TR0712-1: Unfunded Liabilities – Our Community's Fiscal Time Bombs

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28 December 2007

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1 Executive Summary

The County of Nevada, City of Grass Valley and the City of Nevada City each promise tax payer funded defined benefit pension plans to their employees. Each agency has hired California Public Employees Retirement System (CalPERS) in an administration and investment management role to help aid them in responsibly funding their pension plans. Today the taxpayer funded public employee pension plans for Nevada County, Grass Valley, and Nevada City are drastically unfunded. Our local governments have made promises which they have not backed up with adequate funding. This fact should be alarming to both Nevada County taxpayers and its local government employees. Past and present management of these pension plans have the potential to significantly compromise the financial integrity of our community. Over the years the political leadership in Nevada County has chosen to ignore this issue as well as continuing to worsen the looming crisis. Instead of taking steps to address the problem, the City of Grass Valley recently made amendments to their pension plans which heighten the impending fiscal catastrophe. On the Federal level, the amount of unfunded liabilities is estimated to be in the TRILLIONS. The total on the states level is within the hundreds of BILLIONS and our local governments' unfunded liabilities accumulate to tens of MILLIONS. The County of Nevada's pension plan is unfunded by approximately ***$48,137,000*** (as of June 30, 2006). The cities of Grass Valley and Nevada City have an undisclosed debt of over ***$4,000,000*** and ***$677,000,*** respectively. These enormous debts have grown due to the continuing use of outdated defined benefit programs, granting high pay raises to public employees, and irresponsible amendments which continue to further 'improve' untenable public employee pensions. A small fraction of government agencies in the United States have identified the unfunded liability crisis and made positive changes to heal their specific sickly conditions. There is a growing trend to have public employees' compensation packages change to more closely reflect the compensation of the private sector. Defined benefit compensation packages are nearly extinct in the private sector due to their expense, risk, and liability. It is the recommendation of Sierra Environment Studies Foundation that our leaders in Nevada County make positive changes to strengthen the fiscal health of our community and to fulfill the promises made to current and former public employees.

2 Unfunded Liability Defined

This report documents the results of the first study by the Sierra Environmental Studies Foundation (SESF) on unfunded liabilities assessed to Nevada County local governments. It is the commission of SESF to research and publicize public policy and taxpayer issues important to Nevada County residents. The present research covers the pension plans of Nevada County, the City of Grass Valley and the City of Nevada City. We will not be reviewing the unfunded liabilities of the health care benefits at this time. In addition, we hope to quantify the additional unfunded liabilities associated with recent pay raises to public employees. Local government officials have and continue to promise benefits to public employees that have not been adequately funded.

Income statements and balance sheets are used in the private sector to illustrate the financial health of the firm. The income statements reflect the revenues generated minus expenses incurred to calculate net income (or net loss). The balance sheet discloses assets and liabilities of the firm:

— **Assets** are tangible and intangible objects owned by the entity to generate future benefit.
— **Liabilities** are an *obligation* or *debt* of an entity arising from *past* transactions or events, the settlement of which may result in the transfer or use of assets in the future. A liability is a promise to pay for a service or good that was already rendered. It is an IOU.

A complete balance sheet must adequately quantify ALL assets and liabilities. It is imperative for a balance sheet to balance assets against liabilities as its name suggests. A balance sheet must balance to a position where the listed assets equal the listed liabilities. Government agencies are not required to generate a balance sheet. The current unfunded liability crisis on the Federal, State and local levels all stem from the malfeasance of government officials to ignore certain future expenses and adequately disclose their liabilities.

An unfunded liability, as the name suggests, is a liability that has not been funded (matched with an asset such as cash in order to balance). In layman's terms an unfunded liability is an unfulfilled financial promise, a "white lie." An unfunded liability exists when a liability is not properly accounted. This report will focus on the unfunded liabilities for public employee pension plans in Nevada County. Nevada County, City of Grass Valley, and City of Nevada City have all made promises to their employees in the form of pension payments upon retirement. Yet, each of these entities has not set aside adequate funds to cover their promises. They each have debt which has not been funded at a rate equal to their promises. These government agencies can get away with such accounting because they are not forced to complete an annual balance sheet and they adhere to accounting rules different than those of the private sector. Thus, the debt is not disclosed to their employees or to the tax payers. The pensions promised to the employees of Nevada County, City of Grass Valley, and City of Nevada City have not been disclosed as debt. To make matters worse each of the aforementioned entities has not backed their promise to pay pensions with adequate funding. To summarize, the Nevada County, City of Grass Valley and the City of Nevada City pension plans are drastically underfunded and in the red.

According to Nathan Littlefield, of Theatlantic.com et.al. [4], on a larger scale the United States **Federal** government has an unfunded debt of $45.5 trillion. Littlefield says, "$45.5 trillion. That's the size of the long-term gap between the federal government's projected outlays (future spending plus current debt) and its projected revenues. Jagadeesh Gokhale and Kent Smetters, economists working at the Federal Reserve Bank of Cleveland and the University of Pennsylvania, respectively, have looked further into the future and determined that, in effect, if the U.S. government were a company its owner would have to *pay* a rational investor $45.5 trillion to take it off his hands. To put this figure in perspective: the entire U.S. economy generated only about $10.4 trillion last year, and total household wealth is currently only about $39 trillion."

