Public Employee Retirement Benefits

Background and Policy Principles

Legislative Analyst's Office

Presented to: Public Employee Post-Employment Benefits Commission

April 26, 2007

www.lao.ca.gov/retireehealth

Presentation Outline

- Pensions
- Retiree Health
- Principles for Pension and Retiree Health Policy
- Responding to Commissioners' Questions

Public Employee Pensions

- **Governments typically pay for estimated future costs of benefits *as they accrue*.**
  - **Pension prefunding: consistent public policy for generations in California at the state and local level.**
  - **Minimizes unfunded liabilities, or future taxpayers' costs to pay for compensating today's public servants.**
  - **Voter-approved constitutional provisions facilitate pension prefunding.**

Pension Prefunding: Established Public Policy in California

- **Commission on Pensions of State Employees (1929)**
  - **Commission report: "An urgent responsibility rests upon the state to see that any retirement system which it may sponsor is placed upon a sound financial basis, where liabilities are provided for as they are *incurred*, rather than when they mature."**
- **Proposition 5 (1930)**
  - **Authorized state employee pensions.**
  - **Ballot argument referenced prefunding as the "proper method" of financing pensions.**

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Pension Prefunding: Established Public Policy in California *(Continued)*

- **Over time, voter support for pension systems to generate greater returns from prefunding assets.**
  - **1966 and 1970: Stock investments authorized.**
  - **1984: Even broader investment authority.**
    - **Ballot argument: Will help "keep benefits up and costs down."**
  - **1992: Stop "raids" of pension funds by elected officials.**

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Today, California's Pension Systems Are Substantially Funded

- **Largest 15 systems account for over 90 percent of all systems' assets.**
  - On average, about 88 percent of liabilities are funded for these systems.
    - Funded ratios range from 72 percent to 108 percent.
  - For more information, see Appendix A.

For Defined Benefit Pensions, Prefunding Is Desirable

- **Minimizes taxpayer and employee costs.**
  - **"Over the past 10 years, approximately 75 percent of the income used to pay [CalPERS] pension benefits came from investment earnings, not employee or employer contributions." —CalPERS policy brief, 2006.**
- **Helps governments keep benefit promises made to retired employees.**

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Public Pension Contributions Stabilizing After a Volatile Period

- **Unprecedented investment success led to sharp contribution declines in late 1990s.**
- **In the early 2000s, contributions skyrocketed.**
  - **In many cases, caused principally by stock declines.**
  - **Benefit increases and other factors also contributed.**
- **More stability in recent years.**
  - **Successful investments.**
  - **Limited benefit enhancements.**
  - **Implementation of "rate stabilization" policies.**

Retiree Health Benefits: A Growing Cost for Government

- Most California public employers offer retiree health benefits.
- In the past, manageable governmental costs.
- Rapidly rising costs in recent years.
  - Rapid premium growth.
  - Increased retiree longevity.
  - Many more retirees.

