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Contra Costa County Grand Jury Report 1107

COUNTY PENSION REFORM

Time to Stop Kicking the Can

TO: Contra Costa County Board of Supervisors

SUMMARY

Contra Costa County (County) pension costs continue to increase significantly and are ultimately unsustainable without reform. Pension costs for Fiscal Year (FY) 2011-12 are estimated to be $202 million, which is the equivalent of approximately $587 per County household. By FY 2015-16, pension costs are estimated to be $279 million. For FY 2011-12, over $159 million of County General Fund dollars will be needed to cover pension costs. Rising pension costs have resulted in diminishing resources available for public services.

County tax payers are ultimately responsible for covering the shortfall between pension costs and employer/employee contributions and pension fund investment income. It has been reported that every Contra Costa household would have to pay $12,771 to eliminate the County's current unfunded pension liability. If wide-ranging action is not taken to reduce pension costs, County residents will continue to see a dwindling of public services.

One of the problems with public pension systems is the tendency for leadership to defer costs to future generations. The Grand Jury learned benefits to public sector retirees are extremely generous. The time has come to stop putting off making major changes to how pension benefits are derived. The County has authority to make some changes unilaterally, under the authority of California retirement law. However, many changes to pension benefits, especially those that could have the greatest financial savings, require agreement between the County and the unions, and in some cases, State legislation. The County and the unions must work together to address the rising pension costs.

It is not enough, however, to make changes solely to the benefits of future employees. The savings from those changes are too far into the future to help curb rising pension costs. More immediate savings would be realized if steps are also taken to reduce the cost of current employee pensions. While it is recognized that current employees have

vested rights in benefits they have already earned, there may be options to reduce benefits for their **future** employment.

The information in this report is based upon facts and data as of the date of the report.

BACKGROUND

Contra Costa County is one of 15 agencies that are members of Contra Costa County Employee Retirement Association (CCCERA). The County and its employees make contributions to CCCERA. The retirement plan, its assets and distributions, is administered by CCCERA in accordance with the County Employees Retirement Law of 1937 ('37 Act). The County entered into a settlement agreement after a 1997 California Supreme Court ruling enhanced retirement benefits for employees by governing what gets counted in the pension calculation. The County agreed that terminal pay—the payout of vacation and other pay items—would be included in the determination of the pension amount. A subsequent California Supreme Court ruling determined that terminal pay is not required to be included, but *may* be included.

Public employees who are members of defined benefit pension plans have three contractual rights that are protected from impairment by the 'contracts clauses' of the U.S. and California Constitutions:

a. The right to the payment of promised benefits.
b. The obligation of the employer to make contributions to fund the benefits.
c. The obligation of the employer to provide an actuarially sound retirement fund.

The position of most employee benefit legal experts is "a governmental body cannot modify or reduce a promised pension or retirement benefit without running afoul of the Constitution prohibition against impairment of contracts." Case law has supported that, in most situations, benefit reductions cannot be imposed on current employees who have vested rights, but only on future employees.

However, some prominent legal experts contend that "a public employee's right to a pension benefit is not inviolate, but may be changed or even eliminated under appropriate circumstances." This position will continue to be tested, as governments struggle with the rising costs of pensions.

Much has been written about pension reform and a number of legislative proposals have been hotly debated. Public initiatives have been developed. The issue is complex and opinions vary greatly. In recent months, the public is beginning to weigh in more positively on the need for public employee pension reform.

How County Pensions Are Calculated

County employees are classified into one of two categories: 1) "Safety" employees consisting of law enforcement personnel and firefighters; and 2) "General" non-safety employees. The pension plan is a defined benefit system, which guarantees a retiree a set income based on a statutory benefit formula. The benefit amount that an employee receives is determined by multiplying the employee's final average compensation (generally the highest 12 consecutive months of salary, plus other compensable items) by the number of years of service, multiplied by the statutory percentage factor (2% at age 55 for general members and 3% at age 50 for safety members).

