

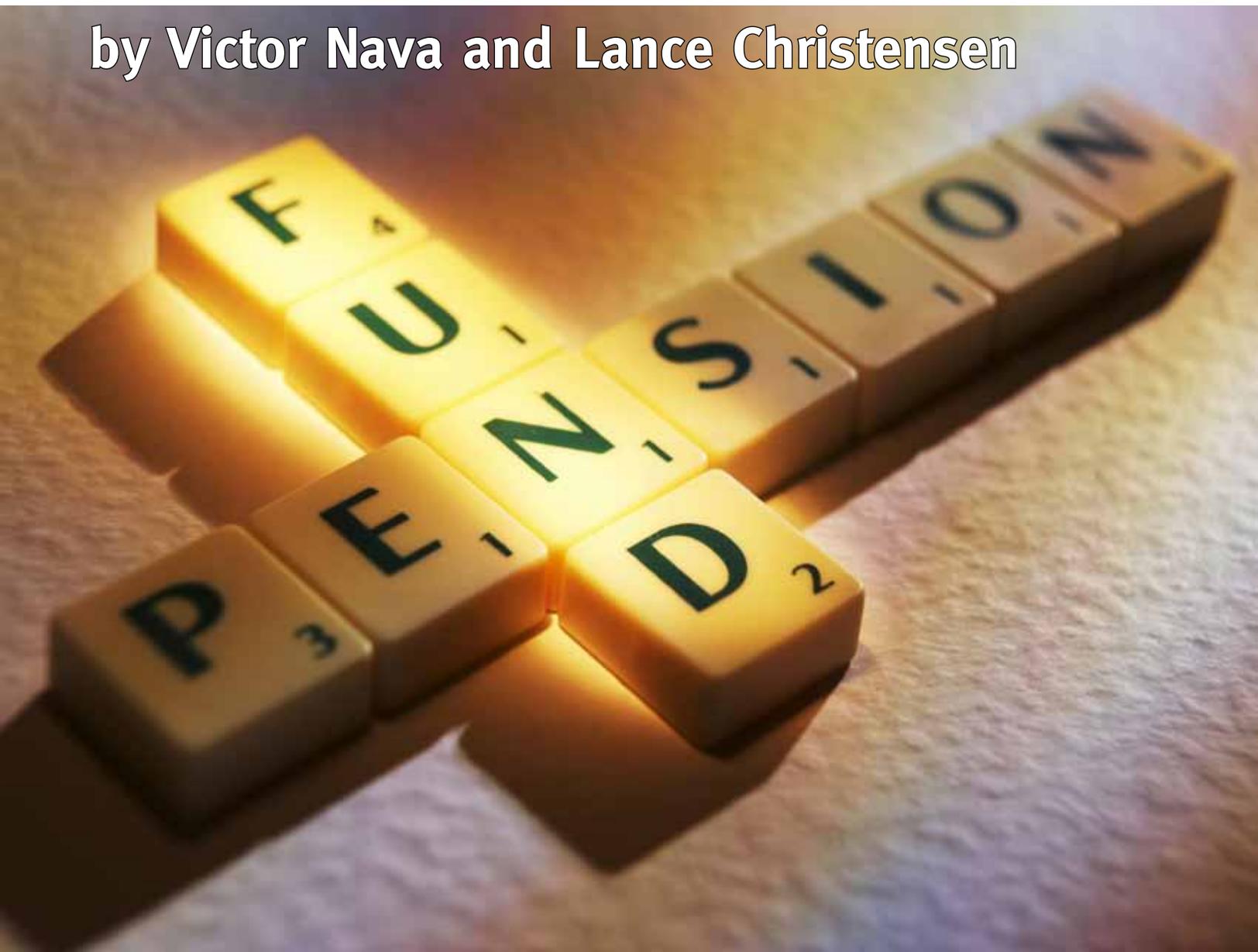


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Analysis of the California Public Employees' Pension Reform Act of 2013 (PEPRA)

by Victor Nava and Lance Christensen



Reason Foundation



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Executive Summary

The state of California and its local governments are saddled with unfunded public pension liabilities estimated to be as high as \$583 billion. As a result, several municipalities in the state now have the difficult task of balancing budgets in a way that is fair to both public employees and taxpayers, while continuing to provide basic services. Indeed, public pension debt has contributed to the bankruptcies of the cities of Stockton, Vallejo and San Bernardino and has left other municipalities, such as Desert Hot Springs, in dire fiscal straits. In response, state legislators on both sides of the political aisle passed the California Public Employees’ Pension Reform Act of 2013 (PEPRA) to address unfunded public pension liability.

Overview of Key Features of PEPRA

PEPRA covers the state’s two largest pension systems, the California Public Employees’ Retirement System (CalPERS) and the California State Teachers Retirement System (CalSTRS), as well as the 20 county systems that operate under the 1937 Act County Employees Retirement Law (CERL). Certain provisions apply to both new and “classic” employees:

Cost-Sharing: Under PEPRAs cost-sharing provisions, employer-paid member contributions (EPMC) are prohibited for new employees, and new employees will be required to pay at least 50% of the total normal cost of their pensions (subject to temporary delays via memoranda of understanding, or MOUs). After January 1, 2018, employers may require classic employees to pay at least 50% of the normal cost so long as the employee contribution does not exceed contribution caps set by PEPRAs. Over time, this may reduce or eliminate EPMCs for classic employees.

Retroactive Benefit Enhancement: PEPRAs bans public employers from retroactively applying any benefit enhancement, except COLAs, after January 1, 2013.

Elimination of “Air Time” Purchases: PEPRAs prohibits all employees from purchasing nonqualified service credits known as “air time.” Before PEPRAs, members had the opportunity to purchase up to five years of service credit to count toward their retirement calculation. These service credits may or may not have had anything to do with state service, but may have come through other government jobs not associated with CalPERS at all.

Limitation of Post-Retirement Public Employment: PEPRAs adds a 180-day waiting period before retirees can obtain post-retirement work with a public employer and continues CalPERS’s limitation of post-retirement working hours in the same retirement system to 960 hours per year (subject to some exceptions). Most CalSTRS retirees, most public safety workers and certain judges are exempt from this rule.

Forfeiture upon Felony Conviction: PEPRAs requires elected officials and employees to forfeit pension benefits if they are convicted of a felony during the course of their official duties, or while seeking an elected office or appointment, or in connection with obtaining salary or pension benefits. Forfeiture takes effect from the date the offense occurred.

Prohibition of Pension Holidays: For all employees, PEPRAs requires employer and employee contributions to equal the normal cost of benefits for every fiscal year unless a plan is more than 120% funded.

Health Benefit Vesting: PEPRAs specifies that a public employer may not provide an elected or appointed employee, a trustee or a manager any health benefit vesting schedule that is more advantageous than that provided to other represented public employees of the same public employer in related retirement

membership classifications. This is the only aspect of retirement health care benefits in California that PEPRA addresses, despite a \$150 billion unfunded retiree health care liability in the state.

Public Safety Industrial Disability Retirement: PEPRA allows public safety members who retire because of disability before the minimum retirement age to collect their earned benefit amount if it is over the 50% benefit provided for disability retirement, rather than the previous limitation of 50%. Applicable to both new and classic members, this is the only benefit enhancement provided to employees in PEPRA.

Benefit Changes for New Employees

Because of the “California Rule,” wherein pension system administrators are prohibited from decreasing a benefit for current or already retired employees, the main cost-saving positions in PEPRA apply only to new employees hired after January 1, 2013 for CalPERS, CalSTRS and the 20 CERL plans. Classic members will continue to receive benefits based off the old formula.

New Formula: Under PEPRA, new members of employer plans must participate in a defined benefit-style plan and may only participate in defined contribution-style plans that were in place before January 1, 2013, unless the new defined contribution plan conforms to all the requirements of PEPRA. Benefits are subject to a new formula.

