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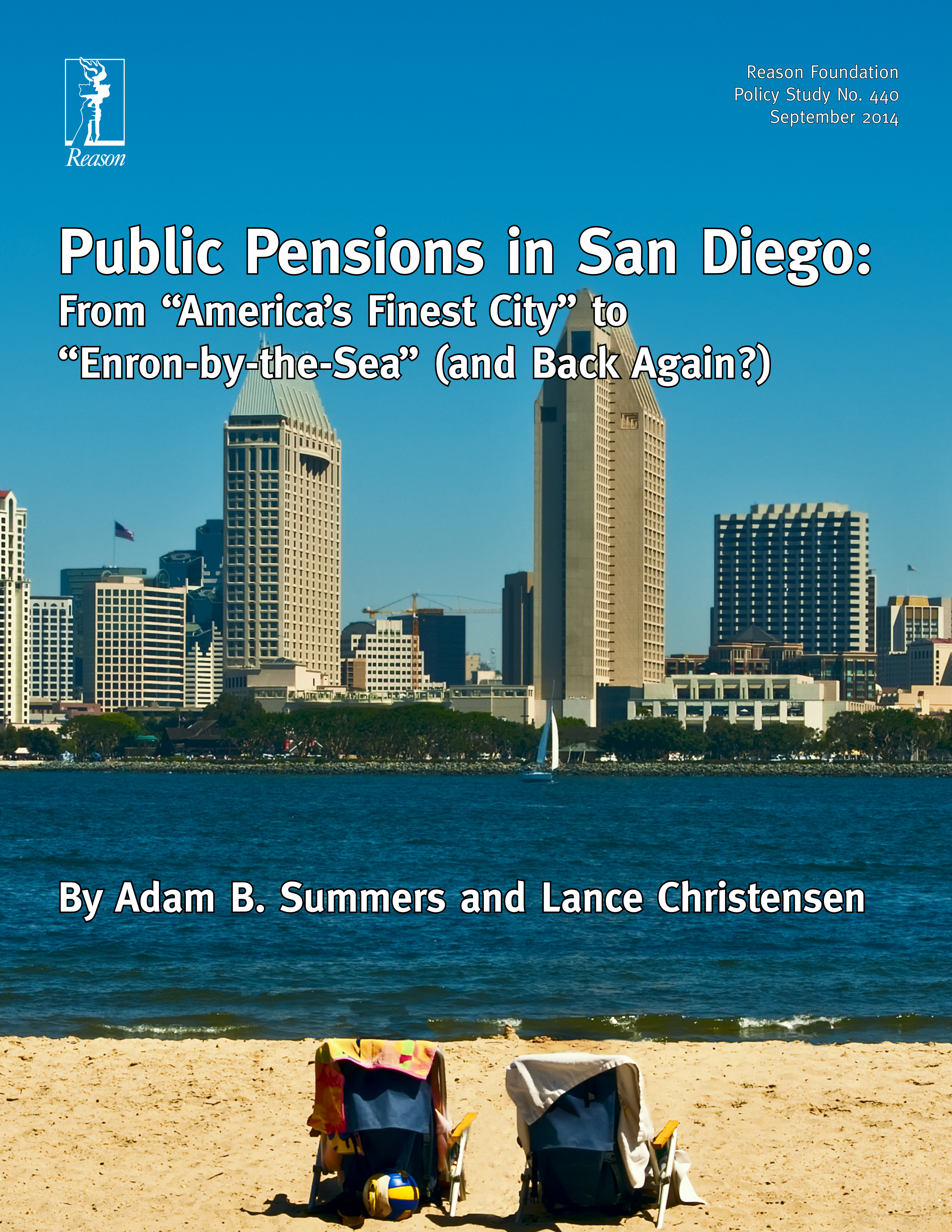
Public Pensions in San Diego:
From "America's Finest City" to "Enron-by-the-Sea" (and Back Again?)

By Adam B. Summers and Lance Christensen



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Executive Summary

Before the high-profile pension and fiscal failures of Vallejo, California and Detroit, Michigan grabbed headlines across the country, San Diego was a poster child for budgetary dysfunction and ripe for a public pension meltdown.

In just a few short years the city of San Diego went from "one of the best-run cities in the country" to being labeled "Enron-by-the-Sea." Its pension system fell from a funding ratio of 100% to just 67% in less than a decade. In 2012, San Diego faced a nearly $2.3 billion unfunded pension liability and its annual pension payment consumed about 20% of the general fund budget. San Diego's pension story is filled with scandal, indictments, a suspended credit rating, significant budget deficits and service cuts, resignations of top city officials, and talk of municipal bankruptcy.

But these years of abject mismanagement also created in San Diego the interest, the will and the opportunity needed to bring about change. Faced with such serious problems, San Diego embarked on a series of incremental pension reforms in order to help the city stabilize its finances and start down the road to

fiscal recovery. This study details the fiscal failure that caused a pension crisis and forged a path for pension reform.

A “Perfect Storm” of Financial Mismanagement

Deliberate Plans to Underfund Pensions

San Diego’s pension troubles started in 1996 when the city began systematically to underfund the pension system. In that year, then-City Manager Jack McGrory promoted a plan to take advantage of “historic returns” on Wall Street (the Dow Jones Industrial Average had surged 33% the previous year). The idea was simple: even though the city would contribute less to the pension fund and city employees’ benefits would increase, the fund’s investment returns would keep it in good shape. During the stock market boom of the late 1990s, money poured into the pension system. Unfortunately, while these gains could not and did not last forever, the city expanded government employee benefits without accounting for the inevitable market correction. Once the market hit a downturn, it became apparent that existing contributions would not be enough to cover pension system expenses. San Diego’s troubles were exacerbated in 2002 when the city again reduced contributions to the pension system and increased employee benefits without making any provision to pay for the increased costs.

The Fallout

By 2003, San Diego’s unfunded pension liability had surpassed $1 billion and the plan’s funding ratio had fallen to just 67%. All the major credit-rating agencies responded by lowering San Diego’s bond ratings. The city’s failure to release annual audits for 2003 and 2004 even prompted Standard & Poor’s Rating Service to suspend its rating altogether in September 2004, which crippled the city’s ability to issue debt to pay for large projects such as water and wastewater system improvements.

This financial mismanagement resulted in federal and city investigations, which found:

- Substantial increases in pension benefits for city employees,
- Intentional (and significant) underfunding of the system,
- Alleged conflict of interest and corruption,

- Excessive influence by city employee labor unions,
- Financial reporting irregularities, and
- A retirement board that operates secretly behind closed doors.

While some have tried to blame the city's pension problems on the downturn of the stock market following the bursting of the "dot-com" bubble, investment performance accounted for just 6% of pension system underfunding between 1996 and 2003, while benefit enhancements accounted for 41% of the problem and the use of plan earnings to pay for contingent benefits constituted another 12%.

Increasing Benefits

The $5.3 billion San Diego City Employees Retirement System (SDCERS) serves nearly 12,000 current city employees and 8,000 retirees of the city of San Diego, San Diego Unified Port District, and the San Diego County Regional Airport Authority. The city of San Diego pension plan manages benefits for various classes of city employees, including general, police, fire, lifeguard and elected officials.

The average San Diego city employee's pension more than tripled between 1996 and 2013. The average city pension for employees who had worked over 30 years was nearly $64,000 in 2012. The increase in retirement costs is due, in large part, to several lavish benefits—including a program for "double-dipping" (the Deferred Retirement Option Program (DROP)), purchasing years of service that were not worked ("air time"), receiving extra pension checks, and employer-matching savings plans—added to an already generous retirement package.

The Reforms

Pension reform in California is constrained by the so-called "California Rule"—the idea that promised benefits for public employees enjoy special constitutional protections and can only be increased and never reduced. As a result, pension reform efforts over the years created several different tiers of benefits, usually affecting only new employees hired after any reform is implemented.

Though Proposition B of 2012 may have been the boldest of San Diego's pension reform measures, the success of a number of other previous reform measures, spanning back nearly a decade, is what ultimately laid the groundwork for its passage.

Propositions G and H (2004)

In light of the revelations about the city's pension underfunding deals, reformers were determined to prevent such deals from happening again. In the November 2004 election, the San Diego City Council put Propositions G and H before voters to prevent the city and the retirement board from delaying full actuarial funding of city pension contributions to the retirement system. The reformers also wanted to amortize losses and to change the composition of the retirement board from one dominated by union representatives and city administrators and appointees to one with a majority of financial experts. The measures passed, revealing a felt need for pension reform among voters.

Dropping the DROP

As it became clear that DROP was a net drain on the city's finances, the public's support for more pension reform continued to grow. The city closed DROP to new employees and reduced the interest paid on DROP earnings.

Voter Approval Requirement

In November of 2006, the city council asked voters if the city charter should be amended to require voter approval of all future increases in retirement system benefits, not including cost-of-living adjustments. The measure passed overwhelmingly, with 70% of the vote.

In 2009, bolstered by public support for reining in city pensions, the city council negotiated agreements with some labor unions and imposed restrictions on others, to increase contribution levels and limit taxpayers' exposure to compensation costs for employees hired after the fiscal year ending June 30, 2009. Additionally, the city imposed a two-year wage freeze, reduced non-union employees' compensation by 6% through a mix of salary cuts and contribution increases, and capped the city's cost of retiree health benefits at existing levels. As of 2012, the retiree health care liability had been reduced to an estimated $444 million.

