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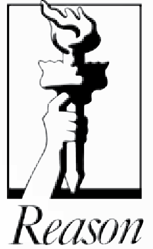

HOW CALIFORNIA'S PUBLIC PENSION SYSTEM BROKE (AND HOW TO FIX IT)

By Adam B. Summers

Governments at all levels are struggling to balance their budgets amid falling revenues and rising costs, particularly of government employee pensions. The state of the economy or the stock market is often blamed for poor public pension system health. In reality, pension fund underperformance merely unmasks the volatile—and ultimately unsustainable—nature of the defined-benefit system, particularly at current benefit rates, which are significantly more generous than benefit levels received in the private sector.
The defined-benefit structure of the vast majority of government worker retirement plans forces governments (that is, taxpayers) to pay more during recessions to make up for shortfalls in pension fund investments. Not only is the defined-benefit pension system unsustainable, it is unfair to taxpayers in the private sector, who are forced to pay more to recession-proof government workers' pensions even as they are struggling to save for their own retiree health care costs and seeing their own retirement benefits reduced during rough economic times.

"The pension system is unsustainable and unfair to taxpayers."

Things are markedly different in the private sector. Private sector workers' pay and benefits are determined primarily by economic realities, rather than by special interest influence. Thus, it is no coincidence that private sector businesses began switching to 401(k)-style defined-contribution retirement plans decades ago, and have by now almost entirely abandoned the defined-benefit plan for being too expensive and too unpredictable. Many of the few businesses that have retained defined-benefit plans, largely those in industries characterized by greater labor union strength, have been forced to dump their pension obligations on the

Pension Benefit Guarantee Corporation (PBGC), the quasi-governmental agency created in 1974 to insure private sector pensions. During the last decade alone the PBGC was forced to absorb $1.3 billion in pension claims for National Steel, $1.9 billion for LTV Steel, $3.9 billion for Bethlehem Steel, $3 billion for US Airways, and a whopping $6.6 billion for United Airlines.[1] Now the auto industry is facing serious pension problems. Last year, the PBGC assumed responsibility for at least a half-dozen auto supplier pensions covering 100,000 workers and retirees, adding more than $7 billion to the agency's deficit.[2] The Big 3 Detroit automakers themselves are also in trouble, with Chrysler facing a $3.6 billion pension deficit, Ford looking at a $12 billion deficit, and General Motors confronting an $18 billion shortfall.[3] There is no such "insurer of last resort" like the PBGC for public sector pension plans, but since vested benefits are guaranteed by the California Constitution, taxpayers are the ones who serve this role and are ultimately on the hook for unfunded pension liabilities.

Famous investor Warren Buffett summed up the state of public pension systems in a sobering discussion from the 2007 Shareholder Letter for his Berkshire Hathaway Inc. company:

> *Whatever pension-cost surprises are in store for shareholders down the road, these jolts will be surpassed many times over by those experienced by taxpayers. Public pension promises are huge and, in many cases, funding is woefully inadequate. Because the fuse on this time bomb is long, politicians flinch from inflicting tax pain, given that problems will only become apparent long after these officials have departed. Promises involving very early retirement—sometimes to those in their low 40s—and generous cost-of-living adjustments are easy for these officials to make. In a world where people are living longer and inflation is certain, those promises will be anything but easy to keep.*[4]

While government pension systems across the nation have strained to cope with escalating pension obligations, California is in worse shape than most because of a large increase in pension benefits made a decade ago, raising benefits as much as 50 percent for some state employees and cementing the state's position as one of the most generous states in the nation in terms of pension and retiree health care benefits.

A recent paper by University of Chicago business professor Robert Novy-Marx and Northwestern University finance professor Joshua D. Rauh calculated California's unfunded liability at about $475 billion.[5] Similarly, an April 2010 Stanford Institute for Economic Policy Research study puts the state's liabilities at around the half-trillion-dollar mark, estimating them at approximately $535 billion.[6] That translates to roughly $36,000 for each California household.[7] These newer estimates are much higher than prior reported estimates of about $63 billion in unfunded pension liabilities.[8]

"Now government employees typically make 35% more in wages and 69% greater in benefits than their private sector counterparts."

