CALIFORNIA
PUBLIC PENSION SOLUTIONS

POST CONFERENCE REPORT
FEBRUARY 2014

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INTRODUCTION

In October 2013, the Hoover Institution's "California Public Pension Solutions" conference, co-hosted by Hoover senior fellow Josh Rauh and SIEPR's David Crane and Joe Nation, engaged Hoover Institution fellows, pension scholars from across the country, current and former California and out-of-state policy leaders, and other pension reform specialists to discuss, in-depth, solutions to California's public pension challenges.

After a full day of rigorously discussing solutions and a public address by San Jose Mayor Chuck Reed, conference attendees were asked to complete a post-conference survey. The survey consisted of ten statements; attendees marked whether they strongly agreed, agreed, were uncertain, disagreed, or strongly disagreed with each statement and then marked their confidence level (very confident, somewhat confident, uncertain, somewhat unconfident, very unconfident). This survey is modeled after the IGM Forum conducted by the University of Chicago's Booth School of Business.

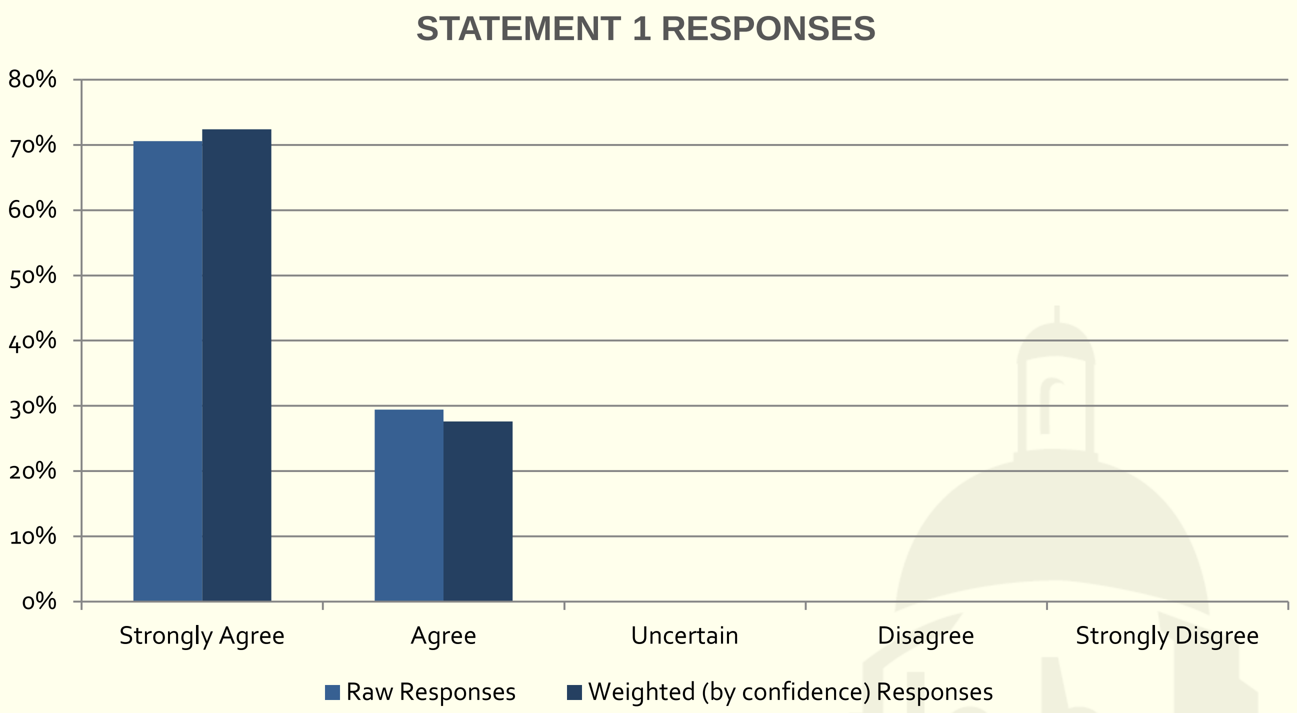
The **Post Conference Report** presents the results of the survey providing a graphic for each statement showcasing the raw and weighted responses. Accompanying each graphic is a short summary providing more detail on the topic addressed in each statement.

The Hoover Institution:
Established at Stanford University in 1919 by Herbert Hoover, the Hoover Institution has evolved into an active public policy research center intent on defining ideas for a free society. The Hoover Institution is also an internationally recognized library and archives home to one of the largest collections related to political, economic, and social change.

Focus California Leadership Forum:
The Hoover Institution's *Focus California Leadership Forum* invites current and aspiring California policy leaders to spend time with Hoover scholars, engaging in substantive dialogue on important matters of California public policy.

STATEMENT 1:

Amending the "California Rule" to allow the state and/or localities to adjust pension benefits *going forward* would make meaningful reform more likely.



Among the bi-partisan group of conference attendees, there is little disagreement about the effect the "California Rule" has on public pension reform within California. 100% of our experts agreed that amending it to allow reform for current employees *going forward* would make a meaningful impact. When weighted by confidence, almost 3/4th of attendees strongly agreed (note: all reported response percentages henceforth are weighted unless otherwise indicated).

