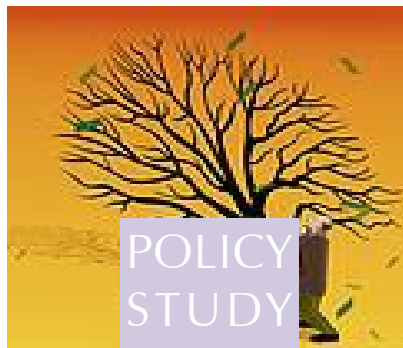




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# THE GATHERING PENSION STORM: HOW GOVERNMENT PENSION PLANS ARE BREAKING THE BANK AND STRATEGIES FOR REFORM

By George Passantino and Adam B. Summers



POLICY  
STUDY  
335



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## Executive Summary

An ominous storm cloud is gathering across the horizon as American governments try to pay for the lucrative pension promises made to their employees. And these clouds are not just over a few skies. They are virtually everywhere. Government employee pension systems across the nation are in crisis.

The city of San Diego is now embroiled in its worst financial crisis ever with more than \$2 billion in unfunded pensions and retiree healthcare costs. The financial mismanagement led TIME Magazine to name Mayor Dick Murphy one of the nation's three worst mayors, and eventually resulted in Murphy's resignation less than five months into his second term. In Illinois, taxpayers face a \$35 billion pension deficit—the worst in the nation. The state of West Virginia faces a \$5.5 billion pension deficit and an additional \$3.3 billion in unfunded workers' compensation liabilities—a deficit nearly three times the state's annual \$3.1 billion general fund budget. And in California, where government pension funds have become synonymous with investment activism, the California teachers' retirement system faces a \$24 billion shortfall and the state pays more than \$3 billion *each year* to keep its retirement funds afloat.

For each government pension system in crisis, another dozen could be listed, as this is clearly a national, systemic problem. Combined, taxpayers are exposed to more than \$350 billion in unfunded pension liabilities.

The recent downturn in the stock market is often blamed for these shortfalls. After all, the market suffered a sharp decline beginning in 2000. But is this a fair defense or is it an incomplete answer provided by government officials hoping to rationalize the major run-up of government debt? This report will explore that question.

While market losses certainly played a role, the declines only unveiled the weaknesses in government pension systems—weaknesses previously masked by the historic investment gains of the late 1990s. The fact that a retirement system could turn so quickly from investment nirvana to debt nightmares should give taxpayers and lawmakers cause for major concern. Moreover, blaming the market ignores the many policy decisions that have created the crisis.

At the heart of the pension crisis is a set of incentives that encourages policymakers to make decisions for which they do not have to bear the consequences. Since corporate executives, lawmakers, and union officials will not bear the costs of the benefit increases they preside over, there is no incentive for them to show fiscal restraint.

The “defined-benefit” pension plan, also referred to as the “traditional” plan, guarantees employees a pre-set benefit upon retirement that can easily be changed by lawmakers. The amount of the benefit is calculated by multiplying a fixed percentage by the number of years that the employee worked for the firm or government agency by the employee’s final compensation (or some average of the employee’s highest earnings). The employer invests money to ensure that these promises can be kept. If the investment returns do not match up, taxpayers are obligated to make up the difference. Alarming, once benefits are bestowed via a defined-benefit plan, the courts have ruled they cannot be taken away.

Because of this reality, taxpayers have been abused to promote political agendas that promise extravagant retirement benefits to government workers—even as the taxpayers themselves must work longer to prepare for their own retirement. Significant benefit increases, such as “3 percent at 50” plans, have proven themselves unsustainable. These excessive benefit levels and a variety of government policies have encouraged premature retirement and pension spiking, driving up costs even further. And as courts have ruled, they cannot be rescinded.

The mistake of offering greater benefits that governments cannot afford is regularly compounded by poor financial planning. The lack of long-term averaging of investment returns leaves governments susceptible to volatile swings in pension contribution payments. The issuance of pension obligation bonds is little more than an expensive gamble that will saddle taxpayers for years to come. And the very assumptions on which these pension promises are theoretically built can easily be manipulated to the taxpayers’ demise. For instance, if a pension fund assumes an overly generous rate of return on its investments or understates the full actuarial costs of benefits, the taxpayers are exposed to a significantly greater risk.

Over the past several decades, the private sector has rapidly shifted away from defined-benefit plans and toward defined-contribution plans for good reason—traditional plans are expensive, unpredictable, and unsustainable in the long run.

The government has been slow to follow the private sector’s lead. But this is not only a reasonable course of action for governments—it also represents significant benefits to workers too.

As the name implies, the main difference between defined-contribution pension plans and defined-benefit plans is that defined-contribution plans spell out the level of contributions employers and employees will make to the retirement system—not the level of benefit they will receive at retirement. Instead, the level of benefit the employee receives upon retirement depends on the performance of his or her investment portfolio, as well as his or her level of participation. Employees bear the risk of their investments but also get to maintain control of these investments.

One of the greatest benefits of a defined-contribution plan, from a government employer's perspective, is that it provides a great deal of stability since contribution levels are known in advance and do not change much from year to year. This is a sharp contrast to the volatility in contribution levels experienced under defined-benefit plans.

While the stability/predictability argument offers one of the strongest *practical* benefits of defined-contribution plans, perhaps the greatest *moral* benefit is that it allows employees the freedom to manage their own retirement accounts and invest their own money as they see fit.

Defined-contribution participants have the freedom to invest their money as they choose and the critical ability to take that entire investment with them from job to job—something defined-benefit plans lack. This portability is extremely appealing to employees in an age where the average worker switches jobs numerous times during his or her career.

Moreover, risk levels and investment strategies change with age and defined-benefit plans allow for that. Defined-contribution plans allow employees to choose more aggressive investments when they are young and switch to more conservative investments as they approach retirement.

Under a defined-contribution plan, lawmakers can still make very appealing retirement packages, including attractive matching options. The defined-contribution plan structure simply requires that these costs be recognized and dealt with in the current year as one of the government's many priorities. Defined-contribution plans prevent lawmakers from creating actuarial liabilities by pushing hidden costs off into the future. This should be reason enough for taxpayers to embrace such a reform.

In addition, there are numerous other steps governments must take to address the pension deficit problem and improve overall financial management of the state to ensure that the current pension crisis does not have a spillover effect. This study presents opportunities for reform within the current pension fund environment.

It is time that governments learn what the private sector concluded decades ago: that defined-benefit plans, typified by exorbitant benefit levels, are simply unsustainable. They should adopt the private-sector model and switch to defined-contribution systems for all future government workers to ensure more responsible fiscal management that rightly places a focus on providing high quality services. While few governments have made the leap, a number are moving in that direction. This report explores that shift and offers new insights on how it can benefit taxpayers, government agencies, and government employees alike.

# Table of Contents

---

Introduction and Overview .....	1
A. Firebell Unheard? .....	1
B. Why does it matter? .....	3
What is a Defined-Benefit Plan? .....	4
A. Defined-Benefit Plan Overview .....	4
B. A Brief History of Pension Plans in the United States.....	5
Underlying Causes of the Pension Funding Crisis .....	7
A. Excessive Benefits for Government Employees .....	7
B. Lack of Proper Planning and Poor Decisions .....	11
C. Demographics .....	13
Defined-Contribution Plans: A Solution to the Pension Problem?.....	19
A. Defined-Contribution Plan Overview .....	19
B. Trends: The Growing Popularity of Defined-Contribution Plans .....	19
C. Investment Returns of Defined-Contribution and Defined-Benefit Plans.....	26
D. Potential Advantages of Defined-Contribution Plans.....	28
Symptoms Revealed: Government Pension Case Studies .....	31
A. San Diego: A “Perfect Storm” of Financial Mismanagement .....	33
B. Illinois: Mired in Pension Debt .....	40
C. California: The Politics of Increasing Benefits and Managing Portfolios .....	44
D. West Virginia: Banking on Pension Obligation Bonds .....	55
E. Los Angeles County: Suffering from Pension Obligation Bonds and “Chief’s Disease” .....	58
F. Detroit: Rising Pension Costs and a Declining Revenue Base .....	62
G. Orange County, California: Ignoring the Lessons of the 1994 Bankruptcy .....	67
H. Houston: Lavish Benefits and Bad Assumptions.....	69
I. Contra Costa County, California: The Costs of Unreasonable Assumptions .....	74
Pension Benefit Guaranty Corporation: The Next Savings-and-Loan Crisis? .....	77
A. About the PBGC .....	77
B. The PBGC’s Bleak Financial Outlook.....	78
Recommendations and Conclusions .....	87
A. Transition to 401(k)-style defined-contribution plans for all future workers.....	88
B. Cope with existing obligations. ....	89

C. Protect the Budget From Pension Overruns.....	93
About the Authors.....	105
Related Reason Studies.....	106
Endnotes.....	107

## Part 1

# Introduction and Overview

## A. A Firebell Unheard?

In 1994, Orange County, California shocked the world by declaring bankruptcy after the highly leveraged investment portfolio of Robert Citron, the County Treasurer at the time, collapsed, resulting in \$1.64 billion in losses.<sup>1</sup> As a result, \$188 million had to be cut from the budget virtually overnight. Ten years later, the pain is still being felt, as the county may have to devote \$100 million per year toward retiring bankruptcy debt until 2027.<sup>2</sup>

Today, Orange County Treasurer-Tax Collector John Moorlach sees an alarming similarity with the growing obligations surrounding government pension funds. This time, under pressure from government employee unions, lawmakers have increased government employee retirement benefits at an unsustainable pace and racked up massive unfunded liabilities in the process.

“We have electeds who seem to believe the line that it doesn’t cost anything [to increase benefits]. But now we have cities up north that are sucking air. They’ve increased benefits so much, and now they can’t afford to pay them. They are looking at layoffs, tax increases and all the stuff we had to do after the bankruptcy,” Moorlach recently told the *Orange County Register*.<sup>3</sup>

While the defined-benefit pension was once a well-intentioned effort to provide stable, post-retirement income through a “paycheck for life,” it is now a heavy weight around the ankles of government- and private-sector organizations alike. Sadly, few citizens are aware of the emerging crisis and few lawmakers have constructively addressed it.

As of April 24, 2005, the National Association of State Retirement Administrators reported an aggregate unfunded liability of over \$264 billion across the 103 systems it surveyed.<sup>4</sup> In a separate analysis by Wilshire Associates, the aggregate unfunded liability of state pension systems was estimated at \$366 billion in 2003.<sup>5</sup> According to the Wilshire study, only two states had pension system assets that exceeded their liabilities and sixteen states had unfunded liabilities larger than their annual state budget.<sup>6</sup>

The story is much the same in the private sector, where the quasi-governmental Pension Benefit Guaranty Corporation (PBGC) serves as insurer-of-last-resort for the nation’s private-sector defined-benefit pension plans. The agency receives no tax funding, and is supported by insurance premiums paid by employers, investment returns, and assets from pension plans taken over by the agency. Firms that offer defined-benefit plans pay a small mandatory premium per worker or retiree covered to the agency. If a company that manages a defined-benefit pension system goes bankrupt and can no longer afford to pay the benefits, the



PBGC steps in and pays the benefits, up to a maximum amount determined by statute. Recent reports suggest that the aggregate unfunded liability in private pension plans ranges from \$400 to \$450 billion.<sup>7</sup>

When underfunding in government and private pensions is combined, the promises made to retirees are projected to cost \$700 billion more than the assets available to support them. While it is not the case that these liabilities will all materialize at once, they should, nonetheless, be a cause for significant concern—much like an ever-growing family credit card balance. As credit card debt accumulates, so too does debt service payment.

When the federal government rescued the failed savings-and-loan industry, taxpayers footed a \$124 billion bailout.<sup>8</sup> Today, taxpayers may be exposed to more than *five times that amount* in unfunded pension obligations across the government and private sectors.

While the liabilities and obligations of the PBGC are not expressly backed by the full faith and credit of the U.S. government, politically, they are. It is hard to imagine that Congress would stand by and watch the pension promises of millions of *voting* taxpayers evaporate and not bail them out. In other words, if the PBGC collapses, it is a good guess that the taxpayer will bear much of the cost.

Shortages in government defined-benefit pension plans are of even greater concern. Pension-related promises are direct contractual obligations that rest on the shoulders of taxpayers and must be paid—either in the form of increased pension system payments, new debt, or higher taxes. And, once instituted, pension benefits are considered “carved in stone,” having been ruled routinely by the courts to be ironclad.<sup>9</sup> As a result, even the most misguided decisions have a permanent effect on taxpayers.

Sadly, few lawmakers seem to acknowledge that a problem exists at all with government pension systems. Those that do quickly find themselves under fire from government employee unions, pension boards, and other entities that have a vested interest in the continuation of existing pension plans—regardless of the costs.

As a result, public debate over the looming pension crisis has been virtually nonexistent, even as debt has mounted over the past few years. Only now is that discussion starting to occur in a few key regions. The primary purpose of this report is to raise awareness of the problem and spawn serious public discourse in order to resolve it before it spirals further out of control.

While there is little doubt that a number of pension systems are in crisis, it is worth asking whether the crisis is the result of poor decisions by individual governments and policymakers or a deeper, systemic problem. We believe that the crisis in defined-benefit pensions is a systemic flaw, resulting from what economists refer to as a “moral hazard.” When individuals make decisions for which they will not bear the consequences, there are few incentives to make good, long-term decisions. In many cases, those making the pension-related decisions also have a direct financial interest in the system, raising other questions of propriety.

With a defined-benefit pension system—where costs of the system are distributed over several decades—policymakers, elected officials, and government-employee union negotiators can all make decisions with long-term consequences for which they are not held accountable. The same can be said of private pensions backed by the PBGC, which must insure even those systems that are built on flawed or short-sighted decisions. In both cases, those at the negotiating table—be they union organizers, elected officials, or

corporate CEOs—can make binding promises whose full costs are not seen for many years, long after they have left their positions of influence.

In California, Gov. Arnold Schwarzenegger has made shifting all future state employees to defined-contribution systems a priority of his administration. He introduced a measure to do so, but recently pulled his proposal to rewrite it to address labor-union assertions that death and disability benefits might not be protected. (Schwarzenegger has said that death and disability benefits would remain intact. He intends to offer a revised pension proposal in 2006 if the legislature does not act.)<sup>10</sup> In South Carolina, Gov. Mark Sanford has issued a similar call. Another call for reform is underway in Louisiana, specifically to raise retirement ages and decrease benefits calculation formulas for new state employees.<sup>11</sup> And the idea is being debated in local governments around the nation, from San Diego to Detroit to Philadelphia.<sup>12</sup>

## B. Why does it matter?

Even if the public is aware that a pension-funding problem exists—that huge debts are piling up within defined-benefit pension promises—the question remains unanswered as to why it really matters. Sadly, governmental debt has become an all-too-common situation, arguably dulling the public’s concern over it.

Some will remember, for instance, that California has faced a severe budget deficit for many years and, in the eyes of the public, seems to be surviving. In fact, the state in 2004 voluntarily racked up billions of dollars in additional debt through the passage of a stem-cell research bond.

So why should these pension liabilities matter?

Ballooning pension obligations necessarily draw resources away from other quality-of-life priorities like transportation, education, and public safety. In California, for instance, the state’s obligations to its government-employee pension system have skyrocketed from \$160 million to \$2.6 billion annually just since 2000.

That increase could build hundreds of miles of new freeway capacity to tackle California congestion. It could pay the full cost of more than 25,000 teachers. It could offer significant tax relief to a high-tax state. Any political philosophy could find a better use for the money.

Good government demands that taxpayer dollars are used as efficiently as possible. To do anything less is immoral and irresponsible.

This report will explore the concept of shifting new employees away from defined-benefit pension plans to defined-contribution plans in a way that is fiscally responsible and still allows government workers to retire with dignity. However, creating a different plan for new employees will do nothing to address unfunded liabilities that already exist. Here, the report will recommend a number of strategies to cope with existing liabilities that do not rely on tax increases or undermine the delivery of quality-of-life services. Finally, the report calls for fundamental reform to prevent existing liabilities from continuing to grow through future benefit increases of the sort witnessed over the past several years.

## Part 2

# What is a Defined-Benefit Plan?

## A. Defined-Benefit Plan Overview

The “defined-benefit” pension plan, also referred to as the “traditional” plan, guarantees employees a pre-set benefit upon retirement. The amount of the benefit is calculated by multiplying a fixed percentage by the number of years that the employee worked for the firm or government agency and applying that figure as a percentage of the employee’s final or highest compensation (or some average of the employee’s highest earnings).

For instance, consider an employee who has worked 30 years and decided to retire with a final salary of \$50,000 (whether calculated by the last year of employment or a three-year or other average as most systems do). Had this employee begun working for the employer at age 25, a “2 percent at 55” plan would allow him to retire at age 55 with 60 percent (2 percent times 30 years) of his final salary, for an annual pension of \$30,000 (60 percent times \$50,000). He would receive this pension benefit (plus a COLA for a typical plan) for the remainder of his life—regardless of how well or poorly the government pension fund performed. The benefits reflect a promise that must be honored.

Defined-benefit plans are managed by the employer (the government, in cases of government pension funds), who makes annual contributions to the plan based upon actuarial assumptions designed to ensure that the fund is sufficiently funded to cover its benefit payouts. (In the government, employees typically contribute a portion of their salaries to the plan; in the private sector, they generally do not.) Pension assets are invested and those returns determine how much extra, if any, must be contributed to ensure the health of the system (Poor fund performance means the fund has fewer assets available to pay retiree benefits, and so necessitates greater contributions to the system, and vice versa.)

Under a defined-benefit plan, the employer bears the risk of loss if investment returns are lower than expected, the system is underfunded, new benefit increases are added to the obligations without funds to support them, or other actuarial assumptions are overly optimistic, as the employer must make up the cost of these deficiencies to make the promised benefit payments. In the case of government defined-benefit plans, where governments are the employers, taxpayers ultimately bear the investment risks.

Under defined-benefit plans, employees have limited ability to access their money if they terminate employment before the regular retirement age. Also, benefits cannot be “rolled over” if the employee switches jobs, and usually cease upon the retiree’s death.

Defined-benefit plans are most common for government employees, having lost favor in the private sector over the past 30 years. In fact, 90 percent of government employees are covered by defined-benefit plans, compared to only 21 percent of private-sector employees.<sup>13</sup> Moreover, government defined-benefit plans often take the place of Social Security (employees covered by these plans may not be eligible to receive Social Security benefits).

## B. A Brief History of Pension Plans in the United States<sup>14</sup>

Government pension plans have existed in America since the colonial era, though they were restricted to disabled veterans and widows. Military pensions became available to a large portion of the population following the Civil War. The federal government provided pensions to disabled Union Army veterans and widows, and each of the formerly Confederate states also provided pensions, albeit less lucrative ones than the federal government's, to Confederate veterans.

In 1875, the American Express Company established the first private pension plan in the United States. Railroad companies, which were among the largest employers in the country during the late nineteenth century, soon followed with their own pension plans. By 1930, most large companies offered pension plans. These private pension plans proved surprisingly durable as the Great Depression hit:

*Most private pensions survived the Great Depression. Exceptions were those plans that were funded under a "pay as you go" system – where benefits were paid out of current earnings, rather than from built-up reserves. Many union pensions were financed under this system, and hence failed in the 1930s.<sup>15</sup>*

The Social Security Act of 1935 prompted a wave of government pension plans for state and local governments. Soon afterwards, private pension plans would multiply as well with the adoption of the Wage and Salary Act of 1942, which froze wages in an attempt to contain inflation. Since firms could not compete for employees by offering higher salaries, they compensated by offering greater retirement benefits. Defined-benefit plans enjoyed a great deal of popularity in both the government and private sectors between the 1950s and 1970s.

The year 1962 saw the birth of "Keogh" plans, or tax-deferred accounts for retirement savings for the self-employed. During the mid-1960s, the Studebaker Corporation failed, leaving a pension plan with less than 20 percent of the assets needed to pay promised benefits. Uproar over the loss of employee pensions eventually led to the enactment of the Employee Retirement Income Security Act of 1974 (ERISA). ERISA established the tax-deductible Individual Retirement Account (IRA) for those not covered by a pension. In addition, ERISA instituted the Pension Benefit Guaranty Corporation (PBGC), a government-owned corporation designed to encourage the growth of defined-benefit plans and insure private defined-benefit plans to prevent cases like Studebaker, in which plans were terminated without adequate funding. Today, the PBGC insures defined-benefit plans covering approximately 44 million private-sector employees.<sup>16</sup>

The Revenue Act of 1978, sec. 401(k), created Internal Revenue Code Section 401(k), establishing privatized or individualized qualified deferred compensation plans. The provision allowed employees to set aside a certain portion of their compensation to be exempt from taxes until withdrawn, generally after retirement, when people are in a lower income tax bracket.

The enactment of ERISA and the 1978 Revenue Act would prove to be a pivotal change in pension history. Since their passage, the private sector has seen a steady trend toward “401(k)” and similar “defined-contribution” plans (which will be discussed in detail later in this paper), and away from defined-benefit plans. Now even government pension systems are re-evaluating defined-benefit plans in favor of defined-contribution plans.

## Part 3

# Underlying Causes of the Pension Funding Crisis

As mentioned earlier, government pension systems face hundreds of billions of dollars in combined unfunded actuarial liabilities. We must know the cause of this shortfall before we can hope to solve the problem. Defenders of defined-benefit plans assert that the bulk of the losses results from cumulative market losses since late 2000. But is this really true?

While the recent downturn in the market and other factors largely out of the control of government pension managers have contributed to the current pension funding crisis in plans across the nation, in general, the central causes of the crisis are poor planning and decisionmaking. At the heart of the pension crisis is a set of incentives which create a “moral hazard.” The fact that policymakers are able to make decisions for which they do not have to bear the consequences actually encourages risky behavior.

In defined-benefit pension systems, there is an inherent danger of a moral hazard. Since corporate executives, lawmakers, and union officials will not bear the consequences of the benefit increases they preside over, there is no incentive for them to show fiscal restraint. Thus, underfunding a system does not create problems until years into the future. But policy leaders do get to reap the political rewards of creating lucrative new benefits for employees or underfunding a system and freeing those monies for other purposes in the short term.

Moreover, as this section will demonstrate, market losses only unveiled the weaknesses and risks in the defined-benefit system, previously masked by investment gains. The fact that a system could turn so quickly from investment nirvana to debt nightmares should give fiscal watchdogs cause for major concern. Rather than offsetting market losses, numerous pension policies tended to leave defined-benefit pension systems more vulnerable to market fluctuations. These policies, as well as various contributing factors, are detailed below.

### A. Excessive Benefits for Government Employees

Supporters of pension benefit increases routinely argue that they are needed to attract a high-quality workforce that is paid less than their private-sector counterparts. Unfortunately, this claim is simply not true. According to the Bureau of Labor Statistics, the average wage for state and local government employees is \$23.52 per hour, compared with \$16.71 per hour for private-sector employees. When benefits (including

pensions) are included in the calculation, state and local government employee compensation jumps to \$34.13, compared to total private-sector compensation of \$23.41.<sup>17</sup> In other words, even when private employees' benefits are included, they still make less than the *raw wage* of state and local government employees.

An Employee Benefit Research Institute study similarly concluded that total compensation costs for state and local governments were 46 percent higher than for private-sector employees.<sup>18</sup> While the study noted that some of the cost differences were attributable to the composition of the respective workforces (a higher percentage of government employees are employed in occupations that require a high level of education, such as teachers, or consist of a high level of danger, such as police officers and firefighters, while a higher percentage of private-sector employees are employed in lower-paid occupations, such as in the service and trade industries), health and retirement benefits are much more costly in the public sector and are to a much greater proportion of employees. Moreover, compensation comparisons of the same occupational groups revealed that government compensation is higher than private-sector compensation. In fact, for every occupational group for which there was comparable data, government compensation was higher. Government compensation costs for "Management, professional and related" jobs are \$42.30 per hour for government employers versus \$41.14 per hour for private-sector employers, "Sales and office" occupation costs are \$23.91 versus \$19.06, and "Service" jobs costs are \$26.37 versus \$11.88.

**Table 1: Employment and Total Compensation Costs in State and Local Governments and Private Sector, by Occupation Group, Ages 16 and Older**

	State and Local Governments		Private Sector	
	Employment (2003)	Total compensation costs (Sept. 2004)	Employment (2003)	Total compensation costs (Sept. 2004)
Total	17,930,229	\$34.72	113,952,460	\$23.76
Occupations				
Management, professional and related	13.7	42.30	17.5%	41.14
Professional and related	7.2	42.14	8.8	37.99
Teachers**	31.8	47.35	2.3	B
Sales and office	14.8	23.91	28.2	19.06
Service	31.2	26.37	25.6	11.88
Natural resources, construction, and maintenance	5.2	**	18.2	26.74
Production, transportation, and material moving	3.2	**	7.1	20.57

\* Includes postsecondary teachers: primary, secondary, and special education teachers, and other teachers and instructors.

\*\* Data not available

Source: Ken McDonnell, "Benefit Cost Comparisons Between State and Local Governments and Private-Sector Employers," *EBRI Notes*, Vol. 6, No. 4, April 2005, p. 5. Available online at <http://www.ebri.org/pdfs/0405notes.pdf>.

Regardless of the impact that market fluctuations have had on retirement funds, decisions to increase government employee retirement benefits have increased system costs significantly. More detail on these benefit enhancements is provided below in Section IV. Still, a number of very specific practices within government pension systems should be reconsidered.

### *1. Pension Spiking*

Over the years—and particularly during the past decade—government defined-benefit plans have offered very generous benefits to employees. One justification for this is that higher benefits encourage employees to remain longer, which, in turn, helps to save on the cost of hiring and retraining new employees. Benefits have often been so attractive that the opposite has happened, however, as employees have taken advantage of higher benefits and retired sooner. Thus, employers may end up with higher pension costs *and* the costs of hiring and training new employees. Employees that “game” the system to improve their final compensation (and thus their pension benefits), only to retire soon afterwards, are said to engage in “pension spiking.” Some benefits are especially prone to pension-spiking abuse.

One such example of pension spiking is the redemption of large quantities of unused vacation time shortly before retirement. Employees contemplating retirement may have accrued significant sums of vacation time over the years. Some government employers have extremely liberal policies regarding the amount of vacation time that can be “sold back,” or exchanged for a lump-sum payment equivalent to the value of the unused vacation time. Employees may use this sell-back policy to spike their final compensation during their final year of employment to increase their pension benefits. Employees with enough time built up may even sell back the maximum amount of time shortly before the end of the year and sell back more time after the start of the new year. If the employee then retires within 12 months of the first sale, he may be able to include both redemptions in the calculation of his final salary, pushing his compensation even higher.

In addition, vacation time is typically “sold back” to the employee at the salary the employee is currently receiving, not what he or she was making at the time the vacation time was earned. If the current salary is significantly higher than when the benefit was initially earned, then the government will have significantly greater costs. In New Jersey, sick time and vacation time sell-back benefits are expected to cost taxpayers nearly \$1.5 billion in coming years.<sup>19</sup>

Another example, unique to California, is found in the practice of calculating pension benefits based on an employee’s single highest year of salary.<sup>20</sup> All other states take an average of the employee’s salary over the last three or five years of employment (or the highest three- or five-year period of an employee’s earnings). The California rule means that employees may realize higher benefits from raises or promotions sooner than employees in other states. On the margin, this means employees considering retirement are more likely to retire sooner in California, rather than waiting a couple or a few years before the higher level of benefits fully kicks in. Liberal unused sick and vacation time sell-back policies and California’s one-year formula may represent excessive benefits, but employees who take advantage of these benefits are acting completely within the system.

Other pension-spiking schemes are simply fraudulent, or encouraged by loopholes in workers’ compensation and disability pension laws. Take the example of “chief’s disease,” for instance. Chief’s disease is the practice of claiming a questionable work-related injury during one’s final year of employment in order to receive greater retirement benefits, and is particularly common among police and firefighter employees



(hence, the name). According to the *Sacramento Bee*, over 80 percent of California Highway Patrol chiefs who retired in the past four years filed disability claims just before they retired, “though many of the alleged medical problems had been building for years and were common for those in any field who are nearing retirement age.”<sup>21</sup>

A successful injury claim allows the employee to take a one-year leave of absence while collecting his or her full salary tax-free. The lack of tax withholding allows the employee to realize a higher salary than he or she would if he or she were working. Thus, the employee benefits from claiming an additional year of service without actually working that full year and also gets to claim a higher salary (one or both of which will increase his pension benefits upon retirement). The filing of the workers’ compensation claim, moreover, opens the door to a disability pension, which grants full medical benefits and greater benefits to the retiree’s spouse upon the retiree’s death. On top of that, half of the amount of the disability pension is tax-free.<sup>22</sup>

Apart from the obvious fraud problem, liberal workers’ compensation and disability pension rules as to what constitutes a “work-related” injury contribute to abuses of the system. Rules have allowed conditions such as cancer and heart disease, for example, to be considered job-related injuries.<sup>23</sup>

## ***2. Deferred Retirement Option Plans***

A Deferred Retirement Option Plan (DROP), also known as Deferred Retirement Option Program, is a plan designed to retain senior employees who are close to or beyond the regular retirement age. Under a standard DROP, an employee agrees to remain at his job a certain number of years (typically, three or five years) in lieu of retiring. In exchange, the employer deposits monthly checks in the amount the employee would have earned in pension benefits had he retired into an individual account (often earning generous interest rates of 8 or 8.5 percent, not counting cost-of-living adjustments).<sup>24</sup> Thus, the employee is earning both a salary and a pension (with interest). Pension benefits are frozen at the time the employee entered the DROP. After the three- or five-year period has passed, the employee retires and cashes out his DROP account, receiving a lump sum.

The DROP originated about 20 years ago in Baton Rouge, Louisiana, as a means to retain experienced police officers and firefighters.<sup>25</sup> Other municipalities soon adopted the idea and it was not long until DROP benefits were extended to other government employees.

DROPs often backfire and end up encouraging earlier retirement and greater costs to the pension system. Some recipients may have otherwise stayed a few more years beyond their DROP agreement, but opt not to because of the enhanced benefit they receive upon departure. The existence of the program also allows those near the end of their careers to earn a guaranteed rate of return and “double dip,” receiving both a paycheck and accruing DROP benefits—whether their decision to stay hinges on it or not. Moreover, DROPs have caused some high-profile controversies in municipalities such as San Diego, Milwaukee County, Houston, and Philadelphia.<sup>26</sup> In Milwaukee County, seven county supervisors were recalled and the chief executive resigned during a 2002 scandal that shed light on lavish benefits received by top county executives as a result of a DROP implemented in 2000.<sup>27</sup> In response to public outcry, San Diego, which has arguably the most visible pension crisis nationally, now plans to scrap its DROP.<sup>28</sup>

### 3. “Air Time” Purchases

Another controversial benefit is the ability to “purchase” years of service, commonly referred to as “service credits” or “air time.” Under this arrangement, the employee pays additional contributions in exchange for higher future retirement benefits. The benefit is generally structured such that the employee must contribute an amount equal to the full actuarial value of the benefits he will receive. Think of it as contributing more now to realize a higher annuity during retirement. The employer may typically purchase a maximum credit of up to five years, depending on the benefit offered. Plans may even allow air time to be purchased through contribution from a private plan such as a 401(k) or 403(b) that the employee can roll over to the government plan.

Of course, allowing air time purchases also encourages early retirement—even as it is typically billed as a flexible policy that enables an employee to increase his retirement benefits *at his own expense*.<sup>29</sup>

The danger inherent in this benefit is that many employees who exercise the option will go on to other jobs at higher salaries that will earn higher retirement benefits. By purchasing additional years at a lower salary—even if they are paying the full actuarial cost of those years at current salary levels—taxpayers may be forced to pay higher retirement costs. There is no way to fully account for an individual member’s salary growth to accurately charge them the “full cost” of purchasing the service credits. If there were, few low-wage workers would buy the service credits at costs based on significantly higher earnings that they *may* earn later.

### 4. “Public-Safety” Employees’ Benefits Expansion

Public-safety employees receive higher benefits than other government employees because of the inherently hazardous nature of their jobs. However, in some states, public-employee unions have cleverly expanded the definition of “public-safety” employees over the years to receive backdoor benefit increases. In Illinois, special benefits once reserved for police officers are enjoyed by roughly one-third of all state employees. In response, Governor Blagojevich has proposed scaling back benefits for new employees to conform to the original intent of the law, a reform that is estimated to save \$1.5 billion over 40 years.<sup>30</sup> In the 1960s, roughly one in 20 California government workers received public-safety pensions. Now it is one in three workers.<sup>31</sup>

## B. Lack of Proper Planning and Poor Decisions

The investment losses that pension funds have suffered have been exacerbated by a series of policy decisions that have exposed taxpayers to additional risks. Better planning and decisionmaking would have, at the very least, minimized the impacts of the stock market declines.

### 1. Unrealistic Actuarial Assumptions

The true costs of pension plans may be hidden by overly optimistic actuarial assumptions. These errors may be intentional or unintentional. Realizing mistakes in these assumptions can be an unpleasant surprise for cash-strapped governments. The Fort Worth Employees’ Retirement Fund still projected investment returns of 8.5 percent a year after the market turned south in 2000.<sup>32</sup> A *Star-Telegram* review of 16 pension plans on the Texas Pension Review Board’s “watch list” revealed that “rosy assumptions” were a substantial cause of increasing funding shortfalls, which totaled about \$12 billion for the plans reviewed.<sup>33</sup> Said a Dallas forensic auditor and former professor of managerial accounting at Texas Christian University, “These

irrational expectations are going to make the whole thing fall apart, and future city councils and taxpayers will get to clean up the wreckage.”<sup>34</sup>

The cases in Texas may have simply been due to the “irrational exuberance” of the pension fund trustees. In Contra Costa County, California, the errors were the result of even more blatant negligence. In the fall of 2004, a re-evaluation of unrealistic actuarial assumptions revealed that the county’s retirement costs for the next fiscal year would be *10 times greater* than County Administrator John Sweeten had predicted only five months prior.<sup>35</sup> A civilian grand jury found that the Contra Costa County Employees’ Retirement Association Board deliberately ignored actuarial advice concerning investment returns, employee morbidity, and employee marriage benefits.<sup>36</sup> An independent analysis similarly found that the county’s pension funding troubles were due primarily to ignoring actuarial advice and adopting overly optimistic assumptions, as well as an ill-advised decision by the county Board of Supervisors to increase employee benefits by up to 50 percent in 2002.<sup>37</sup>

## ***2. Investment Returns***

In establishing expected pension costs and required contribution levels, actuaries must estimate how much the pension fund’s portfolio will return. If assumptions about the rate of return that investments will earn are too high, contribution levels will not be sufficient to cover pension liabilities because planners expect a larger portion of the cost to be covered by investment gains. Pension systems have become underfunded, in part, because investment returns are not meeting expectations and thus contributions are not covering costs. Moreover, over-optimistic expectations are not confined to just a few state and local governments.

According to the *Public Fund Survey*, a survey of government pension plans conducted by the National Association of State Retired Administrators and the National Council on Teacher Retirement, the median investment return assumption for fiscal year 2003 was 8 percent.<sup>38</sup> Unfortunately, nationwide, the median government pension has only grown an average of 4.1 percent over the past five years.<sup>39</sup>

This excessive optimism seems to be endemic to the system. Perhaps pension fund managers should follow the advice of expert investors such as Warren Buffet, who in 2003 announced he was going to assume that the future returns on pension obligations in his holding company would be lowered to 6 percent. And other experts think 5 percent is more likely.<sup>40</sup>

## ***3. Inflation***

The deficiency in assumed and actual investment returns was partially offset by lower-than-anticipated inflation, but only mildly so. According to the U.S. Department of Labor, the Consumer Price Index rose 3.3 percent in 2004, higher than it has been in several years.<sup>41</sup> Nevertheless, the inflation rate is still within the range assumed by most plans in the *Public Fund Survey*. According to the survey, the median assumed inflation rate was 3.75 percent.<sup>42</sup>

When combined with the investment return data above, the median assumed real rate of return (investment return minus inflation) for fiscal year 2003 was 4.25 percent and the median actual real rate of return for the last five years was 0.8 percent. It is going to take either some strong performances or high contributions—perhaps both—in the near term to make up for this deficiency.

## C. Demographics

### 1. Life Spans Are Increasing

According to the Centers for Disease Control, during the 20<sup>th</sup> century, the average American life span rose by more than 30 years.<sup>43</sup> Thus, the time spent in retirement is increasing—and so are the costs to employers. Consider the trend in the length of retirement over the last half a century:

*When Social Security was invented, life expectancy at age 65 for a man was about 12 years. By 1950, life expectancy had risen to almost 13 years and the average age at which a man applied for Social Security was 68.7. Paradoxically, the average age for applying for Social Security benefits fell to less than 64 in 2000 while expected life at age 65 rose to 15.7 years. **That suggests that the time a typical man spends in retirement has nearly doubled since 1950.** This is despite the fact that people are healthier at every age and the physical demands associated with work have fallen as mechanization has increased and the economy has shifted more toward services.<sup>44</sup> (Emphasis added)*

Continuing advances in medical technology make it likely that this trend will continue into the future. Thus, it will be more and more expensive to retire in the years ahead. Employers must consider this when establishing their retirement benefit levels.

