised pensions to their current high levels. The changes were made retroactive, effectively increasing the compensation for work done years and even decades earlier. Lawmakers were told by CalPERS – and chose to believe – that investment returns from the booming stock market would cover most of the costs of the higher benefits and keep required state pension contributions below 1998-99 levels over the following decade.<sup>12</sup>

Wishing failed to make it so. Eleven years after the higher pensions were approved, the stock market remains 10 percent lower than in 1999. Consequently, the required state pension contribution to CalPERS, measured as a percentage of payroll, has more than doubled from the 1998-99 level, to \$3.9 billion for the 2010-11 fiscal year. In addition, the state will pay \$1.2 billion to CalSTRS for teacher retirement and \$1.4 billion more for retiree health costs. Total payments for retiree costs, about \$6.5 billion, now exceeds state support for California's two university systems, the University of California and California State University.<sup>13</sup>

These costs are certain to grow. To reduce budget shocks for state and local governments, CalPERS smoothes out investment returns over a 15-year period, a far longer interval than used in other states. In 2009 it also decided to smooth out the losses it suffered in the 2008-09 financial crisis, which amounted to more than 30 percent of its portfolio. These policies have reduced the immediate pain to government employers struggling to maintain public services in the face of the largest revenue declines since the Great Depression. But the pension funds' investment losses are stacked up like jetliners circling the airport, awaiting clearance to land. In 2011, CalPERS is scheduled to consider reducing its assumed rate of return, now 7.75 percent. A lower assumed investment return would force CalPERS to raise employer contribution levels. CalSTRS, which has suffered similar investment losses but does not set its own contribution rate, will likely ask lawmakers to double the state contribution to teacher retirement in 2011.<sup>14</sup>

And the University of California Retirement System, which for 20 years has funded pensions through investment returns without a state contribution, is seeking renewed contributions in the years ahead.<sup>15</sup>

Many local governments are in even worse shape. The San Francisco grand jury reported in June 2010 that the city's cost for pension and retiree health benefits would grow from \$400 million currently to \$1 billion a year by 2015, equivalent to one third of the city-county's general fund budget.<sup>16</sup> In other cities around California, costs for retiree benefits are running between 25 percent and 50 percent of payroll.<sup>17</sup> Because most of them belong to the CalPERS system, they will see those costs rise even higher in the coming years as CalPERS realizes its investment losses and reduces its assumed investment return.

## How big is the challenge?

Unlike many other states, however, California has not been guilty of deliberately underfunding its state government pensions. After Governor Wilson and the legislature dipped into the pension fund in 1991 to help balance the state budget, voters approved an initiative constitutional amendment, Proposition 132, supported by public employee unions, to protect pensions from raids. The measure gave CalPERS and other pension funds around the state exclusive control over actuarial determinations of required contributions from public employers.

Innocent of deliberate underfunding, California nonetheless finds itself deep in a pension hole. The combination of steep investment losses and the pension increases approved a decade ago has created a large unfunded liability for state and local governments. In a recent report, the Pew Center on the States pegged California's unfunded state liability for pensions and retiree health benefits at \$122 billion. The state's Legislative Analyst's Office estimates the state liability for retiree costs at \$130 billion. In recent testimony to California's Little Hoover Commission, pension expert Girard Miller

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estimated the actuarial deficit for all state and local retirement promises at about \$325 billion. At any of these levels, the liability bulks large, even in a state with total economic output of around \$1.8 trillion.<sup>18</sup>

Some analysts regard even these large estimates of unfunded liabilities to be understated. Under the current rules of the Government Accounting Standards Board (GASB), pension funds can establish their liabilities using a discount rate that reflects their historical investment return, approaching 8 percent. But many economists regard it as improper to use a discount rate reflecting the performance of risky assets to value liabilities for pension payments that are guaranteed and carry no risk to beneficiaries. They believe pension liabilities should be discounted at a risk-free rate such as the return on long-term Treasuries. Using a risk-free rate, graduate student researchers at the Stanford Institute for Economic Policy Research estimated the unfunded liability for the state, teachers, and University of California systems at \$425 billion prior to the recession and more than a half trillion dollars after it.<sup>19</sup>

The Schwarzenegger administration has championed using a lower discount rate to value the state's pension liabilities. Were CalPERS to adopt that position, there would no longer be a risk that lower-than-expected investment returns would transfer the costs of paying the pension benefits of today's public workers onto the backs of the next generation of taxpayers. At the same time, however, the state's required pension contribution would soar at a time when the state faces budget deficits amounting to more than 15 percent of its general fund, forcing deeper cuts in the next generation's education. Barring a major change in California's pension system and a major reduction in the cost of its pension promises, California's children are on the hook for the unwise decisions of their parents.