A recent study completed by PEW and cited by the CATO Institute revealed the following concerning the level of unfunded liabilities on the **State** level: "States have promised at least $2.73 trillion in pension, health care and other retirement benefits for public employees over the next three decades, according to a report released today by The Pew Charitable Trusts' Center on the States. *Promises with a Price* [14], the first 50-state analysis of its kind, finds that states have saved enough to cover about 85 percent of their long-term pension costs, but only 3 percent of the funds needed for promised retiree health care and other non-pension benefits. All told, states already have set aside about $2 trillion to meet their long-term obligations. But they still need to come up with about $731 billion—a conservative figure that does not include all costs for teachers and local government employees. (Pew Press Release, December 18, 2007)" [11].

3 CalPERS Pension System

In this section we give a brief description of the California Public Employees' Retirement System (CalPERS) and how its operation affects the public employees of Nevada County.

3.1 Overview

CalPERS provides pension fund, healthcare and other retirement services for approximately 1.5 million California public employees. CalPERS provides benefits to all state government employees and, by contract provides administration and actuarial services, to local government agencies. Nevada County, City of Grass Valley and the City of Nevada City all contract with CalPERS to perform pension plan administration services. According to their website (http://www.calpers.ca.gov/) CalPERS facilitates the design, implementation and ongoing management of approximately 2000 municipalities' pension plans. The main parameter of a CalPERS pension plan is its salary percentage at age of retirement. They offer 5 different pension plans for the Misc category (non public safety employees):

- 2% at age 55
- 2.0% at age 60
- 2.5% at age 55
- 2.7% at age 55
- 3% at age 60

For Public Safety Plans:

- 3% at age 50

For example, "2% at age 55" means that an employee will make 2% of their salary for every year they work. In this example an employee that retired after 20 years of service and the attainment of age 55 the employee would earn 40% (2% x 20yrs = 40%) of their final year's wages. If the final years wage was $50,000, this employee would be paid a pension of $20,000 each year until death, with cost of living increases each year. This pension is paid thanks to the government agencies' diligence in funding the pension each year in the amount that CalPERS instructs them. The government agency makes payments into their pension pool based on calculations provided by CalPERS. Each pay period the government agency makes payments to the pension pool as a percentage of each employee's wages in excess of wages and other benefits paid to the employee.

3.2 Employer Contribution Rates

The contribution rate is the level of funding that the hiring agency must contribute to the pension plan; it is summarized as a percentage of payroll. The corresponding dollar amount is paid in addition to the public employee's wages. The contribution rate paid by the employer to the pension plan changes annually due to changes to the inputs of the 'CalPERS equation' to compute the Net Present Value (NPV) of the expected future benefit payments which forms the employer's liability assigned to that employee.

To calculate NPV, each cash inflow/outflow is discounted back to its present value and summed. Therefore

$$NPV = \sum_{t=0}^{N} \frac{C_t}{(1+r)^t},$$

where

t - the time of the cash flow,
N - the total time (e.g. number of years) of the project,
r - the discount rate (expected rate of return),
C_t - the net cash flow (the amount of cash) at time t.
C_0 - the capital outlay at the beginning of the investment time ($C_t < 0$ if it is an outlay. Here this occurs at $t = 0$)

For example, the contribution rate paid by the County of Nevada to the "Safety Plan" for employees in the "Safety Plan" for the fiscal year between July 1, 2008 and June 30, 2009 is 32.252%[1]. Every $100 earned by a public safety employee at the County of Nevada costs taxpayers an additional $32.25. This is the contribution rate needed for the County of Nevada to fulfill their promise to pay retirees of the "Safety Plan" with retirement benefits as early as the age of 50 with 3% per year pension income. This contribution rate will be paid in order to provide a 50 year old Sheriffs deputy earning $60,000 annually with 20 years of service, a pension of $36,000. The "contribution rate" provided by CalPERS to the government agency is designed to insure that the $36,000 pension income will not only continue until the death of the retiree, but will also increase each year by the amount of a cost of living adjustment (COLA).

CalPERS is responsible for calculating the NPV of the benefits promised to the employees of the pension plans by the sponsoring government agencies. This calculation allows CalPERS to instruct the government agency on what contribution rate to budget into payroll figures. The NPV calculation incorporated with actuarial tables help guide governments to set aside funds annually to service the pension benefits promised to both current and future retired employees. CalPERS calculates the promises made to present and past employees and instructs their clients (government agencies) to save accordingly. CalPERS is provided the age, wage, years of service of each employee in order to determine what the liability is of the promising entity. It is the responsibility of the sponsoring government entity to fund the pension plan as directed by CalPERS.

There is one more very important element of the CalPERS contribution rate calculation that incorporates the NPV formula. The computation of NPV requires the use of an assumed discount rate (rate of return) on the assets managed by CalPERS. We must remember that government employers with pension plans have guaranteed employees a pension at retirement. In June of 2003 the City of Nevada City's total obligation for benefits was $4,331,529 (for the Miscellaneous plan employees only)[5]. CalPERS provides the contribution rate needed by the City of Nevada City to support the pension promises of $4,331,529 to future retirees. The contribution rate allows the City to contribute <u>less than</u> $4,331,529 and hope that CalPERS can generate an investment return for the difference.

Calculations provided by CalPERS assume a 7.75% rate of return on the investments in the underlying pension pools. The 7.75% rate of return is a planning number void of any guarantees. In fact, from 1988-2003 the actual earnings in the CalPERS investment pool have ranged from -7.2% to a high of 20.5%[5].

