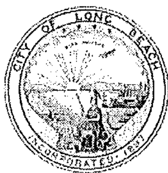

City of Long Beach
Working Together to Serve

Memorandum

R-14

Date: March 22, 2011

To: Honorable Mayor and City Council

From: Councilmember DeLong, Chair, Budget Oversight Committee

Subject: **SUPPORT OF THE LITTLE HOOVER COMMISSION'S RECOMMENDATIONS**

The Budget Oversight Committee, at its meeting held Wednesday, March 9, 2011, considered communications relative to the above subject.

It is the recommendation of the Budget Oversight Committee that the City Council go on record with our State Legislatures to fully support the Little Hoover Commission's recommendations and urge our legislatures to implement them on our behalf, as well as the state.

Respectfully submitted,

BUDGET OVERSIGHT COMMITTEE

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Councilmember, Gary DeLong, Chair

Attachment(s)

Executive Summary

The 2008-09 stock market collapse and housing bust exposed the structural vulnerabilities of California's public pension systems and the risky political behaviors that have led to a growing retirement obligation for state and local governments, the scale of which taxpayers are just beginning to understand.

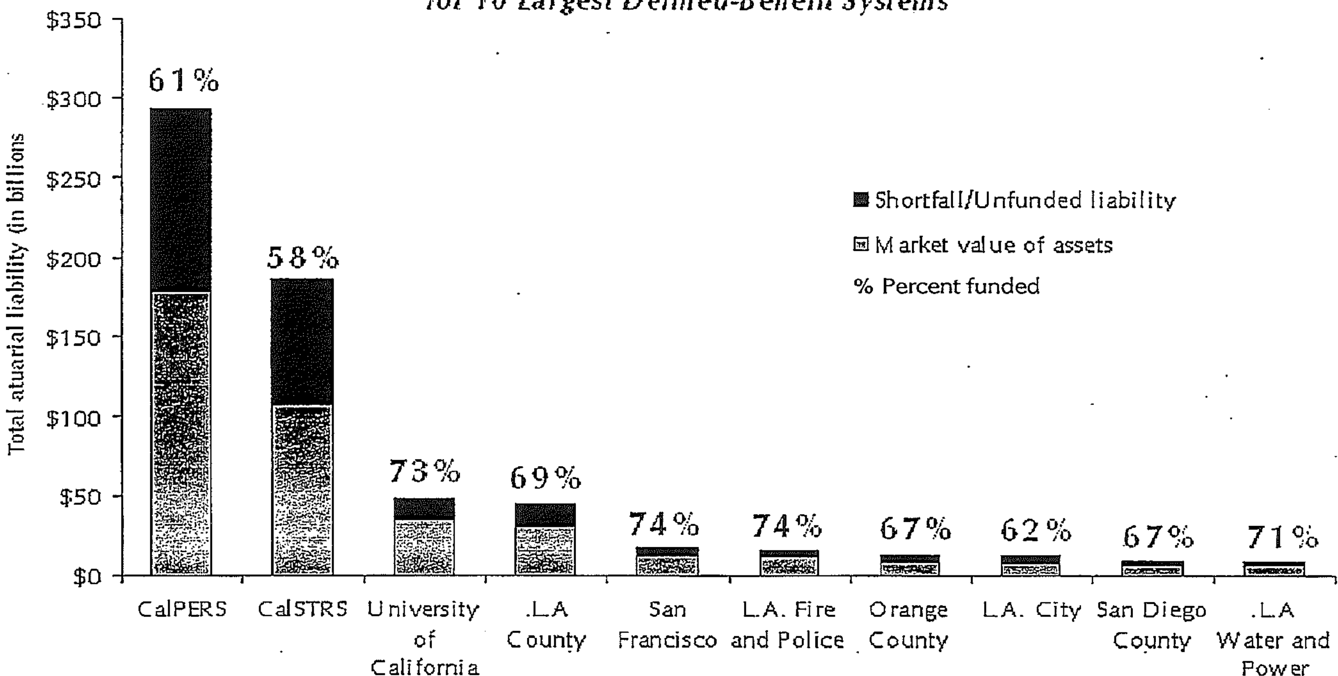
Treated like another speculative house during the boom, the state allowed public agencies and employees to pull equity in the form of increased retirement benefits from the pension funds whose value was inflated by optimistic market return estimates. The retirement promises that elected officials made to public employees over the last decade are not affordable, yet this is a mortgage that taxpayers cannot walk away from easily.