To illustrate: a deputy sheriff retiring at age 50 with 25 years of service who averaged $90,000 in the last year of service and cashed out other compensable pay items such as vacation leave and uniform pay, increasing final pay by an additional $10,000, would receive $75,000 a year for his/her remaining lifetime. In addition, the benefit may be increased by up to 3% a year for cost of living adjustments (COLA).

Since there is no maximum cap on retirement benefits, a retiree can actually collect more in retirement pay each year than he/she would have earned as an employee.

Funding the Pension Plan

CCCERA's plan is funded through employer and employee contributions (as a percent of payroll) and investment earnings. Each year CCCERA's independent actuary conducts an evaluation to calculate the contribution rates for each employer in the system for the next fiscal year. This determines how much unfunded liability exists, based on gains or losses of the plan's assets. The actuary also provides a five year projection of employer contribution rates. Annual employer contribution rates are estimated to increase up to 18% for safety employees and from 8.7% to 13% for general employees over the next five years.

In December, 2010, CCCERA's actuary also provided a schedule of average monthly benefit payment amounts over the past eight years. The table below (excerpted from the actuary's report) indicates the average monthly benefit for the *actual* General and Safety employees who retired in 2002 versus those who retired in 2009.

Average Monthly Benefit

	Years of Credited Service		
Retirement Date	20-25	25-30	30+
2002-General	$2,187	$2,508	$4,769
2009-General	$3,167	$4,114	$6,823
2002-Safety	$5,301	$6,525	$8,309
2009-Safety	$6,838	$10,802	$9,587

To clarify the table above, a 50 year old safety officer who retired in 2002 with 26 years of service would receive $78,300 a year, or over $2.3 million over the next 30 years, whereas a safety officer of the same age and years of service retiring in 2009 would receive $129,624 a year or $3.9 million over the next 30 years. Include a 3% COLA (which is currently the maximum annual COLA for County safety employees hired before January 2007) and the benefit grows to over $3.7 million and $6.2 million respectively. The following table extracts information from the actuary's example above for retirees with between 25-30 years of service and assumes a 30 year payout, with an annual 3% COLA. It illustrates the approximate 30 year benefit of a General or Safety employee who retired in 2002 versus 2009.

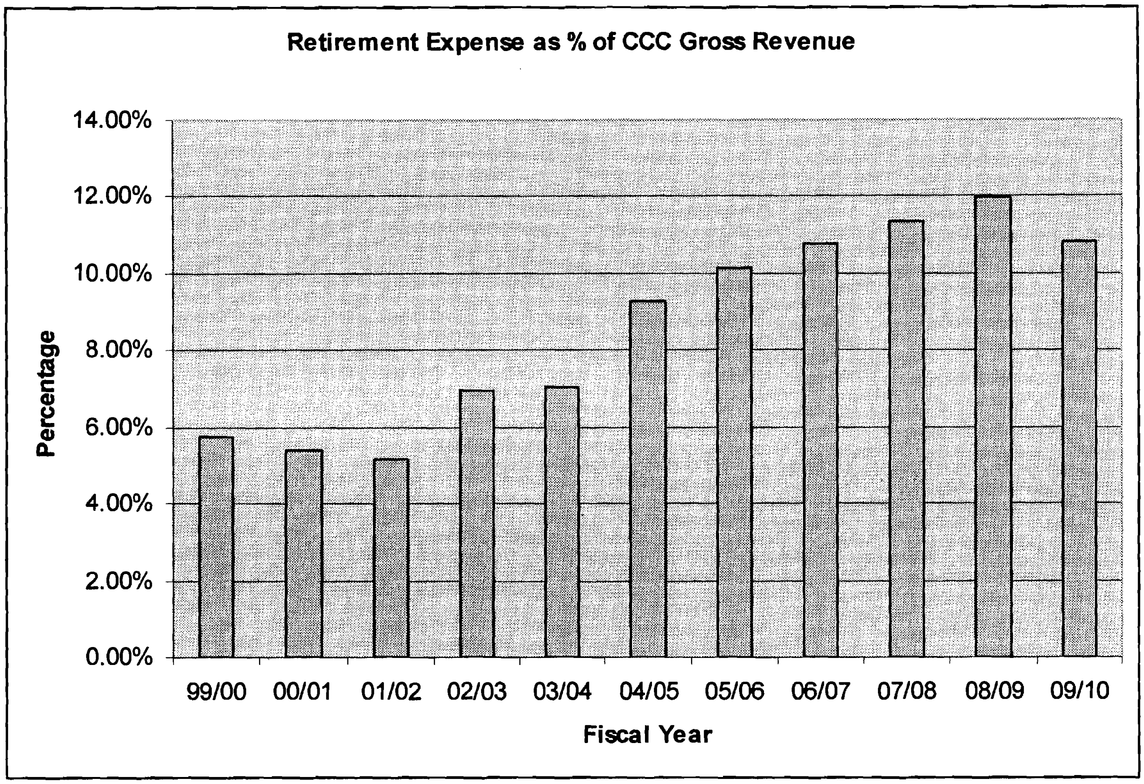
Individual Benefit
Years of Service 25-30 Example