The actual rate of return earned by CalPERS plays an integral role in whether or not the employer has set aside enough funding to cover their promises. The contribution rate of a municipality would have to increase drastically in the year following a negative return of 7.2%. Conversely, the contribution rate *could* decrease following a strong year with 20.5% returns. As a point in fact, **CalPERS reported an investment return for the fiscal year 2004-2005 of 13%. The 13% investment return (almost 2 times the assumed rate of return of 7.75%) did not help the average municipalities' contribution rates. In fact, CalPERS reported that 53% of the plans (1041 total plans) were forced to raise their employer contributions rates even with the 13% rate of investment return [6].**

Regardless of the contribution rate set by CalPERS or the achieved investment returns of the pooled CalPERS managed investments, the employing agency is ultimately responsible for its outstanding pension liability. CalPERS is not liable for the promises made by government agencies to public employees. Again, it is the government agencies' responsibility to financially back the promises they have made and continue to make to their employees.

3.3 Current Contribution Rates

The employer contribution rate is designed to direct the employer to set aside additional funds each pay period to fund their pension promises. Taxpayers must pay the contribution rate in addition to each dollar earned be a public employee. For example, for every dollar a Nevada County Public Safety employee earns, an additional 31.458% is contributed towards their pension plan. Here are the current contribution rates for Nevada County, Grass Valley and Nevada City [1],[2],[3]:

COUNTY OF NEVADA (June 30, 2006):
- Miscellaneous Employer Contribution rate of 18.198%
- Safety Employer Contribution Rate of 31.458%

CITY OF GRASS VALLEY
- Miscellaneous Employer Contribution Rate 2007 of 10.841%
- Safety Fire Employer Contribution Rate 2007 of 15.029%
- Safety Police Employer Contribution Rate of 28.495%

NEVADA CITY:
- Miscellaneous Plan Employer Contribution Rate of 10.47%

Safety Plan Employer Contribution Rate of 29.597%

4 The Effect of Pay Raises on Unfunded Liabilities

With the above preamble we now take a look at some scenarios using actual dollar amounts applied according to CalPERS rules.

4.1 Calculating the Liability

The total effects of each pay raise impacts the contribution rate calculations and the overall ability of the government agency to adequately fund its pension plans. Raises can more than offset great investment returns accomplished by the CalPERS investment advisory group. There are two different types of raises. The first is a compensation increase, usually performance based, which exceeds the assumed cost of living adjustments for most government agencies. CalPERS calculated contribution rates only include a 3.25% cost of living adjustment to wages for member employees. Any additional increases (in addition to COLA) to the wages of the employees have not been incorporated into the CalPERS contribution rates. This is an extremely important point. The benefits of pension holders entitle them to a percentage of their income times each year they are employed at the **highest pay level attained for one year during their entire tenure**. A CalPERS member employee has the ability, via a pay increase just prior to retirement, of drastically improving their retirement income as well as significantly increasing the liability of the local government agency.

4.2 Example Calculation

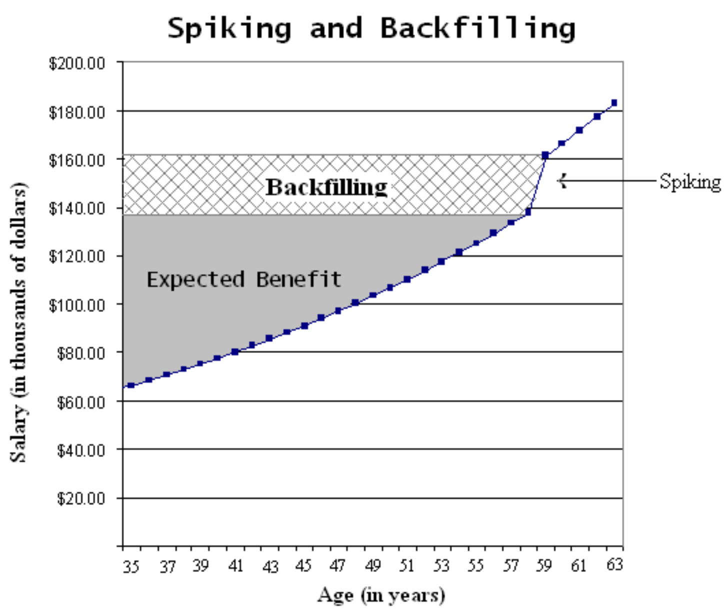
We emphasize that raises just prior to a CalPERS member employee's retirement may have dire financial consequences to the agency offering the pay raise. The entity which raises the pay of the employee must now increase the contribution rates at a level that will cover the additional liability, in the form of the NPV amount, to support the pension for the expected number of years that the employee will live in retirement.

For example, John Dough is a CalPERS member employee who has 23 years of service and is 59 years old. Just prior to retiring, he was just given a raise of 17% which increases his salary to $160,000 from $137,000. Under the Misc plan Mr. Dough would be entitled to an annual pension payment of $96,000 in his first year of retirement (24 years service x 2.5%= 60% of his highest one year salary giving $160,000 x 60% = $96,000). Recall that the $96,000 is just his first year's pension before the annual cost of living increases. The importance of the exercise is to show the drastic impact that the last years' 17% raise had on the debt of the public agency. Conservatively assuming Mr. Dough lives to be 79, his one year wage increase of $23,000 will cost tax payers over $212,000 in total liability to satisfy the additional pension expense caused by the raise (the raise of $23,000 and $189,000+ being an estimate of the net present value of increased future pension payments for twenty years given the COLA and assumed investment return levels).