Table 1: Benefit Formula for New Employees	
New Non-Safety Employees	New Safety Employees
2.5% @ 67	2%, 2.5%, or 2.7% @ 57
1% @ 52	1.4%, or 2% @ 50

Pensionable Compensation: For classic employees, pensionable compensation no longer includes temporary pay increases, but will continue to include base pay plus any sort of “special compensation,” such as overtime, unused vacation and leave, and employer-provided payments, allowances and contributions to deferred compensation.

PEPRA states that pensions for new employees must be based on employees’ “normal monthly rate of pay or base pay” and the law specifically excludes any one-time or ad hoc payments from being counted toward pensionable pay. However, the CalPERS board determined during an August 19, 2014 hearing

that 99 different types of special pay items will be counted as normal pay and will count toward pensions for all employees. The special types of compensation include bonuses for things like staying physically fit, being a notary, completing certain training courses, and longevity.

As well, for new employees only, PEPRA requires that the final compensation for calculating the pension benefit be determined by the average of the highest consecutive three years of earnings, rather than the highest-earning 12-month period, to avoid creating opportunities for significant pension-spiking.

For new employees only, PEPRA places a cap on the amount of earnings that can be used to determine pensionable compensation, differing according to whether an employee is subject to Social Security taxation.

Weaknesses of PEPRA

Negligible Impact: The shortfalls California pension funds face are much larger than the modest savings PEPRA provides. Estimates peg California's unfunded pension liability between \$130 billion on the low end and \$583 billion on the high end, not including the state's estimated \$150 billion dollar retiree health care liability. Compared to those liabilities, the \$20 billion or so in present value savings over 30 years (at the high end of CalPERS and CalSTRS estimates) is a small percentage. Moreover, some of the reforms—such as the changes to benefit formulas, capping and defining pensionable compensation, and averaging final compensation over three years—will reduce costs and future unfunded liabilities, but those provisions have very little impact on the existing unfunded pension liabilities. As pension analyst John Dickerson puts it, “PEPRA tries to prevent fires two decades in the future but completely ignores today's debt firestorm.”

Too Many Employees Are Exempted: PEPRA's narrow definition of “new employee” leaves significant potential savings for employers on the table. As well, whole swaths of pension systems are exempt. Such exemptions dilute the impact of PEPRA in solving the unfunded liability problem.

Excessive OPEB (Other Post-Employment Benefits): While PEPRA creates new tiers for both safety and non-safety employees with lower benefits, PEPRA's pension benefit adjustments do not go far enough. Many public employees in California have been promised health coverage for life, one of the major components to other post-employment benefits (OPEB), even though state

and local governments are not setting aside the funds required to cover these future obligations. An April 2014 report found an unfunded retiree health care liability of \$157.7 billion.

Overuse of “Safety Employee” Designation: The benefits received by safety members are greater than those of regular public employees, but these more generous benefits should be limited to employees who work in risky and dangerous situations protecting people from physical harm. In 1960, approximately 1 in 20 workers in California were classified as peacekeepers. By 2004, that number grew to 1 in 3. The term has become so vague that by 2008, over 60% of the California Union of Safety Employees included non-peace officers, such as milk inspectors, billboard inspectors, DMV drive test employees, lab technicians, smog-check employees and dispatchers.

No Taxpayer Representation on the Board: PEPRA failed to make any structural changes to the composition of the state pension boards that would provide for professionalized governance instead of the current bodies that are otherwise politically motivated and function with little finance or investment experience. As it now stands, government employees, retirees and politicians who have incentives to approve benefits beyond what the system can handle and are possibly be directly financially affected by board actions comprise CalPERS and CalSTRS boards. Rather than build a system that is affordable, sustainable and secure, the boards’ (as currently structured) main goals are to maximize their benefits and reduce costs of members.

Policy Recommendations

Though PEPRA moved the state on a more prudent path, its elected officials failed to make substantial reform to California’s pension systems sustainable for both employees and taxpayers. Substantive pension reform in California should include elements such as:

- Creating a defined contribution plan or defined benefit/defined contribution hybrid pension plan for new employees.
- Providing better taxpayer representation and more investment and financial expertise on the CalPERS board.
- Enacting measures to pay down California’s existing unfunded liability quicker, such as switching to a level dollar amortization schedule and requiring higher employee contributions for new and current employees.

- Addressing the “California Rule” allowing the state and municipalities to modify future pension benefits for current public employees.
- Narrowing “safety employees” classification for employees who are regularly performing their duties at great risk and in harm’s way.
- Expanding PEPRA’s limitations on post-retirement employment to all CalSTRS retirees, public safety workers and judges who are currently exempt from the rule.
- Basing final compensation on an average of three to five years of highest years’ salary.
- Defining pensionable pay as “*the normal monthly rate of pay or base pay*” for all employees.
- Limiting special compensation categories from counting toward pensionable pay by significantly narrowing CalPERS’s list of special compensation, which has not been revised since 1993.
- Freezing cost-of-living adjustments until CalPERS and CalSTRS are 100% funded.
- Including public transit employees as a part of any substantive pension reform bill.
- Classifying any employee who leaves the state pension system for the private sector, and returns after more than a year as a “new employee.”

It is in the interest of all Californians to encourage a public pension law that provides a fair, workable plan to pay down the accumulated pension debt as quickly as possible and implements processes and practices that ensure both the state and local governments adequately fund their retirement promises.

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Part 1

Introduction

The state of California and its local governments are saddled with unfunded public pension liabilities estimated to be as high as \$583 billion. The effects of unrealistic actuarial assumptions, overly generous retirement benefits, system-wide abuses, fraud, corruption and risky investment decisions during the Great Recession have left state and local fiscal crises in their wake.¹ As a result, several municipalities in the state now have the difficult task of balancing budgets in a way that is fair to both public employees and taxpayers. Several municipalities in the state struggle to provide services—including public safety, education and infrastructure maintenance—while keeping debts from increasing.² While not the singular cause, public pension debt has contributed to the bankruptcies of the cities of Stockton, Vallejo and San Bernardino and has left other municipalities, such as Desert Hot Springs, in dire fiscal straits.³

By 2011, the need for pension reform had become apparent to state legislators on both sides of the political aisle. They responded to the crisis by passing the California Public Employees' Pension Reform Act of 2013 (PEPRA).

This brief describes how PEPRA came about, what it did, and what still remains to be done to reform California's public pension systems.

Part 2

Background

In March 2011, Governor Jerry Brown put pension reform front and center in the Golden State when he announced his “12-Point Pension Reform Plan.”⁴ Among the cost-saving reforms Governor Brown sought were equal sharing of pension costs among all employees and employers, a hybrid defined benefit/401(k) style plan for new employees, a reduction of retiree health care costs, governance changes to the California pension system board, and cessation of the practice of “pension spiking.” According to Brown, the goal was to pass a reform bill that would “put California on a more sustainable path to providing fair public retirement benefits.”⁵ Below are the 12 points that were in Governor Brown’s pension reform plan:

1. Share Pension Costs Equally (All Employees)
2. Implement a Hybrid Defined Benefit/Defined Contribution Pension Plan (New Employees Only)
3. Increase Retirement Ages (New Employees)
4. Require Three-Year Final Compensation to Determine Pension Benefit (New Employees Only)
5. Calculate Benefits Based on Regular, Recurring Pay (New Employees Only)
6. Limit Post-Retirement Employment (All Employees)
7. Forfeiture of Pension Benefits if Convicted of a Felony in Carrying Out Official Duties (All Employees)
8. Prohibit Retroactive Pension Increases (All Employees)
9. Prohibit Pension Holidays (All Employees and Employers)
10. Prohibit Purchases of Service Credit (All Employees)
11. Increase Pension Board Independence and Expertise
12. Reduce Retiree Health Care Costs (State Employees Only)

In February 2012, Senate and Assembly Republicans drafted and introduced pension reform legislation nearly identical to Governor Brown's 12-point plan.⁶ Senate Republicans placed the language in two bills—SB 1176 and Senate Constitutional Amendment 18—and in June 2012, they attempted to get the bills to the Senate floor for a vote in order to put them on the November ballot.⁷ Senate Democrats blocked attempts to bring the bills to a vote. “The Senate Conference Committee on Pensions refused to hear the plans,” Sen. Bill Emmerson (R-Riverside) said as the deadline to put pension reform on the 2012 ballot expired.⁸ Senate Democrats countered that Republicans were cherry-picking what parts of state policy they would participate in, and argued that pension reform wasn't the only issue that needed addressing.⁹

