Myths and Facts about Privatizing Public Employee Retirement in California

February 17, 2005

This memo notes a series of incorrect and often downright dishonest arguments made in favor of privatizing public employee pension funds in California, and then lays out the actual situation in response. This version is produced primarily as a reference document for producing further memos on specific topics, materials, handouts and fact sheets responding to Assemblyman Keith Richman and the Howard Jarvis Taxpayers Association's (HJTA) efforts to force public employees into privately managed stock market retirement accounts and to prohibit death and disability benefits for police and firefighter families.

We extensively reviewed HJTA documents, including their website and email newsletters, documents that Assemblyman Richman used in his announcement of filing ACA 5, and his op-ed running in numerous newspapers around the state.

A**. Public employee pensions are in crisis:**

"Massive pension deficits, generous benefit increases, and out-of-control pension costs across the state clearly illustrate the need for a new public employee retirement program."[1]

1. *"Public employee pension costs are devastating government budgets throughout California."*[2]

Despite misleading statements by the proponents, privatizing pensions will not balance the state or local budgets. According to respected financial experts, forcing new employees into private 401(k) stock market retirement accounts will actually create huge transition costs of over $7.6 billion for the State of California's pension systems for teachers and for public employees.[3] The LA County Employee Retirement Agency (LACERA)'s accountants and actuaries project an additional $1.29 billion in transition costs, and warn that the County won't see any net savings for the next 20 years.[4]

2. *"Throughout the state, important services are being cut to make mandatory pension payments."*[5]

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[1] "Public Pensions: Solutions to crisis is in private sector", by Assemblyman Keith Richman in *San Diego Union Tribune*, 2/4/2004
[2] Ibid.
[3] Cited in letter to Michael Cohen, Director, State Administration, Office of the Legislative Analyst, from N. Eugene Hill, Olson, Hagel & Fishburn, LLP on 2/4/2005.
[4] "Cost Impact of Richman Proposal," analysis presented to the Board of the Los Angeles County Employment Retirement Agency (LACERA), by Karen I. Steffen, Consulting Actuary, Milliman, on 1/24/2005.
[5] "Public Pensions: Solutions to crisis is in private sector", by Assemblyman Keith Richman in *San Diego Union Tribune*, 2/4/2004

Public employees have made regular financial sacrifices to help balance the budget and keep the California economy vital over the last decade. They have deferred raises, accepted unpaid days off, experienced layoffs, worked under hiring freezes, and worked hard to increase productivity with limited resources. Many state employees, for example, have not received pay raises in five of the last eight years. Last year a large number of workers gave back five percent of their salaries and agreed to pay more for health insurance. The salary cuts saved the state more than $240 million in fiscal 2003-2004.

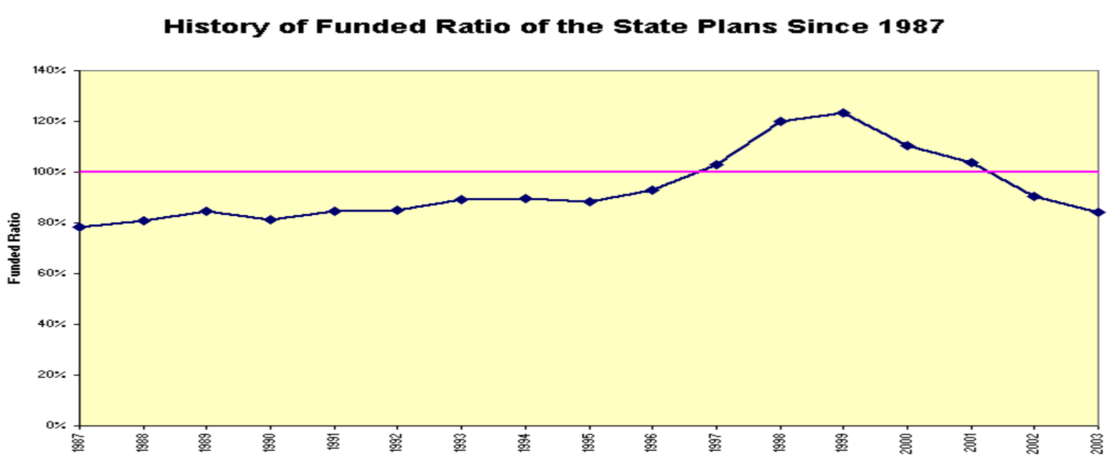
The problem with the state and local budgets are not that public employees aren't sharing the burden of hard times; the problem is with the structure of the revenue side of the budget, which relies almost solely on booming personal income – and the stock market -- for increases. When the stock market goes through ups and downs, so do local government budgets.

