Escalating California Pension Costs Threaten to Choke City Budgets

Runaway Pension

By

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The Command College Futures Study Project is a FUTURES study of a particular emerging issue of relevance to law enforcement. Its purpose is NOT to predict the future; rather, to project a variety of possible scenarios useful for strategic planning in anticipation of the emerging landscape facing policing organizations.

This journal article was created using the futures forecasting process of Command College and its outcomes. Defining the future differs from analyzing the past, because it has not yet happened. In this article, methodologies have been used to discern useful alternatives to enhance the success of planners and leaders in their response to a range of possible future environments.

Managing the future means influencing it—creating, constraining and adapting to emerging trends and events in a way that optimizes the opportunities and minimizes the threats of relevance to the profession.

The views and conclusions expressed in the Command College Futures Project and journal article are those of the author, and are not necessarily those of the CA Commission on Peace Officer Standards and Training (POST).

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Despite California cities going bankrupt Police Officer's Associations (POA's) who consist of line-level staff organized as a Union, negotiate with management on pay, benefits and work related problems. They are still fighting for a Defined Benefit Retirement Plan versus a Defined Contribution Plan. If cities continue to offer a Defined Benefit Plan, it is plausible their financial future will be very bleak.

According to the California Public Employees Retirement System, (CalPERS) a defined benefit plan is a company retirement plan, such as a pension plan, in which a retired employee receives a specific amount based on salary history and years of service. The employer bears the investment risk. Contributions may be made by the employee, the employer, or both. Additionally, PERS states that a defined contribution plan is a company retirement plan, such as a 401(k) plan or 403 (b) plan. The employee elects to defer some amount of his/her salary into the plan and bears the investment risk.

With all the recent press about CalPERS' difficulties and how the impact of the economic downturn will have on cities, there is no doubt that drastic changes need to be made to save the solvency of cities. Even Bill Lockyer, the state treasurer, has said that CalPERS needs to change in order to stay on path and keep their promises. (Lifsher, 2007) Police Unions and cities should explore viable alternatives to save cities from potential bankruptcy if current public safety retirement programs remain the same.

The California Public Employees' Retirement System (CalPERS) is the retirement program that most cities utilize. More than 62 percent of public safety agencies participate in the CalPERS retirement program. (Facts at a Glance, 2009) The majority of cities use a Defined

Benefit Retirement plan which is the 3% at 50 retirement formula. The program works like this: for every year of service you receive 3% of your pay. So if you have 20 years of service and you are 50 years old you can retire with 60% of your pay for as long as you live. Sounds great huh? To the employee that is an incredible benefit but to the employer it is detrimental. In order for them to give this kind of benefit to the employee the employer must contribute an amount determined by CalPERS on behalf of the employee. Currently, it is about 38% the employer has to pay on behalf of the employee's retirement to CalPERS. It is then invested in the stock market and receive returns/losses on investment. City contributions to the state pension fund are tied to how well the CalPERS investment portfolio performs.

For the past 25 years, the economy has allowed most agencies to set aside reserves. A reserve fund balance is money generally available for "contingencies" in the event a government experiences financial difficulty. (Shelton) In addition, the value of homes had increased substantially which has led to soaring property taxes. Property taxes are levied by counties and municipalities (and by a few states). They are the biggest source of revenue for local governments. Income and sales taxes go to federal and state governments. The U.S. Census Bureau statistics for the year ending in 2004 showed that property tax collections grew by 24 percent nationwide, while sales tax revenue grew by 12 percent. Income tax collections actually shrank by a percentage point. (Povich, 2005) This along with record gains in the stock market has fueled the economy. As a result, agencies have excess monies and thus negotiated very lucrative retirement contracts (the 3% at 50) with most public safety agencies. In fact, according to CalPERS in 1999 when its investments were booming they negotiated the 3% at 50 with then governor Gray Davis. (Cassidy, 2009) In addition, the stock market has performed well and CalPERS has been able to realize double-digit returns on their investments. (Lifsher, 2008) This helped maintain a low contribution rate of about 15% on average for the cities contribution for the CalPERS retirement system. However, the financial outlook for the cities has changed for the past few years. It has changed for CalPERS as well. As a response to the change in the market in 2007, CalPERS voted to "diversify its portfolio by buying commodities, such as oil and timberlands, and by investing in public-private partnerships that build roads, bridges, airports and other projects. Although still heavily invested in stocks and bonds". (Lifsher, 2007) They changed their portfolio to broaden their mix of investments to account for the market's downturn.