Two months after the California legislature's failure to even hear debate on SB 1176, a bill sponsored by Assemblyman Warren Furutani (D-Lakewood) emerged from conference committee with the governor's support during the final days of the 2012 legislative session. The bill, Assembly Bill 340, was first introduced in February of 2011, but sat untouched in the California legislature for over a year until August 2012 when the conference committee took it up.¹⁰

The *Los Angeles Times* described the scene at the Capitol during the last day of the legislative session when AB 340 was to be voted on as a “carnival like atmosphere...” where “lobbyists clogged the hallways and huddled behind closed doors with lawmakers, seeking last minute favors.”¹¹ California State Senate Minority Leader Bob Huff (R-Diamond Bar), the senator who introduced SB 1176 earlier in the legislative session, called the bill that came to a vote that day a “gut-and-amend product...the result of closed door negotiations between legislative Democrats, public employee unions, and the Governor's administration.” Despite these grievances by Republicans, in an overwhelming show of bipartisanship, the bill passes both houses on August 31, 2012 with the Senate voting 38–1 and the Assembly voting 66–9.¹²

Assembly Bill 340 was passed in such a rush that a clean-up bill, Assembly Bill 197, was necessary to correct drafting errors discovered in Assembly Bill 340 after it was printed.¹³ Additionally, Assembly Bill 1222 was passed about a year later on October 4, 2013 modifying PEPRA to exclude transit workers employed by agencies receiving federal monies. AB 1222 was treated by the legislature as an “urgency statute necessary for the immediate preservation of the public peace, health, or safety.”¹⁴ On September 12, 2012, Governor Jerry Brown signed pension reform bills Assembly Bill 340 and its companion bill Assembly Bill 197 into law. On January 1, 2013 most of the provisions in the California Public Employees' Pension Reform Act of 2013 (PEPRA) went into effect.¹⁵

Part 3

Overview of Key Features of PEPRA

A. Applicability

The state of California has 62 state and locally administered public retirement pension systems.¹⁶ PEPRA covers the state's two largest pension systems, the California Public Employees' Retirement System (CalPERS) and the California State Teachers Retirement System (CalSTRS), as well as the 20 county systems that operate under the 1937 Act County Employees Retirement Law (CERL).

Most of PEPRA's provisions apply only to "new employees" and "new members" of CalPERS, CalSTRS and the 20 CERL plans. A "new employee" is defined as an employee of a public employer who was either:

- Not employed by any other public employer before January 1, 2013; or
- Was previously employed by another public employer prior to that date, but was not subject to reciprocity between his new employer's plan and another public retirement system.¹⁷

A "new member" refers to an individual who either:

- Becomes a member of the plan for the first time on or after January 1, 2013 and was not a member of any other public retirement system, or retirement system subject to plan reciprocity, prior to that date; or
- Was an active member in the plan and, after a break in service of more than six months, returned to active membership in that plan with a new employer.¹⁸ The six-month condition does not apply to employees who move from one state agency, or school employer, to another. While they might be "new" to the agency, they are considered reciprocal employees and are granted the same benefits as "classic" members under PEPRA ("classic" is the term CalPERS officially uses to refer to members of the plan prior to January 1, 2013).

Under PEPRA, new members of employer plans must participate in a defined benefit-style plan and may only participate in defined contribution-style plans that were in place before January 1, 2013, unless the new defined contribution plan conforms to all the requirements of PEPRA.¹⁹

B. Benefit Changes

Under PEPRA, a new benefit formula creates a new tier of reduced benefits for both new non-safety members and new safety members. New non-safety (miscellaneous) members will be provided a maximum benefit of 2.5% of compensation for each year of service for individuals retiring at age 67. Benefits decline by 0.025% for each quarter year of age that the member retires before age 67. At age 52, the new minimum retirement age, benefits decline to 1%. PEPRA increases the “normal age” of retirement for new miscellaneous employees from 55 to 62 years of age. At 62, benefits are 2% [Government Code Sec. 7522.20 (a)].²⁰ The majority of classic public employees in California receive benefits of 2% at 55, with the maximum benefit being 2.418% at 63.²¹ Classic members will continue to receive benefits based off the old formula.

For new safety employees, PEPRA provides three possible formulas for benefit compensation [Government Code Sec. 7522.25 (a)(b)(c)(d)]. The new normal age of retirement for all three formulas is 57 and the minimum age of retirement is 50.²² The Basic Safety Plan provides a pension benefit of 2% at age 57 and declines about 0.02% for each quarter year of age the employee retires before 57.²³ At age 50 the benefit factor becomes 1.426%. Safety Option Plan One provides a benefit of 2.5% at age 57, which declines by 0.018% for each quarter year of age the employee retires before 57, bottoming out at a 2% benefit factor at age 50.²⁴ Safety Option Plan Two provides a benefit of 2.7% at age 57, that declines by 0.025% for each quarter year of age the employee retires before 57, bottoming out at a 2% benefit factor at age 50.²⁵

New safety employees will receive the benefit that is closest to, but lower than, the current benefit formula at age 55 used by the employer. Based on the current benefit formulas being used by most public safety agencies (3% at 50 or 3% at 55) the formula for over 90% of public employers will be the highest of the formula options, which is Safety Option Plan Two.²⁶

Table 1: Benefit Formula for New Employees	
New Non-Safety Employees	New Safety Employees
2.5% @ 67	2%, 2.5%, or 2.7% @ 57
1% @ 52	1.4%, or 2% @ 50

C. Cost-Sharing

Employer and employee cost-sharing was one of the most contested items in the PEPRAs legislation.²⁷ This is because the cost-sharing provisions in PEPRAs are one of the few aspects of the law that have an effect on both new employees and classic employees.

Under PEPRAs, employer-paid member contributions (EPMC), which were considered a large subsidy to public employees in their salaries, are prohibited for new employees.²⁸ New employees will be required to pay at least 50% of the total normal cost of their pensions [Government Code Sec. 7522.30 (c)]. This level of cost-sharing can be adjusted if the total normal cost rate changes by more than 1% of payroll.²⁹

After January 1, 2018, employers may require classic employees to pay at least 50% of the normal cost so long as the employee contribution does not exceed contribution caps set by PEPRAs at 8% of base pay for miscellaneous employees, 12% for local police and fire, and 11% for all other local safety members.³⁰ Over time, this may reduce or eliminate EPMCs for classic employees.

Through a memorandum of understanding (MOU), employees can agree to pay more than 50% of the normal cost, but an employer cannot impose a higher contribution rate unilaterally. Employees may want to collectively bargain a rate higher than 50% if it came with other perks attached, such as higher base pay. MOUs regarding employee contributions take precedent over PEPRAs 50/50 cost-sharing requirements during the term of the MOU; this is the case even for new employees hired after January 1, 2013. PEPRAs' cost-sharing provision is the only provision in the law that can be superseded by an existing MOU, for the term of the MOU.³¹ Once the MOU expires though, new members will be required to pay 50% and further delays or deferrals of paying 50% are prohibited.³²

D. Compensation Limits

1. Pensionable Compensation: New Employees Only

For new employees, PEPRA reduces the amount of employee compensation that can be counted as “pensionable compensation” factoring into the retirement benefit calculation [Government Code Sec. 7522.34 (a)]. For classic employees, pensionable compensation will continue to include base pay plus any sort of “special compensation”—bonus compensation given for completing certain tasks or gaining certain certifications while employed, unused sick or vacation time, and overtime for example.