Proposition B (2012)

Perhaps the most well-known of San Diego's pension reform measures is Proposition B, which passed in 2012. Due to the "California Rule," Proposition B did not attempt to change benefit formulas for existing employees, but required the following:

- All new city employees (except sworn police officers) were to be enrolled in 401(k)-style defined contribution retirement plans rather than defined benefit pensions. The city's contribution levels were capped at 9.2% of final salary for general employees and 11% for public safety employees.

- Employees' base compensation, upon which their pension benefits are calculated, was limited and would exclude supplemental and specialty pay.

- The city was required to begin negotiations with its labor unions by calling for employees' base compensation to be capped until June 30, 2018, at fiscal year 2011 levels. This bargaining position could be overturned with a two-thirds vote of the city council.

- Newly hired police officers' annual pension benefits were capped at 80% of their final salaries.

- City officers and employees convicted of a felony related to their positions would lose their pension benefits.

- A previous city charter provision that a majority of employees or retirees was required to approve changes to their retirement benefits was eliminated.

- The city was required to annually publish the amounts of pension benefits paid to retirees, although retirees' names would be redacted to protect their privacy.

San Diego's Independent Budget Analyst estimated that Proposition B would result in net savings to the city of approximately $950 million over 30 years if the pay freeze until June 30, 2018, were to go into effect. If no pay reductions were realized, it would end up costing the city about $13.5 million over the same 30-year time frame.

Proposition B passed with 66% of the vote and the city's six labor unions agreed to a five-year freeze in employees' pensionable pay. The agreement was expected to save the city $25 million during the first year. While the main provisions of Proposition B—the pensionable salary freeze and the 401(k)s for new hires—have been implemented, a couple of provisions, which are subject to negotiations with the unions, are yet to be finalized. The pension reform measure continues to face some bureaucratic and legal obstacles, but San Diego is slowly righting the financial ship toward long-term recovery.

Lessons Learned

With so many other cities and states facing similar problems, San Diego offers one model for addressing the weight of mounting retirement obligations and preventing further service cuts and bankruptcy through bold—albeit incremental—public pension reforms. The course of the city's long road to pension reform presents many lessons that will inform other efforts to implement similar reforms.

- Changes will be politically feasible when there is a felt need for change among both a majority of citizens and at least some elected officials. Attempting to pursue one comprehensive set of reforms may be overly complex and, ultimately, counterproductive. San Diego passed numerous narrow pension reform measures over the course of nearly a decade that laid the groundwork for Proposition B. This allowed the public to become better educated on the issues, enabling reform proponents to overcome opponents' negative messages and misrepresentations of the effects of the reforms.

- Making a straightforward case to the general public emphasizing the impact on taxes, government budgets and services if the pension system is not reformed is effective.

- It is essential that a majority—if not all— of the retirement board members have credentials and years of experience in finances and investments. Change the composition of the retirement board by ballot measure, if necessary.

- Conducting audits of additional retirement benefits—such as deferred retirement option programs and "air time" purchases—quantifies the problem for all concerned. If these benefits are costing more than expected or creating unfunded liabilities, they should be scaled back or eliminated.

- When reform seems inevitable, it may be possible to get concessions in union labor contracts through the collective bargaining process. It must be remembered that these concessions do not constitute reform in and of themselves, but this is nevertheless an option for bringing down the costs of pensions while not relying wholly on a political process.

- In jurisdictions where there is strong labor union opposition to pension reform, and particularly where a majority of city council members or state representatives are sympathetic to union interests, take reform directly to the voters through a ballot initiative, where possible.

- Scare tactics become less important to the voters as a pattern of fiscal malfeasance becomes more obvious. Furthermore, unless the voters see serious and substantive reforms implemented, they are not likely to vote for tax increases to shore up failing pension systems.

- If launching a pension reform ballot initiative, be aware of the likely considerable resources needed to counter opponents (such as labor unions), especially in trying to qualify a measure for the ballot. Verify that signatures collected during efforts to get a pension reform measure on the ballot are legitimate—and budget your campaign accordingly.

- Simply blaming a jurisdiction's public employee pension problem on a downturn in the stock market or a period of economic recession prevents an honest assessment of its causes, which may be numerous and go far beyond the typical fluctuations of a dynamic economy.

- It's important to seek outside legal counsel to make sure that you are advocating for the right kinds of reforms. Former San Diego Councilman Carl DeMaio advises, "Really take a look at your options before you just blindly accept the proclamations of government attorneys and labor unions."

- Finally, other general political campaign advice applies here as well for ballot initiative attempts. This includes utilizing a competent political consultant, using polling to test ideas and arguments, ensuring that ballot language is vetted by knowledgeable attorneys, building strong and strategic coalitions, lining up funding, and preparing to counter (labor union) opposition tactics.

We likely will not know the fate of San Diego’s public pension reforms for many years, but even if San Diego ultimately loses some ground, it has cleared a path toward reform that, with relevant adjustments, other financially distressed municipalities around California and across the nation can follow.

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Public Pensions in San Diego:
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Introduction

The city of San Diego was once revered as one of the best-run cities in the country. In just a few short years, a couple of ill-advised plans to intentionally underfund the city's pension system sent the self-described "America's Finest City" from the heights of being touted as one of the most efficiently run large cities in America[1] and the most efficient of California's largest cities[2] to the depths of financial despair, near bankruptcy, and a new moniker: "Enron-by-the-Sea."[3] Before such high-profile pension and fiscal failures as Vallejo, California and Detroit, Michigan, San Diego was the poster child of public pension collapse and budgetary breakdown.

As of 2012, San Diego faced a nearly $2.3 billion unfunded pension liability (see Table 1 below for a summary of San Diego's pension plans, including their financial conditions).[4] The city's annual pension payment increased from $43 million in 1999 to $231 million in 2012, and consumed about 20% of the general fund budget in 2012.[5] In addition, the city's unfunded retiree health care liability was estimated at approximately $1.1 billion in 2011, but a deal reached between the city and its labor unions that year is expected to save over $700 million over 25 years.[6] As of 2012, the retiree health care liability had been reduced to an estimated $444 million.[7]

As former City Councilman Carl DeMaio, one of the city's biggest advocates for, and backers of, pension reform in San Diego, explained, "The impact of (the pension crisis) was twofold: More and more money was diverted from city services to pensions, more and more increases were made in the water fees and development fees to do cost recovery to save the pensions. So there was a higher cost of living in San Diego, a higher cost of government with lower services because they kept cutting services to divert money to the pension system."[8] Those city service cuts included neglecting pothole and other road repairs, the "browning-out" of fire stations, the elimination of community service centers, and a reduction in hours at city libraries, including reductions of 40% to 50% at some branches.

San Diego's pension story is filled with scandal, indictments, the suspension of its credit rating, significant budget deficits and service cuts, resignations of top city officials, and talk of bankruptcy. But there may also be redemption. Faced with such serious problems, San Diego embarked on a series of pension reforms in order to help the city right its financial ship and get on the road to fiscal recovery. Perhaps the most well-known of these reform measures is Proposition B, which was featured on the June 2012 ballot.

Proposition B was unique in that it not only called for the city government to provide more modest pensions to its employees—as many other jurisdictions have done—but it also closed the city's traditional defined benefit pension systems for all employees (police officers were exempted) and placed them instead in 401(k)-style defined contribution retirement plans similar to what most workers in the private sector receive. In addition, it took the step of addressing pensions for existing workers by eliminating supplemental and specialty pays from pensionable pay calculations, focusing instead on base pay, and called for a pensionable pay freeze at fiscal year 2011 levels until June 30, 2018, for current employees. Showing that pension reform is a bipartisan effort and despite a sizable Democratic plurality in voter registration (40% Democrat versus 28% Republican in the last election in San Diego),[9] the public saw the need for further reform and overwhelmingly passed Proposition B with 66% of the vote.

"There was a higher cost of living in San Diego, a higher cost of government with lower services because they kept cutting services to divert money to the pension system."
—Carl DeMaio, former San Diego city councilman

Though Proposition B may have been the most recent and daring of San Diego's pension reform measures, the success of a number of other previous reform measures, spanning back nearly a decade, is what ultimately laid the groundwork for its passage. This study examines the history that led to the pension problems in San Diego, the path to reform, the Proposition B reforms adopted in 2012, the bureaucratic and legal hurdles the city still faces in implementing its reforms, and the lessons learned from San Diego's experience.

Table 1: San Diego Pension Plan Summaries

	City of San Diego	Unified Port District	Airport Authority
Overview (2012 valuation)			
Actuarial Value of Assets	$4,982,442,000	$277,822,000	$95,793,000
Liabilities (AAL)	$7,261,731,000	$382,013,000	$97,225,000
Unfunded Liability (UAL)	$2,279,289,000	$104,191,000	$1,432,000
Funding Ratio	68.6%	72.7%	98.5%
UAL as a % of Annual Covered Payroll	446.0%	301.6%	5.8%
Participants (2013)			
City of San Diego Total Full-Time and Part-Time Employees	*Total:* 10,026 *General:* 6,364 *Safety:* 3,662		
Active Members	*General:* 5,337 *Safety:* 2,228	416	346
Inactive Members	*General:* 2,410 *Safety:* 562	287	80
Number of Retirees Currently Receiving Benefits	*General:* 4,571 *Safety:* 2,899	456	41
DROP Participants	*General:* 546 *Safety:* 438	29	10
Actuarial Assumptions			
Investment Return	7.5%	7.5%	7.5%
Salary Increase	3.75%*	3.75%	3.75%*
Additional Merit Increase	0.5%–8.0%	0.5%–8.0%	0.5%–5.0%
Cost of Living Adjustment (COLA) Increase	2.0%	2.0%	2.0%

* Following a two-year freeze for city and airport employees in FY 2013 and FY 2014.