From 1998 through 2001, while the stock market was strong, government employers made little or no payments to CalPERS. These large investment returns saved employers and taxpayers over $6.05 billion during that period.[6] Over the last 25 years, the employer contributions rate has fallen dramatically from a high of almost 20% of payroll costs in the early 1980s.

But now, because of the recent economic downturn, they must make up the difference. The State of California, for example, made no pension payments for the category of miscellaneous employees in 2000, and, as a consequence of the stock market performing poorly, had to pay 14.83% of payroll in 2004.[7]

3. *"At the statewide level, California's two largest pension funds, CalPERS and CalSTRS, are each underfunded by more than $20 billion."*[8]

In reality, recent unfunded liabilities are normal and acceptable for the funds, which very recently were overfunded at a rate of 123.5%, resulting in employers cutting their contributions by over $6.05 billion. (see chart below[9]). CalPERS is healthy and considered to be in good shape. Two Wall Street rating agencies, Moodys and Fitch, both rated CalPERS as AAA in 2005. Neither fund is in any trouble. There are more than 40 public pension funds in California and almost every one is in very healthy condition.



CalPERS estimates that 80% of the increases in employer contributions is due to the recent economic downturn.[10] But last year's return shows that the fund is bouncing back, and CalPERS's investments earned 23.3% in 2003, increasing fund assets by almost $30.4 billion.[11]

CalPERS estimates that over the past 10 years, taxpayer and employer contributions to the plan only averaged 11.7%, with member contributions contributing 11.5% and the market earning 76.8% of the income to the pension fund. For the ten years preceding 2003, total member contributions have exceeded total employer contributions.[12] Employee contributions to CalPERS have grown steadily over the last decade, while employer contributions have fluctuated wildly as state and local governments used money they would normally have contributed for pensions to pay other expenses.[13] Thus, arguments about high pension payments focus only on a single year. Over time, pension costs are consistently within reason, with employees picking up a greater share of costs.

B. Public employee benefits are out of control.

"*Since given collective bargaining rights in the late '70s, these union bosses have become accustomed to dictating the labor agenda through their use of union dues to elect lawmakers and local officials who would toe the union line. Because of scant opposition to their efforts to guarantee their members "millionaire" pensions at taxpayers' expense, there was little publicity and voters have been slow to catch on."*[14]

3. *"But increasingly, due to union backed changes in the law over the last seven years, public employees are retiring on lavish pensions."*[15]

Currently, CalPERS estimates that the average monthly benefit paid to retirees is $1,669.[16] Some 400,000 retired California school employees, police, firefighters, garbage workers and health professionals receive an average CalPERS benefit of $19, 128 per year.[17] That's barely above the national average of $1500 per month for public employees, but given California's high costs of living, an annual pension of only $20,000 is hardly "lavish." The average age for retirement from public service in California is 60.[18]The very few men and women who draw large pensions worked for the state or other

[10] Page 9, from Agenda Item 3, 2/15/2004, report to CalPERS Benefits and Program Administration Committee

[11] *CalPERS Earns 23.3 Percent for the Year*, news release dated 2/19/2004 at www.calpers.org

[12] *CalPERS Member and Employer Contributions – 10-Year Review Chart*.

[13] *CalPERS Member and Employer Contributions – 10-Year Review Chart* and conversations with CalPERS actuarial staff.

[14] *Six Fallacies About Government Pensions*, by Jonathan Coupal and Richard Rider, 1/31/2005 at www.hjta.org

[15] Ibid.