New employees’ pensionable compensation was originally going to be limited to only their base pay. Base pay is defined as “*the normal monthly rate of pay paid in cash to similarly situated members in the same group or class of employment.*”³³ When PEPRA passed, pensionable compensation was no longer going to include the following forms of “special compensation” for new employees:

- Compensation provided in-kind or to a third-party and converted to a cash payment to the member;
- One-time, ad hoc, severance payments or any bonuses paid;
- Payments for unused vacation, annual leave, personal leave, sick leave or compensatory time off;
- Payments for additional services outside normal working hours;
- Employer-provided payments or allowances for housing, vehicles, uniforms;
- Overtime, except as specified;
- Employer contributions to deferred compensation;
- Any form of compensation a public retirement board determines is inconsistent with the code section or should not be pensionable pay.

PEPRA states that pensions for new employees must be based on employees’ “normal monthly rate of pay or base pay” and the law specifically excludes any one-time or ad hoc payments from being counted toward pensionable pay. However, the CalPERS board determined during an August 19, 2014 hearing that 99 different types of special pay items will be counted as normal pay and will count toward pensions for all employees.³⁴ The special types of compensation include bonuses for things like staying physically fit, being a

notary, completing certain training courses, and longevity. The biggest issue before and during the hearing was whether temporary pay increases, resulting from short-term promotions, should count toward pensions. This was the only type of special compensation that Governor Jerry Brown had publicly objected to being on the list.³⁵ Those who supported the exclusion of temporary pay increases from being counted toward pensions argued that these types of payments are ad hoc in nature, and are specifically not allowed under PEPRAs.³⁶

2. Three-Year Final Compensation: New Employees Only

Prior to PEPRAs, most agencies simply used the highest earning 12-month period to calculate final compensation, which usually occurred in the last year of employment.³⁷ To prevent this sort of pay spiking, PEPRAs require that the final compensation for calculating the pension benefit be determined by the average of the highest consecutive three years of earnings, averaging down the final salary from which a new employee's pension will be calculated [Government Code Sec. 7522.32 (a)]. Using the highest 12-month period to calculate final compensation will continue for classic employees.

3. Pensionable Compensation Caps: New Employees Only

For new employees, PEPRAs place a cap on the amount of earnings that can be used to determine pensionable compensation. For new employees who participate in Social Security, earnings used toward calculating pensionable compensation cannot exceed 100% of compensation that is subject to Social Security taxation, which was \$113,700 for 2013 [Government Code Sec. 7522.10 (c)].³⁸ For new employees who do not participate in Social Security, their cap is 120% of compensation subject to Social Security taxation, which in 2013 was \$136,440.³⁹ The amount will be adjusted annually based on the inflation rate measured by the Consumer Price Index.

4. Prohibition of Retroactive Pension Benefit Enhancement: New and Classic Employees

Applicable to both new and classic employees, PEPRAs banned public employers from retroactively applying any benefit enhancement after January 1, 2013 [Government Code Sec. 7522.44].⁴⁰ COLAs are excluded from this PEPRAs provision.

5. Elimination of “Air Time”: New and Classic Employees

Applicable to both new and classic employees, PEPRA prohibits members from purchasing nonqualified service credits known as “air time” [Government Code, Sec. 7522.46(a)].⁴¹ Before PEPRA, members had the opportunity to purchase up to five years of service credit to count toward their retirement calculation. These service credits may or may not have had anything to do with state service, but may have come through other government jobs not associated with CalPERS at all. The practice of purchasing “air time” was intended to be cost-neutral, with employees paying the full present value cost of the additional benefit they would receive upon retirement. While there was inherent risk by the employee to front a substantial amount of money to buy his or her air time credits, in reality, purchasing air time was anything but cost-neutral because the amount paid for air time was determined by flawed actuarial assumptions of the present value benefit costs and the average retirement age of employees.

6. Limitation of Post-Retirement Public Employment: New and Classic Employees

Applicable to classic and new non-safety workers, PEPRA adds a waiting period before retirees can obtain post-retirement work and continues CalPERS’s limitation of post-retirement working hours in the same retirement system to 960 hours per year.⁴²

Without reinstatement, a retiree receiving a pension from a public retirement system may not work for a public employer under the same system unless it is an emergency to prevent work stoppage or the person has unique skill and will only work for a limited duration. Employment must be limited to 960 hours a year. There is also a 180-day waiting period before retirees can obtain post-retirement work except under certain specified circumstances [Government Code Sec. 7522.56 (f)]. Most CalSTRS retirees, most public safety workers and certain judges are exempt from this rule.⁴³

7. Forfeiture upon Felony Conviction: New and Classic Employees

Applicable to both new and classic members, PEPRA requires elected officials and employees to forfeit pension benefits if they are convicted of a felony during the course of their official duties, or while seeking an elected office or appointment, or in connection with obtaining salary or pension benefits [Government Code, Sec. 7522.72 (b)(1) a].⁴⁴ Public employees convicted of a

felony forfeit benefits earned or accrued after the date the offense occurred. This provision in PEPRA was in response to the scandal in the city of Bell, California where city officials fraudulently inflated their salaries, evaded taxes, and when discovered and fired, attempted to collect millions in what turned out to be fraudulently inflated pension benefits.⁴⁵

E. Other Provisions

1. Prohibition of Pension Holidays

PEPRA requires employer and employee contributions to equal the normal cost of benefits for every fiscal year [Government Code, Sec. 7522.52(a)].⁴⁶ The only instances in which a retirement system can suspend contributions is when the plan is more than 120% funded and continuing to collect contributions would jeopardize the system's tax-exempt status and violate the retirement board's fiduciary duty.⁴⁷ This provision applies to both new and classic members.

2. Health Benefit Vesting

PEPRA contains a provision specifying that a public employer may not provide an elected or appointed employee, a trustee or a manager any health benefit vesting schedule that is more advantageous than that provided to other represented public employees of the same public employer in related retirement membership classifications [Government Code Sec. 7522.40]. However the phrases "related retirement membership classification" and "more advantageous" are undefined.⁴⁸ It is unclear what the purpose of this provision is other than to equalize the health benefit vesting schedules of management and rank-and-file employees.

Section 7522.40 of the Government Code, is the only aspect of retirement health care benefits in California that PEPRA addresses, despite a \$150 billion unfunded retiree health care liability in the state.⁴⁹

3. Public Safety Industrial Disability Retirement

The one benefit enhancement included in PEPRA is a change in the way industrial disability benefits are calculated for public safety employees who retire because of disability after January 1, 2013 [Government Code Sec. 7522.66].⁵⁰ Prior to PEPRA, public safety members forced into retirement

because of disability before the minimum retirement age were limited to collecting 50% of final compensation.⁵¹ PEPRA allows public safety members who retire because of disability before the minimum retirement age to collect their earned benefit amount if it is over the 50% benefit provided for disability retirement.⁵² This is applicable to both new and classic members.