	Annual Benefit	Approximate Lifetime Benefit	Approx. Lifetime Benefit with 3% COLA
2002-General	$30,096	$902,880	$1,431,925
2009-General	$49,368	$1,481,040	$2,348,703
2002-Safety	$78,300	$2,349,000	$3,725,155
2009-Safety	$129,624	$3,888,720	$6,166,916

The unfunded liability is what the actuary determines as the cost to cover shortfalls from market losses, demographic changes, overly-optimistic investment returns by the pension plan administrator or other benefit improvements that were not covered by the contribution rates collected from the employee and employer. From 2008 to 2009 the unfunded liability increased from **$690 million to $1.025 billion**, or a **49% increase.** This was due primarily to an investment return that fell short of the assumed 7.8% rate. Employees do not share any of the unfunded liability burden. It is only recovered through additional charges to the employer.

In other words, if the investment return doesn't meet its objective, the employer/taxpayers will bear ultimate responsibility for the financial shortfall.

Employer contributions, funded with tax dollars, are scheduled to increase again on July 1, 2011. Pension costs for the County have almost tripled since 1998 and are projected to continue to increase through FY 2015-16. In January 2011, the County projected the retirement expenses for FY 2010-11 to jump to $202 million from $193 million in FY 2009-10. It also projected that even greater County contributions will be required in each of the future five years. By FY 2015-16, the pension bill is estimated at $279 million, or an increase of $86 million (45%) over the actual expenses in FY 2009-10. While revenues have also increased since FY 1999-00, they have not kept pace with the growing allocation needed for pension costs. The following graph indicates the percentage of gross revenue that is required for General Fund retirement expenses has more than doubled in the past ten years.



Competing Use of Resources

Increasing pension costs have directly reduced funding available for other priorities in the County budget. Currently the County pays 41 cents in benefits and 40 cents in pension costs for every dollar paid out in salary. Salaries and benefits accounted for more than 52% of the General Fund portion of the County budget in FY 2010-11.

In the past several years, the loss of property tax revenue has forced the County to make substantial reductions in expenditures. The loss of revenue, coupled with increasing pension costs, has resulted in a reduction of services for the public. According to County reports, the County made $41.2 million in cuts in FY 2010-11, which was in addition to $139.4 million of cuts since FY 2008-09. There is a current projected gap of $50 million between revenues and expenditures for FY 2011-12. This structural deficit will likely result in yet another round of cuts to personnel and services.

What Has Been Done?

