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PENSION REFORM CASE STUDY: SAN JOSE

by
Adam B. Summers

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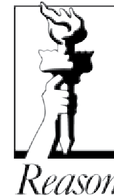

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Executive Summary

This study looks at how San Jose, California reduced the burden of its public employee pensions and other post-employment benefits, thereby enabling it to continue to provide a high level of services and avoid bankruptcy.

San Jose's unfunded liability for post-employment benefits grew from $300 million in 2003 to over $4 billion today, of which $2.3 billion is for pensions and $1.8 billion is for retiree health-care. This is in spite of a massive increase in annual pension contributions, which rose from $73 million in 2001 to $245 million in 2012 and now account for 27 percent of its general-fund expenditures.

The growth in the city's unfunded liabilities has many causes, including the financial downturn after 2008. But the primary cause is a massive increase in both salaries and benefits. Between 1991 and 2009, after adjusting for inflation, the average annual benefit for police and fire retirees increased 75 percent, and by 54 percent for other retired city workers. In 2011, average total annual compensation for working police officers was $178,821, for firefighters it was $203,098, and for other city employees $120,092.

In the face of these rising costs, San Jose tried to save money by cutting employee salaries and government services. Employees voluntarily accepted wage cuts of 10–18 percent. Other budget cuts were wide ranging, affecting

public safety, libraries, sidewalk and park maintenance, and code enforcement. The city even decided not to open four new libraries and a police substation that had been built with bond funds.

But these cuts were not enough, so starting in 2010, the city embarked on a series of pension reforms with Measures V and W. These began with changes to the composition of the pension board, removing most insiders and replacing them with independent members with financial and investment expertise. Then, through a pair of ballot measures passed by voters, it limited the amount of compensation increases that could be awarded in arbitration disputes with city workers and gained the ability to shift new city employees to pension plans with lower benefit levels.

San Jose's pension reforms culminated, in June 2012, with the passage of Measure B, under which retirement benefits were reduced for new employees, while current employees had to choose between switching to a plan with reduced benefits or contributing more of their salaries in order to maintain their existing benefits. In addition, the measure: eliminated the "13th checks" that had been issued in the past when the pension investment fund had earned a return higher than a certain threshold, reduced the automatic annual cost-of-living adjustment from 3 percent to 1.5 percent, and required voters to approve any future benefit increases. Measure B passed easily, garnering 69 percent of the vote.

However, the measure was not immune from legal challenges and was almost immediately litigated in court by several plaintiff groups made up of current employees and retirees from the City of San Jose. On December 20, 2013, Judge Patricia Lucas of the Santa Clara County Superior Court issued a tentative decision that overturned several key pieces of of Measure B, while simultaneously upholding a majority of the initiative and sustaining substantial savings anticipated in the passage of the measure.

With many other cities and states in a similar predicament, San Jose offers one possible model for reform. Among the key lessons from its reforms are the following:

- First, prepare the ground by ensuring, if possible, that the pension review board is independent, in order to reduce internal opposition to reform.
- Second, recognize the true scope of liabilities from post-employment benefits and communicate these to voters and public employees.
- Third, if possible, put proposed reforms to the electorate.
- Fourth, use evidence-based arguments backed up by statistics and reports from reputable sources regarding the actual costs of city workers.
- Fifth, ensure that voters recognize the alternatives to reform (i.e., in San Jose's case, fewer services and fewer government jobs).
- Sixth, in the proposed reforms, include explicit default alternatives, such as lower pay for government workers, that would be painful to all existing employees.

These lessons are of particular use in polities where ballot measures are possible. But even in states that do not allow such measures, it is important to develop a winnable strategy, prepare the ground and stick with a clear message.

Though San Jose still faces legal battles with its employee unions over its constitutional authority to deal with pension benefits, the City has nevertheless identified a path toward reform that other financially distressed municipalities around California and across the nation may use to address their mounting pension liabilities before it is too late to avoid fiscal ruin.

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Part 1

The Problem: A Systemically Underfunded Pension

San Jose is the third-largest city in California and the 10th largest in the nation, with a population of just under one million residents.[1] It is located in the heart of Silicon Valley, yet despite the region's massive economic success—or, as we shall see, perhaps partly because of it—San Jose has found itself mired in unfunded pension and retiree health-care liabilities estimated at over $4 billion.[2] (See Table 1 for a summary of San Jose's two pension plans: one for general employees and one for police and fire employees.) The city responded with significant service cuts and employee layoffs, but fears of bankruptcy remained.

San Jose is not alone. Local governments throughout California have been struggling with growing, unfunded government-employee pension and health-care liabilities. Some cities—such as Vallejo, Stockton and San Bernardino—have filed for Chapter 9 municipal bankruptcy, largely because their employee-pension contracts became unaffordable. According to a May 2013 *USA Today* analysis, 10 additional California cities are on the edge of bankruptcy. These jurisdictions, which range from small, rural towns to large cities, include Atwater, Azusa, Compton, Fresno, Hercules, Monrovia, Oakland, San Jose and Vernon. The 10th, Mammoth Lakes, withdrew its petition for bankruptcy after filing last year, but it remains on shaky financial ground. Additionally, late in 2013, there was concern that Desert Hot Springs may also file for bankruptcy. Fortunately, the city was able to negotiate some employee concessions, freeze cash payouts and contract out certain services after declaring a fiscal emergency in November 2013.[3]

In a July 17, 2012 letter to the California Senate and Assembly leadership, the mayors of eight of the 11 largest cities in the state—including Los Angeles, San Diego, San Jose, Fresno, Sacramento, Long Beach, Anaheim and Santa Ana—noted that escalating pension costs were adversely affecting their budgets,

residents and city employees. They implored the state legislature to grant them the tools and authority to better deal with the problem. The letter stated,

> *The leading cause of [unbalanced budgets] for many of us is the rising cost of pension obligations forcing us to reduce services to our residents, layoff [*sic*] our workers, and defer needed improvements to our facilities and infrastructure . . . . Cities need clear authority to modify future pension accruals and to give their employees an option to choose a lower-cost benefit.*[4]

In the face of these increasing obligations, many state and local governments have implemented reforms. According to the National Conference of State Legislators, between 2009 and 2012, 44 states reformed their pension systems. The most common reforms were increased employee contributions to their pensions, increased age or service requirements for pension benefits, reduced post-retirement cost-of-living adjustment increases in benefits, and an increased period of time on which governments calculate final average salaries for the purpose of determining pension benefits (i.e., calculating one's final salary based on the average of the highest five years of employment instead of the highest three-year period). These reforms generally only apply to new government employees.[5]

Two local governments in California went a step further through voter-approved pension reforms. In June 2012, a San Diego initiative asked voters to support a pension reform that would provide all new city workers other than police officers with a defined-contribution retirement plan in place of the traditional defined-benefit pension, would reduce new sworn police officers' pensions by setting a maximum benefit of 80 percent of final salary (instead of the previous 90 percent), and would freeze pensionable payroll for five years. San Diego's Proposition B passed with 66 percent of the vote and is expected to save the city approximately $1 billion over the next 30 years.[6]

