Date of Hearing: May 6, 2013

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Roger Dickinson, Chair
AJR 10 (Grove) – As Introduced: February 6, 2013

SUBJECT: State debt.

SUMMARY: Urges the Federal government to not take any action to redeem, assume, or guarantee state debt. Specifically, this bill:

1) Makes the following findings:

   a) Each state of the Union is a sovereign entity with a constitution and the authority to issue sovereign debt; and,

   b) Each state legislature has the authority to reduce spending or raise taxes to pay the obligations to which the state has committed itself; and,

   c) The officials of each state of the Union are legally obligated to fully disclose the financial condition of the state to investors who purchase the debt of that state; and,

   d) Congress has rejected prior requests from state creditors for payment of defaulted state debt; and,

   e) During the national financial crisis in 1842, the United States Senate requested the Secretary of State to report any negotiations with state creditors to assume or guarantee state debts, to ensure that promises of federal government support were not proffered.

EXISTING LAW provides for the California Public Employees' Pension Reform Act, which is discussed in more detail later in this analysis.

FISCAL EFFECT: None

COMMENTS:

The impetus behind this resolution is a concern that states with unfunded future pension liabilities will seek funds from the Federal government to backfill those liabilities. The sponsor of the resolution, Illinois Policy Institute (IPI) published a report, *A Federal Bailout of State Pensions Systems will Reward Future Failure*, on September 20th, 2012 that raised concerns regarding state governments that might seek Federal assistance to offset their pension obligations. In the fiscal year budget proposed by Governor Quinn of Illinois the budget relied on a potential federal government guarantee for the state's pension debt.

The IPI report mentions that "states such as Illinois and California that have failed to reform their runaway pension costs, what about those that have been more responsible with taxpayer dollars?" Notwithstanding the hyperbole contained in this statement, California has passed pension reform since the publication of that report. Additionally, the IPI report suggest that changes to federal tax policy is a scheme to bailout state pension costs, though a change in tax policy that could bring federal dollars to the state may be entirely unrelated to pension obligations. This is remarked as the most direct way for the Federal government to provide a bailout, according to IPI.

If it is appropriate to urge the Federal government not to take on any state debt, putting aside the vagueness of just what that means, then perhaps a resolution dealing with a broader array of fiscal inequalities would provide a better vehicle for discussion. Clearly the motivation behind AJR 10 is a concern with state pension debt and that the Federal government might decide to "bail-out" state pension debt thereby creating conditions in which states without such debt would bear the burden of those states deemed as irresponsible with their budgetary finances. In reviewing inequalities relating to federal spending, Alaska and Virginia rank number one and two in per capital federal spending. Alaska receives $17,762 of federal spending per capita, accounted for mostly through defense spending, as well as, Virginia with $17,008 in spending per capita. This spending is the direct result of federal policies in budgeting, military spending and procurement. If we are to be concerned with potential pension bailouts, then we may also be concerned with policies that shift large scale federal benefits through defense spending to a few key states outside of California.

In addition to the aforementioned fiscal issues, the financial crisis led to one of the largest injections of federal money into the financial system in history. Bloomberg News, at one point last year revealed that the United States had lent, spent or guaranteed as much as $12.8 trillion to rescue the economy. Much of this support was in loans, loan guarantees, and continued federal government support for financial institutions. This is in contrast to the estimated $757 billion (Pew Center on the States) in unfunded pension liability nationwide. IPI, in its report on pension bailouts, found that a federal bailout would create a "moral hazard" and that "responsible states" would pay for the fiscal irresponsibility of other states. It is unclear how a state might be measured as "responsible." The basic idea is that states can be measured and categorized between those that are fiscally responsible versus states that presumably have created their own debt trap. However, this one-dimensional analysis fails to provide any contextual explanation as to the impact of federal budgetary policies that have nothing to do with pensions. For example, states with a large agriculture base receive millions, if not billions, in federal subsidies relating to direct aid for certain agriculture products, as well as, price controls on various commodities. More importantly, federal fiscal policy already rewards and punishes states in a myriad of ways.

How likely is a collapse of California's pension systems? CalPERS is currently projecting a 7.5% annual return on its investments. Critics call that “unrealistic.” Some suggest 3% is a safer figure. However, the system yielded a 13.3% return in 2012, and over the past two decades it has earned an average of 8% every year. The years in which returns were negative coincided with peak troughs of the recent recession. CalPERS has funding ratios well over 60% in its various plan categories. Detractors of public pensions often point to a lack of 100% funding ratio for public pension plans. In reality, very few if any, large scale investment portfolios have 100% asset/liability ratios, however CalPERS is collateralized above and beyond our nation's largest private financial institutions. The falter of these private institutions has had, and could have in the future a far larger impact on state and federal budgets than pension obligations.

Finally, the Center on Budget and Policy Priorities, *Misunderstandings Regarding State Debt, Pensions, and Retiree Health Costs Create Unnecessary Alarm*, puts the pension debt into proper perspective. First, pension funds invest for the long term so a few years of low returns can be mitigated when averaged with years of above average returns. Second, state and local governments share of pensions as a portion of their budgets is only 3.8%.

California pension reform.

