California pension funds caught in ever-tighter income-outgo squeeze

By Dan Walters
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Ron Seeling, the California Public Employees Retirement System's chief actuary, believed he was speaking to a closed-door seminar in 2009 when he warned that public employee pension costs were becoming "unsustainable."

However, Ed Mendel, a veteran reporter who writes a blog on pensions, was there, and later published Seeling's dire warning. "I don't want to sugarcoat anything," Seeling said. "We are facing decades without any significant turnarounds in assets, decades of – what I, in my personal words, nobody else's – unsustainable pension costs of between 25 percent of pay for a miscellaneous plan and 40 to 50 percent of pay for a safety plan (police and firefighters) … unsustainable pension costs. We've got to find some other solutions."

It was eerily prescient of what was to come within a few years. Seeling made his remarks a decade after then-Gov. Gray Davis and the Legislature had quietly, virtually without notice, decreed a massive, retroactive increase in state employee pension benefits, which was quickly emulated by hundreds of local governments.

At the time, CalPERS was ringing up big earnings from the 1990s' bullish stock market – so big that it had reduced contributions from member governments to near zero. Public employee unions hankered for a share of the bounty and pressed for a benefit increase. The CalPERS board, dominated by public employees and union-friendly politicians, sponsored the increase, Senate Bill 400, with assurances that it would cost taxpayers nothing. A state Senate analysis of the bill said CalPERS "believes they will be able to mitigate this cost increase through continued excess returns of the CalPERS trust."

Years later, it emerged that the assurances reflected the most optimistic of several scenarios developed by the CalPERS staff. More pessimistic scenarios were kept secret – but they were the ones that came true. By the time Seeling delivered his dark appraisal in 2009, the state was being hammered by an ultra-severe recession, and the CalPERS trust fund was losing what turned out to be nearly $100 billion in value.

Seven years later, CalPERS and other pension funds still haven't fully recovered, and they're sharply raising mandatory "contributions" from state and local governments to cover the gaps left by meager investment earnings.

The state government alone has seen its payments into CalPERS and the State Teachers Retirement System (CalSTRS) climb to $7.8 billion this year, more than twice the $3.7 billion in 2006-07 and seven times what they were in 1999, when CalPERS issued its no-cost assurance for fatter benefits

Validating Seeling's 2009 projection, state and local governments are now routinely paying 40 to 50 percent of payroll for "safety system" employees. The California Highway Patrol, for example, is paying 50.08 percent to CalPERS – nearly four times its 1999 level – and several cities are paying even more.

State and local governments are now routinely paying 40 to 50 percent of payroll for 'safety system' employees. Seeling's estimate of 25 percent of payroll for nonsafety employees was also on target. The state is at nearly 27 percent now.

The crunch hits as baby-boomer public employees retire in droves and claim their enhanced pensions, pushing outflows well beyond current contributions. In 2015, for instance, member governments pumped $10.1 billion into CalPERS and workers added another $3.7 billion, but pension payments took $18.9 billion out.

The net effect, even with rising inflows of cash from employers, is a dramatic increase in "unfunded liabilities" for future pensions. Overall, California's state and local pension obligations top $1 trillion. Current assets are officially projected to cover barely two-thirds of those pension promises, even assuming their perhaps unrealistic investment earnings goals.

California isn't alone. Moody's, a national credit-rating service, and the Wall Street Journal have reported a nationwide trend of rising costs and falling earnings for public pension funds. But California has one of the nation's highest relative levels of unfunded pension debts.

Local governments, particularly cities, have a bigger pension problem than the state, because they devote much of their budgets to costly police and fire services.

Pension costs figured prominently in the bankruptcies of three cities. In one case, Stockton, the federal bankruptcy judge declared that it could legally reduce pension benefits, challenging the long-held assumption that pensions are legally untouchable. However, Stockton opted to not reduce benefits, so the issue remains untested.

If the present pension situation is dim, the future may be even darker.

"It's a struggle to have a positive return." CalPERS chief investment officer Ted Eliopoulos said as he announced a minuscule 0.61 percent return for 2015-16. Most pension funds, including those in California, assume that they'll earn about 7.5 percent a year on their investments, but CalPERS has been below that level, on average, for the past 20 years.

David Crane, a financial adviser to former Gov. Arnold Schwarzenegger, has extensively analyzed pension assets and liabilities, usually in conjunction with Stanford University's Institute for Economic Policy Research, headed by former Democratic Assemblyman Joe Nation.

Crane says CalPERS and other pension funds "should not expect a return greater than 6.4 percent" and that continuing to assume 7.5 percent just builds unfunded liabilities without acknowledging them. Taxpayers and state programs like education will pay the penalty, he suggested.

"The negative consequences of such unreasonable assumptions fall on schoolchildren and future teachers," Crane concludes. Crane and others who question pension fund assumptions are often attacked by union-financed pension support organizations, which portray them as right-wing zealots who hate public workers and want to destroy defined-benefit pensions.

Some pension reformers have suggested at least a partial shift away from defined-benefit plans to defined-contribution systems, such as the 401(k) plans offered by many private employers. But unions have refused to entertain such changes.

Pension reforms were enacted in San Jose and San Diego over the objections of unions, but they are being slowly unwound. And reform advocates have been unable to move a statewide ballot measure. In 2012, Gov. Jerry Brown declared California's pension systems to be, as Seeling said, "unsustainable," and sponsored a very mild reform whose effects, if any, won't be evident for decades.

Brown said it would be just a first step toward making pension funds solvent but hasn't gone further, other than a subsequent plan to shore up CalSTRS with more tax money. And Brown's reform could be unwound by a future governor, just as Davis repealed similar pension reforms that Republican predecessor Pete Wilson had fostered.

As costs increase, one response may be new taxes. California voters are seeing a sharp uptick in ballot measures to raise local sales taxes, with officials often depicting them as vital for police and fire, but never mentioning the pension pinch.

Madera County is a case in point. Its Board of Supervisors will ask voters for a one-cent increase in the local sales tax to generate about $150 million over 20 years. As usual, county officials say it's to bolster police and fire protection, but they don't mention that a substantial share of hoped-for revenues would go to CalPERS.

The county's payments for police and fire pensions, as a percentage of payroll, are jumping nearly 15 percent this year. While the sheriff's office is getting an overall 7.3 percent increase in its budget, retirement costs are increasing 25 percent to $2.1 million a year.

However governments respond to the pension crunch, it's not going away. Outlays will continue to increase and continue to outstrip inflow from employers and employees, making them even more dependent on investment earnings or taxpayers to close the gaps.

Thus, California's unfunded pension debt, at least $300 billion now and as much as $1 trillion with lower earnings assumptions, will continue to grow – and that doesn't count another $100 billion-plus in unfunded obligations for retiree health care.

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