In the same June 2012 elections, San Jose residents voted on major reforms in Measure B. As in San Diego, the reforms passed by a wide margin, with 69 percent of the vote. Unlike San Diego, San Jose took the bold step of reducing future, unearned benefits for *current* employees as well as reducing pensions for

new employees. In so doing, it followed the advice of California's bipartisan Little Hoover Commission, which warned in a February 2011 report that required government pension contributions will remain "at heightened levels *for decades*" (emphasis added),[7] and concluded that only by reducing the unaccrued benefits of current government employees could state and local governments get a handle on their retirement obligations. According to the report,

> *The situation is dire, and the menu of proposed changes that include increasing contributions and introducing a second tier of benefits for new employees will not be enough to reduce unfunded liabilities to manageable levels, particularly for county and city pension plans. The only way to manage the growing size of California governments' growing liabilities is to address the cost of future, unearned benefits to current employees, which at current levels is unsustainable. Employers in the private sector have the ability and the authority to change future, un-accrued benefits for current employees. California public employers require the ability to do the same, to both protect the integrity of California's public pension systems as well as the broader public good.*[8]

Table 1: San Jose Pension Plan Summaries

	Federated City Employees' Retirement System	Police & Fire Department Retirement Plan
OVERVIEW		
Total Current City Employees	5,495	
Active Members	3,076	1,718
Number of Retirees Currently Receiving Benefits	3,688	1,910
Actuarial Value of Assets	$1,788,660,000	$2,685,721,000
Actuarial Accrued Liability (AAL)	$2,770,227,000	$3,196,007,000
Unfunded Actuarial Accrued Liability (UAAL)	$981,587,000	$510,286,000
Funding Ratio	65%	84%
UAAL as a % of Annual Covered Payroll	429%	268%
ACTUARIAL ASSUMPTIONS		
Investment Return	7.50%	7.50%
Payroll Growth	3.25%	0% for FY 2013 and 2014; 3.50% thereafter
Salary Increases	3.25%	0% for FY 2013 and 2014; 3.50% thereafter

Sources: City of San Jose, Federated City Employees' Retirement System, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2012, http://sjretirement.com/Uploads/Fed/CAFR_FED_2011-12_LowRes.pdf; and City of San Jose, Police and Fire Department Retirement Plan, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2012, http://sjretirement.com/Uploads/PF/CAFR_Police_Fire_2011-12_LowRes.pdf .

This study examines the history that led to pension problems in San Jose, the path to reform, the reforms adopted in 2012, and the ongoing litigation and outlook for the city's pension reforms and financial situation.

Part 2

Background: Rising Costs and Obligations

San Jose's unfunded liability for retirement benefits has grown rapidly, from just $300 million in 2003 to over $4 billion today.[9] The city now faces a $2.3 billion pension deficit and a $1.8 billion retiree health-care shortfall.[10] The city's annual pension contributions have risen from $73 million in 2001 to $245 million in 2012, and they now account for 27 percent of its general-fund expenditures.[11]

A primary driver of the pension-funding problem is the high level of benefits offered to San Jose's city employees. According to an August 2012 report from the California Public Policy Center, based on employee-compensation data provided by the City of San Jose, the average base pay for city workers in the 2011 calendar year was $76,458 for miscellaneous employees, $96,378 for police officers and $100,048 for firefighters.[12] Add in additional pay for overtime, sick and vacation payouts; certification and other bonuses; and benefits, and the total annual compensation increases to $120,092 for the average miscellaneous worker, $178,821 for police officers and $203,098 for firefighters (see Table 2).[13]

Table 2: San Jose Employee Average Total Compensation, 2011

Employee Category	Base Pay	Other Pay	City-Paid Benefits	Total Compensation
Miscellaneous	$76,458	$4,714	$38,920	$120,092
Police	$96,378	$15,248	$67,195	$178,821
Fire	$100,048	$25,231	$77,819	$203,098

Source: California Public Policy Center, "San Jose, California – City Employee Total Compensation Analysis," August 10, 2012.

The study additionally used the total pay and the total benefits paid by employers for things like Medicare, health insurance and retirement benefits to

calculate a payroll overhead rate. The overhead rates for San Jose were 48 percent for miscellaneous workers, 60 percent for police officers, 62 percent for firefighters and 55 percent for all workers. These rates far exceed private-sector levels. Even after making extremely conservative assumptions, such as using household income instead of individual income,[14] and assuming very generous private-sector health-care and retirement packages, the study found that the average payroll overhead for a private-sector position in San Jose was still only 21 percent.[15]

A. The History of Pension Benefits in San Jose and in California

To understand how this situation arose, it is helpful to trace the history of public-employee retirement benefits in the city and in California. While the financial downturn in 2007–2008 certainly did not help matters, the primary reason for the large retirement-cost increases has been the increases in benefit levels. Between 1991 and 2009, even after adjusting for inflation, the average annual benefit for police and fire retirees increased 75 percent, and the benefit for other city workers increased 54 percent.[16] The following is a look at the increases in employee benefits over the years.

San Jose first began offering pension benefits in 1941. It established the current plans in 1961 for the Police and Fire plan and in 1975 for the Federated plan (which covers other miscellaneous city employees). As the following brief history of the plans reveals, benefits have been increased a number of times over the years.[17]

Under the 1961 plan, police officers and firefighters with 20 years of service could retire at 55 with a pension equal to half of their final compensation, defined as the highest compensation received over a three-year period. In 1968, the city reduced the retirement age to 50 and allowed public-safety employees to earn an additional 1.66 percent of final compensation for each year of service over 20, raising the maximum benefit to 66.66 percent of final compensation. It increased this longevity bonus to 2.5 percent of final compensation per year of service over 20 years in 1970, lifting the maximum benefit level to 75 percent of

final compensation. Also at this time, the city redefined final compensation as the highest single year of compensation. In 1984, the city began offering its employees and their families health care for life after 15 years of service, and it added dental benefits in 1986.

Benefit levels really escalated during the late 1990s and 2000s. In the mid- to late-1990s, San Jose, the "capital of Silicon Valley," found itself at the heart of an economic boom. State and local government coffers were flush with tax revenue, and politicians acted as though the good times would never end. In this euphoric atmosphere, public-employee unions and the California Public Employees Retirement System (CalPERS) pushed hard for pension-benefit increases. After all, they argued, pension funds were earning historic returns, so it was only right that additional benefits be paid from these exceptional returns. The unions and CalPERS ignored the risk of imposing additional liabilities on taxpayers should returns decline.

The city of San Jose manages its own pension plans for its workers, so it does not participate in CalPERS, but it fell into the same trap as the state around the same time. San Jose felt pressure to keep up with the surrounding cities, lest it lose talented employees to nearby jurisdictions offering higher compensation. As Mayor Chuck Reed explained the competition with other pension plans, "It's a leapfrog, and the unions used that very effectively in arguing for increased benefits."[18] (See the text box for more about how the state and other local governments let pension benefits get out of control.)

In 1998, the city increased Police and Fire benefits to 2.5 percent of final compensation for each year up to 20, and 3 percent per year thereafter, raising the maximum benefit from 75 percent to 80 percent of total compensation. It additionally applied the increased benefit formula retroactively for those eligible to retire as of February 1996. In 2000, the city increased the longevity bonus again to allow public-safety employees to earn 4 percent of final compensation for each year of service over 25, increasing the maximum benefit to 85 percent of final compensation.

Dot-Com Boom Leads to Large State and Local Pension Increases

As large amounts of tax dollars, fueled by the dot-com bubble, were flowing into state and local governments, public-employee unions and CalPERS began pushing for greater retiree benefits for government employees. After all, they argued, pension funds were earning historic returns, and the added benefits could simply be paid for from these exceptional returns without any risk to the taxpayer.