Sources: San Diego City Employees' Retirement System, *Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2013*, https://www.sdcers.org/annualreports/2013%20CAFR.pdf, and city of San Diego, *Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2012*, http://www.sandiego.gov/comptroller/pdf/reports/cafr_2013.pdf.

Part 1

Background

The $5.3 billion San Diego City Employees Retirement System (SDCERS), which serves nearly 12,000 current city employees and 8,000 retirees, was established by the city of San Diego in 1927. In 1963, SDCERS began administering the retirement benefits of the San Diego Unified Port District, and the San Diego County Regional Airport Authority began utilizing its services when it was created in 2003.[10]

The city of San Diego pension plan manages benefits for various classes of city employees, including general, police, fire, lifeguard and elected officials. Due to the prevalence of the so-called "California Rule"—the idea that promised benefits for public employees enjoy special constitutional protections and can only be increased and never reduced—pension reform efforts over the years created several different tiers of benefits, usually affecting only new employees hired after any reform is implemented.[11]

1.1 A "Perfect Storm" of Financial Mismanagement

The city's pension plan is currently operating with a deficit of almost $2.3 billion, and is only 69% funded.[12] On top of this, the city faces an additional $444 million in unfunded health care costs.[13] The city was even forced to consider municipal bankruptcy protection for quite some time,[14] although the reforms of recent years have helped to put the city back onto a more sustainable path and quell that notion.

San Diego's pension system fell from a funding ratio of 100% to just 67% in less than a decade.[15] This is far below the accepted standard for California counties, which even allows for some measure of underfunding. Said Bob Palmer, former legislative chair for the State Association of County Retirement Systems, "I think the rule of thumb (is) … a government pension that's running at 80% or better is well-funded."[16] Palmer's assessment is optimistic; as one commentator has noted, "Wall Street gets nervous when the level slips below

90%."[17] In reality, any system that is not 100% funded risks imposing costs on future generations.

Because of its financial mismanagement, particularly with regard to the pension system, San Diego became the subject of numerous federal and city investigations. These included inquiries by the Federal Bureau of Investigation, Securities and Exchange Commission, and the U.S. Attorney's Office (Justice Department).

As San Diego's Pension Reform Committee reported in 2004, the city's pension crisis was a "perfect storm" of financial mismanagement.[18] This perfect storm was characterized by:

- Substantial increases in pension benefits for city employees,
- Intentional (and significant) underfunding of the system,
- Alleged conflict of interest and corruption,
- Excessive influence by city employee labor unions,
- Financial reporting irregularities, and
- A retirement board that operates secretly behind closed doors.

While some have tried to blame the city's pension problems on the downturn of the stock market following the bursting of the "dot-com" bubble, the Pension Reform Committee report found that investment performance accounted for just 6% of pension system underfunding between 1996 and 2003, while benefit enhancements accounted for 41% of the problem and the use of plan earnings to pay for contingent benefits constituted another 12%.[19]

The Pension Reform Committee report found that investment performance accounted for just 6% of pension system underfunding between 1996 and 2003, while benefit enhancements accounted for 41% of the problem and the use of plan earnings to pay for contingent benefits constituted another 12%.

1.2 Pension Benefits Prior to Proposition B

For years, general employees were able to retire with pension benefits equal to 2.5% of their final compensation per year of service beginning at age 55, increasing to 2.8% at age 65, with a maximum of 90% of final compensation. Benefits were later capped at 80% of final compensation. Public safety employees received a "3% at 50" formula, with a maximum pension of 90% of final compensation. Earlier benefit tiers based one's final compensation on the highest single year of earnings, although this was later changed to be calculated based on the average of the highest three-year period of earnings in order to prevent pension spiking (see Table 2 below for a summary of all plan benefits).

The Unified Port District plan manages benefits for general, miscellaneous, executive and safety (Harbor Police) classes of employees. The Port District plan offered benefits based on a "2.5% at 55" formula for general employees, "3% at 55" for executive employees, and "3% at 50" for public safety employees, with a cap of 90% of final compensation for general and safety employees. As with the city employees, final compensation was based on the highest single year of earnings, then changed to the average of the highest three-year period.

The Airport Authority plan manages benefits for general and executive employees. This plan offered benefits equal to 2.5% of final compensation per year of service at age 55, increasing to 3% at age 65, with a maximum of 90% of final compensation, for general employees and a "3% at 55" formula for executive employees.

The categories of employees in the Unified Port District and Airport Authority plans are additionally subdivided based on a couple of significant events. The first concerned a class action lawsuit brought in 2000 by a former Port District employee against the Port District, the city and SDCERS (*Andrecht v. San Diego Unified Port District*). The retiree (and the rest of the class) asserted that certain specialty pays were improperly omitted from employees' pensionable pay for the purposes of calculating their pensions. The legal proceedings culminated in a settlement in 2001 in which plaintiffs benefits were increased by 7%.[20]

Another subdivision of employee classes occurred as a result of pension reforms passed at the state level. In addition to the reforms implemented by San Diego that are discussed in the following section, the state enacted the California

Public Employees' Pension Reform Act (PEPRA), or AB 340, in September 2012. The law, which became effective as of January 1, 2013, made a number of changes to state and local pension benefits. PEPRA reduced benefit levels, capped pensionable pay, used a three-year average to calculate final compensation for new hires, eliminated air-time purchases, and prohibited retroactive benefit increases for all employees. Since San Diego is a charter city and has discretion in determining its own employee compensation policies, AB 340 did not affect city employees, but it did apply to Port District and Airport Authority employees, in some cases reducing employee benefits.

Table 2: San Diego Pension Benefits Summary (Defined Benefit Plans)

	City of San Diego	Unified Port District[1]	Airport Authority[1]
Vesting	10 years	5 years	5 years
Eligibility	(Applies to all police and to other city employees hired prior to July 20, 2012) **General**: Age 62 with 10 years of service credit, or age 55 with 20 years of service credit. **Safety (Police, Fire, and Lifeguards):** Age 55 with 10 years of service credit, or age 50 with 20 years of service credit.	**CLASSIC PARTICIPANTS** **General and Miscellaneous**: Age 62 with 5 years of service credit, or age 55 with 20 years of service credit **Safety (Harbor Police) hired prior to January 1, 2010**: Age 55 with 5 years of service credit, or age 50 with 20 years of service credit. **Safety hired on or after January 1, 2010:** Age 55 with 5 years of service credit, or any age with 30 years of service credit. **PEPRA PARTICIPANTS** **Miscellaneous**: Age 62 with 5 years of service credit, or age 55 with 20 years of service credit. Safety: Age 50 with 5 years of service credit.	**CLASSIC PARTICIPANTS** Age 62 with 5 years of service credit, or age 55 with 20 years of service credit **PEPRA PARTICIPANTS** Age 52 with 5 years of service credit.
Final Compen-sation	**General:** Highest one-year period for employees hired prior to July 1, 2009; highest three-year average thereafter. **Lifeguards:** Highest one-year period for employees hired prior to July 1, 2011; highest three-year average thereafter. **Police and Fire:** Highest one-year period for employees hired prior to January 1, 2012; highest three-year average thereafter. **Elected Officials:** Final monthly compensation.	**CLASSIC PARTICIPANTS** **General:** Highest one-year period divided by 12 for employees hired prior to October 1, 2006; highest three-year period divided by 36 thereafter. **Miscellaneous:** Highest three-year period divided by 36. **Safety:** Highest one-year period divided by 12 for employees hired prior to January 1, 2010; highest three-year period divided by 36 thereafter. **PEPRA PARTICIPANTS** Highest three-year average divided by 36, subject to pensionable compensation cap.	**CLASSIC PARTICIPANTS** Highest 26 consecutive (twice per month) pay periods divided by 12. **PEPRA PARTICIPANTS** Highest three-year average divided by 36, subject to pensionable compensation cap.
Formula	**General:** For employees hired prior to July 1, 2002, choice of: (1) 2% per year of service at age 55, increasing to 2.55% at age 65, with an additional 10% added to final compensation; (2) 2.25% per year of service at age 55, increasing to 2.55% at age 65; or (3) 2.5% per year of service at age 55, increasing to 2.8% at age 65 (maximum of 90% of final compensation).	**General:** [2] For employees hired prior to November 10, 2001, choice of: (1) formula in place on December 31, 2001 with 10% increase in final average compensation; (2) "Andrecht" formula effective as of January 1, 2002 (2.25% per year of service at age 55, increasing to 2.55% at age 65); or (3) 2.5% per year of service at age 55 (maximum of 90% of final compensation).	**General** (Classic Participants, Andrecht-Covered Members):[2] Choice of: (1) 2.0% per year of service at age 55, increasing to 2.55% at age 65, with an additional 10% added to final compensation;

Table 2: San Diego Pension Benefits Summary (Defined Benefit Plans)