[16] Page 2, From Agenda Item 3, 2/15/2004, report to CalPERS Benefits and Program Administration Committee

[17] Letter to the Editor, *Los Angeles Daily News,* from CalPERS, 7/20/2004.

[18] For the highest tier, pension income is only $1,860.12 per month after 22 years of service, a little more than $22,000 per year. *CalPERS PLRD Research Brief*, February 2004. Most state employees do not have 22 years at retirement, or have a lower retirement formula. The average monthly pension payment from

public agencies for many years at the top level of government. There are less than 1,000 CalPERS beneficiaries, 0.0025 percent, who are at this level, out of 400,000 retirees.

4. *Public employees are double dipping, and getting both fat retirements* *and* *Social Security payments.*

Many public employees, including most municipal workers and teachers, **do not** enjoy the benefits of social security. Almost every private sector worker in the United States pays into the Social Security system and has the right to draw benefits from our safety net system, but many government agencies did not sign up their employees in Social Security Of those retired U.S. public employees who do receive Social Security, many need to supplement their annual average of $18,000 in pension benefits with their social security benefits, if the receive them, so that they can afford to pay for their home and food and basic medical care.

5. "Since given collective bargaining rights in the late '70s, these union bosses have become accustomed to dictating the labor agenda through their use of union dues to elect lawmakers and local officials who would toe the union line."[19]

1999 pension benefit improvements negotiated at the State were actually proposed by employers in contract negotiations. Employees reduced their salaries by 2% that year to pay the cost of the retirement benefit improvement. The cost to the state is the same as if the same 2% were budgeted for salaries. For the largest group of CalPERS' members, the rate of taxpayer contributions is less than in the early and mid-1980s, long before current benefit changes.[20]

C. The private sector is more efficient.

"Again, we would have none of these troubling problems if all government agencies offered only the same type of 401(k) program most offered by the private sector."[21]

6. *"During the last 20 years, most private sector companies have moved their retirement programs from defined benefit programs that provide retirement benefits based upon a formula of years employed and final salary to the 401(k)-type plans that match employee contributions to their own accounts."*[22]

CalPERS (including all public bodies and tiers), was just $1,506.09 in 2003, barely above the national average of $18,000 per year for all public employees. For the State figures, see *CalPERS Summary of Statistics of Retirees and Beneficiaries as of June 30, 2003.* For the national average, see Letter to the Editor of *Fortune Magazine*, 6/26/2004 from the National Association of State Retirement Administrators.

[19] *Six Fallacies About Government Pensions*, by Jonathan Coupal and Richard Rider, 1/31/2005 at www.hjta.org

[20] *Benefit Improvements in 1999 were [NOT] the major cause of employer rates to increase*, CalPERS memo and charts

[21] "Public Pensions: Solutions to crisis is in private sector," by Assemblyman Keith Richman in *San Diego Union Tribune*, 2/4/2004

[22] *Richman ACA 5 Would Start Fiscally Responsible Pensions*, News Release from Assemblyman Keith Richman, 38th Assembly District, 12/6/2004.

The majority of large private sector companies have a defined benefit plan similar to the one managed by CalPERS, CalSTRS or one of the 40 similar traditional pension funds (defined benefit plants that pay a stated regular retirement benefit). Since 1985 the number of large employers offering a defined benefit plan as their primary retirement vehicle has increased. The National Association of State Retirement Administrators reports than only 17 percent of Fortune 100 companies have a 401K style plan as their primary retirement plan. The Federal Bureau of Labor Statistics reports that since 2000, the percentage of all employees in the US covered by DB plans has increased.[23] Watson Wyatt Reports that use amongst employers of more than 10,000 are increasingly using defined benefits plans. The only sector of the American economy that has increased the use of DC plans are smaller employers, partly to avoid complex federal pension oversight that doesn't apply to the public sector.