At the state level, California passed the now infamous SB 400 in 1999. This legislation ushered in an era of dramatic pension increases, including the "3 percent at 50" benefit for the California Highway Patrol, "3 percent at 55" benefit for peace officers and firefighters, and "2 percent at 55" benefit for other state workers. This legislation allowed public-safety workers to earn pension benefits of up to 90 percent of their final compensation. The bill also eliminated California's two-tier system for non-safety/industrial employees. The second tier, which offered a smaller, less-costly benefits package, was established in 1991 for all future employees in an effort to control pension costs. SB 400 eliminated Tier 2 and moved all Tier 2 employees to the more generous Tier 1 plan. Moreover, it made the benefit increases retroactive, meaning that pension increases of up to 50 percent were, as *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."[1] The bill passed with virtually no opposition and hardly any debate.

To make matters worse, an amendment to SB 400 added late in the legislative process made the increased police and firefighter benefits available to local government workers (for cities with plans administered by CalPERS). According to Weintraub, state Senator Deborah Ortiz, who introduced the measure in the Senate, doesn't remember how that amendment came about, and "it was not mentioned as the bill was presented on either the Assembly or the Senate floor."[2]

CalPERS bears as much blame as state legislators for the trend to increase benefits. In addition to strongly lobbying for legislation such as SB 400, CalPERS encouraged local governments that participate in CalPERS plans to adopt higher benefits. In exchange for local-government approval of pension increases, CalPERS offered to reduce municipalities' required contributions to the system."[3]

Unfortunately, local governments followed the state's lead, with disastrous results. As Weintraub notes, SB 400 "began a wave of public employee pension increases at a time when private sector employees were seeing their own retirement benefits shrink or disappear entirely."[4] In 2010, Tony Oliveira, who was the president of the California State Association of Counties, a Kings County supervisor, and a CalPERS board member, told the California Little Hoover Commission that the "3 percent at 50" pension-benefit formula authorized by SB 400 for public-safety workers "moved across agencies like a grass fire," as local governments rushed to match the state pension increases and believed that the higher pensions would be completely paid for by higher investment gains.[5] A similar pension arms race for miscellaneous employees ensued after 2001, when the passage of AB 616 allowed local governments to offer such employees a "3 percent at 60" pension benefit.

But when the inevitable market correction came, governments were stuck paying inflated benefits even as they had to make up for massive pension-fund losses. Within a few years, these added benefits were costing the state hundreds of millions of dollars per year. According to the Legislative Analyst's Office, "these additional benefits add approximately $600 million to anticipated 2004–05 costs—almost one-quarter of the state's total payment."[6] Now governments across the state are attempting to get themselves out of the deep hole dug by the benefit increases.

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1 Daniel Weintraub, "Battered Public Pension Funds – Everyone Pays," *Sacramento Bee*, http://www.caltax.org/documents/2003/Weintraub-BatteredPublicPensionFunds5-18-03.pdf, May 18, 2003, retrieved July 30, 2013.

2 Daniel Weintraub, "Cozy State Pension Deal Costs Taxpayers Billions," *Sacramento Bee*, http://www.caltax.org/documents/2003/Weintraub-CozyStatePensionDealCostsBillions8-10-03.pdf, August 10, 2013, retrieved July 30, 2013.

3 "Harrigan's Costly Legacy," *Sacramento Bee*, December 9, 2004.

4 Weintraub, "Cozy State Pension Deal Costs Taxpayers Billions."

5 California Little Hoover Commission, *Public Pensions for Retirement Security*, February 2011, p. 14.

6 California Legislative Analyst's Office, "General Government," *Analysis of the 2004–05 Budget Bill*, February 18, 2004, p. F-15.

Even after the bursting of the dot-com bubble, the city continued to increase benefits for a number of years. In 2001, public-safety retirees became eligible for an additional pension payment from the Supplemental Retiree Benefit Reserve (SRBR) when the pension fund's returns exceeded their assumed average for a certain period of time (more on the SRBR follows). And in 2002, the city changed the cost-of-living adjustment (COLA) for pension benefits to a guaranteed 3 percent annual increase.

The final pension enhancements came in the mid- to late-2000s. In 2006, San Jose changed the pension formula for police officers to 2.5 percent of final compensation for each year of service up to 20, and 4 percent per year thereafter, raising the maximum benefit to 90 percent of final compensation. Firefighters similarly saw their maximum benefit raised to 90 percent of final compensation in 2008. According to the city, police officers and firefighters who have retired since 2006 now receive an average pension of approximately $103,000 a year, including cost-of-living increases.[19]

Miscellaneous employees saw several benefits enhancements over the years as well, though not as many and not as generous as those for public-safety employees. The current Federated plan established in 1975 increased the previous plan's benefits from 2 percent per year of service, plus 1.0 to 1.3 percent per year thereafter, to 2.5 percent per year. The new maximum benefit level was 75 percent of final compensation, which the city defined as the highest three-year period of compensation. San Jose set the COLA at the level of the consumer price index and capped it at 3 percent per year. As with the Police and Fire plan, Federated members started receiving medical benefits in 1984. In 1986, they became eligible for SRBR payments.

The Federated plan managed to avoid the excesses of the Police and Fire plan during and after the dot-com bubble, but it did add a couple of sweeteners during the 2000s. In 2001, the city changed the definition of final compensation from the highest three-year period of compensation to the highest single year, and in 2006 it changed the COLA to a guaranteed 3 percent annual increase.

B. Service Cuts

As benefits rose, the pension fund fell well below assumed return rates, and pension and retiree health-care costs began consuming greater and greater portions of the city's budget. San Jose experienced 10 consecutive years of budget deficits beginning in fiscal year 2002–03, including deficits of over $115 million in FY 2010–11 and FY 2011–12.[20] In the decade from FY 2001–02 to FY 2011–12, the average cost per employee skyrocketed 85 percent, and retirement benefits grew to more than 50 percent of base payroll.[21]

Policymakers had little choice but to cut services to make up the difference. The cuts were wide ranging, affecting public safety, libraries, sidewalk and park maintenance, and code enforcement. The city was so penniless that it could not afford to open four new libraries and a police substation that had been built with bond funds.[22] According to the Office of Mayor Chuck Reed, the cutbacks forced the city to:

- Shrink the police force by hundreds of officers, including cuts in patrol, special operations and investigative services;
- Eliminate four engine companies and one truck company in the fire department, while also implementing flexible brownouts;
- Cut branch library hours from six to seven days per week to only four days per week;
- Reduce hours at "hub" community centers and seek alternate operators for all 43 satellite/neighborhood centers;
- Greatly reduce funding for street paving (the number of residential and arterial streets sealed annually is down 73 percent and 61 percent, respectively);
- Eliminate funding for sidewalk repairs and street-tree services (which are now the responsibility of property owners);
- Delay opening newly built libraries, community centers and the police substation, and

- Significantly reduce funding for park maintenance, code enforcement, traffic calming, park rangers, crime- and gang-prevention programs and youth/senior services.[23]