According to the National Bureau of Economic Research, the United States is in a recession and has been since December 2007. (Rampell, 2008) With the recent decline in the stock market and the ongoing real estate collapse, there is no way to maintain that low contribution rate and cities no longer have excess money. CalPERS warned that its investment losses, they could force higher contributions from the state, municipalities and other public agencies that rely on the fund for pensions. (Kasler, 2008) As a matter of fact, CalPERS is facing huge losses and has recently replaced their Chief Financial Officer. The LA Times said "Chief Investment Officer, Joseph A. Dear, faces the challenge of reversing steep losses inflicted by the financial downturn on the $178-billion fund, known as CalPERS. Their portfolio includes stocks, bonds, real estate, hedge funds and commodities and has dropped in value by about 25% since July 1." (Lifsher, LA Times, 2009) This decline was just since July of 2008 and doesn't account for the decline we are experiencing in 2009.

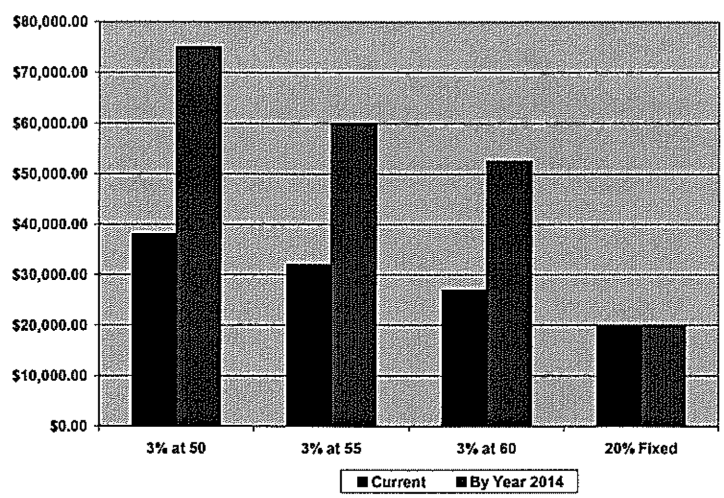
Now let's imagine if we continue down this path and continue to offer the 3% at 50 to employees. By the year 2014 CalPERS will have to increase employer contributed pension amounts up to 75% of and employee's salary. This is double what it is today. Based on a salary of $100,000, the agency will have to pay CalPERS $75,000. So the employer is spending $175,000 right off the bat for that employee, not including the rest of their benefit package. The following example demonstrate the potential financial devastation to cities across California. The City of Fremont said "Fremont contributions to the nation's largest pension fund have climbed to $12.7 million for next fiscal year -- more than triple what the city doled out for retirement costs in 2001... Fremont's pricey CalPERS bill comes as the city is facing a more than $10 million deficit for the new fiscal year that starts July 1." (Wong, Oakland Tribune, 2005) And they are not alone. In fact, there are many cities that are in dire trouble, such as the City of Vallejo who filed bankruptcy due to high Public Safety salaries and their retirement costs. But unfortunately, Vallejo's predicament is not unique and may be the harbinger of many community bankruptcies. As a matter of fact, the City of Rio Vista and Isleton are also considering bankruptcy as an option as they face large budget shortfalls and staggering debt. (Lewis, 2008) Many City Officials have the same feeling. Dan Cort, Mayor of Pacific Grove, said "CalPERS could bankrupt us faster than anything else." (Rundle, WSJ, 2008)

The problem with the pension plan is that it is a defined benefit plan, meaning the retirees are guaranteed certain amounts no matter what happens to the economy or retirement fund investments. In addition, public safety personnel have a relatively young retirement age making the payout of benefits longer. Those in public safety can retire as early as age 50 and receive 3 percent of their salary for every year worked, up to 90 percent of their salary. Many others retire in their mid- to late-50s, younger than what is common in the private sector. With people living longer, it means that pension funds are paying out for 25 years or more. In addition, government agencies have not adequately calculated or funded for long- term pension obligations. The unfunded liability has been estimated at $63 billion statewide. Individual agencies are being required to calculate those long-term liabilities, but there's been little action taken on how to pay for them.