It is often argued that governments must pay greater benefits to their employees because they cannot pay salaries as high as those in the private sector and they need to offer greater benefits and job security to effectively compete with the private sector for quality workers. While perhaps the argument could be made a generation or two ago, it clearly does not hold true today. Now government employees typically make more, on average, in both wages *and* benefits than their private sector counterparts.

According to the U.S. Department of Labor's Employer Costs for Employee Compensation report for December 2009, state and local government employees earned total compensation of $39.60 an hour, compared to $27.42 an hour for private industry workers—a difference of over 44 percent. This includes 35 percent higher wages and nearly 69 percent greater benefits.[9] Data from the U.S. Census Bureau similarly show that in 2007 the average annual salary of a California state government employee was $53,958, nearly 32 percent greater than the average private sector worker ($40,991).

PENSION BENEFIT INCREASES, BENEFIT CREEP AND THE GROWING STATE WORKFORCE

The adoption of SB 400 in 1999 ushered in an era of dramatic pension increases, including the "3 percent at 50" benefit for the California Highway Patrol, whereby a public employee with 30 years of work experience may retire with 90 percent (3 percent for each year of work) of his or her final salary as young as 50 years old, "3 percent at 55" benefit for peace officers and firefighters, and "2 percent at 55" benefit for other state workers. For police, firefighters and other public safety workers, this represented an increase in benefits of between 20 percent and 50 percent.

Moreover, the benefit increases were retroactive, meaning that the aforementioned pension increases of up to 50 percent were, as former *Sacramento Bee* columnist Daniel Weintraub observed, "not only for future employees but for workers whose retirement contributions had been based for decades on the expectation of a lower benefit."[10] These added benefits now cost the state hundreds of millions of dollars per year. The state will be paying for those benefit increases for decades to come. As a result of these benefit levels, there are 9,111 state and local government retirees in California, such as police officers, firefighters and prison guards, who receive pensions of at least $100,000 a year (through CalPERS), and an additional 3,065 retired teachers and school administrators who receive pensions over $100,000 a year (through CalSTRS).[11]

"California's unfunded pension liabilities exceed $535 billion, which translates to roughly $36,000 for each household."

But the government need not change pension benefit rates to increase benefits. For decades, "benefit creep" has allowed more government employees to move up into higher benefit plans. This is particularly true for "public safety" employees in California. As a *Sacramento Bee* article relates,

> *Prison cooks, plumbers, groundskeepers, teachers, dentists, business managers, and "audiovisual specialists"—all are among the 70,000 state workers considered police or firefighters, eligible to retire with better benefits than other state workers.*
>
> *In fact, any worker in a California prison regularly in contact with inmates is considered a police officer, rewarded with a richer public pension for helping safeguard society.*
>
> *The same goes for workers in state mental hospitals—from psychiatrists to podiatrists—who supervise patients.*[12]

In the 1960s, roughly one in 20 state employees received public safety pensions. Now it is one in three workers.[13]

Another problem is the sheer number of workers that the state employs (at great cost). Since 1998, the state workforce has grown by over 31 percent, and today the state employs more than 356,000 workers, including the state university systems.[14] Incredibly, the state has added over 13,000 employees since the onset of the economic recession in 2008 and continued hiring even during the worst of the recession.[15]

Not only are California government workers getting higher pay than most state workers, but the health

California Standard Pension Benefit Formulas Before and After SB 400

Employee Category	Before SB 400	After SB 400 (Effective January 1, 2000)
Miscellaneous/Industrial	2% at 60	2% at 55
Safety	2% at 55	2.5% at 55
Peace Officer/Firefighter	2.5% at 55	3% at 55
Highway Patrol	2% at 50	3% at 50

Source: California Legislative Analyst's Office, "State Employee Compensation: The Recently Approved Package," December 6, 1999, http://www.lao.ca.gov/1999/120699_employee_comp.html.

care benefits are excessive as well. The state covers approximately 85 percent of health care premiums for active state employees. The benefits are even better for retirees, covering 100 percent of health care costs for retirees and 90 percent of costs for their families. This benefit can cost the state close to $1,200 a month per retiree, according to CalPERS.[16]