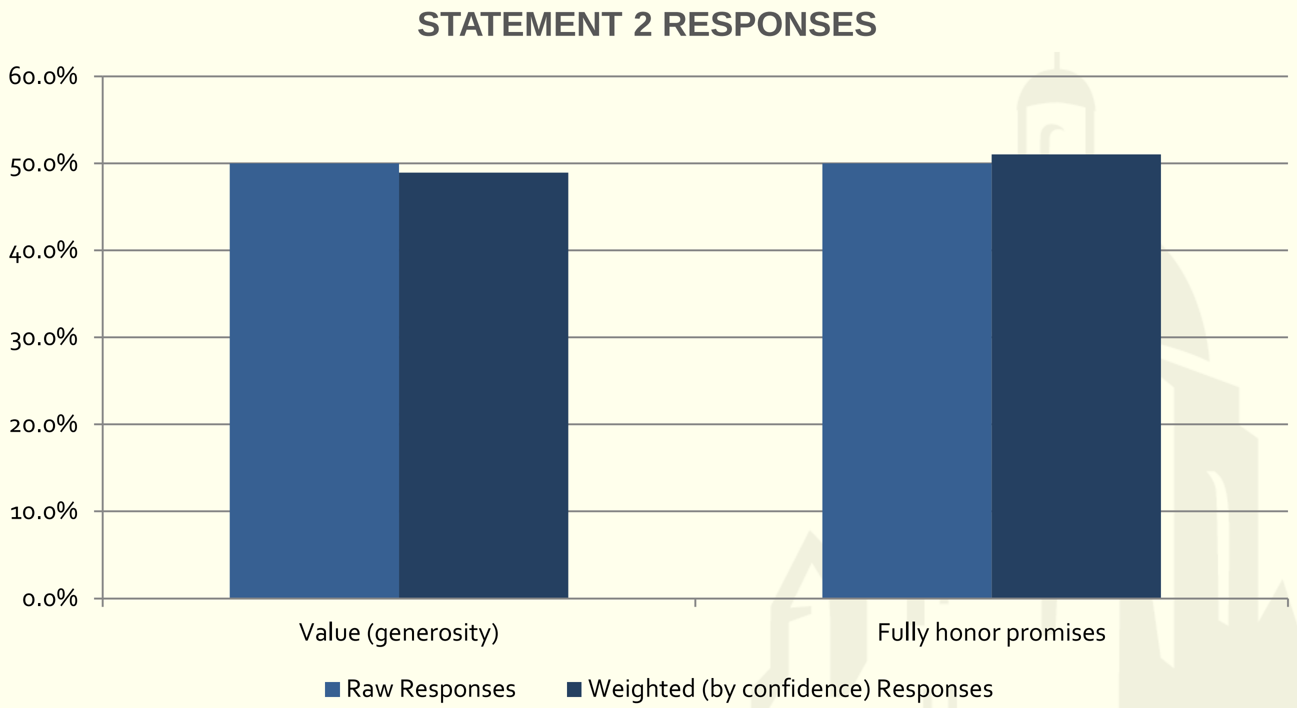
Why is the "California Rule" so important? Courts have long determined that state retirement statutes create a contract between the state and its employees. The "California Rule" takes this one step further by establishing not only a contract that cannot be impaired, but creates the contract on the first day of employment. As University of Minnesota School of Law scholar, "California Rule" expert, and conference attendee Amy Monahan notes in her 2011 paper on the topic, this rule results in "pension benefits for current employees [that] cannot be detrimentally changed, even if the changes are purely prospective." Because changes cannot be made to pension benefits for *future hours worked* by current employees, the only practical method to reforming public pensions is to alter the benefits for new hires, which creates separate classes of employees and delays pension system solvency to many years in the future.

Mayor of San Jose and conference attendee Chuck Reed is exploring a ballot initiative to amend the "California Rule." However, the prospects of such action remain in flux.

STATEMENT 2:

In your opinion, which is the more accurate statement?

Pension reform's focus ought to be about the value (generosity) of the provided benefits.
Or
Pension reform's focus ought to be about requiring pension boards and elected officials to fully honor promises made.



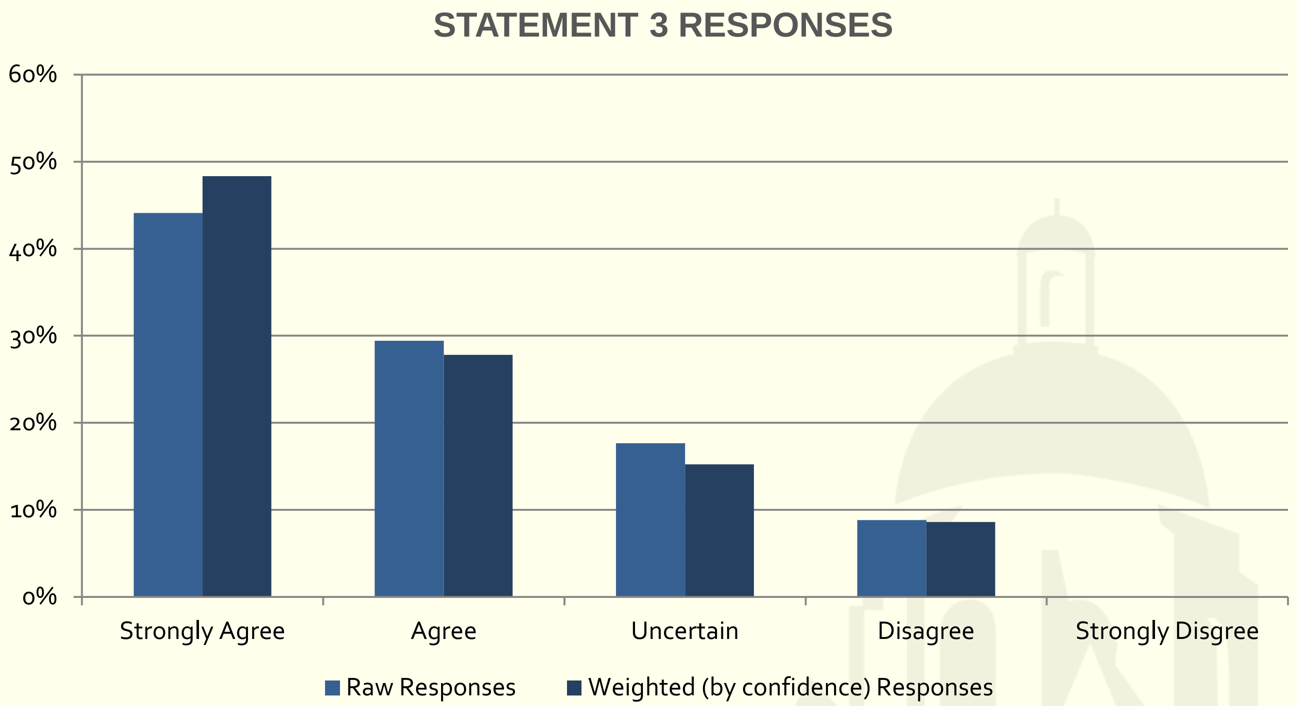
Before weighting for confidence, attendees were split on whether reform should focus on the benefit generosity or fully honoring promises. However, when weighted, 51% of attendees supported fully honoring the promises.