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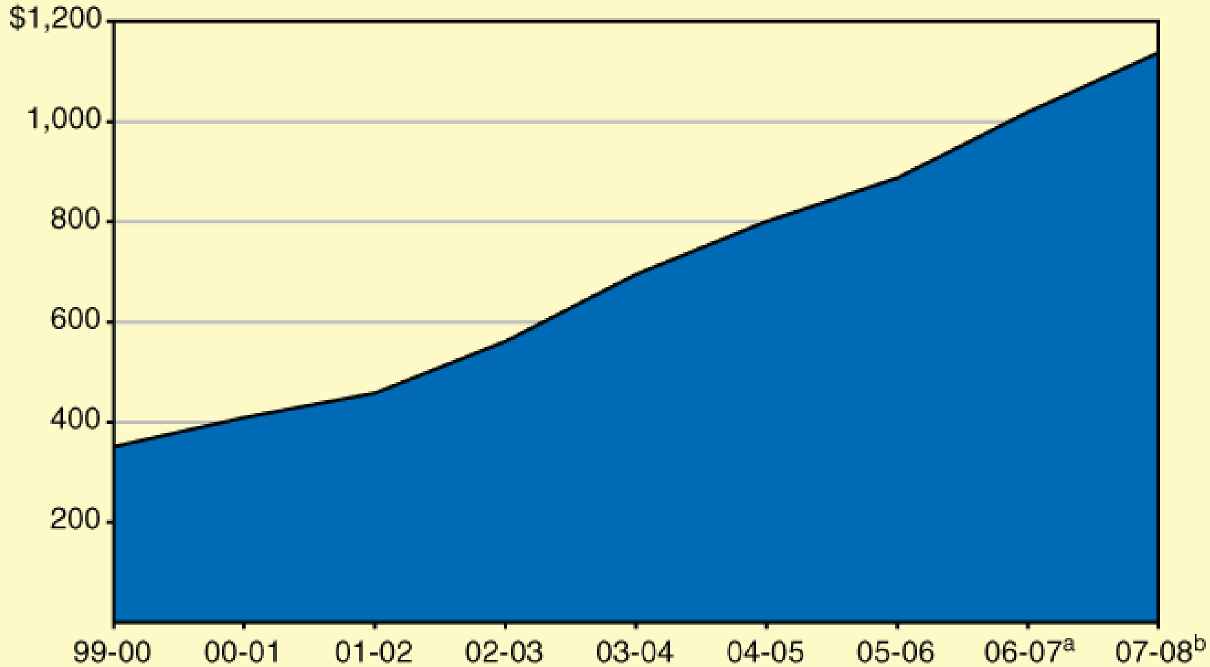
State's Pay-As-You-Go Retiree Health Costs Are Climbing Rapidly

In Millions



[a]Estimated.
[b]Proposed spending from all funds, including off-budget items.

Public Sector Accounting Rules Catch up to the Private Sector

- **Public sector financial statements have listed pension liabilities for decades.**
- **1990: Corporate accounting rules require calculation of retiree health liabilities.**
- **2007: Public sector accounting rules begin to require reporting of retiree health liabilities.**
  - **For large governmental entities: beginning in 2007-08 financial statements (which will be released in late 2008 or early 2009).**

With Little Prefunding, Unfunded Liabilities Often Will Be Massive

- **State Government and California State University**
  - **$40 billion to $70 billion (2006 LAO estimate).**
- **University of California**
  - **$7.6 billion (2006 estimate).**
- **Counties**
  - **May be over $25 billion, according to valuation information known to date.**
- **Los Angeles Unified School District**
  - **$10 billion (valuation released in February 2006).**

How Can Governments and Employee Groups Address the Liabilities?

- **There are *two* general strategies.**
  - **Use prefunding to cover future benefit costs.**
  - **Change benefits so as to reduce future benefit costs.**
- **There are many options to implement these strategies.**
  - **"Full prefunding?" "Partial prefunding?"**
  - **Many options to change benefits, particularly for future hires.**
    - **The ability to modify benefits for current and past workers may be limited *if* the workers have vested benefit rights.**