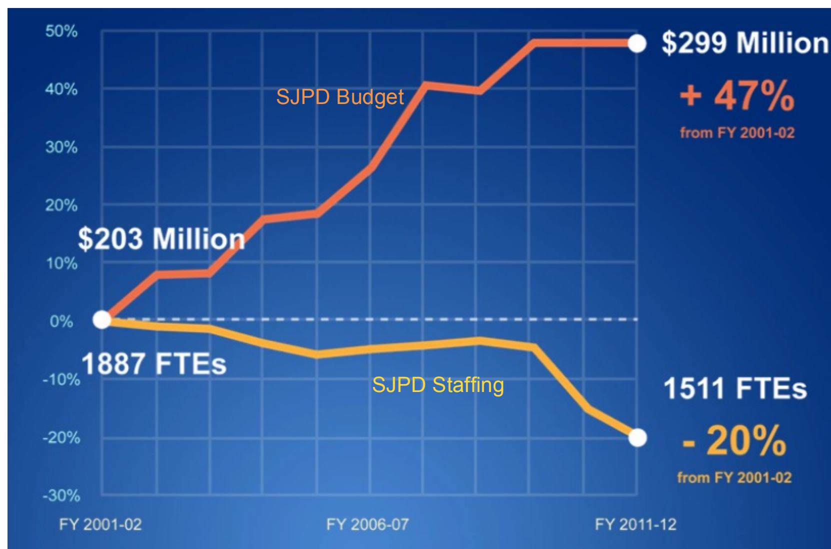
The 2011–2012 Santa Clara County Civil Grand Jury likewise concluded that mounting retirement obligations were a direct cause of the need to scale back government services. In a report on the pension systems of the county and all the cities and towns therein, the grand jury asserted,

> *The Grand Jury concludes that until significant modifications are enacted, there is no doubt that the escalating cost of providing Benefits at the current level is interfering with the delivery of essential City services and the ultimate cost to the taxpayers is an unbearable burden. These costs are already impacting delivery of essential services such as demonstrated by San Jose reducing police and fire department staffing levels, closing libraries or not opening those newly built, curtailing hours of community centers, and not repairing pot-holed city streets.*[24]

Along with large cuts to city services went large reductions in the city's workforce. The number of city employees shrank from 7,453 in FY 2001–02 to 5,400 in FY 2011–12—a drop of nearly 30 percent—before inching up slightly to 5,495 in FY 2012–13.[25] The city forced its employees to take a 10 percent pay cut in 2011 in order to stave off hundreds more layoffs.[26] In a telling graphic, the Office of Mayor Chuck Reed shows police department budgets and staffing from FY 2001–02 to FY 2011–12. Though circumstances forced the department to reduce personnel by 20 percent, its budget increased by nearly 50 percent over the same period (see Figure 1).

Such trends are the reason that, prior to the Measure B pension reforms, the city's pension plans were often criticized as being unsustainable. Before delving into the reforms San Jose undertook, however, it will be instructive to examine what those prior plans offered.

Figure 1: Police Department Budget and Staffing Since FY 2001–02



Source: City of San Jose, Office of Mayor Chuck Reed, "Slides from Mayor Reed's Presentation to the UC Berkeley Institute of Government Studies," 2012.

Part 3

The Retirement Benefit Plans Prior to Reform

Before San Jose's city council reformed its pension plans, the city's retirement plans were as follows:

The Federated plan for miscellaneous employees consists of a "2.5 percent at 55" formula, which means that an employee can retire starting at age 55 (or any age with 30 years of service) with benefits equal to 2.5 percent of his or her final compensation for each year of service. The vesting period is five years and the plan caps benefits at 75 percent of final compensation. Of the two city pension plans, the Federated is in poorer financial shape, with a funding ratio of just 65 percent.

In addition to pension benefits, retirees with at least 15 years of service, or who receive pension benefits of at least 37.5 percent of their final compensation, receive for themselves and eligible family members 100 percent of the premium cost for dental insurance and 100 percent of the premium cost for the lowest-priced medical insurance plan available to active employees. Members may select a more expensive medical plan, but they must pay the difference in premium rates. These other post-employment benefits (OPEB) are only 12 percent funded, but this is not surprising given that governments typically fund retiree health plans on a pay-as-you-go basis, as opposed to the "pre-funded" basis of pensions.

The Police and Fire plan has slightly different benefit formulas for police officers and firefighters. Police officers receive 2.5 percent of their final compensation for each year of service up to 20, and 4.0 percent for each year thereafter. Fire Department employees receive 2.5 percent of their final compensation for each year of service up to 20, and 3.0 percent for each year thereafter. Both plans have

immediate vesting, cap benefits at 90 percent of final compensation and define final compensation as one's highest single year of compensation. The Police and Fire plan is in relatively good financial shape, with a funding ratio of 84 percent.

Police and Fire retirees enjoy the same medical and dental benefits as Federated retirees, with the same eligibility requirements. The Police and Fire OPEB has a funding ratio of only 6 percent, however. (See Tables 3 and 4 for a summary of current pension and retiree health-care/other post-employment benefits for city employees.)

Table 3: San Jose Pension Benefits Summary

	Federated City Employees' Retirement System	Police and Fire Department Retirement Plan
Vesting	5 years	Generally immediate
Eligibility	Age 55 with 5 years of service or any age with 30 years of service	Age 55 with 20 years of service, age 50 with 25 years of service, age 70 with no service requirement, or any age with 30 years of service. Reduced benefits are also available at age 50 with 20 years of service.
Formula	2.5% of final compensation for each year of service **Maximum:** 75% of final compensation	**Police:** 2.5% of final compensation for each year of service up to 20 years plus 4% of final compensation for each year of service over 20 years. **Maximum:** 90% of final compensation **Fire:** For members with less than 20 years of service, 2.5% of final compensation for each year of service. For members with 20 or more years of service, 3% of final compensation for each year of service. Maximum: 90% of final compensation
Final Compen-sation	Based on the highest average annual compensation over a three-year period	Based on the highest one year of annual compensation (overtime pay and expense allowances are included but no compensation that exceeds 108% of compensation during the previous one-year period shall be considered)
Survivor	50% of the service retirement benefit paid to a qualified survivor	Varies depending upon length of employment and whether the employee was killed in the line of duty, was a police or fire employee, was previously disabled, was married and/or had dependent children.
Disability	2.5% of final compensation for each year of service (with a minimum of 40% and a maximum of 75% of final compensation)	**Police:** 50% of final compensation plus 4% of final compensation for each year of service over 20 years, with a maximum of 90% of final compensation. **Fire:** For members with less than 20 years of service, 50% of final compensation. For members with 20 or more years of service, 3% of final compensation for each year of service, with a maximum of 90% of final compensation.

Source: City of San Jose, Retirement Services Department, Federated City Employees' Retirement System and Police and Fire Department Retirement Plan Fiscal Year 2011–12 Comprehensive Annual Financial Reports.

