California's Public Employee Pension Reform Act of 2013

By Grant Boyken

California enacted sweeping public pension reforms in 2012. Despite competing claims that extensive reform either wasn't warranted or didn't go far enough, California's pension legislation will provide immediate savings and reduce unfunded liabilities over the long term.[1]

Introduction

Since the market collapse of 2008–09 and resulting pension fund investment losses, all but a handful of states have adopted significant changes to their public employee retirement plans aimed at reducing unfunded liabilities and bringing contribution rates back down to manageable levels.[2] California Gov. Jerry Brown viewed pension reform not only as a fiscal necessity, but also as political imperative to win voter support for his November 2012 ballot initiative to close the state's long-standing budget deficit with temporary sales and income tax increases. In September 2012, the legislature passed, and Brown signed into law, AB 340, the Public Employee Pension Reform Act of 2013, known as PEPRA.

PEPRA increases minimum retirement ages and establishes a single, less generous, basic safety (police and firefighter) formula, along with two slightly more generous optional safety formulas, and a single nonsafety formula, applicable to all employees hired on or after Jan. 1, 2013. It increases contributions for many employees, including all new state employees, to 50 percent of the actuarial normal cost of the benefit. For new employees, the annual pay used to calculate benefits will be capped—initially $110,000 for workers in Social Security and $132,000 for those without Social Security, increasing as the Social Security maximum annual worker contribution increases in future years—and the type of compensation counted toward pensionable earnings will be subject to several new restrictions. Under PEPRA, local governments will be able to impose higher contributions than permitted under current collective bargaining agreements if, after five years of bargaining, they have not been able to reach agreement with employee unions on implementing the increase. State government savings from higher employee cost sharing will be applied to the state's unfunded liability.

PEPRA provisions apply to the two large state pension funds, the California State Teachers' Retirement System, or CalSTRS, which covers K–12 teachers and community college faculty, and California Public Employees' Retirement System, or CalPERS, which covers state employees, the employees of about 1,500 cities and other public agencies, California State University system professors and nonteaching public school employees. PEPRA also applies to 20 county retirement systems. It does not apply to the University of California Retirement System or the state's 20 independent local retirement systems.

Concern about rising pension costs, not the solvency of retirement systems, drove pension reform in California

The problem that compelled policymakers to act was not the solvency of California's public pension systems. The fiduciaries of all but one of California's 85 public pension systems legally can, and regularly do, impose higher employer contribution rates necessary to adequately fund liabilities. And even the exception, CalSTRS—with a current structural funding deficit largely caused by the fact that, unlike almost every other system in California, its contribution rates are fixed in statute rather than set by its trustees—is not in jeopardy of depleting its assets anytime soon.

Instead, the main systemic problem PEPRA was enacted to solve was the unprecedented increase in the cost of pension contributions at a time when state and local government budgets already were stretched thin by decreasing tax revenues and employee health care costs that significantly outpaced inflation. The current state employer CalPERS contribution rate, as a percent of payroll, is comparable to rates of the late 1970s and early 1980s. But it is markedly higher than in the late 1990s and early 2000s, when the booming financial markets buoyed the system's investment returns and drastically lowered contribution rates.

For the majority of state workers not in public safety positions, the state's contribution went from zero in the 2000–01 fiscal year when CalPERS was overfunded to almost 20 percent of covered payroll in the 2012–13 fiscal year. During that same time period the state's contribution for highway patrol employees increased from 14 percent to 34 percent of payroll.[3]

In terms of actual dollars, the state pension contribution to CalPERS decreased from $1.2 billion in the 1997–98 fiscal year to $160 million in the 1999–2000 fiscal year.[4] The state contribution rose to $2.7 billion in the 2007–08 fiscal year and to $3.7 billion five years later in the 2012–13 fiscal year.[5] Considering the state's annual general fund budget of $90 billion to $100 billion, and the fact that about one-third of the total pension contribution is paid from special funds, the pension payment is a relatively small percentage of the state's general fund budget. But for a state that confronted big annual budget deficits in recent years, any increase in pension costs was difficult to absorb.

For local governments, increases in benefit costs have an even more profound impact because payroll costs are a much larger portion of their total annual expenditures. According to the City of San Jose, for example, the city's pension and retiree health costs of $245 million in the 2011–12 fiscal year amounted to about 20 percent of the city's general fund budget.[6]

Currently, nearly half of CalPERS' local government plans for public safety employees have employer contributions exceeding 30 percent of payroll.[7] Considering health benefit costs of more than 10 percent of payroll, and the fact that some employee groups have bargained contracts that require employers to pay employees' pension contributions as well as their own, many local government employers are now paying more than 50 cents in added costs for each salary dollar to provide benefits for police and firefighters.