### 2. “Baby Boomers” Will Start to Retire Soon

In the next few years, the “baby boom” generation will start to retire. This retirement trend is already being seen in government entities across the nation. At the federal level, more than half of all government employees will be eligible to retire within the next five years.<sup>45</sup> In California, it is estimated that 70,000 of the state’s 208,000 government employees (34 percent) will be eligible for retirement in the next five years.<sup>46</sup> In Colorado, 29.5 percent of state government workers will be eligible to retire within the next five years, including 32.4 percent of higher education workers.<sup>47</sup> South Carolina expects nearly one-third of its state workforce to be eligible for retirement in the next five years.<sup>48</sup> An independent analysis of the Tennessee state workforce estimates that 40 percent of the state’s workers will be eligible to retire over this time frame.<sup>49</sup> This is a trend that is at least several years in the making. According to a 1999 Rockefeller Institute of Government report, “two-fifths of state and local government employees will be eligible to retire in the next 15 years, raising the specter of the most significant talent and brain drain ever experienced by government.”<sup>50</sup>

What makes things especially challenging is that the “baby dearth” that followed the “baby boom” means there will be far fewer workers supporting an increasing number of retirees on pay-as-you-go defined-benefit pension plans. As an Urban Institute paper reports on fertility rate trends during the 20<sup>th</sup> century:

*The fertility rate hovered around 2.2 during most of the 1930s and then began a somewhat erratic upward trend that peaked at 3.8 in 1957. Soon after, it fell even more precipitously than it had risen and reached a low of 1.7 in 1976. After the late 1970s, the rate rose a bit and remained slightly above 2.0 during the 1990s. It is the speed with which the baby dearth followed the baby boom that will cause the ratio of workers to retirees to fall rapidly between 2010 and 2030. The ratio will go from slightly over 3 to only 2.<sup>51</sup>*

In addition, the PBGC notes that the ratio of current to retired workers has already fallen to 1-to-1 in the defined-benefit system, down from more than 3.5-to-1 in 1980.<sup>52</sup> This continuing trend will place even more pressure on government pension systems and require significant contribution increases, benefit cuts, or extraordinary investment returns to sustain them.

The *Public Fund Survey* further notes:

*[I]f fewer members in a prefunded plan (investment-based defined benefit system) are contributing relative to the number of annuitants receiving benefits, a typical result is a larger negative external cash flow (contributions minus benefit payments and administrative expenses). This, in turn, can require a plan to maintain a larger percentage of its assets in liquid securities or to make other adjustments to its asset allocation, which are likely to reduce long-term investment returns, all else held equal.<sup>53</sup>*

In other words, as the ratio of active workers to retirees within a defined-benefit plan continues to decline, it becomes harder for a system to achieve the same investment returns, and so annual contributions out of the budget have to increase.

### ***3. Health-Care Costs Are Increasing***

Government defined-benefit pension plans typically offer generous health-care benefits in retirement. While people are generally healthier and living longer than in the past, medical costs are becoming a larger portion of overall pension costs, as health-care costs rise even faster than other program costs. According to the *Employer Health Benefits 2004 Annual Survey* conducted by the Kaiser Family Foundation and Health Research and Educational Trust, between spring of 2003 and spring of 2004, employer-sponsored health insurance premiums rose 11.2 percent, the fourth consecutive year of double-digit growth.<sup>54</sup> Adds a report issued by credit agency Fitch Ratings, entitled “Local Governments Pressured by Rising Employee Health Care Costs,” health-care costs increased an average of 14.2 percent per year from 2000-2004, compared with average annual inflation growth of 2.4 percent and average annual wage growth of 3.2 percent over the same period.<sup>55</sup>

These spiraling health-care costs have prompted private-sector businesses to take measures to limit their costs. These may include reducing or eliminating health benefits for new employees, increasing retiree contributions for medical premiums, increasing prescription drug co-payments, and raising deductibles and out-of-pocket limits.

Governments typically provide even greater health benefits than private-sector employers. As workers’ compensation and other medical costs soar, government employers may be forced to follow the lead of the private sector in reducing benefit costs for future employees.

### ***4. Short-Term Calculations of Employer Contribution Requirements***

Along with the growth of unsustainable benefits, one key cause of pension underfunding crises is simply poor planning. This often takes place when government employers rely too heavily on investment gains to fund the system. The inevitable ups and downs of the market can result in widely varying rates of return. Hence, state contributions to the pension system can be extremely volatile. Governments may avoid shocks to the system by calculating their contribution requirements based on a long-term average (10 or 15 years,

for example) of investment returns. This longer-term averaging would serve to “smooth out” contribution payments by smoothing out the ups and downs of the market, allowing for a more predictable funding system.

### **5. “Contribution Holidays” and the “13<sup>th</sup> Check”**

Pension systems often get into trouble when the government employer neglects to make contributions as a result of strong pension fund performance. When investment returns are so high that the employer is not required to make any contributions to the system that year, the employer is said to enjoy a “contribution holiday.” As noted above, however, taking a holiday can lead to serious consequences when portfolio performance falters, contribution requirements rise, and the government is left unprepared to adjust its budget accordingly. Governments tend to follow a pattern, however, of spending rather than saving during the good years. Then they are unwilling to cut back, even as revenues (from pension fund investments or taxes in general) do not rise fast enough to support the spending. The correction typically takes years longer than in the private sector.

One of the most dangerous realities is that in the very years that investments perform poorly, municipal budgets are also pinched. This means that just as their need for offsetting contributions increases, their ability and willingness to pay reduces. So instead of increasing pension contributions, some municipalities have actually asked to reduce their necessary contributions. The California Public Employee Retirement Systems (CalPERS) has granted payment restructures to a number of localities that participate in their system, including Santa Clara County and Long Beach. These agreements allow them to reduce their contributions below what would be required this year, with the promise to resume normal contributions later and then pay back, with interest, the amount previously deferred.<sup>56</sup>

Equally troublesome is the disbursement of “excess” returns to beneficiaries in a special payment known as the “13<sup>th</sup> check.” Sometimes the amount of the 13<sup>th</sup> check actually exceeds that of the normal monthly retirement check. The Public Employee Retirement System of Idaho, for example, issued 13<sup>th</sup> checks equal to 106 percent of beneficiaries’ regular monthly payments in 2001.<sup>57</sup> Not only is the employer not saving or reinvesting these funds, he is actually reducing his assets by giving them away. Worse yet, sometimes the formula used to determine whether or not the 13<sup>th</sup> check will be issued does not even take pension system costs into account (i.e., the 13<sup>th</sup> check may be issued if investment returns exceed a certain threshold, even if the system as a whole still has a significant unfunded liability). Thus, some municipalities, such as San Diego, have issued a 13<sup>th</sup> check while in the midst of a pension funding crisis.<sup>58</sup> According to an independent analysis of San Diego pension issues:

*The surplus earnings concept ignores this long-term dynamic of actuarial projections. It evaluates returns on a year-by-year basis and treats all cash generated by system assets (beyond assumed rates of return) as free money.*

*This, of course, flies in the face of the basic premise of actuarially assumed returns: they are rarely met for any individual year, but are expected to average out over time to approximate the projections. Therefore the concept of “surplus earnings” is a misnomer. Unless and until it can be demonstrated that the actuary’s projections are unrealistically conservative, all earnings are necessary to support the long-term viability of the system – none are truly “surplus” or “excess.”<sup>59</sup>*

Taxpayers not covered by such generous defined-benefit plans may sense a certain unfairness in the 13<sup>th</sup> check. Taxpayers, who ultimately pay for the government employees’ pensions, bear all of the costs when

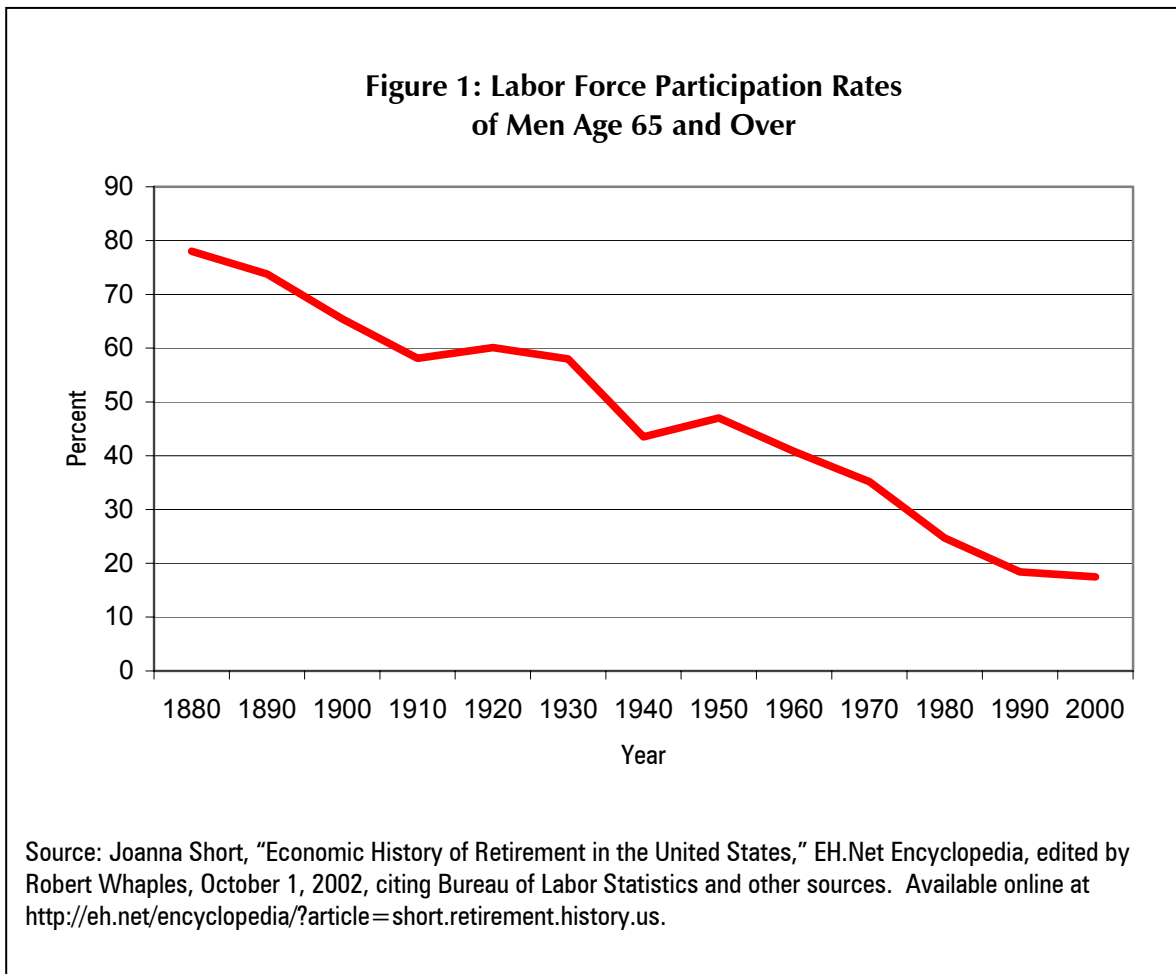
the pension fund's returns are down and the system's liabilities exceed its costs. Then even when the fund performs well, they do not get a break because the "excess" benefits are disbursed to government employees. In short, taxpayers bear all of the costs and enjoy none of the benefits while government employees bear none of the risk and enjoy all of the benefits.

### 6. Encouraging Early Retirement

In addition to increasing life spans, retirements are getting longer because people are simply choosing to retire sooner. This is often fueled by policy decisions that encourage early retirement.

The leisurely retirement is a relatively new phenomenon. Throughout most of the 19<sup>th</sup> century, people essentially worked until they died. It was generally understood that when parents could no longer work to support themselves, they would spend their remaining days living with their children. Nearly half of retired men lived with children or other relatives in 1880, but today, fewer than 5 percent do.<sup>60</sup>

Since that time, the percentage of men age 65 and over still participating in the workforce has steadily declined, remaining fairly stagnant only from 1910 through 1930. In 1880, 78 percent of men 65 and older were still a part of the labor force. By 2000, the figure had dropped to 17.5 percent.



The changing role of retirement to luxury reserved only for the wealthy to expected reward has come about primarily due to wealth creation. Real income, health standards, and the standard of living in general have all risen, and the price of leisure has gotten relatively cheaper. If health-care costs continue to rise as they have in recent years, and if the demand for longer and longer retirement periods continues to increase, the price of leisure may become too high, however. More people would then choose to remain in the labor market longer, thus reversing the trend. They may not be able to afford not to.

Government employees are being encouraged to retire sooner and sooner while pension costs continue to rise. Taxpayers who are experiencing cutbacks in their own retirement plans, though, will grow increasingly resentful if government employees do not share some of the burden. As a *Pasadena Star-News* editorial astutely observes, “the gulf is widening between government employees’ benefits and those of the taxpayers who pay for them. That can’t continue indefinitely without spawning a taxpayer revolt.”<sup>61</sup>

### ***7. Pension Obligation Bonds***

The idea of issuing bonds to pay for current and future pension liabilities originated in 1986 when Los Angeles County first issued over \$460 million in pension obligation bonds. In the ensuing 17 years, states and municipalities would issue approximately \$31 billion of such bonds.<sup>62</sup> While issuing pension obligation bonds is often sold as refinancing a debt, “At its heart, it is a risky arbitrage transaction,” warns a report from Sage Advisory Services.<sup>63</sup> This is because the government issuer must gamble that the pension fund’s investment return will exceed the payments it must make on the bonds, typically at least 6 percent. This might have been a safer bet during the market run-up of the late 1990s, but it is far from certain in today’s markets. As one columnist noted:

*Most of the municipalities that sold POBs [pension obligation bonds] to achieve actuarial nirvana are worse off than they were. They lost the money they raised through the bond sales, and then some. They have to make more contributions to their pension plans, and they now have to pay debt service.*<sup>64</sup>

The idea of issuing one debt to pay another, particularly when issuing bonds to pay an annual operating expense, is poor fiscal policy. Pension obligation bonds are a short-term solution to a long-term problem—this is effectively the same as a family using a credit card to pay utilities because they don’t have enough money at the end of the month and, in the process, run up credit debt with increasing minimum payments. Not only has the credit bailout not addressed the underlying mismatch in revenues and expenditures, it has also contributed to higher minimum payments (in the case of pension bonds, this is new debt service). At the end of the day, the family that follows this strategy is actually worse off. Elected officials must abandon the idea of pension obligation bonds and learn to make difficult decisions to meet their pension obligations.

### ***8. Mixing Politics and Investing***

The primary obligation of retirement boards is the maximization of their own “shareholder” value—that is, seeking and earning the highest rate of return for their members. Increasingly, however, government pension bodies have been accused of advancing political agendas, even at the expense of their shareholders. This is particularly true of very large, high-profile plans like the California Public Employees’ Retirement System (CalPERS), which maintains a gargantuan investment portfolio to leverage.



In recent years, CalPERS has taken positions to punish firms that compete with government employees, foster the development of “environmentally-friendly” technologies, and even put pressure on a grocery company involved in a labor dispute with the CalPERS president’s union. In its latest controversy, CalPERS was accused of violating a state law that bars the use of public funds for campaigning when it created a “Pension Debate Information Center” that characterized pension reform efforts as the largest threat to CalPERS and presented what critics believed was one-sided information and “inflammatory language.”<sup>65</sup> Since legal action was threatened against the CalPERS, they substantially changed the Web site.

Similarly, the New York City Employees’ Retirement System (NYCERS), which controls \$85 billion in investments, has enjoyed the ability to push its financial weight around to obtain political objectives. Three of the retirement system’s trustees—including members of the Teamsters, Transport Workers Union, and the American Federation of State, County, and Municipal Employees—recently issued a not-so-subtle warning to JPMorgan Chase and several other top Wall Street firms: don’t support President Bush’s push for “private” Social Security accounts (or contribute to lobbying firms that do) or else risk losing the hundreds of millions of fees you earn each year for managing public-pension funds.<sup>66</sup> Like CalPERS, NYCERS has adopted an anti-privatization rule that prohibits investment in firms whose services could “have the potential of eliminating public-sector jobs.”<sup>67</sup>

The above examples illustrate the inherent conflict of interest of government retirement system trustees. When political appointees, rather than individuals, manage investments, serving the interests of the beneficiaries and maximizing the health of the pension system take a back seat to pursuing political goals. When governing bodies pursue such strategies, they violate the trust of their beneficiaries not only by sacrificing better investments and better returns, but also by advancing causes with which many beneficiaries may disagree.

### ***9. Failing to Match Assets to Liabilities***

While pension systems assert that the growth in unfunded liabilities is largely the result of market downturns, it is also a result of poor investment strategies that “let ride” the gains they enjoyed in earlier market run-ups. A good analogy is playing blackjack and winning a series of hands. One strategy calls for taking some of these winnings off the table and locking them up (in investment terms, this means cashing out some stock holdings and converting them to low-risk bonds and other instruments, matched for maturity to future liabilities). It should, thus, come as no surprise that in the aggregate, government employee pensions were fully funded as late as Fiscal Year 2001, but by FY 2003, the aggregate funding level had declined to 91.1 percent.<sup>68</sup>

Instead of pulling some of the winnings off the table, many pension systems let their returns ride, leaving the money on the table. When the table eventually goes cold (and the market drops), they lose the previous returns. A sensible strategy of locking in some of the high returns would ensure that the systems can survive the downturns in the market. However, cashing out stock holdings also prevents pension systems from leveraging their portfolio strength for other, non-investment related purposes.

## Part 3

# Defined-Contribution Plans: A Solution to the Pension Problem?

## A. Defined-Contribution Plan Overview

As the name implies, the main difference between defined-contribution pension plans and defined-benefit plans is that defined-contribution plans spell out the level of contributions employers and employees will make to the retirement system, while defined-benefit plans detail the level of benefits employers will be required to provide employees upon retirement. Therefore, in contrast to defined-benefit plans, defined-contribution plans do not offer employees any guaranteed level of benefits. Instead, both the employer and employee make tax-deferred contributions to individual retirement accounts that the employee controls. The level of benefits the employee receives upon retirement depends on the performance of his or her investment portfolio, as well as his or her level of participation. Employees thus bear the risk of their investments, but also get to maintain control of these investments, assigning their own levels of risk and relying upon whichever financial professionals they choose, if any, for financial advice and portfolio management. Note also that, under a defined-contribution plan, when investments perform especially well, beneficiaries realize higher benefits. Under a defined-benefit plan, by contrast, better investment performance merely means that employers and employees invest less in the system (through contributions).

After the employee is vested in the plan (defined-contribution plans typically have a shorter vesting period than defined-benefit plans), the employee may transfer, or “roll over,” his retirement account to future jobs. Upon the retiree’s death, the retirement account’s assets may be passed on to the retiree’s heirs. It is also worth noting that defined-contribution plan participants are eligible to receive Social Security benefits on top of their individual retirement accounts, whereas many defined-benefit plan participants are not.

## B. Trends: The Growing Popularity of Defined-Contribution Plans

Private-sector pension plans have had to face the same demographic pressures and rising pension and health-care costs as have government plans. The difference has been in how they have reacted to these rising costs. While private-sector firms must compete with each other and offer attractive compensation packages—including pension benefits—to entice the best-qualified workers to work for them, they are also constrained by the need to control costs and maintain profitability. Government does not face this efficiency/profitability constraint, as governments can simply raise taxes, issue bonds, or sacrifice service quality (government is the ultimate monopolist and generally does not face any competition to maintain any particular level of service;

service quality is determined instead by available budgetary resources and public officials' tolerance for public complaints). Hence, governments have been much slower than the private sector to react to rising pension costs.

That said, defined-contribution plans have been growing in popularity within both the private sector and the government. They first caught on with the private sector, but soaring pension and health-care costs, combined with the unpredictability of contribution levels associated with defined-benefit plans, have caused the government to take a closer look at them as well in recent years.

### *1. Private-Sector Trends*

Where defined-benefit plans were once the only option for employers wishing to offer pension benefits to their employees, they are now rather scarce in the private sector. In fact, the private-sector defined-benefit plan is now often referred to as a “dinosaur”<sup>69</sup> or a “relic.”<sup>70</sup> Said Donald Straszheim, president of Straszheim Global Advisors, “I cannot think of a single company that has started a new defined-benefit plan in the last few years. No new companies are starting them, and I would guess that’s been the case since at least 1990.”<sup>71</sup>

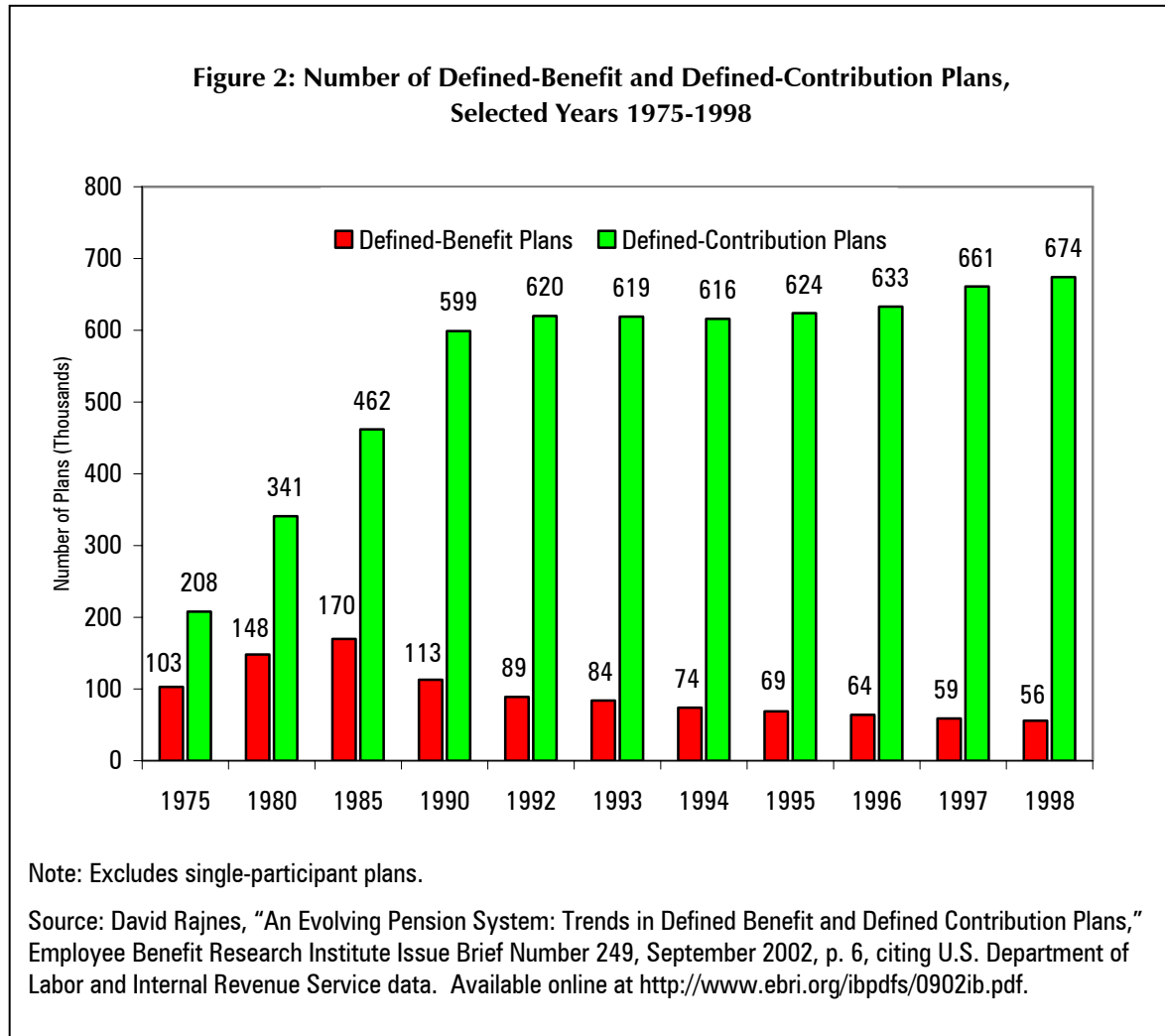
In addition to the significant costs associated with defined-benefit plans, the plans have fallen out of favor because they are viewed as outdated and unsuitable for an increasingly mobile workforce. Employees no longer tend to stay with a single company for decades at a time, but rather tend to switch jobs several times during their careers. Employers in certain industries such as high technology may even encourage this higher turnover, as younger employees with the most recent training on the newest technologies may actually be more valuable than more experienced employees trained on older technologies.

The relatively few firms that have maintained traditional benefit plans are those in industries with large union presence, such as the steel, airline, and automobile industries. Not coincidentally, these are the industries struggling most with rising pension costs, as evidenced by the plight of firms like Bethlehem Steel, National Steel Corp., United Airlines, US Airways, and General Motors. The fact that historically solid blue-chip firms such as General Electric and IBM have abandoned their traditional defined-benefit plans should offer an indication of the future of the traditional pension plan.<sup>72</sup> Indeed, many firms that do continue to offer defined-benefit plans are rapidly “freezing” these plans, or closing them to new employees, and instead offering new employees a defined-contribution plan such as a 401(k). Once a plan is frozen, older workers are promised the level of benefits they have accrued to date under the old plan, but may not build up additional benefits in the future.

Other firms have even terminated their pension plans altogether. In these cases, the company must still pay all the benefits employees have accumulated under the plan. This payment can be made as a lump sum or through the purchase of an appropriate annuity for the employee from an insurance company.

The trend toward defined-contribution plans has been substantial. The popularity of defined-contribution retirement plans has boomed since ERISA became effective in 1975. In 1975, approximately 28 percent of all private-sector, tax-qualified retirement plan assets were held in defined-contribution plans. This rate remained fairly unchanged until the early 1980s when the emergence of 401(k) plans began a dramatic increase in defined-contribution assets.<sup>73</sup> This percentage rose steadily and consistently until 1998, when more than 52 percent of all private plan assets were held in defined-contribution plans, before leveling off somewhat.<sup>74</sup>

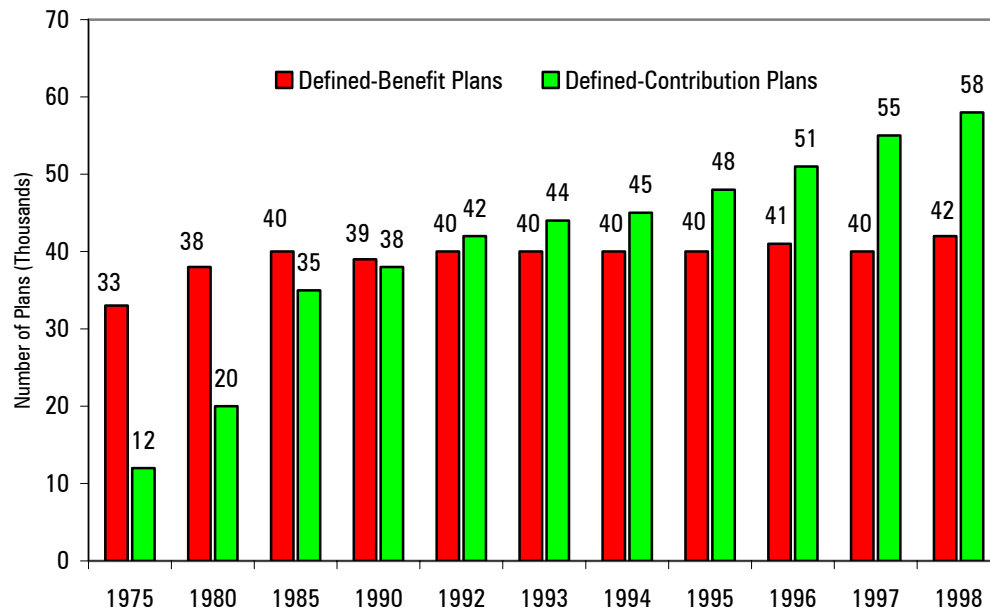
The number of defined-contribution plans has likewise risen, from approximately 208,000 in 1975 to 674,000 in 1998 (most recent U.S. Department of Labor and Internal Revenue Service Form 5500 data). Over the same period, the number of private-sector defined-benefit plans has fallen from 103,000 to 56,000 (see Figure 2). In the six-plus years since then, that number has been cut almost in half. According to the PBGC, the number of private-sector defined-benefit plans is now down to roughly 31,000.<sup>75</sup>



The number of participants in defined-contribution plans has similarly skyrocketed, increasing from 12 million in 1975 to 58 million in 1998. The number of participants in defined-contribution plans exceeded those in defined-benefit plans for the first time in 1992. While the number of defined-benefit plans has been reduced almost in half over the last 30 years, as noted above, the number of participants in defined-benefit plans has remained about the same since the early- to mid-1980s. The number of participants in these plans rose from 33 million in 1975 to 38 million in 1980 and 40 million in 1985 and remained fairly constant through 1998, when 42 million people were enrolled in private-sector defined-benefit plans (see Figure 3).

Even just since 1992, the percentage of heads of household participating in defined-contribution plans increased from 57.8 percent to 78.7 percent in 2001, and has remained about the same since then. By contrast, the percentage of heads of household participating in defined-benefit plans fell from 59.3 percent in 1992 to 38.4 percent in 2001.<sup>76</sup>

**Figure 3: Total Participation in Defined-Benefit and Defined-Contribution Plans, Selected Years 1975-1998**



Note: Includes active, retired, and separated vested participants not yet in pay status. Not adjusted for double counting of individuals participating in more than one plan.

Source: David Rajnes, "An Evolving Pension System: Trends in Defined Benefit and Defined Contribution Plans," Employee Benefit Research Institute Issue Brief Number 249, September 2002, p. 6, citing U.S. Department of Labor and Internal Revenue Service data. Available online at <http://www.ebri.org/ibpdfs/0902ib.pdf>.

## 2. Government Trends

Government interest in defined-contribution plans is more recent than in the private sector, which, as noted above, has been steadily moving in this direction for the past three decades. As noted previously, defined-benefit plans are most popular where there is heavy union presence, so it should come as no surprise that "90 percent of state and local government employees participate in a *defined benefit* (DB) plan as their primary retirement benefit."<sup>77</sup> Nevertheless, as private-sector plans have been forced to scale back benefits in accordance with demographic and economic trends, pressure has grown on the public sector to do likewise. Taxpayers have become increasingly upset with lawmakers granting significant benefit increases to government employees—and saddling them with the bills for these increases—while they have been forced to do with less. As Steve Frates of the Rose Institute for State and Local Government at Claremont McKenna College offers, "People are looking next door, seeing that their 50-year-old neighbor who is in good health and works for the government is retiring with a pension of \$80,000 or \$90,000 for the rest of his life. That is sticking many taxpayers in the craw."<sup>78</sup>

There are signs that taxpayer frustrations and fiscal realities are now boiling over. In recent months, California has become ground zero in the battle over government defined-benefit plans. Governor Schwarzenegger brought the issue to the forefront when he argued in his 2005 State of the State Address:

“For new employees, we must move from a defined benefit to a defined contribution system. We need a public pension system that is fair to employees and to taxpayers.”<sup>79</sup> In an interview with the *San Francisco Chronicle*, Schwarzenegger explained why he thought such pension reform is necessary: “I felt we could do better than to promise people the world when we cannot deliver.”<sup>80</sup> California’s non-partisan Legislative Analyst’s Office has similarly called for the state to consider switching to a defined-contribution plan to limit costs to the state and offer employees a more portable pension plan option.<sup>81</sup>

The efforts to reform California’s pension system have gone beyond mere rhetoric, though. State Assemblyman Keith Richman offered a plan, Assembly Constitutional Amendment 5, in December 2004 that would have switched the state’s pension system to a defined-contribution model. Under the proposal, all state employees hired after July 1, 2007, would have been enrolled in a 401(k)-style plan. Those hired before that date would be given the choice to continue to accrue benefits under their current plan or transfer the present value of their accrued benefits to the new defined-contribution plan.<sup>82</sup>

Governor Schwarzenegger supported a plan like Richman’s and prepared to place a proposition before the voters to switch to a defined-contribution system for future employees. However, public-safety unions utilized a controversial ruling by Attorney General Bill Lockyer that suggested the proposal did not explicitly protect death and disability benefits and thus would result in their elimination. Governor Schwarzenegger claimed that this was not his intention and the initiative did not have this effect. In spite of the fact that his proposal had already garnered 400,000 signatures, he pulled the measure to improve the language. A revised measure could appear on the June 2006 ballot if the legislature does not act before then.<sup>83</sup>

In response, Assemblyman Richman rewrote his proposal and has now introduced ACAX1 8. In addition to providing for death and disability benefits, the proposal would create a defined-contribution retirement plan and a hybrid plan consisting of both a defined-benefit and a defined-contribution plan. New employees hired after June 30, 2007, would have the option of joining either the defined-contribution or the hybrid plan, but would be prohibited from joining the existing defined-benefit plan. In addition, government employer contributions would be capped at a certain percentage of each employee’s salary (and would vary to allow higher contribution levels for public-safety employees) and could only be increased with the approval of the voters.<sup>84</sup>

Since the measure would require a change in the state’s constitution, it will need to receive a two-thirds vote of each house, as well as the majority approval of the public in a statewide election. Richman has acknowledged that it will be an uphill battle to ratify the proposal, citing “vehement opposition” from government employee labor unions.<sup>85</sup>

If California were to move to a defined-contribution pension system, it would hardly be the first state to do so. Numerous states—including Colorado, Florida, Louisiana, Maine, Michigan, Montana, Ohio, Oregon, South Carolina, Vermont, Virginia, and Washington—already offer defined-contribution plans to at least some of their state employees.<sup>86</sup> Some states have switched completely from their traditional plans to defined-contribution plans while others offer defined-contribution plans as an option in addition to existing defined-benefit plans. Consider the following examples of government defined-contribution plans:<sup>87</sup>

1. **Michigan.** All employees hired after March 3, 1997 have belonged to a defined-contribution plan in Michigan. The government employers (departments, agencies, etc.) contribute 4 percent of the employee’s salary to the plan and will match employee contributions of an additional 3 percent.

2. **Florida.** Florida began offering a defined-contribution plan in addition to its traditional plan in 2002. Employees were given the option of remaining in the existing defined-benefit plan, transferring accumulated benefits to the defined-contribution plan, or keeping their accrued balance in the old plan but directing all future contributions to the defined-contribution plan. Employees do not contribute anything to either plan. For 2004, state employers contributed 6.2 percent to the defined-benefit plan and 9 percent to the defined-contribution plan for regular employees.

The defined-contribution plan is taking time to catch on, but has been gaining in popularity. While only 4 to 5 percent of employees switched to the new plan—attributable, at least in part, to the timing of the plan’s introduction near the end of the bear market—new employee participation in the defined-contribution plan has increased from 8 percent in mid-2003 to 19 percent for the first half of 2004.

3. **Oregon.** While Florida began offering its defined-contribution plan mostly to provide its employees a greater choice in their retirement plans, Oregon chose to revamp its pension system to save money. State employees hired after August 29, 2003, participate in both a defined-contribution *and* a new defined-benefit plan. Now all employee contributions go into the defined-contribution plans and all employer contributions are made to a scaled-down defined-benefit plan. According to legislative analysts, the new pension plan will save an estimated \$7 billion over 30 years. Some of these savings are now in doubt with recent court rulings that invalidated portions of the reform.<sup>88</sup>
4. **Nebraska.** Nebraska became the first state to shift to defined-contribution benefit when the State Employees’ Retirement Plan was initiated as a defined-contribution plan in 1964. (Teachers, judges, and highway patrol officers remained on defined-benefit plans.) The state then switched from its defined-contribution plan to a cash-balance plan (a defined-benefit plan with some defined-contribution plan features—see the Cash-Balance Plans box for a more detailed discussion of cash-balance plans) in 2002 (effective January 1, 2003) after a study conducted in 2000 revealed that those in the defined-contribution plan achieved a 6 to 7 percent average annual return versus 11 percent for the defined-benefit (state-managed) plans over a 30-year period.<sup>89</sup> It would appear that the three bad years in the stock market (2000-2002) were the final straw. Under the cash-balance plan, beneficiaries are guaranteed a minimum return of the greater of 5 percent or the federal mid-term rate plus 1.5 percent.<sup>90</sup>

Tellingly, however, there has not been an exodus from the defined-contribution plan. In fact, approximately 70 percent of the members of the defined-contribution plan chose to remain under that plan when the cash-balance plan went into effect.<sup>91</sup> If the defined-contribution plan was so disastrous, as critics claimed, many more people would have switched out of the plan. Apparently, people value the freedom to make their own retirement investment decisions.