When the economy crashed, another lesson from the housing bubble became just as important. A public pension, like a house, is not a get-quick-rich investment. As a house is for shelter, a pension is for long-term financial security. Even the "teaser rates" reflecting aggressive investment assumptions are re-setting, revealing a higher cost to maintain a level of benefits that have become more generous than reasonable.

Boom and bust cycles are natural, if unpredictable, but political leaders agreed to changes in the pension system at the peak of a boom, and as a major demographic event began unfolding – the start of the retirements of the Baby Boomers.

Pension benefits promised to retirees are irrevocable, as are the promised benefits that current workers have accrued since their employment began. It also remains difficult to alter the theoretical, yet-to-be earned benefits for current workers. This situation, reinforced by decades of legal precedent, leaves little room for state and local governments to control mounting retirement costs, particularly when the only venue for change is the bargaining table.

Taxpayer groups, citizen grand juries and think tanks have sounded the alarm for reform, a call that is beginning to resonate in city councils,



The 10 largest public pension plans in California – encompassing 90 percent of all assets and members in the state's defined benefit systems – faced a combined shortfall of more than $240 billion in 2010. As a point-in-time measurement to gauge the financial health of these systems, this chart includes the percent of actuarial liabilities that are covered by the market value of assets in each fund. An 80 percent funded status is considered the low threshold for a stable system. Actuarial methodology used by each system to determine liabilities can vary, which can complicate comparisons between systems. This chart was assembled using the unaltered information as reported by the pension systems.

See end notes for sources.

county boards of supervisors, school boards and among trustees of specials districts now that they face the prospect of increasing required contributions into their pension funds by 40 to 80 percent of their payroll costs for decades to come. It is practically enough money to fund a second government, and it will – a retired government workforce.

Public employees might appear to have little incentive to push for reforms, yet they will pay a price for inaction: salary freezes, layoffs, increased payroll deductions and the threat of a city or county bankruptcy. Doing nothing to current pension obligations will cost public employees everything. A pension cannot grow without a job attached to it.

Public employees also share in the prospect of a very different California, as cities such as Los Angeles, San Diego, San Francisco and San Jose prepare to spend one third of their operating budgets on retirement costs in coming years. Pensions are at the center of what will be an intensifying fight for diminishing resources from which government can pay for schools, police officers, libraries and health services. With 86 percent of the retirees and beneficiaries of the California Public Employees' Retirement System remaining in the state, in what sort of communities do they want to live? Without reform, it will be communities with dwindling services and less police and fire protection.

The Little Hoover Commission began its study of California's public pension systems in April 2010 to understand the scale of the problem and develop recommendations to control growing pension costs in state and local governments. Over a six-month period, the Commission held a series of hearings at the State Capitol and conducted several other public meetings with stakeholders to address these issues. Through these hearings and additional research, the Commission found:

> ***Pension costs will crush government.*** Government budgets are being cut while pension costs continue to rise and squeeze other government priorities. As the Commission heard during its hearings, the tension between rising pension costs and lean government budgets is often presented today in a political context, with stakeholders debating the severity of the problem and how long it will last. In another five years, when pension contributions from government are expected to jump and remain at higher levels for decades in order to keep retirement systems solvent, there will be no debate about the magnitude of the problem. Even with the introduction of two-tiered pension plans, barring a miraculous market advance, few government entities – especially at the local level – will be able to absorb the blow without severe cuts to services.

The math doesn't work. Investment losses in 2008-09 certainly shocked the system, but several other factors have contributed to an unsustainable pension environment. Payroll growth – in terms of both compensation for public employees and the number of employees – has ballooned pension liabilities. The minimum retirement age has dropped to 55 – earlier for public safety employees – as people live longer, creating an upside-down scenario where governments potentially will send retirement checks to an employee for more years than they earned paychecks. At the same time, state and local governments have increased what used to be considered a good pension into pensions that are the most generous in the country. Banking on high fund returns and an aggressive investment strategy, employers and employees also have failed to contribute sufficiently – and on occasion, stopped paying into the system at all. Today, the state's largest pension systems are dangerously underfunded.