As the cost of paying pensions reaches these levels, nobody—not workers, not their unions, not employers, taxpayers or policymakers—seems prepared to continue to live with the status quo. The increasing costs of public employee benefits not only are leaving less on the compensation table to provide pay increases for today's workers, but also threaten to create structural public sector unemployment and permanently reduced services.

What Explains Rising Pension Costs in California?

The rising cost of public employee pensions over the past decade has been driven by several factors. Chief among these is the sudden and severe market crash of 2008–09 in which CalPERS and CalSTRS both experienced investment losses of about 25 percent.[8] These losses shrank the pool of assets available to pay benefits and required higher contributions to make up the shortfall. Similarly, U.S. public pension plans lost an average 19.1 percent of assets during the one-year period ending June 30, 2009.[9] Public plans, which generally smooth asset gains and losses incrementally over a period of three to five years, reached their lowest average funding level in 15 years in 2011.[10]

In addition to investment losses, rising pension costs in California can be explained in part by benefit increases granted retroactively to state and local government employees by legislation enacted in 1999 and 2000.[11] A CalPERS actuarial analysis attributes 27 percent of the increase in the state's contribution from 1998 to 2010 to these benefit enhancements.[12] The 1999 and 2000 legislation established more generous formulas for state employees and allowed local government employees and their employers to bargain for more generous formulas.

Prior to PEPRA's enactment, the state already had rolled back benefits to pre-2000 levels for its own workforce. In recent years, the state implemented a lower tier of benefits for new members and increased from one year to three years the length of time used to determine the highest average salary on which pensions are based. Prior to PEPRA, most of the state bargaining units also agreed to higher employee pension contributions.

Local governments, for the most part, had not rolled back pension benefits. Some observers suggest market pressures led local governments to increase benefits to compete with neighboring jurisdictions for employees.[13] As of 2011, 82 percent of CalPERS local government plans for nonsafety employees offered benefit formulas more generous than the 2 percent of salary multiplied by years of service at age 60—2 percent @ 60—formula adopted for new state employees in 2010.[14] In 2011, 60 percent of local government plans for safety members continued to use the 3 percent @ 50 formula, while the state had reduced its formula for new state patrol members and firefighters to 3 percent @ 55 in 2010.[15]

Because pension costs are based on employers' total payroll, increases in average salaries and the number of employees also have contributed significantly to increasing pension costs. CalPERS estimates 51 percent of the increase in state contributions from 1998 to 2010 can be attributed to payroll growth.[16] In California, state and local government workforces grew by more than 30 percent from 1998 to 2008, and average salaries increased by more than 50 percent.[17]

The politics of pension reform in California also were heated by the large-scale and fairly successful state and national efforts by organized and well-funded anti-public pension research, media relations

and political action that aroused sustained public and editorial anger about pension benefits for public employees, which were stigmatized as excessive when compared to the greatly diminished retirement benefits for workers in the private sector.

What Will PEPRA Accomplish?

PEPRA will not put a significant dent in unfunded pension liability in the short term, but employers will recognize immediate savings. As agencies successfully implement greater cost sharing for current employees, employer contributions will be reduced correspondingly. The reduced pension benefit formulas and the cap on pensionable earnings will reduce liabilities for new employees and result in lower employer contribution costs for employers. This will create significant savings as new employees replace retiring boomers.

The projected savings of $22.7 billion for CalSTRS and $42 billion to $55 billion for CalPERS over the next 30 years are significant.[18] In the first five years alone, CalPERS estimates state government will save $680 million. But these figures don't include the savings for California's 20 large county retirement systems or savings that will come as a result of employers' bargaining for increased employee contributions.

Moody's Investors Services has taken notice. It says the reforms have improved the credit outlook for the state and for local governments that participate in state pension plans, which includes most of California's nearly 500 cities and 1,000 local school districts.[19]

Conclusion

PEPRA makes public pensions more financially sustainable by reducing costs immediately and unfunded liabilities over the long term. By making public plans more financially sustainable, PEPRA also makes pensions more politically sustainable. The law makes pensions more of a shared responsibility by requiring employees to pay up to one-half of the actuarial normal cost of their benefits. It establishes adequate, but not extravagant, benefits for new employees that are capped to avoid spiking. It makes pension formulas easier to understand and more transparent by establishing uniform benefits for most retirement systems.

In terms of political sustainability, PEPRA also steered clear of altering vested benefits for current employees that California courts for decades have viewed as contractual rights guaranteed from the date of hire.[20] The issue of public employees' vested rights to pension benefits has given rise to litigation over reform ballot measures passed by voters in San Diego and San Jose in 2012, and will be tested in the bankruptcy cases of the cities of Stockton and San Bernardino.