5. **Alaska.** Alaska is currently debating a switch to a defined-contribution retirement plan for new state employees. The state’s pension system has an estimated unfunded liability of \$5.6 billion.<sup>92</sup> The system has been strained by double-digit increases in medical costs and poor investment returns. Since 2001, the Public Employees Retirement System (PERS) and Teachers’ Retirement System (TRS) boards have assumed an investment return rate of 8.25 percent, but they lost at least 5 percent in both 2001 and 2002.<sup>93</sup> In addition, from 1999-2001, the pension boards assumed that medical costs would increase between 5 and 6 percent a year. Instead, they shot up between 15 and 20 percent in each of those years. Moreover, medical costs comprise 40 percent of PERS’s liabilities and 28 percent of TRS’s liabilities.<sup>94</sup> The transition to a defined-contribution system is seen as a way to stem the tide of these rising costs and instill a measure of predictability to the state’s contribution requirements. The reform was generally welcomed by the state’s municipalities, which have been suffocated by tight budgets and costly retirement payments to the state, and the Alaska Conference of Mayors supports the bill.<sup>95</sup>

### Cash-Balance Plans: A DB-DC Hybrid

Another form of pension plan that has gained in popularity in recent years is the “cash-balance” plan. Cash-balance plans are a form of defined-benefit plan but are often described as a hybrid between defined-benefit and defined-contribution plans because they mimic or borrow some features of defined-contribution plans. Like a traditional defined-benefit plan, cash-balance plans guarantee workers a certain benefit level and the employer bears the risk of ensuring proper plan funding. Like defined-contribution plans, however, cash-balance plans are portable, and balances can be paid out as lump sums when an employee leaves his or her job. Workers can track the growth of their money in individual accounts, although these accounts are merely hypothetical and employees cannot control the investments since the money is still centrally managed (potentially giving them a false sense of control). In addition, employees typically do not make contributions to cash-balance plans.

With a cash-balance plan, benefits are calculated based solely on the employee’s salary (age and years of service with the company are not factored into the calculation) plus an interest credit. Upon retirement, workers can elect to take their benefits as a lump sum or in the form of a lifetime annuity. Note that employees who have remained with the same company for a long time do not realize escalating benefit levels the longer they stay at the company like they would under a traditional defined-benefit plan. This has led some federal courts to rule that a switch from a traditional defined-benefit plan to a cash-balance plan is discriminatory toward older workers because equal pay credits for younger workers have a longer period of time to earn interest and accrue benefits before retirement than the same pay credits for older workers (see the reference to the 2003 IBM decision below). Other courts have ruled that cash-balance plans are *not* discriminatory, however, so the plans’ status remains an open legal question.

The Federal Reserve Bank of Dallas describes the history of cash-balance pension plans:

*[O]ver the past 20 years companies have shifted from traditional defined benefit to either cash balance or defined contribution pension plans. The first conversion from a traditional defined benefit to a cash balance plan occurred in the mid-1980s. More recently, this shift has accelerated as the economy softened and employers faced increasingly burdensome administrative and regulatory costs. By the late 1990s, approximately 11 percent of all traditional defined benefit plans had converted to cash balance plans, and they now account for an estimated 40 percent of all defined benefit assets.*

*Converting from a traditional defined benefit to a cash balance plan has tax advantages over switching to a defined contribution plan or terminating the plan altogether. If a traditional defined benefit plan is overfunded (most plans do not convert unless they are fully funded), nontrivial taxes must be paid if the plan is converted to a defined contribution plan. In contrast, if a firm has an overfunded pension and converts to a cash balance plan, excess cash can be used toward a retiree health insurance program without triggering excise taxes.*

*Moving from a traditional to a cash balance plan is not without hurdles. The problems involved with IBM’s conversion in the 1990s received significant press, and the conversion was successfully challenged in court. Despite IBM’s experience, most firms converting to cash balance plans have done so successfully and with the support of workers and retirees.*

Excerpt from Federal Reserve Bank of Dallas, “Is the Pension System a Liability?” Southwest Economy, Issue 5, September/October 2004. Available online at <http://www.dallasfed.org/research/swe/2004/swe0405b.html>.



Not only would the proposal, Senate Bill 141, create a defined-contribution plan, it would also increase employee contributions by 0.5 percent per year until the employees' contribution rate equals the government's contribution rates. That would take about five years for PERS participants and six years for TRS participants.<sup>96</sup>

In order to put added pressure on other lawmakers to pass the measure, the state Senate made \$38 million of a proposed \$70 million increase in K-12 education spending contingent on the enactment of the defined-contribution plan. As of this writing, the legislation has passed the Senate and is under consideration in the House.<sup>97</sup>

Whether for cost savings, improved choice for current and potential state employees, or both, the move to defined-contribution plans is proving to be an attractive option for an increasing number of states. Given the growing cost pressures being put on government pension systems, this trend will likely continue—and accelerate—in the foreseeable future.

### C. Investment Returns of Defined-Contribution and Defined-Benefit Plans

The general consensus seems to be that the rate of return and level of benefits achieved by defined-benefit plans are better than those earned by defined-contribution plans, although there is some debate about the results. Consider, for example, some opinions on the topic:

*“Experts say ... that public pension plans tend to make better investment decisions than the average 401(k) holder because they are run by full-time investment professionals, while individual employees have a tendency on the whole to make more conservative investments.”<sup>98</sup>*

*“[T]he typical pension plan return exceeds the typical 401(k) return by 100-200 basis points and sometimes much more.”<sup>99</sup>*

*“[A]verage and median pension benefits are higher under defined contribution plans that [sic] for defined benefit plans.”<sup>100</sup>*

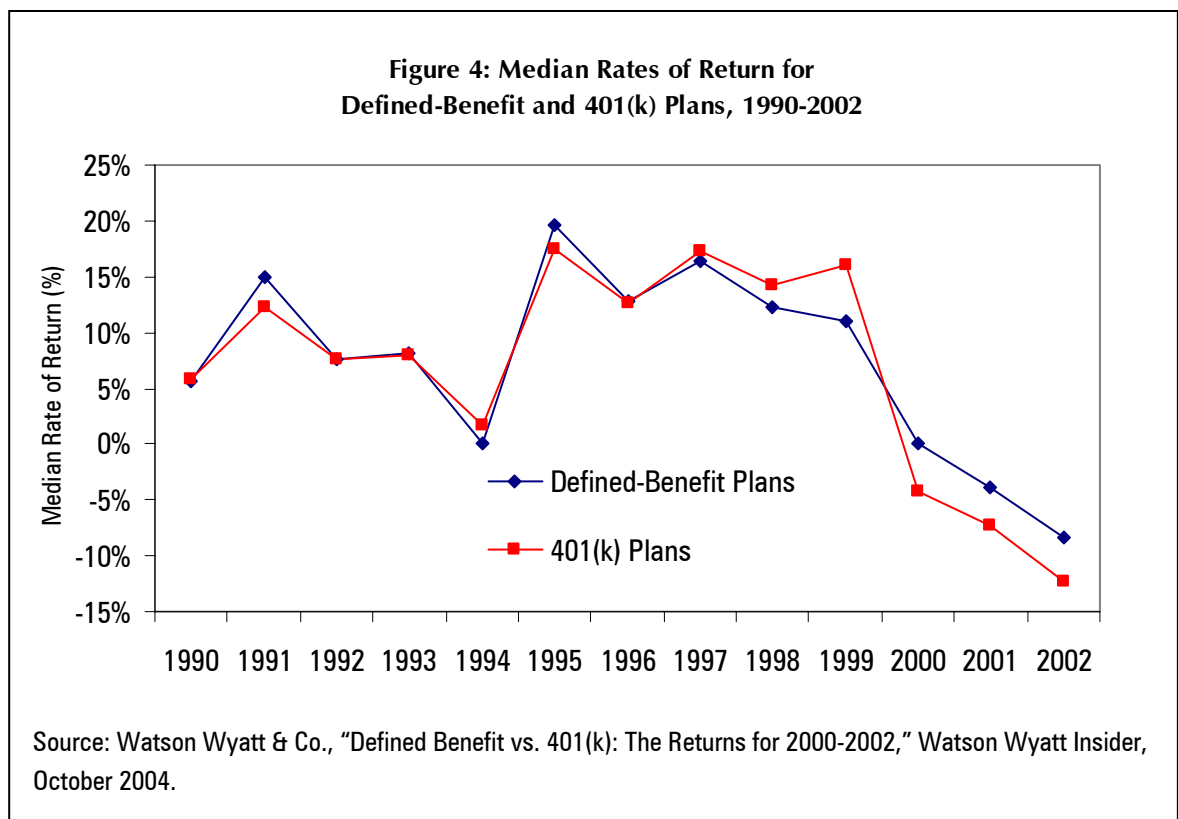
*“Defined benefit plans force participants into potentially underperforming investments (at least from any historical perspective) because fixed-income instruments are almost always used to fund defined benefit plans and better performance causes reductions in funding, not improved benefits. Defined contribution plans on the other hand are free to use equities, market timing and other more free-wheeling investment strategies. Historically, if defined benefit returns have been 5%, and more aggressive defined contribution investment strategy returns have been 9% (geometric mean average), a defined contribution participant could have some 50% more retirement benefits adjusted for all tax implications than a defined benefit participant. Even though the defined benefit tax-deductible contribution is greater its earnings are very likely to be much less.”<sup>101</sup>*

*“Financial experts say there is no clear-cut answer on whether workers will fare better on one of the programs [defined-contribution or defined-contribution]. It depends on the individual and a variety of factors such as frequency of job changes, they say.”<sup>102</sup>*

*“While it may be true that a snapshot at any point in time can produce favorable comparisons from either camp [defined-benefit or defined-contribution], the simple fact is that the average gross investment return is the same for all investors, regardless of the plan type chosen.”<sup>103</sup>*

In addition, data are somewhat limited and the relative youth of 401(k) plans makes any long-term comparison subject to sampling error. A search for comparative rates of return found no solid data between the early 1980s, when 401(k) plans truly emerged, and 1990.

Perhaps the most complete comparison of rates of return has been conducted by financial and employee benefits consulting firm Watson Wyatt & Co. According to Watson Wyatt's survey of Form 5500 data, the median rates of return for defined-benefit and 401(k) plans between 1990 and 2002 were 7.42 percent and 6.86 percent, respectively.<sup>104</sup> According to the Watson Wyatt study, defined-benefit plans performed better than 401(k) plans during the early- and mid-1990s. The 401(k)s outperformed defined-benefit plans during the late-1990s (the peak of the stock market run-up), but stock market downturn appeared to hit 401(k) plans a little harder than defined-benefit plans, which again beat 401(k)s during the market downturn of 2000-2002.



Other factors will affect net rates of return and benefit levels. Investment management expenses tend to be higher (in aggregate) under defined-contribution plans than defined-benefit plans because investments in defined-benefit plans are controlled by a single manager (or board), and thus benefit from economies of scale. Administrative costs may be higher or lower under a defined-contribution plan, depending upon the investment options made available to participants. In addition, retirement benefits realized from investment returns in private-sector defined-contribution plans are supplemented by Social Security benefits, which are not available to most government employees. Finally, the length of service and frequency with which one changes jobs (i.e., whether one remains at a job long enough to be vested in the retirement plan) could make a significant difference, particularly given the typically longer vesting periods of defined-benefit plans.

In short, the rate of return and level of benefits offered by defined-contribution plans may be greater or less than those offered by defined-benefit plans, depending on the time period analyzed (and timing of retirement *vis-à-vis* recent stock market performance), frequency of job changes and length of service at each job, available investment options, Social Security eligibility, and investment decisions made by defined-contribution participants. In any event, these returns are one of many retirement system considerations.

## D. Potential Advantages of Defined-Contribution Plans

### 1. Stability and Predictability of Contribution Levels

One of the greatest benefits of a defined-contribution plan, from an employer's perspective, is that it provides a great deal of stability since contribution levels (i.e., costs) are known in advance and do not change much from year to year. This is a sharp contrast to the volatility in contribution levels experienced under defined-benefit plans. In the government, this is particularly helpful in the budgeting process, as legislators—and the taxpayers on the hook for any funding shortfalls—do not have to worry about being surprised by greater-than-expected contribution requirements when the stock market sours and the pension fund's investment returns plummet. This added predictability of government finances eliminates the risk of unfunded liabilities and thus ensures full funding of the system.

Moreover, if lawmakers decide to increase benefits to government employees (which they still can do) it is transparent and cannot create overnight actuarial liabilities, as happened in California in 1999 (described in detail in the California case study in Part 5).

Critics often assert that shifting to defined-contribution plans would require government agencies to increase salaries of government employees to recruit a high-quality workforce. Though this assertion is questionable at best, the primary means of compensation *should* be the salary and not retirement benefits.

Salary levels are not protected constitutionally and can be modified as economic conditions change. Pension commitments are permanent and should be treated with appropriate care. It actually makes better fiscal sense to use salary levels as the principal means of attracting workers rather than long-term, unalterable pension benefits.

### 2. Choice for Workers

While the stability/predictability argument offers one of the strongest *practical* benefits of defined-contribution plans, perhaps the greatest *moral* benefit is that it allows employees the freedom to manage their own retirement accounts and invest their own money as they see fit.

Earlier we discussed whether defined-benefit or defined-contribution plans tend to offer greater rates of return to participants. Regardless of whether one type of plan performs slightly better than another type, one critical point that is often overlooked is that defined-contribution participants have the freedom to invest their money as they choose. The value one places on this freedom will vary from individual to individual and cannot be captured in investment fund performance comparisons. Moreover, risk levels and investment strategies change with age. Defined-contribution plans allow employees to choose growth-oriented

investments when they are young and then switch to more conservative investments as they approach retirement.

Government employee unions and other defined-benefit plan supporters sometimes claim that defined-contribution plans are inferior because, they argue, these plans will not generate enough income for retirees (a highly dubious conclusion on its face, as explained above). It is inflammatory to imply that people are unable to make their own financial decisions and plan their own lives (and thus the state or someone else must do it for them). As Assemblyman Richman explains, “What [these critics are] really saying is they don’t trust individuals to take care of themselves.”<sup>105</sup>

People have differing retirement needs and investment goals. They also have different levels of risk aversion. Defined-contribution plans offer individuals the freedom and the flexibility to tailor their investment strategies (aggressive, conservative, or some combination of the two) to best satisfy their unique requirements for themselves and their families, rather than forcing participants into a one-size-fits-all investment pool, which is the hallmark of a defined-benefit system.

### ***3. Portability***

Since employer retirement contributions are paid directly into individual accounts under a defined-contribution plan, it is easy for workers to take their accumulated funds with them when they change jobs. Upon the employee’s departure, both employer and employee contributions can be cashed out and “rolled over” to a future employer’s plan. Under a defined-benefit plan, by contrast, only employee contributions may be cashed out.

This portability is extremely appealing to employees in an age where the average worker switches jobs numerous times during his or her career. Bureau of Labor Statistics data illustrate the nature of today’s increasingly mobile workforce. In 2000, for example, the median job tenure was 4.7 years. For employees aged 25 to 34, it was only 2.6 years.<sup>106</sup>

In addition, the vesting period for defined-contribution plans is typically only a few years, whereas the vesting period for defined-benefit plans is often 10 years or more. Thus, government employees that might have otherwise been vested under a defined-contribution plan may leave their jobs before they are vested in their defined-benefit plans, thereby foregoing any retirement benefits and receiving only their own contributions plus interest. Indeed, this has been a widespread problem in California, where 70 percent of state and local government employees lose all employer contributions because they leave their jobs before satisfying the 10-year vesting requirement. In Michigan, 45 percent of state workers and 65 percent of public education employees effectively receive no benefits for this reason.<sup>107</sup> Furthermore, the portability of defined-contribution plans may be especially attractive to women who decide to leave their jobs in order to have children and cannot wait 10 years until they are vested before starting or expanding their families.

### ***4. Younger Worker Appeal***

As TIAA-CREF noted in a recent publication, shifting to a defined-contribution plan provides particular benefits to younger workers—a demographic government recruiters are desperately pursuing across the nation.

*In a defined contribution plan, contributions made at younger ages will have a longer investment horizon, potentially growing over many years. This is true even if employees terminate service after a few years, since accumulations continue to participate in the accounts' investment experience. In a traditional defined benefit plan, an employee's accrued benefit is generally frozen at the time he or she terminates employment. Even with moderate inflation, these benefits lose a great deal of their purchasing power by the time the employee begins retirement income.<sup>108</sup>*

These arguments are supported by various studies that demonstrate potential benefits in defined-contribution plans for younger workers, including higher long-term value of returns.<sup>109</sup>

### ***5. Rational and Individual Investment Choices***

No one has a greater interest in the proper investment of retirement funds than the future retiree himself. As discussed previously, government pension boards are inherently political bodies, whose investment decisions are often colored by political influence or ideology. Under a defined-contribution plan, depending upon the investment choices offered by the employer, the individual is free to invest in companies for the purpose of furthering a political ideology or cause—even if it means sacrificing greater returns—but others are not forced to suffer the consequences if such investments offend their values or post sub-par returns.

### ***6. Accountability and Transparency***

Since defined-contribution retirement accounts are managed by the participants themselves, and not a government pension board, there is complete accountability and transparency with regard to investment decisions; these decisions are simply the responsibility of the individual participant. Thus, there are no backroom deals, no conflicts of interest, and no need to worry about the lack of financial disclosure—all problems that have plagued the pension boards of government defined-benefit plans.

## Part 5

# Symptoms Revealed: Government Pension Case Studies

At the heart of the defined-benefit versus defined-contribution retirement plan debate is the question of who should shoulder the risks of ensuring that investment returns will be high enough to create a respectable post-retirement income—the employer (company or government) or the employee.

Increasingly, government officials are examining defined-contribution systems because a growing number of existing defined-benefit pension plans are in crisis—facing mounting unfunded liabilities that put significant budgetary strain on taxpayers. According to the *2004 Wilshire Report on State Retirement Systems: Funding Levels and Allocation*, the combined unfunded liability across state government pension systems more than doubled from \$180 million in 2002 to \$366 million in 2003. Sixteen states have unfunded pension liabilities larger than their annual state budget.<sup>110</sup> More frequently discussed, however, are the stories of individual pension systems struggling under the weight of massive liabilities.

Whenever these stories are raised in the context of pension reform, the typical response is to blame the decline in pension assets on the downturn in the market over the past few years and blame the increase in obligations and underfunding on poor decisions on the part of individual systems. However, a close look at the state of government pensions nationally reveals two things. First, while the individual health of pension systems does vary widely, unfunded liabilities are a system-wide phenomenon. According to the Wilshire Associates report, only two states had pension systems with greater assets than liabilities in 2003. Some, such as West Virginia, had assets to fund only 40 percent of the state's pension liabilities.<sup>111</sup> (See Figure 5 for a map depicting the states with the worst funding problems. See also Appendix A for a more detailed comparison of state pension system funding ratios and Appendix B for a comparison of city and county system funding ratios.) Second, upon reading of some of the most dramatic pension problems nationally, a clear pattern emerges. While economic losses over previous years did undermine pension assets, a common set of practices and pathologies is seen across systems that resulted in significantly increased liabilities. Chief among these is the rapid increase in retirement benefits granted to government employees. Between 2002 and 2003, pension assets declined 4 percent while liabilities increased by 6 percent over the same period.<sup>112</sup>

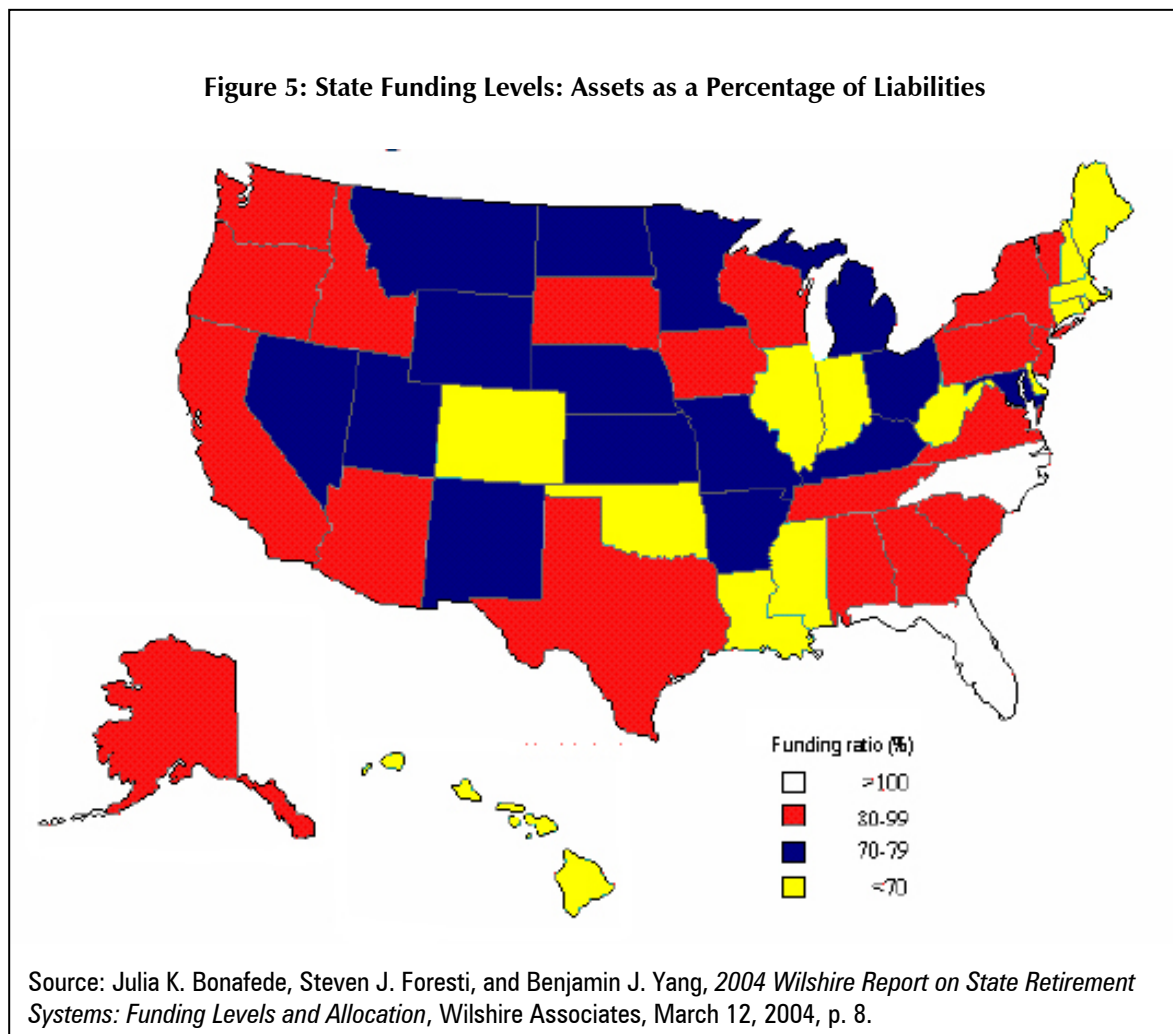
Another common pathology that has resulted in increased pension liabilities is the consistent underfunding of pension systems. Policymakers typically have short-term perspectives. Rarely does a lawmaker look out 20 years into the future for policy impacts. So it should be no surprise that it is common for policymakers to intentionally underfund pension systems. Since the actuarial liabilities will not materialize for years (usually long after elected officials have left office) and the decision to underfund a system in any given year will be

a one-time financial hit, policymakers actually have a perverse incentive to shortchange their pension contributions. And in some cases, this underfunding actually occurs in the very same years when market losses necessitate higher payments from the general fund to maintain actuarial balance. In other cases, pension obligations have resulted from either flawed assumptions or decisions to simply ignore actuarial warnings about the effects that various actions will have.

Presented below is a series of cases studies that represent a broad range of pension systems in crisis—from cities and counties to the most populous state in the nation, from the East Coast to the West Coast, and from the South to the Great Lakes. It is important to point out that these cases studies are merely a representative sampling of pension problems nationally. For each one, ten others could be found. (See Appendix C for a survey of cities, counties, states, and nations that have received significant news attention over the previous five months for their pension woes.)

At the root of this problem is a set of incentives that encourages pension liabilities within defined-benefit systems. Rewards for lavish benefit increases and reduced pension payments are enjoyed in the near term—either in the form of political support from unions or freed resources to spend elsewhere for reduced pension contributions—but the costs of poor decisions are paid out over decades, often long after the offending parties have left their positions of influence. Sadly, given the permanence of benefit promises in the eyes of the courts, there is little incoming lawmakers can do to change those existing liabilities other than pay them.

**Figure 5: State Funding Levels: Assets as a Percentage of Liabilities**



In reviewing these cases studies, the reader will see the common actions that resulted in the unfunded liabilities that the systems now must grapple with. From this will come a clear understanding why pension reform must include changing the incentives so that long-term obligations cannot be created which others will be asked to finance.

Immediately after this chapter of government pension case studies is a comprehensive analysis of pensions in the private sector, which are backed by the Pension Benefit Guaranty Corporation. It reaches the same conclusion—that neither the government nor private sector is immune to incentives that encourage increased liabilities and intentional underfunding.

### A. San Diego: A “Perfect Storm” of Financial Mismanagement

Not long ago, the city of San Diego was touted as one of the best-run cities in the country. In just a few short years, however, “America’s Finest City” has gone from being touted as one of the most efficiently run large cities in America<sup>113</sup> and the most efficient of California’s largest cities<sup>114</sup> to being dubbed the “Enron-by-the-Sea.”<sup>115</sup> The embarrassment caused by San Diego’s numerous financial troubles and investigations even prompted the city to remove the “most efficiently run big city in California” slogan from its Web site.

San Diego is now embroiled in its worst financial crisis ever. The \$3.6 billion San Diego City Employees Retirement System (SDCERS), which serves approximately 11,000 city employees and 5,700 retirees, is now operating with a deficit of more than \$1.4 billion,<sup>116</sup> with an additional \$1 billion in unfunded health-care costs.<sup>117</sup> As the *Los Angeles Times* reported in September 2004, “By underfunding its public employee pension program, the city is now so deeply in the red, critics assert, that without drastic action, pension payments will virtually suck the treasury dry.”<sup>118</sup> Indeed, according to the pension system’s actuary, “Liabilities have doubled in the past six years, and that’s higher than what we’ve typically seen in other cities.”<sup>119</sup> The crisis has even forced the city to consider municipal bankruptcy protection.<sup>120</sup>

The system has fallen from a funding ratio of 100 percent to just 67 percent in less than a decade.<sup>121</sup> The current underfunding is far below the accepted standard for California counties, which even allows for some measure of underfunding. Said Bob Palmer, 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 percent or better is well-funded.”<sup>122</sup> Even Palmer’s assessment may be a bit optimistic, though, as “Wall Street gets nervous when the level slips below 90%.”<sup>123</sup>

Because of its financial mismanagement, particularly with regard to the pension system, San Diego is currently the subject of numerous investigations. The FBI and the U.S. Attorney’s Office (Justice Department) are probing city finances and looking into potential public corruption. The Securities and Exchange Commission is studying whether accounting irregularities and the way the city disclosed its pension debt in financial documents related to municipal bonds constitutes securities fraud by city officials. These federal probes have been ongoing for the past 11 months. In addition, newly-elected City Attorney Michael Aguirre launched his own investigation, through his office’s Criminal Division, of the city’s financial disclosure practices related to the pension system.<sup>124</sup> In his recently issued report, Aguirre concluded that City Hall’s decisions to underfund the pension system while increasing benefits were illegal, and that some former members of the pension board who are also city employees violated the state’s conflict-of-interest law when they voted in 2002 to agree to underfund the system in exchange for benefit increases that enriched them financially.<sup>125</sup> Aguirre was also highly critical of special benefits that were awarded, including benefit increases specifically granted to four labor union presidents and the “purchase of



service credits” benefit.<sup>126</sup> The latter was instituted in 1997 to allow city employees to pay a percentage of their annual salaries in exchange for credit for a year of service that they did not work, up to maximum of five years, thus offering employees to boost their pension benefits while paying only a small portion of the added costs. (See Excessive Benefits text box for more information on the service credit benefit.) Aguirre has suggested that the mayor and some City Council members may have violated conflict-of-interest laws by taking advantage of the benefit.<sup>127</sup>

As San Diego’s recently created Pension Reform Committee reported, the city’s pension crisis is a “perfect storm” of financial mismanagement.<sup>128</sup> This perfect storm is 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 pension board that operates secretly behind closed doors.

### *1. History*

San Diego’s pension troubles started in 1996 when the city began underfunding the pension system. In 1996, then-City Manager Jack McGrory promoted a plan to take advantage of “historic returns” on Wall Street, where the Dow Jones Industrial Average had surged 33 percent the previous year.<sup>129</sup> 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 percent, the city would be forced to immediately return the system to full funding through a lump-sum payment.<sup>130</sup>

During the stock market boom of the late 1990s, returns were pouring into the pension system. Unfortunately, these gains were not to last forever and the city, like so many other jurisdictions, expanded government employee benefits without creating a reserve for the inevitable market meltdown. Once the market hit a downturn, it became apparent that existing contributions would not be enough to cover pension system expenses.

The pension fund’s poor financial condition is more than the just result of stock market slump, however. As April Boling, a certified public accountant and president of the San Diego County Taxpayers Association who also heads 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.”<sup>131</sup> The City Council refused to reduce benefits or offset the losses with increased payments to the pension fund from the general fund, as this would have affected city services in a way clearly – and immediately – visible to the general public.

Incredibly, after several years, the lesson still has not been learned and employee benefits have yet to be reined in. A measure passed by San Diego voters in November 2004 paved the way for the creation of a new pension board, purportedly comprised of more members without ties to the city. The new board began work in April, but it did not take long for the board to garner accusations of stonewalling. To the dismay of City Attorney Aguirre, City Manager Lamont Ewell, and several City Council members, the board refused to turn over confidential attorney-client information to federal investigators, thus preventing an examination that could finally clear the way for the completion of the city’s 2003 financial audit.<sup>132</sup>

## Excessive Benefits

The average San Diego city employee's pension has doubled over the last ten years.\* This is due, in large part, to several lavish benefits that have been added to an already generous retirement package.

### 1. Deferred Retirement Option Program

One of the 1990s benefits that has added to strained pension coffers is the Deferred Retirement Option Program (DROP), put in place in 1997 as a trial program and made permanent in 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 five years. The pay deposited into the DROP accounts earns a generous 8 percent rate of interest plus a 2 percent annual cost-of-living adjustment. In addition, once enrolled in the program, the only contribution employees make is a payment of 3.05 percent of their salary to DROP, which is matched by the city. According to Paul Barnett, assistant retirement administrator for SDCERS, this contribution is generally less than that of even the lowest-paying contributor to the regular pension plan.<sup>2</sup> Under DROP, some of the city's higher-paid employees have received nearly \$1 million upon retirement.<sup>3</sup> The purported purpose of the program is to retain experienced employees a bit longer, and thus to save on the costs of hiring and training replacement employees, but the program has proven – not surprisingly – extremely costly in its own right. Mayor Dick Murphy, who had endorsed the elimination of DROP during his recent re-election campaign, endured some embarrassing press recently when his own chief of staff, John Kern, enrolled in the program.<sup>4</sup> In a shameful and telling example of arrogance and disrespect for the taxpayers that pay city employees' salaries, it was recently revealed that one of Murphy's senior policy advisors received coaching from the city's human resources director (and former retirement board trustee) on how to maximize his retirement payout, including advice to take advantage of the DROP. After the advisor reported in an e-mail message that following his colleague's suggestions would allow him to retire at age 55 with benefits equal to 95 percent of his salary, the colleague replied, "So you've got your ticket to the 'gravy train.'"<sup>5</sup>

### 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 (up to a maximum of 5 years) than were actually worked. Employees who take advantage of this benefit can thus boost their retirement pay, which is based on a certain percentage of their salary multiplied by the number of years of employment, 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 is not the case in San Diego, however. San Diego employees are allowed to purchase their credits at a discount. City Attorney Michael Aguirre estimates that the program has cost the city \$120 million since its inception in 1997.<sup>6</sup> Mayor Murphy himself has taken advantage of the perk, as have six sitting City Council members. Murphy reportedly purchased the maximum of five years of credit at a cost of \$71,760, or \$14,352 per year. Assuming he finishes out his term in office, the benefit will increase his pension from \$42,000 per year to \$59,500 per year, a difference of \$17,500 per year.<sup>7</sup> Thus, his costs will be recovered in just over four years in retirement and he will continue to reap the extra \$17,500 a year for the rest of his life.

The pension system's actuary objected to the benefit due to its substantial subsidy to city employees and twice lobbied the pension board to amend it. The purchase price for service credits was eventually raised in late 2003 from 15 percent to 27 percent for general employees, and to 50 percent for elected officials. No council member has utilized the benefit since.<sup>8</sup>

### 3. The 13<sup>th</sup> Check

Yet another questionable benefit is the Annual Supplemental Benefit, or “13<sup>th</sup> check,” which is a contingent benefit paid in fiscal years when earnings in the pension fund are more than deemed necessary for that year’s expenses. The 13<sup>th</sup> check, which has been around since 1980, was issued again for fiscal year 2004 after being suspended due to insufficient investment earnings in FY 2003. Objections to the 13<sup>th</sup> 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 13<sup>th</sup> check may be issued following short-term market gains even while the system remains severely underfunded. As a *San Diego Union-Tribune* editorial asserts, the 13<sup>th</sup> check “is a huge added liability for which there is no identified source of income. Similarly, the health coverage provided to city retirees is carried off the books – that is, there is no identified source of funds to pay for it.”<sup>9</sup>

<sup>1</sup> Kimberly Edds, “San Diego Snarled in Web of Financial Woes,” *Washington Post*, September 13, 2004.

<sup>2</sup> Catherine Macrae Hockmuth, “Mayor’s chief of staff joins controversial pension program,” *Daily Transcript*, December 20, 2004.

<sup>3</sup> John Ritter, “San Diego now ‘Enron by the Sea,’” *USA TODAY*, October 24, 2004. See also Kimberly Edds, “San Diego Snarled in Web of Financial Woes,” *Washington Post*, September 13, 2004.

<sup>4</sup> Hockmuth, “Mayor’s chief of staff joins controversial pension program”.

<sup>5</sup> Kevin Christensen, “E-mail calling San Diego’s pension ‘gravy train’ irks critics,” *Daily Transcript*, March 25, 2005.

<sup>6</sup> Philip J. LaVelle, “Aguirre probes city officials’ benefit credits,” *San Diego Union-Tribune*, March 27, 2005.

<sup>7</sup> Andrew Donohue, “Figures Detail Controversial Pension Benefit: Purchased by Murphy, Several Council Members,” *Source of San Diego*, April 22, 2005.

<sup>8</sup> *Ibid.*

<sup>9</sup> “Stop the bleeding: Council must control runaway pension costs,” *San Diego Union-Tribune*, August 31, 2004.

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 percent 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* to a 75 percent funding ratio. That proposal was scrapped when the pension board’s attorney advised that it would not hold up in court.<sup>133</sup>

In November 2002, the pension board and the City Council overwhelmingly passed a revised Uberuaga plan that increased city employee benefits and restored the 82.3 percent threshold (but did not require the city to return to full funding of the system if that level was broken). In a telling move, the pension 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.<sup>134</sup>

## ***2. The Negative Effects of Union Influence***

Part of the City Council's inaction can be explained by undue labor union influence and pension board complicity. As observed in a recent *Los Angeles Times* article, "Every member of the council won election with the support of at least one labor union."<sup>135</sup> While the 2002 pension deal was being considered by the pension board, city officials threatened that they would abandon promised benefit increases unless the board passed the underfunding plan. Since several of the pension board trustees are city employees and labor representatives, this represented a clear conflict of interest. As such, attorney Michael Conger has threatened to sue city officials on behalf of Pension Reform Committee Chairwoman April Boling if the 2002 benefits are not rescinded.<sup>136</sup>

Another example of unwarranted labor influence on the 2002 pension deal was the set of special benefits awarded only to the presidents of the police, firefighters, and "white-collar" employee labor unions. As a *San Diego Union-Tribune* editorial describes 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."<sup>137</sup> Conger estimates the cost of the benefit to taxpayers at \$2 million. Ron Saathoff, president of Firefighters Local 145, for example, stands to receive an estimated pension of \$173,268 per year on a salary of only \$84,000.<sup>138</sup> Saathoff, incidentally, was the one that made the motion for the pension board's approval of the Uberuaga pension plan.

Also benefiting from the special benefits are 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 pension 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.*<sup>139</sup>

The conflict-of-interest issue is central to the ongoing U.S. Attorney's Office corruption investigation.

## ***3. 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 pension board trustee Diann Shipione, one of only two trustees to vote against the Uberuaga plan. Shipione blew the whistle on the pension scheme and shook the foundation of City Hall.