The system lacks discipline. The purpose of the public pension system has shifted away from providing retirement security to public employees. Today, the pension system is regarded as deferred compensation – the perceived tradeoff of earning a lower salary in the public sector in exchange for a good retirement package. The retirement systems invest aggressively to help workers accumulate wealth, which leaves taxpayers facing all the risk when returns fail to meet system needs. A lesson from history would suggest that, when the market eventually recovers, the pressure from employees will return to ramp up pension formulas and undo any reforms being made today. The ability or willingness of elected officials to hold the line on their own is in serious doubt.

The system lacks oversight and accountability. CalPERS, the largest pension plan in the country, covers state workers and many city, county and school district workers – roughly half of all public employees in California, 1.6 million altogether. Two million other public workers in universities, cities, counties, school districts and special districts receive retirement benefits through dozens of other independently run pension plans. The collective-bargaining environment also allows numerous employee unions within each government entity to negotiate separately for benefits, resulting in thousands of different retirement packages across the state. Since 2008, fewer than 30 of the 1,500 local public agencies in the CalPERS network have adopted a lower level of pension benefits for new hires. As pension portfolios

shrunk and tax revenues plunged, nearly 200 public agencies in CalPERS continued to increase retirement benefits for current workers. This lack of uniformity:

- Clouds transparency.
- Invites mischief and abuse, such as pension "spiking."
- Creates a compensation arms race among communities.
- Delegates complicated decisions to often inexperienced, local officials.

With needed reforms, defined-benefit pensions can remain a core component of public employee retirement plans.

The problem, however, cannot be solved without addressing the pension liabilities of current employees. The state and local governments need the authority to restructure future, unearned retirement benefits for their employees. The Legislature should pass legislation giving this explicit authority to state and local government agencies. While this legislation may entail the courts having to revisit prior court decisions, failure to seek this authority will prevent the Legislature from having the tools it needs to address the magnitude of the pension shortfall facing state and local governments.

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

Freezing earned pension benefits and re-setting pension formulas at a more realistic level going forward for current employees would allow governments to reduce their overall liabilities – particularly in public safety budgets. Police officers, firefighters and corrections officers have to be involved in the discussion because they, as a group, are younger, retire earlier and often comprise a larger share of personnel costs at both the state and local level. Public safety pensions cannot be exempted from the discussion because of political inconvenience.

Hybrid model. A new "hybrid" model for public employee retirement should be made available to state and local agencies to reinforce the principles of retirement security and shared responsibility. The model, being tested in Orange County for miscellaneous workers, combines a lower defined-benefit pension with an employer-matched 401(k)-style plan. The 401(k) element is risk-managed to protect employee investments from market volatility in order to generate an adequate retirement income.

The idea is not new. The federal government adopted a similar approach more than 25 years ago for federal employees. Federal employees hired after 1987 have joined a three-tiered retirement plan that provides a defined-benefit formula up to 1.1 percent of final compensation for every year of service; a 401(k) plan with an employer match of up to 5 percent of salary (the first 1 percent is automatic); and, Social Security benefits (previously not provided) to augment the workers' retirement income. The newer defined-benefit pension plan requires lower contributions for employees and federal agencies – and it was 100 percent funded as of 2009. Employees hired after July 1, 2010 are automatically enrolled in the 401(k) element, with a 3 percent payroll deduction unless they change the contribution level.

Roughly half of all public employees in California do not participate in or receive Social Security benefits, so many public employees rely more heavily on state and local governments to provide larger retirement benefits. Serious consideration must be given to extending Social Security to non-covered, public-sector workers, toward the goal of building a three-part retirement strategy as has the federal government.

Uniformity. The state also must establish standards for more uniform and reasonable pensions. The public outrage over the "spiking" of benefits to provide a larger retirement income cannot continue to be ignored, nor can the increasing number of six-figure pensions for some managers and high-wage earners. The gaming and abuses of the pension system must end. To restore public confidence in the public pension system, the state must impose a cap in the $80,000 to $90,000 range on the salary used to determine pension benefits, or alternatively, a cap on pensionable income. Under such an arrangement, compensation above the cap would be factored into contributions toward an employee's 401(k)-style plan.