For both the Federated and Police and Fire plans, employee contributions are three-elevenths of the normal cost of providing benefits (the present value of the future benefits earned during a given year) and the city is responsible for the remaining eight-elevenths of the normal cost plus any past service costs (unfunded liabilities). The Santa Clara Civil Grand Jury noted that this arrangement differs from that of the CalPERS system, in which employee contributions are set as a percentage of salary. According to the grand jury's report, San Jose's Federated employees contributed 4.68 percent of payroll toward their pensions, compared with the 8 percent contributed by state employees in the CalPERS miscellaneous workers' plan, and San Jose public-safety workers contributed about 10.5 percent, compared with the 9 percent contributed by state workers in the CalPERS public-safety plan.[27]

Table 4: San Jose Retiree Health-Care and Other Post-Employment Benefits Plans Financial and Benefits Summary

	Federated City Employees' Retirement System	Police and Fire Department Retirement Plan
Active Members	3,076	1,718
Number of Retirees Currently Receiving Benefits	3,062	1,852
Actuarial Value of Assets	$135,454,000	$60,709,000
Actuarial Accrued Liabilities (AAL)	$1,145,359,000	$1,003,795,000
Unfunded Actuarial Accrued Liabilities (UAAL)	$1,009,905,000	$943,087,000
Funding Ratio	12%	6%
UAAL as a % of Annual Covered Payroll	441%	494%
Discount Rate	6.1%	5.7%
Benefits	Retirees with 15 or more years of service, or those who receive pension benefits of at least 37.5% of their final compensation, receive for themselves and family members 100% of the premium cost for dental insurance and 100% of the premium cost for the lowest-priced medical-insurance plan available to active employees. They may select a more expensive medical plan, but must pay the difference in premiums.	Retirees with 15 or more years of service, or those who receive pension benefits of at least 37.5% of their final compensation, receive for themselves and family members 100% of the premium cost for dental insurance and 100% of the premium cost for the lowest-priced medical-insurance plan available to active employees. They may select a more expensive medical plan, but must pay the difference in premiums.

Source: City of San Jose, Retirement Services Department, Federated City Employees' Retirement System and Police and Fire Department Retirement Plan Fiscal Year 2011–12 Comprehensive Annual Financial Reports.

A. SRBR: The "13th Check"

In addition to the standard retirement benefits offered to city workers, San Jose offers employees an extra benefit when the pension investment fund earns a greater return than the actuarially assumed rate for a certain period of time. Some other public-pension systems offer such benefits, which are often referred to as the "13th check," in reference to a bonus payment on top of the usual 12 monthly pension checks retirees receive. San Jose calls this benefit the Supplemental Retiree Benefit Reserve (SRBR).

San Jose first established the SRBR in 1986 for the Federated plan, and later offered it to the Police and Fire Plan starting in 2001. For this "windfall" returns measure to kick in, pension investment-fund returns must exceed the assumed rate of return for a five-year period (averaged) for the Police and Fire Plan, yet under the Federated plan it must only exceed the assumed rate of return for a single year to allow withdrawal of the "excess" profits. This system is a one-way street and a guaranteed extra benefit to employees: when the pension fund falls short of the assumed rate of return, employees do not have to kick in extra contributions to make up the difference. Plans need to reinvest these "excess" returns to make up the difference when the market and the value of the pension fund's assets inevitably decline.

The 2011–2012 Santa Clara County Civil Grand Jury was incredulous when it analyzed the SRBR provision of San Jose's pension system:

> *The largest single contributor to [a pension plan's unfunded liability] is when the achieved ROI [return on investment] falls short of the actuarially assumed ROI. With this in mind, it is difficult to comprehend how responsible financial management would allow withdrawal of any portion of excess ROI whenever the market actually does out-perform the expected rate to be used to pay dividends in the form of an additional "thirteenth check" to retirees. But this is exactly what the SRBR does . . . . A better use for these excess funds might be to retain them to pay down the underfunded Benefits, as long as an underfunded liability exists.*[28]

The grand jury did note that San Jose temporarily suspended SRBR payouts in fiscal years 2011 and 2012, although the program itself was still in effect and the tab for such extra payments was still growing. As explained in the report, "Although San Jose has suspended payouts, the funds remain in the account and San Jose has not used the payout to pay down its underfunded liability. In fact, the suspension merely delays eventual payment to retirees in the form of even larger "13th checks."[29]

Part 4

The Reforms

In the late 2000s, San Jose began trying to get its rising pension and retiree health-care costs under control. These changes took many forms, including adjusting the actuarial assumptions of the city's pension plans, changing the composition of pension boards, altering the arbitration process for disputes between the city and its employee unions, increasing employee-pension contributions, reducing future pension benefits, and requiring voters to approve future benefit enhancements. Implementation of these various measures proved difficult for the city, as it took multiple efforts and many years to implement its pension reforms (and, indeed, some of them are still waiting to be implemented, pending the outcome of current litigation).

A. Changing Actuarial Assumptions

The administrators of both city pension plans realized that their actuarial assumptions were overly optimistic, allowing for an unrealistic view of the financial health of the plans, so they revised some assumptions to reflect a more conservative outlook. For the Federated plan, administrators reduced the investment return assumption from 8.25 percent in 2007 to 7.50 percent in 2011, and they reduced the payroll growth assumption from 4.00 percent to 3.25 percent. They adjusted the discount rate for OPEB from 6.6 percent in 2007 to 6.1 percent in 2011 (see Table 5).

Similarly, in 2011, the Police and Fire Plan reduced the investment return assumption from 8.0 percent to 7.5 percent, and it reduced the base payroll growth rate from 4.0 percent to 0 percent for two years (FY 2013 and FY 2014), and then to 3.5 percent thereafter. The plan also adjusted the discount rate for OPEB from 6.4 percent to 5.7 percent (see Table 6).

Table 5: Changing Actuarial Assumptions, Federated Plan

	June 30, 2011	June 30, 2009	June 30, 2007
Investment Return (net)	7.50%	7.75%	8.25%
Payroll Growth	3.25%	3.83%	4.00%
Base Salary Increase	3.25%	4.08%	4.25%
RETIREE HEALTH CARE/OTHER POST-EMPLOYMENT BENEFITS			
Blended Governmental Accounting Standards Board Investment Return/Discount Rate (net)	6.10%	6.70%	6.60%

Source: City of San Jose, Retirement Services Department, Federated City Employees' Retirement System and Police and Fire Department Retirement Plan Comprehensive Annual Financial Reports.

Table 6: Changing Actuarial Assumptions, Police and Fire Plan

	June 30, 2011	June 30, 2009	June 30, 2007
Investment Return (net)	7.50%	8.00%	8.00%
Payroll Growth	0% for FY 2013 and FY 2014; 3.50% thereafter	4.25% (includes combined inflation and real across-the-board salary increase)	4.00% (includes combined inflation and real across-the-board salary increase)
Base Salary Increase	0% for FY 2013 and FY 2014; 3.50% thereafter	0–5 years of service: 9.75%; 6–7 years: 6.75%; 8+ years: 6.00%	0–5 years of service: 9.00%; 6–7 years: 6.00%; 8+ years: 5.00%
RETIREE HEALTH CARE/OTHER POST-EMPLOYMENT BENEFITS			
Blended Governmental Accounting Standards Board Investment Return/Discount Rate (net)	5.70%	6.70%	6.40%

Source: City of San Jose, Retirement Services Department, Federated City Employees' Retirement System and Police and Fire Department Retirement Plan Comprehensive Annual Financial Reports.

Under defined-benefit plans such as San Jose's two plans (and, indeed, the vast majority of government pension plans), these actuarial assumptions are crucial in determining the amount of contributions that the city will need to make in order to meet future benefits obligations. Even apparently small differences in actuarial assumptions can make a huge difference in the perceived necessary contribution levels and plan health.