The generosity of benefits has become problematic. For instance, in 2012, over 31,000 state retirees received pensions of $100,000 (71% higher than California's 2012 real median household income) and the average total compensation for state employees ranged from $90,000 to almost $130,000.

However, if reform focuses on requiring elected officials to fully honor promises made, the generosity of benefits would also be addressed. For example, if California legislators or local officials had to fully fund pension plans, the true cost of such plans would immediately be apparent. This would either result in cuts to other services or re-negotiated benefits. Therefore, requiring that promises are fully honored could also lead to more reasonable benefit generosity.

STATEMENT 3:

Requiring state and local pension boards to use a risk-free rate of return, contribute 100% of ARC (actuarially required contributions), and publicly post user-friendly financial statements is a prudent step toward the financial health of pension benefits.



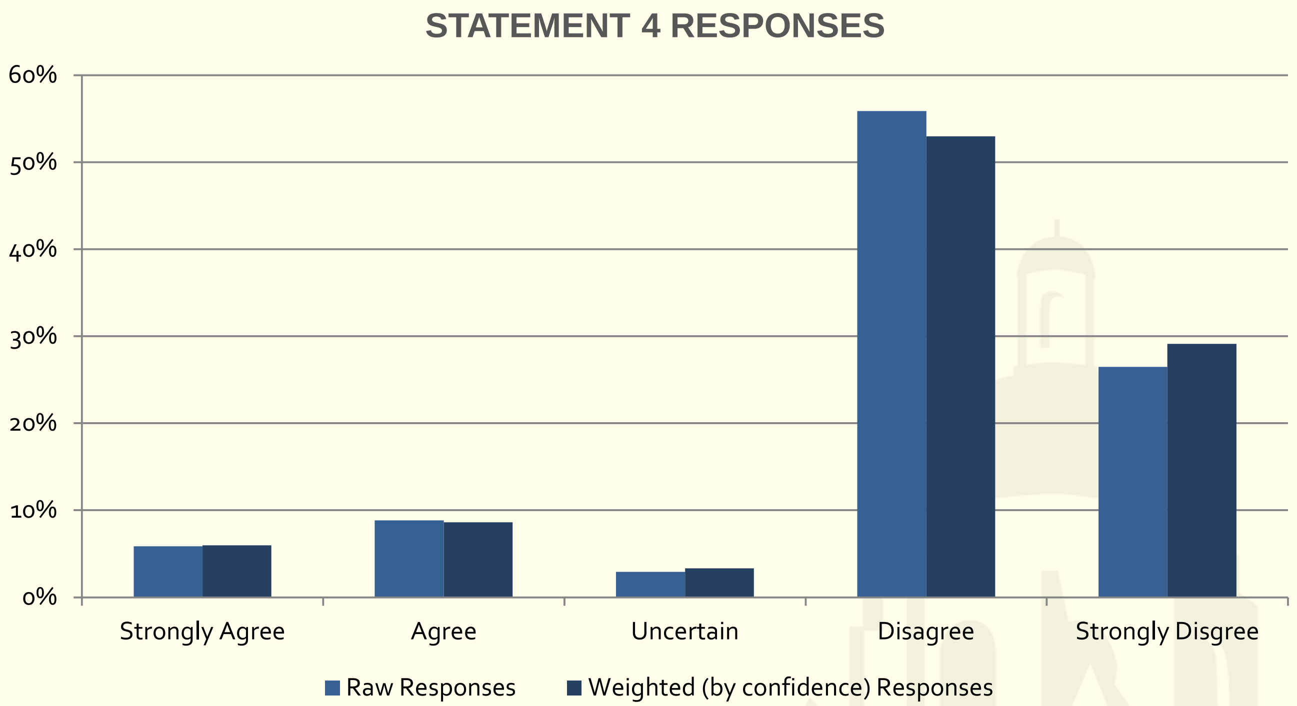
Over 3/4th of conference attendees agreed that following good practices—such as discounting cash flows with a conservative risk-free rate of return, contributing 100% of ARC, and publicly posting financial statements—would lead to better financial health of pension funds.

The rate of return used to discount the pension fund's cash flows has an immense impact on how much employers need to contribute and hence, the financial well-being of pension funds. While GASB allows funds to discount cash flows at their assets' expected rate of return, as Josh Rauh, Hoover senior fellow and conference co-host, and Robert Novy-Marx, University of Rochester scholar and conference attendee, note, this "runs counter to the entire logic of financial economics." Instead, they argue if pensions are indeed guaranteed (i.e. riskless), then a risk-free rate is most logical.