THE ONE-YEAR FINAL SALARY RULE, PENSION-SPIKING AND DOUBLE-DIPPING

Additionally, California state workers play by different rules than other states. While California uses only an employee's final year salary for the purpose of determining pension benefits, all other states use the average of an employee's final three or five years of salary (or highest three- or five-year period) in order to avoid situations where employees retire soon after receiving their final raise. California once used a three-year average as well, but a provision inserted to SB 2465 in 1990 changed state retirement rules to calculate pension benefits based on an employee's highest salary in a single year. The law was expected to cost an additional $63 million per year. In reality, it has proven to be 50 percent more costly, totaling more than $100 million annually.[17]

"Switching to a 401(k)-style defined-contribution plan for new employees would afford California lower costs while offering a number of other benefits. "

The state and some of its government employee unions have agreed to go back to the three-year average in recent years, albeit through the collective bargaining process rather than the stricter legislative process, though pensions for firefighters, highway patrol officers and peace officers are still based on the one-year final salary rule.

In addition to using the one-year final salary rule to increase retirement benefits, employees may intentionally inflate their final compensation so as to increase their pension benefits, a process known as "pension spiking," by having accrued vacation time, unused sick leave, excessive overtime, shift differentials, education incentives, cashed in auto allowances, uniform allowances, etc., included in their final salaries. The passage of SB 53 in 1993 made it more difficult to spike CalPERS pensions by manipulating final-year pay, although "loopholes in state law make pension spiking easy and legal."[18] State workers can increase their pensions by purchasing up to five years of service, called "air time," which they can count toward their retirement, without paying the full actuarial costs of those benefits.

Workers who have already retired may also "double-dip" to enhance their retirement compensation by returning to work for the state, collecting both a salary and a pension. Some states prohibit the practice or force employees to forfeit their retirement checks when they go back on the state payroll, but it is legal in California so long as employees do not work more than 960 hours in a year, about half-time. According to the *Los Angeles Times*, more than 5,600 state employees are currently "double-dipping" in California, a figure 57 percent higher than a decade ago.[19] "The notion is we have retirement systems so once people stop working they are provided for," said Alicia H. Munnell, director of the Center for Retirement Research at Boston College. "It seems just not acceptable to taxpayers that people are earning a salary and a retirement check."[20] And former California Assemblyman Keith Richman says that those collecting both a state paycheck and retirement payments are "ripping off the taxpayers."[21]

California's liberal workers' compensation and disability pension rules as to what constitutes a "work-related" injury also invite abuse. State law presumes, for example, that police officers and firefighters suffering from illnesses such as cancer and heart disease were injured on the job, thus automatically qualifying them for disability pensions.[22] This has also become a problem for local governments that have adopted this state government policy. Paul Derse, a deputy executive administrator from Ventura County, illustrated the waste that such loose disability retirement rules invite: "We had a four-pack-a-day smoker who was presumed to have cancer from his job."[23]

UNREALISTIC ACTUARIAL ASSUMPTIONS

Contributions to defined-benefit plans are based upon actuarial assumptions designed to ensure that the plan is sufficiently funded to cover its benefit payouts. These assumptions include what the average annual pension fund return will be, how much salaries and inflation will increase, how soon employees will retire, how long retirees will live, what disability rates will be, and so on. Complicating matters is the fact that these assumptions must be projected out decades into the future, rendering them little more than educated guesswork. If the actuarial assumptions prove to be wrong and costs are higher than expected, taxpayers are liable for the difference.

One of the major assumptions that has proven to be overly optimistic is the rate at which the pension systems discount their future liabilities. Public pension systems use the average annual rate of return that they expect their pension fund investments to achieve as the discount rate. This tends to encourage riskier investment strategies, which *may* offer higher returns, because this allows pension systems to use a higher discount rate and thus makes liability estimates look lower to the public.