In May 2002, Shipione first attempted to bring the issue to the forefront in a letter to Mayor Murphy claiming financial irregularities and calling for a comprehensive audit of the pension fund. Her letter went unanswered.

In November, she unsuccessfully warned the pension board that the Uberuaga plan was a recipe for disaster. It was not until September 2003, however, that light was shed on the pension crisis when Shipione notified an attorney handling a municipal sewer bond sale that the city had been less-than-forthcoming about the pension system's liabilities, causing the bond issue to be canceled. 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."<sup>140</sup>

City officials responded to Shipione's insights not by undertaking serious introspection to see if there really was a serious problem with the pension system, but rather by lashing out at her. Shortly after the Uberuaga pension plan was adopted, then-Assistant City Manager Lamont Ewell sent a memo to Mayor Murphy and the City Council stating that Shipione had "omitted, slanted and misrepresented the facts."<sup>141</sup> The pension board did not treat Shipione any better. The board even purchased an ad in the *San Diego Union-Tribune* that sneered, "Chicken Little Would Be Proud."<sup>142</sup>

Members of the pension board even held a closed-door meeting without her knowledge during which they passed a resolution to ban Shipione from future closed sessions and voted to ask Mayor Murphy to remove her from the board (which he did not have the power to do before her term had expired). The other trustees even plotted to place her under citizen's arrest and turn her over to police, should she show up and attempt to participate in the meeting.<sup>143</sup>

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."<sup>144</sup> Shipione finally did receive her due recognition, however. On January 18, 2005, the San Diego Regional Chamber of Commerce honored her with its annual "Catalyst for Change" award for being "the lone board member to sound the alarm regarding the city's troubled pension system."<sup>145</sup>

#### **4. The Fallout**

San Diego's pension trouble began in earnest in the public eye when the first of several pension lawsuits was filed in January 2003 by former pension board President Jim Gleason and retiree Dave Wood. The suit alleged that the Uberuaga underfunding deal was illegal and tainted by conflicts of interest. The ball really got rolling after Shipione's revelations.

On January 27, 2004, 12 days after City Auditor Ed Ryan had announced his resignation, the city disclosed errors and omissions in its financial statements. City Manager Michael Uberuaga would follow Ryan's lead, resigning three months later. The FBI, SEC, and U.S. Attorney's Office responded by opening investigations. The SEC has issued numerous subpoenas for documents dating to 1996 and the sworn testimony of city officials.

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. In the meantime, the city's ability to issue debt to pay for large projects such as water and wastewater system improvements has been crippled. The lawsuit filed by Gleason and Wood was settled in July when the city agreed to fully fund the pension system beginning July 1, 2005 (the beginning of the fiscal year). San Diego hired major accounting and financial services firm KPMG to review the city's books, but in October KPMG informed the city that it would not issue its audit opinion until the

city conducted its own investigation and could provide assurances that “illegal acts” have not been committed by the city and its officials.<sup>146</sup>

The city hired Washington, D.C., law firm Vinson & Elkins L.L.P. to investigate the pension crisis. Vinson & Elkins issued its findings in September. Among them:

- “The city’s image as a model of fiscal responsibility has been seriously tarnished.”<sup>147</sup>
- “City disclosure since 1996 has failed to provide investors and other interested readers with adequate information to enable them to clearly understand the relationship between SDCERS and the City’s General Fund and to fully evaluate the creditworthiness of the City.”<sup>148</sup>
- The city government suffered from “decentralized responsibility, balkanization, and poor lines of communication.”<sup>149</sup>
- Communication among key city officials was virtually non-existent and the city bureaucracy operated in “an almost dysfunctional environment.”<sup>150</sup>
- Top city officials, such as former City Manager Michael Uberuaga and former City Auditor Ed Ryan, were deliberately ignorant of key financial details and elected officials had poor knowledge of the pension plan.
- The city’s inaccurate financial statements stemmed from “a remarkable lack of internal control.”<sup>151</sup>
- Sound financial management was discarded in favor of deference to “politically powerful” labor unions.<sup>152</sup>
- Self-interested pension board trustees provided inadequate oversight of the pension plan’s financial health.
- The city applied “the dangerous and widely misused concept of ‘surplus earnings’” and took a “minimalist approach to public disclosure” of negative information.<sup>153</sup>

While Vinson & Elkins found that the errors and omissions in city finances were the result of poor management, it did not find evidence of any criminal activity. As of this writing, KPMG has not found the evidence so exculpatory and has refused to proceed with the audit.

Shortly after being listed in TIME Magazine as one of the three worst mayors in the nation for his mismanagement of the pension system<sup>154</sup> Mayor Murphy announced his resignation, effective July 15.

## ***5. Conclusion***

The current pension crisis in San Diego did not come about because of any single cause. Rather, it was a confluence of mistakes and other causes: negligent and excessively risky financial management, profligate elected officials, poor communication among city officials, secretive closed-door pension board sessions, self-interested pension board trustees, union greed, alleged corruption, and a downturn in the stock market. The news is not entirely bleak, however. The city has taken some steps to address the issue. For example, the city has followed the Vinson & Elkins recommendation to implement financial reporting and internal controls requirements similar to those required of private businesses by the federal Sarbanes-Oxley Act of 2002, which was imposed in response to corporate scandals at Enron and other businesses. As the Vinson & Elkins report notes, San Diego is the first U.S. municipal government to adopt such measures. This despite the fact that

*Municipal governments are expressly exempt by statute from the reporting, internal controls and recordkeeping provisions applicable to public companies, including those added by the Sarbanes-Oxley Act of 2002, and their auditors are not subject to Section 10A of the Securities Exchange Act of 1934, which requires auditors of public companies to establish procedures to detect fraud and to report possible illegal acts they detect in the course of an audit.<sup>155</sup>*

It seems only fair that citizens have the right to demand that their municipalities live up to the same standards as the publicly-traded businesses they own or work for. Other municipalities should adopt these standards immediately.

After downplaying the pension crisis the city seems to be moving toward real reform. Mayor Murphy endorsed the elimination of the city's DROP. In addition, he has called for a two-year salary freeze for all city employees, an equalization of the city's and the employee's retirement contributions (requiring employees to cover a larger proportion of the contribution), and requiring that future meetings of the Retirement Board be televised in order to ensure transparency.<sup>156</sup>

The proposal to issue \$200 million in pension obligation bonds (presumably after the city's FY 2003 and 2004 audits have been finalized) is an idea that should be scrapped, however, as incurring more debt to pay off existing debt is also poor financial management.

One positive development is City Councilman Brian Maienschein's proposal to address the pension problem by ending lucrative benefits for all new employees and switch them to a defined-contribution plan.<sup>157</sup> Regrettably, even this would only keep the current situation from getting worse, and taxpayers will still have to pay for past financial mismanagement for years to come. Nevertheless, Maienschein's proposal is a very welcome sign that elected officials are finally coming to the realization that present benefit levels are unsustainable.

It is unfortunate that it has taken such a financial catastrophe to impel a little financial rationality and positive change. While San Diego has shown some signs of progress, much more work needs to be done to reduce pension benefits in order to correct the structural pension deficit without significantly affecting city services well into the future.

This brings us to an important point: financial profligacy and mismanagement prevent municipalities from focusing on higher-priority goals such as improving service delivery and quality of life. Ultimately, the people who suffer are the taxpayers and those that utilize city programs and services. As the Pension Reform Committee report noted, "The city has been borrowing against the future."<sup>158</sup>

## **B. Illinois: Mired in Pension Debt**

With an unfunded pension liability of \$35 billion at the end of FY 2004,<sup>159</sup> Illinois holds the dubious title of largest pension shortfall in the nation.

The state funds five pension systems, including the State Teachers' Retirement System (by far the largest with over 300,000 participants), State Universities Retirement System (145,000 participants), State Employees Retirement System (113,000 participants), and the relatively small pension funds for judges and the General Assembly.<sup>160</sup>

Between 2000 and 2002, the state's pension systems' assets fell by \$5.7 billion, while its liabilities jumped \$13.7 billion.<sup>161</sup> In 2002, state pension plans had an aggregate funding rate of 54 percent, compared to the 91 percent national average of all state pension plans.<sup>162</sup>

Mercer Consulting Group and Deloitte & Touche recently conducted an analysis of the state's pension funding troubles. The analysis showed that the pension system's deficit has increased by \$23 billion since 1995. Of this amount, \$10.6 billion (46 percent) was due to continued underfunding and \$5.8 billion (25 percent) was due to increased employee benefits. Only \$6.4 billion (28 percent) was attributable to investment losses.<sup>163</sup>

According to John Filan, budget director for Gov. Rod Blagojevich, the pension funding problem "is the single biggest financial challenge Illinois and this administration has, far outpacing Medicaid and everything else. This is an issue that will affect Illinois and its citizens for the next several decades."<sup>164</sup>

### ***1. Pension Contributions Monopolizing State Budgets***

Illinois's rising pension costs are taking up an increasingly large portion of the state budget. Pension contributions are crowding out appropriations for education, health care, and other government services. State pension costs are expected to rise by \$600 million next year to a total of \$2.6 billion. These cost increases are significantly greater than the estimated \$325 million in revenue growth. As columnist Kurt Erickson observes, "If those estimates are correct, there would not be enough money to pay the pension systems, let alone boost spending for other state programs, ranging from schools to bridges."<sup>165</sup>

Unfortunately, the news only gets bleaker. By 2010, the state's pension costs will be \$4 billion and, barring significant reform, will balloon to an astounding \$54 billion by 2045.<sup>166</sup> According to Rep. Robert Molano, one of the General Assembly's pension experts, "In coming years, we will have an unbearable burden for money we owe to the pension systems. All of our (revenue) growth will go to pensions. It will stagnate the state."<sup>167</sup>

In recent years, pension costs in Illinois have increased more rapidly than the tax base.<sup>168</sup> Governor Blagojevich's administration has pointed to this "structural deficit" as an explanation for the pension system's sorry financial state.<sup>169</sup> But Michael Van Winkle of the Illinois Policy Institute refutes the very notion of a "structural deficit":

*How can a state required to balance its budget each year run any kind of deficit, much less a "structural" one? The answer is that "structural deficit" is simply terminology used to describe a situation in which our political leadership seeks to spend more money than it brings in via tax and fee revenue.*

*Yet, because they are the ones controlling the spending, there is really nothing structural about the deficit; it's a deficit of choice. To put it bluntly, the "structural deficit" is merely an excuse dreamed up by the political leadership in lieu of reforming the way the state spends taxpayer money.<sup>170</sup>*

Mr. Van Winkle's point is that the government needs to prioritize rather than perpetuate the problem. Illinois legislators of both parties have lacked the willpower to make sound fiscal decisions over the course of several decades.



## ***2. A History of Underfunding***

While it has had its share of employee retirement benefit increases, Illinois's benefit levels are not as high as many other states. The state's problem lies instead in the simple act of underfunding its pension system. It is an issue that spans decades.

The serious underfunding began back during the 1980s. As one columnist reports, "From 1981 to 1990, the amount the state contributed to pensions increased only 17 percent, even though payroll (one component of pension costs) increased by 77 percent. Good investment returns over those years helped offset the state shortfall, but not entirely."<sup>171</sup>

J. Fred Giertz, a University of Illinois economics professor who analyzes government pension funding issues, argues: "Anyone should have known 20 years ago, when they underfunded the pensions, that these debts would come due."<sup>172</sup>

By 1989, debts had started to mount and legislators concluded that it was time for action. The General Assembly passed a bill that required the state to set aside annual payments to pay off the debt. Unfortunately, it did not authorize the money to make those payments, rendering the bill a hollow promise. It was not until 1995 that legislators undertook serious reform efforts.

## ***3. The 1995 Reform Effort***

After learning the lesson of 1989, legislators in 1995 passed a pension reform bill that included a continuing appropriation that would automatically make payments to the pension systems. The bill delineated a payment schedule that would return the pension funds to an estimated 90 percent funding ratio by 2045.

Since the state was then, as now, experiencing financial straits, the payment schedule was backloaded so that the plan would go into effect gradually. The 15-year "phase-in" period expires in 2010. This is the reason pension costs are expected to explode in the future.

Now the state is finding it extremely difficult to make even these payments. Thus, Governor Blagojevich is proposing to restructure the 1995 repayment plan.

## ***4. The Governor's Reform Efforts***

To his credit, Governor Blagojevich has engaged in a fairly aggressive effort to reduce the number of employees on the state payroll. Under his stewardship, the state workforce has shrunk by 10,000 to a little over 58,000 current employees.<sup>173</sup> This represents the lowest level in decades.<sup>174</sup>

In 2002, Governor Blagojevich established an early-retirement incentive plan, known as the Early Retirement Initiative, in order to reduce the state payroll. Regrettably, as Mr. Van Winkle reports,

*Instead of costing taxpayers \$70 million, it cost them \$382 million. A rough calculation tells us that if the state dumps 2,300 payroll jobs a year but pays \$382 million in early retirement pension contributions, taxpayers are paying about \$166,000 per position eliminated per year. This is just one example in which the "structural deficit" is a deficit of bad choices.<sup>175</sup>*

In April 2003, the state issued \$10 billion in pension obligation bonds to address a \$5 billion budget deficit and provide some temporary breathing room. The short-term relief they were supposed to provide has proved fleeting, however, and the state is still mired in unfunded pension liabilities—and now greater debt.

The governor's most recent budget proposal contains a number of pension reforms, including many of the recommendations of the Governor's Commission on State Pensions, a task force he created in 2004 to study the pension-funding problem and offer possible solutions. Among the governor's proposals are the following:

- Reduce pension and health-care benefits for future state employees, teachers, and state university workers;<sup>176</sup>
- Increase the minimum retirement age from 55 to 60 for new hires;<sup>177</sup>
- Adjust annual cost-of-living increases for new employees in accordance with inflation, with a maximum of 3 percent (instead of the automatic 3 percent per year increase state workers currently receive);<sup>178</sup>
- Prevent school districts from awarding generous end-of-career pay raises to employees (which boost employees' pensions, and thus costs to the state);<sup>179</sup>
- Require all future benefit increase proposals to identify a funding source to cover all of the associated costs of the increase; and<sup>180</sup>
- Require all new benefits to automatically expire after five years.<sup>181</sup>

State employee unions, such as the American Federation of State, County and Municipal Employees, Illinois Federation of Teachers, and Illinois Education Association, strongly oppose any attempt to introduce a "second tier" to the pension system that would provide lower benefits for new state employees.<sup>182</sup> In addition, school districts will certainly be reluctant to pick up the estimated \$149 million price tag<sup>183</sup> to cover the pay raises given to teachers near the end of their careers. But Teachers' Retirement System director Jon Bauman has made it known that he will go to the state comptroller and offset state aid payments to school districts if stubborn districts refuse to pay up. As Bauman notes, "I'll get the money one way or the other."<sup>184</sup> Moreover, not all school officials are cool to the idea. As South Beloit Superintendent Mike Duffy argues, "It goes back to local control. If a district wants to do a big payment like that to teachers they think have been doing a bang-up job, they should expect to pay for all of it themselves, not ask everyone (in the state) to do it."<sup>185</sup> Nevertheless, given the strength of the unions in Illinois, Blagojevich's proposal will doubtless be a difficult sell.

Also controversial is the governor's plan to use the anticipated \$800 million in savings (over 40 years) as justification for reducing the state's payments to the pension system below the levels required under the 1995 reform. But reducing payments in the face of increasing debt will not allow the state to get its head above water and will only make the problem worse in the future. Said state Rep. Mark Beaubien in response to this proposal, "We got into trouble in the first place because we shortchanged the pension systems for a number of years. I don't know that we want to go back there again."<sup>186</sup> In addition, the Commission on Government Forecasting and Accountability determined that, even if every plank of the governor's proposal is adopted, the savings next year would amount to only about \$81 million.<sup>187</sup> Given the substantial size of the funding deficit, it is thus premature for the state to use the \$800 million in anticipated savings as a rationale to continue to underfund the system. Said State University Retirement System director James Hacking, "The state is proposing to spend the savings before they have it."<sup>188</sup>

Moreover, according to Becky Caroll, spokeswoman for the governor’s budget office, the administration is still looking to solve the pension crisis with a series of small changes. Said Ms. Caroll, “A lot of tweaking can add up to a lot of savings.”<sup>189</sup> But with a \$35 billion unfunded liability, Illinois’s retirement systems are well beyond the point of “tweaking.” According to Mr. Hacking, these types of small reforms “might provide some political cover. But [they] won’t provide any long term, meaningful savings at all.”<sup>190</sup>

## 5. Conclusion

Illinois faces a deep pension crisis and requires reforms commensurate with the scope of the problem. The state’s pension obligations have clearly outpaced its means. Governor Blagojevich’s cost-cutting measures are a first step, but they will only put a small dent in the state’s pension deficit.

Unfortunately for taxpayers, the damage was done many years ago when legislators made pension promises that they did not bother to fund. The state constitution prevents legislators from reducing promised benefits. Going forward, the state must rein in benefits for new employees. There has been some talk of a shift to 401(k)-style retirement plans, but this option has not received the attention it deserves.

To offset its growing pension obligations, Illinois will have to make cuts—real cuts, not just lower-than-anticipated increases—in its budget for many years to come. The cuts will be painful, but they are necessary if the state is to regain control of its finances and avoid crippling future generations with debt.

## C. California: The Politics of Increasing Benefits and Managing Portfolios

California has built one of the most generous government pension systems in the nation. With that, of course, come significant costs. These costs have jumped substantially in recent years in the wake of greatly expanded benefits for government employees and a struggling stock market, which the system, through its \$172 billion investment fund, relies upon for a large portion of its funding. State contributions to the California Public Employees’ Retirement System (CalPERS) have skyrocketed from less than \$200 million in fiscal year 2000-01 to an estimated \$2.6 billion in 2004-05.<sup>191</sup> Contributions to the State Teachers’ Retirement System (CalSTRS), the state’s other major retirement fund, are expected to be an additional \$1.1 billion.<sup>192</sup> California’s non-partisan Legislative Analyst’s Office (LAO) estimates that retirement-related costs to the state will increase an additional \$1 billion over the next five years.<sup>193</sup> CalSTRS faces a \$24.4 billion unfunded liability.<sup>194</sup> The financial situation led Gov. Arnold Schwarzenegger to describe the state’s pension system as “another financial train on another track to disaster” in his 2005 State of the State Address.<sup>195</sup>

CalPERS is the largest government pension fund in the nation and the third-largest in the world.<sup>196</sup> The pension system was established by state law in 1931 to provide retirement benefits for state employees and now manages pension and health benefits for more than 1.4 million California employees, retirees, and their families.<sup>197</sup> It serves more than 2,500 employers, including state agencies, city and county governments, school districts, and special districts.<sup>198</sup> CalSTRS, with over 750,000 members and \$116 billion in assets, is the largest teachers’ retirement fund in the nation<sup>199</sup> and the third-largest government pension fund of any kind in the nation.<sup>200</sup>

Like government pension funds across the nation, CalPERS has suffered from the slumping stock market over the past several years. The fund posted losses in three consecutive (calendar) years from 2000 to 2002 before rebounding with a 23.3 percent return in 2003.<sup>201</sup> In 2004, the fund earned a 13.5 percent return.<sup>202</sup>

Though renowned for its strong stance on good corporate governance measures, CalPERS has come under fire in recent years for alleged cronyism and mixing of political agendas with investment objectives. Issues in just the past couple of years include the advancement of an ideological environmental agenda through the so-called “Green Wave” initiative, the highly-publicized ouster of CalPERS President and union official Sean Harrigan, the decision to double its investment in hedge funds (even CalSTRS has declined to invest in such risky funds due to their lack of regulation and transparency),<sup>203</sup> and the use of proxy battles to attack the boards of directors of companies such as Safeway, Disney, and Coca-Cola, which, incidentally, includes Warren Buffet, one of the most respected investors and financial minds in the industry.

**1. The Cost of Benefits**

**a) Retirement Plan Overview**

CalPERS offers several different defined-benefit retirement plans to different classes of government employees. These include two tiers for general or “miscellaneous” employees (Tier 2, which offers a lower level of benefits than Tier 1, was closed to new employees beginning in 2000; the higher-cost plan remains open to new employees), a plan for industrial workers, and separate plans for California Highway Patrol officers, peace officers and firefighters, and other safety workers.

<b>Table 2: State Retirement Plans</b>				
<b>Plans</b>	<b>Basic Benefit*</b>		<b>Employee Contribution***</b>	<b>2003-04 State Contribution</b>
	<b>Per Year of Service**</b>	<b>When Retiring at Age</b>		
Miscellaneous				
▪ Tier 1	2.0	55	5%	14.8%
▪ Tier 2	1.25	65	--	10.3
Industrial	2.0	55	5	11.1
Safety	2.5	55	6	21.9
Peace officer/Firefighter	3.0	55	8	20.3
Highway Patrol	3.0	50	8	32.7

\*Benefits vary by age with smaller percentages at younger ages and higher percentages at ages above these listed in some cases.

\*\*Percent of highest salary for 12 consecutive months.

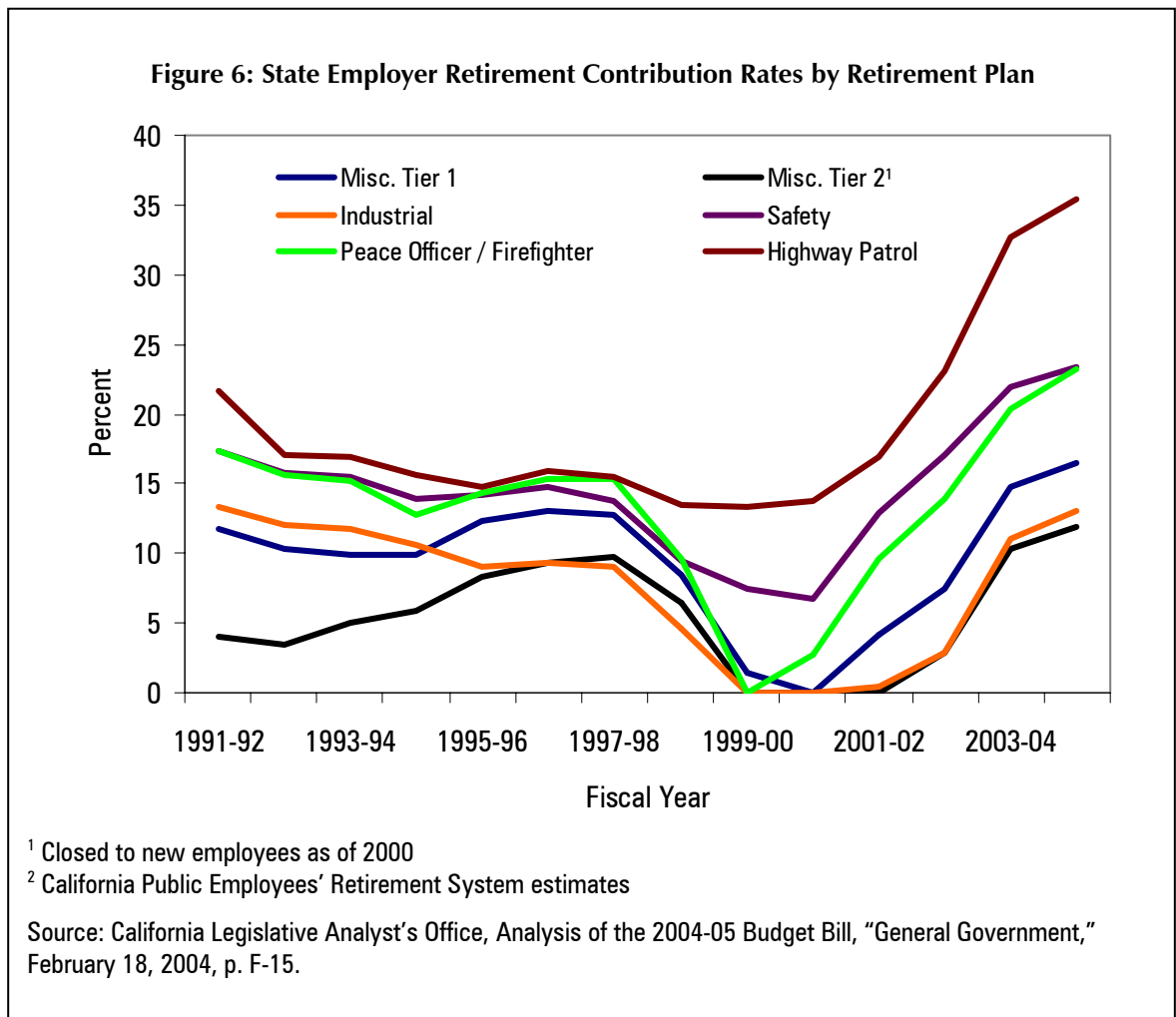
\*\*\*Pursuant to collective bargaining agreements some employees at the present time pay none or only a portion of the amount shown.

Source: California Legislative Analyst’s Office, Analysis of the 2004-05 Budget Bill, “General Government,” February 18, 2004, p. F-14.

b) Effects of the Stock Market Downturn

CalPERS is hardly alone in suffering from the effects of the stock market downturn after the build-up of the late 1990s. The poor financial condition of California’s pension system today is not so much the result of the market downturn itself, however, as it is a failure of planning. Since CalPERS spreads investment gains over a fairly short three-year period,<sup>204</sup> portfolio returns prior to the crash made it unnecessary for the state to contribute to the system during the market’s peak. Unfortunately, this also added to the size and shock of the payments that the state was (and is) forced to make when the system’s investment performance declined. (Notice in Figure 6 below how state contributions to the pension system dropped significantly, in some cases to zero, shortly after the market hit its zenith, then shot up as the market continued to decline over the past few years.) According to CalPERS spokeswoman Pat Macht, “For four years, the run-up in the stock market was so great the state got contribution holidays.”<sup>205</sup>

The use of a longer time frame to calculate investment gains and losses could have smoothed out these payments and prevented the current shocks to the system at a time when the state is already experiencing financial difficulties.



### c) Rising Benefits

As painful as the stock market downturn has been, by far, the biggest cause of California's pension system troubles is the lavish benefits the state has bestowed upon its government workers. The impressive portfolio gains realized during the stock market boom of the late 1990s only masked the problem of rising benefits and postponed the inevitable financial reckoning—until now.

A study conducted by the LAO determined that California's retirement benefits are much more generous than those of comparable states. The study found, for example, that an employee who worked 21 years for the state and retired at age 65 with a final salary of \$65,000 would earn a pension of \$46,500 in California. The same employee would realize benefits of \$40,775 in Texas, \$29,606 in Oregon, \$28,913 in Illinois, and \$28,410 in Florida.

<b>Table 3: California Retirement Benefits Compared to Selected Other States</b>					
	<b>Employee Retiring in 2004 at Age*</b>				<b>Employee Contribution</b>
	<b>55</b>	<b>60</b>	<b>62</b>	<b>65</b>	
California	\$25,200	\$36,098	\$40,958	\$46,500	5%
Florida	11,914	20,424	24,439	28,410	--
Illinois	**	24,250	26,115	28,913	4
Oregon	15,242	24,831	26,741	29,606	6
Texas	**	34,199	36,829	40,775	6

\* Assumes employee started working for the state at age 34 and has earned \$60,000 in salary in the last year before retirement

\*\* Not eligible for retirement at this age.

Source: California Legislative Analyst's Office, Analysis of the 2004-05 Budget Bill, "General Government," February 18, 2004, p. F-19.

The seeds of the problem were planted fifteen years ago and the state's troubles really began to shoot up in 1999. A small change inserted into a bill at the last minute on the last night of the 1990 legislative session would prove to be very costly. The provision changed state retirement rules to calculate pension benefits based on an employee's highest annual salary, instead of on the average salary over the final three years of employment (or highest three-year pay period). The bill, SB 2465, was passed by the Assembly at 2:45 AM on a 71-1 vote without any committee hearings or serious debate. The Senate later passed it on a unanimous 37-0 vote.<sup>206</sup> The lone dissenter, then-Assemblyman and now state Senator Tom McClintock, would later remark on the legislation: "The bill stands out in my mind because it was so shocking. It was so far beyond anything being offered by the private sector."<sup>207</sup>

Fifteen years later, California is still the only state in the nation to use the one-year formula (other states use a three- to five-year average to calculate compensation for rank-and-file-workers<sup>208</sup>)—with good reason. The law was expected to cost an additional \$63 million per year. In reality, it has proven to be 50 percent more costly, totaling more than \$100 million annually.<sup>209</sup> According to an analysis performed by the *Sacramento Bee*, "workers who retired in the past four years have received 5 percent more in pensions than they would have under a three-year system."<sup>210</sup> The costs have caused many local governments, including Sacramento County, to abandon the formula.<sup>211</sup>

In addition to the costs of the one-year salary rule, the measure had other undesirable effects. It provided an incentive for employees to retire earlier, particularly soon after receiving a raise or promotion. In many cases, this has led to the premature loss of highly trained and experienced employees in the prime of their careers. The same *Sacramento Bee* analysis found that the year after SB 2465 passed, the number of retiring state employees increased by 77 percent.<sup>212</sup> As Senator McClintock notes, “It reduces the pool of experienced people in state service. It’s a lose-lose for taxpayers.”<sup>213</sup>

While the offer of high pension benefits is supposed to encourage long-term employment, the one-year standard actually encourages employees to set a shorter timeline, which may be just until the next raise. Thus, it fosters pension spiking, which adds even more costs to the state and, ultimately, the taxpayer. Wisconsin legislative counsel William Ford points out, “Other states have not adopted the one-year formula because they are concerned about the type of problem you have in California. It makes the system easier to manipulate to increase pensions.”<sup>214</sup>

#### A Case Study on the Costs of the One-Year Rule

In July [2004]...correctional officers got a 10.9 percent raise. Although the state’s budget crisis has delayed the raise for working officers, it counts right away for those retiring.

Under the one-year rule, an officer with 25 years of service who earned \$65,000 annually—and retired only a year after the pay raise kicked in—would get about \$3,200 more each year in pension than if his retirement were calculated with a three-year average.

That can add up. If the 400 correctional officers who retire annually each got the additional \$3,200, that alone could increase the state’s pension obligations by about \$1.3 million a year.

From John Hill and Dorothy Korber, “How law fattens state pensions,” *Sacramento Bee*, December 19, 2004.

Another costly benefit change occurred with the adoption of SB 400 in 1999. SB 400, which passed 70-7 in the Assembly and 39-0 in the state Senate, ushered in an era of dramatic pension increases, including the “3 percent at 50” benefit for the California Highway Patrol, “3 percent at 55” benefit for peace officers and firefighters, and “2 percent at 55” benefit for other state workers. The bill also eliminated California’s two-tier system for non-safety/industrial employees. The second tier, which offered a smaller, less costly benefits package, was established in 1991 for all future employees in an effort to control pension costs. Under SB 400, Tier 2 was abandoned and all Tier 2 employees were moved to the more generous Tier 1 plan. Moreover, the benefit increases were retroactive, meaning that pension increases of up to 50 percent were, as *Sacramento Bee* columnist Daniel Weintraub observes, “not only for future employees but for workers whose retirement contributions had been based for decades on the expectation of a lower benefit.”<sup>215</sup>

These added benefits now cost the state hundreds of millions of dollars per year. According to the LAO, “these additional benefits add approximately \$600 million to anticipated 2004-05 costs—almost one-quarter of the state’s total payment.”<sup>216</sup>

Perhaps the most underestimated provision of SB 400 was an amendment added late in the legislative process that made the increased police and firefighter benefits available to local government workers. According to Weintraub, state Senator Deborah Ortiz, who introduced the measure in the Senate, “doesn’t

remember how that amendment came about” and “[i]t was not mentioned as the bill was presented on either the Assembly or the Senate floor.”<sup>217</sup>

Unfortunately, local governments followed the state’s lead—with disastrous results. As Weintraub notes, SB 400 “began a wave of public employee pension increases at a time when private sector employees were seeing their own retirement benefits shrink or disappear entirely.”<sup>218</sup> Adds fellow *Bee* columnist Dan Walters, “Local governments felt impelled to match what the state was granting its own employees, and not surprisingly, state and local public safety agencies have seen a raft of sudden retirements as workers who were eligible scrambled to cash in.”<sup>219</sup> Now governments across the state are attempting to dig themselves out of the deep hole dug by the benefit increases.

CalPERS bears as much blame as state legislators for the trend to increase benefits. In addition to strongly lobbying for legislation such as SB 400, CalPERS encouraged local governments that participate in CalPERS plans to adopt higher benefits. In exchange for local government approval of pension increases, CalPERS offered to reduce municipalities’ required contributions to the system.<sup>220</sup>

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

*Prison cooks, plumbers, groundskeepers, teachers, dentists, business managers, and “audiovisual specialists” – all are among the 70,000 state workers considered police or firefighters, eligible to retire with better benefits than other state workers.*

*In fact, any worker in a California prison regularly in contact with inmates is considered a police officer, rewarded with a richer public pension for helping safeguard society.*

*The same goes for workers in state mental hospitals – from psychiatrists to podiatrists – who supervise patients.*<sup>221</sup>

In the 1960s, roughly one in 20 state employees received public safety pensions. Now it is one in three workers.<sup>222</sup>

The passage of SB 183 in 2002 continued this trend by reclassifying the 3,200 members of the California Union of Safety Employees (CAUSE) as public safety employees, affording them an immediate 25 percent increase in pension benefits. As a result, milk testers, billboard inspectors, DMV driving examiners, forensic pathologists, and deputy directors at the Department of Real Estate (among others) are now included among today’s “public-safety” workers. The cost of SB 183 is estimated at \$216 million over the next 20 years.<sup>223</sup>

Some, including those involved in the deal, view it as a classic case of *quid pro quo*. “All this was the result of buying [former Governor] Gray Davis,” said Sam McCall, the then-union lawyer who helped draft and negotiate the bill. “We would not have got this done if we had not shoved a lot of money his way.”<sup>224</sup> In fact, CAUSE contributed \$100,000 to Davis three days before the bill was amended, \$5,000 the day it passed, and \$250,000 two weeks after he signed it.<sup>225</sup> Taxpayers will pay for this misstep for years to come.

It appears that many lawmakers have yet to see the dangers in this system. Orange County Assemblyman Tom Umberg proposed a bill earlier this year that would have increased pension benefits yet again. Umberg’s proposal, Assembly Bill 310, would boost pensions for non-teacher school employees by 25



percent.<sup>226</sup> As a *Whittier Daily News* editorial claims, “It’s as if the last few years never happened.”<sup>227</sup> After a public outcry, his office later claimed that they had no intention of pursuing the bill in that form.

## 2. Political Activism

The Gray Davis-CAUSE partnership is but one example of the danger of inviting politics to mix with what should be the nonpartisan act of retirement planning. Concentrating the power to invest hundreds of billions of dollars in the hands of a small group of politically connected officials necessarily leads to the politicization of investment decisions. This allows pension boards to circumvent the democratic process and pursue their political or ideological objectives through the power of the pension purse.

CalPERS has built up a strong reputation over the years as a champion of good corporate governance, advocating transparency in financial reporting and director and auditor independence. It has, at times, been too eager to throw its weight around, however, such as when it launched an attack last year on supposed conflicts of interest regarding directors and auditors.

Rather than attacking selected companies exhibiting egregious conflict-of-interest violations to try to foster reform, the fund essentially embarked upon a blanket campaign against corporations in general, withholding votes for directors from approximately 80 percent of the 3,000 companies in which it holds stock.<sup>228</sup> Companies targeted included Coca-Cola, Disney, Royal/Dutch Shell Group (of Shell Oil fame), and Citigroup. The attack on Coca-Cola was particularly curious because among the members of the Coke board of directors is Warren Buffet, one of the most successful investors and staunch advocates for shareholder value in the investing world.

In recent years, the CalPERS pension board’s political activism has been particularly blatant. This was especially true when CalPERS was under the stewardship of President Sean Harrigan from February 2003 to December 2004.

Under Harrigan, CalPERS’s policies were “a labor agenda in corporate governance clothing,” charged David Hirschmann, senior vice president of the U.S. Chamber of Commerce.<sup>229</sup> Hirschmann’s accusation certainly seemed to ring true when CalPERS commenced an assault on Safeway while the grocery chain was involved in a protracted labor dispute with the United Food & Commercial Workers (UFCW) union, which represented grocery clerks involved in the strike. During the strike, Harrigan, a senior official with the UFCW, personally organized and hosted rallies against Safeway.<sup>230</sup> While overseeing CalPERS’s investment in Safeway, Harrigan was working to make it more challenging for Safeway to deliver good investment returns.