Under-funding a plan occurs when the actuarial value of assets is less than the actuarial accrued liability. This can occur either because funds are estimating a higher rate of return than actually occurs or because governments simply do not allocate the full ARC in a given year (for example, CalSTRs only received 44% of its ARC in 2013). Increased transparency, however, would enable stakeholders to hold those overseeing the pension funds accountable for ensuring the fiscal well-being of plans.

STATEMENT 4:

Adjusting or freezing C.O.L.A's, eliminating "spiking" and "double-dipping," changing pensionable pay, and cutting pension benefits for new employees will solve the fundamental problems with the current pension challenges.



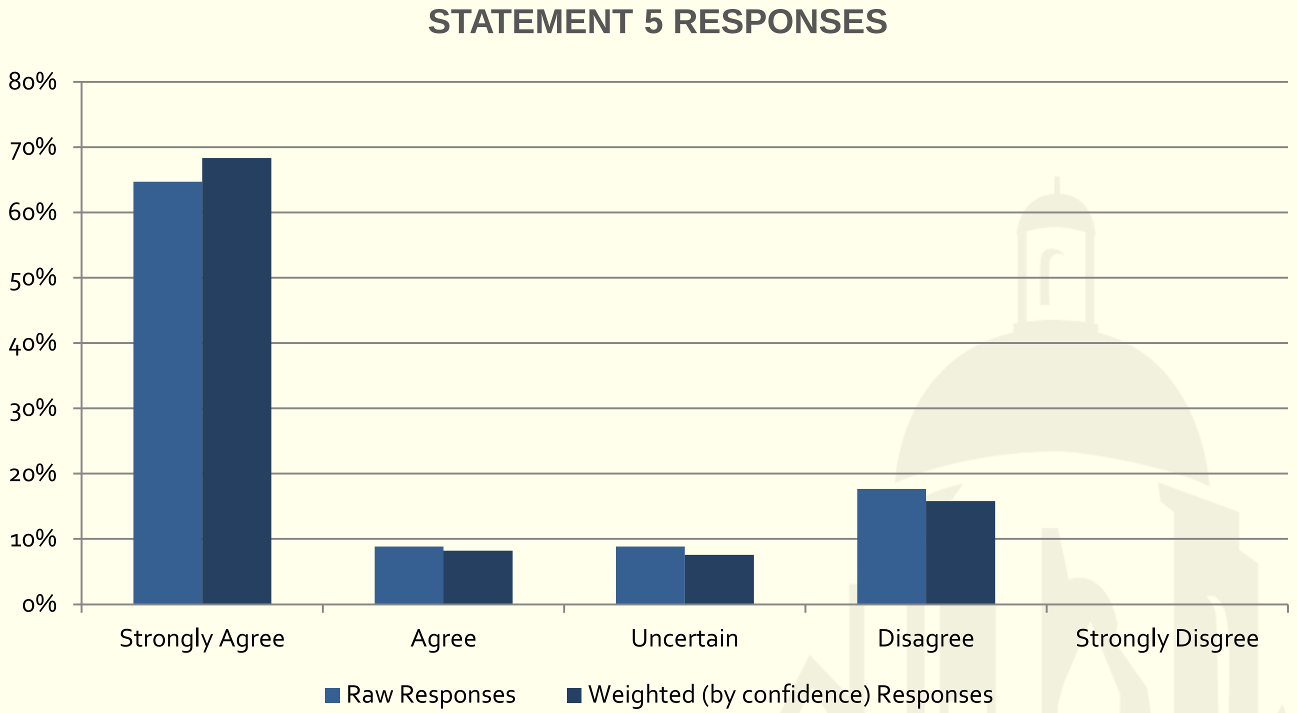
Over 80% of conference attendees disagreed that simply making small reforms like adjusting or freezing C.O.L.A's, eliminating spiking and double-dipping, changing pensionable pay, and cutting benefits for new hires would work to solve the pending pension crisis in California.

These reforms are typically the approach states and localities take, particularly in areas operating under the "California Rule." However, they provide little immediate relief to pension funds and have yet to ensure long term solvency. Changes for new and future hires does nothing to adjust current unfunded liabilities making meaningful cost savings decades away. While "spiking" and "double-dipping" are manipulations of the current system—that get a lot of attention—and should be addressed in reform, they alone do not contribute substantially to pension fund costs.

Similarly, while C.O.L.A's and retirement years should be part of pension reform, adjusting them alone would do little to address current pension challenges. In their 2011 paper, Josh Rauh and Robert Novy-Marx estimate that a 1% C.O.L.A reduction would lower total liabilities by between 9 and 11% and that increasing the retirement age by 1 year would reduce liabilities by between 2 and 4%. Neither is insignificant, but nor are they sufficient on their own.

STATEMENT 5:

Long-lasting structural pension reform should mimic the response to an oil leak: it must fund the current unfunded liabilities (i.e. clean up the spilled oil) as well as re-design pension benefits and structure to prevent future liabilities (i.e. stop the leak).



By almost a 5 to 1 ratio, conference attendees agreed that long-lasting structural pension reform needs to address both the current unfunded liabilities as well as fixing the pension structure to prevent future liabilities. In this respect, it should mimic addressing an oil leak.