	City of San Diego	Unified Port District[1]	Airport Authority[1]
	For employees hired on or after July 1, 2002 and prior to July 1, 2009, 2.5% per year of service at age 55, increasing to 2.8% at age 65 (maximum of 90% of final compensation). For employees hired on or after July 1, 2009 and prior to July 20, 2012, 1% per year of service at age 55, increasing to 2.6% at age 65 (maximum of 80% of final compensation). **Lifeguards**: For employees hired prior to July 1, 2011, choice of: (1) 2.2% per year of service at age 50, increasing to 2.77% at age 55, with an additional 10% added to final compensation (maximum of 90% of final compensation) or (2) 3% per year of service at age 50 (maximum of 90% of final compensation). For employees hired on or after July 1, 2011 and prior to July 20, 2012, 2.5% per year of service at age 50, increasing to 3% at age 55 (maximum of 90% of final compensation). **Fire:** For employees hired prior to January 1, 2012, choice of: (1) 2.5% per year of service at age 50, increasing to 2.99% at age 55, with an additional 10% added to final compensation (maximum of 90% of final compensation) or (2) 3% per year of service at age 50 (maximum of 90% of final compensation). For employees hired on or after January 1, 2012 and prior to July 20, 2012, 2.5% per year of service at age 50, increasing to 3% at age 55 (maximum of 90% of final compensation). **Police:** For employees hired prior to July 1, 2009, choice of: (1) 2.5% per year of service at age 50, increasing to 2.99% at age 55, with an additional 10% added to final compensation (maximum of 90% of final compensation) or (2) 3% per year of service at age 50 (maximum of 90% of final compensation). For employees hired on or after July 1, 2009 and prior to July 1, 2013, 2.5% per year of service at age 50, increasing to 3% at age 55 (maximum of 90% of final compensation). For employees hired on or after July 1, 2013, 2.5% per year of service at age 50, increasing to 3% at age 55 (maximum of 80% of final compensation). A 3% annual reduction factor applies to benefits when retiring prior to age 55. **Elected Officials:** 3.5% per year of service. A 2% annual reduction factor applies to benefits for elected officials retiring prior to age 55.	For employees hired on or after November 10, 2001 and prior to January 1, 2009, 2.5% per year of service at age 55 (maximum of 90% of final compensation). **Miscellaneous:** (1) 0.75% per year of service for years 1-5; (2) 1% per year for years 6-10; (3) 1.25% per year for years 11-15; and (4) 1.5% per year for year 16 and every year thereafter. **Executive:** 3% per year of service at age 55 for officials who took office prior to January 1, 2013; thereafter members receive a blended benefit based on their two categories of service. **Safety (Classic Participants):** For employees hired prior to January 1, 2010, choice of: (1) 2.5% per year of service at age 50, increasing to 2.7% at age 55, with 10% increase in final compensation or (2) 3% at age 50 (maximum of 90% of final compensation). For employees hired on or after January 1, 2010, 3% per year of service at age 50 (maximum of 90% of final compensation). **Safety (PEPRA Participants):** 2% per year of service at age 50, increasing to 2.7% at age 57 (maximum of 90% of final compensation).	(2) 2.25% per year of service at age 55, increasing to 2.55% at age 65; or (3) 2.5% per year of service at age 55, increasing to 3% at 65 (maximum of 90% of final compensation). 2.5% per year of service at age 55, increasing to 3% at age 65 (maximum of 90% of final compensation). **General (PEPRA Participants):** 1% per year of service at age 52, increasing to 2.5% at age 67 (maximum of 90% of final compensation). **Executive:** 3% per year of service at age 55 for officials who took office prior to January 1, 2013; thereafter members receive a blended benefit based on their two categories of service.
Cost-of-Living Adjustment (Post-Retirement)	Based upon changes in the Consumer Price Index, to a maximum of 2% per year.	Based upon changes in the Consumer Price Index, to a maximum of 2% per year.	Based upon changes in the Consumer Price Index, to a maximum of 2% per year.

[1] PEPRA refers to the California Public Employees' Pension Reform Act, or AB 340, which was signed into law in September 2012 and became effective as of January 1, 2013.

[2] Andrecht-covered members are employees who were former Unified Port District employees who were transferred to the Airport Authority when the Airport Authority was established as of January 1, 2003.

Source: San Diego City Employees' Retirement System, *Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2013*, https://www.sdcers.org/annualreports/2013%20CAFR.pdf.

1.3 Retirement Health Care Benefits

San Diego began offering its employees retiree health care benefits in 1982 in exchange for employees switching from being covered by Social Security to being covered by the city's pension plan. As is common in other jurisdictions, San Diego's retiree health care is paid for on a pay-as-you-go basis, rather than a "pre-funded" basis like pensions. The city stopped offering retiree health care benefits to employees hired after June 30, 2005. Its OPEB Trust Fund is currently facing an unfunded liability of approximately $444 million, which is actually a significant improvement from the over $1.1 billion deficit just two years prior. In that time, the system has gone from a little over 9% funded in 2011 to over 20% today (see Table 3 below).[21]

Table 3: San Diego Retiree Health Care and Other Post-Employment Benefits (OPEB) Plans Financial Summary

	City of San Diego OPEB Trust Fund
Active Members	6,382
Number of Retirees Currently Receiving Benefits	6,162
Terminated Vested Members	729
Actuarial Value of Assets	$113,404,000
Liabilities (AAL)	$557,551,000
Unfunded Liabilities (UAAL)	$444,147,000
Funding Ratio	20.3%
UAAL as a % of Annual Covered Payroll	393.8%
Discount Rate	6.81%

City of San Diego, *Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2013*, http://www.sandiego.gov/comptroller/pdf/reports/cafr_2013.pdf.

In addition to a traditional defined benefit retiree health care plan, San Diego offers two defined contribution plans. This means that instead of getting a guaranteed benefit, employees may benefit from city contributions and, in one case, a small employee contribution, which are accumulated over time and paid out to the employee upon retirement (see Table 4 on the next page for a summary of the plan details and benefits).

Table 4: San Diego Retiree Health Care and Other Post-Employment Benefits (OPEB) Plans Benefits Summary

Plan	Description
Defined Benefit Plan	
Eligibility	Available to employees hired prior to April 1, 2012
Vesting	Employees earn 50% of the retiree health benefits after 10 years of service plus 5% for each additional year (maximum 100% after 20+ years)
Benefits	Eligible retirees receive a reimbursement for insurance or Medicare premiums which is adjusted annually based on projected health care cost changes. Current reimbursement/payment rates are between approximately $8,900 and $10,300 per year, between approximately $8,400 and $9,700 per year for those eligible for Medicare, and between approximately $1,200 and $1,400 per year for Medicare Part B premiums.
Option C Plan (Defined Contribution Plan)	
Eligibility	Available to employees hired prior to July 1, 2005
Employee Contribution	None. The city provides a lump-sum benefit to members once they become eligible for retirement benefits.
Medical Trust Plan (Defined Contribution Plan)	
Eligibility	Available to general members hired after July 1, 2009. Elected officials and public safety employees are not eligible.
Employee Contribution	0.25% of gross salary (with 0.25% match by the city)

Source: City of San Diego, *Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2012*, http://www.sandiego.gov/comptroller/pdf/reports/cafr_2013.pdf.

Part 2

Benefits Get Out of Control

2.1 The 1996 and 2002 Pension Underfunding Plans

San Diego's pension troubles started in 1996 when the city began systematically to underfund the pension system. In that year, then-City Manager Jack McGrory promoted a plan to take advantage of "historic returns" on Wall Street (the Dow Jones Industrial Average had surged 33% the previous year).[22] The idea was that even though the city would contribute less to the pension fund and city employees' benefits would increase, the fund's investment returns would keep it in good shape. McGrory's plan did include a safety-net provision, however, that if the pension system's funding ratio fell below 82.3%, the city would be required immediately to return the system to full funding through a lump-sum payment.[23]

During the stock market boom of the late 1990s, money poured into the pension system. Unfortunately, while these gains clearly could not and did not last forever, the city expanded government employee benefits without accounting for the inevitable market correction. Once the market hit a downturn, it became apparent that existing contributions would not be enough to cover pension system expenses.

To reiterate: the pension fund's poor financial condition is not primarily the result of reduced returns on Wall Street. As April Boling, a certified public accountant and former president of the San Diego County Taxpayers Association (who also headed the Pension Reform Committee) noted, the pension crisis resulted from "a combination of factors that all came together at the same time. This was not a result of a downturn in the market."[24] In fact, the market's unusually strong performance during the "dot-com" boom of the mid- to late-1990s only served to mask the underlying pension funding problems.

San Diego's troubles were exacerbated in 2002 when the city again agreed, over the objections of the mayor's Blue Ribbon Committee on City Finances, to reduce contributions to the pension system and increase employee benefits without making any provision to pay for the increased costs. By the middle of 2002, the pension system's funding ratio fell below McGrory's 82.3% threshold. But rather than return the pension system to full funding as required, the city instead simply repealed the requirement. In fact, Michael Uberuaga, who had succeeded McGrory as city manager, proposed in June of 2002 that the threshold be lowered further to a 75% funding ratio. That proposal was ultimately rejected when the retirement board's attorney advised that it would not hold up in court.[25]

In November 2002, the retirement board and the city council overwhelmingly passed a revised Uberuaga plan that increased city employee benefits and restored the 82.3% threshold. However, the revised plan did not require the city to return to full funding of the system if that 82.3% threshold was breached—thus rendering it essentially meaningless. In a telling move, the retirement board required the city to indemnify the board's trustees against any and all lawsuits and legal judgments concerning the pension system as a condition of the plan's passage.[26]

2.2 The Whistle Is Blown

The public remained in the dark about the city's pension system machinations, and likely would have remained so, if not for retirement board trustee Diann Shipione, one of only two trustees to vote against the Uberuaga plan. In May 2002, Shipione first attempted to bring the issue to the forefront in a letter to Mayor Dick Murphy claiming financial irregularities and calling for a comprehensive audit of the pension fund, but her letter went unanswered.

