CONCORDIA CENTER FOR PUBLIC POLICY

DIRECTOR'S COMMENTARY

COMING TO GRIPS WITH PENSION COSTS

Recently the Concordia Center for Public Policy hosted a program on managing pension costs. Rapidly escalating pension expenses have dominated the news and forced the issue to the top of every local government agenda.

The rapid increase in pension costs is due to the poor investment performance of pension funds such as CalPERS, changing assumptions regarding mortality and longevity and rapidly escalating salary and benefit levels which have pushed up pension payments. Today's crisis in pension funding can be traced to 1999, when CalPERS actuaries testified that the California legislature could enact a "3% at 50" pension formula for public safety workers and that it would be "at no cost" to local governments due to the investment performance of CalPERS pension funds at that time. This induced a bi-partisan enactment of the new formula, signature by then-governor Gray Davis and adoption by nearly every local government in California.

In retrospect, it is now clear that the "3% at 50" formula did not work as a matter of mathematics. The investment returns, increasing contributions and mortality assumptions to make it work simply cannot be achieved. CalPERS' testimony to the contrary stands as an act of financial malpractice much greater in scope and cost than the Orange County bankruptcy. People went to jail for the Orange County bankruptcy.

Governor Jerry Brown, Stanford University, the Little Hoover Commission and local elected officials of all political persuasions have all used the same word to describe this system; unsustainable.

In my own city of Newport Beach, the projected increase in pension costs between 2010 and 2014 is estimated to be about $9 million based on the most recent CalPERS announcements. That amount would enable us to more than double the expenditures on our library system or to double our parks, recreation and senior services budget. It is this crowding out of public services by increasing pension costs that has led some so-called liberal communities such as San Jose and San Francisco (where there are more retired than active city workers), to call for pension reform.

Recently, Governor Brown has proposed some far reaching pension initiatives. The most significant is to require public employees to pay half of their pension costs and to create a hybrid, second tier system for new employees. These are substantial reforms that would have a major impact on pension funding.

Again using Newport Beach as an example, going to a 50/50 split would reduce our taxpayer paid pension costs to pre-2005 levels, a very affordable situation. Similarly, a second tier program for new hires would begin to bend the out year cost curve and over time, will reduce our ongoing liability.

What impact would a 50/50 split have on our employees? For safety employees the pension cost is equal to 44.9% of salary, so a hypothetical police officer making $85,000 would pay 50% of $38,165 or $19,082 equal to 22.45% of salary. This would certainly be a big hit to take home pay and cops like everyone else are subject to expenses expanding to meet the amount of income available. This is even more true in the family formation years when officers are in their 20's and 30's.

Higher employee pickups will need to be phased in over time, but is this level unfair or excessive? Not really. Self employed individuals are compelled by law to pay 15.3% in self employment tax for Social Security. If that same self employed individual set aside 10% of income in a 401(k), the percentage of income allocated to retirement would be 25.3%. A private sector employee pays 6.2% in Social Security tax (reduced to 4.2% temporarily by the payroll tax cut), and with 10% to his 401(k) would be paying 16.2%. A lower percentage, but for a much less beneficial retirement plan. Most public employees, including those working for Newport Beach, do not pay into nor receive Social Security.

When you consider that the additional pension contributions by public employees would be pre-tax, the savings from reduced state and federal income taxes would offset the increased cost by approximately 37% or $7,060. While everyone's tax and expense situations are different, the point is the amount is similar to the retirement contributions being made by private sector employees.

The tradeoff is that today's public sector workers are the last generation to enjoy an enhanced retirement benefit paying as much as 90% of salary at 50 years of age, with lifetime adjustments for inflation that he cannot outlive. Furthermore, he is 100% protected from losses due to fluctuations in market value. Any 401(k) holder who has watched his value drop in the past few years would jump at the chance for this investment vehicle.

It is because current employees enjoy such a valuable financial asset in the form of their pensions that I believe, acting out of enlightened self-interest, labor will work constructively with local governments to address this problem. The alternative is massive reductions in workforce. Indeed, nationally, state and local governments have shed 650,000 jobs since 2007 and that number is expected to rise to over 1 million by 2013. A "3% at 50" pension does you no good if you lose your job at thirty five after ten years.

Indeed, we are seeing this happen all over California as local elected officials and their bargaining units are crafting agreements that introduce a second tier and increase contributions by current employees. If the legislature provides the tools and gets out of the way, local governments and their employees together will craft pension programs that are economically sustainable and preserve vital public services.

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