CalPERS’s attempt to remove Safeway CEO Steven Burd ultimately failed, although the pension board did succeed in pressuring the company to replace three of its directors. While CalPERS officially designated Safeway as a corporate governance target because of its financial performance, the claim makes little sense, as the company was seeking new union contracts precisely because it wanted to reduce costs and maximize its profitability for its shareholders. As Columnist Dan Walters points out, had Safeway succumbed to all of the UFCW’s demands, it would have become less competitive, less profitable, and less valuable to its shareholders, which include CalPERS.<sup>231</sup>

Another example of CalPERS's union advocacy is its attack on the outsourcing of government jobs to private industry. In an era when both Republicans and Democrats have looked to competition to lower the cost of public services, CalPERS has actively resisted this option by adopting a policy not to invest in companies that "displace" (or could potentially displace) government employees, which has nothing to do with maximizing returns on its investments. As Daniel Weintraub explains,

*The policy is aimed at companies that manage entire prisons, schools or other agencies for the public and also those firms whose workers might run mailrooms or cafeterias, collect trash or provide health care or security. In other words, anybody who could possibly be seen as competing with a public employee.*<sup>232</sup>

CalPERS consulted a panel of external advisers to discuss the proposed outsourcing policy. The advisers generally disapproved of it, arguing that it would likely prevent the fund from choosing the best investment options and thus maximizing its returns, but CalPERS adopted the policy anyway.<sup>233</sup>

CalPERS has chosen numerous other investment policies that put other, often political, goals ahead of shareholder value (and, ultimately, the interests of government employers and pension beneficiaries). Examples over the past few years include:

- A \$457 million earmark to 11 California equity firms "to target California's underserved markets;"<sup>234</sup>
- "[U]sing CalPERS health care contracts as a weapon against hospitals that have been targeted for union organization;"<sup>235</sup>
- Embarking upon a campaign to combat "excessive" compensation for business executives;<sup>236</sup> and
- Threatening U.S. automakers not to challenge California's anti-global-warming regulations.<sup>237</sup>

The latest CalPERS campaign involves "environmentally responsible" investing. Last year, CalPERS adopted two of the four planks of Phil Angelides's "Green Wave" initiative when it committed to making an initial investment of up to \$200 million over the next few years in the "clean" technology center and investing up to an additional \$500 million in "environmentally screened" stock funds.<sup>238</sup> A press release issued from Angelides's Treasury office proclaimed,

*The Green Wave initiative is designed to bolster financial returns, create jobs and clean up the environment. . . . The Treasurer's four-pronged initiative calls on CalPERS and CalSTRS to marry the jet stream of finance and capital markets with public purpose by committing \$1.5 billion to investments in cutting-edge technologies and environmentally responsible companies.*<sup>239</sup> (Emphasis added.)

The press release continues: "CalPERS' new Environmental Technology Program will look to invest in technologies such as renewable energy, fuel cells, water purification and conservation, waste recycling and processing, and re-use of materials."<sup>240</sup>

In his role at CalPERS, Harrigan was similarly enthused about putting the fund's money into "green" investments. Consider the following excerpts from a speech Harrigan delivered in 2004 to the Coalition for Environmentally Responsible Economies, entitled "Environmental and Sustainable Investing: The CalPERS Way":

- "Facing the climate change challenge requires nothing short of a revolution. I submit to you that it is time to embark upon this revolution."

- “These developing green technologies also suggest an opportunity to create new fair wage jobs. These new emerging companies can lead to thousands of new jobs in California.”
- “We [at CalPERS] closely watch corporate board activity, and we will be interested in how boards and CEOs are relating to the problem of climate risk.”
- “[T]his initiative could mean we would actively encourage companies – through dialogue, shareholder resolutions and other actions – to reduce environmental risks and liabilities.”
- “At CalPERS, we are going to use our leadership and our clout in the marketplace to help advance the proposal I have set forth today [to invest in environmentally responsible companies]. . . . We...hope our actions will lead to solutions for these environmental challenges.”<sup>241</sup>

CalPERS makes the investment decisions that affect the retirement plans of 1.4 million beneficiaries and their families. One could argue this is a classic case of fiddling while Rome burns, with CalPERS board members focusing on achieving political goals through investment during the very years the performance of the investments they managed on behalf of workers was underperforming and creating huge shortfalls. Moreover, while CalPERS was happy to take credit for extraordinary investment returns achieved during the “dot-com boom,” suddenly all the blame for the money lost during the subsequent downturn is placed on the stock market itself, and not those charged with managing the money.

In 1999, the CalPERS public employee retirement fund was 128.4 percent funded.<sup>242</sup> The California State Teacher Retirement System itself maintained a 104 percent funding ratio.<sup>243</sup> While the swelling investment pools were enjoying the high returns of the late 1990s, it was clear that these returns would not last forever. A prudent move would have been for the system to sell some securities and transfer assets to lower risk investments like bonds that better aligned asset holdings to future liabilities. Doing so, California pension officials could have saved taxpayers billions of dollars and avoided much of the current controversy.

Of course, “cashing out” would have meant jettisoning numerous shares of stock, rendering CalPERS and CalSTRS less influential at shareholder meetings—and less able to enforce its political agenda upon private companies. Instead, the pension board members chose to “let it ride” and trade off the health of the pension system for other goals.

Equally problematic, among the workers whose pension plans CalPERS manages, some will agree with CalPERS’s political causes, but many will not. It certainly is not fair to impose an ideology through their retirement funds on those who may disagree, especially since it is quite likely that CalPERS will have to sacrifice greater returns on better investments to support its causes. In a great many cases, retirees’ goal is a stable retirement income—nothing more and nothing less. When other goals compete with this need, members suffer.

### ***3. Reforming the System***

#### ***a) Smoothing Employer Contributions***

The above criticisms notwithstanding, CalPERS has initiated and supported some positive reforms that deserve attention. One reason the pension crisis caught so many governments by surprise was that the amounts they were required to pay into the system rose so dramatically over such a short period of time. The great swings in contribution levels required of government employers due to market volatility have wreaked

havoc on the budgeting process, particularly at the local level. To smooth out payment requirements, CalPERS has endorsed a proposal to calculate contribution rates based on a 15-year average of investment returns, rather than the current three-year average.<sup>244</sup> This will make contributions more predictable and more regular, and thus force governments to focus on the longer term, rather than allowing them to become overly optimistic after realizing strong short-term gains.

#### b) Fighting Disability Pension Fraud

One of the most serious problems facing the pension system is disability claims fraud. (For more on this, see the discussion on pension spiking in Part 3 and the Los Angeles County case study below on “chief’s disease.”) Many argue that the fraud in the pension disability system is worse than workers’ compensation fraud, which has received so much attention.<sup>245</sup> To address the problem, CalPERS voted unanimously to sponsor legislation intended to improve pension system officials’ ability to investigate and punish disability fraud. The proposed anti-fraud legislation would:

- Define disability pension fraud for the first time and establish criminal and civil penalties;
- Grant CalPERS the authority to order medical re-evaluations of those receiving disability pensions to ensure that they are, in fact, still disabled; and
- Allow state agencies to share information pertinent to pension fraud investigations.

Such legislation is long overdue. According to the *Modesto Bee*, “Currently, officials have little authority to investigate, even when they suspect there is fraud.”<sup>246</sup> CalPERS has taken a solid first step toward addressing the pension fraud problem. Now it is up to the legislature to act.

#### c) Improving Transparency

Another area of improvement for CalPERS is in the area of transparency, although it has not always been a willing participant in this reform effort. The investment giant known for its crusades for good corporate governance—including transparency in financial disclosures—has come under fire for keeping its own financial records secret. In short, CalPERS has, at times, struggled to practice what it preaches. As Thomas J. Donahue of the U.S. Chamber of Commerce asserts,

*CalPERS has historically operated under a shroud of secrecy with regard to its private equity investments. It hid from state employees and taxpayers that it invested in Enron’s off-book dealings, which led to the infamous company’s collapse and the loss of millions of dollars in retirement money for Enron employees. Only recently has CalPERS taken steps to more fully disclose its investments and returns – and this only after it first fought, then settled a lawsuit demanding more investment details.*<sup>247</sup>

In fact, CalPERS has settled two such lawsuits in the past two and a half years. In 2002, CalPERS refused to disclose performance results for its 300-plus private equity funds. The *San Jose Mercury News* sued to make the information public and CalPERS eventually agreed to post the performance data on its Web site each quarter.<sup>248</sup> Then, in September 2004, the California First Amendment Coalition (a consortium of news organizations) similarly sued CalPERS to force it to disclose management and advisory fees paid to venture capital and hedge funds. A settlement was reached, whereby CalPERS agreed to disclose more information.<sup>249</sup>

#### d) Eliminating the Use of Pension Obligation Bonds

As if the lack of proper financial planning was not enough, California is compounding its mistake by trying to issue even more debt to cover the pension debt. Governor Schwarzenegger is currently engaged in a battle to issue a \$929 million long-term pension obligation bond to cover the state's pension costs this year.

The LAO recommended rejecting the bond in its *Analysis of the 2004-05 Budget Bill*. In its analysis, the LAO noted that before then-Gov. Gray Davis attempted to take the same action a year prior, “pension obligation bonds had not previously been used to pay a government’s annual retirement contributions—an ongoing expense. Rather, local governments had used these bonds to pay off unfunded liabilities—a preexisting obligation.”<sup>250</sup> The LAO went on to criticize the notion of taking on additional debt to pay operating expenses, arguing that “incurring two decades worth of debt to avoid a 2004-05 operating expense is poor fiscal policy. Current operating expenses should be paid with current revenues.”<sup>251</sup>

In addition to being poor fiscal policy, the legislature and governor are legally barred from issuing pension obligations bonds by the state Constitution. Article 16, Section 1, of the California Constitution prohibits the government from borrowing more than \$300,000 without voter approval.<sup>252</sup> Little more than a year ago, Gray Davis’s bond was challenged on these grounds by the Howard Jarvis Taxpayers Association and the bond was thrown out by a Sacramento Superior Court. Governor Schwarzenegger’s bond has now been challenged in a suit brought by the Pacific Legal Foundation and the Fullerton Association of Concerned Taxpayers (FACT).<sup>253</sup> There is no reason to expect the outcome of this litigation to be any different.

Governor Schwarzenegger was elected, an *Orange County Register* editorial points out, “precisely because he promised to make the tough decisions Gray Davis wouldn’t.”<sup>254</sup> He is presently failing to meet that commitment by, as FACT President Thomas Babcock contends, “pushing off this year’s pension payment onto future generations.”<sup>255</sup> Governor Schwarzenegger can live up to his promise to make tough decisions by scrapping his bond proposal and engaging in responsible financial management, and by making the necessary sacrifices to pay current debts with current revenues rather than saddling taxpayers with mountains of debt indefinitely.

#### e) Requiring Voter Approval for Benefit Increases

Article 16, Section 1, of the California Constitution establishes a sound principle: government officials must receive permission from those footing the bills before borrowing large sums of money. Since pension commitments are ironclad, they effectively carry the same long-term legal obligations as general obligation debt. For this reason, a similar principle of requiring public approval for government employee pension benefit enhancements should be added to the California State Constitution.

The idea is more than just a theoretical construct, and has been successfully employed at the local level. The requirement has even served to restrain pension costs in a city as liberal as San Francisco, while conservative counties like San Diego, Orange, and Contra Costa, which lack the measure, are among the most heavily burdened in the state. According to San Francisco Pension Director Clare Murphy, who manages one of the best-funded pension systems in the state, “Voter approval is the distinguishing factor of San Francisco.”<sup>256</sup>

Instituting a voter-approval requirement for all increases in government employee benefits would help to keep benefits at reasonable levels in the eyes of the taxpayers, who, after all, are paying the employees’ salaries. California should thus adopt a constitutional amendment to ensure that any retirement benefit

increases for government employees first receive the consent of the taxpaying public that will ultimately be obligated to underwrite them.

#### **4. Conclusion**

There is plenty of blame to go around for California’s current pension crisis: state legislators, CalPERS, government employee unions. At the very height of the stock market, these parties all argued that California could afford to extend lavish benefit increases to government employees because they would be “paid for” by pension fund gains. Of course, to do so, they had to assume that the retirement funds would continue to achieve extraordinary returns indefinitely. When the market hit a downturn, the true costs of these benefit increases were revealed. Lack of proper financial planning made the situation worse. The amount of required pension system contributions shot up to compensate for the poor performance of the retirement fund and the state was caught unprepared.

Not only are California’s pension benefits significantly higher than those of comparable states, they are simply unsustainable. If the state wishes to save itself from the structural problems of the existing pension system, it must rein in benefit costs. The adoption of a constitutional requirement to obtain voter approval of future benefit increases would be a good start. Removing the one-year salary rule that encourages pension spiking, sunseting the benefit enhancements awarded in 1999 for new employees, and refraining from the use of pension obligation bonds would provide further relief.

The most significant—and beneficial—improvement California could make to its pension system, however, would be to abandon its current defined-benefit structure in favor of a 401(k)-style defined-contribution plan like those prevalent in the private sector.

### **D. West Virginia: Banking on Pension Obligation Bonds**

West Virginia’s pension story has followed a familiar storyline: over the decades, the state made pension benefit promises that it failed to pay for. Now the state faces a \$5.5 billion pension deficit and an additional \$3.3 billion in unfunded workers’ compensation liabilities.<sup>257</sup> Combined, those liabilities are nearly three times the state’s annual \$3.1 billion general fund budget.<sup>258</sup> As one columnist remarked, “You don’t get in that kind of shape by being responsible. You get there by way of ignoring your obligations, all the while creating new programs.”<sup>259</sup>

The state’s major pension reform effort in recent years consisted of a failed \$3.9 billion pension obligation bond offering. Now Gov. Joe Manchin III is appealing to voters to consent to an even larger bond. It will take more than a bond offering, though, to resolve the state’s pension troubles.

#### **1. Long-Term Pension Mismanagement**

The roots of West Virginia’s pension funding problems can be traced back to at least the 1980s. Pay raises were actually accompanied by *reductions* in contributions.<sup>260</sup> At the time, then-Retirement Board Executive Secretary Willard Ansel was one of the few voices of reason. Recalls former Senate Finance Chairman Oshel Craigo, “He used to go nuts when we would do things like that. He’d say, ‘Guys, what you are doing is wrong. You’re bankrupting the state.’”<sup>261</sup> Unfortunately, legislators did not heed Ansel’s warnings.

From FY 1986 to FY 1989, West Virginia was still not making the necessary pension contributions. Although the required employer contribution during this period was 9.5 percent of payroll, the U.S. Department of Health and Human Services (HHS) found that the state only contributed 1.68 percent of payroll.<sup>262</sup>

This was not the end of the mismanagement, however. HHS also found that West Virginia had raided its pension system and used the funds for general appropriations. According to HHS, “West Virginia withdrew \$19,108,350 in pension funds from [the West Virginia Public Employees Retirement System] fund and used these monies to fund general obligations of the state and to pay health insurance premiums for retirees. [HHS] calculated that 20 percent of the total amount withdrawn, or \$3,821,670, was contributed by the federal government and therefore must be refunded to the federal treasury.”<sup>263</sup>

Until recently, West Virginia failed to employ any financial experts to evaluate “the long-term ramifications of decisions affecting state finances.”<sup>264</sup> In a startling admission, Harry Mandel, actuary for the state Consolidated Public Retirement Board, reveals, “No one really looked at what we should have been contributing to meet future obligations.” Added Mandel, “West Virginia isn’t that unusual. We just didn’t wake up early enough. West Virginia just kept on after other states figured out they had problems.”<sup>265</sup> This sort of mismanagement helps explain how the pension system got to the dreadful condition it is in today.

In 1994, a Supreme Court order to fully fund the state’s teachers’ retirement plans prompted the state to try to restore the financial health of its other pension funds. The legislature adopted a 40-year payment schedule not unlike the 50-year plan instituted in Illinois around the same time. The payment plan compels the legislature to increase West Virginia’s pension contributions by about 6.5 percent a year, until the final payment of \$634 million in FY 2034.<sup>266</sup> This year’s payment will total \$345 million and next year’s requirement will grow to \$363 million.<sup>267</sup> As former state Senator Craigo once said, “The miracle of compounded interest is working against us.”<sup>268</sup>

## *2. Borrowing Your Way to Prosperity*

For four years, former Gov. Bob Wise’s administration tried to issue a \$3.9 billion obligation bond, authorized by the Pension Liability Redemption Act in 2000, to address the pension funding problem. The bond was challenged in court by State Auditor Glen Gainer II and Treasurer John Perdue, who argued that the offering violated the state constitution. According to the constitution, the state is prohibited from taking on new debt without voter approval.

In December 2004, just like the California court’s ruling on Governor Davis’s bond proposal, the West Virginia Supreme Court of Appeals ruled unanimously that, indeed, the bond offering could not proceed without voter approval. In the Court’s opinion, Justice Joseph Albright wrote, “We are compelled to conclude that such a funding mechanism cannot be undertaken absent express approval by the citizens of this state in the form of a constitutional amendment.”<sup>269</sup>

This does not mean that the idea of the pension obligation bond has gone away. Governor Manchin has proposed his own bond measure, which will be put before the voters on June 25, 2005.<sup>270</sup> In fact, Governor Manchin’s proposal is for an even larger, \$5.5 billion pension obligation bond.

Treasurer Perdue is well aware of the hazards of bond financing. In a statement issued by his office, he said, “As your treasurer, I would be less than honest if I didn’t admit to reservations about the issuance of new bonds. But, regardless, the people should speak.”<sup>271</sup>

As in Illinois, the governor is also proposing to restructure the state’s existing pension contribution schedule to reduce the state’s payments.<sup>272</sup> This will only paper over the funds’ obligations and push the problem a little further into the future.

### *3. West Virginia’s Ailing Economy*

The governor’s bond proposal has other ramifications for West Virginia’s business climate. The state’s economy has been struggling for years. Adding large amounts of debt is not going to help any.

According to a recent Standard & Poor’s report, “The state has below-average per capita wealth and income levels and a cyclical economic base lacking deep diversity. The state’s economy has lagged national growth measures for the past few years – a trend that is projected to continue.”<sup>273</sup>

The rating agency warned last July that the pension bond would nearly quadruple the state’s existing debt levels.<sup>274</sup> Thus, the bond offering could potentially lead to a downgrade of the state’s credit rating. This would make it more expensive to engage in future borrowing and harder to fund capital projects like new roads and schools and other infrastructure to support economic growth.

In addition, undertaking more debt will sour an already-poor business climate “because firms don’t want to move to a state where they’re required to help pay off billion-dollar obligations incurred by others.”<sup>275</sup> A state with a sub-par economy should be looking for ways to improve its business climate, not keep business and investment away.

### *4. Abandoning the Defined-Contribution Model*

As if the pension obligation bond proposal was not bad enough, Governor Manchin is trying to compound the state’s pension woes by reversing the only fiscally responsible retirement decision the state has made in the past quarter century. In 1991, the state closed the Teachers’ Retirement System defined-contribution plan due to chronic funding problems. As Delegate Doug Stalnaker remarked, “It was created to stop the bleeding of (TRS).”<sup>276</sup> According to the National Association of State Retirement Administrators’ Public Fund Survey, while Illinois has the largest pension liability in terms of sheer dollars, West Virginia’s Teachers’ Retirement System (TRS) is the worst-funded pension plan in the nation, with only enough assets to cover about 19 percent of its liabilities (see Appendix A).<sup>277</sup>

Legislators, purportedly prompted by sagging investment returns and “less than savvy investing by enrollees,” have now voted to accede to a Manchin proposal to freeze the defined-contribution plan and allow teachers enrolled in the plan to transfer their funds to the old defined-benefit plan that the state still hasn’t been able to fund properly—even though it has been closed for 14 years.<sup>278</sup>

A minority of state senators argued unsuccessfully that such a move would be fiscally irresponsible. As Sen. Andy McKenzie observed, “There’s not a single major corporation going back to a defined benefit plan.”<sup>279</sup> As of this writing, Manchin has not yet signed the legislation.



## 5. Conclusion

West Virginia's reliance on pension obligation bonds to improve its pension system is ill-advised. Because of the interest that must be paid on the bonds, there is little upside to the offering and a potentially significant downside if the market takes another dip during the term of the bond. The last thing West Virginia needs is to worsen its business climate by saddling its residents with more state debt and higher debt service payments.

A recent op-ed published in the *Charleston Gazette* argues that taxpayers should not be so forgiving of the legislature's lack of fiscal responsibility when they step into the voting booth to consider Governor Manchin's pension obligation bond measure. The author is doubtful that the bond will have a positive impact on the pension system's fiscal health, but suggests that taxpayers might be more willing to consider a bailout if they could be assured that the state was taking other steps to get to the heart of the problem. The switch to 401(k)-style retirement plans might provide that assurance. In the author's own words,

*The state got in this jam with defined-benefit plans, which have gone the way of the dodo in the private sector. It would be easier to reassure voters if the state committed to defined-contribution plans for all new state employees, as it has for teachers.*

*If the political class wants West Virginians to bail it out, it needs to prove it has learned its lessons and permanently changed its ways. Otherwise, voters might be better off keeping the crimp on new programs.<sup>280</sup>*

This is essentially what Governor Manchin is proposing for workers' compensation reform. Like the pension system, the workers' compensation system has been riddled with debt for decades. The governor's reform plan calls for selling up to \$3 billion in bonds and raising \$230 million per year in additional taxes or revenue transfers to pay off the bonds. So far, things are not sounding so good for the taxpayer. There is a tradeoff, however. The governor's proposal also calls for the workers' compensation fund to be converted into a privately operated employers' mutual company by the end of the year.<sup>281</sup> Thus, taxpayers will no longer have to fear the government mismanagement of the past. Perhaps a similar deal could be struck to "privatize" the pension system by switching state employees to defined-contribution plans. Sadly, it seems the governor is going the other way by endorsing the switch back to a defined-benefit plan for state teachers hired after 1991. The notion that he would want to return to a system that proved such a failure and saddled the state with so much debt is almost inconceivable (unless one considers the power of the education lobby). As philosopher George Santayana once observed, "Those who do not remember the past are condemned to repeat it."

## E. Los Angeles County: Suffering from Pension Obligation Bonds and "Chief's Disease"

Los Angeles County is suffering from its own pension dilemmas, facing a \$3.9 billion unfunded pension liability as of June 30, 2003.<sup>282</sup> A recent report by the pension system's actuary, however, placed the deficit at a record \$5.6 billion as of June 2004<sup>283</sup>—an increase of \$1.7 billion in just one year. Over the past three years, the county's pension contributions have increased 62 percent.<sup>284</sup> This coming fiscal year (beginning July 1), the required payment will jump \$115 million, bringing the county's annual pension costs to nearly \$1.2 billion.<sup>285</sup>

### *1. Gambling on Pension Obligation Bonds*

At the heart of L.A. County's present—and perhaps future—pension system troubles are the use of pension obligation bonds and alleged gaming of the system, particularly with regard to disability benefits. As with other jurisdictions, the stock market downturn in late-2000 through 2001 did not help matters, but the county's pension funding issues go back even further. As noted previously, Los Angeles County became the first jurisdiction in the nation to issue pension obligation bonds in 1986. Since then, numerous states and municipalities have followed suit, selling tens of billions of dollars of such bonds in aggregate.<sup>286</sup> It is an unfortunate trend that is further burdening already-strained pension systems across the country.

In 1994, the county issued another pension bond in the amount of \$2 billion. The bond provided a short-term budget solution at the time, but the county is still paying off the bond to the tune of approximately \$400 million annually. Add to this the \$750 million in county contributions to the pension system.<sup>287</sup> In addition, the 1994 bond was structured such that annual debt payments will peak over the next three years,<sup>288</sup>

As pension investment return rates have come down considerably in recent years (the Los Angeles County Employees Retirement Association [LACERA] posted a three-year annualized return of -2.5 percent as of June 30, 2003, the most recent data available<sup>289</sup>), returns have not been able to keep pace with the debt service on the bonds and the bonds have become an additional drag on the system. The real effects have not yet been felt, as “excessive” returns from the market highs of the 1990s were placed in reserve and have been tapped to compensate for the fund's recent performance. Those reserves will soon run dry, however. This, along with the increasing debt payments, ensures even more pain in the near term. As LACERA chief counsel David Muir warns, “The hits we're taking now are nothing compared with the hits we'll see starting in 2006.”<sup>290</sup>

### *2. Holding the Line on Benefit Increases*

The above notwithstanding, L.A. County is actually faring better than many other pension entities in the state, and much better than neighboring Orange County. It has been able to do so largely because it has resisted the urge to increase pension benefits to the levels of other jurisdictions. The county's sheriffs and firefighters, for example, currently have a “2 percent at 50” retirement plan, whereby an employee with 30 years of service can retire with a pension equal to 60 percent of his or her salary. By contrast, the statewide trend seems to have been to raise benefits to a “3 percent at 50” plan, particularly for public-safety employees. Approximately 300 law enforcement agencies across California offer their employees a “3 percent at 50” plan. The consequences have been disastrous, however, with some cities and counties cautioning that the pension deal has nearly bankrupted them.<sup>291</sup>

The Association of Los Angeles Deputy Sheriffs originally sought salary increases of 18 percent over three years but has since reduced its demands and joined other county public-safety unions in pushing for a “3 percent at 55” retirement benefit. The union's new demands would still have placed an estimated burden of an additional \$48 million per year on an already stressed pension system.<sup>292</sup> After months of maintaining its tough stand on benefit increases, however, county supervisors agreed unanimously—and without any public discussion—to grant \$13.1 million per year in “longevity bonuses” to the 6,700 high-ranking public-safety officials of the Professional Peace Officers Association.<sup>293</sup> The contract boosts the salaries—and, thus, the pensions—of law enforcement personnel toward the end of their careers and allows union officials to reopen negotiations for additional salary increases from 2006 through 2008.<sup>294</sup> Perhaps even more worrisome is the

precedent the contract sets for negotiations with other government employee labor unions. If the county does not wish to dig an even deeper financial hole, it would be wise to resist further “backdoor” pension increases and not make the same mistake as so many other cities and counties.

### *3. Time and a Half Cheaper Than New Hires*

The county has good reason to be wary of extending additional retirement benefits to its public-safety workers. Some already realize excessive amounts of other types of benefits. Others appear to be abusing disability benefits to enhance their retirement packages.

In 2004, it came to light that L.A. County firefighters’ benefits had become so expensive that it was actually much cheaper for the county to pay \$91 million in overtime than to hire additional firefighters in 2002-2003.<sup>295</sup> Said Fire Chief P. Michael Freeman, “As ridiculous as it sounds, it’s more cost-effective to bring in a firefighter from home and pay them time and a half because we don’t have to pay more benefits for them.”<sup>296</sup> In fact, it costs a full 9 percent *less* to pay time and a half than to hire new firefighters.<sup>297</sup>

County firefighters’ benefits have increased dramatically in recent years, rising from an average of 42 percent of base salaries in 1996 to 58.6 percent at present. Compare that to 49 percent for sheriff’s department employees and 39 percent for county administrative employees.<sup>298</sup>

The problem is widespread within the fire department. According to a *Los Angeles Daily News* article,

*Information obtained under the state Public Records Act shows that in 2002-03, more than 940 county firefighters boosted their salaries by more than 50 percent with overtime, and 15 more than doubled their salaries, including one who took home \$217,036 [of which \$122,559 was overtime pay].*

*The analysis of salary and overtime data for 2,209 county firefighters earning more than \$80,000 a year also found that nearly all of them – 2,116 – earned at least \$10,000 in overtime.*<sup>299</sup>

Lavish benefits are not restricted to firefighters, however. Nearly 1,200 county retirees receive pensions greater than \$100,000 per year.<sup>300</sup> This dwarfs the number of those receiving such extravagant pensions in other public pension plans, including the much larger CalPERS plan. As reported by the Associated Press, citing the *Los Angeles Daily News* public records request, “Overall, Los Angeles County counts 1,198 six-figure pensions while the California Public Employees Retirement System has 816 and the California State Teachers’ Retirement System has 427.”<sup>301</sup>

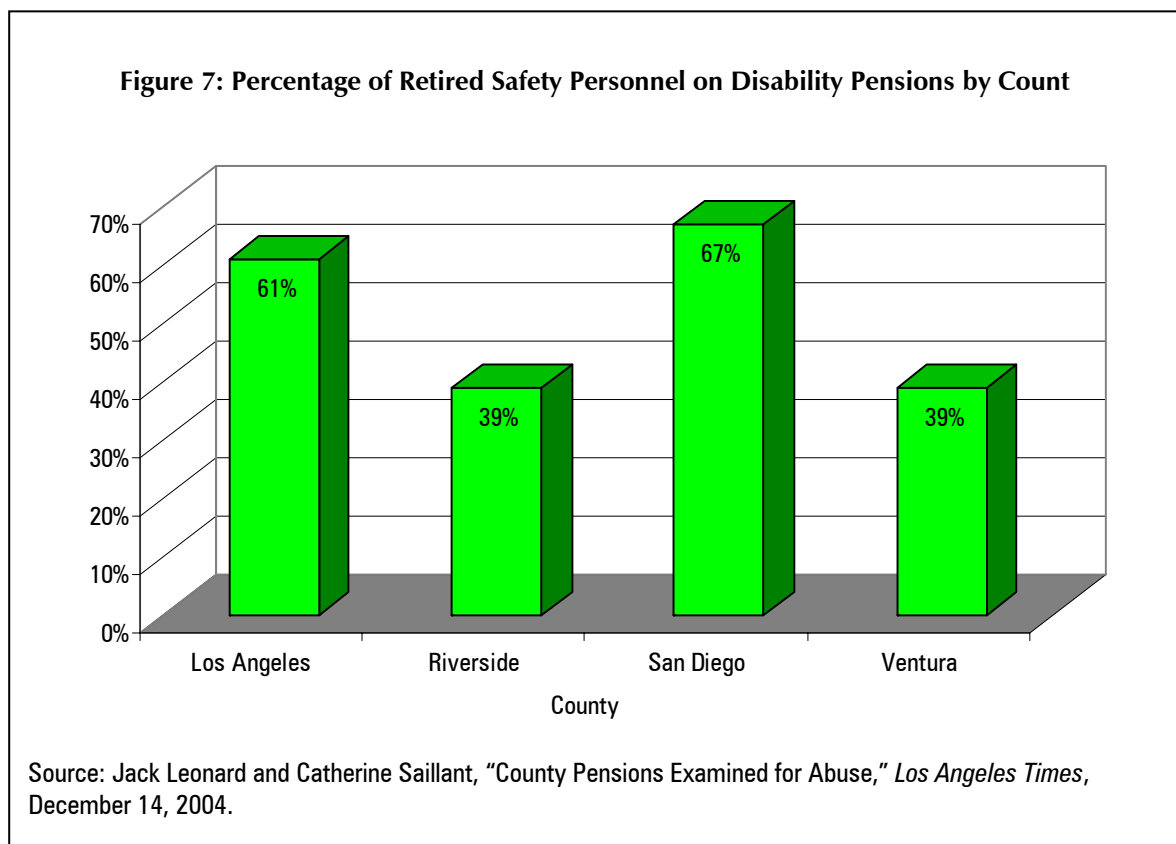
### *4. Suffering from “Chief’s Disease”*

Even more disturbing than the sheer number of county retirees receiving six-figure pensions is the way some employees are abusing the system. L.A. County has suffered from the effects of a pension-spiking scheme known as “chief’s disease.” The chief’s disease problem has become so severe that the L.A. County Board of Supervisors has ordered an investigation to determine the extent of it,<sup>302</sup> the California Highway Patrol has ordered an investigation to determine if criminal charges should be filed against 15 high-ranking officers who filed workers’ compensation claims shortly before retiring,<sup>303</sup> and the state Senate’s Government Oversight and Public Employment and Retirement committees scheduled a joint hearing on pension system abuse.<sup>304</sup>

Here's how the scheme works. Fire and sheriff's employees file a workers' compensation claim under California Labor Code 4850 a year before their retirement dates. They are then allowed to take a one-year leave of absence while collecting their full salaries *tax free*. Since taxes are not taken out of their pay, their salaries effectively increase. Since pension benefits are calculated based, in part, on final (or highest) salary rates, this increases their pensions as well. Moreover, the leave of absence means they get credit for an extra year of work without actually having to work. Since length of service also figures into pension benefits calculations, this boosts their pensions even further.

For many, this is only the first step. Next, the employee may file for a job-related disability pension. Unlike regular pensions, half the amount of the disability pension is tax free, retirees receive fully paid medical care for the rest of their lives, and 100 percent of the disability pension can be inherited by a spouse upon the retiree's death, compared to the 65 percent limit offered to spouses under regular pensions.<sup>305</sup>

Currently, 61 percent of retired county public-safety employees are on disability pensions. That compares with 39 percent in neighboring Ventura and Riverside counties and 67 percent in San Diego County, which has a similar problem.<sup>306</sup>



A county audit in 2000 found that up to 97 percent of firefighters and 86 percent of sworn sheriff's employees seeking a disability pension had filed workers' compensation claims in the previous three years of service.<sup>307</sup> From 2001 through 2003, 85 percent of county firefighters pursuing a disability pension also received injury benefits for at least nine months during their last year of service.<sup>308</sup> Said Supervisor Gloria Molina, "It would seem to me that it's very unlikely that 85 percent of our retirees became disabled in the

last year of service with us.” Added Molina, “These numbers are horrendous. This is costing us an awful lot of money.”<sup>309</sup>

In just the past six years, the cost to the county—and the taxpayers—of these injury benefits has more than doubled, from \$23 million to \$50 million. Similarly, the county’s spiraling workers’ compensation costs have risen from \$157 million in 1999 to \$324 million this past fiscal year.<sup>310</sup> They are expected to swell to \$350 million this year.<sup>311</sup>

The costs to the county have been magnified by its comparatively loose workers’ compensation laws. Employees do not have to file claims immediately after a disabling injury, for example, and may also qualify for benefits if a doctor makes a general determination that a *series* of job-related injuries contributed to the employee’s inability to work.<sup>312</sup> But if previous job-related injuries had made the employee too sick or disabled to work, why then *were* they able to work during this time? This very arbitrary standard leaves the system open to fraud and abuse.

In addition, as a *Los Angeles Times* article notes, “The county follows state law’s presumption that firefighters and police officers who suffer from certain illnesses, such as cancer and heart disease, were injured on the job and thereby automatically qualify for a disability retirement.”<sup>313</sup> This policy practically invites abuse. Consider this example offered by Paul Derse, a deputy executive administrator for Ventura County: “We had a four-pack-a-day smoker who was presumed to have cancer from his job.”<sup>314</sup>

The city of Los Angeles, by contrast, has written stricter rules for its pension system. The aforementioned 2000 county audit noted that the city places the burden of proving job-related injuries on the employee, making them prove by “clear and convincing evidence” that the job was the “predominant cause of the disability.”<sup>315</sup> It should thus come as little surprise that while 74 percent of county firefighters retired with job-related disability pensions from 2001 to 2003, the rate for the city’s fire department is only 21 percent.<sup>316</sup>

## 5. Conclusion

The L.A. County Board of Supervisors is to be commended for having the sense to take steps to address serious issues, such as “chief’s disease,” that are plaguing the county’s retirement system. The Board of Supervisors voted unanimously to conduct a case-by-case investigation of thousands of retired employees receiving disability benefits. As Supervisor Molina noted, “Anyone who rightly deserves [the enhanced disability benefit] should be entitled to keep it, but data shows that L.A. County’s rate of authorization to sheriff’s deputies and firefighters is two to three times higher than other jurisdictions.”<sup>317</sup>

This is just the first step on the road to recovery, however. The county must resist the temptation to gamble on short-term financing “solutions” like pension obligation bonds and rely instead on more sound financial management. It must withstand pressures to dramatically increase county employee benefits and actively work to rein in benefits to avoid further incidents such as the firefighters’ overtime pay controversy. Finally, statewide reform is necessary to close loopholes in state and local workers’ compensation and disability pension systems to prevent fraud and abuse.