The American Benefits Council reports that large and medium private companies prefer DB plans as a primary recruitment and retention tool.[24] And, recently SBC reinstituted its defined benefit plan after a hiatus of several years. Other examples of major corporations offering defined benefit pension plans include Chevron, Unocal, Lockheed Martin, Boeing, Albertson's, Boise Cascade, Louisiana Pacific, Safeco, and Weyerhauser.[25]

The state of Nebraska recently converted back to a defined benefit plan from a DC plan. A study showed that, after 30 years, the typical worker posted an average annual return of only 6% to 7%, while money managers running the previous traditional pension plan posted 11% average annual returns. Even though the state made much effort to help individuals invest wisely, half of all employees stayed in the default fund, even when offered 11 choices. Nebraska was concerned that the state was wasting taxpayer money via matching contributions.[26] In Florida, where employees could leave the DB plan for the 401(k)-style plan, most opted to stay in the traditional pension program. Kansas studied a proposal, but found that "conversion from the current defined benefit plans for Kansas public employees would not result in lower employer contributions… Nor [would it] eliminate past unfunded liability, which must continue to be amortized to provide benefits previously promised."[27]

7. *"Employees have an opportunity to for (sic) increased retirement income based on their investment decisions."*[28]

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[23] *ACAX1, ACA 5, and the DC Proposal*, a Power Point briefing for CalPERS members by Bob Walton, CalPERS.
[24] Ibid.
[25] Ibid.
[26] "Nebraska Sees Red Over Its 401(k) Plans," by KC Swanson,5/7/2002, on TheStreet.com at www.thestreet.com/funds/belowradar/10021041.html.
[27] Legislative activity on the DB/DC issue, 1998-2003, (based on a search of the National Conference of State Legislature's website.)
[28] Page 21, "Comparing the Advantages Between A DC vs. DB" in *Securing California's Fiscal Future,* from Assemblyman Keith Richman, 38th District website.

A 2004 study by Cost Effectiveness Measures, Inc. (CEM is an independent firm that tracks pension performance), found that CalPERS added more value to its investments at a lower cost than other large pension funds.[29] According to the *SF Chronicle,* the median DC plan return from 1990 to 2002 was only 6.86%[30], but for the same time period, CalPERS rate of return was 8.9%.

The cost of administering the CalPERS DB fund is 0.12% of assets, which includes counseling and educating members, individual employer services and plan valuations, and administering complex benefits with a variety of options for both employers and members. The investment costs associated with the CalPERS DB plan are an additional .25% of assets.

According to Morningstar, the average expense ratio of a domestic equity fund is 1.49%, but does not include the overhead associated with a 401(k), including recordkeeping of individual accounts, contracting with fund providers, and providing education to participants. The total annual costs of a DC plan can rise to as much as 2%.

CalPERS earnings 1990 to 2002 after costs are deducted:	8.53%
Average 401 (k) domestic security plan for the same period:	4.86%
Inflation for the same period:	TBD

D. Individual stock market 401(k) plans are better for employees.

"For employees, defined contribution plans allow workers to take their money with them when they change jobs and create individual assets they own and can be passed along to heirs."[31]

9. "*Portability features provide a potential for more retirement income for employees who have several changes during their careers."*[32]

According to a study conducted by the human resources consulting firm Hewitt Associates, 57% of employees who leave their companies choose cash payouts – including the monies contributed by the employer for the purpose of retirement – rather than rolling the funds over to the next employer's retirement plan.

Furthermore, as a result of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) adopted in 2001, member contributions of a DB plan offer similar portability as DC plans. Upon separation from employment, member contributions may be "rolled-over" to a private 401(k) or Individual Retirement Account (IRA), thereby sheltering eh

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[29] Page 21, from Agenda Item 3, 2/15/2004, report to CalPERS Benefits and Program Administration Committee.
[30] "Public Pensions in Flux," *San Francisco Chronicle,* 1/9/2005
[31] *Richman ACA 5 Would Start Fiscally Responsible Pensions*, News Release from Assemblyman Keith Richman, 38th Assembly District, 12/6/2004.
[32] Page 21, "Comparing the Advantages Between A DC vs. DB" in *Securing California's Fiscal Future,* from Assemblyman Keith Richman, 38th District website

funds from tax penalties. In addition, EGTRRA permitted DB plans to accept funds from a variety of common DC accounts for the purchase of service credit.[33]

10. "*Employees have an opportunity to for (sic) increased retirement income based on their investment decisions.*"[34]