Consider, for example, what would happen if the actual discount rate/investment return rate were to fall short of the pension plans' assumptions. A paper published in December 2011 by the Stanford Institute for Economic Policy Research examined how using different discount rates for San Jose's pension plans affected their funding ratios.[30] For each plan, author Joe Nation applied a low, "risk-free" rate, a middle rate based on a 100-year stock market average

with a mix of 80 percent equities and 20 percent fixed-income holdings, and a high rate that is slightly higher than the plan's current assumed discount rate. Under the high rates (7.95 percent for Federated and 7.75 percent for Police and Fire), the Federated pension plan had a market-value funding ratio of 60 percent, while the Police and Fire Plan had a funding ratio of 69 percent. Under the most conservative discount rate (5.64 percent for Federated and 5.24 percent for Police and Fire), the Federated funding ratio fell to 43 percent and the Police and Fire ratio was 47 percent. But Nation suggests that the most accurate discount rate is the middle rate (6.2 percent), under which the Federated funding ratio was 46 percent and the Police and Fire ratio was 55 percent (see Table 7).

Clearly, when pension figures are projected and compounded over the course of decades, even apparently small deviations from actuarial assumptions can result in significant differences—and sometimes nasty surprises for governments and taxpayers—over time.

B. Measures V and W

In 2010, San Jose finally began to address these problems. It restructured its pension boards so that a majority of board members would be independent members with financial and investment expertise, as opposed to the union and city representatives that had previously made up the board.[31] In addition, two employee-compensation-related measures were put before voters in the November 2010 election.

Measure V would change the arbitration process used for disputes between the city and police and fire department employees. It would prohibit the arbitration board from issuing awards that would increase compensation faster than the five-year average of certain city revenues, that would retroactively alter compensation for past service, or that would create new unfunded liabilities that the city would have to pay.[32]

Table 7: Federated and Police and Fire Funding Ratios with Various Discount Rates (as of June 30, 2010)

	Federated		Police and Fire	
Discount Rate	Funded Ratio (Market)	Funded Ratio (Actuarial)	Funded Ratio (Market)	Funded Ratio (Actuarial)
Low[a]	42.6%	48.7%	47.4%	54.7%
Medium[b]	46.4%	53.0%	54.8%	63.3%
High[c]	60.3%	68.9%	69.1%	79.8%

[a] The Federated low-risk rate is 5.64 percent; the Police and Fire low-risk rate is 5.24 percent. Rates are based on the plans' assumed rates of inflation and a current, approximate 16-year Treasury Inflation Protected Security (TIPS) rate.

[b] The medium-risk rate for both is 6.2 percent. It is based on a 100-year stock market average (1900–1999) with a mix of 80 percent equities and 20 percent fixed-income holdings.

[c] The Federated high-risk rate is 7.95 percent; the Police and Fire high-risk rate is 7.75 percent.

Source: Joe Nation, Shrinking Services: Public Pension Costs and Their Impacts on San Jose, Stanford Institute for Economic Policy Research, December 14, 2011.

Proponents argued that rapidly increasing pension obligations had squeezed out funding for city services such as police, fire, libraries and parks in recent years. The ballot argument in favor of Measure V noted that the average pay and benefits for city police and fire employees was over $180,000, and claimed that one reason for the increase in pay and benefits was the decisions of outside arbitrators—and contracts negotiated based on the threat of binding arbitration—in contract disputes between the city and its employee unions.[33] The ballot argument referenced a 2009–2010 Santa Clara County Civil Grand Jury report,[34] which concluded that the existing arbitration process had led to pay and benefits increases that were larger than the growth in city revenues, and cited as an example a pension increase granted to firefighters by an arbitrator in 2007 that created an unfunded liability estimated at $30 million, for which taxpayers were ultimately on the hook.[35]

Opponents countered that the city's politicians were to blame for increased spending and accused them of "balancing the budget at the expense of public safety."[36] The ballot argument against the measure contended that Measure V would lead to further cuts in police and fire staffing, and it implied that such cuts would reduce police and fire protection and increase emergency response times.[37] In the end, the public largely found such arguments unconvincing, and Measure V passed with 66 percent of the vote.

The other measure, Measure W, would allow the city to shift new employees into new pension plans with less generous benefits than the minimum levels then specified in the city charter. It also required that all new pension plans be actuarially sound.[38] As with Measure V, supporters cited the 2009–2010 Santa Clara County Civil Grand Jury report, which concluded that San Jose's pension costs were unsustainable, and emphasized the costs of employee pensions and the effects these rising costs were having on city services. They explained these cost increases in a way that voters could easily relate to by comparing them to the costs of providing city services. The ballot argument in favor of Measure W, for example, noted that the city spent more on pensions than on libraries, gang prevention, senior programs and community centers combined, and that, during a year when the city was forced to lay off firefighters to balance its budget, the city spent more on pensions than for the entire San Jose Fire Department.[39] Proponents additionally focused on city employee benefit levels, arguing that city workers' "defined benefit retirement plan, an employer match of 250%, a retirement age of 55, and city guaranteed benefits for life based on final compensation" were "far more generous than most private sector plans."[40]

Opponents curiously argued that Measure W threatened taxpayers by changing the city charter to give the city council more leeway in establishing less-generous pension plans, and charged that the measure's passage would threaten funding for libraries, parks and public safety. They made these arguments even though proponents were pushing for pension reforms precisely to reduce those costs so that more resources could be put to use for things like libraries, parks and public safety. Opponents of Measure W littered their ballot argument with emotionally charged language: "San Jose politicians are recklessly proposing to eliminate . . . essential taxpayer protections," "Measure W is a risky scheme," and "Measure W threatens funding for police, fire, library, and park services."[41] While the ballot argument claimed, "we agree that pension reform is necessary" near the end of the statement, this claim may have rung hollow in light of the rest of the statement. An emotional appeal for sympathy about city workers' benefit levels perhaps revealed the true position of Measure W's opponents: "City retirees do not get social security. Pensions enable city workers to earn a

retirement with dignity."[42] Yet there was never any substantive discussion of city workers' actual pay or benefit levels.

Proponents' more rational arguments based on pension cost increases and the budgetary trade-offs they necessitated appeared to prevail over the opponents' more emotional arguments. Measure W passed with 72 percent of the vote.

C. Measure B

In spite of these reforms, the city's finances remained perilous, and in 2011 the city council considered declaring a fiscal emergency and placing Measure B on a March 2012 special-election ballot. But when a revised budget estimate came in showing a smaller-than-expected deficit, the city dropped the plan and moved the measure to the June primary ballot.

Among Measure B's provisions were the following:

- Current employees will have to pay a larger portion of their salaries to maintain their existing benefits. They will have to pay up to 16 percent of their salaries, not to exceed half the normal cost of their benefits, which does not include unfunded liabilities. (The city currently pays nearly three-quarters of the normal cost of employees' pensions.) In anticipation of the contentious nature of this provision, Measure B includes a clause that directs an equivalent amount of savings to be obtained through salary reductions, should a court rule the provision unenforceable.
- The city will place employees who do not choose to pay the higher contribution rates to maintain their pension benefit levels going forward in a new, less-generous plan.
- The city will place new employees in more-limited pension plans, and the city has the option to enroll employees in Social Security or establish a 401(k)-style defined-contribution plan for them.
- Employees must pay for at least half the normal cost and unfunded liabilities of retiree health-care plans.