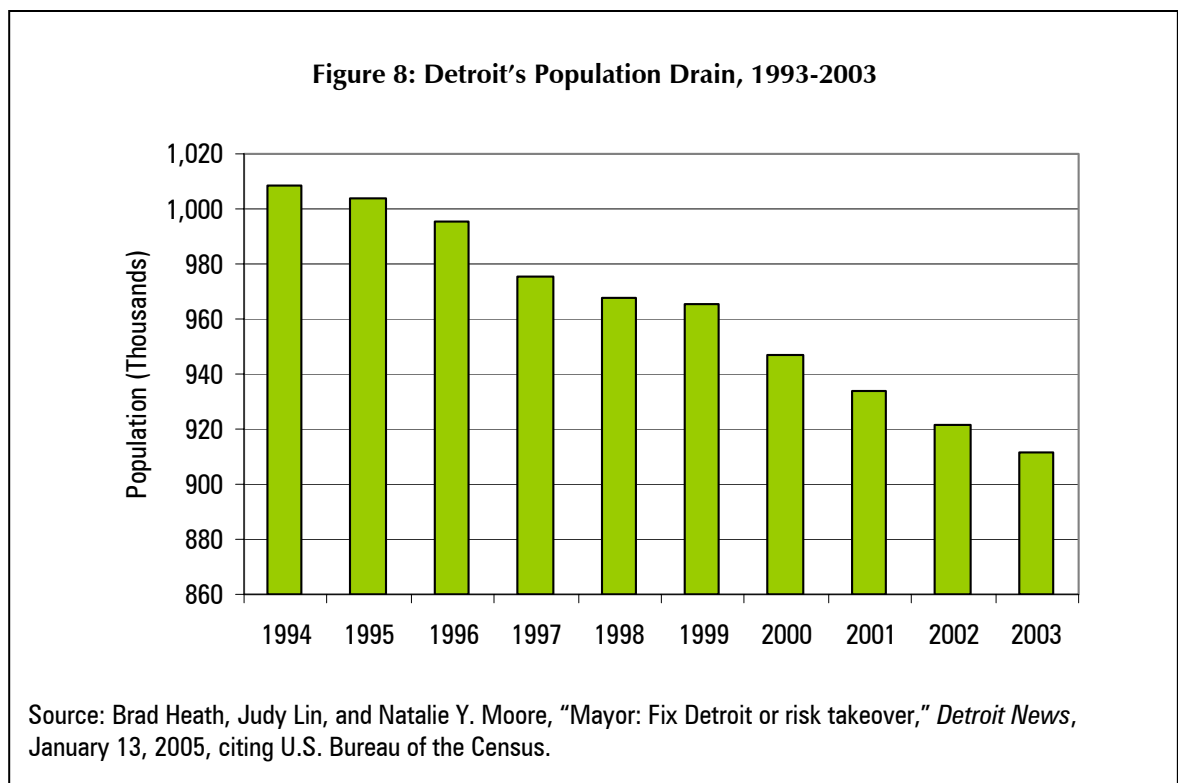
## F. Detroit: Rising Pension Costs and a Declining Revenue Base

The city of Detroit has struggled with its finances for years, but now the situation has really hit the crisis level. The city is currently facing a budget deficit estimated at \$342 million.<sup>318</sup> Standard and Poor’s recently downgraded Detroit’s credit ratings to BBB, just above junk status, citing the city’s “continued deterioration” and the likelihood of a third consecutive year of budget deficits.”<sup>319</sup> In addition, the city must find a way to plug a \$1.2 billion unfunded pension liability.<sup>320</sup> As City Councilwoman Sheila Cockrel affirms, “We’re heading toward a real crisis. I don’t think it’s ever been this bad, and I don’t think people have any idea how serious the situation is.”<sup>321</sup> If the city is not able to turn things around in a hurry, warns Mayor Kilpatrick, Detroit could face a state takeover of its finances within a year.<sup>322</sup>

**1. Detroit’s Shrinking Tax Base**

Detroit is hardly alone in dealing with recent budget and pension difficulties. What makes the situation in Detroit somewhat unique, however, is that the problem is compounded by a considerable erosion of its population, and thus its tax base.

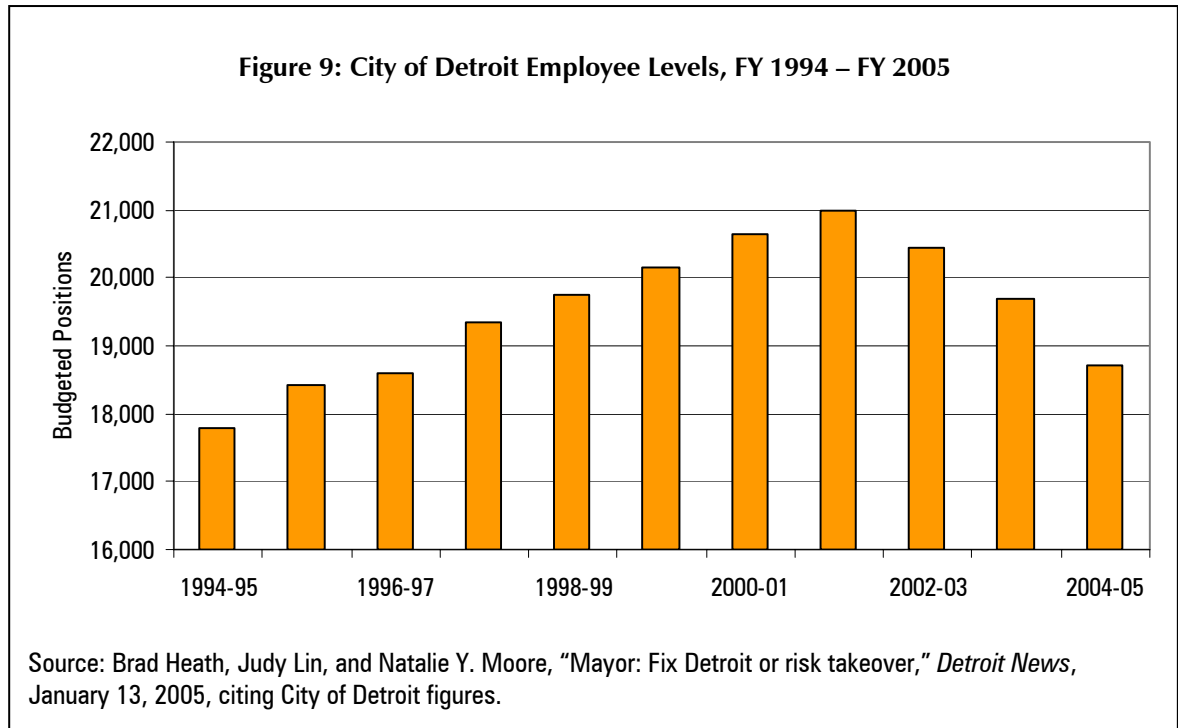
It is not as though Detroit’s declining population has been a sudden phenomenon that caught policymakers off-guard. The city’s population has been declining for decades, and has fallen about 10 percent in the last 10 years. In 1970, Detroit residents made up 17 percent of the total population of Michigan. Today, the figure is 9.6 percent and falling.<sup>323</sup>



This migration to the suburbs has led to a corresponding reduction in tax revenue. In 1970, Detroit processed approximately 747,000 city income tax returns. Today, it processes only about 385,000.<sup>324</sup>

**2. Unsustainable Government Growth**

On the expenditure side of the equation, the city is still recovering from increases in the government workforce under Mayor Dennis Archer during the 1990s. From 1994 to 2002, city employee workforce grew from 17,797 to 20,990 (approximately 18 percent) before the city embarked upon three consecutive years of staff reductions under Mayor Kilpatrick.<sup>325</sup>



Even with these cuts, the number of city employees has increased by more than 6 percent in the past decade. While this might appear to be a model of restraint compared to many other cities, it is actually a mark of profligacy when you consider that the city's population fell about 10 percent during the same period. In addition, despite Detroit's admirable efforts to reduce staff levels in recent years, its personnel costs are still comparatively high. According to City Councilwoman Sheila Cockrel, "Detroit's number of city workers per resident is extremely high. It's one city worker per 50 residents. Other communities have numbers like one to 200, one to 140, one to 150 city workers to residents."<sup>326</sup> In addition, Detroit's government spending per capita is second in the nation only to New York City.<sup>327</sup>

To make matters worse, even in the face of Detroit's trying fiscal climate, Mayor Kilpatrick negotiated a 2-5 percent pay raise for government employees that went into effect in 2003 and will cost the city an estimated \$26 million this year.<sup>328</sup>

### ***3. Pension Reform***

Regardless of the mayor's consent to city employee pay raises, he has taken some bold steps to cut costs and restore the city to sound financial footing. Chief among these is his proposal to freeze the city's defined-benefit pension plans and shift new employees into a lower-cost defined-contribution plan. Detroit's retirement system consists of the General Retirement System (GRS) and the Policemen and Firemen Retirement System (PFRS), each of which offers a defined-benefit and a defined-contribution, or "Annuity Savings Fund," plan. The defined-contribution plans, which were established in 1998, are optional

and have nearly as many active participants as the defined-benefit plans. The GRS consists of 12,312 active defined-benefit members versus 11,025 active defined-contribution members and the PFRS consists of 5,177 active defined-benefit members versus 4,760 active defined-contribution members.<sup>329</sup> The mayor's proposal would require all new city employees to participate in the defined-contribution plan.<sup>330</sup>

As of June 30, 2003, the GRS was 77.6 percent funded and had an unfunded liability of \$733 million, while the PFRS was 86.1 percent funded and had an unfunded liability of \$516 million, for a combined unfunded liability of about \$1.25 billion.<sup>331</sup>

While the vast majority of government pension plans are still defined-benefit plans, pressure has built on state and local governments in Michigan (as elsewhere) to adopt defined-contribution plans in recent years. A number of municipalities in southeast Michigan switched to defined-contribution plans during the 1990s, as did the state government.<sup>332</sup>

The costs of skyrocketing pension and health-care costs for city employees have simply become too much to bear. In just the past two years, Detroit's pension plan costs have grown by \$97 million, and now comprise 11 percent of the city budget.<sup>333</sup> As a *Detroit News* article notes, "The burden of providing rich health-care benefits for city employees and retirees is unsustainable, just as it is for Detroit's automakers. Defined-benefit pensions are too expensive, which is why the mayor has ordered the city to move all new city hires to [defined-contribution plans]."<sup>334</sup>

#### ***4. Bonds to the Rescue?***

Another of the mayor's responses to the city's fiscal woes is not so laudable. A central part of his reform plan was the issuance of a \$1.2 billion pension obligation bond. The bond was presented as an alternative to laying off 2,000 city employees (at least temporarily). As is typically the case with pension obligation bonds, it was also sold as a refinancing measure, which is expected to "save" the city \$80 million this year and \$277 million total over the 14-year life of the bond.<sup>335</sup>

As discussed previously, gambling on pension obligation bonds is a risky proposition. If the pension funds' performance falls below the bond's 5.8 percent interest rate, the city will have to make up the difference to Wall Street bond holders. For the 15-year period ended June 30, 2003, the GRS returned an average of 8.2 percent.<sup>336</sup> Even if it is able to match this performance over the life of the bond, this represents only a 2.4 percent gain after paying the 5.8 percent interest on the bonds. That's quite a lot of risk to assume for such a small expected return. In order to justify such a bond, one would have to assume extraordinary pension investment returns.

To their credit, bond opponents put up a good fight. According to a *Detroit Free Press* article, the bond's passage "took more than six attempts over three months, two failed votes, two special sessions, a threat to have police gather up errant [City Council] members and finally a four-hour visit from the mayor."<sup>337</sup> Even the PFRS, which does not have a direct say in the matter but carries significant political clout, voted against endorsing the bond sale.<sup>338</sup> City Councilwoman Sharon McPhail summed up the bond measure counterargument succinctly: "It's not a responsible way to manage the city's finances. If they'd stop spending money, they wouldn't have to lay off as many people."<sup>339</sup>



### 5. The Mayor's Recovery Plan

Mayor Kilpatrick's recovery plan offers numerous other short-term and long-term solutions:

#### **Short Term:**

- Lay off 686 city employees
- Eliminate 237 vacant positions
- 10 percent pay cut for all non-union employees
- 10 percent pay cut for the mayor and all appointees
- Negotiate 10 percent pay cut with union employees and a reduction in overtime pay
- Negotiate 5 to 10 percent contract concessions from city vendors
- Reduce the hours of operation of the city's bus system

#### **Long Term:**

- Require participation in a defined-contribution retirement plan for all new hires
- Restructure employee benefit programs to reduce costs
- Examine early retirement "buyout" options for long-term employees
- Reduce workers' compensation caseload and costs
- Consider outsourcing functions of the Transportation, Public Lighting, and Health departments
- Consolidate city departments
- Eliminate all generally assigned city vehicles
- Consider increasing the cigarette tax, liquor tax, prepared food tax, and/or utility user tax<sup>340</sup>

The mayor's austerity program will be a tough sell, particularly with the city's labor unions. Even labor unions have an incentive to offer concessions, though, since a state takeover of city finances would open the door for the state to void labor agreements, fire city workers, and reduce services without union input. All parties are coming to realize that drastic structural reform is necessary. This alone provides some hope that an effective solution to the city's financial mess may be found.

### 6. Conclusions

Detroit faces the dual problems of rising employee benefits costs and a shrinking tax base. The return to a strong financial position will require significant government restructuring and cost reductions. As explained in a *Detroit News* column, "Detroit's fiscal meltdown, accelerated by a declining population and tax base, has been a long time coming. It cannot be eased with one-time fixes, accounting gimmicks, thunderous rhetoric from special interests and the political grandstanding of some City Council members."<sup>341</sup>

Mayor Kilpatrick himself acknowledges, "Since the 1960s, the city has at times ignored the writing on the wall and believed that if we wait just one more year, things will improve, federal dollars will come, the balance sheet will get better. But 40 years of red ink have proven that's a financial fairy tale."<sup>342</sup> His eagerness to address the situation by borrowing more money through the issuance of a pension obligation bond notwithstanding, the mayor has taken the lead in proposing a number of bold and necessary reforms, including the freezing of the city's defined-benefit pension plans and a switch to defined-contribution plans. Detroit's situation should serve as a cautionary tale to other municipalities: Adjust your spending to fiscal realities and don't make financial promises you cannot keep.

## G. Orange County, California: Ignoring the Lessons of the 1994 Bankruptcy

In 1994, Orange County, the fifth-largest county in the nation, declared the largest municipal bankruptcy in U.S. history. Unfortunately, the county is experiencing more financial woes a decade later and many see similarities in the two crises. Today, it is facing a \$1.3 billion pension liability.<sup>343</sup> Reserves are expected to dry up in 2006.<sup>344</sup> It seems the county has failed to learn the lesson of the 1994 bankruptcy. Now, once again, the county is gambling on optimistic investment return assumptions to bail itself out.

### 1. The 1994 Bankruptcy

Under the advice of long-time County Treasurer Robert Citron, Orange County adopted a risky investment strategy in the early 1990s to try to take advantage of stock market gains, borrowing heavily to invest. Citron invested primarily in medium-term interest-linked securities, betting that short-term interest rates would remain low. At its height, Citron controlled an investment pool of \$20 billion from the county, cities, school districts, and special districts. But when interest rates rose, instead of falling, as Citron had predicted, the investment pool racked up \$1.5 billion in paper losses. Wall Street began calling for collateral and government entities that had invested in the pool began to withdraw their money. When Wall Street institutions began to sell off securities held as collateral, the Orange County Board of Supervisors declared bankruptcy to stem the tide. When all was said and done, Orange County had lost \$1.64 billion.<sup>345</sup>

To repay the bankruptcy bills, the county incurred more debt, issuing nearly \$1 billion in recovery bonds. To repay the debt, the county must set aside more than \$100 million each year until 2027.<sup>346</sup>

As an *Orange County Register* article points out, there was plenty of blame to go around:

*[A] rogue treasurer making risky investments; an auditor who noticed problems but didn't ensure they were taken seriously; county officials delighted that 33 percent of their general fund was pouring in from interest income – even though anything above 5 percent should have raised eyebrows; supervisors who unquestioningly borrowed hundreds of millions of dollars for the sole purpose of boosting those interest earnings; and voters who ignored warnings about the rogue treasurer and re-elected him anyway.*<sup>347</sup>

As a result of the bankruptcy scandal, Orange County tightened its investment policies, established oversight committees, and improved financial disclosure requirements. Voters even elected a responsible treasurer in John Moorlach, the one who yelled the loudest about the county's risky investments and who had lost the 1994 election to Citron.

### 2. Another Bankruptcy in the Future?

To many, the conditions of the county's pension system today bear a frightening resemblance to the bankruptcy of a decade ago. According to *Orange County Register* columnist Steven Greenhut, "Citron bet on a best-case scenario for the investment pool even as conditions soured, just as the county is now betting on a best-case scenario to pay for the pension increases even as the economic numbers don't support the rosy scenario."<sup>348</sup>

The Orange County Employee Retirement System fund has an assumed investment return rate of 7.5 percent per year.<sup>349</sup> But the fund has returned only 3.12 percent over three years and 5.55 percent over five years.<sup>350</sup> In order to make up that gap in the next five years, for example, the portfolio would have to earn average returns of nearly 9.5 percent a year, a highly unlikely outcome.

Moorlach, too, sees many similarities between the bankruptcy and the county's increasing pension troubles and is again sounding the alarm bell. Said Moorlach,

*We have electeds who seem to believe the line that it doesn't cost anything [to increase benefits]. But now we have cities up north that are sucking air. They've increased benefits so much, and now they can't afford to pay them. They are looking at layoffs, tax increases and all the stuff we had to do after the bankruptcy.*<sup>351</sup>

Moorlach argues that increasing county employee compensation by increasing pension benefits instead of salaries is a dangerous policy. In addition to gambling with the volatility of the stock market to try to generate the money needed to pay the benefits, pension policy is much less flexible than wage policy because pension increases are more permanent than wage increases. While salary increases can be taken back in times of financial strain, pension increases are a "lobster trap" – once you're in, there's no way out.<sup>352</sup>

The benefits increases approved by the Board of Supervisors in recent years are, indeed, significant:

- In 1999, the county launched the Performance Incentive Program (PIP), designed to be a merit-based perk that offers an additional 2 percent of salary to recipients. A 2003 grand jury report revealed, however, that the benefits had become a virtually automatic bonus distributed to 95 percent of employees.<sup>353</sup>
- In December 2001, Supervisors unanimously approved a "3 percent at 50" benefits package for public-safety workers at an estimated cost of \$400 million, even after the stock market boom had become a downturn. Rather than capping the maximum number of years worked (for the purpose of benefits calculations) at 30 like most "3 percent at 50" plans, Orange County allows safety employees to achieve a maximum of 33 years, 4 months, meaning they can collect up to 100 percent of their salaries in retirement (33 1/3 years times 3 percent), compared to 90 percent for other plans.<sup>354</sup>
- In December 2002, Supervisors drew the ire of an Orange County Grand Jury by adopting \$75 million in perks and bonuses, even as layoffs and service cutbacks were being considered.<sup>355</sup>
- In August 2004, Supervisors approved a "2.7 percent at 55" retirement plan for non-safety employees that allows a 30-year employee to retire with 81 percent of his or her final salary. This represents a 62 percent increase in pension benefits for more than 14,000 county employees.<sup>356</sup> The benefits are expected to cost nearly \$300 million. Employees formerly had to wait until age 62 before receiving full benefits.

The deal reached with county employee unions last August is even more troublesome because, while employees agreed to forego raises and increase contributions to the plan for the duration of the three-year contract to help pay for the added benefits, there is no guarantee that they will continue to pick up the tab after the contract expires. If they do not, taxpayers will be stuck with the bill. In addition, the higher benefits are expected to encourage many county employees to retire early. As actuary Pamela Morris argues, "If you implement a program that has huge incentives to retire early, how can you assume the retirement rate

will not grow?”<sup>357</sup> Thus, the costs of the new plan are likely underestimated and costs may continue to grow long into the future. Finally, the August 2004 deal increased benefits for at least a dozen high-level managers so much that the benefits exceed a cap put in place by federal law.<sup>358</sup> State law requires the county to make up the difference, meaning taxpayers will have to bear even higher costs.

Even more recently, the Board of Supervisors unanimously approved a contract with the sheriff’s deputies union in March that will grant the deputies an 8 percent raise over two years.<sup>359</sup> The situation simply will not improve until the leaders of this “conservative” county learn to say no to spending increases.

### ***3. Coming Out of Retirement***

As if Orange County’s pension benefits were not already sweet enough, retirees wanting more can benefit from the county’s practice of hiring retired workers to fill temporary employment gaps. While state law limits county retirees from working more than 700 hours per year for their former government employers,<sup>360</sup> and county policy restricts retirees from working more than 120 days per year for the county,<sup>361</sup> the costs do add up. According to a county report, the county paid \$3.7 million to 211 retired employees in fiscal year 2003-2004 and \$2 million to 204 retirees during the first half of the current fiscal year.<sup>362</sup>

The rehiring policy has drawn strong criticism from Supervisor Chris Norby. According to Norby, “Once you choose to retire, you have a pension. People need to choose between a pension and a paycheck.”<sup>363</sup>

The county has responded to the double-dipping problem by further restricting the practice and requiring approval for all rehired workers from County Executive Officer Thomas G. Mauk.<sup>364</sup> It should additionally plug a loophole that allows retirees to get around the annual limits on work with the county by working for a consulting firm, and thus not directly being rehired by the county. Better yet, the county should just put an end to the unseemly policy altogether.

### ***4. Conclusion***

Orange County’s first gamble, using a highly leveraged bet on the direction of interest rates, for funding ten years ago cost it dearly. Annual payments on the recovery bonds “have forced more than a dozen county departments—including health care, law enforcement, welfare, parks, beaches, roads, and flood control—to absorb more than \$700 million in cuts over the past decade.”<sup>365</sup> This is the ultimate price of foolish investment risk-taking and profligacy. As University of California, Irvine, political science professor Mark Petracca proffers, “Just think. After 10 years, we’re close to having paid a billion dollars just in interest alone. That would buy a lot of everything. It would buy a lot of new roads. It would buy a lot of mass transportation. It would buy a lot of education.”<sup>366</sup>

Sadly, as the recent benefits increases attest, Orange County has not learned the lesson of the 1994 bankruptcy. It continues to hold out the hope that increasing obligations will be covered by increasing portfolio returns. As pension and health-care costs continue to rise dramatically, and the stock market suffers its inevitable downturns, such an expectation seems exceedingly implausible. Hopefully, the county will reverse course before the next financial meltdown.

## **H. Houston: Lavish Benefits and Bad Assumptions**

The city of Houston is currently suffering from a \$1.9 billion unfunded pension liability, nearly double the \$1 billion shortfall reported just a year ago.<sup>367</sup> As a *Fort Worth Star-Telegram* article reports, “The city had to double its contributions and at one point considered a 15 percent increase in [property] tax rates.”<sup>368</sup> The Houston Municipal Employees Pension System (HMEPS), which covers most city employees, is currently only about 46 percent funded and faces a funding gap of \$1.8 billion.<sup>369</sup> On top of all this, Fitch Ratings recently lowered Houston’s bond rating from AA to AA-, citing the city’s “large unfunded pension liabilities.”<sup>370</sup>

The root of the pension system’s troubles is a series of benefit increases of up to 200 percent.<sup>371</sup> The benefit hikes were passed based, in large part, on the flawed determination of the city’s actuary that the city could afford the increases.<sup>372</sup> The actuary’s errors were compounded by a lack of transparency and oversight of the pension funds.

### ***1. Excessive Benefits Increases***

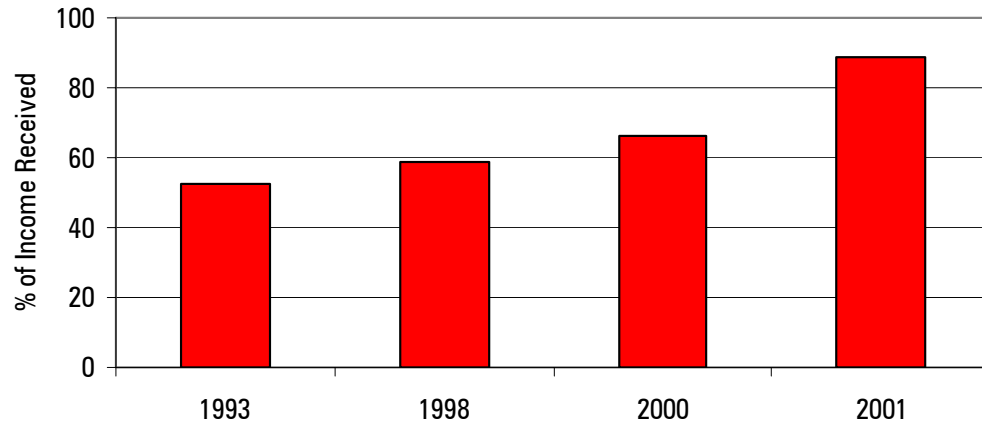
In 2001, despite a warning of an actuary hired by the Texas Pension Review Board about the likely costs, former Mayor Lee Brown’s administration approved an extravagant early retirement plan that allowed a city employee to retire at 45 years of age after 25 years of service with 90 percent of his or her final salary, complete with a 4 percent cost-of-living adjustment.<sup>373</sup> In addition, city government retirees enjoy a survivorship benefit equal to 100 percent of their final compensation, a level found in only one other city in the nation, according to a *Houston Chronicle* survey.<sup>374</sup>

Under the HMEPS, a hypothetical 40-something city employee making \$40,000 per year could retire at age 65 with annuities equaling \$2.7 million. A savvy municipal employee could retire with an income greater than when he was working.<sup>375</sup>

In addition, because of the passage of a constitutional amendment (Proposition 15) that passed in September 2003, Houston was rendered unable to reduce benefits for any city employee who had worked at least five years (a very short vesting period for a defined-benefit plan).<sup>376</sup> Fortunately, Proposition 15 included a provision that offered municipalities a one-time opportunity to opt out of the restrictions with local voter approval. Worried over the costs of increasing benefits, Houston residents passed such an opt-out measure (Proposition 1) in May 2004 by a wide margin.<sup>377</sup> After opting out of the Proposition 15 restrictions, the city was able to negotiate a deal with the police pension board and the main municipal pension board in the fall of 2004 to roll back pension benefits to pre-2001 levels. The change means that an employee with 25 years’ experience will receive a pension equal to 66 percent of his or her salary, compared to 89 percent previously.<sup>378</sup>

Houston’s retirement benefits are significantly greater than comparable cities such as Dallas, Denver, Philadelphia, and Phoenix. Moreover, the increase in these benefits over the past ten years or so is striking. In 1993, a city employee enrolled in the HMEPS could retire after 25 years with a pension equal to 52.5 percent of his or her final income. By 2001, the figure had risen to 88.75 percent of income (see Figure 10).<sup>379</sup> The city must continue to make serious efforts to rein in benefit levels (and resulting costs) if it is to return to a sound fiscal condition.

**Figure 10: Houston Benefits Comparison**  
 Percentage of income a retiring employee received from the Houston Municipal Employees Pension System after 25 years of service



Compared to Other Cities (Years of work to get 65 percent of income in retirement)		
	Employee Contribution	Years
Phoenix	Yes	35
Philadelphia	Yes	33
Denver	No	34
Dallas	Yes	25
Houston	Yes	20

Source: Dan Feldstein and Kristen Mack, "City faces \$1 billion pension shortfall: Taxpayers may have to foot bill for generous benefits," *Houston Chronicle*, February 29, 2004, citing Houston Municipal Employees Pension System, Actuarial Service Co.

## 2. Time to Drop the DROP

Not surprisingly, Houston’s new, rich benefit levels soon caused city workers to retire in droves. In fact, 44 percent of the city’s workforce quit over the ensuing five years.<sup>380</sup> The city then multiplied its error by implementing a generous deferred retirement option program (DROP) to encourage employees to stay on longer. The DROP was first implemented in 1995 and was initially restricted to public-safety employees, but a loud chorus of “me toos” arose among the municipal employees and in 1997 the DROP was made available to them as well.<sup>381</sup>

As evidence of the DROP’s extraordinary benefits, “virtually all workers [entered] the deferred retirement program immediately after becoming eligible.”<sup>382</sup> The DROP accounts’ extremely generous 8.5 percent interest rate on accrued benefits and lack of a limit on the amount of time the money in the DROP account could continue to bear interest proved to be extremely costly to the city.<sup>383</sup> As was the case with Milwaukee County’s notorious DROP, Houston had a “back DROP” provision. As *Milwaukee Journal Sentinel* columnists Jessica McBride and Avrum D. Lank explain, “Under such a plan, employees can wait until they

retire to select a date for the DROP payments to start accruing—in effect creating a lump sum account, including accumulated interest, after the fact.”<sup>384</sup>

While Mayor Bill White has put forth a plan that would tinker with the interest rate for accrued DROP benefits in an effort to save some money,<sup>385</sup> this is not nearly sufficient. Houston should eliminate this costly perk altogether.

### *3. Twice the Pensions, Twice the Fun*

More recently, Houston adopted another ill-advised benefit increase. In 1999, the City Council voted to *double* the pensions of the pension fund executive director, department heads, and other high-ranking bureaucrats. Even worse, in 2001, the benefit increases were made retroactive to years prior to 1999.<sup>386</sup>

The pension increase was sold to the City Council as a way to recruit high-quality department heads from the private sector and “to counter the potentially negative effects of term limits.”<sup>387</sup> In truth, it primarily benefited executives already on the city payroll.

Fortunately, the unseemliness of the arrangement, particularly in an environment where many workers’ benefits had been reduced, caused the City Council to vote unanimously in December 2004 to eliminate the pension “twofer.” Before the vote, City Councilman Mark Ellis remarked, “It needs to be abolished. It sends the wrong message to taxpayers and to all the people working at City Hall. It lowers morale.” Added Ellis, “We want department heads to be happy, but not at the detriment of taxpayers and the rank-and-file employees.”<sup>388</sup>

### *4. Flawed Actuarial Assumptions*

Houston’s problems were facilitated by poor actuarial assumptions. “In Houston, what has happened is they used the wrong actuarial results, and that’s how they got into trouble,” explains state Rep. Martha Wong, who is also a former Houston City Council and pension board member.<sup>389</sup> Mayor White has similarly acknowledged that faulty assumptions masked the pension system’s problems.<sup>390</sup>

Houston is certainly not alone in betting on rosy actuarial assumptions. According to Edward Siedle, a former Securities and Exchange Commission attorney who now owns a business that investigates government pension fund abuses, “In my experience, every pension fund I’ve ever seen has an actuarial assumption that is more akin to wishful thinking than what is reasonably foreseeable.”<sup>391</sup> Houston’s projections were apparently even more optimistic than most, however.

Among the erroneous assumptions were those concerning annual pay increases and retirement rates. The Houston Police Officers Pension Fund (HPOPF) estimated annual salary increases of 4.5 percent, but the actual increase averaged 7.1 percent from 1997 to 2003. The plan neglected to increase the assumption even after collective bargaining agreements in 2001 resulted in planned raises of 6.3 percent in 2003, 10.6 percent in 2004, and 8.2 percent in 2005.<sup>392</sup> The HMEPS estimated that 5 percent of the workforce would retire by age 55. In reality, 30 percent retired within one year.<sup>393</sup>

These and other flawed cost estimates proved to be particularly damaging to the city. Prior to the 2001 benefit increases, the city’s actuary estimated that the city would need to contribute 14 percent of its non-

safety employee payroll to the HMEPS. A re-evaluation in 2003 revealed that the city would actually have to contribute 32 percent of payroll.<sup>394</sup>

### *5. The Need for Improved Transparency and Oversight*

Houston can help to prevent similar faulty actuarial assessments from costing it in the future by improving the transparency and oversight of its pension funds. The city never conducted its own analysis of the 2001 benefit increases, for example.<sup>395</sup> Indeed, the city only discovered the trouble with its municipal and police pension funds after White became mayor and ordered an audit of the funds. The city also ordered new studies last year to compare the funds' actuarial assumptions with actual performance. It was the first time it had done so since 1998.<sup>396</sup>

The good news is that politicians are paying attention to the issue and acting to improve pension fund transparency and oversight. Mayor White brought the issue to the forefront at a meeting with the Texas Pension Review Board last year when he said, "I think on these things, the more transparency, the better. The more scrutiny there is, the better things work."<sup>397</sup> White has also vowed to take personal responsibility for providing greater oversight of the pension funds' actuarial assumptions, declaring, "In my administration, I'll make sure we do have second opinions. Period. I personally will familiarize myself with the actuarial assumptions. I, the person who runs the city, will not rely on secondhand information."<sup>398</sup>

State Rep. Wong has also put forth a proposal to improve the transparency and oversight of government pension plans. Her measure, H.B. 109, would require municipalities with populations of 750,000 or more to commission an independent analysis of any legislation or other changes that could alter the actuarial soundness of a municipal pension fund, in addition to the municipality's internal analysis. The actuary conducting the analysis "may not have a conflict of interest with the retirement system, the municipality, or any member of the governing bodies of those entities."<sup>399</sup>

### *6. Conclusion*

Mayor White has outlined a plan to help shore up the city's pension funds. The proposal includes:

- Increasing employee contributions;<sup>400</sup>
- Increasing the minimum retirement age;<sup>401</sup>
- Creating minimum and maximum interest rates for accrued DROP benefits;<sup>402</sup>
- Issuing pension obligation bonds;<sup>403</sup>
- Extending the HMEPS amortization schedule for unfunded actuarial liabilities from 18 to 30 years;<sup>404</sup>
- Spreading the sell-back of police officers' unused sick and vacation time over a five-year period, rather than allowing lump-sum distribution; and<sup>405</sup>
- Calculating police officers' pension benefits based on a three-year average of their highest pay, instead of on their highest two-weeks pay, as is the current practice.<sup>406</sup>

Most of these solutions are merely short-term fixes, however. An agreement reached with the police officers' union, for example, will allow the city to continue to underfund the HPOPS for years to come.



Under the agreed-upon city contribution schedule, the fund is still estimated to be only 75 percent funded in FY 2012.<sup>407</sup>

Issuing pension obligation bonds and adopting a longer amortization period likewise do nothing to address the fundamental problems of the city's pension system. These measures only put off the problem longer and, barring a significant, sustained rally in the funds' investments (which is doubtless what Houston officials are hoping for), may well leave an even bigger problem for future administrations. Houston needs to adopt serious reforms, such as switching to lower-cost defined-contribution retirement plans and eliminating extravagant employee benefits such as the DROP.

Where Houston does seem to be making progress is in improving the transparency and oversight of its pension funds. The city has been burned by erroneous actuarial assumptions and does seem to possess a genuine interest in preventing future such occurrences. It realizes that it must ultimately bear the responsibility for the actuarial advice that it acts upon. Measures like Rep. Wong's H.B. 109 will serve to provide additional checks against unwise assumptions and ignorant public officials.

Perhaps Houston has learned the lessons of overly generous benefits and overly optimistic projections. For the sake of its employees, retirees, and taxpayers, it cannot afford to repeat those mistakes. Current and future city officials should heed the words of Mayor White: "There is a virtue in not overpromising because people rely on those promises."<sup>408</sup>

## I. Contra Costa County, California: The Costs of Unreasonable Assumptions

Like Orange County, California, Contra Costa County's pension system has racked up over a \$1 billion unfunded liability over the past few years.<sup>409</sup> The *Contra Costa Times* reported in September 2004 that county retirement expenses would increase by \$30 million in the next fiscal year—*10 times greater than County Administrator John Sweeten had predicted only five months prior*—due to a re-evaluation of unreasonable actuarial assumptions.<sup>410</sup> County contributions to the system from the general fund have skyrocketed from \$29.4 million (5.78 percent of the all general fund expenses) in 1994-95 to an anticipated \$103.9 million (12.26 percent of general fund) in 2004-05.<sup>411</sup> As Supervisor Mark DeSaulnier explained the pension problem, "It's not rocket science. We just don't have the money."<sup>412</sup> While the county blamed the downturn in the financial health of the Contra Costa County Employees' Retirement Association (CCCERA) on the stock market,<sup>413</sup> independent analyses showed that the real reasons were a massive increase in benefits and irresponsible financial and demographic assumptions that provided artificially low cost estimates. In contrast to Houston, Contra Costa County received sound actuarial advice. Unfortunately, it chose to ignore that advice.

### 1. Independent Analysis Suggests Deficit Causes

The county Board of Supervisors sought an independent analysis to uncover the causes of the pension deficit. A report by Public Pension Professionals shed light on the situation and identified the key causes of the pension deficit and the magnitude of each factor:

- **35% (\$421 million)** – due to retirement board policies, including the increase of the assumed investment return rate in 2001 from 8.25 percent to 8.5 percent—the highest of any county pension

plan in the state—and rejecting actuarial advice to change other assumptions, such as to reflect the longer life spans of county employees;

- **24% (\$288 million)** – to a court decision that allowed county employees new ways to increase their pensions;
- **20% (\$235 million)** – to benefit increases, approved by the Board of Supervisors in 2002, of up to 50 percent; and
- **2% (\$24 million)** – to market losses.<sup>414</sup>

As these findings indicate, the pension’s unfunded liability cannot be pinned on the stock market. The report concluded: “Retirement benefit costs are currently growing at a rate the county cannot sustain.”<sup>415</sup> As such, the analysis recommended shifting to a defined-contribution plan, establishing a lower benefit tier for new employees, or adopting some combination of both.<sup>416</sup>

In addition to the Public Pension Professionals report, a civilian grand jury was called upon to investigate the pension system’s problems. The Grand Jury’s conclusions mirrored those of the Public Pension Professionals report:

*The UAAL [Unfunded Actuarial Accrued Liability] generally continued to increase every year since 2001, due to:*

- a. The BOS [Board of Supervisors] approved retroactive enhanced pension benefits.*
- b. The CCCERA Board selected overly optimistic rates of investment return against its actuary’s recommendation.*
- c. The CCCERA Board refused to adopt their actuary’s recommendations concerning employee morbidity and employee marriage benefits.<sup>417</sup>*

The Grand Jury report expressed disapproval of the 2002 increase in county employees’ benefits for both safety and non-safety employees. Safety employees realized a 50 percent jump in benefits, moving from a “2 percent at 50” plan to a “3 percent at 50” plan. This allows a county safety employee with 30 years of service to now retire with 90 percent of his salary, instead of 60 percent.<sup>418</sup> The *Contra Costa Times* reported in 2003 that more than one-third of those who retired in the first year after the implementation of the new benefit structure actually received pensions that were greater than their final year’s salaries. As one local taxpayer advocate affirms, “To allow people to go out at retirement rates that exceed their work rates is obscene.”<sup>419</sup> Non-safety employees’ benefits rose from a “1.67 percent at 55” plan to a “2 percent at 55” plan,<sup>420</sup> an increase of 20 percent.