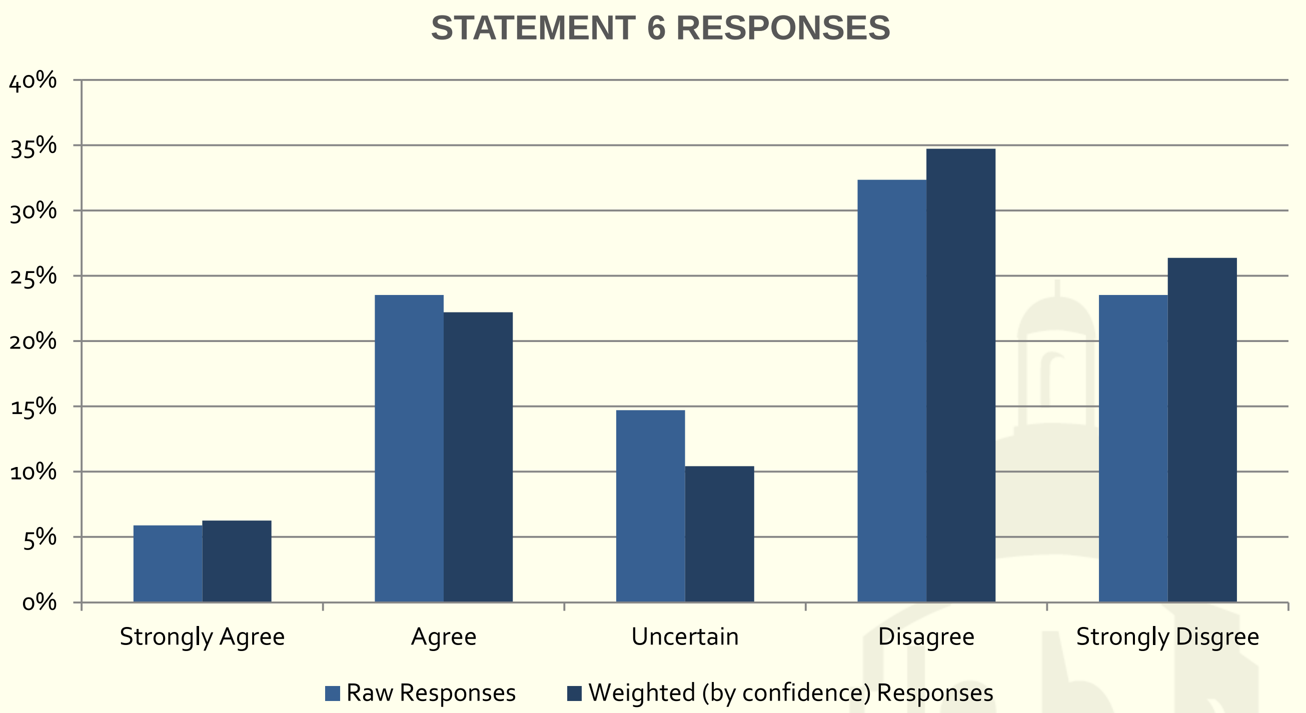
Pension reform, initially, can be daunting. For instance, the California Legislative Analyst's Office estimates—using CalSTRs' official assumptions—that the system has a $71 billion unfunded liability (the Governor estimates it at $80.4 billion) and according to CalSTRs' deputy director, the liability grows $22 million per day. As of 2013, Joe Nation, Stanford scholar and conference co-host, estimates CalPERs' unfunded liability at $170 billion (not the official $80 billion).

If the unfunded liabilities are thought of as the leaking oil, reform must address the proverbial mess. However, it cannot stop there. If the underlying problem, i.e. the hole that is causing the leak, is not addressed then the issue will persist. It is for this reason why reform must also address the structural causes of the unfunded pension liabilities, not just eliminating the obligations themselves.

Reforms that only address one part of the problem are not holistically solving the pension challenge.

STATEMENT 6:

The *only* structural reform that will provide a long-lasting solution is switching public pensions from defined benefit plans to defined contribution plans.



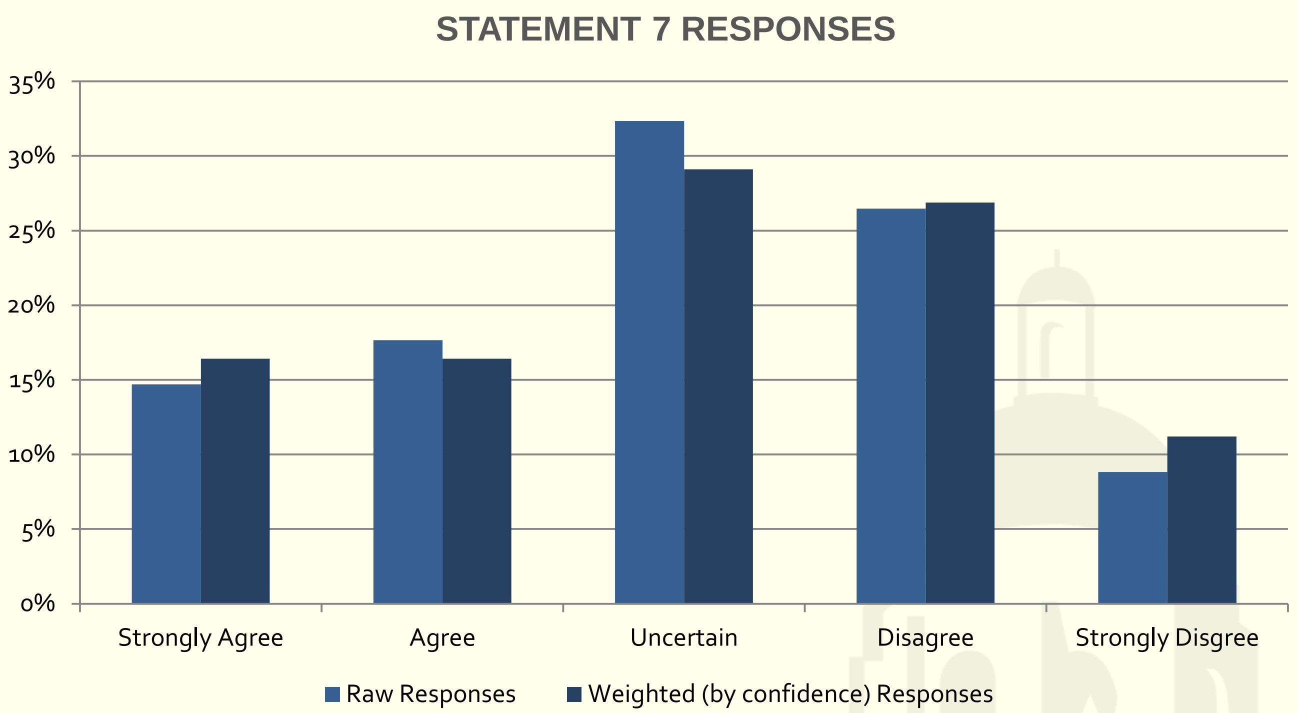
A lot of the pension reform focus is on moving from a defined benefit (DB) system to a defined contribution (DC) one. However, 61% of conference attendees disagreed that the only long-term solution was the switch.