The danger, of course, is that the risk does not pay off and investments underperform, resulting in larger than expected liabilities (as we have now witnessed firsthand). The CalPERS Public Employees' Retirement Fund, for example, has significantly underperformed its assumed 7.75 percent average rate of return[24] for the one-year, three-year, five-year, and 10-year periods.[25] CalSTRS has an even more aggressive 8.00 percent assumed rate of return.[26] Investor extraordinaire Warren Buffet has said that such assumptions are much too high, and has set a more reasonable assumption of between 6 percent and 6.9 percent for the pension plan in his own company, Berkshire Hathaway Inc., over the past decade.[27] Some financial advisors have suggested that an even lower rate, such as 5 percent, would be more reasonable.[28]

"California should adopt salary and benefit rates that are comparable to those in the private sector. "

HOW DO WE FIX IT?

Most of the public pension "reform" proposals that have been put forth in California and elsewhere do not go far enough. The entire defined-benefit system is broken, particularly given the cozy relationships between lawmakers and labor union officials, and only a complete overhaul can restore fiscal responsibility to the state's retirement system. Tinkering with the existing defined-benefit retirement system by implementing a lower tier of benefits or increasing retirement ages does not work because it is too easy to simply increase benefits at a later date. Moreover, preserving the existing defined-benefit pension system would maintain the moral hazard problem that arises from the incentive of policymakers and labor unions to push for benefit increases in the short term when the actual costs of those enhancements will largely not materialize until long after they are out of power.

Switching to a 401(k)-style defined-contribution plan for new employees would afford California lower costs while offering a number of other benefits such as:

- Increasing the stability, transparency and predictability of the annual contribution payments required of the government (i.e., taxpayers)
- Ensuring full funding of the system
- Providing employees greater plan portability and greater freedom to invest their retirement money as they see fit
- Removing political influence from investment decision-making.

While this would have some short-term consequences, requiring the state to effectively deal with significant exiting liabilities, it would represent a long-term shift that would ultimately put California on much healthier financial footing.

In devising its new retirement plans, the state should adopt salary and benefit rates that are comparable to those earned in the private sector. Retiree health benefits are much less generous in the private

sector, if they are offered at all, so California should reduce its retiree health care benefits, just as private firms have been forced to reduce their health care costs for active workers, and/or require employees to make suitable contributions for their retiree health costs. Several states, including Connecticut, Kentucky and New Hampshire, are now requiring employees to make contributions toward their retiree health care benefits in addition to contributions to their pension plans.

Those who do not work for the government should not be forced to pay for ever-richer benefits for public employees while they are seeing their own retirement funds erode during difficult economic times. In addition, requiring voter approval of future government employee benefit increases—as several local governments, including San Francisco, San Diego, and Orange County, have done—would serve as a final check against unwise, overly generous pension enhancements and excessive labor union influence.

The municipal bankruptcy of the city of Vallejo, due primarily to the city's inability to meet rising pension costs, served as a wake-up call to governments across the state and the nation. It may already be too late for some others to avoid the same fate, but those that are able, including the state of California, must realize that only significant reform can solve such a significant problem. To that end, they should follow the lead of the private sector and switch to a defined-contribution retirement system with benefits comparable to those received in the private sector for all future government employees, as well as following these recommendations.

RECOMMENDATIONS

1. Perform an evaluation of wages and benefits offered in the private sector and adjust state employee compensation to bring it in line with this standard. Repeat such an evaluation every five years.
2. Close the defined-benefit pension plans for state employees and enroll all new employees in defined-contribution plans for pensions and other post-employment benefits (OPEB) such as retiree health care and dental benefits.
3. Adopt more conservative investment strategies and more conservative discount rate assumptions for current employees' defined-benefit plans.
4. Begin pre-funding OPEB liabilities for employees already in the current system, with the ultimate goal to achieve full funding.
5. Adopt an amendment to the state constitution requiring all future government employee benefit increases to be ratified by the voters.
6. Adopt an amendment to the state constitution prohibiting retroactive benefit increases.
7. Eliminate "air-time" purchases to reduce pension spiking and discourage early retirement.
8. Require employees who have previously retired to forfeit their retirement checks while they are on the state's payroll to avoid double-dipping.

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