In November, Shipione went to City Hall and warned the retirement board, the mayor, and the city council that the Uberuaga plan was a recipe for disaster but her cries went unheeded and Shipione became the target of intimidation.[27] It was not until the following year that Shipione shined a light on the problems. In April of 2003, Shipione aired out the city's dirty laundry in public in a scathing *San Diego Union-Tribune* opinion piece that explained how the city had been shortchanging its public pension fund.[28] In September 2003, Shipione notified an attorney handling a municipal sewer bond sale that the city had been less-than-forthcoming about the pension system's liabilities and bond-rating agencies took note, causing the bond issue to be canceled.[29] This public revelation brought San Diego's financial crisis to Wall Street's attention and would set off a dramatic chain of events.

Explaining why she felt compelled to act, Shipione offered: “I had completely lost confidence in the city’s financial decision making. I just couldn’t let this go forward.” She added, “I saw this happen in Orange County [before the county was forced to declare bankruptcy in 1994] and I realized I had to speak up.”[30] Expressing her frustration with city officials who refused to listen to her, Shipione said, “I let the retirement board know, I let the mayor and the council know, and no one appeared interested. The city basically did it to itself.”[31]

2.3 The Fallout

By 2003, San Diego’s unfunded pension liability had surpassed $1 billion and the plan had fallen to a funding ratio of just 67%.[32] San Diego’s pension trouble came to the public’s attention when former retirement board President Jim Gleason and retiree Dave Wood filed the first of several pension lawsuits in January 2003. The suit alleged that the Uberuaga underfunding deal was illegal and tainted by conflicts of interest. The lawsuit was settled in July when the city agreed to fully fund the pension system beginning July 1, 2005 (the beginning of the fiscal year).

In January 2004, City Auditor Ed Ryan announced his resignation, and days later the city disclosed errors and omissions in its financial statements. City Manager Uberuaga followed the city auditor’s lead three months later and resigned in April 2004. All the major credit-rating agencies responded by lowering San Diego’s bond ratings. The city’s failure to release annual audits for 2003 and 2004 even prompted Standard & Poor’s Rating Service to suspend its rating altogether in September 2004, which crippled the city’s ability to issue debt to pay for large projects such as water and wastewater system improvements.

In April 2005, *TIME* magazine published an article listing Mayor Murphy as one of the three worst mayors in the nation for his mismanagement of the pension system.[33] Later that month, just four months into his second term, Murphy announced that he was resigning effective July 2005.

2.4 Union Influence and Conflicts of Interest

Part of the city council's disinterest in reining in rising pension costs and staving off the 1996 and 2002 underfunding plans can be explained by undue labor union influence and retirement board complicity. As observed in a 2005 *Los Angeles Times* article, "Every member of the council won election with the support of at least one labor union."[34] While the 2002 pension deal was being considered by the retirement board, city officials threatened that they would abandon promised benefit increases unless the board passed the underfunding plan. Since many of the retirement board trustees were city employees and labor representatives, this represented a clear conflict of interest.[35]

Another example of unwarranted labor influence on the 2002 pension deal was the set of special benefits awarded only to the presidents of the city's police, firefighters and "white-collar" labor unions. As a *UT San Diego* editorial described the agreement, "Under this highly irregular arrangement, the union chiefs were allowed to add their union salaries to their city salaries in calculating their retirement benefits, thus substantially boosting their taxpayer-financed pensions."[36] Attorney Michael Conger estimated that benefit to cost taxpayers $2 million. Ron Saathoff, president of Firefighters Local 145, for example, stood to receive an estimated pension of $173,268 per year on a salary of only $84,000.[37]

Also benefiting from the special benefits were Bill Farrar, president of the Police Officers' Association, and Judie Italiano, president of the Municipal Employees' Association. The resolution granting these special benefits was passed unanimously by the city council less than a month prior to the retirement board's approval of the 2002 underfunding plan. The actions of city officials would appear to be a clear violation of California Government Code Section 1090, which reads, in part:

> *Members of the Legislature, state, county, district, judicial district, and city officers or employees shall not be financially interested in any contract made by them in their official capacity, or by any body or board of which they are members. Nor shall state, county, district, judicial district, and city officers or employees be purchasers at any sale or vendors at any purchase made by them in their official capacity.*[38]

2.5 Increasing Benefits

The average San Diego city employee's pension more than tripled between 1996 and 2013, from $14,299 to $43,952.[39] This represents an increase of 207%, compared to just a 49% rise in inflation during the period. Looking at the average pensions for those who have worked a full career yields even more interesting results. The average city pension for employees who had worked over 30 years was nearly $64,000 in 2012.[40] The increase in retirement costs is due, in large part, to several lavish benefits added to an already generous retirement package. The following presents an overview of these benefits.

An employee could receive 8% interest on DROP account balances during the last five years of employment and then covert the account to an annuity with an 8% rate of return guaranteed for the next 20 years.

2.5.1 Deferred Retirement Option Plan

One of the more controversial employee benefits is the Deferred Retirement Option Plan (DROP). The program was put in place as part of the 1996 underfunding plan (made effective April 1, 1997) as a trial program and made permanent in 2002 (in a vote that retroactively made DROP permanent as of April 1, 2000). DROP allows senior city employees to draw retirement pay, deposited into special accounts, in addition to their regular salaries if they agree to work an additional length of time, up to five years. The fact that this allows city employees to earn both a paycheck and a pension at the same time has frequently led to charges of "double dipping" by critics. Employees are eligible if they have 20 years of work experience and are of retirement age: 50 years old for public safety employees and 55 years old for miscellaneous workers.

The pay deposited into the DROP accounts earns interest (which was set as high as 8% for the first 11 years of the program) plus a 2% annual cost-of-living adjustment. At the end of the employee's DROP period, the accumulated earnings and interest may be taken as a lump sum or converted into an annuity paid out over up to 20 years with a guaranteed rate of return. Before changes were ultimately made to the program in the late 2000s, this meant that an employee could receive 8% interest on DROP account balances during the last five years of employment and then covert the account to an annuity with an 8% rate of return guaranteed for the next 20 years.

Once enrolled in the program, the only contribution employees make is a payment of 3.05% of their salary to DROP, which is matched by the city. According to former SDCERS Assistant Retirement Administrator Paul Barnett, this contribution is generally less than that of even the lowest-paying contributor to the regular pension plan.[41]

The program received some unwanted attention in 2005 when an e-mail exchange between a senior policy advisor to Mayor Dick Murphy and the city's human resources director (and former retirement board trustee) became public. After the mayor's policy advisor boasted that taking advantage of DROP and other city benefits would allow him to retire at age 55 with benefits equal to 95% of his salary, his colleague replied, "So you've got your ticket to the 'gravy train.'"[42] In 2009, Councilman Carl DeMaio released a report called "The Million Dollar Circle" that revealed that five city employees received lump-sum payments of over $1 million from their DROP accounts alone during the previous year.[43]

The city's costs were 1.6% higher with DROP than without it, translating to a net cost of $149 million over the next several decades.

As with deferred retirement option programs in other jurisdictions, the big question was always whether the program was actually cost-neutral, as advertised, whether it saved money, as the unions claimed, or whether it was a net drain on the city, as taxpayer groups and many city officials suspected. According to San Diego Municipal Code section 24.1401, "DROP is intended to be cost neutral."[44] Proponents of DROP asserted that by retaining experienced employees a little longer after their retirement, the city would save on the costs of hiring and training replacement employees. Critics charged that DROP costs the city more money because it allows employees who were planning on retiring soon anyway to collect extra benefits. While this was a matter of dispute for many years, the program has ultimately proven to be rather costly to the city and taxpayers.

A 2005 report cited by the city's unions claimed that the DROP had saved the city approximately $45 million between 1997 and 2004, but the analysis only included a small portion of the program's costs.[45] In 2006, the actuary for the city's retirement board said the program had a net cost of $192 million.[46] Mayor Jerry Sanders claimed that eliminating the program would save the city $350 million.[47] Councilman DeMaio estimated that just cutting the guaranteed DROP interest rate in half to 4% would save the city about $250 million.[48] SDCERS board President Tom Hebrank admitted that the program had clearly failed to deliver on its cost-neutral promise.[49] Even Democratic Councilwoman Donna Frye, a long-time friend of the city's labor unions, said she thought that DROP was a loser for the city.[50]

Revealingly, when legislation was considered at the state level in 2009, California Public Employees' Retirement System chief actuary Ron Seeling, who had previously served as the actuary for the state of Louisiana when the state established the first DROP in the nation in 1984, was very skeptical of supporters' cost savings claims and stated that it likely was a drain on governments and taxpayers. "My number one comment is this bill talks about being cost neutral and I want to go on the record that it's almost impossible to certify or state from the beginning that such a program is cost neutral," said Seeling. "You are guessing at people's behavior," Seeling continued. "I think it costs money, but I can't prove it."[51]

To settle the question, the city finally had actuarial firm Buck Consultants conduct an analysis to determine once and for all whether the DROP was truly cost-neutral. In March 2011, the actuary released its findings, which concluded that the city's costs were 1.6% higher with DROP than without it, translating to a net cost of $149 million over the next several decades.[52]

Another benefit allowed employees to purchase service credits, or "air time," by making a payment in exchange for credit for more years of service than were actually worked.

2.5.2 *Purchased Years of Service*

Another benefit allowed employees to purchase service credits, or "air time," by making a payment in exchange for credit for more years of service than were actually worked (up to a maximum of five years). Employees who take advantage of this benefit can thus boost their retirement pay while funding only a small portion of the added costs. Such programs are not uncommon in state and local governments throughout the nation, but they typically require employees to pay the full actuarial cost of the benefits. This was not the case in San Diego, however.

San Diego employees are allowed to purchase their credits at a discount. Former City Attorney Michael Aguirre estimated that the program cost the city $120 million between its inception in 1997 and 2005.[53] Mayor Murphy himself took advantage of the perk, along with most of the city council members.