DC plans are those where the employer and/or the employee contribute a certain amount to an individual account—which is invested in some type of investment fund—on a regular basis. These accounts are typically transferable and the only employer cost associated with them is the matching contribution (and sometimes, any associated investment management fees). Neither the employer nor the investment fund guarantee a benefit, however. The most widely known example is a 401(k) plan. DB plans, on the other hand, guarantee a previously specified benefit based on a host of criteria. Employers (and to some extent employees) contribute a certain, but not set, amount to an investment fund that is structured to ensure sufficient funds to match the promised benefit amount.

DB plans are not inherently bad. If employers set reasonable parameters when establishing the benefit formula, use a risk-free rate of return to discount investment cash flows, and maintain full contributions, DB plans can be fiscally sound. Pension problems are largely man-made due to over-promising and under-funding, not because DB plans are structurally unsound. On the other hand, DC plans, for the most part, structurally prevent such over-promising/under-funding actions.

STATEMENT 7:

The Rhode Island plan—a combination defined benefit/defined contribution for all employees (except public safety)—is the best example for the State of California to follow.



Conference participants had mixed opinions on whether the Rhode Island pension reform experience serves as the best example for California to follow. A plurality disagreed, but this statement drew the highest "uncertain" response.

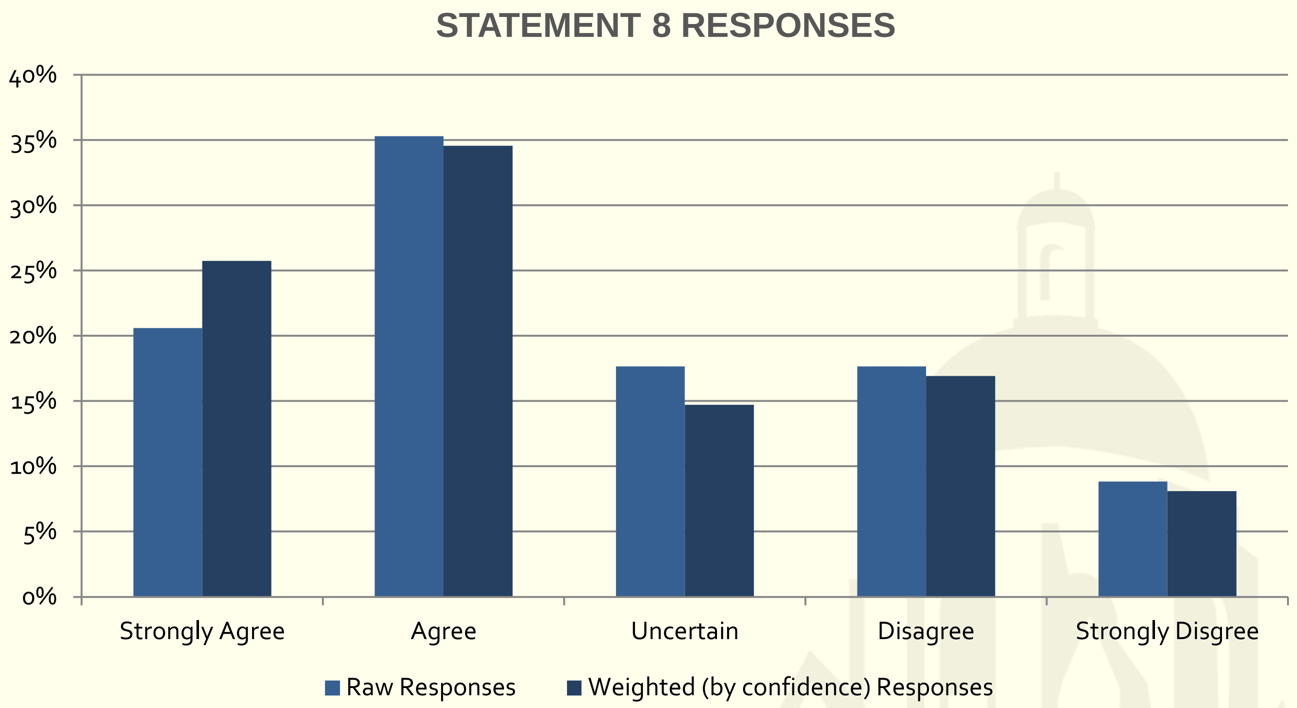
Rhode Island's Democratic State Treasurer lead the reform effort and it passed the Democratic super-majority controlled state legislature 57 to 15 in the lower chamber and 35 to 2 in the upper chamber.