4.3 Spiking and Backfilling

The above described scheme has been played out all over America at the expense of taxpayers to the extent that it has developed two different terms to help describe the impact of late in career pay raises. The first term is "spiking" whereby an employee nearing retirement jockeys to drastically increase his/her salary just prior to retirement. Threats to quit the job or to relocate to a better paying area are often cited as the pressures forcing city managers and county administers to petition for a coworkers pay raise. This practice has caught a lot of bad press lately in the City of Sacramento, where the acting Police Chief admitted to spiking his pay prior to announcing his retirement [7].

The act of "spiking" has been made illegal. At the time of this report no precedent has been set; it appears that the burden of proof is too high for prosecutors to act. Spiking provides the basis for the "backfilling" of an employees pension benefits. The Sutter County Grand Jury Report targeting unfunded liabilities in Sutter County reports that, **"enriching pensions tends to hasten, rather than delay, employees separation from county service among those employees eligible for retirement."**[8] Ironically, as managers, administration, elected officials and employee unions cite retention as a goal of pay raises; employees are more prone to see the increases as an early retirement package or golden parachute.



As a result of spiking CalPERS has acknowledged the troubles such raises create to their NPV calculations. The CalPERS calculations only assume an ongoing 3.25% cost of living adjustment to employees. When an employee spikes his/her salary in the final year, CalPERS must backfill the employee's specific pension benefit. For John Dough's 17% raise, the city would need to pay $189,000 into the pension pool, in addition to the $23,000 raise. To review, the $23,000 raise would cost an additional $189,000 in expenses, assuming CalPERS investment portfolio earns 7.75% annually along with application of the 3.25% COLA. Thus the pay raise would cost the city a total of $212,000 between wage and pension alone (does not include any other benefits). Imagine the financial impact of across the board pay raises in light of pension costs in light of the above-cited Sutter County Grand Jury report of 2007. [8]

The above graphic illustrates spiking and backfilling problem as it shows the COLA appreciated salary of an employee with an intervening spike at age 59. The shaded area is proportional to the sum of agency pay-ins over the years to pay for expected retirement benefit. The cross-hatched area is proportional to the 'backfill' liability that the agency must assume for just that one disproportionate raise given to the employee.

4.4 Amending Existing Pension Plans

The second style of pay increases that have mammoth impacts on a government agencies budget are CalPERS plan amendments. Elected officials, management, and employee unions negotiate and ultimately vote to amend the existing CalPERS agreement with employees. There is not a representative at the negotiation table fighting for the taxpayer.

Late in 2007, the City of Grass Valley voted to give a 25% pension raise to all Misallaneous and Fire employees via amending their CalPERS plan from a 2% at age 55 to a 2.5% at age 55 plan. The undisclosed fiscal impact on a community from such an amendment is **catastrophic**.

The amendment to provide a 25% increase to the pension plans was expected as of a 2004 analysis to add over $664,367 to the cities existing unfunded liability and $1,150,951 of additional debt to the City's overall pension plan (Misc and Fire plans were amended). **The $664,367 and $1,150,951 amounts assume that the CalPERS investment portfolio returns 7.75% AND that no more raises are given to city employees (additional to COLA)**[9]. The total increase in keep in mind that the total budget of Grass Valley is approximately $10,000,000. Which means the added expense to taxpayers was 11.5% of the annual budget. If the CalPERS investment portfolio makes less than 7.75% or the City approves future pay raises the debt would increase accordingly. At this time it is unknown if the management of Grass Valley or the Grass Valley City Council performed the due diligence to account for the actual cost of the amendment to the existing CalPERS plan.

One of the most disconcerting facts surrounding the City of Grass Valley plan amendment or pay raise from 2% at 55 to 2.5% at 55 was the outdated analysis used in the process. It appears that the CalPERS "Contract Amendment Cost Analysis" was completed in 2004 by CalPERS using payroll numbers which were 3 years old at the time the pay raise decision was made[9].

Finally, government agencies across the country choosing to improve the fiscal health of their communities have made sweeping amendments to their pension plans by decreasing their benefits to employees or stopping their pension plans going forward (more on this later). The City of Grass Valley is headed in such a more expensive direction.

In addition to the estimated immediate costs of amending a plan are the "Changes in Rate Volatility." In other words, amendments to sweeten the pension plan will inherently add risk to the sponsoring government's pension plan. To quote the Contract Amendment Cost Analysis prepared in 2004 for the City of Grass Valley "… the cost estimates supplied in this communication are based on a number of assumptions about very long term demographic and economic behavior. Unless these assumptions (terminations, deaths, disabilities, retirements, salary growth and investment return) are exactly realized each year, there will be differences on a year to year basis. The year to year differences between actual experience and the assumptions are called actuarial gains and losses that serve to raise or lower the employer's rates from year to year. So, the rates will bounce around, especially due to the ups and downs of the investment returns.