Part 4

Estimated Savings

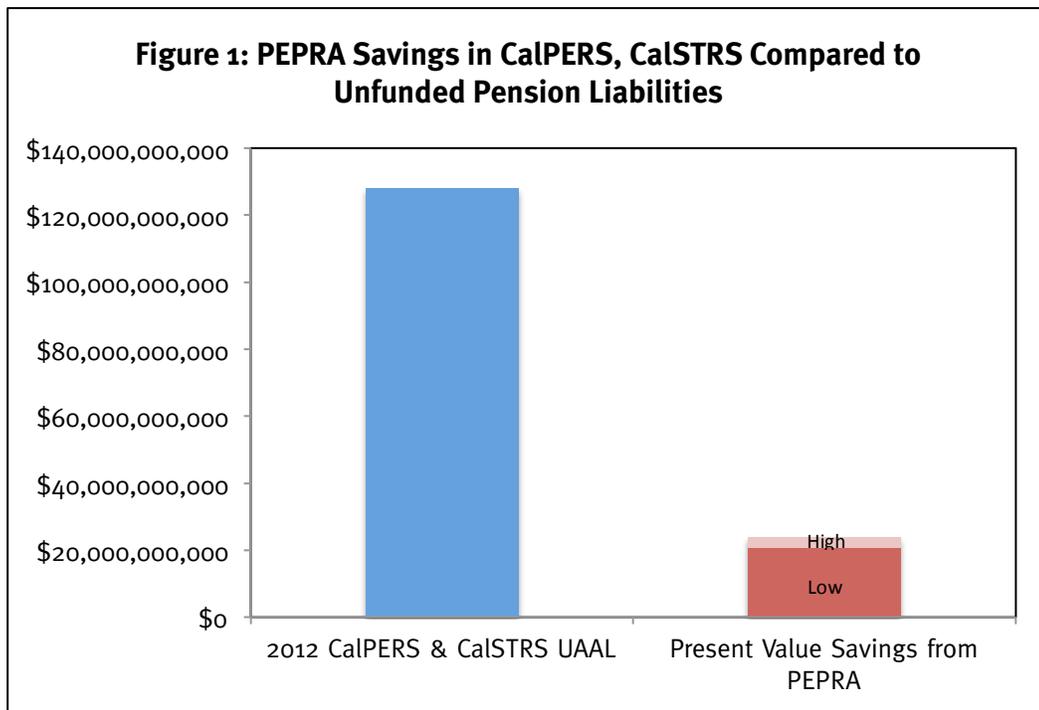
As part of its assessment of PEPRA, CalPERS issued a preliminary actuarial cost analysis on the day PEPRA passed the California Assembly and Senate. The purpose of the analysis was to provide information quantifying the financial impact of the legislation, but only among employers whose pension plans are administered by CalPERS.⁵³ The analysis found that overall, PEPRA is expected to generate savings that will gradually increase over decades as more new employees are hired. Over the next 30 years, savings as a result of PEPRA are expected to range between \$43 billion and \$55 billion for CalPERS.⁵⁴ Shortly after CalPERS's analysis, CalSTRS released its assessment of PEPRA and how it would financially impact the second largest retirement system in the state. The assessment found that future CalSTRS members would have to work longer to receive full retirement benefits, but that the anti-spiking provisions would prove valuable to the fund.⁵⁵ CalSTRS's assessment estimates that total fund savings from the changes by PEPRA would result in a savings of \$22.7 billion over 30 years in their system.

Below is a table summarizing estimated future and present value savings as a result of PEPRA. For school plans, members include all non-teaching school employees in CalPERS.

State Plans	Savings Over 30 Years	Present Value of Savings
▪ Low Estimate	\$10.3 Billion	\$3.2 Billion
▪ High Estimate	\$12.6 Billion	\$3.7 Billion
School Plans	Savings Over 30 Years	Present Value of Savings
▪ Low Estimate	\$8.6 Billion	\$2.3 Billion
▪ High Estimate	\$10.8 Billion	\$2.9 Billion
Local Agency Plans	Savings Over 30 Years	Present Value of Savings
▪ Low Estimate	\$24.4 Billion	\$6.5 Billion
▪ High Estimate	\$32.4 Billion	\$8.4 Billion
Total Savings	Savings Over 30 Years	Present Value of Savings
▪ Low Estimate	\$43.3 Billion	\$12.0 Billion
▪ High Estimate	\$55.8 Billion	\$15.0 Billion

Source: Actuarial Cost Analysis California Public Employees' Pension Reform Act of 2013, California Public Employees' Retirement System, August 31, 2012.
<http://www.calpers.ca.gov/eip-docs/about/pubs/cost-analysis.pdf>

In the first five years of the PEPRA era, CalPERS estimates that the state government will save \$680 million.⁵⁶ These savings figures do not include savings for California's 20 CERL systems or savings as a result of employers' bargaining for increased employee contributions.⁵⁷ The savings expected because of PEPRA have contributed to the improved credit outlook for the state and local governments participating in state pension plans. Moody's Investor Services rates California "A1" with a stable outlook, saying in a report that reduced spending on pensions would help the finances of the state and many of its local governments and agencies in the CalPERS and CalSTRS system.⁵⁸ The state's improved credit outlook is not entirely the result of PEPRA though. Proposition 30, also known as the Temporary Taxes to Fund Education initiative passed a few months after PEPRA. According to some analysis, the tax increase will effectively divert \$30 billion in new tax revenue to service CalSTRS debt over the next seven years.⁵⁹



Source: Actuarial Cost Analysis California Public Employees' Pension Reform Act of 2013. CalSTRS Releases Summary of Pension Changes and Funding Resolution, California State Teachers Retirement System, September 5, 2012. <http://www.calstrs.com/whats-new/calstrs-releases-summary-pension-changes-and-funding-resolution> ; CalPERS 2013 Certified Annual Financial Report, <http://www.calpers.ca.gov/eip-docs/about/pubs/cafr-2013.pdf> ; CalSTRS 2013 Certified Annual Financial Report, http://www.calstrs.com/sites/main/files/file-attachments/financial_o.pdf. "UAAL" stands for unfunded accrued actuarial liability. We assume that CalSTRS's future savings of \$22.7 billion are distributed equally each year over the next 30 years. The present value of these savings is about \$9 billion based on the discount rate of 7.5%, which is CalSTRS's assumed rate of return. Adding this value to the high and low estimates of the present values of savings for CalPERS (\$12 billion to \$15 billion, respectively) results in the total present value between \$21 billion and \$24 billion.

It is important to put the estimated savings from PEPRA in perspective by comparing them with the unfunded pension liabilities. Since the unfunded liability value is the present value of future pension obligations, it should be compared against the present value of the estimated savings. Based on our calculation, the present value of the estimated savings for both CalPERS and CalSTRS over 30 years is between \$21 billion and \$24 billion. Meanwhile, the total unfunded liability of the two systems is almost \$130 billion, based on the official data in 2012.

In the grand scheme of California's unfunded pension liabilities, the estimated savings PEPRA provides are meager. Estimates peg California's unfunded pension liability between \$130 billion on the low end and \$583 billion on the high end—and that's not including the state's estimated \$150 billion dollar retiree health care liability.⁶⁰ Compared to those liabilities, the \$20 billion or so in present value savings over 30 years (at the high end of CalPERS and CalSTRS estimates) is a small percentage. The savings PEPRA provides are not even cuts in California's existing unfunded liability, but rather cuts in potential future unfunded liabilities. Because of the "California Rule," wherein pension system administrators are prohibited from decreasing a benefit under a suspect reading of the Contract Clause in the state constitution, the main cost-saving positions in PEPRA apply only to new employees, hired after January 1, 2013. The so-called "California Rule" was established in the 1955 California Supreme Court case *Allen v. City of Long Beach*, where the court found it unconstitutional to impair a public employee's "vested contractual pension rights" without providing comparable new advantages.⁶¹ This limitation means it will take years, or even decades before the PEPRA provisions have any meaningful impact on the unfunded liabilities of CalPERS, CalSTRS and the CERL plans.

San Jose Mayor Chuck Reed built a bi-partisan coalition of mayors in California and drafted an initiative to amend the California Constitution to allow municipalities to modify future pension benefits for current public employees. Supporters of the initiative had hoped to have it on the ballot in November 2014, but unfavorable ballot summary language generated by the Office of the Attorney General of California skewed the ballot summary, making it unlikely to pass. Rather than fight to change the title and summary language in court, Mayor Reed and his supporters have put the initiative on hold until 2016. If the initiative were to pass, it would effectively undo the "California Rule" for local jurisdictions and provide the ability for pension reform resulting in immediate savings.

Part 5

Weaknesses of PEPRA

Upon signing PEPRA into law, Governor Brown stated, “Under the new rules, employers and employees alike are going to contribute their fair share of the costs, resulting in a more sustainable system.” But with the majority of the changes to California’s pension systems in PEPRA only applicable to employees who became retirement system members on or after January 1, 2013, PEPRA only accomplishes this goal in the distant future at best. Several reforms that were in Governor Brown’s original 12-point plan that could have made California’s pension system more sustainable were taken off the table. After the vote on PEPRA, Senate President Darrell Steinberg stated, “I hope this puts this issue—which has so dominated the public discourse for a long time—if not away, at least off to the side so we can focus on some positive agendas.”⁶² While PEPRA may put the issue of pension reform off to the side for some state legislators, there are several weaknesses in PEPRA that will need to be addressed in the future in order to adequately address the sustainability of California’s pension systems. The following section highlights several major weaknesses in PEPRA that should be addressed in future California pension reform legislation.