Prior to reform in 2011, it was projected that by FY 2013 the state employee pension fund would only be about 48% funded with total state contributions rising about 28% between FY 2013 and FY 2016. State contributions, in FY 2016, would have outpaced total general fund revenue by $130 million. Based on State Treasurer estimates, the reform immediately cut the state's unfunded liability in half.

Key components of the Rhode Island Retirement Security Act of 2011 include suspends a C.O.L.A until the system is 80% funded, links future C.O.L.A's to fund investment performance, shifts all employees (except public safety) to a hybrid plan featuring a cheaper defined benefit plan and a transferable defined contribution plan, increases the minimum retirement age, and protects already earned benefits.

STATEMENT 8:

The San Jose plan—new, lower-cost defined benefit plan for new employees with current employees selecting, going forward, either to pay more to keep their current plan or choose a new, lower-cost plan—is the best example for California's localities to follow.



By over a 2 to 1 margin, conference attendees agreed that San Jose's reform was the best example for the state's localities to follow in their reform efforts.

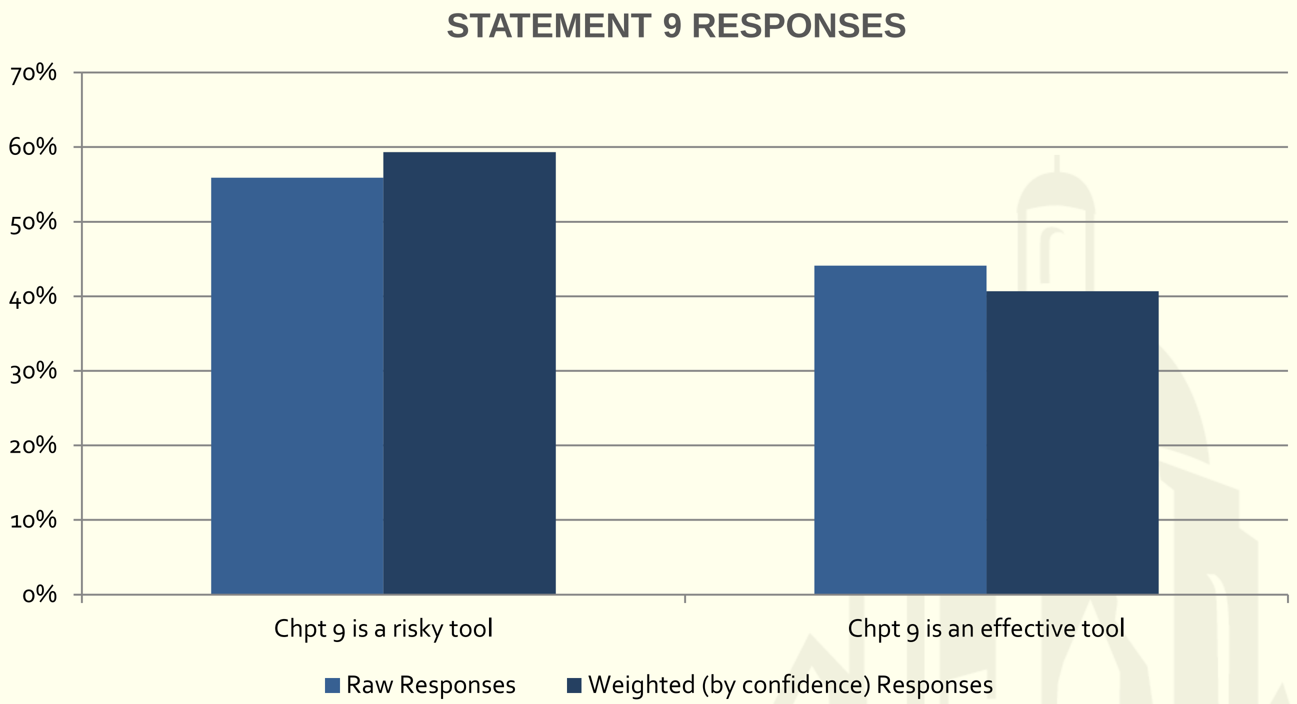
Between FY 2002 and FY 2012, San Jose's retirement costs increased 235% with over 20% of the city's general fund dedicated to pension benefits, despite the fact that the city cut employment by 27% or 2,000 positions during the same time period. In total, the city faced a $3 billion unfunded liability. In June 2012, following about eight months of negotiations between the unions and the City Council, San Jose voters passed Measure B with 69% of the vote.

Key components of Measure B's new defined benefit plan include requiring new employees to pay 50% of the plan's total cost, increasing the retirement age, capping accruals at 2% per year of service and 65% maximum benefit, and capping the C.O.L.A at 1.5% per year. Current employees had a choice: pay an additional 4% of their salary, increasing 4% each year until 16% or half of the unfunded liability is paid down (whichever comes first), or opt into a new plan similar to new employees. All changes to current employees are prospective, protecting earned benefits.

STATEMENT 9:

In your opinion, which is the more accurate statement?

Chapter 9 bankruptcy is a risky tool to enact pension reform.
Or
Chapter 9 bankruptcy is an effective tool to enact pension reform.



As legal battles wage forward in Detroit and many California cities, the issue of bankruptcy becomes more relevant. According to 59% of conference attendees, however, Chapter 9 is a risky tool.