Again, the state of Nebraska recently converted back to a defined benefit plan from a DC plan. A study showed that, after 30 years, the typical worker posted an average annual return of only 6% to 7%, while money managers running the previous traditional pension plan posted 11% average annual returns. Even though the state made much effort to help individuals invest wisely, half of all employees stayed in the default fund, even when offered 11 choices. Nebraska was concerned that the state was wasting taxpayer money via matching contributions.[35]

Employees who manage their own retirement assets are generally too conservative in their asset allocation choice, investing in stable value and other fixed income assets rather than equity assets with greater returns. According to the Employee Benefit Research Institute, more than 38% of workers in their 20s and 27% of workers in their 30s hold no stock funds in their accounts.[36]

It costs more to manage 401K plans, many employees do not utilize the investment options that bring the greatest returns, operational expenses eat up returns in defined contribution plans, and 401K style plans do not include disability and death benefits for family members. Experts agree that the chances are very high that a 401K style plan would not provide adequate retirement benefits for California workers and that adopting them could hurt the ability of the state to recruit and retain qualified employees.

11. *Chile and Great Britain also converted their pension systems from DB to DC.*

According to the *Los Angeles Times*, "In 1981, Chile scrapped a pay-as-you-go similar to the one in the US, in which the contributions of active workers were use to pay pensions of retiring workers. Instead, many Chileans began funneling 10% of their wages into professionally managed private accounts that allowed them to invest in stocks and bonds… But high management fees have trimmed retirees' payouts substantially, while big holes remain in Chile's safety net. An estimated half of the nation's workers aren't saving enough to qualify for even a minimum government pension of about $134 a month… 'Millions of Chileans would go back to the old system if they could,' said Manuel Rieco, direction of the National Center for Alternative Development Studies, a Santiago think tank critical of Chile's reform. Even supporters of Chile's reform say that

[33] Page 10, from Agenda Item 3, 2/15/2004, report to CalPERS Benefits and Program Administration Committee.
[34] Page 21, "Comparing the Advantages Between A DC vs. DB" in *Securing California's Fiscal Future,* from Assemblyman Keith Richman, 38th District website.
[35] "Nebraska Sees Red Over Its 401(k) Plans," by KC Swanson,5/7/2002, on TheStreet.com at www.thestreet.com/funds/belowradar/10021041.html.
[36] Page 8, from Agenda Item 3, 2/15/2004, report to CalPERS Benefits and Program Administration Committee

prponents of US privatization may be raising expectation too high. Economists doubt American workers would see such lofty investment returns…"[37]

According to the *Sacramento Bee,* "Great Britain has a two-tier system: a flat rate basic pension and a second layer of benefits based on wage. Sine 1978, workers have been able to choose between taking their second layer benefits from the government, or carving out 4.6% of their wages – almost one-third of the payroll tax – and putting in a private account. An October 14 report by the British Pensions Commission is a cautionary tale on carving private account out of a public pension system. The report says at least 75% of those with private accounts will not have enough savings to provide adequate pensions. (www.pensionscommission.org.uk)."[38]

E. The scheme will affect only new hires after 2007.

"This reform proposal will not impact the benefits promised to any current public employee or retiree."[39]

Current employees are also at risk, because even though benefits will not change, the cost to provide those benefits will go up. Current benefits are partially funded by the revenue stream from newer, younger employees entering the system. The privatization plan dries up this revenue stream, creating a huge unfunded liability.

Employees could thus be affected in the following ways, as the system seeks to absorb lower returns and increased costs of operating two retirement systems:

* Employee contributions could be increased.
* Retiree cost of living raises will be decreased
* Future raises could be absorbed into new pension-related costs.

California's economy will suffer because CalPERS invests $19.4 billion in the California economy. CalPERS is one of California's largest real estate developers, financing 40,000 new homes and thousands of good paying, middle class jobs.

[37] "A Personal Burden," *Los Angeles Times*, 2/13/2005
[38] "Other Nations' Programs Show Great Risk," *Sacramento Bee*, 2/13/2005
[39] "Public Pensions: Solutions to crisis is in private sector," by Assemblyman Keith Richman in *San Diego Union Tribune*, 2/4/2004