The Board and County management have publicly recognized that they have an increasing pension liability that is significant and unsustainable. Even some union representatives have concluded that pension reform is necessary. The Board, with union concurrence, implemented a change to address pension costs for new safety employees. In January 2007, after negotiation with the Deputy Sheriffs' Association (DSA), and subsequent legislation (SB524 enacted as Government Code section 31484.9), the County created a second tier pension for new safety members. This changed the calculation of final average compensation to 36 months instead of the 12 highest months of salary and reduced the COLA from 3% to 2%. This plan covers approximately 80 out of 1,275 safety employees and without new legislation will expire, or 'sunset' in 2012. The County through its legislative advocate and support of the DSA anticipates extending or removing the sunset clause, so that all safety employees hired after January 2007 would receive the lower tier benefits.

Another change, which was adopted by CCCERA, affected County employees hired after January 1, 2011. Some employees have been able to increase their final average compensation by accruing vacation hours throughout their employment and selling back up to 466 hours in the final twelve months of work. Not only does the employee receive the cash equal to the hours sold, but the value of the vacation hours is added to the salary to increase final average compensation. Newly hired employees cannot sell back vacation hours at termination to increase final average compensation. However, some employee groups can still sell back accrued vacation hours during the last year of employment to boost final average compensation. Additionally, in March 2011 the Board voted to no longer allow non-union managers to convert vacation into cash payments.

While the County is responsible for paying the employer contribution rate, which varies by bargaining unit each year, it has also negotiated with employee labor unions in past years to pay a portion of the employee's share of costs of the retirement contribution as well. Coupled with the County 'pick-up' of the employee share, **the County pays over 75% of the pension cost for each employee**.

Most union contracts, which cover 92% of County employees, will expire in June 2011. Changes made in past negotiations include elimination of retiree health benefits for new employees and a cap on employer-paid health benefits to existing employees for most employee groups. Union representatives, the Board and County management have recognized that additional concessions will need to be negotiated. Included in the latest State of the County report is the need to initiate the process to restructure pension benefits.

What Can Be Done?

When the economy was growing, pension benefits were substantially improved in public systems, and the County was no exception. Then when the economy tanked, investment returns went south, so pension contributions had to go up, just when counties and the State could least afford it. There are a number of avenues for pension benefits to be changed:

- Board action
- Board action that requires union agreement
- Legislation (generally requires Board and union agreement)
- Public initiatives—ballot measures

- Litigation
- Bankruptcy (applies to cities only)

Options to reduce the pension burden are numerous. Some can be achieved by Board and union action, such as items concerning compensation; most however require legislative change, which can either be special State legislation for the County, or approved by the legislature and signed by the Governor with statewide application. For the benefit of the reader, the Grand Jury has identified some of the options being considered by governmental agencies. The following chart indicates potential benefit changes and the level of required approval if considered by a county. Note that there are differing legal opinions as to the approval level of some of these benefit changes.

BENEFIT CHANGE	REQUIRED APPROVAL
Design new pension tiers with lower benefits	• Board for new hires* • Board/Union/Special State Legislation for current employees
Utilize three year final average salary rather than the highest year	• Board for new hires* • Board/Union/Special State Legislation for current employees
Eliminate terminal pay add-ons**	• Board if not in MOU • Board/Union if benefit in MOU
Reduce salaries	• Board/Union
Implement cap on vacation accrual	• Board/Union
Eliminate uniform pay and other pay items to reduce final compensation	• Board/Union
Eliminate the 'pick-up' of the employee's contribution to the retirement plan	• Board/Union
Explore restructure of pension, to include a defined contribution plan to offset reduction in defined benefit plan	• Board/Union
Increase retirement age	• State Legislation
Cap pensions	• State Legislation
Eliminate or reduce COLAs	• State Legislation
Eliminate purchase of additional service year credits	• State Legislation
Eliminate retroactive increases in benefits (ie. increasing benefit from 2%@60 to 2%@55 and applying it to past years of service)	• State Legislation