The pension system's actuary objected to the benefit due to its substantial subsidy to city employees and twice lobbied the retirement board to amend it. The purchase price for service credits was eventually raised in late 2003 from 15% to 27% for general employees, and to 50% for elected officials. No council member has utilized the benefit since.[54]

Even during the worst of the pension crisis—while the city was scrambling to cut services to keep up with its contribution payments—retirees were receiving bonus checks.

2.5.3 The 13th Check

Yet another questionable benefit is the Annual Supplemental Benefit, or "13th check," which began in 1980. The 13th check was a contingent benefit paid in fiscal years when earnings in the pension fund were more than deemed necessary for that year's expenses. The checks have been issued every year since 1984 except 2003, 2009 and 2012.[55] That means that even during the worst of the pension crisis—while the city was scrambling to cut services to keep up with its contribution payments—retirees were receiving bonus checks. In 2013, $5.5 million in 13th checks were issued, with an average sum of $720 per retiree.[56]

Objections to the 13th check are twofold. First, distributing "excess" earnings is precisely the opposite of what a pension system that relies heavily on market returns should be doing. Instead, the system should be saving these earnings to compensate for future periods of market losses. Second, this "contingent" payment is based upon short-term investment gains and ignores the long-term costs and funding level of the pension system. Thus, a 13th check may be issued following short-term market gains even while the system remains severely underfunded. As a 2004 *U-T San Diego* editorial asserted, the 13th check was "a huge added liability for which there is no identified source of income."[57]

In 2005, the city of San Diego and its labor unions negotiated changes to their collective bargaining agreements that eliminated 13th checks for all employees hired after June 30, 2005.[58] During the process though, the city concluded that the 13th checks were a "vested benefit." As a result the city could not cut or make changes to the program for employees hired before July 1, 2005.[59]

The SPSP also allows employees to receive a dollar-for-dollar matching contribution from the city for an additional 3.05% of their salaries (for a total contribution of 6.05% of salary with a 100% employer matching contribution).

2.5.4 Supplemental Pension Savings Plan

In addition to the defined benefit pension and other retirement benefits, San Diego offers a rarely discussed optional defined contribution plan to many employees. The Supplemental Pension Savings Plan (SPSP) was established when employees opted out of Social Security in 1981. Police officers and firefighters are not eligible for the SPSP because they were not covered by Social Security prior to the city opting out.

Under the SPSP, both the employees and the city contribute 3% of the employee's salary to the defined contribution retirement account. The SPSP also allows employees to receive a dollar-for-dollar matching contribution from the city for an additional 3.05% of their salaries (for a total contribution by the city of 6.05% of salary including this 100% employer matching contribution). Participants become fully vested after five years. This plan alone is more generous than most 401(k) retirement plans available to workers in the private sector. Coupled with the other benefits earned and available, city employees can take advantage of retirement benefits unheard of by their private-sector counterparts.

During the early years of the plan, funds were invested in low-risk investments such as U.S. Treasuries and money markets. In 1996, the participants approved a plan that contracted out the plan's investment management to a third-party administrator and allowed for riskier investments.[60]

2.6 Illuminating the Highest City Pensions

In October 2010, City Councilman Carl DeMaio and Marcia Fritz, head of the pension reform group Californians for Fiscal Responsibility, released an analysis of the highest pensions earned by city workers. They estimated that the city of San Diego would pay out approximately $61 million for just the top 10 pensioners over a 25-year period and compared the costs of these pensions with the compensation packages received by officials in the city of Bell, California, which underwent a highly publicized scandal over the compensation offered to its top officials.[61] "When you hear '10 city employees to split $61 million,' you'd think they'd won the lottery, that they'd pooled their money and bought a lotto ticket," DeMaio decried. "No, they're getting payouts from the city's pension system."[62]

"When you hear '10 city employees to split $61 million,' you'd think they'd won the lottery, that they'd pooled their money and bought a lotto ticket," DeMaio decried. "No, they're getting payouts from the city's pension system."

DeMaio commissioned a report from SDCERS about a year later to examine once again the most lucrative pensions paid out by the city. The analysis revealed that approximately 500 city employees received pensions of at least $100,000 a year in 2011. The top 10 pensions alone accounted for $2.4 million in pension payments that year. This included $307,758 for the assistant city attorney, who earned the highest pension, and $234,091 for the city librarian, who earned the fifth-highest total, which was higher than even the fire chief.[63] These 10 employees together received about $2.4 million in pension payments in 2011 (see Table 5 below).

Table 5: Top 10 San Diego Pensions, 2011

Job Title	Annual Pension
Assistant City Attorney	$307,758
Investment Officer	$255,509
Fire Battalion Chief	$244,435
Assistant Police Chief	$242,947
City Librarian	$234,091
Fire Chief	$229,753
Fire Battalion Chief	$228,392
Deputy City Attorney	$224,863
Fire Battalion Chief	$217,649
Assistant Water Department Director	$214,007
Total:	$2,399,404

Source: Jen Lebron Kuhney, "Top city pensioner pulls down $307,000," *U-T San Diego*, February 15, 2012, http://www.utsandiego.com/news/2012/feb/15/top-city-pensioner-paid-307000/.

In 2014, Transparent California, a project of the watchdog groups California Policy Center and the Nevada Policy Research Institute, provided a database that allows users to search and download detailed employee compensation figures. The database does not specify what percentage of the retiree's pension is a result of one-time DROP payments, but the top 10 SDCERS pensions in 2013 totaled $6.78 million—more than two times higher than the top 10 pensions were in 2011 (see Table 6 below). Despite reform, San Diego will pay for its past mistakes for many years to come.

Table 6: Top 10 San Diego Pensions, 2013

Job Title	Total Pension and Benefits Amount
Police Captain	$785,679
Police Sergeant	$783,601
Assistant Fire Chief	$780,080
Fire Captain	$738,669
Police Sergeant	$719,822
Deputy City Attorney	$624,024
Program Manager	$621,027
Police Sergeant	$602,351
Fire Captain	$562,761
Assistant Engineer-Civil	$561,793
Total:	$6,779,807

Source: Transparent California, http://transparentcalifornia.com/pensions/2013/san-diego-city-employees-retirement-system-sdcers/?page=1&s=-pension (retrieved August 5, 2014).

Part 3

The Reforms

While Proposition B in 2012 was arguably the boldest and most significant of San Diego's pension reform efforts, it was preceded by a number of other reforms. Below are the major efforts the city and its voters have taken to correct the course of city pensions.

3.1 Propositions G and H (2004)

In light of the revelations about the city's pension underfunding deals, reformers were determined to prevent such deals from happening again. In the November 2004 election, the San Diego City Council put Proposition G before voters to amend the city charter to prevent the city and the retirement board from entering into any future multi-year agreements that delayed full actuarial funding of city pension contributions to the retirement system. In addition, the measure specified that new retirement benefits would be amortized over a period of no longer than five years, and net accumulated actuarial losses would be amortized over a period of no longer than 15 years.

In light of the revelations about the city's pension underfunding deals, reformers were determined to prevent such deals from happening again.

Proponents of the measure noted in their ballot argument that the changes embodied in Proposition G were recommended by the city's Pension Reform Committee in 2004.[64] The argument simply outlined the reforms included and asked voters to vote in favor of the measure "to ensure that the City's pension fund debt is paid down, not increased" (emphasis in original) and "to force the City and the Retirement Board to understand the true costs associated with increasing employee retirement benefits and to force the City to pay for those benefits over a responsible period of time."[65] Opponents claimed that the measure would not fix the underfunding problems, and even argued that it would make them permanent. The ballot argument included the statement: "Pension systems are simple. If the City grants pension benefits, the Pension actuary tells you how much to put in the system each year to pay for those benefits. Put that amount in, and you are NEVER underfunded. How hard is that?" (emphasis in original).[66] This oversimplification ignores the problem of underfunding in San Diego—and a large number of other municipalities and states across the nation—as evidenced by erroneous actuarial assumptions and unrealistic discount rates. In the end, more voters found the proponents' arguments convincing and the measure prevailed, winning about 54% of the vote.

Another lesson learned from the underfunding scandal was that there was too much labor union influence on the retirement board, resulting in numerous conflicts of interest. Thus, the city council put Proposition H on the same ballot as Proposition G in order to change the composition of the retirement board from one dominated by union representatives and city administrators and appointees to one with a majority of financial experts. The existing 13-member retirement board consisted of the city manager, city auditor and comptroller, city treasurer, three members elected from the active general membership, one member elected from city retirees, one member elected from the active membership of Fire Safety, one member elected from the active membership of Police Safety, and four citizens appointed by the council, one of whom was required to be a local bank officer.

The public's support for pension reform continued to grow.

Under Proposition H, seven of the 13 members of the retirement board would be citizens with a college degree in finance, economics, law, business or a related field, and at least 15 years of experience in pension administration, pension actuarial practice, investment management, real estate, banking or accounting. Board members could not have any personal or professional conflicts of interest, and they were not to receive any compensation. The remaining six board members would include the two members elected by the active general membership, one member elected from city retirees, one member elected from the active membership of Fire Safety, one member elected from the active membership of Police Safety, and one top ranking city management employee appointed by the administration.