## Rocky path to reform

Public worker pensions, to be sure, did not cause the financial crisis that has hit California's state and local

governments. The biggest blow has been delivered by the recession-driven collapse of tax revenue. Not since the Great Depression have the three major sources of tax revenue in the state — income tax, sales tax, and property tax — fallen, in tandem, so far and so fast.

But saying that pensions are not the cause of the crisis is not the same thing as saying that they are not a contributing factor. Pension contributions measured as a percentage of payroll have increased significantly over the last two decades, and are headed higher still. Handing out higher pension benefits in 1999, not just prospectively but retroactively, ranks high on the list of short-sighted decisions, such as tax cuts, increased general obligation borrowing for infrastructure formerly financed through user fees, "Three Strikes" sentencing rules, and extravagant pay raises for correctional officers, that were made in better times but that are now responsible for California's structural budget deficit.

Reforming pensions will not, by itself, end California's budget woes. But it is hard to imagine a fair and responsible budget path for California and its local governments that does not include bringing retirement policy and benefits for public and private workers into a more equitable balance. Ideally, this project would both restructure the retirement system for public workers in ways that protect their security and assure the fiscal sustainability of their retirement plans and, at the same time, provide more California private-sector workers the opportunity to enjoy similar benefits.

## Legal doctrines limit flexibility

Unfortunately, the options for reducing the cost of excessive pension promises are extremely limited. Under California law, public workers enjoy broad contractual protection for their current levels of pension, whether they are already retired or still on the job. Here, again, the contrast between public and private workers is stark.

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Private defined benefit pensions are covered by the 1974 Employee Retirement Income Security Act (ERISA). ERISA protects the pensions workers have earned to date, but it permits employers to close or freeze pension plans and switch current workers to a new plan in which they accrue lower benefits for future work.

Public employee pensions are not regulated by ERISA. In California, they are governed by contract law, which the courts have interpreted to give public workers much broader protection of pensions, both past and future, than those afforded by ERISA. Courts have ruled that public workers have a contractual interest in not only the pension they have earned to date, as ERISA provides for private-sector workers, but also for the pension they expect to earn in the future. Once promised, a pension formula cannot be reduced unless the change is “reasonable and necessary” to achieve an important public benefit and comes with “comparable new advantages” for each individual employee.

This legal doctrine leaves California with little flexibility to address the rising cost of past pension promises. It says, in effect, that within the basket of compensation public workers receive, the costs associated with pensions cannot be restrained while salary or service time can be. This pushes public employers in directions that make little sense as economic policy during a recession since layoffs, furloughs, and salary cuts reduce take-home pay and therefore economic demand. Further, as Professor Amy B. Monahan of the University of Minnesota Law School notes, “it does not allow the state to structure compensation in the manner it finds most efficient. Instead, it locks in the amount of deferred compensation, and as a result might push current salary and other fringe benefits to a lower-than-ideal economic value.”<sup>20</sup>

Some lawyers suggest that there is enough gray area in the law that, in the current crisis, courts might look more favorably on legislation that reduces pension accruals for future work. But “the legislation would have to be passed, challenged by a participant, and then successfully defended

by the state,” Monahan writes. “Not only would the successful defense be an uphill battle, but gathering sufficient political support to propose or pass pension legislation impairing future accruals would likely be very difficult.”<sup>21</sup> A frontal assault, even if it ultimately succeeds, is unlikely to yield quick results to a state in deep budget crisis.

