LAO

60 YEARS OF SERVICE

July 27, 2007

Hon. Edmund G. Brown Jr.
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Toni Melton
Initiative Secretary

Dear Attorney General Brown:

Pursuant to Elections Code Section 9005, we have reviewed the proposed constitutional initiative regarding public employee retirement benefits (A.G. File No. 07-0024).

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 some public employees. Currently, about 4 million Californians—over 10 percent of the population—are members of one or more of the state's 133 public retirement systems, including around 1 million who currently receive benefit payments. Most state and local government employees—including some part-time employees—are eligible to receive a defined benefit pension after retiring that is based on the employee's age at retirement, years of service, salary, and type of work assignment. For example, a typical state office worker 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. (Therefore, after working for 25 years, such a retiree would be eligible to receive a defined benefit equal to 50 percent of his or her highest single year's pay.) Peace officers and other public safety employees often are eligible for larger pensions—as measured by a percentage of their pay during the final years of public employment. Some public employees receive smaller benefits. The pension plans generally provide annual cost-of-living increases to limit how much the effects of inflation erode the purchasing power of the pension benefits.

Legislative Analyst's Office
California Legislature
Elizabeth G. Hill • Legislative Analyst
925 L Street, Suite 1000 • Sacramento CA 95814
(916) 445-4656 • FAX 324-4281

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, for example, the average state or local employee retires at about 60. Figure 1 shows the average retirement ages for several groups of public employees in these three systems. Average retirement ages in other pension systems vary, but are about the same as those listed in Figure 1.

Figure 1

Average Retirement Ages for Selected Public Employee Groups[a]

	Age
California Public Employees' Retirement System	
California Highway Patrol officers	53
Other peace and safety officers	55
Other state and local employees	60
California State Teachers' Retirement System	
School district and community college teachers	61
University of California Retirement Plan	
Academic faculty	63
Professional and support staff members	59

[a] Includes public employees retiring with a disability pension benefit.

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

hood that a public employee will retire in any given year, (4) the employee's future pay increases, (5) the pension benefits for which the employee will eventually 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, the employer may be required to provide additional contributions to fund a given level of pension benefits and pay down what is called an unfunded liability. Currently, California governments contribute about $13 billion per year to the state's public retirement systems for pension benefits, including several billion dollars per year to retire existing unfunded pension liabilities.

Funding Retiree Health Benefits. California governments generally do not prefund retiree health benefits. This means that they pay for the costs of these benefits on a "pay-as-you-go" basis, and there is 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 and dependents. Currently, California governments pay around $4 billion to $5 billion per year for retiree health benefits.

PROPOSAL

This measure amends the Constitution to place limits and conditions on defined benefit pensions and retiree health benefits for state and local government employees hired on or after July 1, 2009 (referred to as "new employees"). The measure would have no direct effect on retirement benefits of state and local government employees and retirees hired before July 1, 2009.

Pension Benefits and Funding

Retirement Ages. The measure establishes the following minimum "full retirement ages" for new employees:

- Peace officers and firefighters: 55.
- Other public safety employees: 60.
- All other new employees: the full retirement age as defined by Congress in the U.S. Social Security Act (currently between ages 66 and 67 for persons born between 1943 and 1959 and age 67 for persons born in 1960 or thereafter).

Employees could retire at an earlier age and receive benefits, although at an actuarially reduced level.

Limits on Benefits. New employees under this measure generally would be eligible for smaller defined benefit pensions than those currently provided to state and local

government employees. The measure specifies the following limits on defined benefit pensions for new employees (expressed as a percent of the employee's annual average base wage multiplied by the number of years of employment):

- Peace officers and firefighters: 2.2 percent.
- Other public safety employees: 1.8 percent.
- Non-public safety employees who are not eligible to receive Social Security benefits: 1.5 percent.
- All other new employees: 1 percent.

Under the proposal, pension benefits may be provided to new employees only after they have worked full-time for one or more public agencies for at least five consecutive years. The annual average base wage to be used in calculating defined benefit pensions would be the highest average annual base salary of the employee during any five consecutive years of government service. The measure allows two-thirds of voters in an agency's jurisdiction to approve benefit payments higher than the limitations described above, except that for state and University of California employees, such changes in the benefit limitations could be approved by a bill passed with the votes of three-fourths of the Members of each house of the Legislature.

Limitations on Benefit Increases That Offset Inflation. Under the measure, public employers would be limited in the amounts of increased benefits that could be promised to new employees to offset the effects of inflation on the purchasing power of their pension payments. Specifically, for those with benefits at the maximums allowed, the measure contains no allowance for inflation-protection benefits during the first five years of a new employee's retirement. After five years of retirement, public employers may provide annual benefit increases to offset the effects of inflation, not to exceed the increase in the California Consumer Price Index or 3 percent (whichever is less).

Other Options for Increasing Benefits. The measure also allows state and local governmental entities to increase defined benefit pension payments to retirees by up to 3 percent if actuaries determine that even after such an enhancement the value of a retirement system's assets still exceeds 110 percent of its accrued financial liabilities.

Retroactive Increases Prohibited. The measure prohibits retroactive increases of new employees' defined benefit pensions. For example, if, during a new firefighter's first year with a public employer, he or she was provided with a 2 percent benefit, the state could not later enhance it to a 2.2 percent benefit *applied to that first year of employment.* A later enhancement, however, could be applied to years of employment *after* the effective date of the change—subject to the other limitations on benefits included in the measure.

Minimum Contributions to Retirement Systems Specified. Under the measure, public employers and/or new employees would have to contribute funds annually to a retirement system equal to at least the normal cost of pension benefits, as estimated by the system's actuaries.