Benefits for retirement system members are funded over the employee's working career from three sources. First, employees make contributions as a percentage of payroll. Employee contribution rates are established in statute, or in rules and charters for the smaller plans. In some cases, employers and employees agree, through collective bargaining, to adjust employee contribution rates. The second source of funding is derived from investment returns on the retirement funds. For example, CalPERS estimates that historically, investment returns have paid for approximately 2/3 of the cost of providing benefits.

The third source of funding is employer contributions, which are also determined and paid as a percentage of employee income. When investment returns do not perform as expected, unfunded liability may occur and employers make up the difference in the form of higher rates. The 2008 economic crisis resulted in significant unfunded liabilities in the retirement systems, impacting most employer rates. Similarly, when investment returns exceed expectations, surpluses may accrue, and employer rates are reduced accordingly. These rate reductions and increases are actuarially "smoothed" over a period of years in order to ease employer rate volatility and ensure continued funding of the retirement systems.

The basic cost of providing an employee's future benefit at any given time is the "normal cost." The normal cost is calculated separately from the unfunded liability or any surplus, and system actuaries use all of these calculations to annually set the employer contribution rate for that year.

On September 12, 2012, the Governor signed into law a pension reform bill, AB 340 – as amended by trailer bill AB 197 – that will make substantial changes to pension benefits for public employees who become members of a retirement system on or after January 1, 2013, as well as some changes that affect current members.

AB 340 enacts the California Public Employees' Pension Reform Act of 2013 (PEPRA), which mandates changes to pension benefits and contributions for all public employee pension systems in California (with a few exceptions noted below). Since public employers are covered by a myriad of retirement laws, AB 340 both adds a new Act to the Government Code and amends existing sections of the State Teachers' Retirement Law (STRS), the Public Employees Retirement Law (PERL), and the County Employees Retirement Law of 1937 (1937 Act).

Summary of pension reform:

1) Requires that final compensation be defined for all new employees as the highest average annual compensation over a three-year period.

2) Requires that compensation for all new public sector employees be defined as the normal rate of regular, recurring pay, excluding special bonuses, unplanned overtime, payouts for unused vacation or sick leave, and other pay perks.

3) Limits all non-safety employees who retire from public service from working more than 960 hours or 120 days per year for a public employer. Additionally, the Conference Committee

Report requires a 180-day "sit-out" period before a retiree could return to work. A retiree would be allowed to return as an annuitant before 180 days if the appointment is approved by the governing body of the local agency in a public meeting and is necessary to fill a critically needed position.

4) Requires public officials and employees to forfeit pension and related benefits if they are convicted of a felony in carrying out official duties, in seeking an elected office or appointment, or in connection with obtaining salary or pension benefits.

5) Prohibits applying pension improvements to prior service.

6) Prohibits all employers from suspending employer and/or employee contributions necessary to fund annual pension costs.

7) Ends the ability of a public employee to purchase nonqualified service or "airtime."

8) Requires all new employees and current state employees to contribute 50% of the normal cost of their pension benefits. Current local employees would be required to reach the 50% level through collective bargaining by January 1, 2018.

9) Requires all new public sector employees to participate in a retirement plan where the amount of compensation that can be used to determine a defined benefit plan is capped at the Social Security wage limit ($110,000) or 120% of that limit if they do not participate in Social Security.

10) Implements a 2% at age 62 defined benefit component of the hybrid plan for all new non-safety employees and adjusts the retirement formulas to encourage members to retire at later ages. The earliest an employee would be eligible to retire is age 52 (increased from age 50) and the formula tops out at 2.5% at age 67 (increased from 63). Additionally, eliminates the 3% at age 50 safety retirement formulas and reduces the number of available retirement formulas for the defined benefit component of the hybrid plan for safety members to three – 2% at age 57; 2.5% at age 57; and, 2.7% at age 57.

11) Prohibits certain cash payments for current employees from being counted as compensation earnable for retirement purposes in counties operating retirement systems pursuant to the County Employees' Retirement Law of 1937.

12) Requires CalPERS to determine what constitutes excessive compensation paid by a public employer that creates a significant liability for a former employer (which may occur due to reciprocity when final compensation is applied to all years of service), and to develop a plan to assess that excess liability to the employer who paid the excessive compensation.

13) Prohibits a retirement board from administering, and a public employer from offering, a benefit replacement plan for any new member who is subject to the IRC Section 415(b) benefit limit.

14) Prohibits newly elected statewide officers and legislative officers from participating in the Legislators' Retirement System. They would continue to be optional members in CalPERS.

15) Requires all public retirement systems in California to adhere to the federal compensation limit under Internal Revenue Code (IRC) Section 401(a)(17) when calculating retirement benefits for members who first join the retirement system on or after January 1, 2013, and prohibits a public employer from making contributions to any qualified public retirement plan based on any portion of compensation that exceeds that amount.

16) Eliminates the ability of an employer to provide better health benefit vesting schedule to non-represented employees than it does for represented employees.

17) Prohibits local elected members from being eligible for salary reciprocity for elected service.

18) Requires a public retiree appointed to a full time state board or commission to suspend their retirement allowance and or serve as a non-salaried member of the board or commission.

REGISTERED SUPPORT / OPPOSITION:

Support

None on file.

Opposition

None on file.

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