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CALIFORNIA PUBLIC EMPLOYEES' PENSION REFORM ACT OF 2013

DEEPLY FLAWED LEGISLATION

ONE PAGE ABSTRACT

10/12/12

The California Public Employees' Pension Reform Act was passed 8/31/12 and signed into law the following month. All but one significant provision affects only new employees. It will take 15 years to produce noticeable improvement. It does next to nothing to prevent significant deterioration of local and state finances until then.

PEPRA's fatal flaw is most government Pension Funds are underfunded (many severely so) and it does nothing about it. They can't make investment profits on money they don't have. The more they are underfunded the more likely returns will fall short and unfunded pension debt will grow. Only governments must pay extra to eliminate unfunded pension debt – employees and retirees have no obligation. The more unfunded debt grows the more money governments pay to eliminate it, which forces them to provide fewer public services, invest less in public infrastructure, and deplete reserves.

Governments have two ways to eliminate unfunded pension debt. First – sell Pension Obligation Bonds which many have done. Pension Funds get the money but governments are still in debt. Bonds allowed governments to avoid solving the causes of this debt, therefore most governments developed more unfunded pension debt they must pay. Many will not be able to sell more Pension Bonds and will be forced to use the next option. Second – pay additional higher-interest amortization payments to the Pension Fund above their "Normal" yearly contributions. Many - probably most are using the "Level Percent of Payroll" method to eliminate this debt over 30 years. That causes payments for the first 12 years or so to be less than annual interest expense and so the debt grows (if all other Pension Fund projections come true).

The State is betting on huge sustained stock market profits and increased taxes to bail state and local government out.

Only 4 of 480 cities entered bankruptcy in the past few years; more will do so. The real danger will come with the next recession. Based on market cycles since WWII that's anywhere from 1 to 6 years from now – an average of 2.

"SB400" (one of the biggest blunders in State history) became law in 1999 and led to huge retroactive pension increases. CalPERS said investment profits would pay for them. But the stock market immediately tanked and is only now back to where it was when SB400 passed. It would have to be 3 times higher today to fulfill CalPERS' projection. CalPERS projected what would happen if returns were as low as they were in '66 through '75 but didn't make the results public or tell the legislature. CalPERS' "official" projection was the state would pay $680 million in 2011. Their unreleased "worst case" scenario indicated it would be $3.9 billion. It turned out to be $3.95 billion. The Legislature didn't ask for a "worst case" scenario. There was no plan if it happened. It did. Today's huge debt is the result. PEPRA is the same – no way to deal with market returns lower than projections which will happen in the next recession.

PEPRA has no impact on current retirees or on pensions earned by current employees in the past – therefore it had no impact on existing unfunded pension debt. That's its "fatal flaw". Some "easy" reforms are imposed on current employees from now on – no "airtime" purchases, some restrictions on "double dipping", no more retroactive increases. PEPRA states the "standard" is current employees should pay half the total yearly "normal" contribution to Pension Funds but there are upper limits that greatly reduce the savings to governments. Most "real" changes are imposed on new employees – higher retirement ages, lower pensions per year worked, tighter definition of and a cap on "pensionable" compensation, and they <u>will</u> pay half the "normal" yearly contribution. But employees still have no obligation to contribute to reduce unfunded pension debt which increasingly is the main problem.

Rhode Island passed reform a year earlier. They cut unfunded pension debt 41%; California 0%. Rhode Island cut state payments to the Pension Fund 40% next year; California 2% from what they would have been but they will still grow.

PEPRA is a profound failure in several important ways. Financially it didn't reduce and restructure existing unfunded pension debt or greatly reduce government pension guarantees, and is far from a comprehensive financial solution. There were also severe organizational-legal-accountability failures. We need serious reform of Pension Fund governance and of the state's retirement laws. We need deep reform of state and local government financial management. There has been little or no effective state oversight of Pension Funds especially at the local level.

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