In addition, the report was highly critical of the county’s vacation sell-back program, which allows some county management employees to forego accumulated vacation time in exchange for additional benefits (within certain limits). Furthermore, the grand jury asserts, managers may use this program to spike their pensions by redeeming large sums of vacation pay during their final year of employment before retirement. A manager with many hours of unused vacation time may even “double-dip,” redeeming the maximum amount of vacation time at the end of the calendar year before retiring and again in the following calendar year. If both redemptions take place within the last 12 months of employment, both are included in the compensation calculation for pension purposes. In this way, one could increase his or her final compensation and pension by nearly 20 percent.<sup>421</sup>

Perhaps of most significance was the Grand Jury's recommendation to completely overhaul the pension system. Like the Public Pension Professionals report, the Grand Jury recommended scrapping the county's defined-benefit plan and transitioning to a defined-contribution plan.<sup>422</sup> One complication is that Contra Costa is one of 20 counties governed by the state's County Employees' Retirement Law of 1937, which prohibits counties from offering only defined-contribution plans. The County could get around the law, however, through special state legislation or by removing itself from the 1937 Act, which would likely require voter approval.<sup>423</sup>

## *2. Conclusion*

Like Los Angeles County, Contra Costa County has taken some preliminary actions to address its pension deficit. Among these measures:

- CCCERA has returned to more actuarially sound assumptions;
- Two members of the labor-dominated retirement board have been replaced;
- County employees will increase contributions by 1 percent of their salaries, on average, beginning in July 2005;
- The county has hired an independent pension consultant; and
- A legislative committee is scheduled to begin hearings on pension reform in March 2005.

Contra Costa County taxpayers can only hope that the Board of Supervisors will take the grand jury's recommendations to heart. The Board of Supervisors dismissed the warnings of a previous grand jury, convened in 2001-2002, that the county could not afford the benefits package that was ultimately approved.<sup>424</sup>

Unfortunately, the prospect for switching to a defined-contribution retirement plan does not look promising. The Board of Supervisors, responding to the Grand Jury's report, claimed that the recommendation is "not reasonable," and that such a unilateral move (as opposed to a statewide mandate) would put the county at a "competitive disadvantage in the recruitment and retention of employees."<sup>425</sup>

Nevertheless, the county should, at the very least, 1) adopt more restrictive sell-back benefit policies to prevent pension spiking and 2) ensure that greater—and more independent—oversight of pension board management will keep the county from making more foolish actuarial assumptions in the future.

## Part 6

# Pension Benefit Guaranty Corporation: The Next Savings-and-Loan Crisis?

Pension plans have been suffering in the private sector as well. Particularly hard hit have been the relatively few remaining private-sector defined-benefit plans. In 2004, these plans were cumulatively underfunded by \$350 billion.<sup>426</sup> Despite the stock market's recent recovery, Labor Secretary Elaine Chao announced in January that the figure had climbed to a record \$450 billion. Said Chao, "If nothing is done, the financial integrity of the federal insurance system will be compromised and the pension security of 34 million workers and retirees will be more at risk."<sup>427</sup>

The PBGC, the government agency that insures private defined-benefit plans and covers over 44 million workers, is now feeling the pinch of private pension underfunding, as more and more companies are unloading their plans on the agency. PBGC executive director Bradley Belt, echoing Chao's concerns, has even gone so far as to warn that the agency's funding responsibilities could "spiral out of control."<sup>428</sup>

The bankruptcies that have plagued the steel and airline industries in recent years have sparked fears that an even larger wave of pension terminations is in the near future for the PBGC. The agency has gone from what was thought to be a fairly comfortable surplus to an alarming deficit in just a few short years. Mr. Belt describes the factors that have contributed to the agency's current financial dilemma:

*You have had structural changes in industry sectors and individual companies. You have fairly dynamic changes in financial markets with respect to equity prices and interest rates. And you have a regulatory framework that is fundamentally flawed in its design, rife with moral hazard and a lack of transparency.*<sup>429</sup>

If the PBGC is unable to meet its commitments and ultimately goes bankrupt, the implicit backing of the federal government means that taxpayers will be on the hook for a bailout on the order of the savings-and-loan crisis of the 1980s. Significant reform is needed immediately to prevent such a bailout.

## A. About the PBGC

As mentioned previously, the PBGC was created by Congress in the ERISA legislation of 1974<sup>430</sup> in response to the high-profile bankruptcy of the Studebaker Corporation and other firms during the 1960s. Its purpose was to insure private-sector defined-benefit plans and encourage the creation of these traditional pension plans. The PBGC receives no tax revenues, but is funded instead through mandatory insurance

premiums paid by pension plan sponsors (employers), as well as investment returns and assets from pension plans taken over by the agency.

The PBGC insures two types of private pension plans, *single-employer plans*, which are generally sponsored by a single company for its employees, and *multi-employer plans*, which are sponsored by labor unions for employees from different companies within the same industry, such as trucking or construction. The single-employer program is the much larger of the two programs, covering 34.6 million workers and 29,651 pension plans, compared to 9.8 million workers and 1,587 plans covered under the multi-employer program.<sup>431</sup> The PBGC is currently responsible for paying the pensions of over one million people (including 518,000 who have already retired) in 3,479 plans that have been terminated. For plans ended in 2005, workers who retire at age 65 may receive a maximum pension payment of \$3,801.14 per month, or \$45,613.68 annually.<sup>432</sup> The maximum level of benefits guaranteed by the PBGC is established by law and adjusted yearly. According to a PBGC analysis, more than 90 percent of pension beneficiaries in plans assumed by the PBGC do not face any reduction in their benefits<sup>433</sup> (although workers cannot continue to accrue benefits once a plan is taken over by the agency).

A single-employer pension plan may be terminated in two ways, through a *standard* or *distress* termination. Under a ***standard termination***, a company that decides to discontinue its defined-benefit plan may end the plan upon payment of all accrued benefits to covered employees and retirees. (Note that in this scenario, the company's pension obligations must be fully funded before the plan can be terminated.) The payment may be made as a lump sum or an appropriate insurance company annuity. After workers receive these benefits, the plan is officially terminated and the PBGC's guarantee ends.

The terminations that have captured the headlines of late—and distressed politicians and taxpayers alike—are the ***distress terminations***. In this case, a company may be able to shed its pension plan (and transfer its obligations to the PBGC) if it is unable to meet its pension commitments and can demonstrate sufficient financial hardship from continuing the plan. As the PBGC describes this scenario,

*In a distress termination, where the plan does not have enough money to pay all benefits, the employer must prove severe financial distress – for instance the likelihood that continuing the plan would force the company to shut down. PBGC will pay guaranteed benefits, usually covering a large part of total earned benefits, and make strong efforts to recover funds from the employer.*

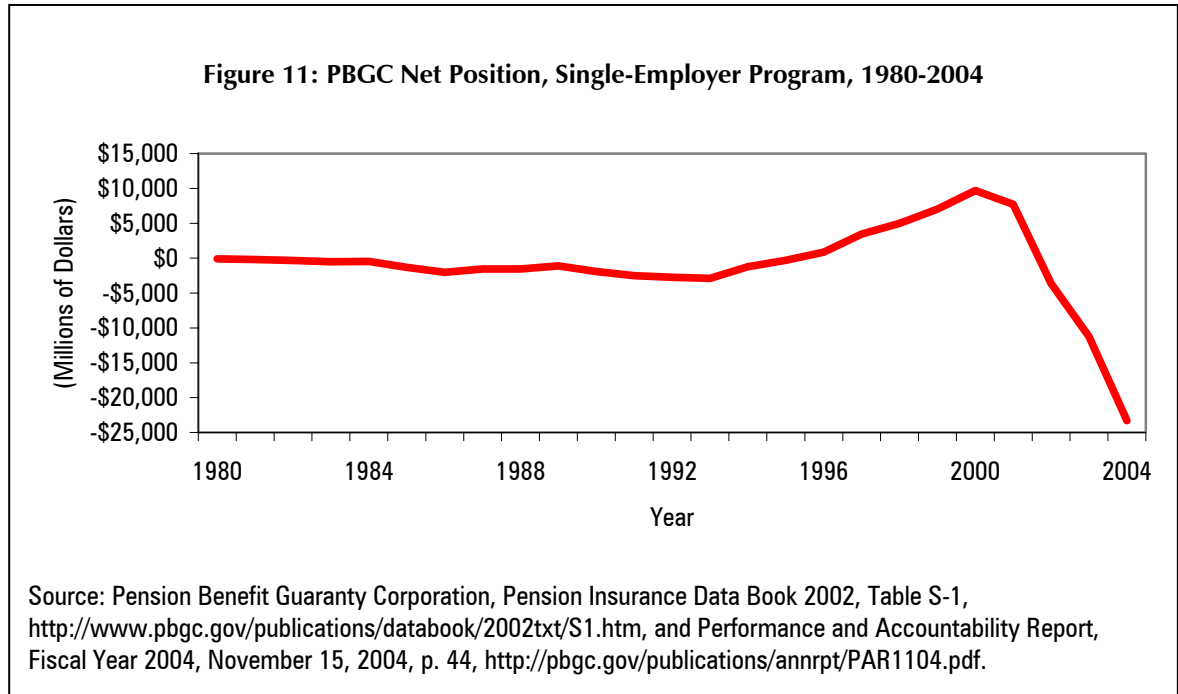
*In addition, PBGC may seek to close a single employer plan without the employer's consent to protect the interests of workers, the plan or PBGC's insurance fund. PBGC must act to terminate a plan that cannot pay current benefits.<sup>434</sup>*

## B. The PBGC's Bleak Financial Outlook

Increasing numbers of distress terminations over the past few years have strained PBGC coffers. The agency went from a \$9.7 billion *surplus* in 2000 to an \$11.2 billion *deficit* in 2003, a swing of \$21 billion in just three years.<sup>435</sup>

While the PBGC's net financial position remained relatively stable through other market downturns over the past quarter century—including those in 1981-82, 1987, and 1990—it saw significant swings during the boom of the late 1990s and bust of the early 2000s (see Figure 11). The deficit more than doubled in 2004 and is now estimated at \$23.3 billion.<sup>436</sup> According to the Center on Federal Financial Institutions, current

projections reveal that the PBGC will likely be bankrupt in 2020 if existing financial conditions remain about the same. Even under a rosier scenario in which financial conditions improve (and thus help to stave off some pension failures), the agency is still estimated to become insolvent in 2023.<sup>437</sup>



### 1. Troubled Industries, Troubled Pensions

The pensions that have been hit the hardest are those in high-cost industries such as the steel, airline, and automobile manufacturing. First, the steel companies shed their pension obligations onto the PBGC. Between 2001 and 2003, the PBGC terminated the plans of Bethlehem Steel, LTV Steel, and National Steel, resulting in obligations of \$3.9 billion, \$1.9 billion, and \$1.3 billion, respectively. As of 2003, these were the three largest pensions ever terminated by the PBGC, and the combined \$7.1 billion liability represented 44 percent of all the claims in the agency's entire 29-year history.<sup>438</sup> In the LTV case, the company apparently did not learn its lesson, as it emerged from bankruptcy only to make more pension promises it could not keep. As the editor of *PLANSPONSOR* magazine put it, "Like a drunk falling off the wagon, [LTV] dumped four heavily underfunded pension plans on the nation's private pension insurer (the Pension Benefit Guaranty Corporation) – then resumed operations, and promised workers new pensions that were just as extravagant as the old ones."<sup>439</sup>

The latest threat to the PBGC's financial viability is the airline industry. Despite a \$15 billion federal government bailout shortly after the September 11, 2001, attacks<sup>440</sup> and relief from the requirement that employers must pay increased "deficit reduction contributions" to severely underfunded pension plans,<sup>441</sup> the airline industry has continued to flounder. The industry lost an estimated \$5 billion in 2004 and is projected to lose up to \$2 billion more in 2005. It has not made a cumulative profit since 2000.<sup>442</sup>

The PBGC and bankrupt UAL Corporation, parent company of No. 2 U.S. carrier United Airlines, recently agreed to the termination of all four of United's employee pension plans. Under the agreement, the PBGC

agreed to guarantee \$6.6 billion of the \$9.8 billion combined funding shortfall. The termination marks the largest claim in the agency's 30-plus year history, dwarfing the Bethlehem Steel claim.<sup>443</sup> United had already come to an agreement with its pilots' union to end the group's pension plan covering 14,000 current and retired pilots and accept a 15 percent pay cut in exchange for added contributions to a separate, defined-contribution plan and \$550 million in notes convertible to stock upon the company's emergence from bankruptcy. Interestingly, that deal was contingent upon United's successful termination of the pension plans for its flight attendants, mechanics, and airport ground workers, who strongly opposed the termination of their defined-benefit plans.<sup>444</sup> This arrangement effectively pitted union against union. In another interesting twist, under the agreement, United committed to continuing the plan until May 2005. The date is significant because it would allow just enough time for a previously agreed upon benefit increase to be fully phased in.<sup>445</sup> The PBGC would then have to bear the cost of the additional benefits, estimated at \$140 million.<sup>446</sup> In response, the PBGC asked a federal bankruptcy court to allow it to terminate the plan, retroactive to December 30, 2004. United countered by halting some pension payments to the pilots, pending the court's decision, so as not to pay any more into a system that the PBGC may ultimately be responsible for after that date.<sup>447</sup>

US Airways has faced similar struggles. The No. 7 U.S. airline recently filed for Chapter 11 bankruptcy protection for the second time in two years.<sup>448</sup> The PBGC also took over three pension plans covering more than 51,000 US Airways Group Inc. workers and retirees. The agency estimated that the plans were only about 40 percent funded, holding \$1.7 billion in assets versus \$4.2 billion in liabilities. The PBGC is responsible for \$2.3 billion of the \$2.5 billion shortfall. The terminations come on the heels of the 2003 termination of the airline's pilots' pension plan, which represented an additional \$726 million claim. Before the United termination, the combined \$3 billion in obligations was second only to the Bethlehem Steel termination.<sup>449</sup>

The United and US Airways pension terminations are putting pressure on other "legacy" airline competitors with similar business models to do likewise. The competition from profitable low-cost carriers such as Southwest and JetBlue (who provide their employees with 401(k) plans, profit-sharing, and stock purchase benefits and have nowhere near the pension liabilities of their higher-cost competitors)<sup>450</sup> only enhances this pressure on the legacy carriers. As Mr. Belt notes, "Rivals may feel they are at a competitive disadvantage and follow suit, raising the specter of a domino effect in the industry."<sup>451</sup> Adds columnist George Will, "In 2002 the five strongest legacy carriers had costs of \$95,500 per employee. Southwest had costs of \$59,100...No legacy airline can compete with another that has dumped its pension burdens in the government's lap."<sup>452</sup>

No. 3 U.S. airline Delta Airlines has lost \$5.6 billion over the past three years, more than any other carrier except United.<sup>453</sup> Delta has agreed to freeze the defined-benefit plan for its pilots and start a new, less generous (and less costly) defined-contribution plan.<sup>454</sup> No. 4 U.S. carrier Northwest Airlines, which has lost approximately \$2.5 billion over the same period, is reportedly looking to follow Delta's lead in freezing its pilots' plan and developing a new 401(k)-type plan.<sup>455</sup>

As bad as the pension situation is for the airline industry, it is worse for the auto industry. Even if the PBGC manages to weather the storm of airline pension failures, yet another round of major pension terminations may be just around the bend. According to a *Wall Street Journal* report, the airline industry's combined \$31-billion underfunding pales in comparison to the auto industry's \$45 billion to \$50 billion shortfall.<sup>456</sup>

As Donald Straszheim of Straszheim Global advisors explains, “What happened is that the old industrial companies – the ones that have been around for 50 years or more – never got around to ending defined-benefit plans. Now it’s a disaster for the companies, the employees and ultimately for taxpayers.”<sup>457</sup>

Government subsidies and the required backing by the PBGC have encouraged some employers to maintain their expensive defined-benefit plans long after the rest of the private sector came to the conclusion that such plans are untenable.

## ***2. A Taxpayer Bailout on the Horizon?***

If history has taught us anything, it’s that government does not provide insurance coverage well. The current pension crisis has often been compared to the savings-and-loan crisis of the 1980s, in which savings-and-loan corporations extended too much credit and were ultimately unable to cover their deposits.<sup>458</sup> As Emory University finance professor George J. Benston declares, “The similarities [to the pension crisis today] are incredible.”<sup>459</sup>

Like savings deposits, private (defined-benefit) pensions are guaranteed by a federal government insurance program. As with the thrift crisis of the 1980s, worsening market conditions have revealed symptoms of the impending crisis, but government delays and policies, including attempted short-term fixes, are only making the problem worse.<sup>460</sup> Both cases likewise involve “maturity mismatching” between short-term funding sources and long-term obligations—making companies susceptible to market volatility—and overly optimistic hopes that returns on riskier investments will help to bail companies out of their financial straits. Finally, the premium structure in both cases is such that all firms essentially pay the same flat rate, meaning that well-managed, more conservative companies effectively subsidize poorly managed, more risky ones. (Such “adverse selection” and “moral hazard” problems are discussed in more detail below.)

As Heritage Foundation scholar David C. John explains the similarities between the current pension situation and the savings-and-loan crisis,

*Twenty years ago, Congress faced a funding crisis in the savings and loan industry by allowing S&Ls to declare that they had more assets than they actually did. Congress also passed provisions that gave even more undeserved benefits to specific companies that had the lobbying muscle to get that language hidden in bills. . . .*

*Even after receiving special treatment, the savings and loan industry began to run massive deficits that resulted in a bailout that cost ordinary taxpayers hundreds of billions of dollars. While a less “generous” Congress would have seen companies fail earlier, the cost to the taxpayer would have been much less.*<sup>461</sup>

The savings-and-loan debacle resulted in costs of \$153 billion, \$124 billion of which was borne by taxpayers.<sup>462</sup> The looming private pension scandal is poised to rival that crisis, as PBGC officials estimate that if there are more significant failures outside of the airline industry in the next decade, the necessary government (i.e., taxpayer) bailout would total up to \$110 billion.<sup>463</sup>

The current pension crisis has been described as a “slow motion train wreck.”<sup>464</sup> It is important to sound the alarm bells now and take action before the situation deteriorates any further. As immediate past PBGC executive director Steven A. Kandarian elucidates, “The real blowup doesn’t happen right away; it happens over time. You’ve got to address it now, but it doesn’t look like a crisis now. The crisis is always over the next hill.”<sup>465</sup>



Fortunately, the pension problem is receiving a good deal of attention in the media and even on Capitol Hill. Said Rep. John Boehner (R-OH), chairman of the House Education and Workforce Committee, “It will be an absolute outrage if American taxpayers are stuck with a multibillion-dollar tab for another S&L-style bailout because of Washington’s failure to adequately update pension laws.”<sup>466</sup> Let’s hope that Washington has learned the lessons of the 1980s so that another taxpayer bailout may be averted.

#### **4. The Moral Hazard and Adverse Selection Problems**

The existence of an insurance contract in which a third party (i.e., the government/taxpayers) pays for losses causes changes in the behavior of the insured. In the case of private pensions, a company has an incentive to engage in riskier investment strategies. If these risky investments pay off and yield high returns, the company doesn’t have to contribute as much to its pension plan. If they result in heavy losses, the shortfalls can be dumped on the insurer (i.e., the PBGC). As the company gets into worse and worse financial trouble, it has even more of an incentive to engage in risky investments to make up the difference. Such a scenario is an example of the “moral hazard” problem. The same can be said of government pension funds. In their case, the guarantor is the taxpayer that will need to foot the bill for underfunding, risky investments, or broken promises. Short-term thinking encourages putting off serious reform into the future.

As George Will explains, “Moral hazard exists when government policy creates incentives that make bad behavior rational. One example is ... a PBGC that assumes substantial responsibility for pension promises that companies have found convenient to make.”<sup>467</sup>

Moral hazard is a serious problem for the PBGC. According to Mr. Belt, “there is a significant moral hazard [with the insurance provided by the PBGC], which includes perverse incentives to engage in riskier behavior and the ability to shift risks onto a federal insurance program.”<sup>468</sup>

Another problem facing the PBGC is that of “adverse selection.” Adverse selection generally refers to an asymmetry of information between the insurer and the insured. For example, if a health insurance company is unable to screen for people who smoke (and thus represent a higher risk to the insurer), it will end up bearing higher costs. To make up for these higher costs, the insurance company will raise premium prices. These higher costs are borne by the entire insurance pool—smokers and non-smokers alike. Non-smokers may resent subsidizing smokers’ costs and abandon the insurance pool in search of a lower-cost alternative, leaving the insurance company with a riskier (and higher-cost) pool of clients. The “death spiral” continues.

Mr. Kandarian describes the adverse selection problem as applied to pensions and the PBGC:

*When PBGC takes over pension plans that are underfunded by billions of dollars, it is the premium payers – employers that sponsor defined benefit plans – who bear the cost. Financially healthy companies with well-funded pension plans end up subsidizing financially weak companies with chronically underfunded pension plans. As a result, over time, strong companies with well-funded plans may elect to leave the system. This potential for “adverse selection” could pose a serious problem for the insurance program.*<sup>469</sup>

Returning to our hypothetical example above, notice that if the insurance company was able to “price discriminate” by charging higher prices to higher-risk clients and lower prices to lower-risk clients, the insurer could minimize its exposure and allocate premiums more fairly. For firms with defined-benefit pension plans, the problem is not so much that there is a lack of information about the level of risk that they

pose to the PBGC (company credit ratings and information in financial disclosure documents for publicly-traded companies are readily available), it is that the PBGC lacks the ability to effectively price discriminate and essentially charges well-managed and poorly managed firms the same insurance premiums.

The annual PBGC premium for single-employer pension plans is \$19 per worker or retiree. Firms are also supposed to pay a “variable rate premium” (VRP) of \$9 for each \$1,000 in unfunded vested benefits. This is intended to force companies to pay more for poorly managed plans. In practice, however, loopholes and congressional bailouts, such as the deficit reduction contribution holiday signed into law in April 2004, render the VRP ineffective. (These congressional measures only reward risky behavior and postpone—and oftentimes worsen—the inevitable pension failures.) It is estimated that the PBGC collects only 10 percent of the actual VRP amount.<sup>470</sup> In addition, there are no penalties for plans that engage in risky investment strategies and mismatch assets to liabilities.

The backing of the PBGC by the federal government, and the requirement that the PBGC must serve as the insurer of last resort for all private defined-benefit retirement plans, ensures the subsidization of poor investments. This has created a moral hazard problem whereby the companies in the worst shape are encouraged to turn to the government for assistance. If the PBGC’s liabilities exceed revenues from the premiums these companies pay (which are believed to be artificially low, or below free-market prices, particularly for risky and poorly managed plans), taxpayers will be forced to make up the difference. It is time for Congress to seriously address the PBGC’s problems.

### **5. Reform Efforts**

There have been many reform proposals and there has been much legislative tinkering over the years, but after more than 30 years of existence the PBGC is mired in its worst crisis yet. Several recent short-term fixes have only added to the PBGC’s troubles.

In response to the stock market downturn at the beginning of the decade (and successful lobbying by business interests), Congress lowered pension funding rules. At the time, the normal discount rates used to calculate a firm’s required pension contributions were the 30-year Treasury bonds rates. The legislation allowed pension plans to use discount rates of 120 percent of the T-bills rates for 2002 and 2003 (making pension liabilities appear lower).<sup>471</sup> This did nothing to address the actual underfunding of the pension plans. It merely permitted—even encouraged—companies to underfund their plans without consequence.

The aforementioned April 2004 legislation (H.R. 3108) likewise redefined pension liabilities and reduced the amount companies are required to contribute to their plans by an estimated \$80 billion over two years (the bill expires in December 2005). After the Treasury Department stopped issuing 30-year bonds, Congress allowed companies to discount plan liabilities at corporate bond rates, “which are about 100 basis points higher than long-term Treasuries.”<sup>472</sup> H.R. 3108 also provided \$1.6 billion in “relief” to the troubled steel and airline industries by allowing seriously underfunded plans in these industries to disregard the deficit reduction contribution requirements (which will prove to be no relief to taxpayers).<sup>473</sup> It, furthermore, permitted underfunded plans to spread “catch-up” payments up to 30 years, instead of the previous three- to seven-year requirement. A *Wall Street Journal* editorial described these relief measures as “a truly staggering example of short-term mindlessness.”<sup>474</sup>

In addition to these short-term “fixes,” however, there have been some legitimate efforts to reform the system. The Bush administration has put forth a plan to address numerous pension/PBGC problems. The proposal includes the following reforms:

1. **Improve premium pricing.** The current premium rate of \$19 per employee or retiree has not increased since 1991. The administration’s proposal would raise premiums 58 percent to \$30 per employee or retiree.<sup>475</sup> The Labor Department estimates that the premium hike would increase PBGC premium revenues from \$600 million per year to nearly \$1 billion.<sup>476</sup> The proposal also aims to address the moral hazard problem by implementing a risk-based premium system that would assess higher rates on companies with poor credit ratings. This introduction of market dynamism in premium pricing would represent a vast improvement over rates determined arbitrarily—and infrequently—through the political process.
2. **Tighten the definition of pension underfunding.** The proposal would introduce a “yield curve” formula that would help to ensure full funding by requiring companies with a large proportion of older workers close to retirement to contribute more to their pension plans.<sup>477</sup>
3. **Force companies to return underfunded plans to full funding within 7 to 10 years.**<sup>478</sup> This would put an end to the practice of spreading out deficits for decades which tends only to allow the pension plans’ financial conditions to deteriorate further.
4. **Allow companies to set aside greater surplus returns during “good years.”** Companies are currently restricted in their ability to set aside additional pension fund returns during strong years. These rules were put in place to prevent companies from taking “excessive deductions,” since pension systems are tax-sheltered.<sup>479</sup> As a *New York Times* editorial slyly notes, the rules also “forces companies to pay taxes on income that would otherwise go into pensions, thus raising revenue to improve the government’s own dismal budget outlook.”<sup>480</sup> The effect of all this is that companies are left with less money in their pension systems when investments take a turn for the worse, and they must then make the highest contribution payments during the worst-performing years—when they can least afford to do so. The plan would essentially allow companies to establish rainy-day funds to compensate for difficult years and help smooth out company contributions. Under the proposal, companies could increase tax-deductible contributions from 100 percent of plan liabilities to 130 percent.<sup>481</sup>
5. **Improve transparency and reporting requirements.** The PBGC is currently prohibited by law from making information about pension funds’ financial conditions public. The administration proposal would remove this barrier to give employees better access to information about the true status and funding level of their pension plans. It would require companies to describe both “how well funded the plan appears to be as it continues into the future” and “how well funded it would be if it were terminated right away.”<sup>482</sup> The proposal would additionally compel companies to provide this information in a timelier manner.
6. **Prevent benefit increases for companies with underfunded plans.** Under the White House proposal, companies with underfunded pension plans or junk bond credit ratings would not be allowed to offer their employees any additional retirement benefits unless those benefits are paid for up front.<sup>483</sup>
7. **Allow the PBGC to enforce liens for missed contributions during bankruptcy.** The PBGC now has rather limited powers in bankruptcy court. According to Mr. Belt, “[The PBGC’s] ability to enforce a lien is stayed under current law.”<sup>484</sup> This provision would allow the PBGC greater

authority to secure a bankrupt company's assets to ensure that it can salvage as much of the retirees' benefits as possible.

Implementation of the Bush administration proposal would certainly result in marked improvement from the current state of affairs. That said, it overlooks a simpler and even better solution: ending the government monopoly on pension insurance.

Some may be leery of allowing the private sector to provide pension insurance, but this really is no different than the market for similar services offered in the market, such as auto insurance. States mandate certain minimum levels of auto insurance coverage, but they don't set the premium prices. Competition among numerous insurance firms keeps prices affordable for consumers. The same would be true for pension insurance. Moreover, the risk of default on the plans would be borne voluntarily by the insurance companies and their shareholders, not the taxpayers.<sup>485</sup>

Not only is the PBGC a monopoly, it is a government-controlled monopoly. As referenced previously, this means premium prices are set arbitrarily by politicians with political motivations and little knowledge of the insurance business. Competition in the pension insurance business would lead to a more rational and efficient premium structure. Eliminating the monopoly by fully privatizing the PBGC and opening up the pension insurance market to competition would allow premium prices to accurately reflect the costs and value of the insurance, taking into account all the risks involved. As one analyst argues:

*It does not seem possible for Congress to run an insurance function at anything like market premiums. Lawmakers are too susceptible to political influence from the small group of firms that stand to gain from free insurance, and taxpayers, who ultimately have the responsibility to pay for shortfalls, often do not even know that the insurance exists. . . .*

*Once the insurance fund is managed by business people with a stake in the bottom line, one can confidently predict that the pool will accomplish what has evaded Congress for 30 years. Premiums will quickly converge to those that would exist in the private market, and both the amount and volatility of pension underfunding will quickly fall to manageable levels.<sup>486</sup>*

## 6. Conclusion

Defined-benefit plans are quickly becoming extinct. Private companies must decide what is best for them in terms of offering retirement or other benefits, and they must live with the consequences of their actions. If other private companies wish to insure their pension systems, and the employers are willing to pay the requisite premiums to obtain the insurance, then they should be allowed to engage in such a voluntary transaction in a free market.

The dramatic increase in losses from pension plan terminations, combined steadily increasing benefits obligations and declining employer premiums, is threatening to bankrupt the PBGC.<sup>487</sup> Let us hope Congress has learned the mistakes of the savings-and-loan crisis so that taxpayers may avoid another colossal bailout. One of those lessons is that failing to act now will only lead to more misery down the road. As Douglas J. Elliott, president of the Center on Federal Financial Institutions, maintains, "The longer we wait, the closer we get to the cliff edge, where a massive taxpayer rescue would be necessary."<sup>488</sup>

Congress needs to avoid more short-term "fixes" and focus instead on long-term *solutions*. The current Bush administration plan takes a solid step in the right direction by addressing the moral hazard problem and

providing greater incentives for companies to maintain full funding of their pension plans. Even this may not be enough, however. Government should simply not be in the insurance business in the first place.

The risk of pension failure must be borne by the employer and employee. In the unfortunate event that a company does go bankrupt and is unable to pay promised retirement benefits, the employee may not be at fault, but neither is the taxpayer. Why should the taxpayer be forced to pay for a company's mismanagement or inability to compete? A market-based pension insurance industry with stringent financial disclosure requirements would afford insurers and employees alike the best information on which to base their pension decisions. Employers would have stronger incentives to either fully fund their pension plans or transition to more affordable defined-contribution plans. And, most importantly, taxpayers would not be on the hook for pension mismanagement.

## Part 7

# Recommendations and Conclusions

Government pension systems across the country face funding crises that are, by and large, products of their own creation. While the recent downturn in the stock market is often blamed for the crises by government officials hoping to rationalize the major run-up of government debt—and this certainly did play a role—the market losses only unveiled the weaknesses in the system that were previously masked by the historic investment gains of the late 1990s. The fact that a system of investments could turn so quickly from investment nirvana to debt nightmares should give taxpayers and lawmakers cause for major concern.

Over the past several decades, the private sector has rapidly shifted away from defined-benefit plans for good reason—they are expensive, unpredictable, and unsustainable in the long run. The government should follow the private sector's lead in transitioning to defined-contribution retirement plans that will offer employees greater freedom and choice of retirement planning options at lower, more stable costs to the employer. The argument that this amounts to an assault on government employees is simply false. Under a defined-contribution plan, lawmakers can still make very attractive retirement packages, including attractive matching options. The defined-contribution plan structure simply requires that these costs be recognized and dealt with in the current year as one of the government's many priorities. Defined-contribution plans prevent lawmakers from creating actuarial liabilities by pushing hidden costs off into the future. This should be reason enough for taxpayers to embrace such a reform.

At the heart of the pension crisis is a set of incentives that encourages policymakers to make decisions for which they do not have to bear the consequences. Since corporate executives, lawmakers, and union officials will not bear the costs of the benefit increases they preside over, there is no incentive for them to show fiscal restraint.

Policymakers must also be cognizant of demographic trends that threaten the viability of their retirement and health-care systems. Retirement today is drastically different from what it was just a couple of decades ago. People are living much longer and retiring sooner. Health-care costs are rising. The “Baby Boom” generation is soon to begin retiring and employers will have to face the problem of a relatively small current workforce supporting a sizeable retired population. While some people may continue to work later into life out of necessity, it is unwise for policymakers to find much comfort in this possibility, given the clear trend toward longer lives and longer retirements.

Sadly, the very real challenges presented by the changing world of retirement are routinely ignored by policymakers, even as warning bells go off all around them. In fact, pension woes often worsen simply because policymakers reject sound actuarial advice and hope that the stock market will erase unfunded liabilities in the future.

Significant benefit increases, such as “3 percent at 50” plans, and supplemental benefits like DROPs have proven themselves unsustainable. These excessive benefit levels and a variety of government policies have encouraged premature retirement and pension spiking, driving up costs even further.

The mistake of offering greater benefits that governments cannot afford is regularly compounded by poor financial planning. The lack of long-term averaging of investment returns leaves governments susceptible to volatile swings in pension contribution payments. The issuance of pension obligation bonds is little more than an expensive gamble that will saddle taxpayers for years to come.

Pension reforms need to break this vicious cycle of systematic problems, long-term costs, and short-term budget crises. True reforms demand three separate tracks of action. First, they must focus on fundamentally changing the system to prevent existing problems from getting any worse. Leaders should ask themselves: How do we create a retirement system that allows workers to retire with dignity but does so without creating open-ended obligations for the taxpayers? Second, reforms must tackle existing liabilities. Finally, successful reforms must ensure that pension obligations do not threaten other areas of the budget and quality-of-life services or create pressure for tax increases.

#### **A. Transition to 401(k)-style defined-contribution plans for all future workers.**

Lawmakers should follow the clear and undeniable trend in the private sector and convert future employees from defined-benefit plans to self-directed, 401(k)-style defined-contribution plans. If the existing benefits of current employees are untouchable due to constitutional or charter restrictions, then, at the very least, lawmakers should close this open-ended obligation.

Unlike defined-benefit plans, defined-contribution plans are not plagued by the uncertainty of contributions payments since contribution levels are set in advance, and the employer is not accountable for shortfalls during years of poor retirement fund performance (neither is the employer able to forego payments during years of strong performance). As the California Legislative Analyst’s Office noted, “defined contribution plans would give the state predictable retirement expenses each year.”<sup>489</sup> Since costs can be more accurately determined, employers (including government employers) can make more rational cost-benefit decisions regarding the level of employee retirement benefits.

Equally important, such a shift would effectively prevent lawmakers from creating actuarial liabilities overnight by changing benefit calculations. While they would still be able to create lucrative retirement packages through attractive matching formulas, such decisions would be transparent—reflected in the current year’s budget—not put off into future budget years, as is the case with actuarial liabilities. In this way, the moral hazard problem would disappear.

Defined-contribution plans offer numerous additional benefits to individual workers, such as the ability to exert greater control in their investments, “roll over” their retirement funds when they change jobs, and pass along retirement fund earnings to their heirs.

In short, the move to a defined-contribution plan affords the government employer lower costs while offering more stability, transparency, and predictability of contribution payments; ensures full funding of the system; provides employees greater plan portability and greater freedom to invest their retirement money as they see fit; and removes political influence from investment decision-making.

As fewer existing members contribute to the system, a condition of negative cash flow will emerge that will require a greater share of existing investment assets to be held in more liquid form. This will, in turn, tend to reduce the investment returns generated. Any serious reform effort that seeks to shift toward defined-contribution retirement options must recognize this investment reality and begin preparing for it. Just like the payment of any debt, the quicker and earlier the debt is paid, the greater the interest savings. While there are tradeoffs associated with that strategy, it still makes the best fiscal sense.

## **B. Cope with existing obligations.**

Shifting new employees into defined-contribution systems only addresses a portion of the problem. Doing so does nothing to confront the challenges related to employees already in the current system, such as how to cope with existing debts or how to avoid racking up additional debts in the future. Shifting to a defined-contribution system also does nothing to ensure that existing obligations do not threaten other areas of the budget. To make existing defined-benefit systems stronger and less costly, lawmakers must consult a wide range of options, including the following:

### ***1. Enact constitutional or charter amendments to require voter approval of all government employee benefit increases.***

Historically, pension benefits have been upheld as constitutionally guaranteed in both the U.S Constitution as well as state constitutions. As such, they have virtually the same long-term fiscal impact as a general obligation bond, which very frequently requires a vote of the public.