- The city will no longer issue extra SRBR pension payments, or "13th checks," to retirees when the pension investment funds experience "excess" returns.
- The city will reduce the automatic annual COLAs paid to retirees from 3 percent to 1.5 percent for new employees and for current employees that opt into the newer, less-generous plan, and COLAs may be suspended for up to five years if the city declares a fiscal emergency.
- Disability retirements are limited to cases where city employees are "incapable of engaging in any gainful employment for the City, but not yet eligible to retire."
- Voters must ratify all future city employee-pension or other post-employment benefits increases.[43]

Measure B's proponents made some familiar arguments in stating the case for the pension-reform proposal. As they had with Measures V and W about a year and a half prior—for the measures' supporters were essentially the same people—proponents pointed out how city employee retirement costs had grown rapidly, consuming a larger and larger portion of the budget and leaving less funding for other city services. The ballot argument in favor of Measure B noted that San Jose's retirement costs had jumped from $73 million to $245 million during the previous decade, and that they now comprised over 20 percent of the city's budget.[44]

Supporters also pointed out the disparities in compensation between city employees and private-sector workers. Proponents' ballot argument explained that the city's share of retirement costs was greater than 50 percent of payroll, which was compared with the 6.2 percent of payroll that private-sector companies contribute to Social Security. In addition, city workers paid only about one-fourth of the costs of their retirement benefits, while private-sector employees typically pay about half of their retirement costs.[45] Finally, supporters asserted that Measure B would prohibit pension spiking, and they assured voters that benefits earned up until the measure went into effect would be protected, so those already in retirement would not see any cuts to their pensions.

Opponents argued that city employees had already sacrificed through pay cuts of 10–18 percent in recent years, and noted that the average pension of miscellaneous city workers was about $38,000 (although they omitted discussion of average police and fire pensions and did not explain whether the $38,000 figure was for recent retirees or included retirees that had retired many years ago under less-costly benefit formulas).[46] They noted that the city's employee unions had offered to agree to a number of pension reforms, including increasing retirement ages and reducing benefits and COLAs, although they did not mention whether such reforms would only apply to new employees or whether they would be codified in the city charter or merely agreed to in collective bargaining agreements, which could be easily overturned by future negotiations. In addition, opponents criticized city officials for planning to declare a fiscal emergency, then discovering a $10 million budget surplus and spending millions of dollars to improve roads near a proposed sports stadium and to subsidize the San Jose Downtown Association, a nonprofit organization representing downtown business and property owners.

Other ballot arguments rested primarily on more emotional pleas, such as alleging that Measure B could eliminate disability retirements for police officers and firefighters, claiming that the measure was "riddled with legal risk" and objecting that "widows and seniors" would have to pay thousands of dollars more for "promised health care."[47] Opponents also tried to cast Measure B as illegal, imploring voters, "Tell the city to negotiate on legal pension reform, **Vote NO on Measure B!**" (emphasis in original).

This latter charge led the measure's supporters to begin their rebuttal ballot argument with an explanation of why they believed Measure B was legal:

> *Measure B follows California law. The California Constitution grants the City authority to change employee compensation. The City Charter gives voters the right to change retirement benefits. The Municipal Code allows the City to require employees to pay more for retirement benefits, which is an element of Governor Brown's pension reforms and was recommended by the Santa Clara County Grand Jury.*[48]

In addition to Governor Brown's pension-reform proposal[49] and the Santa Clara County Grand Jury report,[50] backers of Measure B cited and provided Web links to reports that substantiated their claims about the need for pension reform. These included a Stanford Institute for Economic Policy Research report that found that the $90,612 average pension for public-safety workers in San Jose was greater than that for any other independent pension system in California,[51] a city auditor report that concluded that the city's level of disability retirements (including 67 percent of all fire employees) was significantly higher than in other jurisdictions,[52] and a legal opinion of Measure B by outside counsel Meyers Nave.[53]

As with Measures V and W, voters appeared to be more swayed by evidence of the existing pension system's high costs, especially when compared with those of the private sector, and Measure B passed with roughly two-thirds of the vote, with 69 percent voting in favor.

Nearly three months after Measure B's passage, the San Jose City Council passed an ordinance to establish the new, lower pension plan for future hires. The plan maintains the traditional, defined-benefit plan format, but non-safety employees will now receive 2 percent of their final salary for each year worked, down from the previous 2.5 percent, and total payouts may not exceed 65 percent of final salary, compared with the 75 percent maximum available under the previous plan. In addition, the council raised the minimum retirement age to receive full benefits from 62 to 65 for general employees, and from 55 to 60 for public-safety employees.

Part 5

The Politics of Reform

While many people, on both sides of the public pension reform debate, and some members of the media seem to believe that pension reform is a partisan issue, and that Democrats always side with public-employee unions to resist reform, the truth is that some of the boldest reforms in recent years have taken place in jurisdictions with Democratic leadership. In reality, pension reform is a pragmatic response to a budget problems caused by overly generous pension benefits. Politics matters, however, and this section describes some of the issues that the San Jose City Council had to navigate.

A. Challenges Leading up to Reform

The city of San Diego, which undertook a major pension reform that is the subject of another case study in this series, has a plurality of registered Democratic voters, a city council with a Democratic majority and, since December 2012, a Democratic mayor. Likewise, San Jose has a plurality of voters registered Democrat (46 percent), compared with just 22 percent registered Republican.[54] As Mayor Chuck Reed explains:

> *[San Jose is] a California city led by Democrats with a Democratic majority on the City Council that's taken the action because we're trying to avoid the fate of Detroit and others. We're trying to find an alternative to bankruptcy. Mayors all over the country are hoping there's alternatives to bankruptcy to bring down these skyrocketing retirement costs.*[55]

This support for pension reform by Democratic politicians and many Democratic voters does not mean that the city's labor unions have gone along with its Democratic political leadership, however. In fact, the relationship between the administration and the labor unions has been extremely contentious. Labor unions fought the pension-reform effort vigorously at every step, from trying to keep it from ever making it onto the ballot, to attempting to modify the ballot language and get the measure removed from the ballot, to litigating Measure B after its passage.

Some unions accused the administration of refusing to negotiate on pension reform.[56] Even before Measure B was placed on the ballot, the San Jose Police Officers' Association filed two lawsuits against the city in the Santa Clara Superior Court in March 2012, claiming that in pursuing its pension reforms, the city was engaging in unfair labor practices. The unions attempted, and failed, to get the court to force the city into arbitration over their differences in opinion on employee compensation, rather than allowing the city to place a pension-reform measure on the ballot.[57]

But the city spent more than eight months negotiating with the unions before the city council voted to place Measure B on the ballot,[58] and Mayor Reed retorted that the city had "spent hundreds of hours negotiating with its employee unions over the Measure B pension reforms."[59] Moreover, the city asserts, those negotiations led to a number of changes in the pension-reform proposal before it was placed on the ballot. These included reducing the amount of proposed increases in employee contributions (from an additional 5 percent a year up to a maximum of 25 percent, to an additional 4 percent a year up to a maximum of 16 percent), adding the option for employees to select a reduced pension plan instead of paying the higher contributions to continue in the old plan, and eliminating several other provisions that the unions opposed.[60] The administration and the unions never reached an agreement, however, and the fight over what became Measure B continued.

Another union lawsuit filed in March 2012 on behalf of San Jose Fire Fighters Union President Robert Sapien, Police Officer Franco Vado, Environmental Service Specialist Karen McDonough and retired firefighter Clifford Hubbard claimed that the wording of the ballot question was prejudicial and sought to get Measure B kicked off the ballot. The Santa Clara Superior Court ultimately made some minor modifications to the wording and allowed Measure B to remain on the ballot.