While PEPRA addresses pension costs and funding shortfalls for California's public employee pension plans, an even more significant funding gap threatens retirement security for private sector workers in California and across the U.S. A 2010 study by the Center for Retirement Research at Boston College finds the gap between what U.S. households have saved for retirement and what they should have saved is $6.6 trillion.[21] Another 2010 study found nearly half—47 percent—of California workers are on track to retire with incomes below 200 percent of the federal poverty level, $22,000, a widely accepted threshold for economic hardship.

These figures suggest it's a struggle for most people to save adequately for retirement. The task is even more difficult for the 47 percent of U.S. workers—55 percent in California—with no access to retirement savings plans through their employers.[22] Among workers without employer-sponsored plans, people of color are disproportionately represented—64 percent—and Latinos constitute the largest share—46 percent.[23]

To address the private-sector component in the retirement security equation, Senate Bill 1234, enacted alongside PEPRA in 2012, established the California Secure Choice Retirement Savings Program. The measure lays the groundwork for an automatic-enrollment retirement savings program for the 6.3 million California workers with no access to an employer-sponsored retirement plan.[24] Prior to implementation, the bill requires the Secure Choice governing board to complete a feasibility study and obtain federal approval of the program. By enacting Senate Bill 1234, California has taken a significant step toward addressing the broader retirement security problem.

Notes

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www.calpers.ca.gov/eip-docs/about/pubs/employer/2011-st-body.pdf. p. 41

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[7] *Agenda Item 5a, Results of the Actuarial Valuations for Public Agencies*, Benefits and Program Administration Committee of the California Public Employees' Retirement System Board of Administration (Dec. 13, 2011). Accessed on Jan. 30, 2013 at *http://www.calpers.ca.gov/eip-docs/about/board-cal-agenda/agendas/bpac/201112/item05a-0.pdf*. p. 3.

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[9] Keith Brainard, *Public Fund Survey Summary of Findings for FY 2009*, National Association of State Retirement Administrators (Nov. 2010). Accessed on Jan. 28, 2013 at *http://www.publicfundsurvey.org/publicfundsurvey/pdfs/Summary%20of%20Findings%20FY09.pdf*. p. 9.

[10] *State and Local Pensions: An Overview of Funding Issues and Challenges*, Center for State and Local Government Excellence (Jan. 2013). Accessed on Jan. 24, 2013 at *http://slge.org/wp-content/uploads/2013/01/2013-State-Local-Pensions-final.pdf*. p. 4

[11] California Senate Bill 400 (1999) Chapter 555; California Assembly Bill 616 (2000) Chapter 55.

[12] *Impact of Economic Downturn on Employer Contributions and Changes to the CalPERS Smoothing Methods Webinar Slides*, CalPERS (Feb. 17, 2010). Accessed on Jan. 28, 2013 at *http://www.calpersresponds.com/Resource-Library.php?end=5*.

[13] Ed Mendel, *Reform ends market pressure to boost pensions*, Calpensions (Dec. 3, 2012). Accessed on Jan. 30, 2013 at *http://calpensions.com/2012/12/03/reform-ends-market-pressure-to-boost-pensions/*.

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[15] *Agenda Item 5a, Results of the Actuarial Valuations for Public Agencies, Attachment 1*, Benefits and Program Administration Committee of the California Public Employees' Retirement System Board of Administration (Dec. 13, 2011). Accessed on Jan. 30, 2013 at *http://www.calpers.ca.gov/eip-docs/about/board-cal-agenda/agendas/bpac/201112/item05a-1.pdf*.

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[20] For example, see: *Vested Rights of CalPERS Members: Protecting the pension promises made to public employees*, California Public Employees' Retirement System (July 2011). Accessed on Feb. 8, 2013 at *http://www.calpers.ca.gov/eip-docs/about/press/news/vested-rights.pdf*.

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[22] Nari Rhee, 6.3 Million Private Sector Workers in California Lack Access to a Retirement Plan on the Job, UC Berkeley Labor Center (June 2012). Accessed on Feb. 13, 2013 at *http://laborcenter.berkeley.edu/research/ca_private_pension_gap12.pdf*.

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[24] Nari Rhee, 6.3 Million Private Sector Workers in California Lack Access to a Retirement Plan on the Job, UC Berkeley Labor Center (June 2012). Accessed on Feb. 13, 2013 at *http://laborcenter.berkeley.edu/research/ca_private_pension_gap12.pdf*.

About the Author

As the Pension and Benefits officer for the California State Treasurer's Office, **Grant Boyken** analyzes issues related to employee benefits and insurance. He also serves as the acting director of the California Secure Choice Retirement Savings Program.