Transparency. The Legislature also must take steps to improve transparency of the state and local government costs of providing retirement benefits to current and future retirees. The debate over discount rates used to determine unfunded pension liabilities has laid bare the volatility of pension assets and raised important questions

about the public's exposure to systemic pension obligation risk. A measure of liability is a way for the public to understand and start a fact-based discussion about solutions to the problem. It is reasonable to try to come up with a "bottom line" on how much taxpayers owe, but it is an imperfect process. Numbers that have been used by think tanks and researchers to estimate the unfunded liabilities of California public pension plans can vary by hundreds of billions of dollars. Methodologies across studies are often inconsistent – using different asset bases, investment assumptions, the number of pension plans captured in the estimates, and the inclusion of retiree health benefits – leading to more confusion. There is no one "right" number that the state should mandate to determine actuarial liabilities. But an honest and public assessment of the risks and options about determining obligations can inform decision-makers when setting contribution rates and making investment strategies. Adding more independent, public members to retirement boards can help broaden perspectives to facilitate this conversation.

The Commission offers its recommendations in the spirit of Governor Brown's call in his State of the State address for pension reforms to be "fair to both taxpayers and workers alike." The Commission asks the Governor and the Legislature to take immediate and bold steps to put the state's pension plans on a path to sustainability and to add oversight to protect current employees, retirees and taxpayers. Delay will continue to create concern over California's ability to pay for its promises, distort local government budgets and further erode California governments' standing in the municipal bond market. The stakes are too high to continue making temporary changes at the margin.

Recommendations

Recommendation 1: To reduce growing pension liabilities of current public workers, state and local governments must pursue aggressive strategies on multiple fronts.

- ❑ The Legislature should give state and local governments the authority to alter the future, unaccrued retirement benefits for current public employees.
- ❑ State and local governments must slow down pension costs by controlling payroll growth and staffing levels.

Recommendation 2: To restore the financial health and security in California's public pension systems, California should move to a "hybrid" retirement model.

- ❑ The Legislature must create pension options for state and local governments that would retain the defined-benefit formula – but at a

lower level – combined with an employer-matched 401(k)-style defined-contribution plan.

- ✓ The 401(k)-style component must be risk-managed to provide retirement security and minimize investment volatility.

Recommendation 3: To build a sustainable pension model that the public can support, the state must take immediate action to realign pension benefits and expectations.

- ❑ To provide more uniform direction to state and local agencies, the Legislature must:
  - ✓ Cap the salary that can be used to determine pension allowances, or cap the pension, at a level that is reasonable and fair. Once the employee exceeds the threshold, employees and employers could make additional retirement contributions into a risk-managed, 401(k)-type defined-contribution plan.
  - ✓ Set appropriate pension eligibility ages to discourage early retirement of productive and valuable employees.
  - ✓ Set a tight definition of final compensation, computed on base pay only, over a five-year average to prevent and discourage pension "spiking."
  - ✓ Set uniform standards for the maximum hours that retirees can return to work and continue to receive public-sector pensions.
  - ✓ Set uniform standards and definitions for disability benefits.
  - ✓ Restrict pension allowances to exclude service in an elected office.
  - ✓ Eliminate the purchase of "air time."
  - ✓ Strengthen standards for revoking or reducing pensions of public employees and elected officials convicted of certain crimes involving the public trust.
- ❑ To minimize risk to taxpayers, the responsibility for funding a sustainable pension system must be spread more equally among parties.
  - ✓ The Legislature must prohibit employees and employers from taking contribution "holidays," except under rare circumstances.
  - ✓ The Legislature must prohibit retroactive pension increases.
  - ✓ The Legislature must require employees and employers to annually adjust pension contributions based on an equal sharing of the normal costs of the plan.
  - ✓ State and local governments must explore options for coordinating pension benefits with Social Security.

Recommendation 4: To improve transparency and accountability, more information about pension costs must be provided regularly to the public.

- The Legislature must require government retirement boards to restructure their boards to add a majority or a substantial minority of independent, public members to ensure greater representation of taxpayer interests.
- All proposed pension increases must be submitted to voters in their respective jurisdictions.
  - ✓ The ballot measures must by accompanied by sound actuarial information, written in a clear and concise format.
- The Legislature must require all public pension systems to include in their annual financial reports:
  - ✓ The present value of liabilities of individual pension funds, using a sensitivity analysis of high, medium and low discount rates.
  - ✓ The government entity's pension contributions as a portion of the general operating budget and as a portion of personnel costs, trended from the past and projected into the future.
- The State Controller must expand the *Public Retirement Systems Annual Report* to include the above information. Administrative fees to pension systems should be considered as a funding source to support actuarial expertise and the timely production of the report.
- The Legislature must require pension fund administrators to improve procedures for detecting and alerting the public about unusually high salary increases of government officials that will push pension costs upward.