* Legal opinions vary on whether the Board can design new tiers without State legislation

** Note that CCCERA has made a change for new employees

What Others Have Done

Other counties, cities and the State have successfully modified pension benefits. In the November 2010 elections, six cities and two counties had some type of local pension reform on the ballot. In November 2006, the City of San Diego stripped the power to raise pension benefits from elected officials and from the collective bargaining process. That power now rests with the electorate. In 2008, Orange County passed Proposition "J" with 75% of the vote, requiring voter approval for increases in county employee retirement benefits. More recently, the City of San Diego has proposed to cap pension pay by excluding 'add-ons' or 'specialty pay' and use only base salaries to calculate benefits.

The Little Hoover Commission, a bipartisan group appointed by the former governor and State legislature, issued a report in February 2011. The Commission recommended California state and local governments "roll back pensions for existing employees, dump guaranteed retirement payouts and put more of the pension burden on workers." Specifically they urge the Governor and Legislature to establish the legal authority to freeze the benefits of current employees and reduce them in future years. The Commission acknowledged the significant legal challenges to modifying pension benefits for current workers, but recognized that the problem cannot be solved without addressing the mounting pension obligations of current employees.

A poll jointly conducted by the University of California, Berkeley and *The Field Poll* in February and March, 2011, found that California voters have changed their views about government pension benefits. By a margin of four to three, voters now view pension benefits as too generous. As recently as two years ago, *The Field Poll* found that 40% of voters believed the pension benefits of most government workers were at about the right level. The strongest support (73%) was for establishing an upper limit or salary cap when calculating pension benefits of public employees, followed by 69% favoring government workers paying more each month for their pension and health care benefits.

FINDINGS

1. Pension benefits, as currently structured, are ultimately unsustainable.

2. Continued increases in pension cost may result in further reduction of public services.

3. The Board has taken some actions to reduce pension costs but more must be done to achieve sustainability.

4. Under the California Employer Retirement Law, the Board, without union agreement, could unilaterally adopt lower pension tiers and/or three-year averaging for final compensation for new employees.

5. The Board could achieve lower pension benefits and costs, if successfully negotiated with the union, by reducing salaries and other pay items that currently increase final average compensation. Some pay items, such as uniform pay, could be eliminated and excluded from final average compensation.

6. While the financial impact of many pension changes will not be recognized in the short-term, the County—with Union agreement—could immediately reduce costs by approximately $18 million a year by eliminating its 'pick-up' portion of the employee's contribution to the retirement plan.

7. It is possible for retirees to receive more in pension benefits than the combined base salary those retirees earned while employed at the County.

8. Taxpayers are ultimately responsible for covering the shortfall between the cost of pensions and the amount accumulated from employee/employer contributions and pension fund investment income.

9. Some of the possible changes require State legislation, as noted in the table on page 7.

10. Pension reform is complex due to the differing legal opinions on what can be done, who can make it happen and when it can be done. This has led to public interest.

RECOMMENDATIONS

1. In order to bring about change, the Board should work with its union partners during the current contract negotiations for concessions to offset rising pension costs.

2. The Board should prioritize its focus on benefit changes that have an immediate financial impact, while pursuing legislative relief where necessary, to accomplish further reductions. (See table on page 7)

3. Those changes that can be made unilaterally by the Board for new employees should be adopted. (See table on page 7)

4. The Board should require employees to contribute more to their retirement costs.

5. County leadership should work expeditiously to eliminate the 'pick-up' portion of the employees' contributions to the retirement plan, saving up to $18 million a year.

6. The Board should seek special legislation to enable the County to cap retirement income so that no employee receives a pension greater than the base salary earned.

7. Given the complexity of pension reform issues, the number of legislative changes being proposed and ongoing labor negotiations, the Board should keep the public informed of what is being proposed and the Board's positions on these issues.

REQUIRED RESPONSES

Findings

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Recommendations

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