A. Failure to Address the Current Unfunded Pension Liability in California

Arguably one of PEPRA’s biggest weaknesses is its failure to address the monumental problem of unfunded pension liabilities in California’s various pension systems: the 24 largest independent county and city pension systems face a \$130 billion unfunded liability, CalPERS is facing a \$57 billion unfunded liability, and CalSTRS has more than \$70 billion in unfunded liabilities.⁶³ Some of the reforms—such as the changes to benefit formulas, capping and defining pensionable compensation, and averaging final compensation over three years—will reduce costs and future unfunded liabilities, but those provisions have very little impact on the existing unfunded pension liabilities. As pension analyst John Dickerson puts it, “PEPRA tries to prevent fires two decades in the future but completely ignores today’s debt firestorm.”⁶⁴

Underfunded systems inherently limit the amount that pension funds can make in investment profits. When investment returns fall short, the unfunded liability grows. By not addressing California’s current unfunded pension liability in PEPRAs, governments may pursue a number of paths in order to close the gap or simply keep it from growing, such as raising taxes to amortize the debt, structuring pension obligation bonds to cover pension debt, investing in riskier assets, providing fewer public services and laying off employees. The impact of unfunded pension liabilities affects all Californians, not just public employees. According to the *Los Angeles Times*, “...every California household may be on the hook for roughly \$23,000 for public retirements over the coming decades...Brown's plan might, (might) whittle that tab to \$18,000.”⁶⁵ The shortfalls California pension funds face are much larger than the modest savings PEPRAs provides.

B. Most Provisions Apply Only to “New Employees”; The Term Is Too Narrow

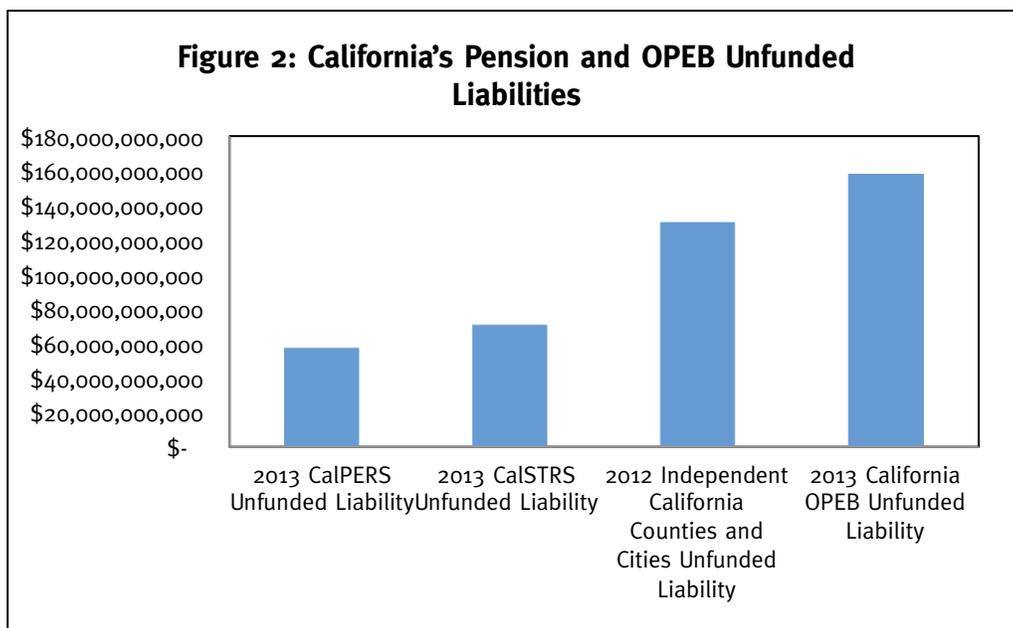
“New employee” is narrowly defined in PEPRAs and leaves significant potential savings for employers on the table. It excludes anyone who was employed by any public employer before January 1, 2013. The way the term is defined, someone who has not worked for a public employer in 20 years could start work in 2014 and receive all the benefits that classic employees receive since most of PEPRAs is only applicable to new employees. If these individuals are accepting new jobs under a new contract that does not contain the same provisions as the contract they served under previously, then logically it only makes sense to classify them as new employees. Individuals who were previously employed in the public sector were guaranteed their pension conditions for that term in which they worked, not for all future terms. For all intents and purposes, they are “new employees” and should not be treated as current employees if they return to public employment after leaving for the private sector.

In addition to limits on PEPRAs’ definition of “new employee,” whole swaths of pension systems are exempt. These systems include the University of California Retirement System and all charter-based retirement systems that do not participate in CalPERS, which include the city and county of San Francisco and the cities of San Jose, San Diego, Los Angeles, Oakland, Sacramento and Fresno.⁶⁶ The Judges’ Retirement Systems, administered by CalPERS, are also exempt from PEPRAs’ new benefit formula and cap on final compensation.⁶⁷ Public transit employees in the state who work for agencies that receive funding

from the Federal Transit Administration are also temporarily exempted from PEPRA.⁶⁸ With threats of loss of funds for those projects funded with federal monies, the legislature quickly passed Assembly Bill 1222, which exempts California public transit employees from PEPRA until a federal court determines whether their collective bargaining rights have been violated by PEPRA, or until January 1, 2015, whichever comes sooner. Assembly Bill 1783 extended the exemption until January 1, 2016.⁶⁹ Constrained in this way, PEPRA's impact is considerably reduced.

C. Negligible Benefit Changes

While PEPRA creates new tiers for both safety and non-safety employees with lower benefits, PEPRA's pension benefit adjustments do not go far enough. Many public employees in California have been promised health coverage for life, one of the major components to other post-employment benefits (OPEB), even though state and local governments are not setting aside the funds required to cover these future obligations. An April 2014 report by non-profit watchdog group California Common Sense assessed the financials of 690 OPEB plans statewide and found an unfunded retiree health care liability of \$157.7 billion.⁷⁰ Reform to the retiree health care system was initially part of Governor Brown's 12-point pension reform plan, but not included in PEPRA. Figure 2, below, demonstrates the size California's unfunded OPEB liabilities in comparison to the unfunded liabilities in other state and local pension systems in California.



Source: CalPERS, CalSTRS, California Common Sense, Stanford Institute for Economic Policy Research.⁷¹

Another issue with PEPRA is that while it did create new benefit tiers for safety and non-safety members, it did not modify the definitions of those terms. Who exactly counts as a “safety member” in California? The term has been loosely defined for years, grouping several employee categories whose jobs are neither risky nor hazardous, but simply associated with public safety. Generally speaking, the benefits received by safety members are greater than those of regular public employees, but these more generous benefits should be limited to employees who work in risky and dangerous situations protecting people from physical harm. In 1960, approximately 1 in 20 workers in California were classified as peacekeepers. By 2004, that number grew to 1 in 3.⁷² The term has become so vague that by 2008, over 60% of the California Union of Safety Employees included non-peace officers, such as milk inspectors, billboard inspectors, DMV drive test employees, lab technicians, smog-check employees, and dispatchers.⁷³ As shown in Table 3, the growth rate since the year 2000 of police/fire members, California Highway Patrol members, and other safety members in CalPERS has outpaced the growth of all non-safety CalPERS members. PEPRA fails to narrow the classifications eligible for more generous retirement benefits leaving potential savings on the table.