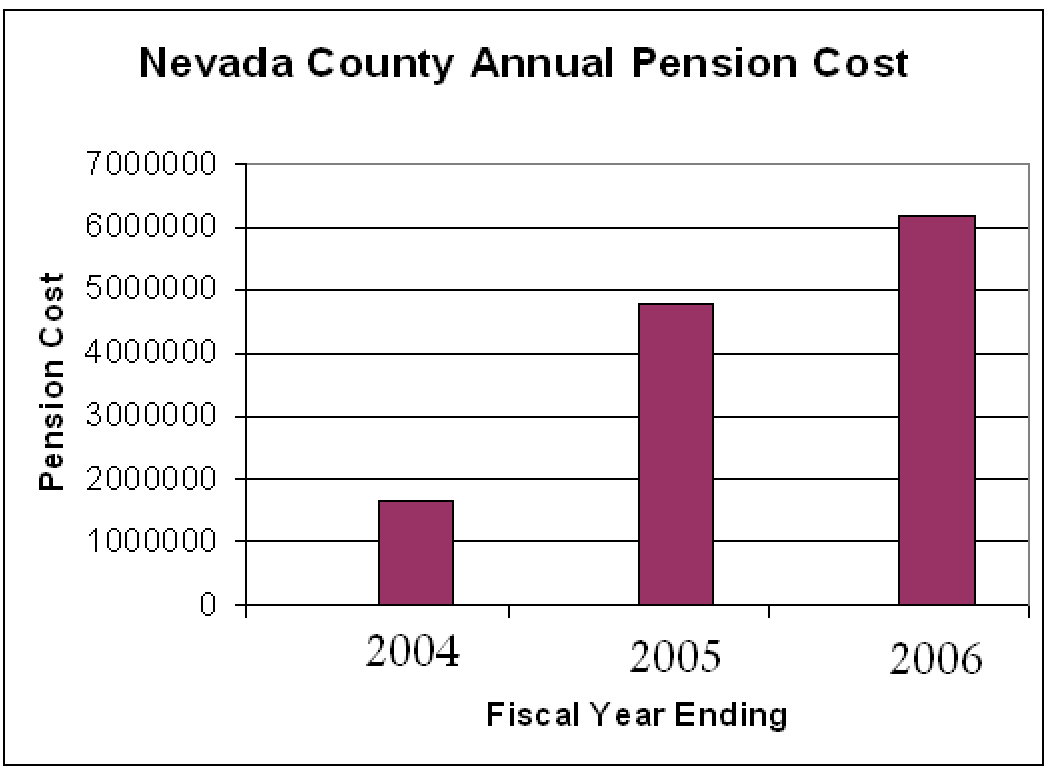
The volatility in annual employer rates will be affected by this amendment. The reason is that this amendment will require your plan to transfer into a pool with higher benefits and earlier retirement ages. This will in turn require the accumulation of more assets per member earlier in their careers. Rate volatility can be measured by the ratio of assets to active member payroll. Higher asset to payroll ratios produce more volatile employer rates … . For all pools, the desired state is to be 100% funded (i.e. to bring assets to equal accrued liabilities)".[9] In layman's terms the risk associated with the CalPERS annual calculations just increased by 21.6% (see table below). The likelihood of CalPERS' calculations being correct is now further reduced for each year going forward. This fact should concern the city council members of Grass Valley as well as public employees with a vested interest in the plan's future viability.

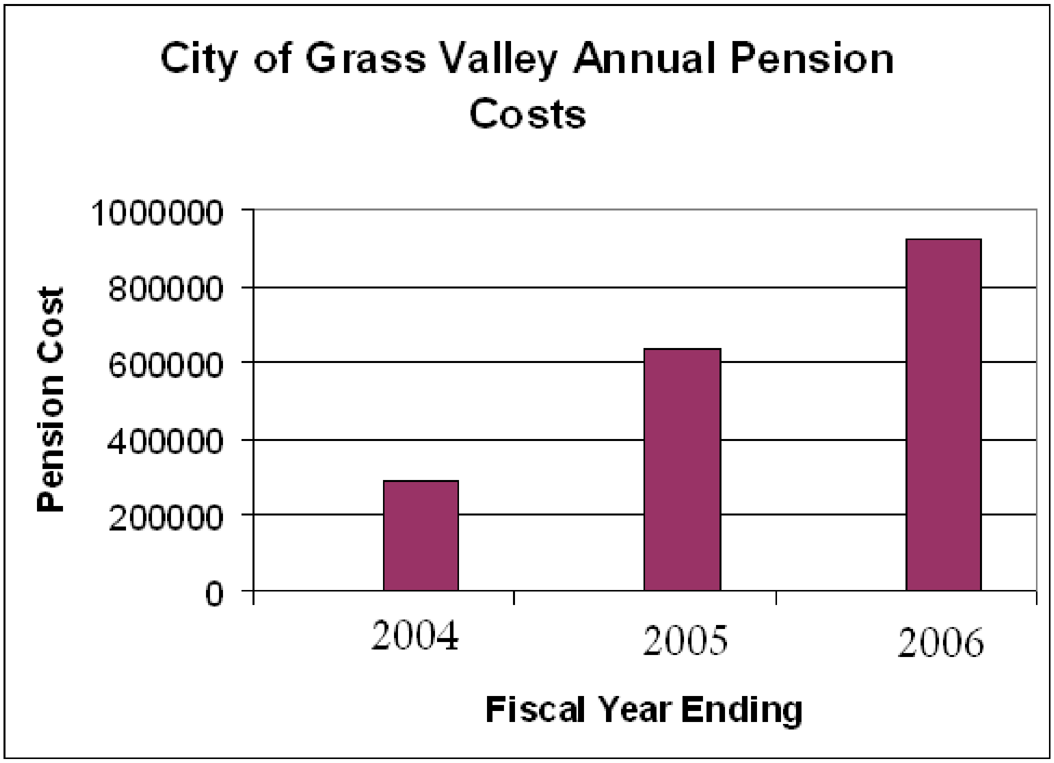
Source: Contract Amendments Cost Analysis; June 30,2004	Current Pre-Amendment Pool as of June 30, 2004	New Post-Amendment Pool as of June 30, 2004
Volatility Index Increase (%)	N/A	21.6%
Volatility Index	3.7	4.5