## Short-term relief must be negotiated

Barring a change by the courts, any reduction in costs of pensions for current workers with vested rights will have to come through collective bargaining. The Schwarzenegger administration has negotiated contracts with six of the state’s smaller bargaining units that raise the employee share of contributions for pensions and retiree health costs and lengthen the period for determining final compensation from one year to three. The contracts also increase the vesting period and introduce reduced pension benefits for newly hired workers, creating a two-tier pension system going forward. To achieve significant budget savings, the state needs to negotiate similar agreements with corrections officers, who have the biggest pensions and whose top pay is 39 percent above the national median. Unfortunately, protecting prison guards’ pay and perks is one of few items on which there is bipartisan agreement in California’s polarized legislature.<sup>22</sup>

Local governments face a similar budget and political challenge in reining in compensation for police and firefighters, whose pay and pensions are also far above the national average and make up three-quarters of the general fund costs of the typical city. But some local governments have won, or are pressing for, concessions like those negotiated by the state. One good measure of the depth of local fiscal distress is that Oakland, one of the state’s most pro-union cities, laid off for 80 of its 776 police officers because of lack of pension concessions.<sup>23</sup>



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## Two-tier plans provide uncertain savings

For California, the push by Schwarzenegger for a two-tier pension system is, in the words of Yogi Berra, “*déjà vu* all over again.” In the wake of the fiscal crunch in the beginning of the 1990s, Gov. Wilson led a successful effort to implement a two-tier pension system with lower benefits for newly hired workers. California’s experience counsels against expecting a two-tier system to provide either immediate or long-term pension reform.

First, by its nature, a two-tier system would do little to nothing to relieve the short- to medium-term pressure of pension contributions on the state budget. Especially at a time when governments are hiring few new workers, it will take years to achieve significant contribution savings from the second tier. Even more important, the state will amass long-term savings only if it sustains the lower tier of benefits.

But once instituted, a two-tier system is unstable. It exacerbates the “pension envy” that now exists between members of the public and private sector by injecting this inequity into the public sector. California’s last experiment with two tiers was quickly undone when SB 400 in 1999 made the lower tier optional and allowed newer workers in Tier 2 to buy their way into the higher tier at bargain rates. We have strong reason to suspect, therefore, that all of the blood and sweat now being put into negotiating second tiers of defined benefit pensions may be for naught.

## A cash balance plan for California

There is, however, another long-term reform option for California, one that would provide more retirement security for public workers and more fiscal stability and certainty for taxpayers. It is known as a cash balance pension, a hybrid that combines the best aspects of defined benefit and defined contribution plans. This type of retirement plan has become increasingly popular among private employers and was adopted by the state of Nebraska in 2003 after its four-

decade-long experiment with a defined contribution plan showed that workers were earning insufficient returns on their self-managed accounts.<sup>24</sup>

A cash balance plan has two pieces. As in a defined contribution plan, an employer contributes a percentage of a worker’s salary into an account that belongs to the worker. As in a defined benefit plan, the employer provides a defined benefit in the form of a stated guaranteed rate of return on the money in the account. A cash balance account belongs to the individual worker and is portable. But the employer assumes all the investment risk: workers earn the guaranteed rate of return on the cash balance in the account each year regardless of the performance of the markets.

A cash balance system has advantages for workers and taxpayers. Because it is portable and always vested, workers can move to a new job and take their account with them; public workers in defined benefit plans lose any employer contributions if they leave public employment before they vest. Because the return on their accounts is guaranteed, workers in cash balance plans do not risk having their accounts dwindle because of their poor investment decisions or their retirement plans dashed because of untimely market swings.

For taxpayers, a cash balance plan reduces the risks of pension underfunding and overpromising. The public is liable only to make a negotiated percentage of payroll contribution each year and to pay the guaranteed return on each worker’s cash balance. Both the contribution rate and a guaranteed return can be adjusted going forward according to budget circumstances; they are not subject to the legal doctrines that now make it difficult for governments to adjust unwise promises. A cash balance plan eliminates abuses like pension “spiking” and prevents the kind of retroactive pension increases that SB 400 provided. In a cash balance plan, the public contribution to, and liability for, public retirement is transparent and subject to regular budget processes and political

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deliberation. It is a much better fit for a state whose broken governing system pushes both local and state government toward sending today's bills to tomorrow's taxpayers.

Like a two-tier system, a cash balance plan for new workers would achieve budget savings slowly. But it could also be put in place for current employees going forward as part of labor negotiations, allowing the state to reduce the unfunded liability for its excessive promises in the past.

The cash balance option offers another potential benefit: California could sponsor a parallel cash balance plan for private workers to which employers could voluntarily contribute. Such a plan could address the biggest source of pension envy: that too many California private workers have too little retirement savings or security. At the same time that it addresses the fiscal challenge of a public pension system gone awry, California should be looking to repair the social contract between public and private workers by building a cash balance retirement system to serve the needs of all.

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