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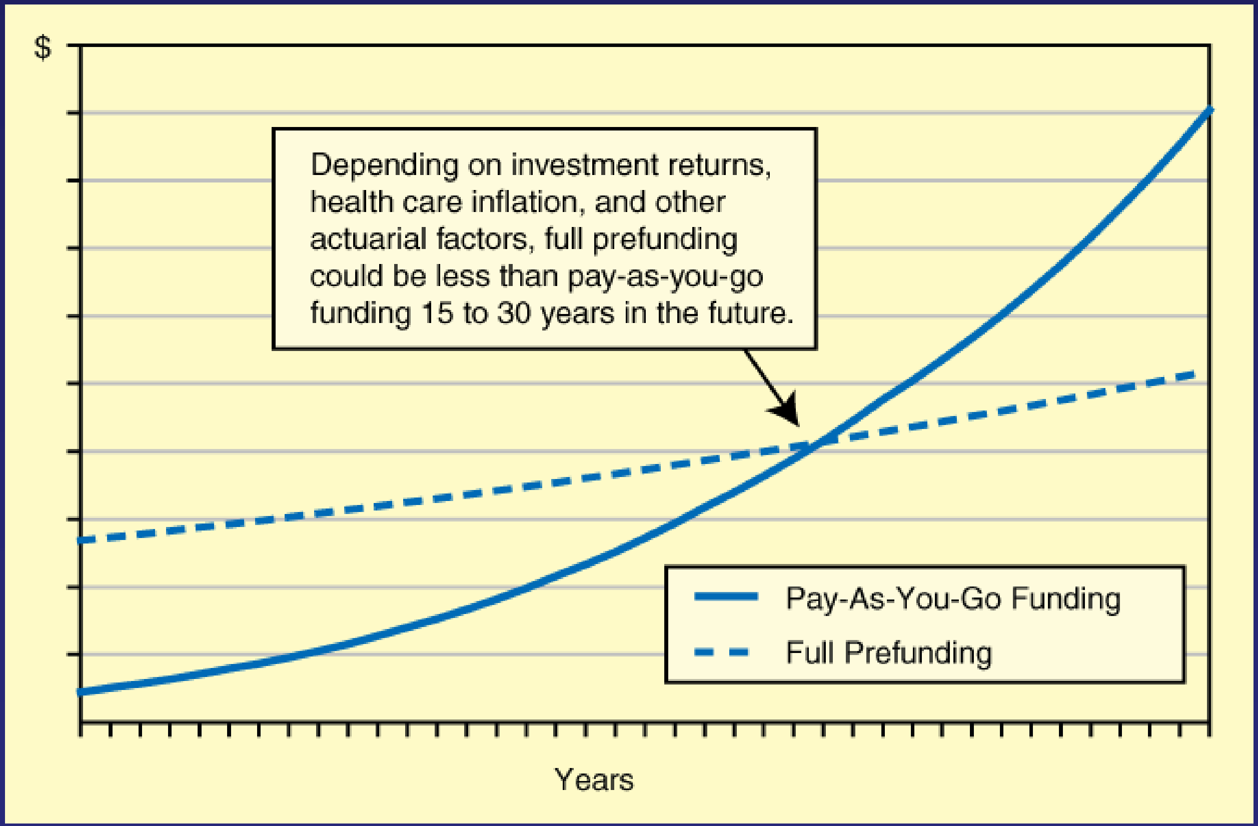
Prefunding: Costs More Now, Costs Less Later



Prefunding: Costs More Now, Costs Less Later *(Continued)*

- **Full prefunding—the annual amount to retire liabilities in 30 years—is expensive.**
  - **The choices often will not be easy ones.**
    - **Revenue increases.**
    - **Use funds that otherwise would go to programs.**
- **Delays in reducing liabilities may lead to even tougher choices in the future.**

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Changing Benefits: Many Options Exist

- **Most options involve shifting costs or financial risks to retirees.**
  - **Increasing premiums, copayments, deductibles, etc.**
  - **Changing eligibility criteria.**
  - **Reducing “implicit subsidy” paid as part of active employees’ health premiums.**
  - **Defined contribution retiree health plans.**
  - **Many other options exist.**

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Changing Benefits: Many Options Exist

(Continued)

- **Proposed reforms of the health care system also seek to change benefit delivery, thereby reducing future costs.**
  - **Reforms that slow future growth of premiums or other employer payments undoubtedly would help.**
  - **However, actuarial valuations assume that premium growth in the future will be much less than it is now.**
    - **Therefore, unless health care reform succeeds, public employer liabilities may turn out to be *much more* than currently estimated.**

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Establishing Principles for Public Retirement Policy

- **Pension and retiree health benefits are alike in several important respects.**
  - **Deferred compensation earned during employee's working life.**
  - **Typically, both are *defined benefits*.**
  - **Future costs can be estimated through actuarial valuations.**
  - **Both can result in unfunded liabilities that may have to be paid by future taxpayers.**

Establishing Principles for Public Retirement Policy *(Continued)*

- **We recommend that the Legislature adhere to several general principles when setting policy for public employee pension and retiree health benefits.**
- **These principles would produce benefits for both the public and public employees.**