5 Financial Health of Local Pension Plans

5.1 Overview

In order to review and analyze the fiscal health of our local municipalities we need to compile current indebtedness and present day expenses in relation to the pension plans. We should also see if we can spot trends in the Nevada County[12] and City of Grass Valley[13] pension expenses shown the following figures. The annual pension cost increases are disconcerting. Can you see a trend?





CalPERS generates an annual plan analysis for review by our elected officials and administration. In the annual report CalPERS tabulates the unfunded liabilities of the plan as of the latest valuation date. The unfunded liabilities will either be listed as "unfunded liabilities" or as a "side fund". In addition, CalPERS calculates the employer contribution rate for the coming year. To review, the employer contribution rate is designed to direct the employer to set aside additional funds each pay period to fund their pension promises. For example if the employer contribution rate is 10% the employer needs to set aside an additional 10% of the wage paid for pension obligations; an additional 10 cents per dollar of wage earned. This additional expense to taxpayers will fluctuate based on employee pay raises, CalPERS investment return of underlying assets and cost of living increases. It should also be noted that there is a 2 year delay from the valuation date to the effective date of the contribution.

5.2 Current Unfunded Liabilities

Here are recent snapshots of the pension indebtedness of our local government agencies [1],[2],[3]:

COUNTY OF NEVADA (June 30, 2006):

Miscellaneous Plan: Unfunded Liability of $41,784,693
Safety Plan: Side Fund (Unfunded Liability) of $6,352,749
Total Unfunded Liability as of June 30, 2006 was ***$48,137,442***

CITY OF GRASS VALLEY (June 30, 2006):

Miscellaneous Plan: Side Fund (Unfunded Liability) of $762,294
Safety Fire Plan: Side Fund (Unfunded Liability) of $148,442
Safety Police Plan: Side Fund (Unfunded Liabilities) of $1,680,809
City of Grass Valley Total Unfunded Liability (before amendment to plan) of $2,591,545
City of Grass Valley Total Unfunded Liabilities after amendment to plan of ***$4,194,144*** (this is understated because we need to get next year's CalPERS report and show the cost of the amendment, these numbers are too low, they don't include police)

NEVADA CITY:

Miscellaneous Plan: Side Fund (Unfunded Liability) of $106,385
Safety Plan: Side Fund of $570,789
Nevada City Total Unfunded Liabilities of ***$677,174***

6 Case Study – Public vs. Private Sector Compensation

6.1 Overview

According to the Pension Insurance Data Book, less than 20 percent of working Americans participate in pension plans today, in contrast to 35 percent of workers participating in 1980. It is rare for private enterprise to offer pension plans to employees due to the expense, risk, and liability of such plans. There are some other striking differences between the private sector employee costs and those of a public agency. What is most striking to review is the actual or true cost of a public employee. In an actual Personnel Payroll Rate Computation sheet for the City of Nevada City, completed by the City Clerk Cathy Wilcox-Barnes, there is shown a detailed account of the true cost of a public employee. She cites the **employer's retirement cost** of a $36,367 salaried employee to be $8,847.36 per year (line 3 below). See the illustration below noting the employer retirement contribution:

CITY OF NEVADA CITY
PERSONNEL PAYROLL RATE COMPUTATION
Effective 02/02/06

Salary Range: (Employee Name)