Year	State Miscellaneous	Police/Fire	California Highway Patrol	Other Safety
2000	208,227	40,675	6,542	15,521
2001	219,095	42,950	6,668	16,390
2002	227,522	45,801	11,754	17,478
2003	231,693	46,599	11,959	17,782
2004	227,096	44,740	10,236	16,714
2005	219,919	46,485	11,359	21,750
2006	214,721	46,605	6,968	23,129
2007	219,101	48,722	6,987	26,099
2008	222,806	51,371	7,133	28,763
2009	224,966	51,260	7,471	29,911
2010	224,084	49,437	7,589	29,305
2011	223,251	48,243	7,573	29,402
2012	228,667	47,162	7,565	28,935
2013	227,291	45,116	7,556	28,878
Percentage Increase Since 2000	9%	11%	15%	86%

Source: CalPERS Comprehensive Annual Financial Reports⁷⁴

PEPRA bans the practice of retroactive pension benefit enhancements (for both new and classic employees), but it is important to note that an increase to a retiree’s annual cost of living adjustment (COLA) does not count as a benefit

enhancement under PEPRA. A COLA adjustment from 2% to 5%, for all employees for example, would be allowed under PEPRA even though it would significantly increase liabilities. By definition, a “cost of living adjustment” should enable the retiree’s pension to maintain its value against the pace of inflation, and any increase higher than inflation would enhance the retiree’s benefit. While CalPERS explicitly says on its website that COLAs “cannot be greater than the actual national rate of inflation,” in 2014, most CalPERS retirees received a 2% COLA (some received a COLA as high as 5%) even with an inflation rate of 1.5% the previous year.⁷⁵ In addition to the automatic COLAs, the legislature has and retains the ability under PEPRA to authorize permanent ad hoc COLAs.⁷⁶ These kinds of benefits have not been paid for and are enhancements that taxpayers (employers) will have to cover.

In a 2011 paper in the *Journal of Pension Economics and Finance*, academics Robert Novy-Marx and Joshua D. Rauh find that a one percentage point reduction in COLAs would lower total liabilities by 9% to 11%.⁷⁷ Likewise the reverse is true, every percentage point hike in COLAs will increase pension system obligations by about 10% over the span of benefits. Other pension reform measures, such as the reforms in the state of Rhode Island, have suspended COLA adjustments as a means of cutting costs for this very reason. One of the major planks of the Rhode Island Retirement Security Act of 2011 was a suspension of cost-of-living adjustments until the pension system reaches a combined 80% funding level.⁷⁸ The legislation allows for the General Assembly to consider a COLA adjustment every five years during the suspension period. Once Rhode Island’s pension system is above 80% funded, COLAs will be calculated between 0 and 4% and will only apply to the first \$25,000 of an individual’s annual pension. California could learn from Rhode Island and restrict COLA adjustments unless certain funding thresholds are met, holding down unfunded costs for taxpayers for what appears to be “benefit enhancements” at face value.

D. Impact of Equal Cost-Sharing May Not Be That Significant

While PEPRA intends to narrow the gap between employer and employee contribution rates, several issues may minimize the impact of equal cost-sharing. For example, any savings from the increased employee contribution could be offset by commensurate pay raises. California’s nonpartisan Legislative Analyst’s Office has said that much of the long-term savings from the employee contribution will be offset by pay raises at the end of the new labor contracts.⁷⁹ Further, 50-50 cost-sharing is already the norm for most state employees.

PEPRA simply asserts this as “the standard” for all California state employees and eventually all local employees.⁸⁰

E. No Changes to California Pension System Boards

Perhaps no groups of people are more responsible for creating the state’s current pension crisis than the pension boards that mismanaged funds and approved unrealistic actuarial assumptions. PEPRA failed to make any structural changes to the composition of the state pension boards that would provide for professionalized governance instead of the current bodies that are otherwise politically motivated and function with little finance or investment experience.

As it now stands, government employees, retirees and politicians who are vulnerable to approve benefits beyond what the system can handle and possibly be directly financially affected by board actions comprise CalPERS and CalSTRS boards. Six of the 13 members of the CalPERS board are elected by either active or retired CalPERS members. Three members are political appointments, and four are automatic appointments based on their positions in government.⁸¹ Rather than build a system that is affordable, sustainable and secure, the boards’ (as currently structured) main goals are to maximize their benefits and reduce costs for members. There is little incentive to address the out-of-balance benefits or unfunded liabilities in the pension system. That responsibility eventually devolves to the state and taxpayers.

Indeed, the average California taxpayer is poorly represented on the state’s pension boards. The three political appointments (two by the governor and one by the speaker of the Assembly), while intended to represent the interests of all Californians, are not adequate to represent the interests of average California taxpayers. The boards also lack professional experts who have keen financial insight and understanding of how pension systems work.⁸² In order to have a well-run pension system, the board must include competent, impartial experts whose employment does not pose conflicts of interest on the board. CalPERS and CalSTRS would avoid many of the problems they face today if they would simply appoint professionals to govern their investment choices.

California is not the only state with these conflicts of interests. A National Association of State Retirement Plan Administrators survey on the composition of the boards of 88 state and municipal pension systems found that only 4 include no members who are participants in the plan itself.⁸³ The academic literature on whether public pension board composition affects the soundness of

plans is decidedly mixed and more analysis is necessary to determine exactly what the ideal board of a pension system would look like, but adding more expertise to the board (as Brown once proposed) would improve the system.

F. Provisions Can Be Undone Too Easily

Acknowledging that PEPRA contains some solid provisions, all the reforms could easily be changed or repealed by a majority vote of the legislature. If the economy improves, investments come in over the expected returns and public scrutiny and pressure on the state's pension systems subsides, the California Legislature may see it as politically safe to increase benefits again. In 2000, Senate Bill 400 expanded the pool of pension earners, dramatically enriched pension formulas and provided retroactive increases to employees without funding them. PEPRA barely dealt with those issues. Given that the legislature is highly sensitive to pressure from public employee union groups, authority to modify the terms of retirement plans should be left to the pension systems themselves or to the taxpayers of California who are on the hook for unfunded liabilities. But as referenced earlier, nothing was done in PEPRA to reform the state pension boards or their composition. Thus, the CalPERS board maneuvered around PEPRA to include 99 types of special pensionable compensation. This provides a great example of why board governance must improve before giving them substantially more authority.

G. No Hybrid Defined Benefit/Defined Contribution Plan

Defined contribution systems generally look like 401(k) plans typically found in the private sector where employees and employers regularly contribute a certain (or "defined") amount into the retirement account, usually a percentage of the employee's salary. Those funds are invested to earn returns and grow into a pool of funds the employee can live off of in retirement. Depending on the rules established in law, employees own the full amount in their account and their funds are flexible, portable and transferable as their own property, and can be bequeathed to family members upon the death of the beneficiary. While there are strategies and protections that can mitigate the risks employees must bear with their defined contribution retirement accounts and investment returns, in the case of public pensions, the government has no liabilities because it must regularly pay its full contribution; the employer does not guarantee specific benefit levels in retirement. Therefore, the government employer cannot create any unfunded liabilities, or debt, for taxpayers or future generations to pay off.

Governor Brown originally proposed the creation of a 401(k)-style defined contribution plan, to go along with a defined benefit, creating a hybrid plan for new employees. Watchdog group California Foundation for Fiscal Responsibility noted that such a plan had the potential to save local governments \$3 billion to \$4 billion per year.⁸⁴ A hybrid plan would have allowed employers and employees to share the risk of long-term investments. The unions vigorously opposed the hybrid system, and Democratic legislators kept it out of the final version of Assembly Bill 340.⁸⁵

H. No Actuarial Evaluation Done on PEPRA

Section 7507 of the California Government Code stipulates that:

*[T]he Legislature and local legislative bodies, including community college district governing boards, when considering changes in retirement benefits or other postemployment benefits, shall secure the services of an actuary to provide a statement of the actuarial impact upon future annual costs, including normal cost and any additional accrued liability, before authorizing changes in public retirement plan benefits or other postemployment benefits.*⁸⁶

The legislature did not procure an independent actuarial impact study before the implementation of PEPRA. There is no formal analysis of annual payments, normal costs, risk thresholds, investment targets and debt amortization schedules for each of the impacted pension systems. It is unknown how much PEPRA may save taxpayers in the short term. Had the matter been investigated more fully in a comprehensive actuarial analysis, there could have been better scrutiny on the inflated investment return projections that have plagued the systems for years. Legislators failed to confront this issue, which masks the true size of California's unfunded pension liability and what it will take to fix it.

At the time of PEPRA's passage, legislative rules mandated a 72-hour window for the public to review the law and provide comments.⁸⁷ This never happened. The language of Assembly Bill 340 was written and passed with no actuarial analysis done and very little public scrutiny.