Public Employers to Determine Annual Make-Up of Contributions. Under the measure, state and local governmental entities would have the right to adjust employer and employee contributions to retirement systems for pension benefits for new employees, subject to the requirement that they and/or their employees contribute at least the normal cost of pension benefits. The measure, however, would not affect any existing contracts related to how governments pay retirement systems for pension benefits of current and past employees.

Retiree Health Benefits and Funding

Retirement Ages and Eligibility. Under the measure, retiree health benefits could be provided to new employees only upon their attaining the full retirement ages described above with certain limited exceptions. Retiree health benefits could be provided only if he or she has been (1) a full-time employee of one or more governmental entities for at least five consecutive years immediately preceding retirement and (2) a full-time employee of one or more public agencies for an aggregate of at least ten years. The measure specifies no limits on the types of retiree health benefits that may be provided to new employees.

Retiree Health Prefunding Required. The measure requires public employers to prefund retiree health benefits for both new employees and current employees. Under the measure, public employers and/or public employees would have to contribute funds annually to a retirement system or similar fund equal to at least the normal cost of retiree health benefits, as estimated by the system or fund's actuaries. As with the normal cost of pension benefits, these normal costs are those amounts estimated to be sufficient—when combined with future investment returns—to cover the portion of future retiree health benefits earned by that employee during a given year. As with employers' pension benefit contributions, employers would have the right to adjust their contributions for retiree health benefits, subject to the requirement that they and/or their employees contribute at least the normal cost of such benefits each year.

Pension Trust Funds May Not Be Used for Health Benefits. Currently, some retired public employees receive health benefits funded from a portion of their pension funds' assets. This measure would prohibit the use of this type of funding mechanism.

FISCAL EFFECTS

The measure would result in major changes to how the state and local governments compensate their employees. The fiscal effect of these changes would depend in part on how the measure is interpreted by the courts and implemented by governmental entities and voters. The requirements for changes in retirement benefits would apply only to those public employees hired on or after July 1, 2009. Accordingly, the full fiscal effect of the proposal would not emerge until several decades after the measure's passage. Below, we discuss how the measure would affect state and local government costs for defined benefit pension and retiree health benefits, respectively.

Pension Benefits

Major Reductions in Pension Contributions. 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 begin making smaller normal cost contributions for new employees hired on or after July 1, 2009. Measured as a percentage of payroll, normal cost pension contributions for new employees often would be less than one-half—and in some cases, much less than one-half—of the contributions paid by governments for current employees. Accordingly, several decades in the future (after most current governmental employees retire and most of the state and local governmental workforce consists of persons hired on or after July 1, 2009), normal cost pension contributions by California governments would probably be less than $5 billion per year (as measured in today's dollars). This assumes that, in most cases, governmental entities offer the maximum pension benefits specified in the measure (but not the higher benefits which could be authorized by super-majority votes of the Legislature or the voters of a local jurisdiction).

Increases in Other Forms of Compensation. In order to offset the decline of retirement benefits required under this measure for new employees, many governments likely would increase other forms of compensation above current levels in order to remain competitive in the labor market. These other forms of compensation include salaries and contributions to employee retirement funds other than those addressed in this measure (such as "defined contribution" retirement accounts, for which governments make a specific payment, rather than promise a specific future benefit). These increases would offset the reductions in pension contributions to an unknown extent. The magnitude of these additional costs would be determined by various factors, including labor market conditions and choices made by governmental entities and voters.

Retiree Health Benefits

Requirement to Prefund Costs of Retiree Health Benefits. Under the measure, governments and/or employees would be required to start prefunding retiree health benefits that they commit to provide to both current and new employees. Most governments

do not currently prefund these benefit costs. In the short term, therefore, the measure would result in annual governmental payments above those that otherwise would be made in order to fund normal cost retiree health benefit contributions. (We assume that actuaries would determine that these normal cost payments are in addition to existing pay-as-you-go costs that governments make for current retirees' health benefits.) The increased payments are likely to be several billions of dollars per year in the short term. In the long run, however, reductions in annual governmental costs for retiree health benefits would more than offset the short-term increases in payments. This is because investment returns would fund a significant amount of future retiree health benefit costs and cover costs that otherwise would have to be paid by governments, employees, and/or retirees.

Other Fiscal Effects

Variety of Other Fiscal Effects Are Possible. Over the long term, the measure could result in numerous other impacts on governments. For example:

- Changes in the types and amounts of public employee compensation could change the demographics of state and local government workforces.
- Public retirement systems could have reduced funds to invest in various sectors of the state, national, and international economies.
- 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.
- Administrative costs for public retirement systems could rise if the systems hire additional actuarial and other staff members in order to implement the provisions of the measure.

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

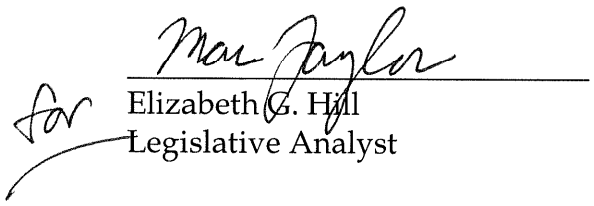
Fiscal Summary

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

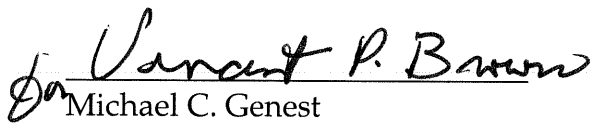
- Major reductions in annual pension contribution costs for employees hired on or after July 1, 2009, offset to an unknown extent by increases in costs for other forms of public employee compensation.

- Major short-term increase in annual governmental payments to prefund retiree health benefits, more than offset in the long run by annual reductions in these costs.

Sincerely,



for Elizabeth G. Hill
Legislative Analyst



for Michael C. Genest
Director of Finance