Principle: Benefits Should Be Considered As a Part of Overall Compensation

- **Governments and employee groups should be able to bargain in good faith to set retirement benefits.**
- **Benefits:**
  - **Flexibility for governments and employee groups to agree to changes in benefits.**
  - **One size does not fit all. Different employers and employee groups have different needs.**

Principle: Pay for Estimated Benefit Costs as Benefits Accrue

- Governments should adhere to long-term funding strategies designed to address likely costs of future defined benefit payments.
- Annual payment of "normal costs" by employers and/or employees is needed, at a minimum.
  - Exception: Rare (and usually temporary) instances when liabilities are substantially overfunded.
- Benefits:
  - Avoids shifting operating costs to future taxpayers.
  - Reduces costs in the long run.
  - Helps governments provide promised benefits.

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Principle: Unfunded Liabilities Need to Be Addressed

- **The policy of *every level of government* should be to minimize unfunded liabilities over the long run—both for pensions and retiree health.**
- **May take many years of funding to address initial reported retiree health liabilities.**
  - **Similar to the many years it took to build substantially funded pension systems.**
- **Benefits:**
  - **Reduces costs in the long run.**
  - **Helps governments provide promised benefits.**

Principle: Public Benefits Require Transparency

- Collective bargaining agreements, laws, and employee/retiree documents need to be clear about employer obligations.
- Example: Can benefits be changed in the future or not?
- Benefits:
  - Facilitates financial planning by employers and employees alike.
  - Prevents future judicial disputes.

Principle: Adhere to Long-Term Retirement Funding Strategies

- **Long-term strategies rely on strong investment years offsetting the inevitable weak investment years.**
  - **Unexpected investment gains often are followed by unexpected losses.**
  - **“Stock market bubbles” tend to burst.**
- **Be cautious about enhancing benefits based on short-term investment gains.**

Conclusion: Future Risks Point to the Need for Action

- Demographic and economic risks heighten the importance of tackling existing liabilities beginning now.
  - GAO: Social Security and Medicare benefits are unsustainable.
  - Medical advances may lengthen life expectancy more and increase retirement costs.
  - The “Baby Boom.”
    - Unprecedented changes in pension system demographics.

Questions

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Appendix A

In Billions

Retirement System[a]	Actuarial Asset Value	Unfunded Liabilities	Percent of Liabilities Funded	Valuation Date
California Public Employees' Retirement System[b]	$183.7	26.6	87.3%	6/30/2005
California State Teachers' Retirement System	121.9	20.3	85.7	6/30/2005
University of California Retirement Plan	42.0	—	104.1	6/30/2006
Los Angeles County Employees Retirement Association	32.8	3.4	90.5	6/30/2006
San Francisco Employees' Retirement System	12.7	—	107.6	6/30/2005
Los Angeles Fire and Police Pension Plan	12.1	0.7	94.6	6/30/2006
Los Angeles City Employees' Retirement System	7.7	2.2	77.8	6/30/2006
Los Angeles Water and Power Employees' Retirement Plan	6.4	0.6	91.5	7/1/2006
San Diego County Employees Retirement Association	6.2	1.2	83.6	6/30/2006
Orange County Employees Retirement System	5.8	2.3	71.5	12/31/2005
San Bernardino County Employees' Retirement Association	5.2	0.4	92.0	6/30/2006
Sacramento County Employees' Retirement System	4.8	0.4	93.0	6/30/2006
Contra Costa County Employees' Retirement Association	4.1	0.7	84.8	12/31/2005
San Diego City Employees' Retirement System[c]	4.0	1.0	79.9	6/30/2006
Alameda County Employees' Retirement Association	3.8	0.8	83.2	12/31/2005

[a] Largest defined benefit public pension programs (as reported by the State Controller), which include over 90 percent of all systems' assets.

[b] The system also presents funding information based on the market value of assets.

[c] Includes only assets and liabilities for the City of San Diego, one of three plan sponsors.