Is there a solution for the problem? There is no quick fix for this predicament. However, there are some possible yet challenging solutions. One is to wait for the cities to bankrupt themselves and allow them to impose a pension reform. Another would be for Police Officer Associations to rethink their negotiation strategy for pension and benefits to save on employer costs. The pension reform could be changed from a 3% at 50 formula to a 3% at 55 or even a 3 % at 60. Furthermore, as the Governor pushed for several years ago a switch to a Defined Contribution Plan, which is like a 401(k). Employees are given a set amount of money each year to invest as they see fit, such as a fixed 20% of their salary per year. This will put the risk on individuals as opposed to employers, but so far Unions have squelched the idea.

Lastly, another alternative is Hybrid Defined contribution plan. The Hybrid plan would include many of the elements needed to sustain retirement pensions into the future and maintain financial stability of the public safety agencies and government. It would work as follows: An agency would determine a maximum percentage of contribution for each individual safety employee. The current contribution rate CalPERS requires of agencies based on actuarial tables is around 38 %. The norm for most agencies is the employer pays the entire contribution. In the Defined/Hybrid contribution plan the employer would for example set a maximum contribution to the employee's retirement plan of 20 %. This would in essence lock in the employer's pension costs. They would budget knowing their pension contribution on behalf of the employee would be 20% of the individual's salary. A caveat to this is they would only pay and match what the employee contributes. If an employee chose to only contribute 10% of their salary, then the agency would only be required to contribute a matching amount of 10%. The concept of this idea is shared commitment on the part of the employee and employer. The percentage of commitment on the part of the employee is their responsibility. They may contribute as little or much as they like. Contributions on the part of the employee and employer would continue to be managed by CalPERS and the amount of pension at retirement would be determined by rate of returns. An employee could realize a much higher or lower retirement pension determined by the direction of invested contributions.

The chart below is for comparison purposes only. The figures are based on current data from an average small city police department. The chart is for current employer costs versus their costs in the year 2014 for the different retirement formulas. This chart is based on a current 38% average for the employer cost to pay for the 3% at 50 at current costs. As we can see from the chart, based on a $100,000 salary, there is a 20 percent savings to change to a 3% at 55 formula. A further savings of 30 percent is realized for an employer if they converted to a 3% at 60 formula. The most significant savings is 50 percent using a Defined Contribution Plan. With CalPERS costs rising significantly over the next few years, the only value that won't continue to rise is the



Defined Contribution which gives the city an unexpected cost. It is a constant as opposed to the various rise by CalPERS based on the stock market and real estate performance.

What does this mean for the employee? It means unions need to start thinking about what they are going to be willing to negotiate. With rising costs and cities unable to pay them, the choice may be to either negotiate a different contract or have one imposed on them. If a city files bankruptcy, they have the authority to then impose whatever salary and retirement program they choose. However, if a Union can negotiate a different contract first saving the city money, the employees may have a better retirement than one that may have been imposed.

The future of the retirement pension plan for safety employees and the financial stability of all CalPERS recipients are at stake. All stakeholders must take responsibility or face unpleasant choices. The employee and/or Police Associations must step up and accept a change to the current pension plan and force employers to be accountable. It is inevitable the current pension formula must and will change. It is how the employees negotiate and except the new plan which is at stake. A "bury your head in the sand" attitude will accelerate the current economic breakdown and will delay and opportunity to make an economic recovery viable in the near future.