As with Proposition G, proponents of the measure noted that it was based on the recommendations of the Pension Reform Committee. The Committee had actually recommended a seven-member board comprised entirely of independent board members and no representatives from the city management or city labor unions at all, but proponents argued that they were compromising by maintaining city management and city employee representation, while still ensuring that the independent representatives would constitute a majority of the retirement board. This, they maintained, provided both independence and fairness to taxpayers, city employees and city retirees.[67] Opponents once again argued that the measure itself would not resolve the city's pension underfunding problem. In their ballot argument, they asserted, "The problem isn't who sits on the board. The problem is the **private underfunding agreements** and **deals that occur behind closed doors**, before the Pension Board ever meets" (emphases in original).[68] The scandals involving labor union representatives on the retirement board apparently had taken their toll, however, and Proposition H passed much more easily than Proposition G, garnering approximately 65% of the vote.

3.2 Dropping the DROP

Two mayors have tried and failed to eliminate San Diego's deferred retirement option program, and the retirement board resisted reducing DROP interest and annuity rates for years before the program was finally reformed. In his 2005 State of the City address, Mayor Dick Murphy, who had voted for the measure that made DROP permanent in 2002 (retroactive to April 1, 2000), called for the elimination of the DROP.[69] Mayor Jerry Sanders also pushed to get rid of the program, and though he was not able to completely eliminate it, he did have some success at shrinking it and reducing its costs.[70] As it became clearer that DROP was a net drain on the city's finances, the public's support for pension reform continued to grow.

The city was also able to lower its costs by reducing the interest rate paid on DROP account earnings.

Though the city was not able to entirely eliminate the program, it was able to scale it back dramatically. First, the city closed the program to new employees. DROP was closed to city employees hired after June 30, 2005, Port employees hired after September 30, 2005, and Airport Authority employees hired after October 2, 2006.

The city was also able to lower its costs by reducing the interest rate paid on DROP account earnings. For years, the DROP account guaranteed interest rate was 8%, the same rate as the assumed average annual investment returns for the pension fund. That rate was bumped down to 7.75% in 2008, though that was still considered exceedingly high by many, who pointed out that the DROP benefit was intended to be a short-term benefit (no more than five years) and that it was risk-free to the employee. “If DROP is a risk-free investment, then it should have a risk-free return,” argued then-city Chief Operating Officer Jay Goldstone.[71]

The city went to court with the Police Officers Association over whether or not DROP benefits were vested, and therefore could not be reduced. The city won decisions in 2009 and 2011, when the courts affirmed that DROP benefits were not vested, and that the city could thus modify or eliminate them. The city finally succeeded in significantly cutting the DROP rate of return in 2009 when the retirement board voted 7–2 to base the rate on an index of short-term and low-risk investment rates. This included the five-year indices for U.S. Treasury bonds, Individual Retirement Account Certificates of Deposit (CDs), and high-quality corporate bonds, with the U.S. Treasury bonds and CDs rates weighted twice as much as the corporate bonds rate. This reduced the DROP rate of return from 7.75% to 3.54%.

At the same time, the retirement board also voted 8–1 to reduce the guaranteed DROP annuity rates for those employees who chose to convert their balances to annuities when they left. The new annuity rates were calculated similarly to the new interest rates, except that they were based on longer-term investment rates because of the 20-year duration of the annuities, and capped at 5% whenever the normal DROP interest rate was less than 5%. Based on existing interest rates, the 7.75% annuity rate would have fallen to 5.59%; however, since the interest rate at the time was only 3.54%, the annuity rate was limited to the 5% cap.[72]

3.3 Voter Approval Requirement

Before the Proposition B of the June 2012 election, the city council placed another Proposition B on the November 2006 ballot that was more narrowly tailored. It asked voters if the city charter should be amended to require voter approval of all future increases in retirement system benefits, not including cost-of-living adjustments. Prior to a proposed benefit increase going on the ballot, the retirement system would have to prepare an actuarial analysis detailing the full cost, impact, and source of funding of the new benefits. A summary of this report would be included with the ballot materials sent to voters prior to the election. The measure was set to go into effect on January 1, 2007, and was scheduled to automatically expire after 15 years.

Proponents of the 2006 Proposition B argued that the measure would allow voters a kind of insurance policy against the sort of backroom deals that led to the city's pension underfunding problems and noted that such a measure had kept labor-friendly San Francisco—where voter participation on pension changes is a regular occurrence—from getting into the kind of pension trouble that other state and local governments were in.[73] Opponents, led by the city's police and firefighters unions, claimed that the measure would make it "harder to hire qualified police officers and firefighters," and warned that lower pay and benefits would lead to lower quality public safety services.[74] Interestingly, this argument implicitly concedes that police and fire compensation is higher than taxpayers would be willing to pay if they had the final say on benefit increases.

Proposition B passed overwhelmingly, with 70% of the vote. Many other local governments have since followed suit, particularly in California. In November 2008, Orange County, California passed a voter approval measure, Measure J, with over 75% of the vote. San Jose, California also included a voter approval provision in its pension reform package, Measure B, which passed with 69% of the vote in the June 2012 election.

3.4 2009 Pension Reforms

Not all of San Diego's pension reforms came at the ballot box. During the spring of 2009, agreements negotiated with some labor unions and imposed on others by the city council increased employee contribution levels and limited taxpayers' exposure to compensation costs for employees hired after the fiscal year ending June 30, 2009. Labor contracts approved in April and May of 2009 called for new city employees to contribute more to their pensions. City contributions for non-safety workers were reduced from more than 16% of an employee's annual salary to about 8.7%.[75] Additionally, the city imposed a two-year wage freeze, reduced non-union employees' compensation by 6% through a mix of salary cuts and contribution increases, and capped the city's cost of retiree health benefits at existing levels.[76] The latter change alone was expected to reduce taxpayers' unfunded liability by $350 million.[77]

3.5 Rejecting Tax Increases

Sometimes the changes to public policy that are not made are as important as the ones that are made. In the November 2010 election, San Diego voters were asked to approve a one-half cent sales tax (Proposition D) that was expected to raise more than $500 million over five years and shore up the city's budget, which was facing a deficit estimated at over $70 million the next year. Although there were other factors at play including a state raid of local government funds, part of the deficit was related to rising retirement costs.

Proposition D was unique in that it specified that a number of financial and pension reforms would have to be undertaken before the tax increase would be triggered. These reforms included the following:

- Elimination of "retirement offsets," or employee retirement contributions that had been paid, or "picked up," by the city (in addition to the city's normal contribution), for all employees who are not members of a labor union.
- Reduction of retirement offsets for employees who are members of a labor union.
- Completion of a study of the costs of the Deferred Retirement Option Program (DROP) and whether the plan is truly "cost-neutral," as it was intended.
- Reduction of the city's retiree health care liability.
- Establishment of a second-tier, reduced pension plan for new firefighters.
- Adoption of an ordinance allowing city employees to opt into a defined contribution retirement plan.
- Elimination of terminal leave, which allows employees to use accrued leave to stay on the payroll instead of taking a lump-sum payment when their employment ends, for all city employees.
- Adoption of a managed competition guide to spell out the process of allowing city employees and private-sector companies to bid for contracts to provide city services.
- Solicitation of bids to provide information technology and landfill operations services for the city.

An unusual coalition comprised of Republican Mayor Jerry Sanders, liberal Democrat Councilmember Donna Frye, city labor unions, and the San Diego Regional Chamber of Commerce united in support of the measure. They argued that the tax increase was necessary to end fire station brownouts and restore city services such as library hours and pothole repair, which had suffered from budget cuts that the city was forced to make due to rising pension costs and the effects of an economic recession.[78] They also threatened that public safety would suffer greatly if the measure was not passed.[79]

Opponents countered that threats to cut public safety if the tax measure did not pass were a scare tactic, and that offering politicians a "blank check" was irresponsible and would not fix the city's structural financial problems.[80] They argued that the supposed financial reforms presented as necessary conditions for triggering the tax increase were vague and inadequate. Moreover, they charged that there were no guarantees that the increased tax revenues would go toward public safety or restoring services that had been cut, arguing that the bulk of the money would be used to bail out the beleaguered pension system.[81] (Indeed, before any additional revenues are approved, the public is always wise to demand that substantial reforms are in place and effectively reducing the financial burdens on taxpayers.) For this reason, opponents often referred to Proposition D as a "pension tax."[82]

San Diegans, weary of both the city's ongoing pension problems and the effects of the 2008 recession that was continuing to depress the local economy, sided largely with the opponents and Proposition D was soundly defeated, garnering only 38% of the vote.

3.6 Proposition B (2012)

San Diego's pension reform efforts culminated with Proposition B in June of 2012. The measure did not attempt to change benefit formulas for existing employees, but was different from most pension reform efforts in other jurisdictions because it called for switching new employees (other than police officers) into defined contribution plans. Among Proposition B's provisions are the following:

- All new city employees (except sworn police officers) are to receive 401(k)-style defined contribution retirement plans rather than defined benefit pensions. The city's contribution levels are capped at 9.2% of final salary for general employees and 11% for public safety employees.
- Employees' base compensation, upon which their pension benefits are calculated, is limited and excludes supplemental and specialty pay.
- The city is required to begin negotiations with its labor unions by calling for employees' base compensation to be capped until June 30, 2018, at fiscal year 2011 levels. This bargaining position may be overturned with a two-thirds vote of the city council.
- Newly hired police officers' annual pension benefits are capped at 80% of their final salaries.
- City officers and employees convicted of a felony related to their positions will lose their pension benefits.
- A previous city charter provision that a majority of employees or retirees was required to approve changes to their retirement benefits is eliminated.
- The city is required to annually publish the amounts of pension benefits paid to retirees, although retirees' names will be redacted to protect their privacy.[83]

San Diego's Independent Budget Analyst estimated that Proposition B would result in net savings to the city of approximately $950 million over 30 years if the pay freeze until June 30, 2018, were to go into effect. If no pay reductions were realized, the fiscal impact would be about the same as the status quo, and would end up costing the city about $13.5 million over the same 30-year time frame.[84]

In the end, the vast majority of taxpayers agreed that the additional pension reform measures were needed and Proposition B passed with 66% of the vote.