When lawmakers approve benefit increases, they are committing the taxpayer to a long-term obligation that must be paid for into the future. In the event that payments into the system or investment returns do not fully fund these benefit increases, the taxpayers must make up the difference. Thus, approval of enhanced pension benefits should be subject to a vote of the general public just like a general obligation bond.

A voter approval requirement ensures that the taxpayers who pay government employees' salaries can operate as a final check against overly generous deals. The experience of San Francisco has shown that this is an effective means of controlling benefit levels while preserving local control and flexibility.

### ***2. Establish long-term averages of investment returns for the purpose of calculating government employer contributions.***

Establishing long-term averages for the calculation of investment returns will help to “smooth out” government employers’ annual contributions and prevent the volatility that has, at times, provided unpleasant surprises and funding emergencies. Calculating assets and liabilities on this basis will allow the ups and downs of the stock market to even out and, in turn, provide governments with more stable pension contribution schedules. In addition, governments should eliminate “contribution holidays” and “13<sup>th</sup> Check” distributions, as these undermine long-term stability and worsen the moral hazard problem (Why pay today when someone else can pay tomorrow?).



### ***3. Adopt, adhere to, and frequently re-evaluate sound actuarial assumptions.***

In some cases, such as Contra Costa County, California, sound actuarial advice was simply ignored. Governments should impose strict penalties (i.e., fines, removal from office, and jail time) on pension board trustees or politicians that are negligent in their fiduciary duties to pension beneficiaries and responsibilities to taxpayers. It is often said that government management failures, and accounting, in particular, would be criminal if performed as such in the private sector. There should be no double standard. Public officials should adhere to the same standards as corporate CEOs and be subject to the same consequences.

In addition, states and municipalities should consider enacting measures similar to H.B. 109 in Texas, which requires an independent analysis of any legislation or other changes that could alter the actuarial soundness of a municipal pension fund, in addition to the municipality's internal analysis.

### ***4. Scale back, or “sunset,” realized benefit increases for new employees.***

The benefit increases that were put in place during the height of the stock market rally, when pension portfolios were realizing historic returns, proved unsustainable when the market resumed more reasonable levels. While those enhanced benefits realized by government employees may have been locked in, governments can still adopt reduced benefits for future employees. The advantage of this option is that it can be taken immediately (without having to wait for union contracts to expire and the collective bargaining process to play out), offering savings in the short term. The disadvantage, of course, is that it can easily be reversed by future policy actions. These reforms include:

#### ***a) Establish a new benefit calculation for future employees.***

While existing benefits are legally protected for existing employees, lawmakers should explore the creation of more rational formulas for future years of service. This practice is often referred to as “tiering.” Such a system of tiered benefits would apply only to newly hired employees and would not run afoul of constitutional restrictions.

#### ***b) Restrict the definition of “public safety employee.”***

Lawmakers should adopt narrow definitions of “public safety” employees for the purposes of retirement benefits. Prison cooks, plumbers, and groundskeepers may perform valuable services for the government, but they should not receive the same enhanced benefits as true public safety employees who endanger their lives on a regular basis. As stated above, once these benefits are in place, they are deemed to be protected by both federal and state constitutional contract protections. The best way to avoid this problem is to resist extending the “public safety” definition to additional employees in the first place. If it is already too late for this, governments may re-establish the original definition, with more rational limits on what is considered a public safety employee, for future employees.

#### ***c) Eliminate DROP benefits.***

Deferred Retirement Option Programs have proven to be costly and politically unpopular across the country in municipalities such as San Diego, Houston, Philadelphia, and Milwaukee County. They often backfire and can cause experienced employees to retire sooner rather than later. In addition, the ability to collect a

paycheck while racking up additional retirement benefits smacks of unfairness to taxpayers. For these reasons, DROPs should be eliminated altogether.

### ***5. Eliminate “air time” purchase benefits.***

While intended to be actuarially neutral, air time purchases can sometimes increase costs significantly and lead to “pension spiking.” They also encourage early retirement. Furthermore, this option is wholly unnecessary, as employees are always free to put additional money into annuities or other investments on their own. Thus, air time purchases should also be eliminated.

### ***6. Strictly limit vacation time sell-back programs.***

Vacation time sell-backs can be a significant means of pension spiking, even though they were created to eliminate another obligation—massive build ups in vacation accounts. Governments must assure that this system is kept within reason and does not undermine fiscal stability. Stricter limits on the amount of vacation time that can be “sold back” each year will help keep these expenses in check. Moreover, rules should be set to limit the frequency of sell-back activity (e.g., employees should only be able to sell a certain number of hours during any 18-month period). This would eliminate “double dipping.” Ultimately, governments need to evaluate existing unused vacation liabilities and consider coping with them directly, rather than paying a short-term obligation (vacation liabilities) with long-term commitments (enhanced pension benefits).

### ***7. Re-evaluate government employee retirement ages.***

Benefits and health-care costs are increasing, people are living longer, and yet government policy encourages them to retire sooner. The fact that people are living longer, healthier lives, however, means that they are able to contribute to the workforce—with greater wisdom and patience—later in life. With this in mind, it is hard to understand why a standard government employee should be allowed to retire at age 50 or 55 and collect substantial benefits while others cannot begin collecting Social Security benefits until age 62. A logical reform would be to synchronize government retirement ages, to the greatest extent possible, with Social Security for all those enrolled in defined-benefit plans. (Those controlling their own retirement benefits through defined-contribution plans should be free to select their own retirement ages since they are the ones bearing the risk of their investments.) To prevent hypothetical cases such as a well-past-his-prime, 61-year-old state trooper still on the job and, thus, chasing criminals, governments could easily carve out rational, tightly-defined exemptions for true “public-safety” officials like firefighters and law enforcement personnel to permit earlier retirements or facilitate transfers to other office duties. For standard government employees, however, retiring at 62 should be the norm, not the exception. Enacting this reform would be a much more effective tool to retain seasoned workers than instituting programs like DROP.

Finally, as health-care premiums continue to rise, it is reasonable *and generous* to pay a portion of these costs but ask that employees contribute as well. With longer lives, longer retirements, and increasing health costs, to do otherwise is asking the taxpayer to enter a fiscal death trap.

***8. Adopt a 3- or 5-year average final salary formula for the determination of employee pension benefits.***

This recommendation is specific to California, which is the only state in the nation to calculate pension benefits based on an employee's highest single-year's compensation. California's formula invites pension-spiking abuse and should be replaced by the 3-year average common in other states.

***9. Rethink pension obligation bonds.***

While the idea of issuing pension obligation bonds to “lock in” low interest rates may be appealing to policymakers, it is a risky game of arbitrage and something that should be avoided—particularly when these debt instruments are used to cover current-year expenditures. In addition to the fact that issuing one debt to cover another is not a sound financial strategy, many state and local governments have been burned when pension investment returns dropped and they were forced to incur additional expenses to cover the debt service. At the very least, such actions should only be taken with a vote of the public and repayment of the obligation must be given the very highest priority—the quicker the repayment, the lower the investment risk and the lower the overall interest payment. In such instances, states and municipalities should consider imposing (subject to collective bargaining) additional assessments on government employees that would be dedicated to bond repayment. Since these employees will benefit from the debt, they should be required to help finance it.

***10. Improve pension investment transparency by adopting Sarbanes-Oxley-type financial reporting, internal controls, and recordkeeping requirements.***

The Sarbanes-Oxley Act of 2002 was enacted to improve corporate governance and prevent future Enron- and MCI WorldCom-like meltdowns. Citizens should expect their government to abide by the same level of financial disclosure as publicly traded companies.

***11. Adopt strict anti-fraud measures.***

Spiraling workers' compensation and health-care costs are threatening the viability of the workers' compensation and medical pension systems. State and local governments must take measures to minimize these costs and protect against fraud. These measures may include:

- Reducing workers' compensation benefits for those already receiving disability pension benefits.
- Raising the standard for establishing that an injury sustained by an employee is job-related (i.e., removing the presumption that the presence of diseases or ailments such as heart disease and cancer are necessarily proof of work-related injury).
- Requiring periodic medical re-evaluations of those receiving workers' compensation and medical pension benefits to ensure that those who have properly healed from their injuries are no longer receiving benefits.

## C. Protect the budget from pension overruns.

For any government confronting unfunded pension obligations, one of the greatest concerns is to what extent the obligations will crowd out other government programs and negatively affect government services. To ensure that the remainder of the budget is not threatened and that taxes are not increased to fund pension commitments, lawmakers should look at the pension crisis as a call for broader government reform with the explicit goal of increasing the quality of government services at lower costs. When one combines the \$2.6 billion payment to CalPERS and another \$1.1 billion to CalSTRS, California's annual pension payments exceed \$3.7 billion this year.<sup>490</sup> While this is a significant obligation, it represents only a few percent of the state's budget. Identifying 3 percent savings through increased efficiency (a modest proposition by reform standards) would essentially offset these contributions. Moreover, any additional savings from reform can be channeled to early payment of existing pension obligations (either hard, bonded debts or soft, unfunded liabilities—as the case may be).

While the recommendations for efficiency-enhancing reforms are far too numerous to warrant a comprehensive discussion, a sampling of potential reforms is presented here.<sup>491</sup>

### *1. Identify and divest unneeded government-owned assets.*

It is unwise to assume that a massive stock run-up will wipe out unfunded pension liabilities. Hence, most of the existing deficits will ultimately be funded through increased payments. While governments find it incredibly difficult to pay growing pension costs, many have accumulated portfolios of real property assets with billions of dollars in net value. Increasingly, governments are recognizing ways to extract revenues from this source. For government entities coping with unfunded liabilities, selling underutilized property can provide the infusion of revenues to cover unfunded liabilities without undermining the delivery of government services. Numerous government entities have been able to achieve astounding savings results through asset sales. In the wake of its bankruptcy, Orange County, California, generated over \$300 million in real estate sales and sale-leasebacks over an 18-month period.<sup>492</sup> The Empire State Development Corporation in New York generated hundreds of millions of dollars in revenues through sales and leasebacks of state-owned properties including the New York Coliseum, state mental health campuses, parking lots, armories, and state-owned golf courses. In one of its first sales, New York divested a golf course for more than \$3 million.<sup>493</sup> For governments facing unfunded pension liabilities, disposal of unneeded assets seems a common-sense reform.

### *2. Implement performance reviews to identify poor-performing and unneeded programs.*

One of the most important questions for government reformers to ask is: What should government *not* do? Oftentimes, reform efforts focus on improving service delivery without first asking why the service is even provided by the government in the first place. Texas, which has pioneered the concept of the performance review, is also a testament to the success of the idea, having saved \$16 billion through performance reviews since 1991.<sup>494</sup> Again, such efforts enable reformers to identify savings within existing budgets and render unto the private sector the jobs it does best, leaving to government its core mission. This confines the government to its true function, and this decrease makes it possible to cope with growing pension contributions without having to undermine service delivery or increase taxes.

### *3. Apply competition to government services.*

Over the years, the idea of applying competition to government services has been evaluated and routinely shown to save between 5 and 50 percent on the cost of delivery.<sup>495</sup> A good rule of thumb, however, is that applying competition to government services will save between 15 and 30 percent—regardless of who wins the competition—government or a private competitor. Just the act of applying competition results in savings by creating incentives to reduce costs and improve performance. These savings can be directed toward coping with pension obligations.

### *4. Reform procurement practices.*

According to The Government Performance Project at Syracuse University, contracting for goods and services consumed about 19 percent of the average state operating budget in 2000.<sup>496</sup> However, very often the rules and procedures used to procure these goods and services are outdated and wasteful. Revamping the procurement process through standards, modern approaches such as reverse auction and strategic sourcing, and efforts to reduce billing and payment errors through recovery auditing can achieve significant potential savings. Given the sheer amount of goods and services purchased by governments, even a 5 percent reduction in contracting costs (not at all unreasonable for most governments) can result in significant savings to the general operating budget.

### *5. Consolidate government agencies and functions and implement e-government reforms.*

Governments typically grow over the course of years, not along a strategic path, but by happenstance. That is, elected officials routinely pursue new projects and simply “place” those activities within the existing structure where they seem to be most appropriately situated. Very often, these departments develop a tangle of functions and tend to resemble the “junk drawer” in the kitchen, where miscellaneous items are stowed away and accumulate. Out of this accumulation arises redundancy and inefficiency.

For instance, California state government has 11 agencies and 79 subordinate departments. Each of these entities has its own executive staff, legal support, public information office, information technology personnel, and clerical accounting staff. Obvious opportunities exist for consolidation of these “back office” functions. By some estimates, as much as 15 percent of the cost of an organization’s budget can be saved by consolidating administrative staff.<sup>497</sup> Similarly, by converting various governmental services to online, electronic exchanges—such as driver’s license renewals, marriage license applications, etc.—governments can realize additional efficiencies while enhancing the quality of services to taxpayers.

The bottom line, as it relates to the pension crisis and the accompanying demands that it places on budgets, is that while lawmakers seem to have only two options to cope with increasing costs—either increasing taxes or cutting quality-of-life services like police, fire, and road maintenance, this simply is not the case. A broad range of reform opportunities is available to lawmakers serious about making significant improvements that can help “reinvent” the way government services are delivered, resulting in lower costs and higher quality of services. In fact, as history has clearly demonstrated, it is this kind of financial crisis that tends to propel reform. Reform of government does not occur in a vacuum.

Applying these reform measures, and others like them, will help government leaders to take two key steps toward restoring financial health to their pension systems. First, as in the case of asset divestiture, they can

achieve short-term infusions of cash to offset liabilities or transition costs that otherwise are difficult to manage. Second, by reducing other demands on the taxpayer dollar, fundamental reform creates the “breathing room” in which true, long-term pension reform can occur.

Coupling structural reforms with a defined-contribution plan for new employees and key reforms to the system for existing employees can yield significant improvements not only in the fiscal condition of the pension system itself but in the fiscal health of the government as a whole. In this way, reformers will be able to protect the financial interests of government employees and taxpayers alike.

It is clear that pension reform remains a divisive and highly controversial issue with the livelihoods of government employees and their own interests in the cross hairs. No doubt, most reform proposals will be greeted with jeers and the common argument that “come bad economic times, they always pick on the workers.” Many will argue that this strategy is simply not fair. To those individuals, we ask the following question. When the California Teacher Retirement System has a \$23 billion liability or the State of Illinois has a \$35 billion unfunded liability, is it “fair” to ask the taxpayers to pay this out of their pockets? Only in the world of special-interest politics could one consider this remedy fair.

<b>Appendix A: Comparison of State Pension System Funding Ratios, FY 2003</b>					
<b>State System</b>	<b>Report Date</b>	<b>Ratio of Assets to Liabilities</b>	<b>Rank (of 95)</b>	<b>Assets Minus Liabilities (\$ Millions)</b>	<b>Rank (of 95)</b>
New York State Teachers	06/30/01	1.25	1	\$17,48	1
Washington LEOFF Plan 1	09/30/02	1.20	2	\$836	7
Florida RS	07/01/03	1.14	3	\$12,65	2
North Carolina Teachers & State Empl	12/31/02	1.12	4	\$3,456	3
Texas LECOS	08/31/03	1.11	5	\$69	12
New Jersey PERS	06/30/02	1.07	6	\$1,886	4
Delaware State Employees	06/30/03	1.07	7	\$330	11
Pennsylvania State ERS	12/31/03	1.05	8	\$1,286	5
Arizona SRS	06/30/02	1.05	9	\$1,036	6
Minnesota Teachers	06/30/03	1.03	10	\$528	10
Georgia Teachers	06/30/02	1.02	11	\$796	8
Virginia Retirement System	06/30/02	1.02	12	\$692	9
Georgia ERS	06/30/03	1.00	13	\$58	13
New Jersey Teachers	06/30/02	1.00	14	\$2	14
New York State & Local ERS*	04/01/02	1.00	15*	\$0	15*
New York State & Local Police & Fire*	04/01/02	1.00	15*	\$0	15*
Washington LEOFF Plan 2*	09/30/02	1.00	15*	\$0	15*
Washington PERS 2/3*	09/30/02	1.00	15*	\$0	15*
Washington School Employees 2/3*	09/30/02	1.00	15*	\$0	15*
Washington Teachers Plan 2/3*	09/30/02	1.00	15*	\$0	15*
Montana PERS	06/30/02	1.00	21	-\$1	21
Tennessee State and Teachers	07/01/01	1.00	22	-\$81	26
Indiana PERF	07/01/02	0.99	23	-\$71	24
Minnesota State Employees	06/30/03	0.99	24	-\$73	25
Michigan SERS	09/30/02	0.99	25	-\$137	28
North Dakota PERS	06/30/03	0.98	26	-\$22	22
Texas ERS	08/31/03	0.98	27	-\$481	39
Vermont State Employees	06/30/03	0.97	28	-\$27	23
New Mexico PERF	06/30/03	0.97	29	-\$247	31
South Dakota PERS	06/30/03	0.97	30	-\$123	27
Pennsylvania School Employees	06/30/03	0.97	31	-\$1,543	56
Wisconsin Retirement System	12/31/02	0.97	32	-\$1,757	60
New Jersey Police & Fire	06/30/02	0.96	33	-\$803	44
Alabama ERS	09/30/02	0.95	34	-\$393	37
California PERS	06/30/02	0.95	35	-\$7,894	88
Arkansas PERS	06/60/03	0.94	36	-\$258	33
Texas Teachers	08/31/03	0.94	37	-\$5,230	83
Arizona Public Safety Personnel	06/30/03	0.94	38	-\$304	34
Alabama Teachers	06/30/03	0.94	39	-\$1,247	53
Maryland PERS	06/30/03	0.93	40	-\$839	45
South Carolina Police	07/01/03	0.93	41	-\$177	30
Maryland Teachers	06/30/03	0.93	42	-\$1,525	55

<b>Appendix A: Comparison of State Pension System Funding Ratios, FY 2003</b>					
<b>State System</b>	<b>Report Date</b>	<b>Ratio of Assets to Liabilities</b>	<b>Rank (of 95)</b>	<b>Assets Minus Liabilities (\$ Millions)</b>	<b>Rank (of 95)</b>
Ohio Police & Fire	01/01/02	0.93	43	-\$709	43
Utah Noncontributory	12/31/03	0.92	44	-\$947	48
Wyoming Public Employees	01/01/04	0.92	45	-\$420	38
Washington Teachers Plan 1	09/30/02	0.92	46	-\$869	46
Michigan Public Schools	09/30/02	0.91	47	-\$3,575	76
Missouri State Employees	06/30/03	0.91	48	-\$605	42
Nebraska Schools	07/01/03	0.91	49	-\$512	41
Tennessee Political Subdivisions	07/01/01	0.90	50	-\$340	35
Oregon PERS	12/31/02	0.90	51	-\$3,983	77
Vermont Teachers	06/30/03	0.90	52	-\$141	29
Iowa PERS	06/30/03	0.90	53	-\$1,867	64
South Carolina RS	07/01/02	0.86	54	-\$3,148	73
Ohio PERS	12/31/02	0.86	55	-\$7,166	87
Arkansas Teachers	06/31/03	0.86	56	-\$1,332	54
Washington PERS 1	09/30/02	0.86	57	-\$1,803	61
North Dakota Teachers	07/01/03	0.85	58	-\$252	32
Massachusetts SERS	12/31/03	0.84	59	-\$3,065	72
Idaho PERS	07/01/03	0.84	60	-\$1,215	52
Montana Teachers	07/01/02	0.83	61	-\$495	40
Nevada Regular Employees	06/30/03	0.83	62	-\$2,612	69
Ohio School Employees	06/30/03	0.82	63	-\$1,862	63
California Teachers	06/30/03	0.82	64	-\$23,10	94
Missouri Non-Teachers	06/30/03	0.82	65	-\$372	36
Minnesota PERF	06/30/03	0.81	66	-\$2,580	67
New Mexico Teachers	06/30/03	0.81	67	-\$1,748	59
Missouri Teachers	06/30/03	0.81	68	-\$4,671	79
Kentucky ERS	06/30/03	0.80	69	-\$1,811	62
Mississippi PERS	06/30/03	0.79	70	-\$4,506	78
Kansas PERS	12/31/02	0.78	71	-\$2,829	70
Rhode Island ERS	06/30/02	0.78	72	-\$2,233	65
Oklahoma PERS	07/01/03	0.77	73	-\$1,620	57
Massachusetts Teachers	01/01/02	0.76	74	-\$4,908	80
Connecticut Teachers	06/30/02	0.76	75	-\$3,293	74
Hawaii ERS	06/30/03	0.76	76	-\$2,878	71
Colorado State & School	12/31/03	0.75	77	-\$9,392	91
Alaska PERS	06/30/02	0.75	78	-\$2,447	66
New Hampshire Retirement System	06/30/03	0.75	79	-\$1,169	51
Ohio Teachers	06/30/03	0.74	80	-\$17,07	93
Nevada Police Officer & Firefighter	06/30/03	0.74	81	-\$1,045	50
West Virginia PERS	06/30/03	0.73	82	-\$991	49
Kentucky Teachers	06/30/03	0.72	83	-\$5,452	85
Maine State and Teacher	06/30/02	0.69	84	-\$2,593	68



<b>Appendix A: Comparison of State Pension System Funding Ratios, FY 2003</b>					
<b>State System</b>	<b>Report Date</b>	<b>Ratio of Assets to Liabilities</b>	<b>Rank (of 95)</b>	<b>Assets Minus Liabilities (\$ Millions)</b>	<b>Rank (of 95)</b>
Louisiana Teachers	06/30/03	0.69	85	-\$5,346	84
Alaska Teachers	06/30/02	0.68	86	-\$1,723	58
Louisiana SERS	06/30/03	0.66	87	-\$3,309	75
Connecticut SERS	06/30/02	0.62	88	-\$4,912	81
Missouri DOT and Highway Patrol	06/30/02	0.62	89	-\$908	47
Oklahoma Teachers	06/30/03	0.54	90	-\$5,488	86
Illinois Universities	06/30/03	0.54	91	-\$8,311	89
Illinois Teachers	07/01/03	0.49	92	-\$23,89	95
Illinois SERS	06/30/03	0.43	93	-\$10,02	92
Indiana Teachers	06/30/02	0.42	94	-\$8,488	90
West Virginia Teachers	06/30/03	0.19	95	-\$5,053	82
<i>Average Funding Ratio:</i>		<i>0.87</i>			

\*Note: Plans with an unfunded liability of zero use the aggregate cost actuarial valuation method, which does not identify an unfunded liability.

Source: Keith Brainard, "Public Fund Survey, Summary of Findings, FY 2003," National Association of State Retirement Administrators, September 2004, Appendix B. Available online at <http://www/publicfundsurvey.org/SurveyFindingsFY03.pdf>.

<b>Appendix B: Comparison of City and County Pension System Funding Ratios, FY 2003</b>					
<b>City/County System</b>	<b>Report Date</b>	<b>Ratio of Assets to Liabilities</b>	<b>Rank (of 104)</b>	<b>Assets Minus Liabilities (\$ Millions)</b>	<b>Rank (of 104)</b>
City of Fresno ERS	06/30/02	1.35	1	\$185	3
City of Fresno Fire & Police RS	06/30/02	1.34	2	\$198	2
City of Tallahassee PP	09/30/01	1.25	3	\$151	5
City of Baton Rouge PGT	12/31/03	1.16	4	\$4	19
San Francisco City & County RS	06/30/03	1.12	5	\$1,117	1
San Jose Police & Fire Dept. RP	06/30/01	1.10	6	\$151	6
San Joaquin County ERA	12/31/01	1.08	7	\$99	7
Imperial County ERS	06/30/03	1.07	8	\$23	15
Sacramento City ERS	06/30/03	1.06	9	\$23	14
Tulare County ERA	06/30/03	1.05	10	\$31	11
Milwaukee City ERS	12/31/02	1.05	11	\$152	4
Marin County ERA	06/30/02	1.04	12	\$35	9
San Jose Federated City ERS	06/30/01	1.03	13	\$33	10
Arlington County ERS	06/30/02	1.03	14	\$29	13
Anne Arundel County ERP	12/31/03	1.03	15	\$10	17
City of Birmingham R&RS	06/30/03	1.02	16	\$15	16
Alameda County ERA	12/31/03	1.01	17	\$30	12
Oakland County PERS	09/30/02	1.01	18	\$4	18
Texas County & District RS	12/31/03	1.01	19	\$58	8
Gainesville General EPP	09/30/03	1.00	20	\$0	20
Anne Arundel County PSRP	12/31/03	1.00	21	\$0	21
City of Oakland Police & Fire RS	06/30/02	1.00	22	-\$2	25
Oakland Co. Road Commission PERS	12/31/02	0.99	23	-\$1	22
Gainesville Police & Firefighters RP	09/30/03	0.99	24	-\$1	23
Grand Rapids Police & Fire RS	06/30/03	0.98	25	-\$4	26
Sonoma County ERA	12/31/03	0.98	26	-\$19	34
Anne Arundel County FSRP	12/31/03	0.98	27	-\$7	28
City of Cincinnati RS	12/31/03	0.95	28	-\$81	44
Denver ERP	12/31/01	0.95	29	-\$79	43
Norfolk ERS	06/30/03	0.92	30	-\$63	40
Orlando Firefighter PF	09/30/03	0.92	31	-\$15	32
City of Los Angeles Water & Power	06/30/03	0.92	32	-\$483	75
Oklahoma City ERS	06/30/02	0.91	33	-\$34	37
Grand Rapids GRS	06/30/03	0.90	34	-\$28	35
Orlando Police PF	09/30/03	0.90	35	-\$29	36
Orlando GEPF	09/30/03	0.90	36	-\$17	33
Knox County Teachers	06/30/03	0.90	37	-\$7	29
Ventura County ERA	06/30/03	0.89	38	-\$235	57
Jacksonville General EPP	09/30/03	0.89	39	-\$175	49
Tacoma ERS	12/31/02	0.89	40	-\$76	42
Baltimore County ERS	06/30/03	0.89	41	-\$208	54

<b>Appendix B: Comparison of City and County Pension System Funding Ratios, FY 2003</b>					
<b>City/County System</b>	<b>Report Date</b>	<b>Ratio of Assets to Liabilities</b>	<b>Rank (of 104)</b>	<b>Assets Minus Liabilities (\$ Millions)</b>	<b>Rank (of 104)</b>
Anne Arundel County DODSRP	12/31/03	0.88	42	-\$6	27
Howard County RP	06/30/02	0.88	43	-\$14	31
Los Angeles City Fire & Police	06/30/03	0.87	44	-\$1,410	93
Fairfax County Police	06/30/02	0.87	45	-\$83	45
Baltimore City ERS	06/30/03	0.87	46	-\$180	51
Los Angeles County ERA	06/30/03	0.86	47	-\$4,226	101
Denver Public Schools RS	12/31/03	0.86	48	-\$390	68
Seattle City ERS	12/31/03	0.86	49	-\$251	59
Knox County	06/30/03	0.86	50	-\$12	30
Fairfax County Uniformed RS	06/30/02	0.86	51	-\$103	46
City of Memphis RS	06/30/03	0.85	52	-\$301	64
Baltimore City Elected Officials RS	06/30/03	0.84	53	-\$2	24
Houston Firefighters' R&RF	06/30/02	0.84	54	-\$310	65
Phoenix ERP	06/30/03	0.84	55	-\$242	58
St. Louis County ERP	12/31/03	0.84	56	-\$65	41
Fairfax County ERS	06/30/02	0.84	57	-\$335	66
Milwaukee County ERS	12/31/02	0.83	58	-\$259	60
City of Baton Rouge & Parish ERS	12/31/03	0.83	59	-\$172	48
Orange County ERS	12/31/03	0.81	60	-\$1,140	88
City of Austin ERS	12/31/03	0.81	61	-\$292	63
Fresno County ERA	06/30/02	0.81	62	-\$367	67
Chicago Teachers PF	06/30/03	0.81	63	-\$2,208	97
Santa Barbara County ERS	06/30/03	0.80	64	-\$285	62
St. Louis Public School RS	12/31/02	0.80	65	-\$210	55
Santa Clara VTA ATU PP	06/30/03	0.80	66	-\$56	38
San Diego City ERS	06/30/02	0.80	67	-\$641	79
New York City Teachers RS	06/30/02	0.79	68	-\$7,155	103
Sacramento County ERS	06/30/03	0.79	69	-\$869	85
Los Angeles City ERS	06/30/03	0.78	70	-\$1,675	94
City of Baltimore Fire & Police	06/30/03	0.77	71	-\$517	77
Detroit Fire & Police	06/30/03	0.77	72	-\$843	83
San Antonio Police & Fire PF	09/30/03	0.77	73	-\$391	69
New York City Police PF	06/30/02	0.77	74	-\$4,409	102
Montgomery County Public Schools	06/30/03	0.76	75	-\$191	52
Kern County ERA	06/30/02	0.76	76	-\$463	74
Dallas Police & Fire	12/31/03	0.76	77	-\$706	82
Fulton County ERS	12/31/02	0.75	78	-\$267	61
New York City ERS	06/30/02	0.75	79	-\$10,778	104
Houston Police	06/30/02	0.75	80	-\$645	80
Los Angeles County MTA	06/30/02	0.74	81	-\$193	53
Kansas City Police ERS	04/30/03	0.74	82	-\$180	50

<b>Appendix B: Comparison of City and County Pension System Funding Ratios, FY 2003</b>					
<b>City/County System</b>	<b>Report Date</b>	<b>Ratio of Assets to Liabilities</b>	<b>Rank (of 104)</b>	<b>Assets Minus Liabilities (\$ Millions)</b>	<b>Rank (of 104)</b>
Minneapolis ERF	06/30/03	0.73	83	-\$451	73
San Bernardino County ERA	06/30/03	0.73	84	-\$1,198	89
San Luis Obispo County PT	12/31/02	0.72	85	-\$154	47
Montgomery County ERS	06/30/03	0.72	86	-\$685	81
Detroit General RS	06/30/03	0.71	87	-\$947	86
San Diego County ERA	06/30/03	0.70	88	-\$1,750	95
San Mateo County ERA	06/30/03	0.69	89	-\$548	78
Fort Worth ERF	09/30/02	0.68	90	-\$489	76
Chicago Municipal EA&BF	12/31/02	0.68	91	-\$2,449	98
Price George's County PTF	06/30/02	0.65	92	-\$394	70
Howard County Police & Fire ERP	06/30/02	0.65	93	-\$58	39
Dallas ERF	12/31/02	0.65	94	-\$845	84
Contra Costa County ERA	12/31/02	0.64	95	-\$1,312	91
St. Paul Teachers' RFA	06/30/03	0.64	96	-\$432	71
City of Richmond RS	06/30/03	0.63	97	-\$235	56
Jacksonville Police & Fire PP	09/30/03	0.61	98	-\$442	72
City of Boston RS	12/31/03	0.60	99	-\$2,184	96
City of Philadelphia RS	06/30/02	0.59	100	-\$2,769	99
Chicago Policemen's ABF	12/31/03	0.56	101	-\$2,888	100
Houston Municipal EPS	06/30/02	0.51	102	-\$1,243	90
Chicago Firemen's ABF	12/31/03	0.44	103	-\$1,408	92
Minneapolis Teachers' RFA	06/30/03	0.43	104	-\$952	87
<b>Average Funding Ratio:</b>		<b>0.85</b>			

Source: Julia K Bonafede, Steven J. Foresti, and Benjamin J. Yang, 2004 Wilshire Report on City & County Retirement Systems: Funding Levels and Asset Allocation, Wilshire Associates, October 1, 2004, pp. 18-19. Available online at [http://www.wilshire.com/Company/2004\\_City\\_County\\_Funding\\_Report.pdf](http://www.wilshire.com/Company/2004_City_County_Funding_Report.pdf).

Appendix C: Survey of Pension News Articles, By Location*		
Cities and Counties		
California		
Anderson	Merced	Sacramento County
Bakersfield	Millbrae	San Bernardino County
Berkeley	Monterey Park	San Diego
Carlsbad	Moraga	San Diego County
Contra Costa County	Novato	San Francisco City & Co.
Dale City	Oakland	San Joaquin County
Desert Hot Springs	Ojai	San Marcos
Escondido	Orange County	San Mateo County
Fresno County	Palm Springs	San Rafael
Lodi	Pasadena	Santa Clara County
Long Beach	Petaluma	Santa Cruz
Los Angeles	Redding	Shasta County
Los Angeles County	Riverside	Shasta Lake
Marin County	Riverside County	Vista
Martinez	Sacramento	Watsonville
Colorado		
Colorado Springs		
Connecticut		
Hamden	Waterbury	
Delaware		
Kent County		
Florida		
Coral Gables	Hallandale Beach	Naples
Delray Beach	Jacksonville	North Miami Beach
Fort Lauderdale	Miami	Palm Beach
Georgia		
Atlanta		
Illinois		
Chicago	Du Quoin	Salem
Cook County	Maywood	
Indiana		
Indianapolis		
Iowa		
Burlington		
Louisiana		
Lafayette	Lake Charles	
Massachusetts		
Chelmsford	Wakefield	Westford
Plymouth County	Watertown	
Michigan		
Detroit	Macomb County	Pontiac
Ironwood	Mount Clemens	Saginaw

Appendix C: Survey of Pension News Articles, By Location*		
Minnesota		
Minneapolis		
Missouri		
Carthage	Springfield	
New Jersey		
Colts Neck		
New York		
Highland	Suffolk County	Susquehanna County
Ohio		
Cincinnati	Dayton	
Oregon		
Portland		
Pennsylvania		
Bucks County	Pittsburgh (Port Authority)	York
Rhode Island		
Coventry	Newport	Providence
Cranston	Pawtucket	Westerly
East Providence	Portsmouth	
Texas		
Austin	Forth Worth	Waxahachie
Dallas	Houston	
El Paso	Marshall	
West Virginia		
Charleston	Huntington	
Wisconsin		
Milwaukee County		
States		
Alaska	Massachusetts	Pennsylvania
Arkansas	Minnesota	Rhode Island
California	Montana	South Carolina
Colorado	New Jersey	Tennessee
Connecticut	New Mexico	Texas
Illinois	New York	Washington
Iowa	Ohio	West Virginia
Louisiana	Oklahoma	
Maine	Oregon	
Countries		
Belgium	Italy	South Korea
Canada	Japan	Spain
China	Netherlands	Sweden
France	Norway	United Kingdom
Germany	Portugal	United States of America
Ireland	Russia	

\*Note: The table above is by no means a comprehensive list of jurisdictions plagued by pension troubles. During the course of our research, however, we were stunned by the extent of the problem. This table is thus intended simply to show that pension issues are not confined to a small number of cities, counties, states, or even regions, of the country (or world!). The problems truly are widespread and demand serious and significant action. Please note also that this list consists of jurisdictions in which pension funding is a major issue, and that it omits numerous other jurisdictions, for which increasing pension obligations are an issue in that they affect tight budgets, but are not as pressing a problem.

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## About the Authors

**George Passantino** is a Senior Fellow in Government Reform for Reason Foundation. George has authored numerous studies, white papers, and commentaries on California's need for fundamental economic, legislative, and regulatory reform. George's views have appeared in newspapers and radio programs across California and the nation. In 2004, George Passantino served as a full-time Director of the historic California Performance Review established by Gov. Arnold Schwarzenegger. In this effort, George helped lead a multi-pronged, top-to-bottom review of state government, including its organizational structure and policy priorities. Prior to joining Reason in 1997, George served as a legislative consultant to the California State Legislature. To his credit is a wide range of high-profile legislative accomplishments, including the 1996 passage of California's version of Megan's Law, which has helped thousands of parents protect their children from dangerous sex offenders. George graduated cum laude with a Bachelor of Arts in Applied Economics from California State University, Bakersfield. George lives and works from his home in Palmdale, California with his wife and two children, where he serves as Regional Manager for TMG Communications, a Southern California public affairs firm specializing in land use, economic development, and local government.

**Adam B. Summers** is a policy analyst at Reason Foundation. He has written extensively on privatization, government reform, law and economics, and various other political and economic topics. His articles and studies have been published by the Reason Foundation, the *Los Angeles Times*, *Baltimore Sun*, *San Diego Union-Tribune*, *Orange County Register*, *Los Angeles Daily News*, American Institute for Economic Research, Maryland Public Policy Institute, Pioneer Institute for Public Policy Research, and Ludwig von Mises Institute, among others. He holds a Master of Arts degree in Economics from George Mason University and Bachelor of Arts degrees in Economics and Political Science from the University of California, Los Angeles.



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Reason Public Policy Institute  
3415 S. Sepulveda Blvd., Suite 400  
Los Angeles, CA 90034  
310/391-2245  
310/391-4395 (fax)  
[www.rppi.org](http://www.rppi.org)