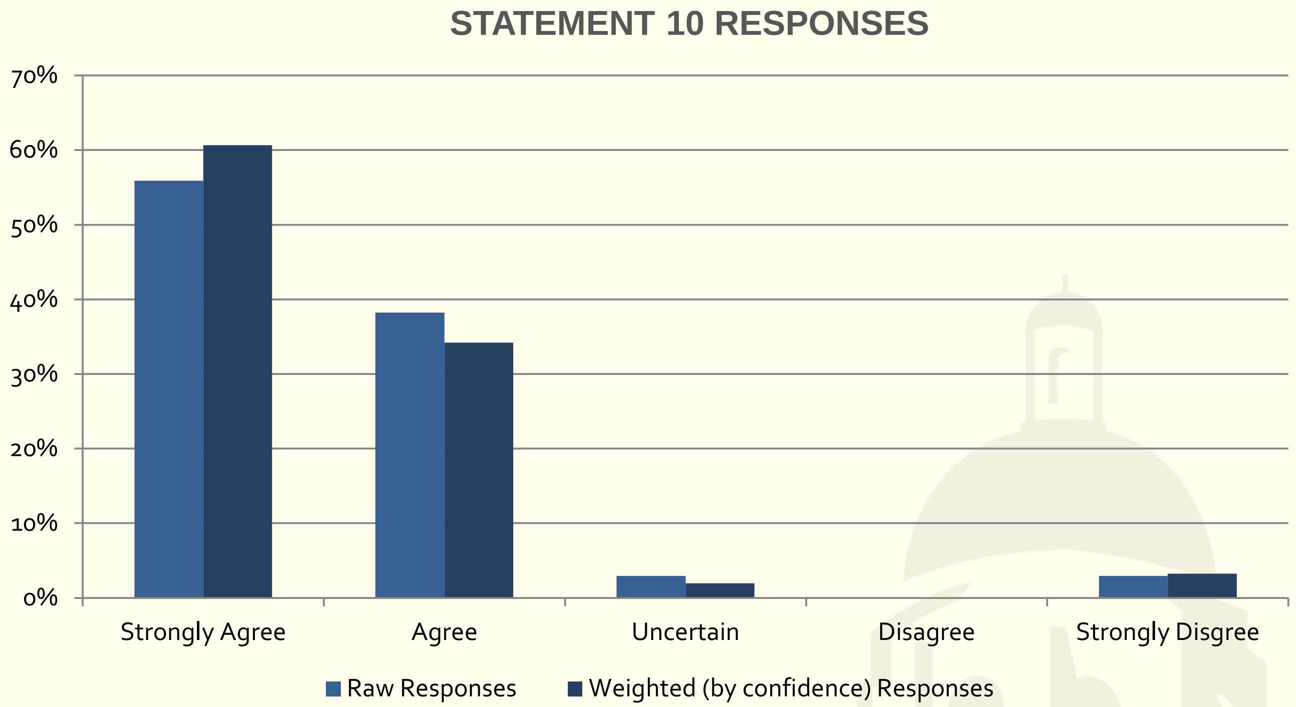
Chapter 9 is risky for localities because of the eligibility requirements. First, only a "political subdivision or public agency or instrumentality of a State" can file for Chapter 9 relief. This excludes the possibility of a state itself using Chapter 9 to enact statewide reform.

In order for a municipality to file for Chapter 9 it must 1) be authorized by state law or by a state officer or entity empowered by state law to be a debtor, 2) be insolvent, 3) intend to adjust its debts, and 4) negotiate, in good faith, with creditors.

In particular, two eligibility components are precarious. The first requirement puts a municipality at the will of the state. California has a very broad approach here, but the state legislature could alter that whenever they wish. Secondly, whether a municipality is insolvent is at the complete discretion of the presiding judge and is largely a case-by-case decision. In all, precedent is very important, but the legal process is very expensive and sometimes hard to justify for cash-strapped localities.

STATEMENT 10:

Pension reform cannot occur without a broad coalition and sufficiently educating the public of the implication of failing to act.



95% of conference attendees agreed that to enact reform a broad coalition and a public education campaign are necessary. This statement is the second most lopsided in terms of participant cohesion.

While debates on the policy merits of one reform alternative to another are plentiful, the political strategy of reform is rather uncontroversial. In order for reform to occur, elected officials require the strong backing of public support. In Rhode Island, the Democratic State Treasurer spent months prior to submitting a reform bill negotiating and discussing the issue with stakeholders. While these actions did not create a completely smooth legislative process, the heavily Democratic legislature did overwhelmingly support the reform bill. In San Jose, City Councilmembers and Mayor Reed publicly discussed with city residents the fiscal effects of inaction, pointing to closed libraries or parks and laid-off policemen. Although negotiations with employee unions did not produce an agreement, Mayor Reed and the City Council did incorporate some of their concerns into Measure B. Their education and coalition efforts resulted in 69% of voters passing the reform. In San Diego, another reform (Proposition B) enjoyed 66% support among voters in June 2012.

Pension reform represents a classic disbursed-cost/concentrated-benefit scenario, where the pension liability is disbursed among citizens, but the benefits are concentrated among a small group of public employees. Education and coalition building can combat this particular public choice dilemma.

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CONFERENCE ATTENDEES

Travis Allen
Member, State Assembly

Scott Baugh
Former Member, State Assembly

Carson Bruno
Research Fellow, Hoover Institution

Tom Church
Research Fellow, Hoover Institution

Robert Clark*
North Carolina State University

Richard Costigan
Ex Officio Member, CalPERs Board

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Partner, SchiffHardin LLP

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Deputy Treasurer, Rhode Island

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California PFG Team Lead, Moody's

Jean-Pierre Aubry
Boston College

Donald Boyd
Senior Fellow, Rockefeller Institute of Government

Autumn Carter
Executive Director, California Common Sense

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Founder, New Sonoma

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David Crane
Stanford University

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CONFERENCE ATTENDEES

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Amy Monahan
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California Deputy Controller for Investments

Ranji Nagaswami
Former Advisor, Mayor Bloomberg

Robert Novy-Marx
University of Rochester

John Raisian
Director, Hoover Institution

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Mayor, San Jose

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**Indicates conference participant did not respond to the post conference survey*