Employees and their unions must understand that the success of the organization hinges on the compromise of all parties and the sharing of difficulties in economically challenged times. Without the employee willingness to address this crisis, no amount of bargaining will salvage the agencies financial stability. However, current retirees should be exempted from the change. They did not create the problem and should not have any pension revoked. Retirees are a vulnerable population who would possibly have to return to the work force if anything happened to their pension, which would create a whole not set of obstacles for pension reform. Pension restructuring should be shouldered by current employees who have the time and resources to make financial adjustments and can continue working if their pension is not sufficient.

The City must also be willing to be open to compromise and listen to the concerns of their employees whether they are represented or not. The city must take some responsibility for contributing to the problem when prior negociated pension terms were voted on and accept. We all know good economic times change. The key is planning for turbulent times and ensure their community is prepared and financially sound.

CalPERS must also be flexible and adaptable to changing times. They have in the past conveyed a message to employees and employers that their "defined pension plan was the only viable option for public safety employees". In fact, in 1999 CalPERS sponsored a bill, signed by the Governor, which boosted state employee pensions. (Vellinga, 2003) This bill encouraged agencies to offer the very lucrative 3%@ 50 formulas to all safety employees. That was a time when the economic boom was in full swing and nobody thought it would end. CalPERS realizes they must adapt to a changing financial environment. Their new Investment Officer, Joseph A. Dear, says "stemming losses and planning for the future are essential tasks during a deep economic recession". (Lifsher, 2009) They must offer alternative plans that suit the differing financial status of an individual cities. A combination of plans to include defined benefit, defined contribution and hybrid retirement plans must be part of their business plan. If not, they will face competition in an openly competitive environment. Who says CalPERS has the monopoly on safety pension plans?

If the current pension plan is not addressed, several potential negative reactions may occur. First and foremost, the public safety agency may face insurmountable economic and catastrophic financial obligations. Unable to remain viable the agency may consider bankruptcy which will void all employee contracts. This gives the city the ability to force renegotiate all current contracts and pension formulas. The second negative reaction may be the poll of public opinion. The current public perception is safety pensions or already more expensive and lucrative than the private sector. Like many people who work for private employers, Ms. Nolan-Stewart, an AT&T account manager, says she is astounded at the generosity of public-employee pensions. "If I were to retire, my retirement would be one-quarter of what I make today for the rest of my life," she says (Rundle, 2008). By contrast, city firefighters and police who retire at age 50 with 30 years of service may retire with 90% or more of their final year's salary. (Rundle, 2008) Therefore, the idea of raising taxes to support these lucrative safety pensions does not appeal to the average already over taxed citizen. When faced with other financial difficulties of fob losses and huge losses in the stock market the concept of raising taxes to support already over paid public employees is not acceptable.

Conclusion

Police agencies and CalPERS could be successful weathering this financial storm. The key is flexibility and a mutual understanding and respect for the importance each player has in this game of "pension reform". It is imperative CalPERS, local city agencies and police officer associations unite in a spirit of bipartisanship to plan and compromise and insure the financial stability of future pension obligations.

CalPERS can assist the state in reducing pension costs. But the savings promised must be real. They should come from closing loopholes that encourage early retirements, unwarranted disability claims and pension spiking and advocating the inclusion of the 3%@ 50 retirement formula. CalPERS could work proactively take the lead and join taxpayers in using a shareholder type initiative to require the state to fully disclose all labor costs, not only base wages. In other words, CalPERS could do just what it has done successfully with executive compensation in its private-sector investments.

CalPERS could pursue improved governance to eliminate tit-for-tat arrangements between labor union representatives, legislators and governors who receive union campaign contributions and then approve exorbitantly expensive labor contracts. These contracts put a strain on state budgets and make it difficult for the state to pay its bills, including its obligations to fully fund retirement costs. At the same time, current retirees have earned the right to enjoy well earned pensions and should be able to continue without fear of reduced future benefits. With unfortunate, but necessary changes to public safety retirement plans, cities and their police departments can place their focus where it should be; the dangers of being a police officer in our modern society instead of dwelling on the hazards of getting old with no or little pension.

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