If this were not enough, the city also had to deal with the intervention and opposition of the state of California. In March 2013, the California Public Employee Relations Board (PERB) filed complaints on behalf of the American Federation of State, County and Municipal Employees (AFSCME) Local 101, San Jose Firefighters Local 230, International Federation of Professional and Technical Engineers Local 21 and Operating Engineers Local 3 over the city's negotiations with the unions on the pension reforms that became Measure B.[61] PERB's board members are primarily former unions officials and union attorneys, so the agency is, not surprisingly, very partial to union interests. An administrative law judge will hear the complaints, and the judge's proposed decision may be appealed to the agency's board, and thereafter to the state appellate court.

Despite the litigation, it has been argued that the city's labor unions did not put up much of a fight during the actual election.[62] Campaign contribution information does not appear to support this argument, though. According to campaign disclosure forms, the union opponents of Measure B, led by AFSCME, AFL-CIO (AFSCME Local 101 is the city's largest labor union), raised approximately $550,000 to contest the measure, about $87,000 of which (16 percent of the total) came in the form of donations larger than $1,000 less than a week before the election.[63] This sum was not quite as much as the roughly $800,000 raised by Measure B supporters,[64] but it is hardly insignificant.

B. Subsequent Challenges

A major portion of the Measure B pension reforms might face an obstacle in the form of the U.S. Internal Revenue Service. According to a 2006 IRS rule, if a public employee selects a retirement plan with a lower benefit, that retirement plan may not be eligible to receive pretax contributions. Orange County, California, negotiated with its labor unions in 2009 to similarly offer employees the option of choosing a less-generous pension plan, or contributing more to keep the more-generous plan. Years later, the IRS still has not made a ruling on Orange County's opt-in plan (and now San Jose has been waiting over a year as well).[65] The IRS has apparently failed to act on at least two dozen such requests from around the country.[66]

Should a prolonged delay prevent the needed cost savings from pension reform, Measure B may have to rely on another of its provisions. If IRS decisions (or the lack thereof) or court decisions were to prevent the city from implementing this part of its pension reforms, another clause of Measure B calls for pay reductions to make up the expected cost savings.

In addition to bureaucratic roadblocks, San Jose will also have to weather some legal storms. Immediately after Measure B's passage, the city employees' unions started filing lawsuits to block the law's implementation. The unions claim that the California Constitution and court opinions over the past several decades have determined that their pension benefits are a "vested right" from the first day they start working and cannot ever be reduced—not even future benefits that have not yet been earned. The city counters that its status as a charter city affords it greater latitude in determining the compensation of its employees, and the city's charter explicitly grants it the authority to modify employee contribution rates, amend retirement plans and establish new plans.[67]

The trial was held in the Santa Clara County Superior Court in July of 2013. When asked what the city would do if it lost the lawsuit, Mayor Reed responded, “If that fails, then we will have to go back to cutting services to balance the budget. We ought to have alternatives to that, and the alternative should not just be bankruptcy.” When pressed about whether the city would have to resort to bankruptcy if that were the case, Reed offered the following:

> *Well, I think we will be going into what’s called “service delivery insolvency,” which is, you have enough money to pay your bills and pay your pensions, you just don’t have money to provide services. So we’ll go back into cutting services in order to balance the budget. That’s a terrible place to be. And when you get into that position, and something bad happens, then the only alternative is bankruptcy. We’re doing everything we can to avoid that.*[68]

On December 20, 2013, Judge Patricia Lucas of the Santa Clara County Superior Court issued a tentative decision that overturned several key pieces of Measure B, while simultaneously upholding a majority of the initiative and sustaining substantial savings anticipated in the passage of the measure.

San Jose is likely to continue appeals that would preserve the measure in whole. As noted by Mayor Chuck Reed, “I am pleased that Judge Lucas has upheld a majority of the Measure B provisions and has protected a vast majority of the targeted fiscal savings that will help rebuild essential public services and protect the long-term sustainability of our employee retirement systems. In particular, this ruling protects $20 million in annual savings the City is already reaping due to the elimination of bonus pension checks and changes to our retiree healthcare plans. Those savings have allowed us to slowly begin restoring services to the public and slowly begin restoring pay to our employees.”[69][69]

As it now stands, San Jose is able to preserve a significant amount of savings, which will allow them to restore some services and to offer competitive pay and benefits packages to their public safety personnel, while the battle for reform continues.

Part 6

Lessons Learned

This study has sought to elucidate how San Jose addressed the weight of mounting retirement obligations and prevented further service cuts and bankruptcy through bold public-pension reforms. With many other cities and states in a similar predicament, San Jose offers one model for reform.

- First, the San Jose City Council prepared the ground by changing the structure of the pension review board so that there would be less opposition to reform internally.
- Second, it recognized that the scope of the city's pension problems required it to pursue bold reforms, including altering the unearned future benefits of current employees.
- Third, it put its proposals to the electorate, thereby ensuring that the reforms had democratic legitimacy.
- Fourth, evidence-based arguments backed up by statistics and reports from reputable sources about the high costs of the city's retirement system—especially when compared with employee compensation in the private sector—won out over emotional arguments about the supposed plight and unfairness faced by public employees.
- Fifth, the mayor consistently made clear that the alternative to reforms is fewer services (which helps to motivate voter support) and fewer government jobs (which helps to pit those government employees who might lose their jobs against the union leadership, potentially undermining union solidarity).
- Sixth, the proposed reforms included default alternatives (lower pay) that would be painful to all existing employees, thereby incentivizing those employees to favor the reforms.

- Seventh, anticipating legal challenges, the city council and mayor demonstrated resolve by dedicating the necessary resources to withstand a barrage of litigation in several different venues.
- Eighth, San Jose exposed the problems facing municipalities that lack the constitutional ability to deal with vesting rights. In doing so, the city has shown leadership to other jurisdictions that face the same fiscal and budgetary challenges.

These lessons are of particular use in polities where ballot measures are possible. But even in states that do not allow such measures, it is important to develop a winnable strategy, prepare the ground and stick with a clear message.

We likely will not know the fate of San Jose's public-pension reforms for many years, and it could end up being determined more by events in courtrooms than at ballot boxes or around collective bargaining tables. But even if San Jose ultimately loses its legal battle, it has cleared a path toward reform that, with relevant adjustments, other financially distressed municipalities around California and across the nation can follow.

About the Author

Adam B. Summers is a writer and public policy analyst. He has written extensively on privatization, government reform, individual liberty, law and economics, public pension reform, occupational licensing and various other topics. Summers has testified before state legislative committees in Arizona, California, Louisiana and Michigan on topics such as public pension reform and occupational licensing regulations. He previously worked as a policy analyst and senior policy analyst at Reason Foundation for 12 years.

In addition to his dozens of studies and policy briefs, Summers's articles have been published by *The Wall Street Journal, Los Angeles Times, San Francisco Chronicle, San Diego Union-Tribune, Atlanta Journal Constitution, Orange County Register, Los Angeles Daily News, Washington Times, Baltimore Sun, Los Angeles Business Journal, Contra Costa Times, The Freeman, Reason* magazine and many others.

Summers holds an M.A. in Economics from George Mason University and a B.A. with a double-major in Economics and Political Science from the University of California, Los Angeles.

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5737 Mesmer Ave.
Los Angeles, CA 90230
310-391-2245
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