Proponents of the measure emphasized that Proposition B would cap taxpayer pension costs and end "pension spiking" by preventing employees from using specialty and supplemental pay to bump up their final pension payments. In addition, they argued that the nearly $1 billion in long-term savings could be used to restore services that had been cut—such as library hours and access to parks and recreation facilities—as well as maintaining the city's infrastructure, fixing potholes and making other street repairs.[85]

Opponents argued that pension reform had already been done in 2009 (see "2009 Pension Reforms" above), and that Proposition B was unfair to city employees.[86] Interestingly, while arguing that the measure went too far, proponents also argued that it did not go far enough, as they criticized the measure for not capping pensions of $100,000 or more.[87]

The policy debate was arguably the easiest part of the Proposition B campaign. "The biggest challenge was just getting it on the ballot," said then-Councilman Carl DeMaio.[88] To qualify for the ballot, proponents of Proposition B had to collect 94,000 signatures. To complicate matters, less than three months before the signature deadline the campaign discovered that there were roughly 20,000 duplicate and fraudulent signatures on its petitions, which could have doomed the effort.[89] This forced the campaign to take the unusual and costly step of verifying 100% of the signatures collected. Large numbers of duplicate signatures had helped to foil previous attempted ballot measures opposed by the city's labor unions, which led the Proposition B campaign to conclude that this was due to a concerted effort on the part of the unions. The unions were accused of using other hardball tactics as well, such as harassing and intimidating signature collectors in front of stores or at other public places.[90]

In the end, the vast majority of taxpayers agreed that the additional pension reform measures were needed and Proposition B passed with 66% of the vote. In June 2013, Mayor Bob Filner, who had opposed Proposition B but promised during his mayoral campaign to try to implement it if it did pass, kept his campaign promise when he secured a deal with the city's six labor unions for a five-year freeze in employees' pensionable pay. The agreement was expected to save the city $25 million during the first year.[91]

Part 4

Stumbling Blocks

4.1 Implementation

While the main provisions of Proposition B—the pensionable salary freeze and the 401(k)s for new hires—have been implemented, there are still a couple of provisions yet to be finalized. First, Proposition B guarantees death and disability benefits for the new employees covered by defined contribution plans instead of traditional pensions. Second, the measure provides that elected officials, city officers or employees who are convicted of a felony will forfeit their pensions. This provision is subject to negotiations with the unions, however, and would only apply to those hired after it goes into effect. As of this writing, the city was still negotiating both the disability and felony conviction provisions with the employee unions.[92] While the city would limit its exposure by dealing with this problem soon, any unfortunate situation that caused any harm to a city employee would be covered under the general fund. It behooves the city to act quickly to resolve this issue and implement a death and disability plan soon.

4.2 The Public Employment Relations Board

In addition to the aforementioned difficulties getting Proposition B on the ballot and during the campaign, supporters of the pension reform measure faced bureaucratic and legal obstacles. The bureaucratic hurdles came primarily in the form of the California Public Employment Relations Board (PERB). The PERB board members are primarily former union officials and union attorneys, so the agency is, not surprisingly, very partial to union interests. The PERB process is as follows: When a complaint is filed with PERB, it is first heard by an administrative law judge. The judge's proposed decision may be appealed to the agency's board, and thereafter to the state appellate court and, if necessary, the state Supreme Court.

The agency filed injunctions against Proposition B three times: once before it was placed on the ballot and twice after it was passed by the voters. Supporters won each time, dealing the powerful board an unprecedented defeat. “That was the first time PERB lost an injunction motion in its history, from what I understand,” said San Diego City Attorney Jan Goldsmith, who argued the case in favor of the measure each time.[93]

This does not mean that the matter is settled, however. Despite winning the injunction decisions, the city lost a ruling by PERB administrative law judge Donn Ginoza in February 2013 that Mayor Sanders acted improperly by publicly advocating for Proposition B, and that the city should have negotiated with its unions before putting the measure on the ballot. Goldsmith argued that such reasoning was a perversion of the whole initiative process. “When it comes to a citizens’ initiative, it belongs to the 116,000 who signed for it,” he said. “For hundreds of years, governors and mayors have said, ‘I’m going directly to the people.’ PERB came up with this loony idea that before you go to the people you go to the labor unions and negotiate whether that’s okay.”[94]

Ginoza’s ruling called for the city to rescind Proposition B, but since only a court ruling can force the city to stop implementing the measure, the city does not have to abide by the PERB administrative judge’s ruling. The matter now heads to the PERB board, which may not get to the case for up to a couple of years due to a large backlog of unfair labor practices cases.[95] Whatever the outcome of that decision, the losing party—be it the city or the labor unions—will almost certainly appeal the decision to state appellate court.

4.3 The California State Legislature

After Proposition B passed, the state legislature also tried to interfere. Then-Assemblyman Ben Hueso (D-San Diego) authored AB 1248, a measure that would require the city to provide Social Security for workers.[96] The bill passed both houses in the legislature and was signed by Governor Jerry Brown in September 2012. The city of San Diego subsequently filed a lawsuit against the state, arguing that the legislation violates the city’s constitutional protections as a charter city to determine its own employee compensation policies.[97]

The state law would not affect the overall amount of employee benefits, just the way it is invested and distributed. The city’s contribution caps for its new 401(k)-style retirement accounts were set at 9.2% for general employees based on a 3% base contribution plus the 6.2% the city would have had to set aside for Social Security. The city expected to settle the Social Security question at a later date, and perhaps to allow the employees to decide whether or not they want to participate,[98] but if it is ultimately forced to place new employees into Social Security, its 9.2% contribution could simply be divided so that 3% would go into the employee's 401(k) and 6.2% would go toward his or her Social Security. Again, the main issue is whether the state has the right to interfere with a charter city's employee compensation decisions (and, by extension, whether the state has the power to override the taxpayers and voters who altered that charter). As with the PERB challenges, an ultimate resolution could be years away.

Part 5

Lessons Learned

With so many other cities and states facing similar problems, San Diego offers one model for addressing the weight of mounting retirement obligations and preventing further service cuts and bankruptcy through bold public pension reforms. During the course of the city's long road to pension reforms, there are many lessons that will inform other state and local efforts to adopt and implement similar reforms.

- While it may be desirable to implement one broad and comprehensive reform measure, it is not reasonable to assume that such changes will be politically feasible until there is a felt need for change among both a majority of citizens and at least some elected officials. Attempting to pursue that one comprehensive set of reforms may be overly complex and, ultimately, counterproductive. San Diego passed numerous narrow pension reform measures over the course of nearly a decade that laid the groundwork for Proposition B in 2012. This allowed the public to become better educated on the issues, enabling reform proponents to overcome opponents' negative messages and misrepresentations of the effects of the reforms.

- Making a straightforward case to the general public emphasizing the impact on taxes, government budgets and services if the pension system is not reformed is effective.

- Professionalizing the governance of the pension system is a necessary and effective way to provide transparency and improve oversight over benefit and investment decisions. While it is preferable that all members of the retirement board have financial expertise, it is essential that most members of the retirement board are independent (i.e., they are not representatives of either city management or city labor unions). If a majority of the board members have credentials and years of experience in finances and investments, there is a better chance that decisions will reflect the best advice to provide consistent and higher returns on investments, as well as reduce conflicts of interest. Change the composition of the retirement board by ballot measure, if necessary.

- Conducting audits of additional retirement benefits such as DROP and "air time" purchases quantifies the problem for all concerned. If these benefits cost more than expected or create unfunded liabilities, they should be scaled back or eliminated.

- When reform seems inevitable, it may be possible to get concessions in union labor contracts through the collective bargaining process. It must be remembered that these concessions do not constitute reform in and of themselves, but this is nevertheless an option for bringing down the costs of pensions while not relying wholly on a political process.

- In jurisdictions where there is strong labor union opposition to pension reform, and particularly where a majority of city council members or state representatives are sympathetic to union interests, take reform directly to the voters through a ballot initiative, where possible.

- Scare tactics become less important to the voters as a pattern of fiscal malfeasance becomes more obvious. Furthermore, unless the voters see serious and substantive reforms implemented, they are not likely to vote for tax increases to shore up failing pension systems.

- If launching a pension reform ballot initiative, be aware of the likely considerable resources needed to counter opponents (such as labor unions), especially in trying to qualify a measure for the ballot. Take extra care to verify that signatures collected during efforts to get a pension reform measure on the ballot are legitimate—and budget your campaign accordingly.

- Simply blaming a jurisdiction's public employee pension problem on a downturn in the stock market or a period of economic recession prevents an honest assessment of its causes, which may be numerous and go far beyond the typical fluctuations of a dynamic economy.

- Seek outside legal counsel to make sure that you are advocating for the right kinds of reforms. "I always encourage elected officials, taxpayer groups to seek outside legal counsel," said former San Diego Councilman Carl DeMaio. "Really take a look at your options before you just blindly accept the proclamations of government attorneys and labor unions."[99]

- Finally, other general political campaign advice applies here as well for ballot initiative attempts. This includes utilizing a competent political consultant, using polling to test ideas and arguments, ensuring that ballot language is vetted by knowledgeable attorneys, building strong and strategic coalitions, lining up funding, and preparing to counter (labor union) opposition tactics.[100]

These lessons are of particular use in jurisdictions 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 Diego'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 Diego 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.

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