Department: Park & Recreation

Job Title: Park and Recreation Coordinator

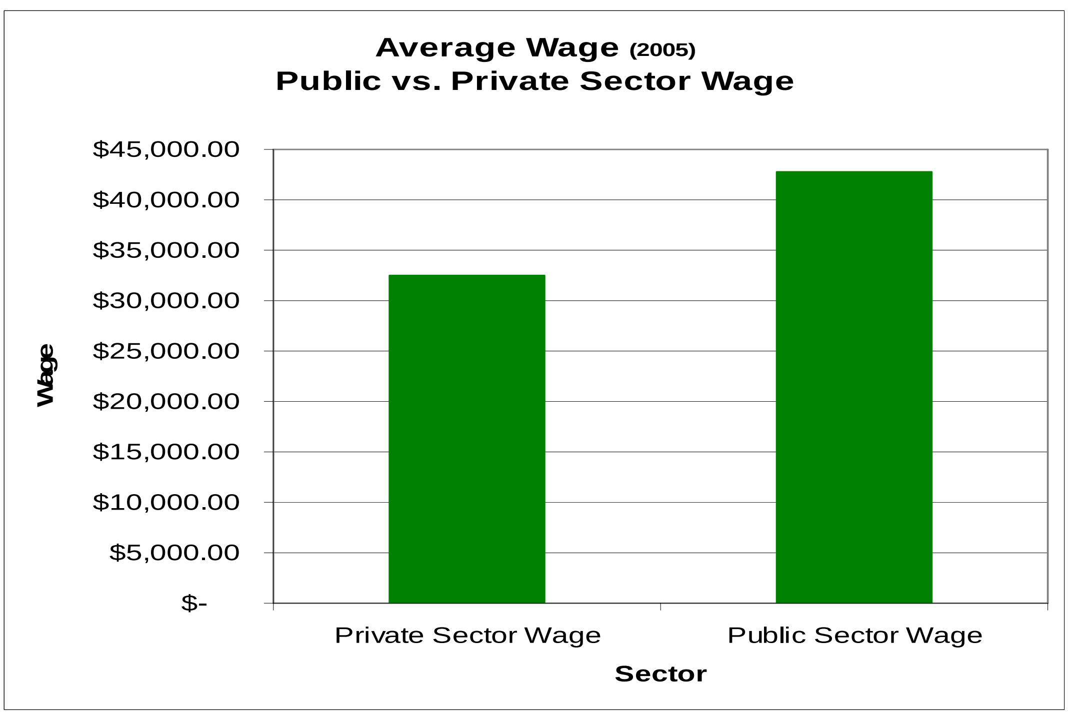
(1)Annual Salary	$36,367.00
(2)Employer Medicare (1.45%)	$527.32
(3)Employer Retirement (10.128%+8%+6.2% =24.328%)	**$8,847.36**

(4)Workers' Comp (3.66%)	$1,331.03
(5)Unemployment Insurance	n/a
(6)Deferred Compensation	n/a
(8)S.D.I. (0.8%)	$290.94
(9)Sub-Total (1) through (7)	$47,363.65
(10)Insurance (Life & Health *) ($850.00/mo.+$1000/yr. dental+$120/yr. life)	$11,320.00
(12)Total (9) plus (10 and 11)	$58,683.65
(13)Hours per Year 40 hrs. per week	2080.00 hrs.
(14)Vacation Earned (2 weeks)	160 hrs.
(15)Holiday Time Allowed 14 days	112.00 hrs.
(16)Estimated Sick Leave 5 days	40.00 hrs
(17)Other-	$0.00
(18)Total Lines (14) through (17)	312 hrs
(19)Subtract Line (18) from (13)	1768.00
(20)Regular Hourly Rate Equals (12) divided by (19)	$33.19
(21)Annual Cost:	$69,039.59

*Approx.- Cost determined by employee age and dependent status-
Includes life, STD &LTD (approx. $20.00/mo.
Completed by: Cathy Wilcox-Barnes, City Clerk

6.2 Public and Private Sector Wage Comparison

The overwhelming difference in wages between public and private sector employees begs many questions. One of which is what would a private sector employee need to save in order to have a comparable (yet self funded) pension plan? For discussion purposes lets start by looking at the average wages of private vs. public employees in Ne-



vada County. As shown in the figure below **the average wage for employees in the Nevada County private sector was $32,500 in 2005. The average salary for those employed by local government agencies was 33% higher, $42,761** [10]. This difference does not include the enormous defined benefit pension plan or health insurance benefits funded by tax payers. A whopping 27.1% of all wages earned by residents of Nevada County were paid by tax payers. This says **taxpayers are employing approximately 15% of the Nevada County workforce at 33% higher wages.** [10]

Using the average wages of each employee type we can calculate what a private sector employee needs to save in order to have a comparable (albeit self funded) pension plan. Keep in mind that the employees of the cities and Nevada County have their pension plans funded by taxpayers (not self-funded) - also see Current Contribution Rates §3.3 above. We will look at this case study as if we were a 25-year-old employee, 'Joe', in the private sector starting at $32,500, but envious of the public employee's retirement provisions. This private sector employee has posed the question - how much do I need to save each year to self fund a pension plan like my neighbor has working in the public sector?

Let's assume that Joe and his neighbor start working at age 25 and both work until age 55; for a total of 30 years of employment. A public employee in a 2.5% at age 55 pension plan would qualify for 75% of his highest 1 year's salary at age 55. Let's further accept the 7.75% assumed investment return used by CalPERS as well as the 3.25% cost of living increase before and after retirement.

Joe, the private sector employee, will have a final year wage of $82,166.56 and his 75% pension at retirement would equate to $61,624.92 in 'year 1' of retirement (scheduled to increase annually by a 3.25% COLA). What does Joe need to save by age 55 to retire with this retirement plan? Further, we assume that Joe purchases a self-funded immediate annuity upon retirement. Using today's single premium immediate annuity numbers Joe would need to save over ***$1,520,000*** according to Protective Life Insurance Company.

To accomplish this goal Joe will need to set aside $20,000 per year (61.53% of his first year's income). Add to this enormous savings rate requirement the fact that Joe cannot save more than $4,000 to an Individual Retirement Account per year (2007). Also, the savings projection does not take into account the taxes (capital gains and interest) that would be owed on investment returns in a taxable (non-retirement qualified plan) savings account. At best Joe may be employed by an employer with a 401k whereby he could save up to $15,500 per year maximum (2007). The ability of a private sector employee to self-fund a pension plan comparable to that of a public sector employee is totally unrealistic. All of these considerations are not a problem for Joe's neighbor working for the government.