I. Failure to Address Pension Debt Amortization Issues

In several counties, unfunded liability costs continue to increase because officials are using “level percent of payroll” debt amortization. Using this method, unfunded pension debt is paid off over 30 years, but for the first 12 years, payments are less than annual interest expenses.⁸⁸ During this period the debt is actually going up, not down, which is known as a period of “negative amortization.” After this period of negative amortization, payments become larger than interest, but it takes another eight years to get back down to just the original debt. An analysis on the 21 counties with independent pension systems in California found that on average, amortization payments are 25% less than the interest.⁸⁹ The use of level percent of payroll amortization has led all 21 counties to cumulatively increase their debt by over \$1 billion a year.⁹⁰ A substantial amount of pension debt was also created during the 2007–2009 financial crisis, so governments using level percent amortization are still in the early years of these payments. As a result, unfunded liabilities are going to be increasing for several more years to come in places using level percent amortization schedules. Addressing the kind of amortization schedules that pension systems should be allowed to use may have helped reduce the statewide unfunded liabilities, but PEPRA failed to confront this issue.

J. Debilitates Local Pension Reform

PEPRA requires that employers must offer a defined benefit plan unless they already have a defined contribution plan in place. Reforms adopted in San Diego and San Jose are allowed to be grandfathered in, but no other local agency (except for charter cities or counties that run an independent retirement system) is able to create local efforts to save its pension system without the approval of the legislature and the approval of CalPERS’s chief actuary. PEPRA applies to CERA counties and leaves the decision to the local governments as to whether to stop offering a defined benefit plan and begin offering a defined contribution plan in the future. However, the necessary approval from the CalPERS board and the legislature, many of whose members may be heavily influenced by public sector unions, makes this more of a challenge under PEPRA. In August 2014, reformers in Ventura County attempted to get an initiative on the ballot that would shift new hires into defined contribution pension plans, but a judge struck down the initiative on the grounds that the county must petition the legislature for reform and not do so through a local referendum.⁹¹

K. Pensionable Compensation Provisions Weakened

While PEPRA implements several cost-saving rules limiting pensionable compensation, most of these provisions apply only to new employees. These compensation provisions are meant to limit incidences of pension “spiking,” wherein employees inflate their compensation in the years immediately preceding retirement in order to receive larger pensions than they otherwise would have received. Classic employees will still be able to receive special compensation that factors into pension benefit calculations (such as allowances for maintaining uniforms and cashing in unused sick/vacation time). This is especially expensive for California’s retirement systems since as many as 95% of classic safety workers receive special compensation creditable to their pension benefits.⁹²

PEPRA was quite clear in what does and does not constitute pensionable compensation for new employees. As mentioned earlier, PEPRA states that pensions for new employees must be based on employees’ “normal monthly rate of pay or base pay” and the law specifically excludes any one-time, temporary or ad hoc payments from being counted toward pensionable pay.⁹³ However, the CalPERS board determined during an August 2014 hearing that 99 different types of special pay items will be counted as normal pay and will count toward pensions for all employees.⁹⁴ CalPERS did not provide a cost estimate of how much employers’ pensions cost might rise from adding the special pay categories to newer employees’ pensionable income, or how much more workers or their employers would have to contribute to the fund.

These spiking situations are especially harmful to cities that contract with CalPERS to administer their pension systems because they have no control over the size or range of these extra costs that will likely be paid for out of constrained general funds. Before the CalPERS board ruling, City Manager Laura Gill from Elk Grove, California said including temporary upgrade pay “really does invite spiking” and may erode savings from pension changes Elk Grove has enacted the past couple of years.⁹⁵ Allowing temporary pay increases to count toward pensions could lead to pension spiking situations in which employees late in their careers find a temporary assignment and earn a higher salary for six months to a year, boosting their pensionable salary. As Gill notes, if such practices become the norm, “it would put us backward from all the work we’ve done to have a sustainable and sound pension system.”⁹⁶

As a result of CalPERS’s ruling, the calculation of new employee pensions will be based on income that includes special pay items in addition to base salary. As

CalPERS board member Steve Cooney pointed out during the August hearing, the list hasn't been revised since 1993. While Governor Brown only objected to the temporary pay increases being included, several of the other special pay items are antiquated, vague and seemingly unnecessary—things that should fit within the regular duties of a particular job.

The list calls for premiums for questionable skills such as auditorium preparation, which CalPERS explains is for employees who are “routinely and consistently assigned to prepare auditorium(s), i.e. setting up stages, lighting, props and chairs for performing arts purposes.”⁹⁷ There is also a parking citation premium for employees who “are routinely and consistently assigned to read parking meters and cite drivers who have violated parking laws” as well as a marksmanship and physical fitness premium for officers who pass certain tests. Good marksmanship, being physically fit, and being able to read parking meters should not be considered “special skills”; they are skills that every police officer and traffic enforcement official should have and they should not contribute to additional, pensionable compensation.

CalPERS voted on the issue without listing a cost estimate to taxpayers. This is despite the fact that even a relatively small salary increase through these special pay bonuses can lead to hundreds of thousands of dollars in additional pension benefits over a retiree's lifetime. The San Diego Taxpayers Association found that an increase of \$7,850 to a \$100,000 salary can amount to an additional \$118,000 in total retirement benefits if the employee lived to 80.⁹⁸ Until pension boards do a better job at representing all stakeholders interests (employees, employers and taxpayers), the boards will continue to issue rulings like this one, strongly favoring public employees over all other stakeholders.

Part 6

Conclusion and Summary of Policy Recommendations

So, does PEPRA represent real pension reform in California? Not exactly. As former San Luis Obispo City Councilmember Andrew Carter penned in an op-ed, “For new employees, it does. For existing employees it doesn’t.”⁹⁹ And even for new employees, given the right circumstances, all it takes for future legislators to revert to the previous untenable pension provisions is a simple majority vote and a compliant governor.

In addition to the few positive elements brought about by PEPRA, substantive pension reform in California could include elements such as:

- Creating a defined contribution plan or defined benefit/defined contribution hybrid pension plan for new employees.
- Providing better taxpayer representation and more investment and financial expertise on the CalPERS board.
- Enacting measures to pay down California’s existing unfunded liability quicker, such as switching to a level dollar amortization schedule and requiring higher employee contributions for new and current employees.
- Undoing the “California Rule” and allowing the state and municipalities to modify future pension benefits for current public employees.
- Narrowing “safety employees” classification for employees who are regularly performing their duties at great risk and in harm’s way.
- Expanding PEPRA’s limitations on post-retirement employment to all CalSTRS retirees, public safety workers and judges who are currently exempt from the rule.
- Basing final compensation on an average of three to five years of highest years’ salary.
- Defining pensionable pay as “*the normal monthly rate of pay or base pay*” for all employees.

- Limiting special compensation categories from counting toward pensionable pay by significantly narrowing CalPERS's list of special compensation, which has not been revised since 1993.
- Freezing cost-of-living adjustments until CalPERS and CalSTRS are 100% funded.
- Including public transit employees as a part of any substantive pension reform bill.
- Classifying any employee who leaves the state pension system for the private sector, and returns after more than a year as a "new employee."

PEPRA does not include any of the recommendations referenced above and addresses only four of the 12 points in Governor Jerry Brown's original plan for California pension reform. Potential cost-saving measures in the governor's plan left out of PEPRA include changes to the CalPERS board, changes to the retiree health care benefit system, and the inclusion of a defined benefit/defined contribution hybrid pension plan for new employees.

Failing to address the current pension unfunded liabilities in California is a significant weakness in PEPRA, and ignoring the debt pressure pension costs have on other budget priorities reduces the impact of the well-meaning reforms in the bill. Though PEPRA moved the state on a more prudential path, its elected officials failed to make substantial reform to California's pension systems that would be affordable, sustainable and secure for the employee and the taxpayer.

It is in the interest of all Californians to encourage a public pension law that provides a fair, workable plan to pay down the accumulated pension debt as quickly as possible and implements processes and practices that ensure both the state and local governments adequately fund their retirement promises.

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