7 Unfunded Liability Solutions –

7.1 What Other Communities Have Done

"States (within the United States) have promised at least $2.73 trillion in pension, health care and other retirement benefits for public employees over the next three decades, according to a report released by The Pew Charitable Trusts' Center on the States.

Promises with a Price, the first 50-state analysis of its kind, finds that states have saved enough to cover about 85 percent of their long-term pension costs, but only 3 percent of the funds needed for promised retiree health care and other non-pension benefits. All told, states already have set aside about $2 trillion to meet their long-term obligations. But they still need to come up with about $731 billion—a conservative figure that does not include all costs for teachers and local government employees." (Pew Press Release, December 18, 2007)

The $2.73 trillion in pension, health care and other retirement benefits for public employees does not include the federal or local government's unfunded liabilities. A CATO Institutes study and the Pew study highlight two fundamental problems. "First, governments have been irresponsible in making huge promises to workers regarding future benefits, but then not funding them as private benefit plans would. Second, "public sector employees are far more likely to receive retirement benefits (than private sector employees) and the gulf between private and public sectors continues to grow," according to Pew. For example, 82 percent of government workers receive retiree health benefits, compared to just 33 percent of private sector workers." Cato sites the following solution, "the solution is to cut back sharply on the gold-plated benefits received by government workers, while privatizing as many state and local activities as possible."[11]

According to the Pew report many states are setting aside funds or even restructuring benefits. Michigan and Alaska, for example, have moved state employees from traditional defined benefit pension programs to traditional 401(k)-style programs, where the state contributes a set amount each month to an employee's retirement account.

The Pew report [14] highlights **positive changes being made across the country to pension plans**:

- **Adopting hybrid pension plans:** Ohio, Washington and Oregon adopted plans that combine elements of traditional and 401(k) pension plans.

- **Raising the number of years of employment needed to qualify for benefits:** North Carolina in 2006 increased to 20 years, from five, the time that new employees need to work to qualify for full benefits.

- **Setting up "irrevocable" trusts:** At least 13 states have set up trusts to pay for future retirement benefits, ensuring that none of the funds can be diverted to other purposes."
- **Revoking of past raises and plan amendments (see Orange County below):**

7.2 Recommended Actions from Orange County

In July of 2007, John M.W. Moorlach, Supervisor for the second district in Orange County California recommended the reneging of a recently approved pension plan amendment for Association of Orange County Deputy Sheriffs (AOCDS). He sites that the recent increases to AOCDS pension plan benefits "violate the debt limitation provisions, is a gift of public funds, and is extra compensation paid to public employees, all in violation of Article IV, Section 17, Article XI, Section 10(a), Article XVI, Section 6, and

Article XVI, Section 18 of the California Constitution." In the case of Orange County (and thus unknown others) the increases of public sector employee pension plans are illegal as cited within the California Constitution. To the best of our knowledge this action is setting a new precedent which other agencies may follow. The first three points of his memorandum are cited here:

"I strongly recommend that we pursue the following recommended actions:

RECOMMENDED ACTIONS:

1. Rescind, as void and in violation of Article IV, Section 17, Article XI, Section 10(a), Article XVI, Section 6, and Article XVI, Section 18 of the California Constitution, the retroactive portion of the "3% at 50" pension increase to all Public Safety employees who received such retroactive increase as part of the Amendment to the MOU with the County of Orange approved by the Board of Supervisors on December 4, 2001 (made effective June 28, 2002), except that members who retired after such retroactive increase took effect shall not be required to repay any pension payments representing the retroactive increase that they have actually received since the MOU was approved and implemented, but shall only be ineligible to receive payments attributable to such retroactive increase going forward;

2. Employ counsel to immediately file a Declaratory Relief action in the Orange County Superior Court against AOCDS and the Orange County Employees Retirement System (OCERS), confirming the rescission, seeking a judicial declaration that the retroactive portion of the "3% at 50" pension increase to members of AOCDS violates the debt limitation provisions, is a gift of public funds, and is extra compensation paid to public employees, all in violation of Article IV, Section 17, Article XI, Section 10(a), Article XVI, Section 6, and Article XVI, Section 18 of the California Constitution, and that the County of Orange has no obligation to make any further payments toward the retroactive portion of the pension increase, and enjoining further payments by OCERS of the portion of payments to retirees based on the 1% retroactive portion; and

3. Direct the CEO and/or County Counsel to send a letter to the Chief Executive Officer of OCERS informing him or her that the Board of Supervisors considers the retroactive portion of the "3% at 50" pension increase to all members of the AOCDS pursuant to the Amendment to the MOU with the County of Orange approved by the Board of Supervisors on December 4, 2001 unconstitutional and void, that the County of Orange will not include as its future payments the retroactive increase, requesting that OCERS immediately calculate the required future payments based on a "2% at 50" rate through the effective date of the Amendment to the MOU and a "3% at 50" rate thereafter, and that OCERS immediately begin paying retirement benefits to retirees applying a "2% at 50" formula to their service through the effective date of the

MOU and a "3% at 50" rate thereafter, if an AOCDS member continued to work after the effective date of the MOU."

In light of these actions by other local governments, SESF recommends that our own county and city governments take immediate and positive steps to disclose to the county's taxpayers and government employees the extent of their individual unfunded liabilities along with their plans to meet such funding obligations.

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